Retrospective Rating Programs

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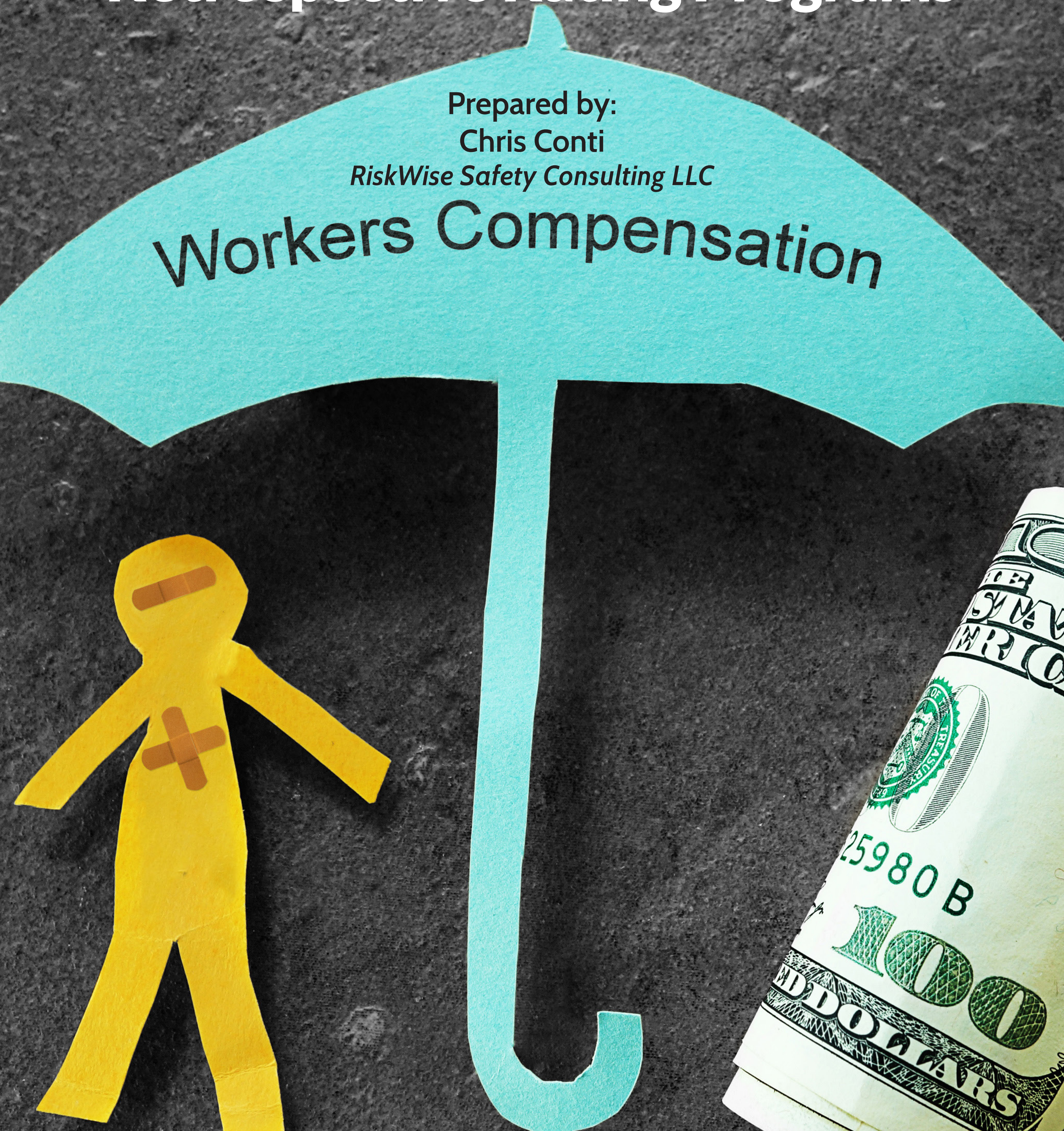

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Retrospective Rating Programs

Retrospective Rating Programs, hereafter called Retro's, is a type of insurance pricing tool used in workers' compensation insurance to reward and possibly penalize insured's based on loss ratio performance. The Retro is a loss sensitive pricing mechanism which means that the ultimate cost of coverage to the policyholder is a function of the losses that have occurred during the policy period. The Retro, or any loss sensitive product for that matter, is attached to the standard NCCI contract which modifies the contract to allow the pay-out/pay-in as warranted. Retros are different from other loss sensitive products because the ultimate cost formula is set in writing as a retrospective rating endorsement is attached to the policy.

Retros are usually offered only on accounts at or above $250,000 however, they have been put on accounts as small as $100,000. Retros start in the underwriting process as a guaranteed cost product however, the premium discount is removed. So, the amount is called standard premium. The premium discount is used to reduce the cost of premiums because as premiums grow the admin expense for the carrier does not necessarily go up as the premium goes up. For example, it takes the same time to activate a $25,000 policy as it does a $250,000 policy, which is why premium discounts exist. However, in the case of Retro's the carrier will have some additional admin expenses in the form of calculating the retro ultimate cost. So premium discount is removed in the calculation, meaning the carrier will collect a little more money.

Retro's charge a minimum premium as the carrier needs to cover it's admin expenses. The minimum is often called the basic premium and is fully earned by the carrier with no chance of being refunded to the insured. The money left over is used to pay losses. Any loss money not used may be subject to refund to the customer.

An example follows:

Unity Max Retro which means the insured max pay in is 1.00.
$300,000 Annual Retro Work Comp Policy
40% Basic Premium or $120,000
60 % Loss Fund or $180,000

If the insured on a retro has NO losses the carrier will refund $180,000 to the insured.

The above example assumed a UNITY MAX Retro which is where the total pay-out by the insured is 100% of the standard premium, This is called a NO Downside Retro, so called because the insured can only get money back in comparison to a guaranteed cost product. Other Retro's give security to the carrier and have a downside to the insured.

A Debit Max Retro is not as favorable to the insured and lends some protection to the carrier. Let's assume a Debit Max retro of 1.20

1.20 Max Retro:

$300,000 Annual Premium
40 % Basic charge
60% Loss Fund

If Losses exceed the 60% ($180,000) the insured is on the hook for the difference up to 120% of the Premium, in this case $60,000 or 20% of $300,000. So, total premium paid may reach $360,000. This is called a Downside Retro as the insured now has money at risk of loss; 20% above standard premium. Obviously there is no money to refund here and a loss penalty. This is a gamble for both parties. It is common for the carrier to ask for some form of security such as a Letter of Credit, or a cash deposit as there exist a credit risk here. The insured will only pay in the 100% standard premium but is obligated to pay 120% of losses.

In the determination of the actual losses to be used in the formula carrier often add a loss conversion factor to claims. This is the cost of handling claims for such expenses as adjuster payroll, office overhead, etc. It is common to see LCF's of 1.10, 1.15 even 1.20. If the insured had losses of $100,000 the carrier would add 1.10 (if that is the quoted factor) to make the actual incurred losses $110,000. Obviously, the lower the LCF the less impact on loss adjustment and the greater the potential refund.

There are several types of Retro Loss formula's:

Straight Retro is where the insured pays in 100% of standard premium over the policy period and then waits until the settlement or loss adjustment date to apply the particular calculation formula to arrive at amount refundable or due. This is the most common approach. Incurred Loss Retro is where the carrier only bills for the basic premium and incurred losses (paid losses plus reserves). The insured does not have to pay in the 100% standard premium and may never have to if losses do not occur. This is better than a Straight Retro because the insured holds his own money.

Paid Loss Retro is the most favorable because the carrier only bills the insured for the basic premium and paid losses. This is rarely used, except on the very best of accounts because the carrier will be losing significant investment income as they are holding no money in reserve for open claims.

An example follows:

1.30 Max Retro
45% Basic
1.15 LCF
Standard Premium of $500,000
Incurred Losses of $600,000

Security required of $150,000 (30% of $500,000) in the form of an LOC
Retro is on an Incurred Basis
At inception carrier bills account for the 45% of $500,000 = $225,000
Over the policy period carrier reserves and pays losses of $600,000 and adds an LCF (loss conversion factor) to cover adjusting expenses:
$600,000 (1.15%) = $690,000.
However, by contract, the most the insured will pay is $650,000. {$500,000 (1.30) = $650,000}
Carrier losses $40,000 ($690,000 needed but only $650,000 collected)
Same retro but assume losses of $200,000
Carrier bills for basic charge at inception $ 225,000
Converted Losses are (200,000 (1.15) = $ 230,000
So cost to insured for coverage is $ 455,000
Meaning insured saved $45,000
If it had been a straight retro the carrier would have refunded the $45,000

Other loss sensitive products, just for a complete understanding are:

Dividends- by law cannot be guaranteed and subject to the Board of Directors of the insurance company to “declare” a dividend for the policy year it is attached to. Here again, this is an endorsement to the standard NCCI contract. A common dividend is the sliding scale dividend which as the insureds loss ratio goes up the less money is (available to be) refunded. Basically, this is the insurer sharing the underwriting profit with the customer. They have a twofold purpose. One, to reward good accounts for low loss ratio’s. Two, when historical poor performing account have to pay more to get coverage, sometimes dividends are attached to motivate employers to strive to improve workplace safety as to potentially enjoy a refund. Attached to the policy will be a dividend disclosure statement that lays out the terms and conditions of the offering. Terms include date of loss valuation, date of dividend pay-out, etc.

Deductibles – are sometimes called upfront Retro’s because with a deductible product the insured agrees to take the first layer or first dollar of risk, which is pay all claims up to a pre-set amount. Because the insured is taking risk, that is paying claims, the carrier will charge a lower premium for coverage. The lower premium may be the ultimate cost of insurance if no claims occur- that is why it is called an upfront retro. When claims do occur, the carrier will pay the claim and the bill the insured for the amount paid. Because the insured is paying the claims that the customer has agreed to pay (the deductible amount) it is common for the carrier to ask for security as their exist a financial risk. The financial risk lies in the possibility that the customer will not or cannot pay the deductible amount when billed.