IRP

Indiana Assigned Risk Reinsurance Pool

October 13, 2004

Indiana Compensation Rating Bureau

Table of Contents

Background

The Indiana Compensation Rating Bureau (ICRB) is the licensed workers compensation rating organization in the state, created by statute. All insurance companies that write workers compensation insurance in Indiana by law must be members of the Bureau. The statute also designates the Bureau to be responsible for the assigned risk market in Indiana.

Accordingly, the ICRB is also the "Plan Administrator" in Indiana. To carry out that responsibility, the Bureau has filed a set of rules on how the assigned risk market operates within the requirements of the law. This set of rules is called the Workers Compensation Insurance Plan (WCIP) also known as the assigned risk plan. The statute requires that all insurance companies must be "reinsurers as among themselves." This means they must all share in the operating results (premiums collected from employers and losses or claims paid to injured workers) in the assigned risk market. Even though only a few insurance companies are actually writing the policies (servicing carriers), all share in paying for the losses. Direct assignment of risks is permitted in some states, but not in Indiana. The ICRB Governing Board is the Plan/Pool Administrator in Indiana and in 1970 elected to meet the statutory requirement through participation in the National Workers Compensation Reinsurance Pool (NWCRP).

The NWCRP is a pooling or "sharing" arrangement. It is not an entity or company. There are no employees to do any work. The Pool is an "arrangement" or reinsurance mechanism that insurance companies join and agree on how they will share in the losses, state-by-state. Each state's financial results are kept separate. Once an insurance company signs the Articles of Agreement, it becomes a member of the National Pool.

The ICRB has established a reputation of providing exceptional, quality service with annual expenditures far less than those of other rating bureaus. Maintaining this record necessitates constant attention to the methods used to accomplish its goals, and the quality and value received from vendor partners.

In April 2003, the ICRB released an RFP soliciting bids for consultative assistance in the creation and implementation of a stand-alone Indiana WC Assigned Risk pooling mechanism. Cost effectiveness is a primary motivator, but the level of control exercised over the operations of the National Pool also is a concern. Since Indiana is but one of 21 states that make up the National Pool, the ICRB Governing Board does not have exclusive control over the operational decisions made by the National Pool.

Proposal

With the approval of the Governing Board by an eleven to one vote, and the subsequent approval by an overwhelming majority of the member companies, the ICRB selected Compensation Insurance Services (CIS) to aid in the creation and initial administration of the Indiana Reinsurance Pool. CIS is a Mississippi general partnership established in the latter part of 1992 to provide administration and management services to the Mississippi Workers Compensation Assigned Risk Pool. Mississippi had been a member of the National Pool prior to establishing its own State pool in 1993.

The cornerstone of the proposed Indiana Reinsurance Pool is a fundamental change in the cash flow associated with Assigned Risk premiums and carrier assessments. The NWCRP uses a cash flow approach wherein funds are distributed to all carriers in the State, less certain fixed expenses and losses paid in the first quarter, immediately following the quarter in which the premiums are generated. Over the ensuing years, these carrier distributions are "called back," to pay claims and ongoing expenses. Uncollectable sums owed by insolvent carriers are assessed against the remaining Members.

In contrast, the Indiana Reinsurance Pool would hold and invest funds at the Pool level, and make distributions to and assessments from Pool member companies based on operating surplus and losses, not cash flow. Although carriers would lose the opportunity to directly invest the funds while losses are maturing, they would not forfeit investment income. Rather, the ICRB would invest the funds on the carriers' behalf, while virtually eliminating the financial burden associated with carrier insolvencies.

ICRB staff has no vested interest either in the creation of a stand-alone Indiana Pool, or continuation of the status quo. Its sole impetus is a desire to provide the best, most cost efficient method for carriers to comply with the statutory mandate (IC27-7-2-29) with regard to the assigned risk plan:

> "…all members of said bureau shall be reinsurers as among themselves in the amount which the compensation insurance written in this state during the preceding calendar year by such member bears to the total compensation insurance written in this state during the preceding year by all members of said bureau."

ICRB staff is convinced the proposed IRP achieves the objectives that were established for a stand-alone Pool, and it offers several distinct advantages over maintaining the status quo (NWCRP). In the long run, carriers will benefit financially from an Indiana Pool, and the Board will achieve complete, local control, which is valued highly by certain Board Members.

One could argue, however, that the creation of an Indiana Pool would have the effect of *doubling* carriers' costs because of the long run-off tail associated with withdrawing from the National Pool. Certainly, in the first few years subsequent to withdrawal, the administrative (non-loss) costs emanating from the National Pool will essentially be the same as would exist with continued membership. This must be balanced against the savings outlined below under *Advantages*, particularly the (near) elimination of the burden of insolvencies, and the value of greater localized control.

Advantages associated with the IRP include:

- Establishes greater, direct control over financial and operational activities of the Indiana Pool
- Virtually eliminates the financial impact of insolvencies on member carriers
- Reduces legal and administrative costs associated with collection of unpaid assessments and legal fees
- Reduces the costs of managing a pool financial credit policy
- Simplifies administration by the elimination of continual shuffling of money between servicing carriers, the Pool and member companies
- Supports Indiana banking institutions through the local deposit of funds
- Accommodates eventual absorption of all functions into the ICRB, rather than requiring continued dependence on a vendor, should outsourcing become less attractive in future years

Disadvantages associated with the IRP:

- All new and renewal multi-state Assigned Risk policies that now include other NWCRP states would have to be written as Indiana-only. Such employers would need to submit one more application than done today. For 2003 there were 709 multi-state policies that included Indiana vs. total policies in force of 8,372 (8.5%).
- The costs associated with participation in the National Pool will continue indefinitely. Although no "new" costs will accrue for subsequent policy years, the run-off costs for prior policy years will continue to be assessed.
- Carriers will not have the advantage of the inflow of new funds to offset the prior years' assessments.
- Carriers lose direct control over investment of Pool funds.

Cost

An accurate apple-to-apples comparison of costs is a bit illusive because of difficulties in quantifying the run-off costs associated with participation in the NWCRP. When consideration is given to the reduced carrier costs associated with insolvencies, the IRP model clearly would result in lower overall costs to Member carriers. An issue for some Member carriers, however, might be the impact to the cash flow of funds associated with the National Pool run-off.

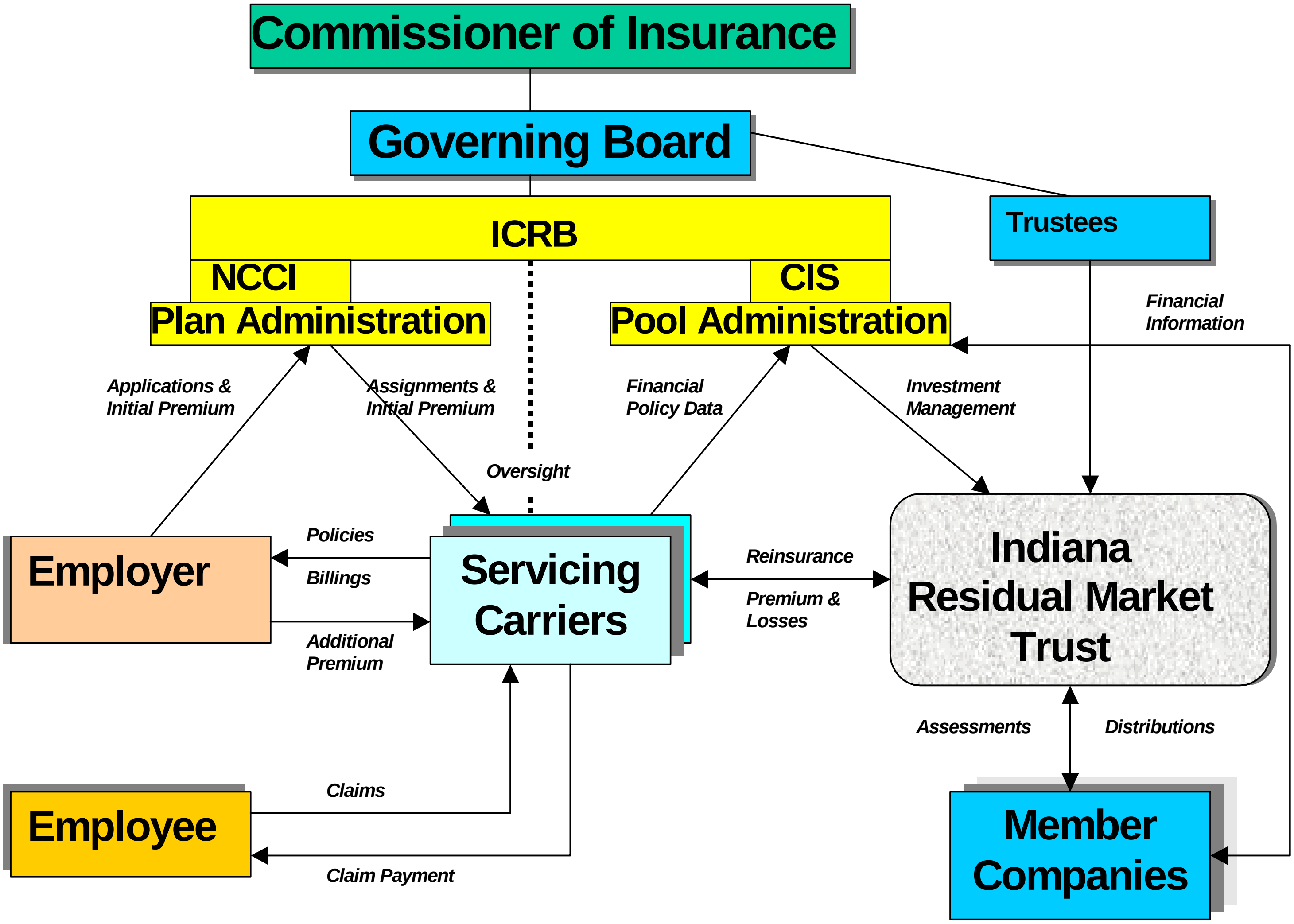

Diagram Summary

- *Commissioner Regulates ICRB*
- *ICRB Board Manages Affairs and Directs Staff*
- *ICRB Contracts with NCCI for Plan Administration*
- *ICRB Contracts with CIS for Pool Administration*
- *SC Writes and Services Employers in Assigned Risk Market*
- *Employers Seek Coverage in Assigned Risk Market as a Last Resort*
- *Member Companies Participate in Pool Results per Statute*

Plan and Pool administration functions are listed on the following page.

Pool Administration

- Provide actuarial service and support (loss reserving);
- Process servicing carrier reports;
- Calculate Pool participation ratios;
- Provide procedures to address insolvency management;
- Litigation management;
- Prepare quarterly results for distribution to membership;
- Process Pool payables and receivables;
- Develop procedures of profit and loss sharing to comply with the Terrorism Risk Insurance Act of 2002;
- Prepare bank reconciliation;
- Calculate Pool administrative expenses and allocate to appropriate policy years;
- Produce Pool profit and loss statements;
- Manage and maintain Pool by-laws;
- Coordinate Board meeting minutes;
- Analyze reserves and distribute quarterly updates; and
- Develop effective mechanisms to address multi-state employers.

Plan Administration

- Servicing carrier quota management;
- Management and accounting of local bank accounts;
- Management and support of residual market filings including:
    - Rate filings
    - Form filings
    - Classification filings/changes;
- Maintenance of residual market assignment databases;
- Servicing carrier performance standards review and updates; and
- Perform servicing carrier audits, or support external auditors' reviews.

Compensation Insurance Services

Every facet of the proposal has been tested in actual practice and is in use today in Mississippi. Feedback from member carriers, references and the Mississippi Commissioner of Insurance is positive.

After the initial contract period, the ICRB would own the licenses to CIS systems and processing protocols should it decide to bring most aspects of Pool Administration in-house.

Certain functions would be contracted out to Compensation Insurance Services, and others support vendors, as follows:

Costs associated with administration of the Indiana Reinsurance Pool can be divided into the following categories:

- initial organization costs; and
- ongoing administration costs.

Initial organization costs are primarily related to:

- the drafting of documents and agreements that provide the legal framework for the creation and operation of the Pool;
- developing the member company database and implementing premium reporting rules and procedures; and
- establishing reporting and remittance procedures with the servicing carriers.

Fees for organization of the Indiana Pool are as follows:

Outside legal fees (estimate)
CIS fee for organization assistance
CIS's fee for organization assistance is a one-time charge and will be due upon completion of the organization of the Indiana Pool

Ongoing administration costs consist of:

- reimbursements of servicing carrier expenses (USL&H assessments, collection agency fees, subrogation expenses, etc.);
- indemnification of servicing carriers (legal fees, judgments, etc.);
- the Pool administrator's fee; and
- fees associated with the independent audit of the Pool's financial transactions and review of the Pool's loss reserves.

Many ongoing administrative costs will vary from year to year, sometimes substantially. The amount paid to reimburse servicing carriers for USL&H assessments, collection agency fees, subrogation expenses, and legal fees will depend, to a large extent, on the amount and type of business written through the Plan. These expenses will increase or decrease as the amount of premium written increases or decreases, but not necessarily in proportion.

It is anticipated that outside professionals (legal, banking, audit, etc.) will be located in Indiana and Board and other similar meetings will take place in Indianapolis.

CIS will license to the ICRB the CIS systems and processing protocols and provide the training and assistance necessary for the ICRB to bring Pool administration in house.

Insolvencies' Impact on Indiana Participants			
Group	**Cash Amount Assessed/(Distributed) to Participants**	**Total Reserves**	**Total Impact to Participants**
2001			
Credit General	29,229.34	21,644.64	50,873.98
HIH	3,808.78	2,511.80	6,320.58
Reliance	231,585.69	504,913.45	736,499.14
Superior National	14,451.24	11,568.97	26,020.21
Subtotal	$ 279,075.05	$ 540,638.86	$ 819,713.91
2002			
Phico	$ (102,791.32)	$ 816,736.69	$ 713,945.37
2003			
None			
Grand Total	$ 176,283.73	$ 1,357,375.55	$ 1,533,659.28

Notes

These are the amounts solvent carriers were forced to contribute to the Pool to offset uncollectible assessments from insolvent carriers.

2001 insolvencies were distributed with the 3rd quarter 2001 distribution
2002 insolvencies were distributed with the 2nd quarter 2002 distribution
2003 No insolvencies for this year impacted Indiana participants

Excerpt from The National Pool's 2002 Annual Financial Statement:

"Nine Pool participating insurance groups with an aggregate obligation to the Pool of $59,991,431 at December 31, 2002 are insolvent as defined by the Articles of Agreement. In addition, three Pool participating insurance groups with an aggregate obligation to the Pool of $84,386,104 at December 31, 2002 are currently rated E (under regulatory supervision) by A.M. Best."

Managing the Pool's Investments

The centerpiece of the proposal to create an Indiana Pool is the decision to hold and invest funds generated by Plan policies at the Pool level until they are needed to reimburse the servicing carriers for losses paid. Since the premiums for several policy years will be collected long before the losses of the first policy year are completely paid, the Pool will accumulate a substantial amount of investable funds. Investment of these funds provides a significant additional revenue source for the Plan, but perhaps more importantly, these funds are the security provided by the member companies to ensure their ability to meet their financial obligations to the Pool. Consequently, proper management of these funds is of paramount importance.

Fixed Income Investing

Fixed income investing (i.e., investing in financial instruments with a fixed return and maturity) involves two types of risk – credit risk and interest rate risk. Credit risk is the risk that the issuer of the security will be unable to repay the principal when the security matures i.e., the risk of default. Interest rate risk is the risk that a security will be worth less when it is sold than it cost (because interest rates have risen since the security's original purchase). Credit risk is virtually eliminated by only investing in securities of the highest quality – U.S. government and agency bonds. Interest rate risk is a little trickier.

Professional managers of fixed income portfolios are always concerned with (and attempting to predict) the direction of interest rates. This is because changes in rates affect the value of their portfolios. (When rates go up values go down and vice versa.) To mitigate the risk of guessing wrong on the direction of interest rates, these portfolio managers engage in an endless variety of hedging schemes and other techniques designed to reduce risk. There is, however, a far simpler technique – holding to maturity. A quality bond held to maturity will *always* pay its face amount. Interest rate risk is only a problem if the security must be sold prior to maturity. When fixed income securities are held to maturity, interest rate risk is eliminated.

Successfully managing the Pool's investment portfolio will require selecting securities of the highest quality and making certain that no security ever *has* to be sold before its time. Since return of principal is of primary importance, the Pool's investments should be restricted to U.S. government and agency bonds. There is simply no higher quality security available and selecting a government bond doesn't require the expertise of a professional portfolio manager. Being certain that the Pool's securities can be held to maturity involves predicting the Pool's cash needs and availability – a job for the Pool administrator not a portfolio manager.

A by-product of the analyses performed each quarter to determine the Pool's loss reserves is an analysis of predicted loss pay out. Viewed in the context of current reality matched with historical trends, this analysis provides the basis for predicting the Pool's cash needs/availability with a reasonable degree of accuracy. The final step is to match investment *maturities* with the need for funds. The result is a portfolio of the highest quality earning a market rate of interest – without the expense of a professional portfolio manger.

Control of Pool Funds

Servicing carriers will report Plan activity and remit funds due to the Pool forty-five days after the end of each calendar quarter (i.e., May 15th, August 15th, November 15th, and February 15th). If a servicing carrier's paid losses and expenses during a quarter are more than the premiums collected, the report to the Pool will be a request for reimbursement rather than a remittance. Consequently, these are the dates when the Pool will either need funds or have additional funds to invest. Cash receipts and disbursements between remittance dates will be few and the amounts negligible. To take advantage of this situation, the Pool's investments should be set up to mature during the months of May, August, November and February. Since fixed income securities pay interest semiannually, selecting maturities in these months will result in interest payments also occurring in these months.

Because the Pool's level of banking activity (check writing, etc.) will be very low (fewer than twenty-five checks a quarter), banking and investment activities can be handled through a single brokerage account. This account can be established through the Indianapolis office of a national brokerage firm or the investment division of a local bank. The account will be in the name of the Indiana Pool and will be jointly controlled by the Pool administrator and the ICRB staff. All disbursements will require two signatures, and investments will be restricted to those specifically approved for the Pool.

Accounting for the Pool's investment activity will be handled by the Pool administrator and included in quarterly financial reports to the Board and member companies.