

Understanding Exmod



Preface

Why experience rating?

Insurance is the spreading or sharing of risk by a group of policyholders who are likely to experience losses. The losses of an entire group can be predicted with a fair degree of accuracy. However, it is not possible to determine which group member will actually have a loss. Because of this, the cost of insurance is apportioned to each member on the basis of average cost for the group. It is assumed that each member's own experience will approximate the average. In reality, very few risks are really average; some are much worse, and some are much better. Experience rating recognizes these differences to encourage the prevention of industrial accidents.

What it is?

California's Workers' Compensation Experience Rating Plan (the "Plan"), approved by the Department of Insurance and overseen by the Workers' Compensation Insurance Rating Bureau (WCIRB), tailors the cost of insurance to the performance of the individual employer. It compares the employer's past loss record to all members of that same industry classification. The workers' compensation insurance cost is then adjusted based on that comparison.

This system allows the employer the opportunity to develop loss control programs. The potential premium savings provide the incentive to establish and maintain meaningful safety programs.

Eligible

A risk shall qualify for experience rating of its California workers' compensation insurance premium under the Plan if the amount produced by applying the approved expected loss rates to the total remuneration that would be used in the experience rating calculation for the risk is greater than or equal to the eligibility threshold of \$10,300. Only completed policy periods shall be used in determining eligibility. Any risk eligible for experience rating shall be experience rated.

How does it work?

The policyholder's manual premium (class rate times payroll in hundreds of dollars) is adjusted by the experience modification, which is expressed as a percentage factor. The result is called the standard premium. If an employer has a good loss record with an experience modification of 75%, the standard premium will be 25% below the manual premium. On the other hand, if the experience modification is 125%, due to a poor loss record, then a surcharge of 25% above the manual premium level will be applied.

Both the credits and the debits can be significant. For example, a risk that develops a manual premium of \$100,000 would pay only \$75,000 with a 75% experience modification, or \$125,000 with a 125% experience modification. The difference in premium is \$50,000 for one year.

The experience modification factor is computed and published annually for each experience-rated risk by the WCIRB, not the insurance company.

The factor is applied on the policy anniversary date for a period of one year. Any insurance company issuing a policy must use the published modification.

Unit Statistical Filing

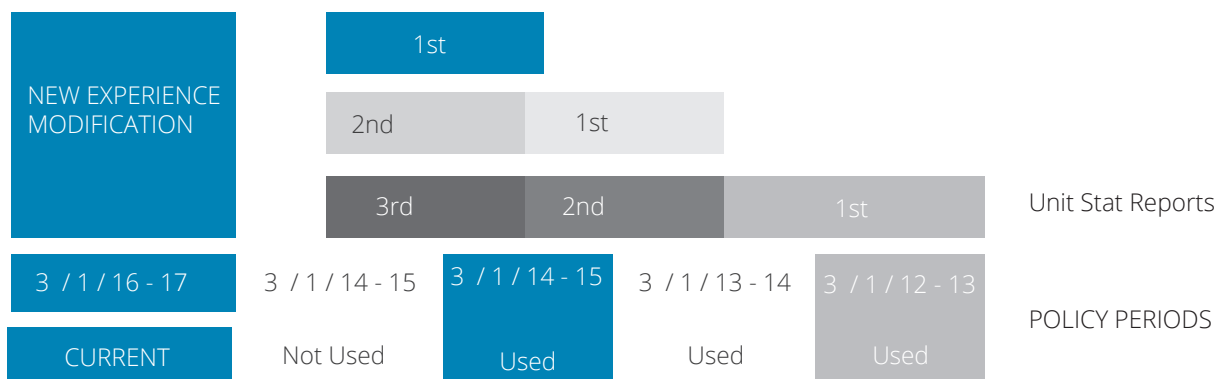
Experience rating begins with a unit statistical filing. Every insurance company must report the individual experience of each policy to the WCIRB. The first filing is made 18 months after the inception of the policy.

Two additional filings are made at 12-month intervals to reflect any changes in open or late reported claims. The filing includes total payroll by each classification code. Claims of \$2,001 and over are listed individually, and those less than \$2,001 are grouped together.

The Rating Period

Rating is based on a period of three policy years of experience beginning up to four years and nine months prior to the rating date. The most recent policy year is omitted to allow a final audit to be completed, to permit open or late reported claims to close, and to allow claim reserves for open claims to stabilize.

Policy periods and unit stat. reports used to calculate a new experience modification for a 3/1/16 - 17 policy.





Short Term Policies

A short term policy affects future experience modifications (mods). The rating period used to develop a new mod may be extended or shortened by rewriting a policy mid-term. If a policy is rewritten within three months of its original inception, it will retain the original mod for the full term of the rewritten policy. If rewritten after three months, the original mod will apply only for the balance of the original policy period. A new mod calculation will apply from the normal expiration date of the original policy to the expiration of the rewrite. From that point forward, the mod will be calculated on the new policy anniversary date. See the **WCIRB** manual for more information

Effects of Ownership on Experience Rating

For purposes of experience rating, a change in ownership may be considered nominal or material. A nominal change (see below) allows the experience modification to continue unchanged. A material change (see below) is not only a change in ownership, but also a change in management, control, operations or employees. In cases which involve a material change, the experience modification reverts to 100% and the policy should be rewritten.

After a material change, the policy is treated as a new policyholder and must requalify under the standard rules for experience rating. If, however, the new owner acquires a majority interest and has an additional business in which he holds a majority interest, the payroll and losses of the newly acquired business will be blended with that of the acquiring business to develop a single experience modification for both businesses.



What constitutes a material change or a nominal change?

	Material	Nominal
I	Sole proprietor Death of the individual	Immediate family member takes over as executor, administrator or sole owner
	Business sold to another a) Changes in operations, and/or b) Change in excess of 50% of the employees. In addition, the payroll for the changed employees must exceed 50% of the total payroll of the corporation	Business sold to another a) No change in operations, and b) No change in employees
	Bankruptcy or insolvency	Original owner named "Debtor in Possession"
	Forms trust	Trustor as sole trustee: all trustees immediate family: living trustor and grantor retain unrestricted right to modify or terminate trust
	Forms partnership	Consists of only two general partners; all partners, immediate family; limited partnership in which individual is one of not more than two general partners
	Forms corporation.	Individual or immediate family owns 50% or more of issued voting stock
II	Partnership Sale, conveyance, transfer or assignment of partnership interest by one or more partner.	If, prior to the change, all partners were immediate family members and after the change, one-half or more of the general partners in the new partnership own a majority interest in the new entity
III	Corporation Any change involving more than 50% of voting stock a) Change in operation, and/or b) Change in excess of 50% of the employees. In addition, the payroll for the changed employees must exceed 50% of the total payroll of the corporation.	Any change involving more than 50% of voting stock a) No change in operations, and b) No change in employees

Limited Liability Companies and Partnerships

In addition to sole proprietorships, partnerships, limited partnerships, joint ventures and corporations, business owners may operate as Limited Liability Companies (LLC) and certain businesses may operate as Limited Liability Partnerships (LLP).

An LLC combines the liability protection provided to shareholders of corporations with tax advantages and the flexibility found in partnerships. However, the law provides that certain businesses (which include banking, insurance, trust companies and companies providing professional services such as legal or accounting services) cannot become LLCs. Such business may, though, become LLPs. For experience rating purposes, LLPs are treated in the same manner as general partnerships.

When a partnership dissolves, and the former partners create an LLC to operate the business without changing the operations or employees, a nominal change in status will result and the past experience of the partnership will apply to the LLC.

Unlike corporate ownership, LLC ownership is not recorded in stock certificates. Owners of LLCs are known as members and each member owns an equal share. Normally, if a corporation dissolves, and the former shareholders form an LLC to operate their business, a nominal change in status will occur and the past experience of the corporation will apply to the LLC. Exceptions may apply. Purchases of existing entities by LLCs or LLPs will require a change in status analysis to determine whether a nominal or material change has taken place.

Employee Leasing Arrangements

When an experience-rated risk enters an employee leasing arrangement where:

(a) the employment of the majority of the employees is transferred to a labor contractor and,

(b) the service of the employees is provided to the original policyholder, a separate policy must be written. This policy will cover the leased employees and the experience mod will be based on the experience of the original employer.

An experience-rated policyholder will not receive an experience mod benefit or penalty by transferring employees to an employee leasing company.

Calculation of the Experience Modification Factor

The formula to calculate an experience modification is designated to tailor a class rate to the employers. To do so, it must reflect a basic statistical law: the larger the exposure, the more credible the actual loss record. In addition to a minimum premium threshold, scales and weightings are used to ensure statistical accuracy. Employers above a certain size actually determine their own final modification based entirely on their own record. In the calculation, the industry average is compared to the actual record. The resulting ratio of *Actual Losses over Expected Losses produces the Experience Modification*

$$\frac{\text{Actual Losses}}{\text{Expected Losses}} = \text{Experience Modification}$$

Loss Severity vs. Loss Frequency

Recognizing the difference between severity and frequency is fundamental to understanding experience rating. While severity is primarily a matter of chance once an accident has occurred, frequency is largely controllable. Therefore, frequency is a better measure of management effectiveness than severity. A weighting is used for each of these in calculating the experience modification, with a greater emphasis on frequency.

The first \$7,000 of each claim loss is considered primary, and any remainder up to the \$175,000 individual claim limitation is considered excess.

Weighting factors used are **Expected Loss Rate, "D" Ratio, Credibility Primary and Credibility Excess values**. These are obtained from tables published in the WCIRB California Experience Rating Plan Manual. These factors are explained further in the following illustrations of how an experience modification is calculated. The example shown on pages 4 and 5 illustrates high-severity loss experience.

