Workers' Compensation Insurance Rating Bureau of California

Report on Operational Examination
To the California Department of Insurance

Rector & Associates, Inc.

April 22, 2009

WCIRB Report on Operational Examination
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Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner Poizner:

Pursuant to your instructions, Rector & Associates, Inc. ("R&A") performed an Operational Examination of the Workers' Compensation Insurance Rating Bureau of California ("WCIRB"), 525 Market Street, Suite 800, San Francisco, California 94105-2767.

I. INTRODUCTION

R&A was appointed as a Special Examiner to assist in an examination of the affairs of the WCIRB pursuant to California Insurance Code ("CIC") Sections 733 and 11752. The California Department of Insurance ("CDI") began the examination in response to its May 29, 2007 decision regarding the WCIRB's July 1, 2007 pure premium rate filing (File No. REG-2007-00015). Among other things, that decision highlighted potential concerns regarding the WCIRB's standards and procedures pertaining to data collection, the WCIRB's process for developing loss cost projections, and the system pursuant to which the WCIRB is governed.

In reaction to the CDI's May 29, 2007 decision, the WCIRB took two actions to address the CDI's concerns. First, the WCIRB engaged Towers Perrin ("Towers") to conduct a comprehensive evaluation of the WCIRB's pure premium ratemaking methodologies. Following its evaluation, Towers issued a report dated July 28, 2008 (the "Towers Report"), in which Towers made a series of recommendations to improve the WCIRB's pure premium ratemaking process. Based on its initial evaluation of those recommendations, the WCIRB developed an "Overall Ratemaking Methodologies Potential Long-Term Enhancements Evaluation Plan." In addition, the WCIRB has undertaken a series of initiatives to improve the quality and accuracy of future pure premium rate recommendations.

Second, the WCIRB established a task force of independent stakeholders to undertake a comprehensive review of the California Workers' Compensation Experience Rating Plan (the "Experience Rating Plan"). The charge to the task force was to assess the effectiveness of the Experience Rating Plan in meeting its statutory objectives of providing incentives for loss prevention and workplace safety. The task force issued a report dated June 18, 2008, in which the task force made a series of recommendations to enhance the transparency and effectiveness of the Experience Rating Plan.

II. OBJECTIVES, SCOPE, AND APPROACH

The objectives of the examination were (1) to provide information to the CDI that will assist the CDI as it determines whether the WCIRB's analyses and projections are reliable, including whether the WCIRB's pure premium rate filings are based on accurate and complete data, and (2) to provide recommendations regarding how the WCIRB's processes and procedures pertaining to data collection and loss cost projections can be improved.

To accomplish those objectives, the scope of the examination consisted of a review and evaluation of the following items:

1. The composition and effectiveness of the system pursuant to which the WCIRB is governed;

2. The effectiveness of the WCIRB's collection and compilation of statistical data from insurers, including the accuracy and completeness of the data underlying the WCIRB's loss cost projections;

3. The effectiveness of activities of the WCIRB other than data collection and compilation (focusing on the WCIRB's efforts in the following areas: policy documents, experience rating plan, audits of insureds' payrolls and claims classifications, classification inspections, and identifying uninsured employers); and

4. The reasonableness of the recommendations contained in the Towers Report.

The WCIRB's Governing System

To assess the effectiveness of the WCIRB's governing system, we performed various tasks, including:

- Reviewing California law pertaining to the formation, governance, and functions of the WCIRB;

- Reviewing the WCIRB's Constitution and Bylaws;

- Interviewing WCIRB senior staff;

- Interviewing members of the WCIRB's Governing Committee, Classification and Rating Committee, Actuarial Committee, and Claims Subcommittee of the Actuarial Committee;

- Reviewing minutes of recent meetings of the various WCIRB Committees and Subcommittees; and

- Attending the March 2009 meetings of the Governing Committee, the Classification and Rating Committee, the Actuarial Committee, and the Claims Subcommittee of the Actuarial Committee, focusing, in particular, on the deliberations within those groups as to a proposed 2009 mid-year pure premium rate filing.

The WCIRB's Data Collection and Compilation Activities

To assess the effectiveness of the WCIRB's collection and compilation of statistical data, including the accuracy and completeness of the aggregate financial data underlying the WCIRB's loss cost projections, we performed various tasks, including:

- Interviewing WCIRB senior staff;
- Reviewing the California Unit Statistical Reporting Plan;
- Reviewing the various sets of instructions issued by the WCIRB to assist insurers as they prepare aggregate financial data for reporting to the WCIRB;
- Performing detailed testing of data filings made by insurer groups;
- Reviewing and performing testing relating to the WCIRB's Data Quality Enhancement Program;
- Evaluating actions taken by the WCIRB in response to inaccurate or incomplete data filings;
- Reviewing the WCIRB's *System of Fines for Deliquent Unit Statistical Reports*; and
- Evaluating decisions by the WCIRB as to whether to exclude data from certain insurers due to data problems.

WCIRB Activities other than Data Collection and Compilation

To assess the effectiveness of the WCIRB's performance of certain activities other than data collection and compilation, we performed various tasks, including:

- Interviewing WCIRB staff;
- Reviewing policy documents;
- Performing detailed testing of the experience rating plan;
- Reviewing the WCIRB's Test Audit Program;

- Reviewing the WCIRB's Classification Inspection Program; and

- Reviewing documents that evidence the WCIRB's efforts to assist the Employment Development Department ("EDD") in identifying uninsured employers.

The Towers Report

To evaluate the recommendations contained in the Towers Report, we performed various tasks, including:

- Reviewing the WCIRB's Retrospective Evaluation of Pure Premium Rate Projections dated November 2007;

- Reviewing the Towers Report;

- Interviewing WCIRB actuarial staff regarding the status of the WCIRB's implementation of the recommendations in the Towers Report;

- Analyzing the WCIRB's January 1, 2009 pure premium rate filing, including the actuarial methodologies and assumptions underlying the filing;

- Reviewing the WCIRB's letters to the CDI dated August 25, 2008, and October 6, 2008, regarding the recommendations in the Towers Report; and

- Reviewing the WCIRB's "Overall Ratemaking Methodologies Potential Long-Term Enhancements Evaluation Plan" dated December 15, 2008.

III. EXECUTIVE SUMMARY

The WCIRB staff and the members of its various Committees are hard working and dedicated to performing the tasks given the WCIRB pursuant to the California Insurance Code and the WCIRB's governing documents. The WCIRB does a number of things well. However, the effectiveness of the WCIRB's pure premium rate recommendations hinges on two key things—(1) the quality of the data received and used by the WCIRB, and (2) the actuarial projection of that data into pure premium rate indications—and we found that improvements are needed in both areas:

Quality of Data Received and Used

- Because insurer data filings frequently contain errors, the WCIRB is forced to spend significant time and resources to detect and attempt to resolve data issues.

- Notwithstanding the WCIRB's diligent efforts, procedures are not in place to sufficiently assure that all of the information being relied on by the WCIRB is accurate and complete.

- The data call instructions sent by the WCIRB to insurers are generally clear and appropriate. The data errors appear to be caused primarily by the failure of insurers to comply with the WCIRB's data call instructions.

- In addition to errors in the data submitted, insurers frequently do not make data filings in a timely manner, thereby impacting the quality and completeness of the data relied on by the WCIRB.

- We question whether the WCIRB has, or uses, sufficient enforcement powers to require insurers to make accurate, complete, and timely filings. There is a natural reluctance on the part of the WCIRB to be forceful in demanding that its member insurers comply with the data reporting requirements and to punish its member insurers for noncompliance.

- The WCIRB does not collect data that is sufficiently detailed to enable it to make refined estimates as to the impact of legislative, regulatory, or judicial actions or to determine in a refined way why components of claim costs are increasing or decreasing.

Actuarial Projection of Data

- When making pure premium rate projections, the WCIRB uses fewer actuarial methods than we believe, or Towers believes, is appropriate.

- Even when the WCIRB uses multiple actuarial methods, it provides the CDI with the results of only one method. If the WCIRB were to provide information showing the results of multiple methods, the key assumptions underlying each method, and the reasoning as to the selection of the WCIRB's "best estimate," such information would allow the CDI to better understand the variability surrounding the WCIRB's projections and the extent to which the projections are sensitive to alternate assumptions.

- There does not appear to be sufficient time for the WCIRB to appropriately evaluate "mid-year" (effective July 1) loss cost projections before they are submitted to the CDI.

- The WCIRB has begun to take steps to anticipate how legal, regulatory, or judicial actions could impact future claims costs. However, additional steps in this area are needed.

Throughout this Report, we provide a number of recommendations that we believe, if implemented, would improve the WCIRB's processes and procedures pertaining to data collection and loss cost projections.

As to the processes and procedures pertaining to data collection, we recommend that the WCIRB take a variety of steps to improve the accuracy, completeness, and timeliness of data filings made by insurers. Such steps include:

- mandating insurer participation in the "eSCAD" electronic filing system;
- requiring insurers to resolve data errors identified by the eSCAD system before data filings are submitted to the WCIRB;
- requiring senior management of large insurers to attest to the effectiveness of the insurers' statistical and financial reporting systems;
- initiating remedial action plans (including on-site audits, if necessary) of insurers that are not able to obtain "clean" audit reports pertaining to the insurer's annual aggregate data report and of insurers that are unable to obtain the senior management "attestation" referred to above;
- promptly notifying the CDI when the WCIRB discovers significant problems with the accuracy, completeness, or timeliness of data filings made by insurer groups with significant market share;
- considering whether the WCIRB needs additional enforcement powers to prompt insurers to make accurate, complete, and timely data filings; and
- collecting the detailed data needed to perform refined analyses of the potential impact of legislative, regulatory and judicial actions and of why specific components of claim costs are rising or falling.

As to the processes and procedures pertaining to loss cost projections, we recommend that the WCIRB:

- increase the number of actuarial projection methods used to develop pure premium rate recommendations;
- present the CDI with a range of reasonable results rather than the results of only one method. We also recommend that the presentation identify the key assumptions of each method, the extent to which the WCIRB believes those assumptions are valid, and alternate scenario projections for key assumptions; and
- do what is necessary to ensure that the WCIRB has adequate time to validate data and conduct appropriate actuarial analysis prior to submitting "mid-year" (effective July 1) pure premium rate recommendations to the CDI. The WCIRB

may want to consider various options, including not submitting a "mid-year" filing, moving the proposed effective date of the "mid-year" filing to a date other than July 1, basing the primary analysis pertaining to the "mid-year" filings on data submitted as of an earlier date so that there is sufficient time for data review and analysis, etc.

The WCIRB has a difficult task before it. The traditional actuarial projection methodologies that the WCIRB has historically relied on to make pure premium rate recommendations have significant limitations when used in an environment (such as the California workers' compensation market) that is subject to significant and radical change. In such an environment, past is not always prologue. The WCIRB appears to recognize that it needs to do a better job of anticipating the effects of such changes—of anticipating what will happen before the results of such changes emerge in the historic data. We encourage the WCIRB's efforts in this area, and we urge the WCIRB to move even farther and faster in seeking to predict the effects of changing market forces and of a changing regulatory environment rather than waiting to react to such changes.

IV. THE WCIRB'S GOVERNING SYSTEM

Findings Pertaining to the WCIRB's Governing System

WCIRB Purposes, Membership, and Committee Structure

The WCIRB is a licensed rating organization, formed pursuant to CIC Section 11750 et seq. ("Rating and Other Organizations"). The WCIRB has been designated by the California Insurance Commissioner (the "Commissioner") as a statistical agent to collect workers' compensation statistical data, which is used to develop the standard classification system and to determine experience modifications that are used for rating purposes. The WCIRB also develops pure premium rate recommendations on behalf of its insurer members for the Commissioner's consideration. In particular, the purposes of the WCIRB are to:

- Provide reliable statistics and rating information;
- Collect and tabulate statistics to develop pure premium rates to submit to the Commissioner for approval;
- Formulate rules and regulations in connection with pure premium rates and administration of classification and rating systems;
- Inspect risks for classification and rating purposes and provide reports to insurers and employers;
- Examine policies and endorsements to ensure they comply with the provisions of law and to make reasonable rules governing their submission;

- Perform test audits of employers' payrolls and insurers' audits of those payrolls; and

- Exchange information and experience data with rating organizations, advisory organizations, and insurers for ratemaking purposes.[1]

As of year-end 2008, the WCIRB had approximately 200 staff members, with approximately 175 staff members located in its San Francisco headquarters. Approximately 100 staff members were devoted to processing insurer reports or otherwise working to obtain accurate information from insurers. The WCIRB's actuarial group consists of 11 staff members, including the Chief Actuary.

Insurers authorized to transact workers' compensation insurance in California are eligible to become members of the WCIRB.[2] An eligible insurer applies for membership by doing three things: submitting proof that it is authorized to write workers' compensation insurance in California, stating that it will sign the Constitution and Bylaws of the WCIRB, and stating that it will accept and conform to the obligations of membership.[3] According to the WCIRB's Bylaws, membership is conferred when an applying insurer "subscribe[s] to and file[s] with the WCIRB a copy of the WCIRB's Constitution and Bylaws."[4]

The WCIRB's Constitution provides for three committees through which the WCIRB is to operate: a Governing Committee, a Classification and Rating Committee, and an Actuarial Committee. The Governing Committee is responsible for managing the affairs of the WCIRB.[5] The Classification and Rating Committee is to formulate classifications of risks and to formulate rules to prompt insurer compliance with regulations of the Commissioner governing the underwriting of workers' compensation insurance in the State of California.[6] The Actuarial Committee is to advise the Governing Committee and the Classification and Rating Committee with respect to actuarial and statistical problems pertaining to methodology involving pure premium rates, rating plans, and related matters.[7]

The WCIRB Constitution also sets out requirements pertaining to the membership of each committee. The Governing Committee is to have 12 members, consisting of the State Compensation Insurance Fund ("SCIF"), seven other insurer members elected by the WCIRB's membership, and four "public members" appointed by the Commissioner; the Classification and Rating Committee is to have seven members, consisting of SCIF and six other insurer members; and the Actuarial Committee is to have no more than six members, consisting of persons appointed by the President of the WCIRB.[8]

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[1] CIC Section 11750.3.
[2] WCIRB Constitution, Article III.
[3] WCIRB Bylaws, Article II, Section 2.
[4] Id.
[5] *See*, WCIRB Constitution, Article VII, Section 1.
[6] *See*, WCIRB Constitution, Article VIII, Section 1, and Article II, Section 1.
[7] WCIRB Constitution, Article V, Section 3.
[8] WCIRB Constitution, Article III.

"Public" Participation on WCIRB Committees

Although the membership of the WCIRB is limited to insurers, the WCIRB's Constitution and the California Insurance Code provide for some "public" input with respect to the Governing and Actuarial Committees. As noted above, four of the 12 members of the Governing Committee are required to be "public members."[9] Two of the four public members are to "represent organized labor" and two are to "represent insured employers".[10] The public members may vote on "all issues involving pure premium rates, classifications, rating plans, rating systems, manual rules, and policy and endorsement forms which are properly brought before the Governing Committee. The public members are not entitled to vote on any other issues."[11]

As to the Actuarial Committee, a "Fellow of the Casualty Actuarial Society retained by the public members of the Governing Committee shall be entitled to attend and participate in all Actuarial Committee proceedings."[12] The actuary retained by the public members is allowed to fully participate in such meetings, including to vote on items brought before the Committee.

There is no formal "public" input with respect to the Classification and Rating Committee. All seven members of that Committee are required to be insurer members.[13] Further, although public members of the Governing Committee and their representatives can attend public meetings of the Classification and Rating Committee, they cannot attend "executive session" meetings unless the Classification and Rating Committee believes that the public members' participation will assist the Classification and Rating Committee in its deliberations.[14]

Control Structure and Implications

To summarize, then, all members of the WCIRB are insurers, and insurers control all WCIRB Committees, including the Governing Committee. However, persons representing organized labor and insured employers have a (minority) vote on certain matters brought before the Governing Committee, and the public members can retain a credentialed actuary who can attend and fully participate in Actuarial Committee meetings. Public members have no formal input into deliberations of the Classification and Rating Committee.

Based on our interviews and what we observed, it appears that the WCIRB and its staff, and the insurer members of the various committees, want to reach the "right" answer to matters, without regard to whether the answer favors insurer interests. However, it is only natural for insurer members to see issues and how to resolve them from an insurer point of view.

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[9] WCIRB Constitution, Article V, Section 1; CIC § 11751.35(a).

[10] Id. Also, there are currently only two public members of the Governing Committee—one representing organized labor and one representing insured businesses. The third public member position became vacant on March 17, 2009, when the person filling that position became a member of the board of the State Compensation Insurance Fund. The fourth public member position has been vacant since March 2007.

[11] WCIRB Constitution, Article V, Section 1; see, also, CIC § 11751.35(a).

[12] WCIRB Constitution, Article V, Section 3; see, also, CIC § 11751.35(c).

[13] WCIRB Constitution, Article V, Section 2.

[14] WCIRB Constitution, Article X, Section 8.

As might be expected, then, based on the control structure just described, decisions made by the WCIRB tend to reflect an insurer point of view. We noted that comments, suggestions, and recommendations made by public members of the Governing Committee, and by the actuary retained by the public members, are considered seriously by the Governing and Actuarial Committees during their deliberations and that such comments, suggestions, and recommendations often are incorporated into decisions made by those Committees. When differences between insurer members and public members are not resolved, the insurer point of view prevails. However, it is important to note that the public members, by statute, are given the opportunity to submit information to the Commissioner expressing their point of view.

Two items of particular significance follow from the existing control structure:

Data Reporting

First, there is a natural reluctance on the part of the WCIRB, given that it is controlled by its insurer members, to be forceful in demanding that its member insurers comply with data reporting requirements and to fine or otherwise punish its member insurers for noncompliance. This reluctance to demand compliance helps foster an environment where flawed statistical and financial report filings are tolerated.

For further discussion of this item, including our recommendations regarding it, please see Section V of this Report ("The WCIRB's Data Collection and Compilation Activities").

Dissenting Views Not Automatically Presented to the Commissioner

Second, dissenting views of the public members and the actuary they retain are not automatically presented to the Commissioner and, therefore, have the potential to be "lost", even though those dissenting views might be helpful to the Commissioner when reviewing pure premium rate filings submitted by the WCIRB.

It is logical that the actuary retained by the public members will consider issues from a different point of view than the point of view of insurer members of the Actuarial Committee. For example, the public members' actuary may be more skeptical, than would be the insurer Actuarial Committee members, of data and actuarial methodologies that indicate that an increase in pure premium rates may be needed. Because many actuarial decisions require making judgments when the data are not clear—should one year's worth of data showing rising costs be relied on or would it be best to wait for two year's worth of data before concluding that the increase is not merely a one-year aberration, for example—it is likely that the actuary retained by the public members will reach conclusions different from the insurer members with some frequency.

In connection with the examination, we noted instances where the views of the public members' actuary were accepted by the Actuarial Committee. However, we also noted instances where the views of the public members' actuary were not accepted by the Actuarial Committee.

Similarly, the views of the public members of the Governing Committee periodically differ from those of the insurer members, with some such differences remaining unresolved at the time of the Governing Committee's vote.

In those instances where the views of the public members' actuary or of the public members of the Governing Committee are not included in formal materials that are presented to the Commissioner, there are no WCIRB procedures in place to allow the public members to present their views to the Commissioner. As a result, the views of the public members and their actuary have the potential to be "lost", even if those views contain valuable information for the Commissioner's consideration.

During the course of the examination, we learned that the actuary recently retained by the public members has a number of suggestions regarding improvements that he believes could be made to the WCIRB's actuarial analysis process. Although reviewing and commenting on those proposed changes is beyond the scope of this examination, we noted that many of the proposed changes, at a minimum, appeared to warrant serious consideration by the WCIRB and the Actuarial Committee. The actuary intends to make those suggestions to WCIRB staff and to the Actuarial Committee. However, if some or all of the suggested changes are not adopted by the WCIRB staff or the Actuarial Committee, such suggested changes are potentially "lost", even if the Commissioner would believe that the changes would improve the quality of the actuarial findings presented to the CDI for review.

Need for Sufficient Time to Evaluate Pure Premium Rate Recommendations

Another issue we noted that arises from the WCIRB's governing system is that the sequencing and timing of committee meetings does not appear to allow enough time for the WCIRB to sufficiently evaluate "mid-year" loss cost projections before they are approved by the WCIRB's Governing Committee and submitted to the CDI.

The WCIRB typically makes pure premium rate filings twice a year: one filing seeks to be effective as of January 1 of each year; the second filing seeks to be effective as of July 1 of each year. Both filings can lead to significant changes in the filed pure premium rates. For example, the filing to be effective as of July 1, 2009, seeks an increase of 24.4%.

When preparing the filing to be effective as of January 1, the WCIRB staff appears to have sufficient time to evaluate the data on which the filing is based and sufficient time to run actuarial calculations using alternate actuarial methods before developing a recommendation, should they choose to do so. However, when preparing the filing to be effective as of July 1, the WCIRB staff appears not to have enough time to properly evaluate the data on which the filing is based or enough time to prepare calculations using a number of actuarial valuation methods. For the July 1 filings, therefore, time does not exist for the members of the Actuarial Committee to receive information that has been fully vetted or to receive a range of actuarial projections from which to make determinations. Rather, for the July 1 filings, the members of the Actuarial Committee are asked to recommend a loss cost rate adjustment based on less than fully-vetted data and based on only one actuarial method and one resulting set of numbers.

Complicating the issue is the rapid sequence of the WCIRB's committee meetings at which rate recommendations are considered. With respect to the July 1, 2009 filing, for example, the Actuarial Committee met on March 16, 2009, to consider the WCIRB staff's recommendations. Materials about the proposed pure premium rate increase (materials consisting of over 125 pages) were first submitted to members of the Actuarial Committee just one week prior to the meeting of the Actuarial Committee. Additional material was presented to members of the Actuarial Committee at the Committee meeting. At the Actuarial Committee meeting, insurer members and the public members' actuary asked questions about the WCIRB staff's recommendations. However, there was not sufficient time for the WCIRB staff to make and circulate alternate calculations for further consideration by the Actuarial Committee prior to its vote—the Actuarial Committee needed to vote that day in order for its recommendation to be placed on the agenda of the Governing Committee, which met two days later to take final action on the rate filing. We noted that members of the Actuarial Committee were making decisions without having firm numbers in front of them. Rather, individual committee members tried to calculate, roughly and by hand, the overall impact of adjustments being proposed to various components of the rates. At the time of the vote, neither the members of the Actuarial Committee nor the WCIRB staff knew exactly how the component changes on which they were voting would ultimately translate into a final rate number.

We understand that the timeframe is driven by the WCIRB's desire for the rate filing to be effective by July 1 of each year—when a number of policies renew. Given the timing of the WCIRB's receipt of data from its members and the need to comply with various notification requirements for the rate to become effective as of July 1, the sequencing involved is necessarily tight. However, regardless of the cause, the current approach does not appear to provide enough time for the WCIRB staff or the members of the Actuarial Committee to fully evaluate the data on which the filings are based, to consider alternate actuarial methods that could be helpful in making rating decisions, or to fully deliberate about possible changes suggested by members of the Actuarial Committee to the rates proposed by WCIRB staff.

Need for the WCIRB to Better Predict the Impact of Legislative, Regulatory, Judicial, and Other Emerging Changes on Loss Costs

Until recently, the WCIRB's approach to determining pure premium rate recommendations was focused almost exclusively on the trending of historic claim data: workers' compensation claims occurred and were paid by insurers, insurers reported those historic claim payments and case reserves to the WCIRB, and the WCIRB used actuarial projection techniques to "trend", or project, that historic data into the future. In other words, until recently, the WCIRB attempted to predict future claim costs by focusing on what claim costs had been in the past.

Although consistent with standard actuarial practice, this projection approach has significant limitations when there are material changes in the legislative, regulatory or judicial environment in which the market operates. For example, the fact that the average severity of a particular type of claim has consistently risen by 3% each year does not mean that they will rise by 3% over the next year if the rules that historically governed such claims are changed. To continue the example, notwithstanding the historic 3% annual increase, costs associated with such claims (all other things being equal) will rise by less than 3% over the next year if a law is passed that

reduces the average claim payment. As a further example, if a judicial decision is issued that increases the number of people who are eligible for a particular type of claim, loss volume will increase by more than expected based on historical experience. When there are periods of dramatic and rapid change in a particular market, historic trending information—although still helpful—needs to be supplemented by analytical and other techniques that seek to anticipate what effect the changes in the rules will have on future claim costs.

The WCIRB recognizes that the California workers' compensation marketplace has undergone radical changes over the past several years and is continuing to undergo such changes. In response, the WCIRB has initiated efforts to better anticipate how such changes will impact future loss costs. For example, in September, 2007, the WCIRB formed a Claims Subcommittee of the Actuarial Committee and gave the Claims Subcommittee the task of evaluating the potential cost implications of legislative, regulatory and judicial actions and of other emerging claims trends that could impact the costs underlying pure premium rates.

Given the radical changes in the California workers' compensation market, this evolution of emphasis by the WCIRB is appropriate. However, the evolution is in a very early stage. For example, although we noted good and extensive discussion of several Workers' Compensation Appeals Board ("WCAB") decisions at the meeting of the Claims Subcommittee we attended—the WCAB decisions *Olgivie v. City of San Francisco* and the combined cases of *Almarez v. Environmental Recovery Services* and *Gusman v. Milpitas United School District*—the discussion was primarily anecdotal in character and not of the type that would readily lend itself to prompting specific adjustments to projected loss costs.

Complicating the WCIRB's ability to make such adjustments is the policy decision by the WCIRB not to require insurers to provide data at a detailed, transactional level. Rarely does a regulatory or judicial change affect all claims equally. Rather, such changes usually affect some claims and not others and certain components within claims more than other components of even the same claims. Accordingly, the more detailed the data captured and available for analysis, the greater the likelihood that the precise components that will be affected by a particular change can be identified and properly modified. Of course, the analysis of data at a more detailed level will have implications pertaining to the credibility of the data that will have to be taken into account. However, all other things being equal, having more data to analyze would increase the ability of the WCIRB to make decisions regarding the future impact of legislative, regulatory and judicial decisions.

Consistent with the finding noted above—that there is a natural reluctance on the part of the WCIRB, given that it is controlled by its insurer members, to be forceful in demanding that its insurer members comply with data reporting requirements—there is also a natural reluctance on the part of the WCIRB to require its member insurers to file detailed transaction-level data since such a requirement would generate additional costs for insurers and the WCIRB. If the WCIRB had such detailed data, the WCIRB would be in a better position to identify the specific components of claims that will be affected by a pending change, which would allow the WCIRB to use standard actuarial trending techniques on those components that are not being changed and to use different techniques on those components that are being changed.

The decision not to require insurers to file detailed, transaction-level data also reduces the ability of the WCIRB to determine in a refined way why cost changes are occurring. For example, the WCIRB currently requires insurers to file information pertaining to the costs of drugs. However, insurers are not required to file detail such as cost by injury type or detail information regarding the class and brand of prescription drugs. Accordingly, the WCIRB might know that "drug costs" are going up or down, and by how much, but the WCIRB does not have sufficient information to be able to determine what is driving the change—whether it is higher utilization per claim vs. more expensive drugs per claim, or a shift in the percentage of payments of Class III to Class II drugs vs. higher drug costs in all categories. By not knowing in a refined way why the cost of drugs is going up or down, it is difficult for the WCIRB to know what impact a change that alters the cost or availability of a particular class of drugs might have on future claim costs. Not knowing precisely why the cost of drugs is going up or down also limits the ability of the WCIRB and its members to initiate steps that could minimize future cost increases.

The WCIRB has access to at least some such transaction-level data since some such data are collected by the California Workers Compensation Institute ("CWCI"). For example, in the "drug cost" example just discussed, the CWCI reported to the WCIRB's Actuarial Committee that the percentage of Class II drugs appears to be rising significantly, both in terms of the percentage of prescriptions filled and the percentage of payments. The CWCI observed that these drugs are more narcotic in nature than other classes of drugs and are usually more expensive than other drugs. So some such transaction-level data are available to the WCIRB. However, it was unclear the extent to which the CWCI's data are available to the WCIRB, the type and breath of the data collected by the CWCI, and the extent to which the CWCI's data are compatible with data compiled by the WCIRB.

Recommendations Pertaining to the WCIRB's Governing System

1. *We recommend that procedures be adopted whereby the views of public members of the Governing Committee and the actuary they retain be presented to the CDI on a routine basis. Such views could be presented in any of a number of ways, ranging from a memorandum by the public members' actuary to the CDI following each meeting of the Actuarial Committee (in which the actuary notifies the CDI of any major differences between his views and those adopted by the Committee) to a formal "minority report" of the public members that accompanies any pure premium rate filing with which they disagree. In making this recommendation, we note that CIC Section 11751.35(c) provides not only that the public members of the Governing Committee may retain experts (including an actuary), but also that "[t]he public members may submit information obtained from these experts, as well as any other information they deem appropriate, to the commissioner for his or her consideration in approving a change of any matter specified in subdivision (a)" (which includes changes in pure premium rate filings). We encourage the public members to use this statutory right, when appropriate. By doing so, the Commissioner can be assured of having additional relevant information for his or her consideration.*

2. *We recommend that the WCIRB staff consider expanding the minutes of Committee meetings so that such minutes better describe the various points of view expressed in the meetings.*

3. *We recommend that steps be taken to allow more time for the review of pure premium rate recommendations before "mid-year" rate filings are made with the CDI. We do not have a specific recommendation as to how this should be accomplished, but options that could be considered include not submitting a "mid-year" filing, moving the proposed effective date of the "mid-year" filing to a date other than July 1, and basing the primary analysis pertaining to the "mid-year" filings on data submitted as of an earlier date so that there is sufficient time for data review and analysis. The WCIRB should also consider holding a second meeting of the Actuarial Committee prior to voting on pure premium rate recommendations if Actuarial Committee members propose significant changes to the WCIRB staff recommendation in the initial meeting. We also refer the reader to our comments pertaining to Section V of this Report ("The WCIRB's Data Collection and Compilation Activities"). In that Section, we make recommendations that might streamline the data collection process and thereby free up time that could be used to perform additional analysis and review. Further, our understanding is that the WCIRB and Actuarial Committee prepare and review full rate indications quarterly, even though pure premium rate filings are made only twice a year. Another way to free up time may be to prepare and review full rate indications only twice a year—in conjunction with the rate filings.*

4. *We recommend that the WCIRB begin to collect the detailed, transaction-level data needed to perform refined analyses of the potential impact of legislative, regulatory and judicial actions and of why specific components of claim costs are rising or falling.*

V. THE WCIRB'S DATA COLLECTION AND COMPILATION ACTIVITIES

Findings Pertaining to the WCIRB's Data Collection and Compilation Activities

As noted previously, a key function of the WCIRB is to collect data from insurers to analyze industry trends and to develop loss cost rate recommendations for the Commissioner's approval. The WCIRB collects such information on a quarterly basis through a "data call" process. The WCIRB's Actuarial Committee oversees the data call report templates and instructions. The WCIRB's Governing Committee adopts revisions to the data calls.

The WCIRB appears to care deeply about the quality of data on which it bases its analyses and projections. Further, the WCIRB works hard to identify data problems and to fix any problems it has identified prior to relying on the data submitted. We saw extensive evidence that many data problems had been detected and corrected by the WCIRB staff prior to the WCIRB's use of the data. In that regard, we noted and evaluated several of the WCIRB's major projects in this area—the WCIRB's "Submission of California Aggregate Data Program" (SCAD), the

WCIRB's web-based filing initiative (eSCAD), and the WCIRB's "Data Quality Enhancement Program."

However, notwithstanding these good intentions and considerable effort, procedures are not in place to sufficiently assure that all information being relied on by the WCIRB is accurate and complete. Even when data errors are detected, they are sometimes detected only after the WCIRB has relied on the flawed data, at least in part. Further, even when data errors are detected and corrected in a timely fashion, solving data errors takes a significant amount of the WCIRB staff's time that could be spent in other ways.

It is clear that the data filings submitted by insurers to the WCIRB contain errors. As described in more detail in **Appendix A** and **Appendix B**, we performed detailed testing of various data submissions to the WCIRB and found numerous errors in the information submitted.

It is important to note, as a threshold matter, that the errors do not appear to have been caused by faulty instructions from the WCIRB. Rather, the WCIRB's filing requirements and instructions for completing data calls appear to be clearly documented and to have been properly communicated to insurers. Instead, the problem is that insurers frequently submit data in a manner that does not comply with the WCIRB's instructions.

After receiving data filings, the WCIRB employs numerous automated and analytical testing procedures in an attempt to identify data errors. The automatic testing procedures include electronic edits to validate the filings as well as various "cross-check" type tests to determine whether the filings are internally consistent. In addition to automated testing procedures, the WCIRB actuarial staff also performs analytical testing of the filings in an attempt to detect data anomalies. Such analytical tests include reviews of various categories of data in an attempt to identify unusual changes from prior data submitted by the same insurer. The analytical tests also compare the data submitted by one insurer with the data submitted by other insurers in an attempt to identify anomalies. The categories of data subjected to such analytical testing include: paid, incurred, and claim count development patterns; loss ratios; ratios of insurer premiums to advisory pure premiums; and average claim costs.

These tests—whether automated or analytical—consist of a review of the filings submitted to the WCIRB. As such, the tests can only detect errors that are observable from the data submitted. The tests are neither designed to, nor can they, detect flaws that are not discernable from the data filings. For example, the tests likely would detect the failure of an insurer to complete one of the required data columns. The tests likely would also detect inconsistencies in a filing (where various columns do not properly sum or cross check, for example) or significant variations in the data filed by a given insurer from one year to another. However, the tests likely would not detect a situation where an insurer has consistently, but improperly, categorized data each year or situations where the filings, although accurate so far as they go, are not complete because they do not include data that should be filed.

To try to prevent these types of data problems, the WCIRB does various things, including (1) requiring each of the largest 50 insurer groups to obtain a report from its independent auditor attesting to the correctness of the insurer's annual data filing (as part of this report, the auditor is

required to reconcile data contained in the data filing to data contained in the insurer's statutory annual statement) and (2) implementing the WCIRB's Data Quality Enhancement Program ("DQEP"). More detail pertaining to the DQEP and our testing relative to it is set out in **Appendix B**. These initiatives provide additional protection against the use of flawed data. However, the initiatives are not sufficient to detect such things as a systematic problem with an insurer's data collection process.

In addition to errors in the data filings, our testing also showed that insurers frequently do not make the required data filings in a timely manner. The delays impact the quality and completeness of the data on which the WCIRB relies to make loss cost projections. For example, the majority of instances in which the WCIRB had to exclude an insurer's data when developing pure premium rates resulted from the insurer's data not being submitted in a timely manner.

One of the reasons why there are so many data problems, and so much inconsistency in data filings made by different insurers, is that insurers are allowed to make data submissions in various formats and media, including that some insurers submit data in hard copy form while others submit data in electronic form. By allowing insurers this flexibility, the WCIRB creates unnecessary operational burdens for its actuarial staff as the staff seeks to properly aggregate the data that have been filed. We anticipate that eSCAD, the WCIRB's new web-based filing system, will significantly improve the data collection process, including the initial quality of insurers' aggregate data filings. Although the WCIRB has experienced good participation in the eSCAD system to date, and although the WCIRB expects to reach full participation in the near term, participation is not mandated.

Given the frequency and persistency of problems with data filed by insurers with the WCIRB, we question whether the WCIRB has, or uses, sufficient enforcement powers (such as financial assessments) to require member insurers to make accurate, complete, and timely data filings. As noted above, the fact that the WCIRB is controlled by its member insurers may also create a natural reluctance on the part of the WCIRB to aggressively use the enforcement powers that it has to compel proper data filings. If insurers knew that the WCIRB would consistently impose significant penalties for failure to make accurate, complete, and timely filings, insurers likely would be more inclined to ensure that their filings are properly prepared and filed.

Recommendations Pertaining to the WCIRB's Data Collection and Compilation Activities

1. *We recommend the WCIRB require all insurers to submit their aggregate financial data call reports via eSCAD and require insurers to resolve all data validation errors prior to submitting the information to the WCIRB.*

2. *For those data elements not covered by eSCAD, we recommend that the WCIRB determine the most efficient means for insurers to submit data electronically. We further recommend that the WCIRB prescribe a single, uniform method by which insurers submit such data to the WCIRB.*

3. *We recommend that the WCIRB alert the CDI if it determines that that there is a significant problem with the completeness, accuracy, or timeliness of aggregate financial data filed by insurer groups with significant market share. It is important that the CDI be alerted promptly—within 20 days, for example—after the problem is discovered. By making the CDI aware of such problems, the WCIRB can gain additional support and/or advice regarding the proper course of action with the insurer to remediate current and future reporting problems.*

4. *We recommend the WCIRB take remedial action with respect to any insurer group that is required to obtain an independent auditor's report attesting to the insurer group's annual aggregate data report but is unable to obtain a "clean" opinion regarding such data report. The failure of an insurer to obtain such a report should raise questions regarding the effectiveness of the insurer's internal controls over financial reporting. Accordingly, we further recommend that the WCIRB's existing remedial action procedures be supplemented by having the WCIRB Governing Committee authorize WCIRB staff, or independent persons engaged by the WCIRB, to perform an on-site audit of insurers that are unable to obtain such a "clean" independent audit report.*

5. *We recommend that the WCIRB implement a program applicable to the largest insurers whereby the senior management and the controllers of the insurers attest to the effectiveness of the insurers' statistical and financial reporting systems. Such a program should increase the accuracy of the insurers' reports. The WCIRB may wish to pattern its program after a similar program that has been implemented by the National Council on Compensation Insurance, Inc. ("NCCI"). Similar to the recommendation 4 above, we further recommend that the WCIRB authorize WCIRB staff, or independent persons engaged by the WCIRB, to perform an on-sight audit of insurers that do not file the attestation report.*

6. *We recommend that the WCRIB work closely with SCIF to assure that SCIF's data collection and reporting system is functioning effectively. Given SCIF's share of the workers' compensation market in California, it is important that SCIF's data-capturing and reporting systems function effectively.*

VI. WCIRB ACTIVITIES OTHER THAN DATA COLLECTION & COMPILATION

Policy Documents

Findings Pertaining to Policy Documents

As noted previously, one of the WCIRB's responsibilities is to examine insurance policies and endorsements to ensure they comply with the provisions of law and make reasonable rules governing their submission.[15] In furtherance of that responsibility, the WCIRB collects and analyzes information pertaining to workers' compensation insurance policies that have been issued by insurers. Policy document filing requirements are set forth in the California Workers'

[15] CIC Section 11750.3(e).

Compensation Unit Statistical Rating Plan ("USRP"). The provisions of the USRP are intended to facilitate experience rating, the accurate and timely reporting of USR data, classification and test audit functions, and the use of policy forms that have been approved by the WCIRB. In addition, the filings provide the basis for ensuring California employers maintain workers' compensation coverage.

To evaluate work performed by the WCIRB in this area, we reviewed the WCIRB staff's handling of discrepancies that they had identified to determine how those discrepancies had been resolved. We also reviewed a random selection of filings to assess the accuracy and timeliness of the filings. Finally, we analyzed whether policies filed by insurers with the WCIRB were based on policy forms that had been approved by the CDI.

The attached **Appendix C** sets out our work and findings relative to the WCIRB's work in this area as it pertains to most categories of workers' compensation insurance. As noted in the Appendix, we found that the WCIRB's policy examination staff performs its functions in these areas well. The WCIRB staff is vigilant in reviewing errors they discover and in working to resolve discrepancies in a timely manner.

In addition to performing procedures relative to workers' compensation insurance policies issued to most employers, the WCIRB performs various tasks relative to policy forms issued to two categories of employers that generate special issues: policies issued to employee leasing companies and policies issued to groups/associations.

Testing of Employee Leasing Policies

We judgmentally selected five employee leasing policies from among policies issued by three different insurers that issue such policies to test for compliance with the special requirements pertaining to employee leasing policies. As a part of our testing, we verified that the policy included the name of both the employee leasing company and the underlying individual entities. We also reviewed follow-up WCIRB queries to the employee leasing company, if applicable. We found no discrepancies or exceptions as a result of the testing performed.

Testing of Group/Association Policies

We judgmentally selected five group/association policies from among policies issued by three different insurers that issue such policies to test for compliance with the special requirements pertaining to group/association policies. As a part of our testing, we verified that the policies were approved by the CDI and that the group/association met the criteria set forth by statute pertaining to group/association policies. No discrepancies or exceptions were noted as a result of the testing performed.

Recommendations Pertaining to Policy Documents

We recommend that the WCIRB move toward requiring insurers to file policy information in a standard filing medium, preferably electronically. We note that insurers currently file policy information in both hard copy and electronic format.

Experience Rating Plan

Findings Pertaining to Experience Rating Plan

We reviewed the WCIRB's experience rating procedures to assess whether those procedures are adequate to ensure compliance with the rules specified in the California Workers' Compensation Experience Rating Plan. The review focused on the WCIRB's determination of experience rating eligibility, the establishment of anniversary rating dates, the selection of policy periods to be included in the experience data, the combination of employer entities for experience rating purposes, and the use of the correct experience rating values.

Using our base sample of insurers, policies, and related USRs, we performed a variety of procedures to test the accuracy of the employer's experience rating form, including the experience modification factor. Generally, our testing procedures indicated that the WCIRB's processing system is functioning effectively in capturing accurate information and computing experience modification factors.

Recommendations Pertaining to Experience Rating Plan

None.

Audits of Insureds' Payrolls and Claims Classifications

Findings Pertaining to Audits of Insureds' Payrolls and Claims Classifications

As noted previously, one of the WCIRB's responsibilities is to perform test audits of employers' payrolls and insurers' audits of those payrolls.[16] In furtherance of that responsibility, the WCIRB has engaged in two programs: one that it calls the "Test Audit Program" and another that it calls a "Classification Inspection Program."

Test Audit Program

Pursuant to the Test Audit Program, the WCIRB performs test audits of insurers' audits of their insureds' payrolls and claims classifications. On a monthly basis, the WCIRB randomly selects experience-rated policies to be tested. The test payroll audit component of the Test Audit Program compares the pure premium as determined for each classification of an insurer's audit with the pure premium determined for each classification by the WCIRB. The test claims classification component of the Test Audit Program compares the classification to which an insurer assigns an insured's claims to the WCIRB's classification assignment for the same claims.

The WCIRB takes action depending on what it finds pursuant to the tests. Insurers with test payroll and/or claims classification audit results that fall below minimum audit performance standards are required to provide the WCIRB with a detailed explanation of the remedial measures being taken to improve their audit proficiency. Insurers that continue to fall below the

[16] CIC Section 11750.3(f).

minimum audit performance standards are referred to the WCIRB Classification and Rating Committee for further analysis and review. Conversely, insurers with test payroll and/or claims classification audit results that fall well above minimum audit performance standards are exempted from participation in test audits for a period of two years for test payroll audits and/or six quarters for test claims classification audits.

In order to evaluate the Test Audit Program, we reviewed test payroll audits and test claims classification audits performed by the WCIRB with respect to five insurer groups. Three of the five groups we reviewed had test audits that fell below the minimum audit performance standards. The audits of the remaining insurers met the minimum performance standards. For the insurers reviewed that had test audit results that fell below the minimum standards, we noted that the WCIRB appropriately obtained detailed remedial plans from the insurers. For the insurers reviewed that had continued test audit results that fell below the minimum audit performance standards, we noted that the insurers were appropriately required to discuss their remedial plans at a meeting of the Classification and Rating Committee.

During the Classification and Rating Committee meeting in March 2009, we observed the interaction between the Committee and an insurer group that had been referred to the Committee because it had failed to achieve the WCIRB's minimum standard regarding the test audits of payroll reporting. At the Committee meeting, we observed an effective dialogue between the insurer group and the Committee. The Committee delivered an appropriately stern message to the insurer representative that if immediate improvements were not made by the insurer, the insurer would be referred to the Governing Committee, and possibly to the CDI, for further action.

WCIRB Classification Inspection Program

The Classification Inspection Program helps ensure that policy level payroll and loss data reported by insurers are assigned to the appropriate standard classification for experience rating and pure premium ratemaking purposes. The WCIRB routinely inspects most experience-rated policies. The inspection is performed by a WCIRB field representative on-site at the policyholder's place of business. The field representative meets with a knowledgeable representative of the policyholder, tours the facility, and obtains a detailed description of the policyholder's operations and an estimated allocation of employee payroll by classification in order to verify that proper classifications are being used.

In order to evaluate the Classification Inspection Program, we reviewed inspections performed by the WCIRB with respect to 31 policyholders. The results of this review indicated that the inspections are an effective tool for ensuring correct payroll classifications.

Recommendations Pertaining to Audits of Insureds' Information

None.

The WCIRB's Assistance Identifying Uninsured Employers

Findings Pertaining to the WCIRB's Assistance Identifying Uninsured Employers

Pursuant to CIC Section 11751.5, the WCIRB is required to provide to the Director of Industrial Relations ("DIR"), upon request, any information in the WCIRB's possession or that the WCIRB can reasonably obtain that would assist the DIR in identifying employers who fail to secure adequate insurance in violation of Section 3700 of the Labor Code. The WCRIB is required to provide the requested information in the form and manner that the DIR requires.

To fulfill this responsibility, several Memoranda of Understanding ("MOUs") have been entered into among the DIR, the Department of Labor Standards Enforcement ("DLSE"), the EDD, and the CDI/WCIRB to assist with the identification of uninsured employers.

Our work consisted of reviewing the MOU between the EDD and the WCIRB and reviewing e-mail communications between the EDD and the WCIRB regarding the most recent transmission of data between those agencies.

On a quarterly basis, the EDD submits to the DLSE a list of 500 randomly selected commercial employers. The DLSE then forwards the list to the WCIRB and asks the WCIRB to determine which employers have evidence of workers' compensation insurance on file with the WCIRB. The WCIRB's staff researches its coverage records for each of the identified employers and provides the results of its research to the DLSE.

Subsequently, the DLSE investigates those employers as to which the WCIRB has no record of workers' compensation insurance coverage. If the DLSE determines that an employer actually has coverage, the DLSE may, but is not required to, notify the WCIRB. If so notified, the WCIRB will then determine the reason(s) why the WCIRB's records did not reflect evidence of workers' compensation insurance coverage for that employer. The process for reviewing records of uninsured employers is to be repeated on a quarterly basis until February 28, 2011.

Based on our review, it appears that the WCIRB is fulfilling its obligations under California law and the related MOU.

Recommendations Pertaining to Identifying Uninsured Employers

None.

VII. THE TOWERS REPORT

Findings Pertaining to the Towers Report

Analysis of Retrospective Evaluation of Pure Premium Rate Projections

In connection with our evaluation of the recommendations in the Towers Report, and as background, we reviewed the WCIRB's November 2007 retrospective evaluation of pure premium rate projections ("Rate Projection Report"). We were not provided with the detail supporting the retrospective evaluation and only reviewed the Rate Projection Report itself.

The objectives of the evaluation were to:

- Document the key assumptions and methodologies underlying each annual WCIRB pure premium rate filing and the CDI pure premium rate decision;
- Assess the accuracy of each WCIRB annual pure premium rate filing by comparing the actual cost of losses and loss adjustment expenses that have emerged relative to each policy year to the projections reflected in the filings;
- Provide a detailed explanation as to the significant differences between the WCIRB pure premium rate projections and the cost levels that have actually emerged;
- Describe what actions might have been appropriate based on the information available at the time of the rate filings to improve the accuracy of the pure premium rate projections; and
- Recommend enhancements to the WCIRB pure premium ratemaking process, as appropriate.

The Rate Projection Report summarized the WCIRB analyses and findings for the 1995 through 2006 filings and compared the projections reflected in the filings and the CDI decision with the current estimate of losses and loss adjustment expenses that actually emerged through December 31, 2006. For each of the 1995 through 2006 pure premium rate filings, the WCIRB identified and summarized the key assumptions and methodologies regarding loss development, loss trends, legislative and regulatory changes, wage inflation, and loss adjustment expenses. For each of the key assumptions, the WCIRB analyzed the basis for the assumptions. The WCIRB also explained the methodologies reflected in the original projections and why the projected values may have differed from the actual emerging costs. Finally, based on its retrospective analysis, the WCIRB made various recommendations that are consistent with recommendations made by Towers and procedures implemented in the WCIRB January 1, 2009 pure premium rate filing.

For the 1995 through 2001 pure premium rate filings, the WCIRB appeared to significantly underestimate the pure premium rate need. The 2002 filing projections appeared to be reasonably accurate based on actual emergence through December 31, 2006. For the 2003 through 2006 filings, the WCIRB appeared to significantly overestimate the pure premium rate need based on actual emergence through December 31, 2006.

The WCIRB indicated that due to dramatic judicial, regulatory, and legislative changes during the experience period reviewed, projecting pure premium rate need was particularly challenging. During periods of relative stability in the claims environment, relatively accurate pure premium

rate projections can be made. However, when the claims environment is altered by changes resulting from judicial, regulatory, or legislative actions that radically impact the economic incentives to use the workers' compensation system, it can be extremely difficult to accurately project pure premium rates primarily due to the lack of data available immediately following the changes. In addition, workers' compensation is a very long-tailed line of business, which further adds to the difficulty in making accurate projections. We agree with these observations by the WCIRB.

The WCIRB believes that its transition away from unadjusted incurred projection methods to methods that were more responsive to the post-1993 reform environment was appropriate, but it believes that it did not transition quickly enough. In addition, the WCIRB noted that, at the time of the 1997, 1998, and 1999 filings, workers' compensation medical inflation increased rapidly following the Minniear decision. The WCIRB commented that it may have been able to more accurately assess the potential impact of the Minniear decision at an earlier stage by evaluating a number of relevant indicators. Therefore, the WCIRB indicated that it will continue to work to identify and monitor leading indicators that would allow sharp shifts in loss trends to be more quickly identified.

Review of the Towers Report

Reviewing the WCIRB's Rate Projection Report gave us background and context for our review of the Towers Report. As noted previously, the Rate Projection Report shows that the WCIRB's pure premium rates had probably not been high enough for years 1995 through 2001, had probably been appropriate for 2002, and had probably been too high for years 2003 to 2006. Understanding this history helped us put the recommendations contained in the Towers Report in context.

The primary objectives of our review of the Towers Report were to evaluate whether Towers' recommendations are reasonable and whether the recommendations, if implemented, would improve the accuracy of the WCIRB's pure premium rate estimates.

For purposes of our analysis, we reviewed the following information:

- The Towers Report, including its recommendations;
- The WCIRB's January 1, 2009 pure premium rate filing dated August 15, 2008,
- The WCIRB's modified pure premium rate analysis based on data as of June 30, 2008;
- The WCIRB's letters to the CDI dated August 25, 2008 and October 6, 2008 regarding the recommendations in the Towers Report; and
- The WCIRB's Overall Ratemaking Methodologies Potential Long-Term Enhancements Evaluation Plan ("Evaluation Plan") dated December 15, 2008.

In addition, we interviewed the WCIRB's actuarial and executive staff to gather additional information regarding the WCIRB pure premium ratemaking procedures.

We noted that the Towers Report is an extensive document with a number of recommendations relating to the WCIRB's rating methodology. We focused on those recommendations that will likely have the most significant short-term impact on the WCIRB's ratemaking process and that do not require extensive resources and costs to implement. We understand that the WCIRB is continuing to consider whether to implement other recommendations contained in the Towers Report.

Analysis of Loss Projection Methodology

WCIRB Actuarial Methodology. To analyze the Towers Report recommendations pertaining to loss projections, it first was necessary to review the loss projection methodology used by the WCIRB. Based on our review, we determined that although the WCIRB indicated that it considered various actuarial methods, the WCIRB relied solely on the paid development actuarial method for purposes of projecting ultimate losses. In addition, the WCIRB relied on only the most recent year's paid development data to project ultimate losses.

The WCIRB made its decision to rely solely on the paid development actuarial method primarily because it believes that paid development patterns have been relatively stable since significant reforms were made in the workers' compensation system beginning in 2004. In addition, the WCIRB believes that by using the most recent paid development patterns, it can respond quickly to changes in loss patterns caused by various factors, including workers' compensation reforms, changes in claims by injury type, and changes in the mix of insurers with losses.

Towers Report Recommendations. The Towers Report recommends that the WCIRB consider using several actuarial methods, rather than only one, for projecting ultimate losses. In addition, Towers recommends that the WCIRB consider employing various diagnostic tests to aid in developing more accurate loss projections.

At the same time, Towers supports the WCIRB's reliance on only the most recent year's paid development data so that the WCRIB can respond quickly to recent changes in development patterns. (This is the same reason the WCIRB provided for why it uses only the most recent paid development data.) Towers acknowledges that, although responsiveness is increased by using only the most recent year's paid development data, using only that data decreases the stability of the WCIRB's loss projections from one evaluation to the next.

Analysis of WCIRB Methodology and Towers Report Recommendations. We agree with Towers that, instead of relying on only one actuarial method to project ultimate losses, it is more appropriate to take into account more than one loss projection method as well as to consider various diagnostic tests that can result in more accurate loss projections. In our view, no single actuarial method is ideal for projecting ultimate losses. We believe that, by using additional methods and by applying appropriate actuarial judgment to evaluate which methods are most appropriate for a particular accident year, the WCIRB can increase the stability and accuracy of its projections.

As an example of why it is more appropriate to consider various actuarial methods and diagnostic tests, for recent accident years (particularly the two most recent accident years), the loss development factors ("LDFs") developed by the WCIRB by using the paid development method were particularly large. WCIRB data indicates that paid medical plus indemnity losses for accident year 2007 as of March 31, 2008, were 19% of the WCIRB's projected ultimate losses. As a result, the LDFs that the WCIRB used in its loss projections were highly leveraged. However, during discussions with the WCIRB concerning its use of the paid development actuarial method, the WCIRB noted that its paid development patterns have been reasonably stable for the years beginning with and following significant workers' compensation reforms (i.e., 2004 and later years). While we acknowledge that the paid development patterns are reasonably stable for the post-reform years, the magnitude of the LDFs could result in significant variability with respect to the projected cumulative LDFs, particularly for the two most recent accident years.

In addition, choosing whether to rely solely on the most recent loss data or to rely, instead, on averages of loss data for two or three years presents a trade-off between responsiveness and stability. Relying only on the most recent data allows the WCIRB to respond more quickly to recent changes in development patterns; however, using two or three year averages increases the stability of the WCIRB's projections from one evaluation to the next and reduces the chance that aberrations in the most recent years' data are improperly included in the rate calculations. Accordingly, it may be appropriate to prepare calculations both ways—relying solely on the most recent loss data and relying on averages of loss data for two or three years—so that the differences can be measured and observed. The uncertainty regarding the extent to which the effect of workers' compensation reforms has fully impacted development patterns serves to support the concept of considering more than one loss projection method, more than only one year's worth of data, and various diagnostic tests to more accurately prepare loss projections.

Finally, we recommend that the WCIRB begin preparing hindsight projections for various actuarial methods to test the reliability of the methods. We also recommend that the WCIRB review various diagnostic testing information that we believe will provide additional insight into which actuarial method the WCIRB should consider for a particular accident year.

Analysis of ALAE Projection Methodology

WCIRB Actuarial Methodology. To analyze the Towers Report recommendations pertaining to ALAE projections, it first was necessary to review the ALAE projection methodology used by the WCIRB. To project the ultimate ratio of ALAE to losses, the WCIRB first relies on the paid ALAE development method to project ultimate ALAE. The WCIRB then compares projected ultimate ALAE to its projected ultimate indemnity counts to produce an average projected ALAE per indemnity count by accident year. Finally, the WCIRB trends the average severity to the level expected for policies incepting in 2009.

The WCIRB has found that the ratios of ALAE to losses are significantly different for SCIF than they are for private insurers. Therefore, the WCIRB uses a special formula to calculate the ratio of ALAE to losses for the entire California workers' compensation market. First, the WCIRB

projects ratios of ALAE to losses separately for SCIF and for private insurers. It then calculates a projected ratio of ALAE to losses for the entire market by taking into account SCIF's percentage of the workers' compensation market and by recognizing that the difference in the ratios of ALAE to losses for SCIF and for private insurers might not continue in the future at the same magnitude. The possible change in the different loss ratios is adjusted by applying a tempering factor to the SCIF data to derive the selected ALAE ratio.

We note that if the WCIRB calculated pure premium rates on combined SCIF and private insurer data, the resulting pure premium rates would be too high for the private market and too low for SCIF. However, since the WCIRB must produce projected pure premium rates for the entire California workers' compensation market, the WCIRB assumes that insurers and SCIF will adjust for inequities in the pure premium rates for their segment of the market in their selected rate modification factors. Based on our review of data calls for selected insurers, it appears that insurers are adjusting for inequities in pure premium rates, as applied to the insurers' market, by use of selected rate modification factors.

Towers Report Recommendations. The Towers Report recommends that the WCIRB consider several actuarial methods for projecting ALAE. In addition, Towers recommends that the WCIRB consider employing various diagnostic tests to aid in developing more accurate ALAE projections. We note that Towers agreed with the WCIRB's decision to not rely on the paid ALAE to paid loss development method because historical ALAE did not appear to be tracking losses directly.

Analysis of WCIRB Methodology and Towers Report Recommendations. Our comments and recommendations pertaining to the WCIRB's ALAE projections are similar to our comments and recommendations pertaining to the WCIRB's loss projections.

First, we agree with Towers that the WCIRB should use additional actuarial methods to select ultimate ALAE. As with methods used to project losses, no one actuarial method to project ultimate ALAE is perfect in every situation. By employing different actuarial methods, we expect that the WCIRB can produce more stable projections between each evaluation and increase the accuracy of its projections.

One of the actuarial methods that we recommend that the WCIRB consider using to select ultimate ALAE is the paid ALAE to paid loss development method ("Paid to Paid Method"). Although we note that the WCIRB considered the Paid to Paid Method, it chose not to rely on that method.

The WCIRB indicated that it chose not to rely on the Paid to Paid Method because of volatility in development patterns following significant workers' compensation reforms (i.e., 2004 and later years). Further, Towers agreed with the WCIRB's decision not to rely on the Paid to Paid Method because historical ALAE does not appear to be tracking losses directly. Towers indicated that an assumption widely used by the actuarial profession is that ALAE should roughly track losses.

Although we agree that recent development history for the Paid to Paid Method has been somewhat more volatile than paid development history, we do not believe that the differences in volatility are significant for calendar years 2006 and 2007. We also believe that part of the variability in ratios of ALAE to losses in the post-reform years was due to one-time distortions in ALAE resulting from reforms that were enacted during those years. Therefore, we recommend that the WCIRB consider placing some reliance on the Paid to Paid Method when it projects ultimate ALAE.

We also note that, by using only the paid development method, the ratios of ALAE to losses have increased significantly in the post-reform years. Currently, the WCIRB projects ALAE based on a selected ratio of ALAE to losses. While loss volume has decreased due to recent reforms, ALAE has remained fairly stable, which results in a higher ratio of ALAE to losses. Further, we believe that projected losses used in recent pure premium rate development may be overstated, which would result in overstated ALAE and an even more inflated overall pure premium rate change.

In addition to the Paid to Paid Method, we agree with Towers that the WCIRB should consider additional methods for ALAE projections, particularly the counts and averages method and projections based on ratios of incremental ALAE to incremental losses. We also recommend that the WCIRB consider various diagnostic tests that can provide insight as to which actuarial methods might be preferable for a particular accident year. Finally, we recommend that the WCIRB begin to prepare hindsight projections for various actuarial methods to test the reliability of the methods.

Analysis of ULAE Projection Methodology

WCIRB Actuarial Methodology. To analyze the Towers Report recommendations pertaining to ULAE projections, it first was necessary to review the ULAE projection methodology used by the WCIRB. As part of the development of its January 1, 2009 pure premium rate filing, the WCIRB reviews the results of a variety of projection methods to estimate ultimate ULAE. After its review of the various methods, the WCIRB chose to select its ultimate ratio of ULAE to losses based on the average of the results of two projection methods: the open indemnity claim-based projection method and the calendar year paid loss-based projection method.

The WCIRB has found that the ratios of ULAE to losses are significantly different for SCIF than they are for private insurers. Therefore, the WCIRB uses a special formula to calculate the ratio of ULAE to losses for the entire California workers' compensation market. First, the WCIRB projects ratios of ULAE to losses separately for SCIF and for private insurers. It then calculates a projected ratio of ULAE to losses for the entire market by taking into account SCIF's percentage of the workers' compensation market and by recognizing that the difference in the ratios of ULAE to losses for SCIF and for private insurers might not continue in the future at the same magnitude. The possible change in the different loss ratios is adjusted by applying a tempering factor to the SCIF data to derive the selected ULAE ratio.

We note that if the WCIRB calculated pure premium rates on combined SCIF and private insurer data, the resulting pure premium rates would be too high for the private market and too low for

SCIF. However, since the WCIRB must produce projected pure premium rates for the entire California workers' compensation market, the WCIRB assumes that insurers and SCIF will adjust for inequities in the pure premium rates for their segment of the market in their selected rate modification factors.

Towers Report Recommendations. The Towers Report recommends that the WCIRB implement the Paid to Paid Method for projecting ULAE. Towers also suggests that the WCIRB consider incorporating non-traditional approaches to ULAE estimation.

Further, Towers recommends that the WCIRB explore implementing procedures that recognize shifts in mix of business by insurer that affect ULAE. Finally, Towers recommends that SCIF ULAE data be excluded from ULAE projections due to significantly differing cost structures that are in place for SCIF and for private insurers.

Analysis of WCIRB Methodology and Towers Report Recommendations. We agree with Towers's recommendation that the WCIRB should implement the traditional Paid to Paid Method for projecting ULAE, even though we recognize that the WCIRB will need to collect paid ULAE data in the future to implement this method. As Towers noted, the WCIRB concluded that historical ULAE does not appear to be tracking losses directly and that the use of incurred ULAE can distort projections due to calendar year shifts in IBNR estimates.

We also note that, as with ALAE projections, the ratios of ULAE to losses have increased significantly in the post-reform years. While loss volume has decreased due to recent reforms, ULAE has remained fairly stable, which results in a higher ratio of ULAE to losses. Further, we believe that projected losses used in recent pure premium rate development may be overstated, which would result in overstated ULAE and an even more inflated overall pure premium rate change.

Further, we agree with Towers' recommendation that the WCIRB explore implementing procedures that recognize shifts in mix of business by insurer that affect ULAE. We note that ULAE ratios can differ significantly by insurer in the private market. Therefore, the WCIRB's projections of ULAE may not be within the range of reasonableness for some insurers.

We also agree with Towers' recommendation that SCIF ULAE data be excluded from ULAE projections due to significantly differing cost structures that are in place for SCIF and for private insurers. However, we note that SCIF would need to account for this projection method change by making changes to its rate modification factor.

Towers also suggests that the WCIRB consider incorporating non-traditional approaches to ULAE estimation. However, we believe that the effort and cost required to implement such non-traditional approaches may not be warranted. We note that ULAE is extremely difficult to accurately project so that even using non-traditional approaches might not result in more accurate projections. In addition, the WCIRB currently reviews six ULAE projections methods that produce reasonably similar results, so considering even more approaches might not improve the WCIRB's projection results.

Recommendations Pertaining to the Towers Report

1. *We recommend that the WCIRB consider multiple projection methods when making pure premium rate determinations. No one projection method will be appropriate for all accident years. The WCIRB also should review various diagnostic statistics and retrospective analyses to assist in determining which projection methods are appropriate for each accident year.*

2. *We recommend that retrospective projected ultimate loss ratios ("LRs") be selected judgmentally by accident year and that the original projected ultimate LRs be compared to the updated projected ultimate LRs by accident year. Further, we recommend that retrospective analyses be prepared annually so that changes in projected ultimate pure premium LRs by accident year can be observed and explained.*

3. *After considering the results of multiple methods, we recommend that the WCIRB provide a range of reasonable pure premium rate level indications to the Actuarial Committee and the Governing Committee.*

4. *Rather than presenting the CDI with the results of only one method, we recommend that the WCIRB prepare and provide to the CDI a chart or side-by-side comparison showing projected on-level pure premium LRs by accident year using each method considered by the WCIRB. Providing this information will allow the CDI to better understand the variability surrounding the projections and the extent to which projections are sensitive to alternate assumptions. We also believe it would be helpful for the WCIRB to explain why it believes certain methods are more reasonable than others for particular accident years. We recommend that the WCIRB describe the key assumptions underlying each method, the extent to which the WCIRB believes those assumptions are valid, and alternate scenario projections for key assumptions. We also recommend that the WCIRB explain its rationale behind the selected LRs by accident year.*

VIII. CONCLUSION

We would like to thank the WCIRB and its staff for their assistance and cooperation in connection with this Operational Examination. We found the WCIRB staff and the members of its various Committees to be hard working and dedicated to performing the tasks given the WCIRB pursuant to the California Insurance Code and the WCIRB's governing documents.

The WCIRB is charged with a difficult and highly complex task, and the WCIRB does a number of things well. However, at its core, the effectiveness of the WCIRB's pure premium rate recommendations depends on two key things: (1) the quality of the data received and used by the WCIRB and (2) the actuarial projection of that data into pure premium rate indications. We found that improvements are needed in both of these areas.

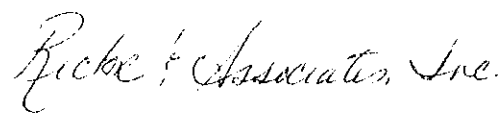
As to the quality of the data the WCIRB receives and on which it relies, Section V of this Report ("The WCIRB's Data Collection and Compilation Activities") sets out our finding that insurers

frequently make filings with the WCIRB that are not accurate, complete, or timely. Although the WCIRB cares deeply about the quality of the data on which it bases its analyses and although the WCIRB works hard to identify and correct data errors prior to relying on the data submitted, we found that procedures are not in place to sufficiently assure that all information being relied on by the WCIRB is accurate and complete.

As to the WCIRB's actuarial projections from the data it receives, Section VII of this Report ("The Towers Report") sets out our findings that the WCIRB should use additional actuarial projection methods. Section VII of this Report also sets out our finding that the WCIRB should present a range of reasonable pure premium rate level indications and additional explanatory material to the CDI so that the CDI can better understand the variability surrounding the projections and the extent to which the projections are sensitive to alternate assumptions. As described further in Section IV of this Report ("The WCIRB's Governing System"), we also found that the sequencing and timing of WCIRB committee meetings do not appear to allow enough time for the WCIRB to sufficiently evaluate "mid-year" (effective July 1) loss cost projections before they are approved by the WCIRB's Governing Committee and submitted to the CDI.

Finally, we recognize that the WCIRB has begun to focus more on trying to anticipate what the effects of legislative, regulatory and judicial changes will be rather than waiting for such effects to emerge in the historic data. We encourage the WCIRB's efforts in this area, and we urge the WCIRB to move even farther and faster in seeking to predict the effects of changing market forces and of a changing regulatory environment rather than waiting to react to such changes.

Throughout this Report, we provide a number of recommendations that we believe, if implemented, will improve the WCIRB's processes and procedures pertaining to data collection and loss cost projections. We hope the CDI and the WCIRB will find them useful.



RECTOR & ASSOCIATES, INC.

APPENDIX A

Testing of the Aggregate Data Call Reports

All insurers licensed to write workers' compensation insurance policies in California are required to submit aggregate financial data to the WCIRB in accordance with the Submission of California Aggregate Data ("SCAD") Program Guide published by the WCIRB. This data underlies the pure premium rates developed by the WCIRB and submitted to the Commissioner for approval. Insurers may elect to submit their aggregate data on either a group or individual company basis, though most insurers report on a group basis. The aggregate financial data is submitted to the WCIRB by insurers through various aggregate data call reports on a quarterly and annual basis. We chose 15 insurance groups that are required to file complete quarterly and annual aggregate financial data reports. Of those 15 groups, we chose the five insurers with the largest workers' compensation insurance market share and chose 10 insurers on a judgmental basis. We also chose an additional five insurers that only file an abridged version of the annual report on a judgmental basis.

For each insurer group, we performed the following testing procedures:

- Reviewed the insurer group's 2007 quarterly and annual financial data reports to test the timeliness, completeness, and accuracy of the reports; and
- Reviewed whether the WCIRB accurately calculated and levied appropriate financial assessments.

In addition, we reviewed the facts and circumstances surrounding decisions made by the WCIRB to exclude insurers from prior rate filings due to data issues requiring remediation.

We tested the following aggregate data calls for these insurance groups:

- first quarter ("1Q") 2007;
- 1Q 2007 claim count;
- 2007 annual expense;
- 2007 annual indemnity and medical; and
- CPA attestations.

The aggregate data call attributes tested were based on compliance with the guidelines set forth in Section III of the SCAD Program Guide.

For each aggregate data call report tested, we performed the following procedures: 1) determined that the data call report was submitted timely and that the date of submission per the WCIRB system was the same as the date of submission per the data call report; 2) determined that all required information was submitted in the data call report; 3) verified that the insurer was notified by the WCIRB within five business days after receipt of the data call report that the report was either received or was incomplete; and 4) determined that a written query was sent to the insurer when an edit failed and that the insurer responded to the edit query within the timeframe specified by the WCIRB. In those instances where the insurer did not file the aggregate data call report timely or respond to the WCIRB's edit query timely, we also verified that the assessment calculation was accurate.

Testing for Timeliness

We noted the following as a result of the testing performed:

- Five of the 15 insurers sampled submitted one or more aggregate data call reports after the due date. For two of the insurers, the late filed data call report was the 1Q 2007 claim count report. There were no assessments for those late submissions because claim count reports were not subject to assessment until the first quarter of 2008. In addition, another insurer submitted several data call reports after the due date. However, assessment calculations were not applicable to that insurer since it was already subject to special assessments due to remediation.

- For seven of the 15 insurers sampled, the WCIRB did not notify the insurer within five business days that one or more of the aggregate data call reports was received. (With the new eSCAD system, this issue will no longer be applicable, since notification is automatically provided when the data call is submitted through eSCAD.)

- For two insurers, the date of submission per the data call report was different from the date of submission per the WCIRB system. (With the new eSCAD system, this issue will no longer be applicable since the WCIRB will no longer have to date-stamp filings and log them into the system.)

- For one insurer, even though one of the questions on the expense data call report was not answered, the WCIRB did not query the insurer to get the information. However, the incomplete data call report was not considered significant since responses to other questions on the filing implicitly answered the unanswered question.

- For one insurer, the response to a WCIRB query was not received timely. In this case, it was noted that the assessment was calculated correctly.

- For two insurers, the WCIRB queried the insurers via a telephone query rather than a written query as required by the SCAD Program Guide.

Testing for Accuracy

We found the following 19 different edit failures arising from nine different insurers (these findings do not include failures for an insurer under a remedial action plan):

- Eight of the edit failures arose from reconciliation issues between the 2007 data call and a prior data call or between different data calls submitted in 2007;

- Two of the failures resulted from unusually large increases or decreases in reserves from the prior data call;

- Five of the failures resulted from minor arithmetic or spreadsheet errors;

- Two of the failures arose from claim count inaccuracies discovered by the WCIRB during its actuarial review;

- One failure arose from a telephone query that was not documented; and

- One insurer's calendar year 2007 medical and indemnity paid losses on the call report did not reconcile to the system report or the insurer's CPA report. The discrepancy arose because of the method that the insurer uses to account for paid reinsurance receivables. Since the amount of the discrepancy is minor (based on a percentage of total paid losses), the WCIRB determined that the insurer did not need to revise data calls for 2006 and prior years.

For the 19 different edit failures that we found, the following summarizes the effect of these failures on assessments:

- Thirteen failures arose from actuarial edits that were not subject to assessments;

- Two failures related to claim count data calls that were not subject to assessment (claim count calls were not subject to assessment until the first quarter of 2008);

- The WCIRB waived assessments for two of the failures (according to the WCIRB's actuarial staff, the WCIRB can waive assessments if the needed revision is made quickly); and

- Only one edit failure was subject to assessment, and the assessment calculation was accurate.

Findings on Completeness

- We found the WCIRB's universe of required filers to be complete by using the CDI's *Insurance Organizations Authorized in California 2007.*

Exclusion of Insurers' Data From Rate Filing Preparation Due to Remediation

We reviewed all of the instances in which insurers' data was excluded from data used to prepare pure premium rate filings from the year 2006 and forward due to data problems requiring remediation. We then analyzed whether the WCIRB processes detected the problems that led to the data exclusions.

Generally, we found that WCIRB actuarial staff performs reasonability testing that is sufficient to detect data anomalies. The WCIRB reviews paid, incurred, and claim count development patterns to look for unusual changes from prior data calls and to see if development factors are unusually high or low compared to other insurers. The WCIRB also reviews loss ratios, ratios of insurer premium to advisory pure premium, and average claim costs for consistency between data calls and reasonableness compared to the statistics for other insurers. In addition, we found that the majority of the instances in which data was excluded from rate filing preparation resulted because the WCIRB did not receive an insurer's data in time to include it in preparation of pure premium rate filings.

We identified three instances (Company A, Company B, and Company C) in which the WCIRB procedures for reviewing insurers' data did not timely identify issues with the insurers' data, as described below. For those three insurers, we:

- Determined how the WCIRB processes detected problems that led to the data exclusions;

- Reviewed the remediation plans to ensure that all of the required elements were included in the remediation plans as required by Section IV.A of the SCAD program;

- Verified that the remediation plans were approved by the WCIRB; and

- Tested the accuracy of the assessments levied as a result of data exclusion in compliance with Section IV.B of the SCAD program.

Sections IV.C, IV.D, and IV.E of the SCAD program pertain to noncompliance with remediation procedures. The three insurers that we reviewed complied with these sections, so we did not perform any testing pertaining to these sections.

Summary of Company A's Data Problems

We believe that the WCIRB staff should have been more attentive to issues raised by Company A's failure to file an independent auditor's report certifying to the accuracy of Company A's workers' compensation data for the data year ending December 31, 2005 ("2005 Company A's Auditor's Report"). Although the WCIRB staff indicated that they performed more detailed analysis of Company A's quarterly data reports beginning in 2006, we believe that Company A's failure to file a 2005 Company A's Auditor's Report should have been a strong indication that even more analysis was necessary. Additional analysis might have resulted in earlier discovery of issues involving Company A's data that were later discovered.

Company A's Filings and WCIRB Analysis for the December 31, 2005 Data Year. As previously stated, Company A did not file a 2005 Auditor's Report. In lieu of a 2005 Auditor's Report for Company A, Company A's senior management attested to the accuracy of the data, and the attestation was accepted by the WCIRB. In addition, the WCIRB staff did not notice any data anomalies during their actuarial reviews of Company A's 2005 data. Accordingly, the WCIRB included Company A's 2005 data for purposes of preparing the pure premium rate filing.

Company A's Filings and WCIRB Analysis for the December 31, 2006 Data Year. Since Company A did not submit a 2005 Auditor's Report, the WCIRB's actuarial staff indicated that they used a higher level of scrutiny for data submitted by Company A during 2006. After reviewing Company A's data as of March 31, 2006, the WCIRB staff noticed a significant shift in Company A's paid loss development factors ("LDFs"), as compared to statewide LDFs. The WCIRB staff noticed similar anomalies in Company A's data as of June 30, 2006.

Eventually, the WCIRB staff determined that the data issues resulted because Company A's comptroller staff resolved a backlog of large risk rating plan ("LRRP") business, which resulted in the booking of a significant amount of historical account premiums and claims transactions. In addition, Company A's third party administrators were treating LRRP business as high self-insured retention ("SIR") business and did not provide the required detailed claim information for this business to the WCIRB until the SIR was reached. The WCIRB staff determined that these data issues impacted data filed by the WCIRB for 2004, 2005, and 2006. We understand that the Actuarial Committee concurred with the WCIRB staff's determination.

Remediation Plans Resulting From Data Errors. In 2006, the WCIRB approved a remediation plan that required Company A to revise historical data calls for 2005 and 2006 through September 30, 2006 evaluations, and the WCIRB agreed that Company A would exclude the LRRP business from the revised data calls. However, the WCIRB discovered in 2007 that the LRRP business accounted for two thirds of Company A's workers' compensation data in California. As a result, the WCIRB approved a second remediation plan, which required Company A to include the LRRP data in its data calls and to revise and submit historical data calls.

Both remediation plans were approved by the WCIRB and contained all of the elements that are required by Section IV.A of the SCAD program. In addition, assessments levied as a result of the exclusion of Company A's data for purposes of preparing pure premium rate filings were calculated correctly.

Summary of Company B's Data Problems

In 2007, the WCIRB actuarial staff reviewed data submitted by Company B and noticed significant anomalies. After querying Company B, it was determined that the majority of the anomalies occurred because it reported premiums and losses net of deductibles (instead of gross of deductibles, as required in SCAD) for some of the required time periods. In addition, errors were made in the reported claim counts. Company B's remediation plan was approved by the WCIRB and contained all of the elements that are required by Section IV.A of the SCAD program. In addition, assessments levied as a result of the exclusion of Company B's data for purposes of preparing pure premium rate filings were calculated correctly.

The WCIRB actuarial staff indicated that they only perform reasonability testing to detect data anomalies on a quarterly basis for the 20 insurers with the largest workers' compensation insurance market share. Because reasonability testing is only performed for all other insurers, including Company B, on an annual basis, the WCIRB actuarial staff did not discover Company B's data issues as soon as they would have if Company B's data had been examined on a quarterly basis. At the same time, we believe that it is not reasonable for the WCIRB actuarial staff to perform reasonability testing of all insurers' data on a quarterly basis because of the inordinate amount of time required by WCIRB actuarial staff necessary for quarterly testing, especially since the effect of finding data errors is lower due to the minimal impact caused by the exclusion of smaller insurers' data on pure premium rate development.

Summary of Company C's Data Problem

In 2007, the WCIRB actuarial staff reviewed data submitted by Company C and noticed differences in Unit Statistical Report ("USR") pure premiums and in written and earned premium at the pure premium rate level, as reported in aggregate financial data calls. It was determined that the differences resulted from Company C's errors in calculating its USR pure premiums. Company C's remediation plan was approved by the WCIRB and contained all of the elements that are required by Section IV.A of the SCAD program. In addition, assessments that were levied as a result of the exclusion of Company C's data for purposes of preparing pure premium rate filings were calculated correctly.

Currently, the WCIRB actuarial staff uses a benchmark to identify instances when further investigation is warranted based on a 10% difference between USR pure premiums and written and earned premium at the pure premium rate level, as reported in aggregate financial data calls. In Company C's case, its data did not indicate a 10% difference between the two reported premiums until 2007. However, Company C's errors in

calculating its USR pure premiums affected data that was submitted between 2003 and 2007.

APPENDIX B

Testing of the Unit Statistical Reports

Unit Statistical Reports ("USRs") are required to be submitted for each policy on an annual basis in accordance with the guidelines set forth in the California Workers' Compensation Uniform Statistical Plan (the "Plan"). The Plan also specifies the policy level data required to be submitted on the USR.

To test the accuracy, completeness, and timeliness of USRs submitted by insurers, as well as the general effectiveness of the WCIRB's processing controls pertaining to USRs, we used the same sample policies that were selected for the testing of the policy examination process. The USR attributes tested included the policy effective date, policy expiration date, experience modification, and the USR receipt date(s). In addition, for those USR filings that contained data quality deficiencies, we reviewed applicable correspondence from the WCIRB to the insurer to determine the effectiveness of the WCIRB in resolving the deficiencies. Further, for those insurers with a current California Inspection Report ("CIR"), we traced any classification changes, made as a result of the CIR, to the appropriate experience modification.

For each USR filing tested, we performed the following procedures: 1) matched the various key USR elements to the WCIRB's policy system; 2) made inquiries as to whether the USR created any data quality deficiencies; and 3) determined whether the USR was filed timely (within 20 months for the initial filing and then every 12 months thereafter for subsequent filings). For USR filings with identified data quality deficiencies, we reviewed the WCIRB's queries and evaluated the final outcome. Finally, for those insurers with current CIRs that resulted in changes in classifications, we reviewed supporting information to determine whether appropriate experience modifications were made as a result of the reclassifications.

We noted the following as a result of the testing performed:

- USRs reviewed for 18 of the 31 sample policies contained discrepancies, with certain USRs containing multiple discrepancies. The discrepancies noted included differences in policy numbers, differences in expiration dates, unreported experience modifications, differences in reported experience modifications, and differences in reported classification codes. For all but one of the USRs with unreported or inconsistent experience modifications, there was no apparent follow-up communication with the insurer to correct the USRs.

- USRs reviewed for 11 of the 31 sample policies contained experience modification factors which were different from the experience modification factors contained in WCIRB's master file for the policies. According to WCIRB staff, these policies were affected by a WCIRB system programming

problem that existed prior to 2006. Because of this programming problem, the WCIRB system did not detect the discrepancy between the WCIRB's correct experience modification factor and the incorrect modification factor contained in the USRs. As a result, the insurer was not asked to apply the correct experience modification. According to WCIRB staff, this problem was diagnosed and remedied in 2006.

- USRs were not filed timely for 12 of the 31 sample policies. For some of the policies, there were multiple late filings (e.g., the initial filing was submitted late and then one or more subsequent filings were also submitted late). However, none of 12 USRs reviewed were deemed delinquent or subject to fine because the USRs were filed with the WCRIB by the end of the second month following the filing due date.

Testing of the Data Quality Enhancement Program

Most of the data validation procedures used by the WCIRB to facilitate the integrity of the data captured pertaining to individual policies involve review of insurer data submitted at the individual USR level. While those procedures facilitate the identification of potential data reporting errors for each insurer on a policy-by-policy basis, they do not provide a comprehensive, insurer-wide analysis of the USR submissions. As such, the WCIRB has designed a Data Quality Enhancement Program ("DQEP") that focuses on insurer groups that write at least 100 policies and have at least $40 million in annual premium. Presently, there are approximately 50 insurer groups that are subject to the DQEP.

We selected five insurer groups that had issued policies that were included in our policy level testing. For those five insurer groups, we obtained the third quarter 2008 quarterly and rolling summary reports to determine current compliance. All five of the sampled insurer groups were in compliance with the DQEP data quality measurements.

We also obtained a listing of insurer groups that exceeded one or more of the designated thresholds of the DQEP data quality measurements. From that listing, we selected three insurer groups for additional testing. For each of those insurer groups, we reviewed DQEP reports, WCIRB correspondence with the insurer group pertaining to remedial procedures, and the insurer group's remediation plan.

Two of the three insurer groups were required to be within the data quality measurement thresholds by the end of the first quarter of 2009. The other insurer group was unable to comply with the data quality measurement threshold by the end of 2008 and was therefore referred to the WCIRB's Classification and Rating Committee ("C&R Committee") for further action. We reviewed the WCIRB staff's report to the C&R Committee and observed the interactions between the C&R Committee and the insurer group. We found the procedures followed by the WCIRB staff and C&R Committee to be appropriate and likely to be effective in improving compliance with the data quality measures.

Testing of the *System of Fines for Delinquent Unit Statistical Reports* Process

To test the WCIRB's System of Fines for Delinquent Unit Statistical Reports, we used the same sample that was selected for the testing of USRs. We reviewed the control lists provided to the insurers prior to the due dates for the USRs to determine whether the sample policies were included in the control lists. We also reviewed subsequent delinquent and fine lists to determine whether the sample policies were included in either or both of these lists, if appropriate.

The following was noted as a result of the testing performed:

- Three of the 31 policies were not properly reflected on the control list.

- None of the sample policies appeared on the related delinquent and fine lists. We verified that the sample policies were properly excluded from those lists by review of the USR filing system. However, as a part of this review, we did note that the delinquency list pertaining to January 2004 incepting policies showed approximately 36% of one insurer's USRs were delinquent, approximately 18% of which were subject to fines.

APPENDIX C

Testing of the Policy Examination Process

The WCIRB's policy examination process helps ensure the quality of the policy level data included in the WCIRB master file. This data is used to: 1) create and maintain evidence of workers' compensation insurance coverage held by California employers; 2) provide new insurers with key underwriting information; 3) collect unit statistical reports; 4) ensure application of correct experience rating rates; 5) ensure that payroll and loss experience is accurately compiled; 6) facilitate classification and test audit functions; and 7) ensure the use of CDI approved forms.

We judgmentally selected 31 policy submissions from among the policies issued by 20 different insurer groups in January 2004 to test the accuracy, completeness, and timeliness of the policy filings and the general effectiveness of the WCIRB's processing controls pertaining to the policy examination process. The policy attributes tested included the policy effective date, policy expiration date, and experience modification.

For each policy submission tested, we performed the following procedures: 1) matched the various key policy elements to the WCIRB's policy system; 2) made inquiries as to whether the policy filing created a data quality issue; 3) determined whether the policy filing was received within 60 days of its inception; and 4) determined whether the policy was issued on a CDI approved policy form. For policy filings with data quality issues identified, we also reviewed the WCIRB's follow-up communication with the insurer groups and evaluated the final resolution of the issues.

We noted the following as a result of the testing performed:

- Policy submissions for 10 of the 31 sample policies contained discrepancies, with certain policy submissions containing multiple discrepancies. The discrepancies noted included misclassifications/invalid classifications by the insurer, inaccurate experience modifications, and issues pertaining to changes of ownership. For most of the discrepancies noted, we found that the WCIRB's policy examination staff was diligent in their review of the policy submissions and resolution of the inaccuracies. For many of the discrepancies noted, we found documentation supporting the resolution of the discrepancies.

- According to the WCIRB system records, all sample policies were filed within 60 days of the policy inception date. Our results were also confirmed by the Policy Examination Department manager. We noted that the WCIRB policy examination staff checks for compliance with timely filing requirements as a part of its pre-coding process.

- We noted that the WCIRB policy examination staff verifies that policy forms issued by insurers have been approved by the CDI. For one of the sample policies, the policy form indicated by the insurer on the policy submission was

not a CDI approved form for that insurer. This discrepancy was pursued by the WCIRB policy examination staff and it was determined that the insurer had included the wrong policy form on the policy submission. The actual policy form issued by the insurer had been approved by the CDI.