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**Testimony before South Carolina Senate Workers' Compensation Study Committee
Columbia, South Carolina
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Thank you, Mr. Chairman and members of the Committee. Please feel free to interrupt me at any time if you have questions or if my comments need further explanation.

My name is Martin M. Simons. I am a member of the American Academy of Actuaries, an Associate of the Casualty Actuarial Society, and a Fellow of the Conference of Consulting Actuaries. Following several years of insurance industry experience, I served as Deputy Director and Chief Casualty Actuary for the South Carolina Department of Insurance for twelve years. Since that time, I have provided actuarial and technical insurance assistance to consumers, legislative, regulatory and other public agencies throughout the United States and Canada.

Since 1997, I have been the lead actuary for the Professional Team of the Florida Commission on Hurricane Loss Projection Methodology. I am the property and casualty actuary for the Hawaii Insurance Division and creator and Chairman of the Hawaii Hurricane Model Review Committee. I assisted in the creation of the Hawaii Hurricane Relief Fund, and served as technical advisor to the Fund throughout its existence.

I was involved in the establishment and approval of Hawaii Employers Mutual Insurance Company, an employer owned insurer that has written the State's previous workers' compensation "assigned risk" business at actuarially sound profitable rates since its inception, a decade ago.

I am a consultant to the Massachusetts Property Insurance Underwriting Association and have recently provided technical assistance to the California Earthquake Authority, the Florida Hurricane Catastrophe Fund and Florida State University. I am a regular speaker at meetings of the Casualty Actuarial Society and the Conference of Consulting Actuaries and have authored or co-authored several articles and technical papers on insurance regulation, rate making, accounting, and hurricane insurance.

I am actively involved in updating standards for the American Academy of Actuaries, including standards pertaining to the use of hurricane models, data quality and risk classification that are of extreme significance in South Carolina today.¹

Three weeks ago, as co-chair of the Natural Catastrophe Subcommittee of the Extreme Events Committee of the American Academy of Actuaries, I met with the Government Accountability Office (GAO) in Washington D.C. to present the Academy's position and to respond to questions pertaining to natural catastrophe insurance in the United States.

I have testified at each workers' compensation insurance loss cost and rate hearing in South Carolina, Hawaii and Oklahoma for the past twenty years, and have assisted the Hawaii and Oklahoma Legislatures in workers' compensation related legislation and analysis. I have also testified in Illinois, Colorado, New Mexico, Louisiana, and Texas specifically relative to workers' compensation insurance issues.

I was involved in the adoption by the National Association of Insurance Commissioners of loss costs and loss cost multipliers as the recommended rate regulatory procedure in the United States, was the only non-commissioner voting member at hearings held across the country to assess the benefits and challenges involved in implementing loss cost regulation, and subsequently chaired the NAIC Liaison Working Group and the working groups that drafted both prior approval and file-and-use language that have become the basis for the loss cost statutes and regulation in most states.

I have produced an analysis of the liabilities and expected future assessments of the South Carolina Second Injury Fund in 2003 and 2005² as well as a similar analysis for the Georgia Subsequent Injury Trust Fund in 2004³. I am currently updating the analysis for the Georgia Fund.

It is an honor to have been asked to speak to you today, and I sincerely hope that this testimony will provide meaningful information in your deliberations regarding workers' compensation insurance, and in particular the effects of the Second Injury Fund on our workers' compensation insurance market. You asked me to describe the reasons behind the extremely high Fund assessments in recent years, and whether it may be expected that those assessments will decrease and level off in the near future.

¹ Actuarial Standard of Practice Number 12 – Risk Classification may be found at:

http://www.actuarialstandardsboard.org/pdf/asops/asop012_101.pdf

Actuarial Standard of Practice Number 23 – Data Quality may be found at:

http://www.actuarialstandardsboard.org/pdf/asops/asop023_097.pdf

Actuarial Standard of Practice Number 38 – Using Models Outside the Actuary's Area of Expertise:

http://www.actuarialstandardsboard.org/pdf/exposure/asop38_exposure.pdf

² As requested, the 2005 analysis has been submitted with this testimony.

³ Georgia 2004 analysis as a Word or pdf document may be found at the GSITF web-site:

http://sitf.georgia.gov/00/article/0,2086,20194284_20300205_34075772,00.html

Before I begin, please understand that these remarks are solely mine, and for those who may view this testimony electronically as a pdf file, hold your mouse over the underlined portion of any one of the footnotes and depress the left mouse click to be taken directly to the site. If you do so, please be patient as some of these files are quite large, and may take a minute or two to download.

The assessments increased following pre-hearing legislative discussions beginning around 2002 relative to closure of the Second Injury Fund. At these and subsequent hearings, the Legislature was provided with a substantial amount of what I would term veracity challenged information regarding the effects of closing the Fund. For example, proponents of the Fund's closure originally expounded upon the substantial savings that would be gleaned by closing the Fund, but the way it was designed to operate, closing the Fund adds to rather than reduces the premiums paid by employers. In addition to evidence contradicting some of the erroneous information that had been provided to the Legislature, my testimony⁴ in those early hearings included a caveat that if the Fund was being closed to save money that in fact the opposite would result, and substantial additional analysis was recommended prior to any decision to close the Fund.

Insurers and self-insureds realized that there was a significant probability that the Fund would soon be closed, or would soon discontinue accepting unknown condition claims. They delved into their old claim files to see if some could be presented for reimbursement before the Fund stopped accepting them. As a result, the Fund witnessed increases in the number of claims submitted, and a great many of those claims were determined to be statutorily acceptable. Reimbursements were paid at a greater rate than at any time in the Fund's history, causing commensurate increases in the subsequent annual assessments. The additional claims submitted to the Fund were much greater than any of us had anticipated at the time, but with the benefit of hindsight as well as similar industry activity in Georgia, the cause of the increase is now quite obvious.

§ 42-7-310 subsection (d) of South Carolina statutes⁵ provides that assessment for the Second Injury Fund shall be calculated as

. . . one hundred seventy-five percent of the total disbursement made from the fund during the preceding fiscal year less the amount of net assets in the fund as of June thirtieth of the preceding fiscal year.

The seventy-five percent provides an effective safety valve for years when claims take an upward jump. Since the money available at the end of the year is subtracted in the formula, the seventy-five percent is more a "loan", than an expense.

⁴ The issues covered in my 2004 legislative testimony may be found at: <http://www.secondinjuryfunds.com/SC%20SIF%20SIMONS.pdf>

⁵ § 42-7-310 subsection (d) may be found at: www.scstatehouse.net/code/t42c007.htm

The way the system is designed, reimbursements from the Fund reduce insurers' claim costs, and these reductions are credited back against employers' claim files; thus reducing the loss costs and the employers' experience rating modification factors and reducing the penalty that the employer would otherwise have had to incur for hiring an employee with a previous impairment. The assessment is included in the insurance companies' loss cost multiplier, so that after accounting for those expenses directly involved in the process, the reimbursements and assessments are designed to offset each other as far as the employer is concerned. The Second Injury Fund process as well as the entire loss cost based rate making process hinges on the relationship between claims and expenses (assessments); and therefore on the relationship between the loss costs and the loss cost multipliers.

One problem caused by this increased claim submission activity is that these older claims for which the Fund is statutorily liable, and which made up a large portion of the influx of reimbursements, were beyond the period of time considered in the insurance industry's experience rating plan calculations. More than \$34,000,000 in reimbursements between 7/1/2004 and 6/30/2006 were for accidents that occurred more than 4 years prior.⁶ While the Second Injury Fund was established to provide assistance, mainly through the experience rating plan, to employers who hire disabled employees, these older reimbursements provided benefits to the insurance providers but not necessarily to employers, since the time period used in the experience rating plan had expired.

Perhaps a greater concern relates to the calculation of premiums paid by all employers. Second Injury Fund reimbursements are an integral part of the information needed to determine the appropriate loss costs. If everything functions as intended, a Second Injury Fund reimbursement will result in a reduction in the loss costs, regardless of whether the employer is experience rated or not. A claim is paid by either the Fund or the insurer, but not both, and insurers are statutorily required to reduce the claims they have incurred for reimbursements they have received, net of any expenses incurred in obtaining those reimbursements. When functioning correctly, the loss costs decrease and the loss cost multiplier increases for each reimbursement paid by the Fund. The absence of the appropriate reductions results in an unauthorized and unearned windfall to insurance companies at the expense of all employers.

This was one of several major concerns expressed by the Consumer Advocate during the recent loss cost hearings.⁷ Requests were made for information to determine whether insurers were reducing the incurred losses when reimbursements were received from the Fund as well as whether reductions had been made when insurers received subrogation recoveries from legally liable third parties (an issue of equally great potential magnitude). Given the fact that the Fund has reimbursed approximately \$1 billion since its inception, it is important to be certain that those reductions were properly reflected in the statistics

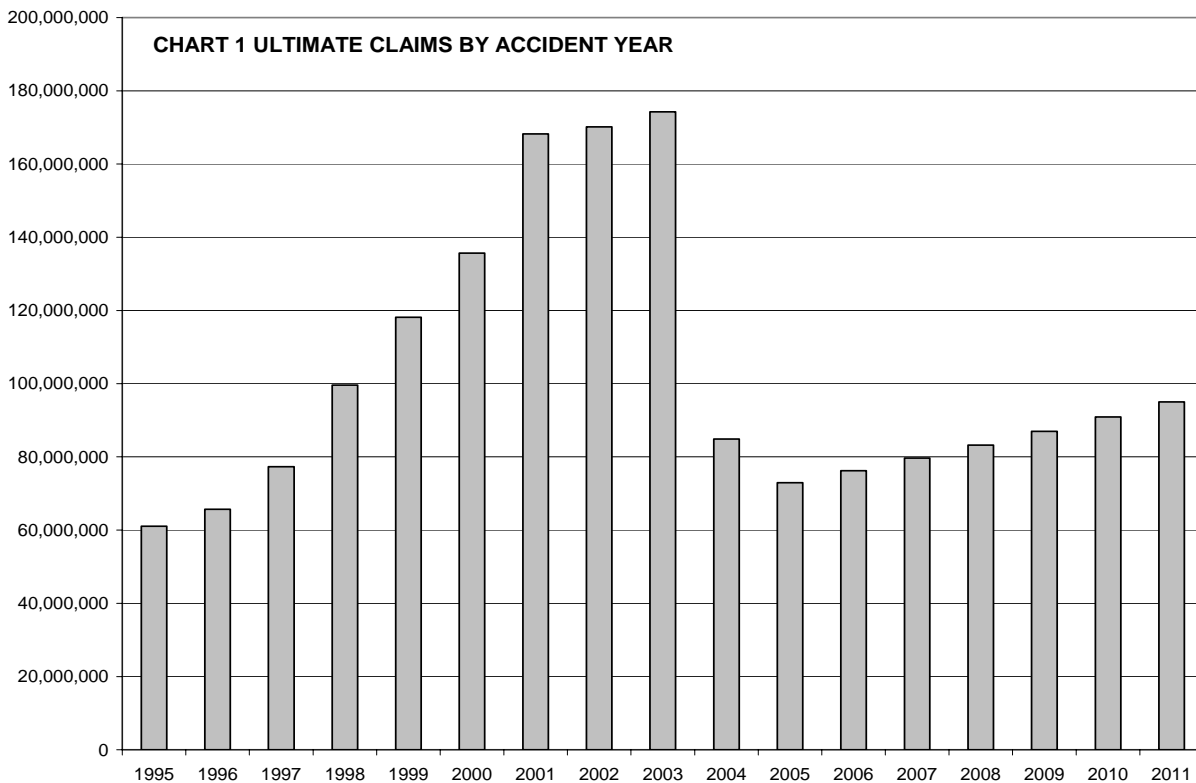
⁶ (Second Injury Fund Report LCL620NP)

⁷ A description of these concerns is found in my testimony in Docket No. 05-ALJ-09-0277-CC at: www.sconsumer.gov/advocacy/ncci_ca_testimony.pdf

used in calculating the loss costs. Testimony was presented at the hearings, and studies have been performed subsequent to those hearings that indicate there have been frequent incidents where the appropriate reductions have not taken place. The potential excess premium payments over the life of the Second Injury Fund are in the hundreds of millions of dollars, but we simply do not know what the actual amount is.

Since I have been frequently misquoted on this as well as a myriad of other contested issues related to South Carolina workers' compensation insurance this year, I'm compelled to reiterate that I am not accusing any specific insurance company of not making the appropriate reductions. It's just that nobody in South Carolina knows, and in recognition of the enormous potential impact on our employers and on our economy, I think we should.

The estimated effects of the 2003 legislation eliminating the unknown condition claims, may be seen in Chart 1 which follows. Each bar on Chart 1 represents the ultimate dollar amount of claims applicable to workplace accidents that occurred during that particular year. The ultimate claims are the dollars of claims that will finally be paid for the specific year after all claims for accidents that occurred in that specific year have been fully paid. The effect of the 2003 legislation is plainly visible in the shorter bars for the accident years following the passage of the legislation, indicating significantly lower estimated ultimate claims for accident years subsequent to the effective date of the legislation.

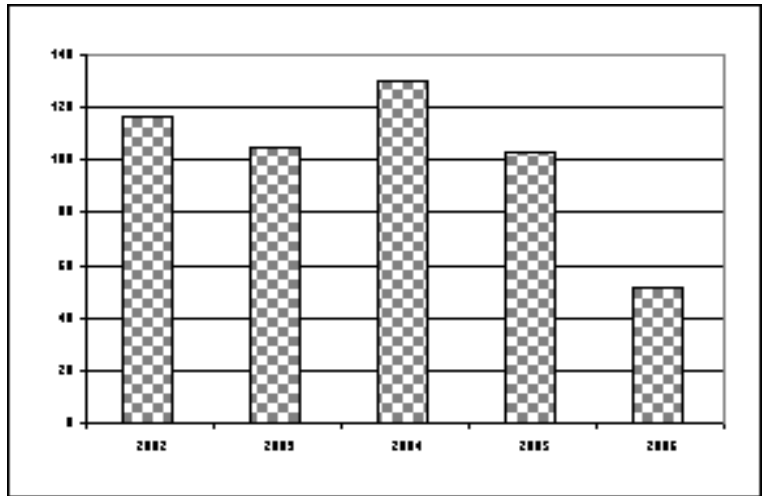


(source: Analysis of Liabilities and Estimate of Future Liabilities and Assessments of the South Carolina Second Injury Fund as of June 30 2005)

More recent information is now available from the Fund. The following table presents the dollars of claims paid for all accident years during fiscal years 2002 through 2006:

TOTAL AMOUNTS PAID BY THE SECOND INJURY FUND

<u>Fiscal year</u>	<u>Reimbursements</u>
2001-2002	\$ 116,479,287
2002-2003	105,213,295
2003-2004	129,885,013
2004-2005	102,993,214
2005-2006	51,642,650

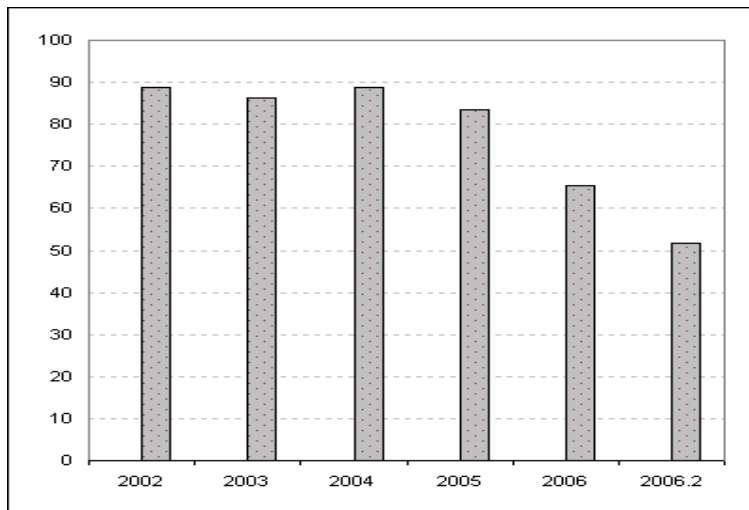


(source: South Carolina Second Injury Fund report LCL611NP)

As additional evidence that the 2003 legislation is working as planned, the following table shows the percentage of total claims that are “unknown condition claims” for each fiscal year”.

AMOUNTS PAID BY FUND FOR UNKNOWN CONDITION CLAIMS

<u>Fiscal year</u>	<u>% Unknown</u>
2001-2002	88.86
2002-2003	86.15
2003-2004	88.79
2004-2005	83.61
2005-2006	65.54
7/1 - 9/4/06	51.85



(source: South Carolina Second Injury Fund report LCL611NP)

Future assessments will continue to decrease with no further action on the part of the Legislature. The fiscal year assessments as estimated in the 2005 analysis are as follows:

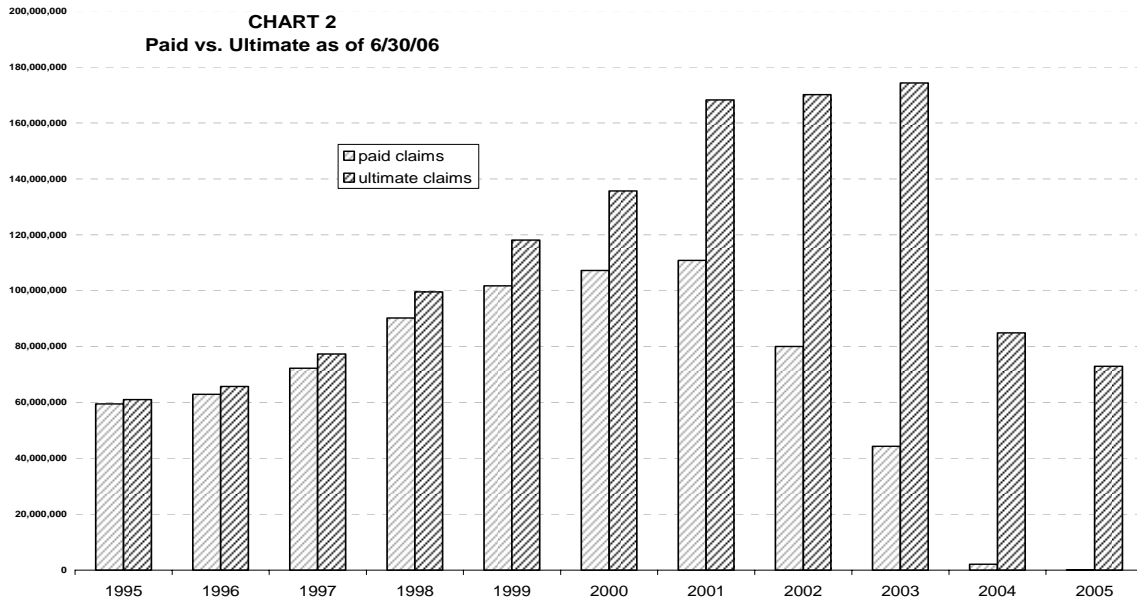
FUTURE SECOND INJURY FUND ASSESSMENTS

<u>Year</u>	<u>Estimated Assessment</u>
2007	\$ 85,000,000
2008	73,000,000
2009	69,000,000
2010	87,000,000
2011	83,000,000

(source: Analysis of Liabilities and Estimate of Future Liabilities and Assessments of the South Carolina Second Injury Fund as of June 30 2005)

Although I previously have been publicly awarded (but never actually received) a “thumb’s down” award from the Chamber of Commerce for having stated this, my professional standards require that I disclose that these are estimates of future behavior based upon currently available information and they may not prove to be accurate.

These recent Fund statistics provide compelling evidence that reductions as forecast in the 2005 analysis have been amply supported by subsequent experience. It was estimated that reimbursements, and hence assessments would drop substantially due to the 2003 legislation as well as the fact that there will eventually be a bottom to the industry’s old claim files. The actual reduction in old claim submissions is taking slightly longer than originally anticipated, but there have been substantial reductions in the number of new Second Injury Fund claims in the last half of 2005 and greater reductions through August of 2006. Excluding the effects of the 2005 temporal assessment adjustment, the Fund assessments would have dropped from \$250 million to somewhat close to \$110 million.



(source: Analysis of Liabilities and Estimate of Future Liabilities and Assessments of the South Carolina Second Injury Fund as of June 30 2005)

Our rate position relative to other states will continue to deteriorate for at least the next two or three years, regardless of what you do here, and regardless of the decision in the recent loss cost and rate proceedings. Chart 2 is provided to help explain why it takes so long for legislation to have an appreciable effect on the results.

Each darker bar on Chart 2 represents the ultimate claims for that specific accident year as did the bars on Chart 1. The lighter bars just to their left represent the amount of claims paid for those accident years as of June 30, 2005. The difference in height between the bars represents the amount of claims that have not yet been paid for that year. As you are well aware, the results of workers' compensation insurance reform legislation will generally apply to accidents that occur following the effective date of the act.

Looking at the rightmost bar on Chart 2 (accident year 2005), we can see that very few accident year 2005 claims have yet been reimbursed since the lighter bar is too small to be visible on the chart. In fact, as of June 30, 2005, \$101,000 was paid for accident year 2005 out of an estimated ultimate \$73 million to be paid. Looking on the far left of Chart 2, these two bars represent the paid and ultimate claims for accident year 1995. Of the \$61 million that will ultimately be paid for accident year 1995, \$59.5 million has been paid, leaving \$1.5 million still to be paid for accidents that occurred in 1995. If you will look at the differences between the shorter lighter bars and the taller darker bars, you will see the amount of claims still to be reimbursed by the Fund for each accident year.

Perhaps the most misunderstood aspect of the Second Injury Fund mechanism is the "unfunded liability". The term itself is a misnomer. These are not "unfunded" liabilities, but are estimates that represent future legal liabilities of those who are providing workers' compensation insurance in South Carolina (including insurers, self-insureds, self-insured groups, and the State Accident Fund). Although these liabilities are not included in the loss cost and rate-making calculations while the Fund is active, there are accounting rules that require insurers to carry a reserve for these future liabilities. If the Fund ceases operating, these obligations for future claims become direct insurer liabilities, and insurers will then rightfully be permitted to include them in their loss cost calculations. The rates will need to be increased to provide the future loss costs that would have been part of the "unfunded liabilities" if the Fund had continued to operate. In addition, the Fund will continue to reimburse insurers for accident years prior to the Fund closure. Assessments will continue until all claims have been paid; that is, until all of the lighter bars on Chart 2 are of the same height as the darker ones. These assessments (for prior accident years) will be in addition to the direct liabilities (for future accident years), and that is why costs will increase following closure of the Fund.

You have asked for my recommendations relative to future changes for the Second Injury Fund, and while I believe that this Committee is better served by my providing actuarial and technical information, my personal opinion is that we should sit back and see the results of what has been done before making any additional changes. At the very least, and some may experience a feeling of déjà vu when I say, "it is highly recommend that

an independent analysis of the entire South Carolina workers' compensation insurance system be performed before any decision is made relative to the future of the Second Injury Fund". In light of our rapidly deteriorating insurance cost position relative to all other states, this may not be the opportune time to further increase insurance costs and widen the "rate increase gap" between South Carolina and everywhere else. In addition, I personally believe that the Fund will have its work cut out for it as employment seeking veterans return to South Carolina from Iraq, Afghanistan and elsewhere.

I suggest that an analysis be performed, relative to the Second Injury Fund, before any major decision is made, and that the analysis address at least these issues:

- 1) Why did other states close their Funds?
- 2) How do those reasons compare to the situation in South Carolina?
- 3) What were the effects of those closures on employers and disabled employment seekers?
- 4) Did the ADA really eliminate the need for the Second Injury Fund?
- 5) What are the true net costs of the Fund?
- 6) What are its benefits?
- 7) What are the true net costs of closing the Fund?
- 8) What are the benefits of closing the Fund?
- 9) The NCCI testified at the loss cost hearing that as a part of the effects, South Carolina will save 10 to 30% of the claim costs if the Fund was closed, because the insurance industry would then be dealing with its own money instead of ours. Is that true, and if so, might we wish to do something about it?
- 10) Do Fund reimbursements reduce the loss costs as required by both the statute and the NCCI's statistical plan?
 - a. Who is supposed to be receiving the Fund benefits?
 - b. Who is receiving the Fund benefits?
 - c. Is the answer the same?
- 11) When adjustments were made to postpone part of the 2005 assessments, had employers already been charged for the higher assessments? If so, did those employers receive any benefit from the postponements?
- 12) Is there a way to just get rid of the bathwater?

These questions are specific to the Second Injury Fund. The criteria necessary to investigate the current state of workers' compensation insurance and to prepare strategies to improve the current situation include these as well as many others.

You don't need an actuary to tell you that insurance pricing is a complex art; certainly more art than science. The actuarial profession thrives on contention, and it is quite normal to have three actuaries analyze the same set of statistics and arrive at three different conclusions (or in the case of our recent hearings, five different conclusions). Actuaries are assessors of future risk based upon currently available knowledge. Rather than a specific answer, the process produces estimates based upon what is available to us at the time of the analysis. By its very nature, there is a tendency for biases to affect the estimations and results. This is clearly evident in the Administrative Law Court order

following the 2001 South Carolina workers' compensation loss cost and rate hearing.⁸ This Order provides a wealth of information relative to the questions you've asked throughout your workers' compensation investigations and clear and detailed descriptions of how loss costs are made as well as the accounting for the expenses, taxes, assessments, investment income and profit factors that make up the loss cost multiplier.

Actuaries are bound by strict professional standards that include mandatory disclosures relative to how we reach our conclusions⁹. Those of you who rely on the work of actuaries to make or amend laws, establish or regulate insurance rates should look at each actuarial product placed before you to determine whether it includes any inherent bias. Be skeptical of us. Demand information about the data, methods, and most important, the rationale behind each estimate or opinion, and don't accept any actuarial work product that doesn't provide detailed disclosures and clear answers to your questions as to how that estimate, projection or opinion was derived.

This applies not only to workers' compensation but to all lines of insurance. The potential for bias, errors and invalid assumptions is large enough when pricing workers' compensation or automobile insurance, but that potential is far greater when pricing hurricane insurance since there are not only insurance variables, but also meteorological, geographic and engineering variables that must be considered in establishing loss costs that are not excessive, inadequate or unfairly discriminatory in accordance with South Carolina statutes.

South Carolina is losing ground at an extraordinary pace as our insurance rates increase by greater amounts than in any other state, and as the industry requests rate increases exceeding those requested in any jurisdiction over the past fifteen years. While it may have been suggested that our current problems are due to workers' compensation loss costs that were "too low" in prior years, a proper analysis will prove this contention to be misguided and limited at best.

In summary, you are in control of a long fully loaded freight train traveling at full speed on a snaky downhill grade, and your goal is to get that train to go in the opposite direction. I wish you the best of luck.

Thank you for your attention. I will attempt to answer any additional questions.

⁸ The decision (order) in the 2001 South Carolina hearing may be found at: www.scale.net/doi9/doi9_1/000687.htm

⁹ Actuarial Standard of Practice Number 41 – Actuarial Communications - may be found at: http://www.actuarialstandardsboard.org/pdf/asops/asop041_086.pdf