Manual Override

Special Audit

Audit Begin Date: October 2005
Audit End Date: October 2006

Distributed to:

Bill Mabe, Administrator
Cathy Moseley, Chief of Staff
Tina Kielmeyer, Chief Operations Officer
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IA

To: Bill Mabe, Administrator
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From: Joe Bell, Chief of Internal Audit
Keith Elliott, Manager, Internal Audit

Cc: Cathy Moseley, Chief of Staff
James Barnes, Chief Legal Officer

Date: December 20, 2006

Re: Manual Override Special Audit

At the request of the BWC Administrator, the BWC Internal Audit Division performed a special audit of the manual override processes involving employer experience modifiers (EM), claims costs or Micro Insurance Reserve Analysis (MIRA) reserves.

The objective of the audit was to ascertain the adequacy of internal controls over the manual override processes and to determine the appropriateness of a sample of overrides processed during the audit period.

The scope of the project included a review of existing controls and an examination of a sample of override transactions performed from January 1, 2003 to September 30, 2005 and focused primarily on those overrides performed as the result of administrative order/executive decision or request by BWC management.

Due to the nature of this special audit, typical audit procedures were not employed, such as entrance conferences and management update meetings. However, we appreciated the timely and detailed responses to address the issues noted in this report. We also thank you for all the cooperation shown to us by your personnel that we engaged during this audit.

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EXECUTIVE SUMMARY

The BWC Internal Audit Division conducted an audit of the manual override processes involving employer experience modifiers (EM), claims costs or Micro Insurance Reserve Analysis (MIRA) reserves during the period January 1, 2003 through September 30, 2005.

I. Activity Reviewed:

- Obtained an understanding of the procedures and internal controls over manual overrides of employer claim costs, reserves, and/or EMs in the Rates and Payments (R&P) system;
- Determined whether controls in place provided reasonable assurance that manual overrides were properly authorized, reasonable, accurate, and complete;
- Determined whether BWC policies and procedures relating to manual overrides complied with Ohio Revised Code (ORC) and Ohio Administrative Code (OAC) requirements; and
- Evaluated whether overrides were appropriate in light of law and policy.

II. Observations:

1. During the period of testing, no written policies and procedures existed for the overrides of EMs, MIRA reserves or claims costs. (Comment Rating: Material Weakness)
2. The assignment of responsibility for processing manual override transactions is in the same area responsible for assisting employers in dealing with issues, which can increase the potential for inappropriate transactions. (Comment Rating: Material Weakness)
3. No quality assurance procedures were in place to provide assurance regarding the appropriateness of override transactions processed by supervisory/managerial personnel. In addition, quality assurance procedures for override transactions processed by staff were inadequate. (Comment Rating: Material Weakness)
4. BWC's Rates and Payments system does not enable identification of deactivated override transactions. Programming for the system does not result in deactivated reserve overrides reverting back to the previous levels, which may result in incorrect rates for employers with deactivated reserve override transactions. (Comment Rating: Significant Weakness)
5. Of the manual overrides of employer EMs tested, approximately 75% (27 instances) were deemed exceptions as they did not appear to follow fixed and equitable rules; appeared to contravene existing policy; and/or there was no documentation authorizing or explaining the reason for the overrides. (Comment Rating: Material Weakness)
6. Group rating programs resulted in rating inequity between group rated and non-group rated employers, causing non-group rated employers to pay a subsidy to off-set the high discounts received by some groups. A study performed by BWC's independent actuary for the 2002 group rating year indicated the subsidy was $169 million for private employers. (Comment Rating: Material Weakness)

III. Recommendations:

1. Establish and maintain written policies and procedures to govern the processes for EM, MIRA reserve and claim cost overrides.

2. Reassign the function of making adjustments to employers' claim costs, reserves, or EMs to the BWC Actuarial Department. Require signatures of senior management from at least two divisions for approval of overrides.
3. Revise security profiles in the Rates and Payments system so management cannot perform override transactions. Review all override transactions performed by staff personnel to provide reasonable assurance regarding the appropriateness, validity, and accuracy of the overrides processed.
4. Modify the Rates and Payments system to display all EM override activity and ensure MIRA reserves revert to previously predicted values upon the removal of overrides.
5. Develop fixed and equitable rules controlling the effect on rating calculations of claim costs arising from factors outside employers' control and other instances in which override transactions are performed.
6. Resolve the current rating inequity between group rated and non-group rated employers. Adopt standard controls to prevent rate manipulation by employer groups. Possible corrective actions could include restoring credibility factors assigned to employer groups to levels consistent with sound actuarial standards and prohibiting groups from utilizing claims experience as an eligibility criterion for group participation.

IV. Management Responses:

1. In June 2006, management developed and implemented policies over these processes. Management will develop a form to be used when requesting EM overrides. The existing Experience Modifier Override Policy will be modified to reflect process changes.
2. The Rate Adjustment Unit was reassigned to the Actuarial Department in November 2006. Approval of overrides by management will be defined within the new policies.
3. Management will eliminate the ability of supervisory personnel to perform override transactions and supervisors will review and approve staff override transactions to ensure appropriateness, validity and accuracy of the overrides processed.
4. In November 2006, recommended system changes were implemented.
5. Management will develop rules, policies and procedures for employer rating adjustments.
6. Management engaged an independent actuarial consultant to evaluate the group rating program and recommend changes. This report is due to management by December 2006. Once these recommendations are received and a corrective course of action is developed, management will support implementation of the plan.

V. Auditor Opinion:

Overall, our review found internal controls for the manual override process to be inadequate. There were three areas identified that could be improved:

- Lack of written policies, procedures and system documentation;
- Inappropriate segregation of duties; and
- Rating inequity between group rated and non-group rated employers.

Management is generally in agreement with the recommendations and has committed to an action plan for implementing the changes.

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BACKGROUND

BWC personnel informed the former Internal Audit Department that reductions were being made to employers' Micro Insurance Reserve Analysis (MIRA) reserves or experience modifiers (EMs) in the Rates & Payments (R&P) system with very little documentation supporting the decisions to perform the override transactions. They further indicated that the appropriateness of some of these reductions appeared questionable. These concerns were subsequently discussed with Administrator Bill Mabe and a special audit was requested.

Manual adjustments to an employer's reserves or EMs are called "overrides." Some overrides result from more systemic issues and are routine, while others involve requests from employers for special consideration.

Based upon information obtained during our review, the legal basis used to support most overrides predicated on special circumstances was cited by the BWC Legal Division as being contained within ORC 4123.34 (C). This section states, "The administrator may apply that form of rating system which he finds is best calculated to merit rate or individually rate the risk more equitably, predicated upon the basis of its individual industrial accident and occupational disease experience, and may encourage and stimulate accident prevention. The administrator shall develop fixed and equitable rules controlling the rating system, which rules shall conserve to each risk the basic principles of workers' compensation insurance."

Special circumstance overrides may also be provided for catastrophe claims, as defined in OAC 4123-17-12 (A). Within this section, a "catastrophe" is defined as "…an occurrence in which two or more employees of one employer are killed or receive injuries resulting in permanent and total disability." and (E), "Notwithstanding the provisions of this rule, the administrator may consider any special circumstances which may affect the determination of a catastrophe loss."

The population of override transactions includes overrides of EMs, Claims Costs and/or MIRA reserves. According to information contained within the BWC R&P system, as provided by the BWC IT Division, the total override transactions from January 1, 2003 to September 30, 2005 include the following:

Type of Override	Number of Override Transactions	Transactions Involving Administrative Order
Experience Modifier	153	151
Claims Costs	551	(*)
MIRA Reserve	376	28

(*) - Information within the R&P system does not differentiate claims cost overrides involving Administrative Order.

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SCOPE AND OBJECTIVES

Manual overrides created during the period January 1, 2003 through September 30, 2005 and related procedures and internal controls were examined.

The objectives of the audit were:

1. To obtain a thorough understanding of the procedures and internal controls over manual overrides of employer claim costs, reserves, and/or EMs in the R&P system;
2. To determine whether controls in place provide reasonable assurance that manual overrides are properly authorized, reasonable, accurate, and complete;
3. To assure that BWC policies and procedures relating to manual overrides are in compliance with ORC and OAC requirements; and
4. To evaluate a sample of overrides for appropriateness in light of law, policy, and fiduciary responsibility.

In order to accomplish the objectives listed above, the following procedures were performed:

- Reviewed applicable provisions in the ORC and OAC;
- Obtained written policies and procedures that govern the override process;
- Obtained reports of all overrides for the audit period from the IT Division;
- Selected the largest overrides for evaluation;
- For EM overrides, reviewed the Workers' Compensation Information System (WCIS) notes and screens;
- Reviewed the Recalculated Employer Experience Modifier screen on the R&P system;
- For MIRA reserve or experience overrides, reviewed WCIS notes and Version 3 (V3) notes and imaged documents;
- For MIRA reserve or experience overrides, reviewed the Quarterly Claim Analysis Detail screen on the R&P system;
- Reviewed risk files;
- Requested emails and/or any other supporting documentation from employees that processed the overrides;
- Searched the Adjudicating Committee (AC) database to determine whether the overrides contravene any AC or Administrator's Designee orders; and
- Accessed V3 and WCIS data on claims and employers to verify underlying events and evaluate the propriety of transactions.

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OBSERVATIONS AND RECOMMENDATIONS

Observation #1: During the period of our testing, no written policies and procedures existed for the overrides of EMs or reserves, or for associated claim cost adjustments. Also, documentation for the authorization of override transactions was insufficient.

Written policies and procedures provide a basis for ensuring accountability for the proper processing of transactions and to document the prescribed processing steps and authorization requirements. All special transactions which otherwise fall outside of the normal business process should be fully documented and provide background on the reason for the request and the rationale for the ultimate adjudication of the request. Failure to provide such documentation decreases accountability for such decisions.

In our review, the risk files did not contain authorization documentation from executive management for 23 EM or MIRA reserve overrides. Instead, most of the documentation evidencing approval of the overrides was contained in e-mail records. Many e-mails requesting the transactions merely referenced the approval by a member of executive staff and in most instances the member of executive staff allegedly authorizing the transactions was not copied on the e-mails. In 36 instances, documentation for the reasons for overrides was absent. When a member of one of the units responsible for processing overrides requested that the requests include sufficient documentation and justification for the transactions, they were instructed that such documentation was not required.

In 33 instances of EM or reserve overrides or claim cost adjustments, WCIS notes did not contain a description of the transaction or contained only a generic reference to approval of the transaction without any rationale or business reason behind the decision to perform the override.

The lack of written policies and procedures can increase the probability of noncompliance with laws or regulations, increase the risk of errors and irregularities, reduce accountability, and impede training of new employees. In July 2006, the Experience Modifier Override Policy was implemented by BWC management.

Lack of adequate documentation of an override transaction decreases accountability for such transactions and potentially raises questions as to the accuracy and appropriateness of undocumented transactions. If authorization from the proper level of management is not documented, the transaction may have been executed outside of policy. Authority cited indirectly also compromises accountability. When the calculation of transaction amounts is not documented, the risk of error is increased.

<u>Recommendation:</u>

Establish and maintain written policies and procedures to govern the EM and MIRA reserve override function, including claim cost adjustments performed as part of an override transaction (i.e., outside of established business rules). These policies and procedures should document the situations and circumstances in which overrides can be performed, the required documentation to be submitted to the party approving such transactions, the individuals authorized to approve such transactions, and the specific information to be included in the WCIS notes and the risk file documenting the approval of the override.

To improve accountability and transparency of override transactions, establish formal policies regarding the documentation and approval of override transactions to include:

- A standard form for requesting and approving override transactions;
- Detailed documentation requirements for such transactions, which should include:
  - Key employer identification information (i.e., employer name, tax identification number, policy number, employer representatives, etc);
  - A statement regarding the reason the override is being requested;
  - Background rationale for the reasons the party feels that the transaction should be performed;
  - Where claims costs are being reduced for one or more claims, the documentation should include a summary of the facts in the claim(s). The summary provided by the requestor should be validated prior to processing and any discrepancies or inaccuracies should be clearly documented on the form;
  - Formal signature by the party authorizing the transaction, with detailed rationale for the approval of the override. For "special circumstances" overrides, approval documentation should describe the nature of the "special circumstances";
  - Overrides should require, at a minimum, the approval of the Administrator, Chief Financial Officer, and Chief Operations Officer. No override transactions should be processed without required signatures and policies and procedures manuals should stipulate this requirement;
  - WCIS notes should be required to include key information included on the authorization document to enable a reviewer of the WCIS notes to obtain an understanding of the reasons for the overrides performed; and
  - If an override does not go through the standard Adjudicating Committee process, the form should explain the reason for the deviation.

Designated Chief: **Chief Operations Officer**
Comment Rating: **Material Weakness**
Management Response: **Agree**

Management agrees with the recommendation to create a form for overrides and with the recommendation of maintaining written policies and procedures for EM overrides. The belief was so strong regarding this that a formal written policy was finalized by the EM Policy department and implemented in July 2006. Preceding this formal policy, informal directives to staff regarding approval processes and documentation requirements were communicated in late 2005. Management will take the following additional actions:

- *Management will develop a form to be used when requesting EM overrides; and*
- *The existing Experience Modifier Override Policy will be modified to reflect the reorganization as described in Observation #2. Additionally, the Chief of Employer Operations and the Finance Division will ensure input is received by the Internal Audit Division and make policy changes accordingly.*

Target completion date: January 2007

Observation #2: Currently, the assignment of the responsibility for processing manual overrides resides within the Employer Operations Department, which results in inadequate segregation of duties over this process. Housing the area responsible for performing override transactions in the same area that is responsible for working with and assisting employers in dealing with issues can increase the potential for inappropriate transactions.

Overrides of claims costs, EMs and MIRA reserves are currently performed by either the Employer Rate Adjustment Unit or the Employer Programs Unit, both of which are located within the Employer Operations Department. However, the Actuarial Department within the Finance Division is ultimately responsible for the integrity of information used in rate making.

The responsibility for processing override transactions previously resided under the Actuarial Department. However, during a prior agency restructuring (1996), this responsibility was transferred to the Employer Operations Department.

The practice of assigning responsibility for the authorization and processing of override transactions which impact rate making decisions outside of the Actuarial Department increases the risk that such transactions may not conform to sound actuarial principles.

Recommendation:

Place the function of making adjustments to employers' claim costs, reserves, or EMs in the R&P system within the BWC Actuarial Department. Overrides should require, at a minimum, the approval of the Administrator, Chief Financial Officer, and Chief Operations Officer.

Designated Chief:	**Chief Financial Officer**
Comment Rating:	**Material Weakness**
Management Response:	**Agree**

Management agrees that the adjustment function should be assumed by BWC's Actuarial Department. Further, management recognizes that EM overrides result in financial impacts to employers and the SIF and that sound rules and internal controls are imperative to ensuring rating integrity and compliance with applicable rules.

The Chief of Employer Operations in conjunction with the Finance Division and the Director of Employer Policy will work with appropriate BWC staff to revise and update the current formal written policy for the EM override function (to include EM, claim costs, and/or MIRA reserve overrides) and ensure documented procedures, controls and quality assurance procedures are addressed as Finance assumes the responsibility for this function.

Management transferred the Rate Adjustment Unit from Employer Operations to Finance on November 20, 2006. This transition will also include a review of current workflows, policies and procedures to determine how the process currently operates and the various control points. In addition, this will include a review of current staff roles and responsibilities to identify the appropriate staff to perform these functions.

Target completion date: January 2007

Observation #3: At the time of audit, no quality assurance procedures were in place to provide assurance regarding the appropriateness of override transactions processed by supervisory/managerial personnel. In addition, the quality assurance procedures for override transactions processed by staff in the Employer Programs Unit were inadequate to provide assurance that only properly approved transactions are processed and that such transactions are processed accurately.

Different levels of management in Employer Operations have update access in the R&P system allowing them to process overrides. However, there is currently no quality assurance process in place for reviewing the override transactions performed by these individuals, which increases the potential for inappropriate override transactions to be performed and go undetected.

In addition, the quality assurance review procedures currently used for overrides to the EMs of group rating plans (performed by staff within the Employer Programs Unit) are not designed properly to ensure appropriate control over these transactions. For these override transactions, co-workers within the unit provide documentation for the transactions they process to designated co-workers for their review. There is currently no reporting to provide assurance that all transactions processed have been forwarded for review and the supervisor is not involved in reviewing these transactions. The reviews also have not been documented.

Sound systems of internal control require that management establish control procedures to provide reasonable assurance regarding the accuracy of transactions processed by supervisory personnel by implementing a random review of transactions by an independent third party. In addition, quality assurance reviews should be performed based on reports of transactions actually processed, not from hardcopy transaction documents provided by the party processing the transactions, as the party could easily conceal inappropriate transactions by simply failing to forward documentation for such transactions.

Recommendation:

Revise security profiles in the R&P system for the Director of Employer Rate Adjustments and Supervisor of Employer Programs Unit so they cannot perform override transactions. All override transactions should be performed by appropriate staff. The Director of Employer Rate Adjustments and the Supervisor of Employer Programs should establish controls to provide reasonable assurance for the appropriateness, validity, and accuracy of the overrides processed.

These review procedures should include, but are not limited to:

- Use of data warehouse or other systemic reports to identify all such transactions processed;
- Required reviews of larger/more significant overrides and random review of other transactions;
- Documentation of the reviews performed, including the results and/or any follow-up actions needed based on the review findings;
- Retention of review documentation for a period of at least one year; and

- Detailed policies and procedures stipulating the step by step procedures to be performed during the reviews, record retention requirements, and procedures for dealing with issues identified during the reviews.

Designated Chief: **Chief Financial Officer**
Comment Rating: **Material Weakness**
Management Response: **Agree**

Management agrees with the need to eliminate the ability of supervisory personnel to perform override transactions. The Experience Modifier Override policy which went into effect in July 2006 specifically addressed and corrected this past deficiency.

A systems change control request was submitted in 2005 requesting a reconfiguration of the employee security profiles in R&P for all affected employees in Employer Services. To date, the change has not been implemented; therefore, employees within Employer Services will continue to have access to update EMs or claim cost/reserves until the change is executed. The Chief Operations Officer will work with the Chief Information Officer to ensure that the security profiles are modified and that a scheduled report is developed.

In January 2006, Employer Rate Adjustment Unit implemented a new EM override process where the Director was not permitted to update the EMs but would assign this to the underwriter resulting in the segregation of duties.

In addition, management also agrees that management staff should ensure appropriateness, validity and accuracy of the overrides processed. The Experience Modifier Override policy which went into effect in July 2006 specifically addressed this recommendation.

Employer Rate Adjustment submitted a systems change control request in 2005 for the creation of a scheduled report that reflects not only EM overrides, but all adjustments/ overrides to claim costs/reserves completed in R&P. To date, this report has not been systematically generated. However the unit requests IT to run a report to reflect all EM overrides within a certain period and identify the employee number. This report is compared to the EM Override Tracking database that is maintained in the Employer Rate Adjustment Unit. The report is reviewed by management and any override on the IT report not listed in the database is immediately reviewed. When rates were adjusted in WCIS prior to 2002, a comprehensive report was developed to reflect such data. We are still lacking this data in the new EM Recalc system. Until a report can be generated automatically on a monthly basis, the Unit must submit a change request each time.

The existing Experience Modifier Override Policy will be modified to reflect the reorganization as described in observation #2. Additionally, the Chief of Employer Operations and the Finance Division will ensure input is received by the Internal Audit Division on the adequacy of the controls in the policy and make changes accordingly.

Target completion date: January 2007

Observation #4: The current programming for deactivated override transactions results in an inability to easily identify deactivated override transactions in the R&P system EM Recalculation Override Listing screen. Additionally, programming for the system is not resulting in deactivated reserve overrides reverting back to the previous levels, which may result in incorrect rates for employers with deactivated reserve override transactions.

EM overrides for individual employer policies that are subsequently deactivated are not reflected on the R&P Employer Policy EM Recalculation Override Listing screen. In the case of a reserve override created on February 25, 2005 for a claim that was removed on April 4, 2005, the reserve did not revert back to the previously predicted value. It was found that the coding that should have resulted in reserves reverting back to previously predicted values was faulty.

All activity related to EM overrides should be evidenced in the R&P system Employer Policy EM Recalculation Override Listing screen. Overrides that are manually removed should allow EMs or reserves to revert back to previously predicted values.

There were instances of overrides of individual employer EMs during the audit period that applied to policy years after 2002 (those for policy years 2002 or earlier were not reviewed due to the lack of data in the R&P system). Five of the EM overrides had deactivation dates other than 1/1/3000 (default date) as of testing. There were 68 overrides of MIRA reserves during the audit period that had deactivation dates other than 1/1/3000 as of testing.

Deactivated overrides not displayed on the Employer Policy EM Recalculation Override Listing screen impede the investigation of EM overrides potentially allowing inappropriate activity that might not be readily identified. The failure of MIRA reserves to revert back to previous values when overrides are removed can thwart the intentions of those processing the removals, resulting in errors in rate making and revenue collection.

Recommendation:
Modify the R&P programming to display all EM override activity in the Employer Policy EM Recalculation Override Listing screen. In addition, programming should be corrected to ensure that MIRA reserves revert back to previously predicted values upon the removal of overrides.

Designated Chief: **Chief Information Officer**
Comment Rating: **Significant Weakness**
Management Response: **Agree**

IT personnel worked with the Actuarial Department to correct the coding that prevents EM and reserves from reverting back to previously predicted values after the removal of an override. The failure of MIRA reserves to revert back to previous values when overrides were removed was treated as a defect. As of November 14, 2006, both system changes were implemented.

Target completion date: Implemented (November 2006)

Observation #5: Approximately 75% of the manual overrides of employer EMs which we tested were deemed exceptions as they did not appear to follow fixed and equitable rules, appeared to contravene existing policy and/or we could find no documentation authorizing or explaining the reason for the overrides.

During our review we examined overrides over employer EMs or MIRA reserves which were done by "Administrative Order." Of the overrides examined, we deemed that 27 were exceptions due to the fact that the overrides appeared to not follow fixed and equitable rules regarding rate making, appeared to contravene existing policy and/or we could find no documentation authorizing or explaining the reason for the overrides. The following expands on the types of overrides tested that we deemed exceptions:

- In one instance (in 2004), an electrical employee worked for the same company for 30 years, retired from the company and was later diagnosed with and died from asbestosis. The employer did not appeal the claim. Once the claim hit the employer experience, the employer premiums were impacted and the employer was faced with being removed from their group rating program and indicated they would be forced to close their business and move to another state. After an inquiry to the BWC Constituent/Legislative Affairs and subsequent review of the case by BWC management, the entire claims costs were removed from the employer's experience. Authorization documentation involved an e-mail from management citing the approval for the adjustment. According to e-mail records, the employer was unwilling to meet with BWC representatives to discuss other programs currently in place to help reduce the impact of the claim, and would only consider complete elimination of the claim from its experience;
- In another instance (in 2004), an experience modifier for a group with 700 employers was reduced from .12 to .05 which would help remedy an increase in the group's premiums caused when a Professional Employment Organization (PEO) was permitted to join the group and then enrolled an employer with negative claims experience. In order to minimize impact to the group's rates, BWC management agreed to permit the PEO to change the dates on the employee leasing arrangements and allowed the PEO to transfer the employers to another policy. Based upon e-mails pulled by the BWC IT Division, one manager indicated that the activities requested by the group and the PEO seemed to indicate potential rate manipulation, yet the override was granted. This case also involved a request for special consideration for the employer;
- Other cases were noted in which the claims appeared to be legitimate and due to relatively common accidents for the type of business in which the employer participated, yet overrides were granted to modify either the claims costs, EMs or the employer reserves;
- Some cases were identified in which overrides were granted to minimize the effects of claims caused by events outside of the employers' control (i.e., tornado related claim, 9-1-1 claims resulting from World Trade Center terrorist act). However, there are no policies stipulating the ability to perform overrides in such instances.

Based upon information provided by the BWC Actuarial Department, the effect of the 27 questioned overrides reduced the affected employer premiums by approximately $3.8 million.

Granting relief from costly claims to some employers in order to reduce their premiums or keep them in group programs results in the appearance of giving preferential treatment to a limited number of entities. Granting relief from claim costs outside their control to some employers on a case by case basis creates the potential for allegations of favoritism. Premium revenue forgone by such relief is inequitably shifted onto the general employer community via higher base rates.

Recommendation:
Methods employed by BWC to determine premium rates for employers should comply with ORC 4123.34 (C), which prescribes fixed and equitable rules that provide to each risk the basic principles of workers' compensation insurance. These rules should preclude favoritism, or its appearance, as much as possible as stipulated by OAC 4123-15-03 (G).

Develop fixed and equitable rules controlling the effect on rating calculations of claim costs arising from factors outside employers' control and other instances in which override transactions are performed. In addition, these rules should specify the role of the Adjudication appeals process in hearing and approving such overrides.

Designated Chief:	**Chief Financial Officer**
Comment Rating:	**Material Weakness**
Management Response:	**Agree**

Management agrees with the recommendation to establish rules regarding rating calculation adjustments. While employer EMs are calculated by the rate making system based on actual payroll and claim losses, pursuant to OAC 4123-17-03, at times, as the result of business or court decisions, it is necessary and appropriate to adjust an employer's EM even when the controlling payroll and losses are accurately reported. These overrides to an employer's EM can be generated from various sources including: court orders, Administrative/Adjudication orders, executive decisions and system corrections.

Management contends the current rating system does not provide for adjustments to employer claims reserves on a case by case consideration as is standard in the insurance industry. Other industry considerations such as scheduled rating for appropriate employers should also be explored to further mitigate the necessity for justified EM overrides. Further, management recognizes that EM overrides result in financial impacts to employers and the State Insurance Fund and that sound rules and internal controls are imperative to ensuring rating integrity and compliance with applicable rules.

- *Management will research and develop rules, policies and procedures for employer rating calculation adjustments. Specifically, management will develop rules for court orders, Administrative/Adjudication orders, executive decisions and system corrections; and*
- *Management will engage in benchmarking and analysis of insurance industry practices of scheduled rating of employers by BWC underwriters and individual case reserving by BWC Claims Service Specialist (CSS) or other specified staff as is standard in the commercial insurance industry.*

Target completion date: March 2007 (rating calculation adjustments) and July 2007 (benchmarking)

Observation #6: Many of the conditions giving rise to employer requests for overrides of EMs, claims costs or reserves were the result of the employers being removed from group rating programs in which they were enrolled (by their group sponsoring organizations) as a result of their claims experience. Various problems with the group rating programs have resulted in rating inequity between group-rated and non-group-rated employers, which is causing non-group rated employers to pay a subsidy to off-set the high discounts received by some groups. Based on information contained in a 2004 study by the BWC actuarial consultants, this subsidy began shortly after the inception of group rating. For the 2002 group rating year, the study indicated that the subsidy was $169 million for private employers. Annually, this subsidy amounts to approximately 8 percent of premium revenue.

In many cases, the premium increase being experienced by the employer was minimal over what they would have experienced if they were not in a group. However, since many participants in group rating programs receive as much as 95% discount over the standard base rated premiums, being ejected from these programs in some cases would have resulted in a 20-fold increase in the amounts required to be paid by the employers (e.g., from 5% of base-rated premium to 100%).

The following are a number of concerns that were identified within the actuarial reports pertaining to the group rating program:

- Purpose of Group Rating Program Establishment Not Achieved – The initial formation of the group rating programs was to help improve safety for injured workers since members of groups with poor claims experience would impact the premium costs of the other members, which would then potentially create peer pressure for improvement in safety activities and result in lower claims frequency and severity. However, because groups frequently remove employers from their groups when they have claims, this intended benefit of group rating is not being realized.
- Reasonableness of the 95% Discounts to Group Members – The group rating discounts received by many (but not all) group rated employers are high and premiums are in some in stances insufficient to cover the claims expenses incurred by those employers during the rating period. A study of group loss ratios for 2002 identified many groups with loss ratios ranging between 250% and 810%, which indicates that the claims costs for these groups were between 2.5 and 8 times the amount of premium paid by the employers in the groups for that year. Since revenues have to be sufficient to cover all claims costs incurred by BWC, the base rates for non-group rated employers must be increased to make up for the steep discounts some group members receive. A number of studies conducted by the BWC actuarial consultants over the last ten to fifteen years have stressed that there is a current rating inequity between group and non-group rated employers which should be addressed. These studies specifically recommended a significant reduction in the discounts provided to group rated employers and a corresponding increase in the premiums charged to these employers. These recommendations were not adequately addressed by BWC.
- Claims Experience as an Eligibility Criteria for Group Membership – The current group rating program permits group sponsors to utilize an employer's claims experience as an eligibility criterion for membership in groups. If employers have high, or even normal, claims experience they are frequently not permitted to enroll in

the group the following period. The actuarial consultant recommended in 1991 that BWC not permit groups to use claims experience as an eligibility factor, as this practice would permit groups to establish memberships with abnormally low experience in order to manipulate the premiums for those groups. The consultants indicated that such manipulation would result in rating inequity between the group rated and non-group rated employers, with the non-group employers paying higher than they should have paid and the group rated employers paying less. Despite these very clear recommendations, BWC did not take action to prohibit this practice.

- Credibility Levels Currently Assigned to Groups – Part of the benefit of group rating is that by forming the larger employer groups, the credibility (or predictability) associated with the employer experience is greater. The credibility factors are a significant component in the calculation of employer premiums. However, due to the ability of the groups to expel employers with poor claims experience, past studies by the actuarial consultant indicated that credibility factors assigned to group rated employers were no longer actuarially correct. A 1995 study indicated that the maximum credibility that the groups should receive should range between 68% and 77% for the years 1991 and 1993. A 1994 actuarial consultant memorandum also indicated that the credibility assigned to each group should possibly vary depending on the length of time the group has been in existence. Under this recommendation, they indicated that a group formed within the last year might only qualify for a 65% credibility, while groups formed four or five years prior might qualify for an 85% credibility factor. Despite these observations by the actuaries, the credibility factors assigned to the group rating programs are currently 93% and there is currently no variability in these factors based on the number of years the groups have been in existence. While they had previously recommended that BWC reduce the credibility percentages by 10% each year for three years to restore them to the appropriate levels, the current plan for addressing this issue calls for only reducing the credibility factors to 95% in 2005, 93% in 2006, and 90% in 2007. The plan calls for further analysis of this issue following 2007.

  While the current plan for addressing the problem with the group rating credibility factors is moving toward the actuarial consultant's recommendation, the pace of change is insufficient to address this problem in a timely manner. For each year in which the credibility percentages are out of line with the recommended levels, non-group employers continue to subsidize the rates of group rated employers. A 2004 study by the actuarial consultant indicated that the non-group employer subsidy paid to offset the discounts provided to group rated employers totaled approximately 8% of the annual premium revenue for private employers for each year group rating has been in existence.

The BWC group rating program should convey the benefits of group rating while also maintaining rating equity between group and non-group rated employers. In addition, group rated employer premiums should be sufficient to cover the claims incurred by those employers. The group rating program currently permits the formation or maintenance of groups in a manner that results in abnormally low claims experience or excessive premium discounts to group rated employers. Sound actuarial principles should govern all aspects of the BWC rate making process.

Failure to properly address the rating inequities created by the current group rating methodology results in rating inequity between group rated and non-group rated employers, which may be inconsistent with the statute requiring the Administrator to establish rating systems that result in fair and equitable premiums for Ohio employers. As a result, non-group rated employers are forced to pay higher premiums. In addition, failure to address this issue negatively affects the ability of Ohio to attract new employers to the state, as it causes the base rates to be increased to offset the discounts offered to group rated employers.

Recommendation:

Take steps to resolve the current rating inequity between group rated and non-group rated employers and adopt standard controls to prevent rate manipulation by employer groups. Corrective actions should include restoring credibility factors assigned to employer groups to levels that are consistent with sound actuarial standards and prohibiting groups from utilizing claims experience as an eligibility criterion for group participation. Such changes should be performed over a reasonable period as recommended by a recognized actuarial consultant. Previous actuarial studies have suggested that these modifications occur over a period of three years. In addition, these prior studies also suggested that the group retain the experience for a minimum of three years.

Designated Chief: **Chief Financial Officer**
Comment Rating: **Material Weakness**
Management Response: **Agree**

Beginning approximately three years ago, BWC management began the arduous process of redesigning the Group Rating Program which includes approximately 100,000 employers. Using past information from various sources, the first step was to put into place a three year initial credibility percentage reduction approach. The result of this initial action coupled with the implementation of the non-group discount factor application, was a reduction of unintended non-group rate impacts by almost $100 million per year. In addition, an internal cross-departmental workgroup developed recommendations in early 2005 that were submitted to senior BWC management. A portion of these recommendations were implemented with further study required.

It should also be noted that management has engaged an independent actuarial consultant to complete an evaluation of the group rating program and recommend changes. This report is due to management by November 30, 2006. Once these recommendations are received and a corrective course of action is developed, management will support implementation of the plan.

Target completion date: December 2006 (actuarial study); January 2007 (implementation plan)