

Approved February 11, 1988
Date

MINUTES OF THE HOUSE COMMITTEE ON JUDICIARY

The meeting was called to order by Representative Robert S. Wunsch at
Chairperson

3:30 ~~xxx~~ p.m. on February 3, 1988 in room 313-S of the Capitol.

All members were present except:
Representatives Jenkins and Peterson, who were excused.

Committee staff present:

Jerry Donaldson, Legislative Research Department
Mike Heim, Legislative Research Department
Jill Wolters, Revisor of Statutes Office
Mary Jane Holt, Committee Secretary

Conferees appearing before the committee:

Lori Callahan, American Insurance Association
Homer Cowan, Kansas Insurance Service Systems, Inc., Ft. Scott
Mike Mullen, The Medical Protective Company, Ft. Wayne, Indiana

Lori Callahan introduced Homer Cowan and Mike Mullen, respentatives of the insurance industry to discuss medical malpractice liability insurance.

Homer Cowan testified that insurance is a constant flow of money. The money comes in as premiums and goes out as claims, and the premiums charged today should be adequate to pay the claims of tomorrow. He explained that rate making is based upon past losses, plus trend, plus 5%. The first million dollar verdict did not impact rates so much as it changed the trend factor for losses to be paid in the future with the premiums collected today. He said the system is pricing insurance out of the market, and if rates continue to rise, 10 to 15 years from now there won't be any medical malpractice insurance available. He also said it isn't the cost of insurance that is the underlying problem, the problem is the cost of things insurance has to pay for, (see Attachment I). The dismantling of the Health Care Stabilization Fund (H.C.S.F.) would be the same as dismantling an insurance company. He said it would be a disaster due to the number of liabilities which may have accrued and are yet to be reported.

Mike Mullen testified his company only writes medical malpractic insurance. He said Kansas is one of the worst states Medical Protective has in their entire book of business which includes the large states of Pennsylvania, Texas and Ohio, which have large metropolitan cities with large losses. Kansas has become a leader in jumbo judgements.

He stated the H.C.S.F. is the main factor that keeps the minimum competition in the State of Kansas. Medical Protective would absolutely not insure limits in excess of \$200,000 in Kansas. His company is having difficulty now in making a decision whether they want to continue the \$200,000 limit. The H.C.S.F. is an excess carrier, and if it were not in existence the Medical Protective Company would be expected to carry limits up to a million dollars and they could not do that. In his opinion some of the other insurance companies would leave the state if the H.C.S.F. was not in existence.

Mr. Mullen explained the theory of rate making, (see Attachment II). He also distributed copies of the Wausau Experience, (see Attachment III).

The Committee meeting adjourned at 5:40 p.m.

The next meeting will be Thursday, February 4, 1988 at 3:30 p.m. in room 313-S.

GUEST REGISTER

DATE Feb. 3, 1988

HOUSE JUDICIARY

NAME

ORGANIZATION

ADDRESS

Michelle Mullen

The Medical Protection Co.

5814 Road Rd
H. Wayne IN

Todd Fowler

The Medical Protection Co.

5814 Road Rd
H. Wayne IN

Ray Callahan

am. lens. Assoc.

Topeka

HOMER COWAN

KISS Inc

H. SCOTT

Mary Harper

farmer

Soett City

BERNARD METZ

KCCI

TOPEKA

Chip Wheelen

Ks Medical Society

"

DeAnn Bernhard

alliance of American Insurers

Schaumburg
Illinois

Glenn Cogswell

" " "

Topeka, Ks

LARRY MAGILL

INDEP. INS. AGENTS

" "

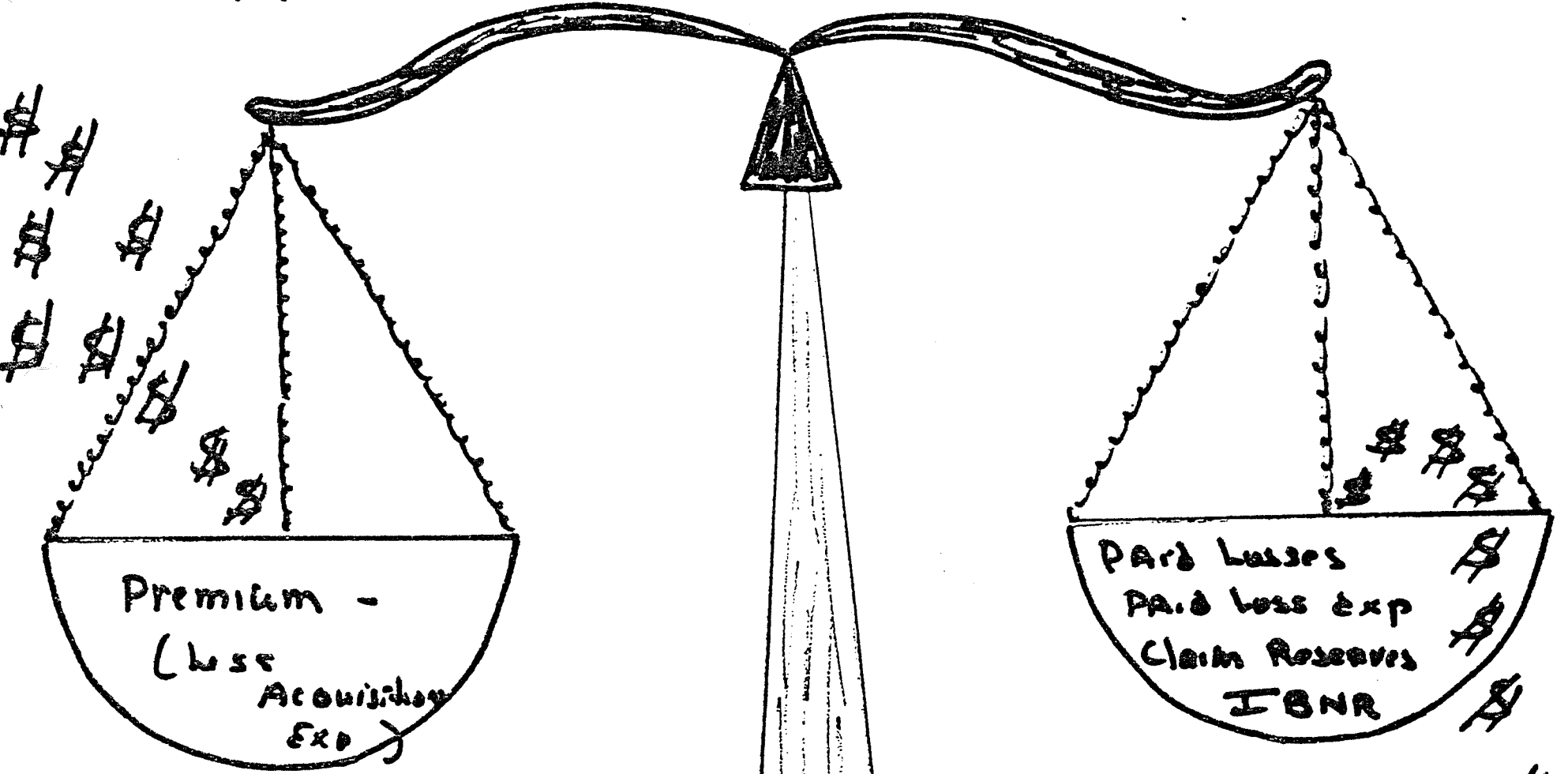
Ron Smith

Ks Bar

" "

A Need To BALANCE The Scale!

Attachment I



The Premium Charged today should be Adequate

to pay the losses or tomorrow!

Rate making - based upon past losses + Trend + 5%

The Premium to be charged today -- is based upon Losses paid out on the given classification of Insurance (usually 5 years) tomorrow!

Premium comes in daily....

And Losses are paid daily. Thus all figures - premium -- and Losses change day by day.

On a day by day basis, distortions appear, but when smoothed out over a 5 year period of time, does reflect the best possible basis to make Rates.

So the Rate established today is based upon the Losses paid in the past. This Record of Losses is your data base.

A data base can tell you how many accidents you should have for so many policies. OR so much premium. Likewise, the average cost per claim for each classification of Insurance.

To TRACK "Average Cost" of claims, the data base produces statistics daily. These figures can be totally misleading except they do reflect how the Losses being paid today track with the Losses of the Past.

Companies have - :

LOSS RATIO TO WRITTEN PREMIUM
 LOSS RATIO BY CALENDAR YEAR
 LOSS RATIO TO EARNED PREMIUM
 LOSS RATIO BY POLICY YEAR

Companies must "RESERVE" for Losses.

Companies must "RESERVE" for unearned premium

LOOK AT THE FOLLOWING CHART:

| | | | | | | | | | | | | | |
|---------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|---|
| \$10. | \$10. | \$10. | \$10. | \$10. | \$10. | \$10. | \$10. | \$10. | \$10. | \$10. | \$10. | \$10. | = |
| \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | | |
| ANNUAL POLICY | | | | | | | | | | | | | |

1st MONTH (or by the day actually) THE COMPANY earned \$10.00
\$110.00
\$120.00

At this point the Company only has \$10.00 with which to pay claims. Thus a \$10.00 claim produces a Loss Ratio of 100% to earned premium But less than 10% Loss Ratio to written premium.

If the policy-holder cancels at this time, \$110.00 must be Returned to the Insured.

12th MONTH - ALL PREMIUM is earned - and only \$10.00 paid out. BUT all claims ARE NOT YET REPORTED. This is called IBNR (INCURRED BUT NOT REPORTED). A company must (IRS) establish a 40% IBNR to have money to pay the claims not yet Reported. Depending on the 'AVERAGE' cost as contained within their DATA BASE, a company may establish a higher RESERVE...but not lower.

The only Real test of profitability is the LOSS RATIO by POLICY YEAR.

To understand policy year, take the drawing of the \$120.00 policy above... and FREEZE FRAME IT! Add No more premium. Set the money aside in a special trust and pay all remaining claims only from this Trust Account. Do not use money from any other premium collected... JUST THE \$120.00.

Depending upon the Statute of Limitations it will take 2-5 years to be positive all claims have been Reported. Whom a claim has been Reported, a RESERVE must be established and maintained until paid.

Depending upon the type of Claim, the RESERVE will be refined as the case progresses and all the facts and measure of damages are known. (DISCOVERY PROCEEDINGS - which depending upon the Court and the Attorneys may take from 6 months to SIX YEARS and Longer!

PROPERTY DAMAGE CLAIMS can be Reserved accurately at inception - but

PERSONAL INJURY cases can not.

In some lines - (PRODUCTS...Mal-Practice)
Reserves may not be MATURE for 5 - 10 years.

A Data Base print out will look like this:

| <u>PREMIUM</u> | <u>LOSSES PAID</u> | <u>LOSSES INC.</u> | <u>IBNR</u> | <u>EXP. PAID</u> |
|----------------|--------------------|--------------------|-------------|------------------|
| \$120.00 | \$10.00 | | \$45.00 | |

So when our \$120.00 policy expired, the company still has \$110.00 (Less acquisition costs) and \$45.00 set aside for IBNR.

When another Loss is Reported.....

| <u>PREMIUM</u> | <u>LOSSES PAID</u> | <u>LOSSES INC.</u> | <u>IBNR</u> | <u>EXP. PAID</u> |
|----------------|--------------------|--------------------|-------------|------------------|
| \$120.00 | \$10.00 | \$30.00 | \$30.00 | \$15.00 |

LOSS INCURRED is the RESERVE...the money expected to be needed to pay the claim.

THE IBNR has been reduced since one of the expected claims has now been reported. The reduction of the IBNR is largely dependent upon the PAST LOSS DATA as to what is the AVERAGE EXPECTED LOSS.

One more claim is Reported - THE STATUTE OF LIMITATIONS HAS RUN No more claims will be Reported. The \$30.00 Loss above has now been paid and the actual cost was \$25.00.

| <u>PREMIUM</u> | <u>LOSSES PAID</u> | <u>LOSSES INC.</u> | <u>IBNR</u> | <u>EXP. PAID</u> |
|----------------|--------------------|--------------------|-------------|------------------|
| \$120.00 | \$35.00 | \$20.00 | 0 | \$20.00 |

NOW \$75.00 HAS BEEN SPENT OR IN RESERVE.

This Last Loss was a personal injury case and six months later, the injury was more serious than first thought. Therefore, the RESERVE MUST BE CHANGED.

| <u>PREMIUM</u> | <u>LOSSES PAID</u> | <u>LOSSES INC.</u> | <u>IBNR</u> | <u>EXP. PAID</u> |
|----------------|--------------------|--------------------|-------------|------------------|
| \$120.00 | \$35.00 | \$40.00 | 0 | \$30.00 |

At this point, the company has spent or reserved \$105.00 of the original \$120.00. Acquisition costs run between 20-35%. Using \$20.00 acquisition cost, the company has now accounted for \$125.00 for \$120.00 received.

The Last Case finally settles for \$35.00

Now For the first time, the Company knows for certain the exact profit or loss.

| <u>PREMIUM</u> | <u>LOSSES PAID</u> | <u>LOSS INC.</u> | <u>IBNR</u> | <u>EXP. PAID</u> |
|----------------|--------------------|------------------|-------------|------------------|
| \$120.00 | \$70.00 | 0 | 0 | \$35.00 |

\$105.00 + ACQUISITION COST - \$125.00 (A LOSS OF \$5.00)

Until this type of data is obtained, all other loss runs are designed to track the losses of today with the "averages" of yesterday.

RATE MAKING:

The expected Losses of tomorrow + 5%.

Expected Losses is based upon the Loss Ratios of the past 5 years + Trend factors.

TREND FACTORS can be for inflation...cost of things Insurance must pay for.

- (1) WAGES
- (2) MEDICAL COST
- (3) CONSTRUCTION COSTS
- (4) REPAIR COST
- (5) ETC. ETC. ETC.

If everything remained the same, Insurance cost would remain the same. But everything does change.

DATA, can tell you how many accidents there will be per 100 cars. And the average cost of those claims as it relates to the past.

Anything that changes the data base, will change the rates up or down.

For example, lets say inflation has remained steady at 1% for the past 10 years. Rates have thus been trended to allow 1% per year. Suddenly, inflation hits 10% - Rates are now inadequate, but the company cannot change its rates, until

that 10% gets into data base. That 10% will not show up in the Loss Statistics for Approximately 2 years or more!

Conversely - Inflation at 10% for 10 years, and suddenly drops to 4%. It will take two years for Loss Statistics to reflect this downward trend, at which time rates will be excessive.

Remember the "under the dash air conditioner?? Factory installed A/C were only for the rich, but suddenly people were adding the under the dash unit to 2 out of 10 vehicles. Average cost about \$600.00. The automobile at that time was approximately \$2,500. The A/C added nearly 1/4 more value to the car. The premium which had been collected did not contemplate this additional cost...and virtually every collision caused damage to the coil unit by the radiator. So to every collision claim, the average loss increased by about 1/4 to the average cost of the collision claim. Rates were now inadequate.

Lets take the State of Kansas in about 1973. Kansas followed the guest passengers rule that had grown up in the law. Over-Simplified because you were doing your neighbor a favor by taking him to work, the guest passenger could not sue you for ordinary negligence. Rates were made on this basis.

When Kansas knocked out the guest passenger rule allowing anyone in your car to sue you for negligence...it created a new legal cause of action... a cause that had not been expected. No trend factor was in the rate for this. Thus each case based upon this rule of law changed the data base in respect to the average cost per BI claim. But it took 3 4 years before all of these new costs got into the rate making stream. A rate increase 3 years later, was never tied back to the cause as far as the public was concerned.

If you look at some of the more glamorous lines like products or mal-practice...the changes of society - or expansion of the law may not get into the rate making stream for 5 year-- 7 years. So as legislators, when you change a law which cause the cost of the average claim to go up...we can tell you what we think will be the percent of increase, but we really don't know until the losses get into the rate making stream. And that will normally be at least 2 years...Now in those two years if wage

loss...and medical bills...etc. also increase more than expected - the impact will be much greater. Remember ---as the cost of things insurance must pay for under the policy goes up, so do rates!

The same is true when legal remedies are restricted - eg. cap...collateral source rule, etc. You ask for an immediate rate and reduction. It seems logical. But unfortunately the basis for reduction will not be known for a number of years. Likewise, in those interim years if other factors change, the rate reduction may not be there at all...OR to rephrase..the legal remedy restriction = a 15% rate reduction, offset by factors of inflation or societies jury attitude.

The issue which has been before us the past 10 years is not the cost of Insurance, but the underlying reason for the increase in the costs of things Insurance must pay for under the policy. Primarily, we are talking about the 1st million dollar verdict in a companies history did not impact rates so much as it changed the trend factor for losses to paid in the future with the premium collected today.

How much is Insurance? The answer is how much can you afford, because the system is pricing insurance out of the market...and with that we all three lose - you and me and the legal profession.

The only parties to the present day issue is "we three" - the legal profession and you and me.

GLOSSARY OF PRODUCTS TERMS

LIST OF TERMS

GENERAL

Classifications
Completed Operations
Development Factors (b) Tail
Expected Loss Ratio
Exposures
Investment Income
Loss Ratio
Underwriting Ratio

DATA SOURCES

Bests Executive Data Services
Closed Claim Survey
ISO Ratemaking Reports
Page 14

EARNING PERIODS

Written Premiums
Earned Premiums
Accident Year
Policy Year

EXPENSES

Loss Adjustment Expenses
Allocated
Unallocated
General Expense
Acquisition Expenses

LIMITS

Basic Limits
Excess Limits
Total Limits
Per Claim
Per Occurrence
Aggregate Limit

LOSSES

Bodily Injury
Compensatory
General
Incurred
Medical Payment
Outstanding
Paid
Pain and Suffering
Property Damage
Reserves
IBNR Reserves

RATES

(a)
Guide (a)
Manual
Increased Limits Factors

RATING PLANS

Composite
Experience
Large (a) Rated
Loss Rated
Manually
Monoline
Package
Schedule

REGULATIONS

File and Use
Open Competition
Prior Approval
OSHA
Underwriters Laboratories

STATISTICAL PLANS

CRSP
CSP
GLSP

DEFINITIONS OF TERMS

GENERAL

Classification

Products rates are listed in the ISO manual for various products classifications. The classification definitions denote the type of product. For example, one classification definition is "lawnmowers".

Completed Operations

This is a sub-category of products liability insurance. It applies to construction operations where claims arise after completion of the projects.

Loss Development Factors

This term is used in insurance ratemaking for long-tail lines. It applies to the situation where losses reported do not yet include all losses which ultimately will be payable under a policy. Loss development factors are applied to immature losses to estimate ultimate mature losses.

Expected Loss Ratio

Also a ratemaking term. It represents the percentage of the premium dollar targeted to pay losses.

Exposures

A measure of insured risk. Manual rates are expressed in units of exposures. For example, for many product classes, the unit of exposures equals receipts. Therefore rates are expressed per unit of receipts.

Investment Income

This arises when insurance premiums are collected months or years before losses must be paid. During the interval between premium collection and loss payment, investment income is earned on the premiums.

Loss Ratio

A ratemaking term. This equals the ratio of losses to premiums.

Underwriting Ratio

This equals the total losses plus expenses taken as a ratio to premiums.

DATA SOURCESBests Executive Data Services

This reference document provides summaries of insurer Annual Statement Data taken from page 14 (see below) of annual statements.

Closed Claim Survey

An ISO survey of products closed claims taken in 1976. The survey was designed to measure the relative frequency and severity of various types of products claims.

ISO Ratemaking Reports

These reports summarize products premium and loss data in a format suitable for calculation of insurance rates.

Page 14

This refers to a page in the Annual Statement blank. The data included contains written and earned premiums and paid, incurred and unpaid losses on a calendar year basis.

EARNING PERIODSWritten Premiums

This equals the total premiums for all policies becoming effective within a given annual period.

Earned Premiums

For each policy, the earned premium equals the pro-rata portion of the written premium allocated to a given year. For example, if a one year policy becomes effective on July 1, 50 percent of the premium is allocated to the same year, while the remaining 50 percent is allocated to the next year. The total earned premiums within a year equals the sum of the earned premiums for each policy.

Accident Year

This applies to a ratemaking method, whereby all losses incurred within a year are compared to all exposures and premium earned within the same year.

Policy Year

A ratemaking method whereby premiums and exposures for all policies becoming effective within a year are compared to losses incurred on those policies.

EXPENSES

Loss Adjustment Expenses

Insurer expenses, such as legal expenses, incurred in the process of settling claims.

Allocated

These are loss adjustment expenses which can be directly allocated to individual claims.

Unallocated

These loss adjustment expenses, such as Claims-Adjusters' salaries, cannot be directly allocated to individual claims.

General Expense

This expense element largely consists of salaries of insurance company employees.

Acquisition Expense

This consists of the expenses necessary to acquire business. It largely includes producer commissions.

LIMITS

Basic-Limits

A ratemaking term. To improve stability in the ratemaking calculations, losses are all limited to a basic limit. Rates that are therefore calculated will be sufficient to only provide that limit of coverage. Basic limits rates are typically the rates displayed in the ISO manual.

Excess Limits

Excess limits losses equal the difference between total losses and basic limit losses.

Total Limits

The sum of basic and excess limits.

Per Claim

Insurance coverage limits are often expressed on a per-claim basis. For example, the policy may cover a maximum of \$100,000 per claim.

Per Occurrence

The policy may also impose a per occurrence limit, or a limit on the total payment on the insured event.

Aggregate Limit

The policy may also impose a limit on the total of all payments during the term of coverage. Aggregate limits, as well as the other limits referred to above normally apply to indemnity, but not to payments of loss adjustment expenses.

LOSSES

Bodily Injury

A loss where medical injury is inflicted upon human beings.

Compensatory

This legal term refers to losses paid to injured parties sufficient to compensate for medical expenses, wage losses and other expenses arising out of insured incidents.

General

Loss payments to injured parties in excess of compensatory payments.

Incurred

The total losses ultimately payable on insured incidents.

Medical Payments

Immediate reimbursement to injured parties for medical expenses.

Outstanding

A loss that has been incurred but not yet paid.

Paid

A loss payment

Pain and Suffering

Loss amounts payable in excess of compensatory payments to compensate injured persons for pain and suffering.

Property Damage

Insured losses resulting from damage to real or personal property.

Reserves

Loss amounts set aside to pay future claims.

IBNR Reserves

Incurred-but-not-reported reserves. These are estimates of loss amounts which will be needed to pay covered claims which have not yet been reported.

RATES(a)

An (a) rate is a rate for a class which is broadly defined where the individual risks within the class are dissimilar. The (a) rate is correct on average but would either be excessive or inadequate if applied to any individual risk within the class.

Guide (a)

This refers to an (a) rated class where rates are shown in the ISO Guide (a) manual. Guide (a) rates are calculated for many (a) rated classes. However, for others where data is really erratic or where risks are extremely diverse, guide (a) rates are not calculated.

Manual

Manual rates as included in the ISO manual, are those rates which are filed-in all states in accordance with applicable rating laws. In many states, manual rates must be filed, while filing of (a) rates is not required.

Increased Limits Factors

These factors are contained in the ISO manual and may be applied to the rates for basic limits coverage to obtain appropriate premiums for any desired limit of coverage.

RATING PLANSComposite Rating Plans

The ISO composite rating plan is used to calculate premiums for larger risks with exposures in several classifications. In the composite rating procedure, a composite exposure base such as receipts is first selected. A composite rate is then computed by dividing the manual premium for the risk (for all classes combined) by the composite exposures. The manual premium is not recomputed each year that the policy is renewed. Instead, the composite rate is simply multiplied by new composite exposures to determine the premiums.

Experience Rating Plan

Under the ISO Experience Rating Plan, a risk's manual premium may be modified by an experience rating modification, based upon the risk's previous loss experience. This modification is calculated using a formalized mathematical procedure.

Large (a) Rates Risk

For large risks generating in excess of \$100,000 annual manual basic limits premium, underwriting flexibility is permitted in the premium determination. This recognizes the unique nature of most large risks.

Loss Rated Risk

An ISO rating plan applies to large risks with 3 year basic limits losses exceeding \$425,000. For these risks the premium can be based solely upon the loss experience for that risk and not upon manual rates.

Manually Rated Risk

This is a risk rated directly with the ISO manual.

Monoline

Monoline risks are those who purchase policies covering only a single line of insurance.

Package Risk

Package risks are those who purchase policies offering a combination of lines of insurance. For example, a typical policy covers both property and liability insurance.

Schedule Rating Plan

The ISO schedule rating plan recognizes individual risk characteristics affecting premiums, such as quality of corporate management. Individual risks often receive schedule debits or credits depending upon whether the risk characteristics are better or worse than average.

REGULATIONSFile and Use Rating Law

In states with this type of rating law, insurers may file and use rates without waiting for approval.

Open Competition Rating Law

Rate filings are not required in states with this type of law.

Prior Approval Rating Law

Approval is required before rates may be used.

Occupational Safety and Health Act of 1970

This federal law imposes minimum safety standards on industrial equipment.

Underwriters Laboratories

This is an insurance industry sponsored organization that performs safety inspections on electrical products.

STATISTICAL PLANS

Commercial Risk Statistical Plan

This ISO statistical plan was once used to capture ratemaking data for commercial package policies. It has been replaced with the new Commercial Statistical Plan (CSP).

Commercial Statistical Plan

This ISO statistical plan is currently in affect for all Commercial Lines.

General Liability Statistical Plan

This ISO statistical plan formally applied to monoline general liability. It has been replaced by CSP.

DEVELOPMENT OF A RATE LEVEL INDICATION

1. DEVELOPMENT OF THE PERMISSIBLE LOSS RATIO

| | PERCENT OF DIRECT WRITTEN PREMIUM ----- |
|---|--|
| Acquisition Expense | 3.0% |
| General Expense | 5.0% |
| Taxes, Licenses and Fees | 2.0% |
| Profit and Contingencies | 5.0% |
| | ----- |
| Total Expenses | 15.0% |
| Permissible Loss and LAE Ratio (1.00-.15) | 85.0% |
| | ----- ----- |

2. DEVELOPMENT OF THE INDICATED RATE LEVEL CHANGE

| Year ----- | Trended Ultimate Incurred Loss and LAE ----- | Earned Premium at Current Rates ----- | Loss Ratio ----- |
|--------------------------------|---|--|------------------------|
| 1982 | \$15.01 | \$12.00 | 1.251 |
| 1983 | 15.43 | \$12.60 | 1.225 |
| 1984 | 15.86 | \$13.23 | 1.199 |
| 1985 | 16.30 | \$13.89 | 1.174 |
| 1986 | 16.76 | \$14.59 | 1.149 |
| Total | \$79.36 | \$66.31 | 1.197 |
| Permissible Loss and LAE Ratio | | | 0.850 |
| Indicated Rate Level Change | | | 40.8% |

Attachment II

WAUSAU EXPERIENCE

| | <u>Written Premiums</u> | <u>Payments</u> | <u>Difference</u> |
|-----------|-------------------------|-----------------|-------------------|
| Thru 1974 | \$167,400,000 | \$78,300,000 | +\$89,100,000 |
| Thru 1978 | \$167,400,000 | \$203,900,000 | -\$36,500,000 |
| Thru 1986 | \$167,400,000 | \$497,900,000 | -\$330,500,000 |

Reserves (including IBNR and ALE Reserves) existed at year end 1986 of \$100,000,000.