New York State
Workers' Compensation Board

Individual Self-Insurance Alternative Funding Models

Report to the Governor and the Legislature

December 2007

Chair Zachary S. Weiss – Workers' Compensation Board

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Appendices

Chapter One – Executive Summary

A. Individual Self-Insurance Environment

1. Background and Context

Section 64 of the 2007 Workers' Compensation reform bill directed the Workers' Compensation Board ("WCB") to report on the feasibility of a statewide individual self-insured employer bond program, and an improved individual employer bond program. This report will provide the background and context for individual self-insurance, describe the current environment, and recommend that a new methodology be adopted.

Workers' Compensation insurance provides indemnity and medical benefits to injured workers. All employers must provide compensation in one of three ways: through a private carrier, through the New York State Insurance Fund, or, with WCB permission, as a self-insured employer.

There are a total of 150 parent companies approved to self-insure on an individual basis. The 150 parent companies also bring 285 subsidiary corporations into the program (for a total of 435). Collectively, the self-insured employers have approximately 525,000 New York employees. The total amount of security deposits held under WCB purview for active self-insurers is $1.8 billion. In addition, inactive self-insurers, entities that no longer self-insure their obligations, have approximately $800 million in security on deposit, to cover the long-term payout of current and potential future claims.

2. The Current Silo Approach

Under the current approach (silo approach), the most significant qualification to self-insure is financial standing. If the WCB grants consent to self-insure, the employer must provide a security deposit with the WCB based on payroll and industry classification codes. The employer retains its status as a self-insurer regardless of ongoing financial status, except in the event of a major program failure, such as the inability to maintain adequate security.

Under the silo approach an actuarial model is used to annually update security deposit requirements. Every individual self-insured employer is required to post the amounts determined by the model. The model is complex and can be inadequate in terms of quantifying risk.

In the event of default, the WCB draws on the security deposit to pay current and future claims. If that deposit is exhausted, the WCB levies an assessment against the entire self-insurance community to make up the shortfall. However, the security deposits posted by other self-insurers cannot be utilized as each individual security deposit is posted in its own silo.

This report explores two alternatives to the current silo approach: a pooled approach, where a cash fund is created to take the place of individual security deposits, and from which claims for defaulting self-insurers can be paid; and an enhanced silo approach, whereby self-insurers will continue to post individual security deposits, but the risk of shortfalls is mitigated by a small residual default pool.

In this report, the WCB respectfully recommends adopting a pooled approach.

B. The Recommended "Pooled Approach"

Under a pooled approach, a guarantee pool would be created and funded with the money that would otherwise have to be paid to financial institutions for individual security deposits. In turn, the pool would be used to guarantee the payment of claims in the event of default.

The approach has worked elsewhere. For example, in California, the Self-Insurers' Fund was implemented in 2003 in the wake of a high frequency of defaulting self-insurers, and a deficit of $55 million. In three short years, the Fund reduced annual contributions, yet now has a surplus of approximately $100 million.

Initially, the Board would evaluate the ability of active self-insured employers to meet eligibility requirements. Subsequently, eligible active self-insured employers would make annual payments into the guarantee pool. This would enable the WCB to release most active self-insurers' current security deposits. The major benefit to the self-insured employers of New York would be the freeing of billions of dollars in credit facilities that would otherwise be reserved for security, including any collateral required by the financial institutions.

As this report details, the element most crucial to the success of the pool will be strict compliance with eligibility requirements, so that the program is limited to those employers with good credit. Employers who are unable to demonstrate the financial standards may suffer revocation of their privilege to self-insure.[1]

Under a pooled approach, each employer's contribution would be based on the risk they bring to the pool. The WCB would measure each employer's exposure based on a WCB directed independent actuarial estimate of each employer's overall claims liabilities. This estimate would then be adjusted based on the employer's credit rating.

The pool would grow over time, until it is deemed to be sufficient to cover shortfalls created by defaulting active and inactive self-insurers. Due to the stronger financial

[1] The impact on active self-insurers who may not qualify under the new eligibility requirements could be tempered depending upon the financial criteria selected or some other method for securing their claims.

criteria the likelihood of default is less. The use of standardized actuarial models to predict the exposure will allow the program to better absorb defaults should they occur.

In its initial years, while the liquidity of the guarantee pool rises, there may be gaps in funding. As such, the WCB anticipates issuing revenue bonds to smooth funding gaps, if necessary. In addition, the issuance of bonds would protect self-insurers from unpredictable swings in assessments.

C. *The Enhanced Silo Alternative*

In the event that the pooled approach is not favored, there is a method which, while not preferred, is an improvement over the current approach. This alternative is considered an 'enhanced silo' approach.

Similar to the pooled approach, the element most crucial to the success of this option is strict compliance with eligibility requirements, so that the program is limited to those employers with good credit. Employers who are unable to demonstrate the standard may suffer revocation of their privilege to self-insure.[2]

Under the enhanced silo approach, the self-insurer would continue to post individual security deposits based upon a WCB directed independent actuarial analysis. The most creditworthy self-insurers would be eligible for a reduction in their required security deposit. In addition to these individual deposits, each self-insurer would pay a fee into a residual default pool. This pool would grow over time and provide initial funding for defaults until the posted security deposit is liquidated and would cover any portion of a default that exceeds the amount of the security deposit, if necessary.

D. *The Recommended Integrated Solution*

The implementation of the recommended pooled approach would require several legislative and regulatory changes. Most notably:

- Creation of Pool: Amend Workers' Compensation Law ("WCL") Section 50 to provide for the creation of a self-insurers' guarantee fund and, as necessary, amend any references to security deposit requirements.

- Loss Portfolio Transfers: Amend the WCL and the Insurance Law to authorize the WCB's Chair to sell off workers' compensation liabilities resulting from the default or insolvency of an individual self-insurer by means of a portfolio transfer policy.

[2] The impact on active self-insurers who may not qualify under the new eligibility requirements could be tempered depending upon the financial criteria selected or some other method for securing their claims.

- Revenue Bonds: Create statutory authority for the WCB to issue revenue bonds on behalf of the self-insurance community, if necessary. These revenue bonds will be used to cover short-term costs such as claims and any long-term costs associated with a portfolio transfer.

Chapter Two – Purpose of Report

A. Reform Bill

Chapter 6 of the Laws of 2007 enacted sweeping reforms to the Workers' Compensation system in New York State which raised benefits for injured workers while achieving system savings in the range of one billion dollars.

Section 64 of the legislation requires the WCB to report to the Governor and the Legislature, on or before December 1, 2007, on the possibility of implementing a statewide individual self-insured employer bond program and an improved individual employer bond program.

The WCB presents this report in response to that legislative requirement.

B. Report Content

Three fundamental principles govern the regulation of self-insurance. First, eligibility criteria must be controlled to ensure that the privilege to self-insure is only granted to employers who have the financial strength to pay all of their workers' compensation obligations. Second, risk must be accurately quantified through properly valuing outstanding self-insured liabilities. Finally, there must be a mechanism to ensure that obligations to injured workers continue to be met should the employer become insolvent.

Although these principles can be implemented in a number of ways, the various methods used by states that offer self-insurance fall into two general categories:

1. A silo approach where individual self-insurers post their own deposits that can only be used for their claims in the event of a default. A silo approach typically includes some type of additional funding or assessment method in the event the individual deposit is inadequate; or

2. A pooled approach, where individual deposits are replaced with a cash fund that can be used for the claims of any defaulted self-insurer.

At the current time, the New York individual self-insurance program utilizes the silo approach to protect self-insured claims. Chapter Three provides background on the current program. Chapter Four of this report presents a description of the current risks. Chapter Five describes a pooled approach and Chapter Six describes a hybrid of a silo and a pooled approach in what is termed an enhanced silo. Chapter Seven presents a quantitative analysis of the three options. Finally, Chapter Eight recommends an integrated regulatory and legislative solution in the form of a pooled approach (or statewide self-insured employer bond program).

C. A Note on Scope

Pursuant to the legislative mandate, the analysis and recommendations set forth in this report concern only employers that individually self-insure for workers' compensation. There are other types of self-insurance programs that the WCB oversees, including group workers' compensation self-insurance, disability benefit self-insurance and political subdivisions that self-insure (for workers' compensation and/or disability benefits). These other types of self-insurance are outside the scope of this report. However, Appendix B briefly outlines the problem of significant defaults beginning to surface among self-insured group trusts.

D. How This Report Was Created

On this project, staff from the WCB collaborated with Bickmore Risk Services ("BRS"). BRS is a nationally recognized leader in self-insurance program design, implementation and administration for both private and public sector employers. BRS has extensive experience in several key areas including: self-insurance regulations; self-insurance administration; guarantee fund administration and consultation; and security deposit determination, arrangement and posting.

This report is based on information derived from a number of different sources:

- The current self-insurance market and regulatory environment in New York;
- The current method for securing collateral of self-insured employers in New York;
- Stakeholders in the self-insurance community and their feedback on securing collateral;
- Other states' methods for securing claims under their self-insurance programs; and
- Methods used for managing credit risk within the individual self-insurance program, and measuring the probability of default to ensure that adequate financial resources are put in place to protect against potential defaults, and that the program includes only the most creditworthy employers.

To more fully understand the methods used in other states to secure claims, a series of interviews was conducted with representatives from California, Florida, Michigan, Minnesota, North Carolina, Pennsylvania, and Texas. The states were chosen based upon the size of their self-insurance programs and how they compared to New York, as well as new or innovative ways in which they have addressed all or part of the components of their programs.

Some limited data related to self-insurance programs in other states was also reviewed. The states reviewed on a more limited basis were Alabama, Georgia, Illinois, Oregon, South Carolina, and Tennessee.

It is important to note that unlike New York not every state guarantees the timely and uninterrupted payment of benefits regardless of the financial condition of the employer. This important distinction limited to some extent the relevance of other states practices for consideration in New York.

In addition, a survey was sent to every active self-insured employer in New York State. The survey asked about the costs they incur in meeting the current security deposit requirements in addition to the major challenges they face in obtaining and renewing their security deposits. These comments formed the basis for the quantitative analysis contained in Chapter Seven, and were used to gauge the effectiveness of the proposed alternatives to the current system.

The survey was sent to the entire community of 150 active individual self-insured employers. Of those employers, 79 (or 52%), responded. Although not all self-insurers responded, information was received from a representative cross-section of the self-insurance community. The percentage of employers from the various industry groupings that responded is as follows:

- 43% of the Manufacturers;
- 53% of the Service Industry;
- 41% of the Hospitals;
- 60% of the Retail Industry;
- 56% of the Trucking Industry; and
- 67% of the Colleges.

The WCB also hosted a meeting in Albany, New York on July 17, 2007, in order to update all individual self-insured employers on the status of this project, as well as to encourage them to participate in this review process. At the meeting, the WCB described the options under consideration for the security deposit model and provided an opportunity for each self-insurer to discuss their own concerns and provide feedback. Approximately 50 self-insured employers were represented at this meeting and the WCB and BRS benefited significantly from this dialogue.

Chapter Three – Background

A. Workers' Compensation Board

The mission of the WCB is to equitably and fairly administer the provisions of the WCL, including the provisions relating to workers' compensation benefits, disability benefits, volunteer firefighters' benefits, and volunteer ambulance workers' benefits on behalf of New York's injured workers and their employers.

Workers' compensation benefits provide indemnity[3] (weekly cash payments to replace lost income) and medical benefits[4] (the cost of full medical treatment, including rehabilitation) for covered employees disabled due to a disease or injury causally related to their employment. Benefits may also be paid to qualified dependents of a worker who died as a result of a compensable injury or illness.[5] Disability benefits are paid when a covered employee becomes disabled as a result of a disease or injury that is not connected to his/her employment.[6]

WCL Section 50 requires New York State employers to provide coverage to their employees for these benefits. WCL Section 50 states that employers may provide this coverage in one of the following ways: (1) by insuring and keeping insured the payment of such compensation from the State Insurance Fund[7]; (2) by insuring and keeping insured the payment of such compensation with any insurance carrier authorized to transact such business in New York State[8]; or (3) by becoming self-insured.[9]

B. Office of Self-Insurance

Employers who wish to self-insure for workers' compensation must apply to and be approved by the WCB.[10] It is the mission of the WCB's Office of Self-Insurance ("OSI") to ensure that the option to self-insure remains a viable and cost effective alternative for employers who can demonstrate and continually maintain the financial strength to self-insure the benefits required under the WCL. In addition, the WCB must also guarantee the continuation of those benefits to injured workers of defaulted self-insured employers.[11] In the event their financial standing weakens significantly or the self-insurer fails to meet the program requirements, the Chair of the WCB has the

[3] WCL Section 15
[4] WCL Section 13(a)
[5] WCL Section 16
[6] WCL Sections 203 & 204
[7] WCL Section 50(1)
[8] WCL Section 50(2)
[9] WCL Section 50(3)
[10] WCL Section 50(3) & (3-a)
[11] WCL Section 50(5)(f)

authority to revoke the privilege of self-insurance "for good cause".[12] Similarly, self-insurers may voluntarily terminate their status at any time.[13]

C. Governance

The WCB oversees all aspects of the individual self-insurance program, including the initial application for approval to self-insure[14], the amount of security deposit that is required[15], and the ongoing approval to provide benefits.[16] All of the costs associated with administering the self-insurance program are billed back to the self-insurance community through the WCB's assessment process.[17]

WCL Section 50(5)(b) provides for an Advisory Committee for Self-Insurance. The Chair of the WCB is Chair of this committee. The committee consists of seven members representing a cross section of the self-insurance community (three from the manufacturing and trade group; three from the transportation, public utilities and construction group; and one member chosen at large by the Chair of the WCB, who is the Vice Chair of the committee).

WCL Section 50(5)(b) provides that "it shall be the duty of the advisory committee to advise the Chair on all matters relating to self-insurance, particularly in respect to rules governing self-insurance, the deposit or withdrawal of securities and on such other matters as the Chair shall request." The Advisory Committee holds regular meetings twice a year, and the statute anticipates the need for additional meetings, giving the Chair the authority to call special meetings of at least three members at any time.

Notice of additions and terminations to the program is provided to the members of the Advisory Committee twice per year. However, they have not historically played an active role in the approval process for new self-insurers. Nor do members of the Advisory Committee play any role in setting the security deposit requirements for individual self-insurers (active or inactive).

This limited role of the Advisory Committee represents a noteworthy difference between the current system in New York, and other states. In most other states, a separate board or association exists which works closely with the workers' compensation agency in initially approving self-insurers and renewing them. Representatives from the self-insurance community typically make up these separate boards and associations. Many believe that an active advisory committee provides valuable input into the decision as to whether to approve or renew a self-insurer since these very same employers will ultimately bear the burden of any shortfalls.

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[12] WCL Section 50(3) and (3-a)
[13] 12 NYCRR 317.20
[14] 12 NYCRR Section 315.1
[15] 12 NYCRR Section 316.1
[16] 12 NYCRR Section 315.4
[17] WCL Section 50(5)(c)

D. Current Demographics

Currently, there are a total of 150 parent companies approved to self-insure on an individual basis. The 150 parent companies also bring 285 subsidiary corporations into the program (for a total of 435). Collectively, the self-insured employers have approximately 525,000 employees in New York alone with a combined New York payroll in excess of $27 billion annually. The largest self-insurer has more than 30,000 employees in the State, while some of the smallest self-insurers have less than 100.

The most common type of self-insurers in New York are employers in the manufacturing industry, with 53 of the 150 employers (representing 36% of the total), followed by 31 service employers (21% of total), 27 hospitals (18% of total) and 25 employers in the retail industry (16% of total). There are 8 trucking employers, and 6 colleges, representing 5% and 4% respectively, of the total number of self-insurers.

The WCB has district offices throughout New York to provide greater access to injured workers. Geographically, every district in the State includes the presence of employers that self-insure on an individual basis, with the most significant numbers in the New York City, Buffalo, and Albany areas. Several of the larger self-insurers have employees in every district.

As provided in the WCL, the WCB requires every self-insurer to post a security deposit in the form of cash, securities, irrevocable letters of credit ("LOCs") and/or surety bonds. Currently, the WCB is holding more than $1.8 billion in security for the active self-insurers, the vast majority of the amounts are held in the form of either letters of credit ($994 million or 54% of the total) or surety bonds ($772 million or 42% of the total), with the remainder in the form of cash and/or securities ($63 million total).

The security deposit amounts are recalculated annually for each self-insured employer. The annual reporting data for any year is collected in the late fall of the preceding year. Upon submission, reserve estimates are reviewed and amended as necessary and then final security deposits are calculated. If an employer needs an increase, a letter is sent and the employer generally has 45 days to post the required amounts.

The $1.8 billion in security deposits does not include increases required during the most recent security deposit cycle, which the WCB was in the process of receiving as this report was being prepared. The most recent annual updates will result in increases of more than $308 million or 16% more than is currently being held. Once those deposits are received and processed, the total amounts held for active self-insurers will be in excess of $2 billion.

The minimum required deposit is currently $780,000[18], and, at the current time, the average amount on deposit for an individual self-insured employer is about $14 million. A handful of the largest self-insured employers have posted security deposits greater than $100-$200 million each.

In addition, the WCB must also maintain security deposits for employers that are inactive and no longer self-insure. An individual workers' compensation self-insurer who has discontinued business in New York State, or who selects to provide prospective coverage by one of the other acceptable methods, may voluntarily terminate their status as a self-insurer at any time.[19] The WCB maintains the security deposit (or some portion thereof) as long as payments are made for claims incurred while the employer was self-insured.[20] Due to the long-term nature of workers' compensation obligations, security deposits are often maintained for years (if not decades) after an employer has left the self-insurance program.

Currently, the WCB is holding nearly $800 million in security for inactive or discontinued self-insurers. This amount represents more than 360 employers who self-insured on an individual basis, but have since terminated that privilege (either because they are no longer in business, have left the State, or have obtained prospective coverage via one of the other acceptable methods under WCL Section 50). The average deposit for these inactive self-insurers is more than $2 million, and while the most significant amounts are being held for employers who discontinued self-insurance since 2000, the average date of termination is more than twenty years ago.

Currently, there is more than $12 million on deposit for employers who discontinued their self-insurance program prior to 1970; $17 million for employers who discontinued from 1970 – 1979; $136 million for employers who discontinued from 1980-89; and $272 million for employers who discontinued from 1990-99. The biggest portion of the $800 million held for discontinued self-insurers is the $356 million held for employers who recently discontinued their participation (since 2000). As the outstanding claims are paid, the WCB will allow inactive self-insurers to reduce their deposits, provided they demonstrate that excess security is held on the remaining claims. However, given the long-term nature of workers compensation obligations it is often decades before the employer is relieved from the financial and administrative burden of posting a deposit.

[18] WCL Section 15(6) and 12 NYCRR Section 316.1
[19] 12 NYCRR Sections 315.5 & 317.20
[20] 12 NYCRR Sections 315.5 & 317.5

If either an active or inactive self-insurer defaults on their workers' compensation obligations, and the security deposit posted for that self-insurer proves inadequate, the remainder of the self-insurance community bears the burden of the shortfall in the form of assessments.

The following chapter provides more detailed information on the current program, including how the current structure attempts to control credit risk, how that risk is quantified, and what happens in the event of a default.

Chapter Four – Current Program

A. Overview

Larger employers who have the ability to meet the required financial standards may elect to self-insure under the individual self-insurance program. They do so by submitting an application to the WCB's Office of Self Insurance (OSI) that includes general information about the applicant (location, current payroll, legal entity, loss history, etc.) as well as three years of complete, certified, and independently audited financial statements.[21]

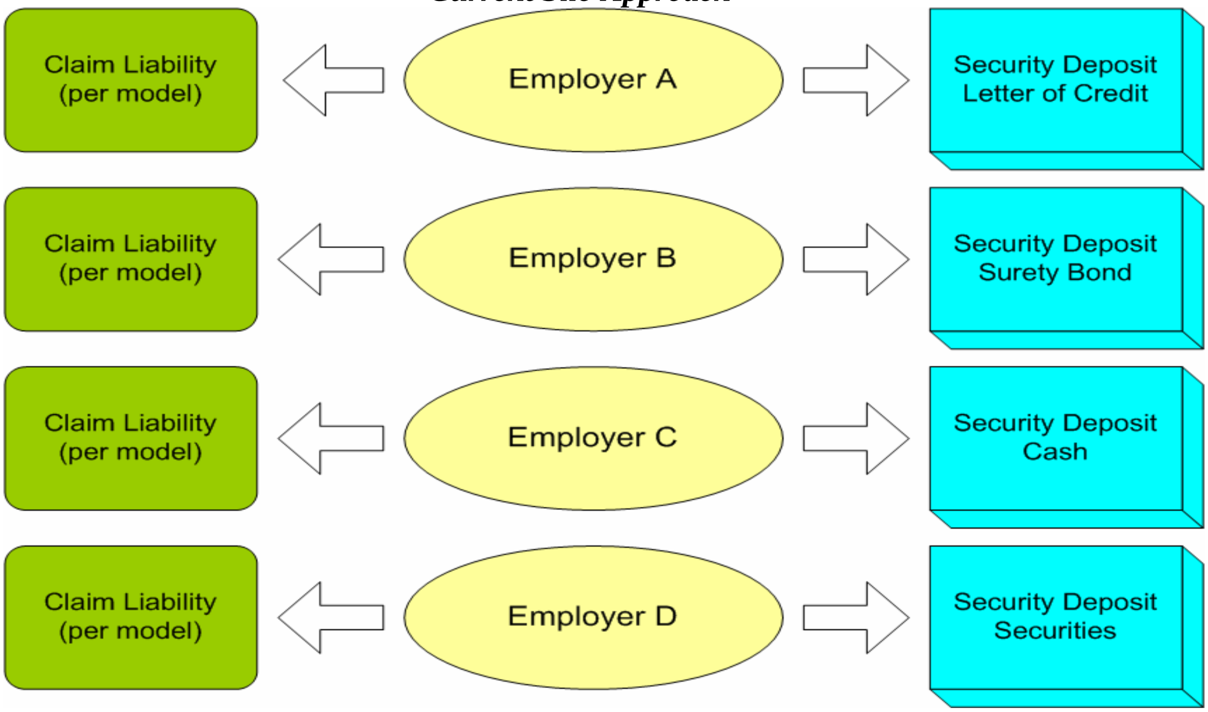
The OSI reviews this information. In doing so, it pays particular attention to the applicant's financial position and other financial data to ensure that applicant has the ability to pay claims. When all documentation as well as an adequate security deposit is received, final approval is effective. For good cause shown, the Chair of the WCB has the authority to deny an employer's application to self-insure, or to revoke consent already furnished.[22] Historically, an initial application is typically denied only when the financial standing of the employer is inadequate. Revocation only occurs when one or more of the major program requirements are not met (e.g., pay all self-insured obligations, post adequate security, maintain appropriate excess protection, etc.), regardless of financial standing.

In New York, the security deposit posted with the WCB is meant to fully secure all outstanding self-insured obligations (indemnity and medical) for each employer's cumulative period of self-insurance. The initial security deposit is based upon current payroll information by classification code[23], and rates that have been developed by the New York Compensation Insurance Rating Board ("NYCIRB").[24]

Thereafter, the self-insured employer must annually submit detailed data, including claim specific reserve information as well as updated payroll and payment amounts.[25] The WCB summarizes this data and the summary information is entered into a complex actuarial model, in order to project the value of the fully developed outstanding indemnity and medical obligations. The security deposit requirements are updated annually, based on the results of the model, and the required deposits are made.[26]

[21] 12 NYCRR Sections 315.4
[22] WCL Section 50(3) & (3-a)
[23] A classification code is a system of insurance risk classifications based on industrial or occupational categories used to identify an employer's ratemaking class(es) and establish basic pricing for workers' compensation insurance.
[24] The law provides that the workers' compensation rating board collect and summarize loss, premium and payroll data in order to establish workers' compensation rates. The New York Compensation Insurance Rating Board has been designated as such until February 1, 2008. NYCIRB is a non-profit, unincorporated association of insurance carriers (including the State Insurance Fund).
[25] 12 NYCRR Sections 315.4 & 317.19
[26] 12 NYCRR Sections 316.3 & 317.5(b)

Current Silo Approach



As previously noted, the WCB is holding more than $1.8 billion in security deposits (primarily in the form of letters of credit or surety bonds) for the active self-insurers in the silos depicted above. In addition to the amount held for active self-insurers, the WCB is also holding roughly $800 million for inactive self-insurers

Collectively, the active and inactive individual self-insurers pay approximately $25 million and $8.8 million respectively on an annual basis to secure the almost $3 billion in deposits. In addition to this annual expense, the security deposits posted with the WCB are often collateralized with other assets of the employer. Depending upon the financial rating of the employer, the collateral can represent a large percentage of the security deposit. Based on the survey data, several of employers are required to post almost full collateral to the bank or surety company to secure a letter of credit or surety bond.

If a default occurs (because either an active or inactive self-insurer stops paying their self-insured workers' compensation obligations), the WCB will immediately draw on that self-insurer's security deposit.[27] In the event the security deposit for a defaulted self-insurer proved to be inadequate for the reasons discussed below in the *Default Risk* section, the entire self-insurance community will bear the burden of the shortfall by paying increased assessments.[28] However, the security deposits posted by the other self-

[27] WCL Section 50(5)(f) & 12 NYCRR Sections 315.2 & 317.5
[28] WCL Section 50(5)(f)

insurers cannot be utilized, (as each individual security deposit is posted in its own silo "account").

Overall, the risks of the current program fall into three general categories: eligibility criteria; quantification of risk; and default risk.

B. Eligibility Criteria

The assessment of creditworthiness is an integral part of the approval process, and is continued as part of the annual security deposit update. However, it has not been the practice of the WCB to eliminate financially unsound self-insurers once they have been approved.

1. Initial Qualifications

In general, applicants that meet the qualifications for self-insurance are approved, while those that fail to meet one or more of the qualifications are subject to further financial review. The WCB verifies the information in the application and performs a financial review of the applicant that includes evaluating the applicant's tangible net worth, credit ratings (if available), Dun & Bradstreet (D&B) Financial Stress score, Altman's Z-score, and various other ratios and financial tests. Additional criteria are applied if the applicant fails to meet some of the initial financial tests. The WCB rates an employer's financial score on a scale of 1 to 5 (best to worst). Applicants that receive a score of 1 or 2 are approved to self-insure; applicants that receive a 3, 4 or 5 will be rejected.

2. Annual Review of Financial Soundness

Once approved, each active self-insurer must submit annual reports so that the WCB can review the adequacy of the posted security deposit, creditworthiness, proper excess insurance, and acceptability of third party claims administrator (if applicable).[29] However, unlike many other states with similar programs, there is no regular renewal process for individual self-insurers in New York. In New York, once an employer has been approved to self-insure, that privilege exists indefinitely until such time as the employer fails to meet one or more of the major program requirements (i.e., pay all self-insured obligations, post adequate security, maintain appropriate excess protection, etc.). The financial standing of the employer is monitored annually to determine if a surcharge should be added to the level of the posted security deposit due to the credit risk the employer poses.

In many of the other states that offer self-insurance, the privilege to self-insure is not granted indefinitely, and employers must go through a regular renewal process, where they face the same stringent financial requirements that they faced in the application

[29] 12 NYCRR Sections 315.4 & 317.19

process. In many of these other states, if the self-insurer fails to meet minimum standards, the privilege of self-insurance will be revoked.

Not only is New York's practice of indefinite approval to self-insure vastly different from that used in other states, it has led to one of the major challenges facing the individual self-insurance program. Specifically, there are 10 current active self-insured employers that fail to meet the financial criteria that are applied to new applicants, yet these employers are permitted to continue to self-insure.

The following chart depicts the distribution of the current financial ratings as determined by the WCB for active self-insured employers. The rating scale ranges from one to five (best to worst) format:

Summary of Financial Scoring: Current Self-Insurers

<table>
<tr><th>WCB Financial Scoring</th><th># of Current Self-Insurers</th><th>Result If New Applicant</th></tr>
<tr><td>1</td><td>88</td><td rowspan="2">140 would be granted self-insured status</td></tr>
<tr><td>2</td><td>52</td></tr>
<tr><td>3</td><td>5</td><td rowspan="3">10 would be denied self-insured status</td></tr>
<tr><td>4</td><td>4</td></tr>
<tr><td>5</td><td>1</td></tr>
</table>

As shown, the vast majority of the active self-insurers (140 of the 150) would receive a financial score of 1 or 2 if the WCB received and approved their initial application to self-insure today. However, the remaining 10 (who would receive a score of 3, 4, or 5) would be rejected.

It is not the current policy of the WCB to eliminate financially unsound self-insurers once they have been granted self-insurer status. The WCB has repeatedly discussed with the previous administrations the need to change its policy so poor performers can be removed from the self-insurance program. The WCB once again recommends that this policy be changed, so that the risk associated with the financially suspect self-insurers can be limited.

The rationale behind allowing these employers to continue to self-insure is that the security deposit posted with the WCB is meant to fully secure their outstanding liabilities, so there should be limited exposure should they default. However, as described below, historical experience has shown that there are limitations to the current process for quantifying the outstanding exposure, and the security posted is often insufficient when a default actually occurs.

C. Quantification of Risk

Another significant risk to a self-insurance program is the inability to adequately quantify the exposure of outstanding claims obligations. Several states simply quantify the risk as a factor of paid claims (i.e., two times the prior year's paid amount). However, in a state like New York, where benefits are guaranteed, it is essential to be able to reasonably quantify the ultimate claims obligations assumed within the program both individually and collectively.[30]

The OSI utilizes a computerized actuarial model, to determine the amount of outstanding self-insured obligations and related security deposit required by every active self-insurer. The model used by the WCB is based on commonly used actuarial principles to arrive at the expected value of outstanding claims.

In order for the OSI to utilize the model, every active individual self-insured employer must submit an annual reporting packet to the WCB. This package must contain the following items: payroll broken out by payroll classification; detailed claim information, including indemnity and medical amounts held in reserve for each claim; and cumulative indemnity and medical payment information reported by claim year.[31]

These reporting packages must be completed annually by every self-insurer, and submitted to the OSI no later than November 1st of every year.[32] Upon receipt of the annual report, the OSI undertakes a review of this information, including a claim-by-claim analysis of the indemnity reserves. If necessary, the OSI makes adjustments to the reserve information submitted based on internal reserve guidelines, and notifies the self-insurer accordingly. Once the OSI completes its review, summary payroll, reserve and payment information are inputted into to the security deposit model.

In addition to the payroll and claim data, the WCB's examination extends to a review of the self-insurer's financial condition. Historical trends indicate that the ultimate development[33] on a defaulted self-insurer's reserves are significantly higher for those insurers that are not in default (and continue making payments themselves). Therefore, the WCB actively monitors the financial condition of each individual self-insured employer.

The security deposit requirements of self-insurers assigned a poor financial rating (and thus more likely to default) are increased by insolvency risk factors (ranging from 15% to

[30] Loss development factors are actuarially determined factors which use historical payment patterns and other statistics to determine how much a reserve dollar reported today will ultimately grow to.
[31] 12 NYCRR Section 315.4
[32] 12 NYCRR Section 315.4(b)
[33] Loss development factors are actuarially determined factors which use historical payment patterns and other statistics to determine how much a reserve dollar reported today will ultimately grow to.

35%), depending on the financial rating assigned to the employer (the worse the financial condition, the higher the factor). If the financial condition of the self-insured employer improves, the insolvency risk factor is reduced or removed. It is important to note that while the financial standing of every individual self-insurer is closely monitored, this is done to determine the "surcharge," that needs to be added to the self insurer's required security deposit for poor risks. The insolvency risk factor is not used, however, to determine if they should continue to enjoy the privilege of self-insuring. Nor is it used to grant credits for those employers who have strong financial ratings.

Once the summary information and insolvency risk factors (if applied) are loaded, updated deposit requirements are generated. Individual self-insured employers are then notified if their security deposits need to be adjusted and the WCB ensures that the updated deposit, in the proper form and amount are submitted in a timely fashion.

From the self-insurer's perspective, the time frame for the submission of the reports, the recalculation of the deposit amounts, the notification of the updated requirements, and the deadline for the increases to be posted with the WCB is relatively short, leaving little lead time for the self-insurer to budget for any increases that may be required.

These security deposit requirements are calculated for the very specific purpose of ensuring that the outstanding liabilities of a self-insured employer are met in the event of a default. Thus, the amounts calculated by the WCB can vary greatly from those liabilities that self-insured employers calculate for their own financial statements. This makes it difficult for the self-insured employer to project and budget for the increases that may be required. These discrepancies often lead to difficult and time-consuming disputes, which result because the WCB's methodology (which is solvency based) differs from the methodology (which is based on GAAP accounting standards) that the employers use to internally develop their own reserve estimates.

D. Default Risk

Finally, there is the risk that a default will occur and leave the other self-insurers exposed. The obvious question when this happens is why?

As previously stated, the financial integrity of active self-insured employers is closely monitored to ensure that the security deposit requirements include an insolvency risk contingency, when necessary. The financial integrity of all active and inactive self-insurers must also be monitored to predict when a default might occur, and ensure that, in the event of a default, the timely and appropriate payment to claimants is continued without interruption.

Employers who self-insure for any length of time make a long-term commitment, not only in terms of making payments related specifically to their claims, but also in terms of the security deposit that is to be posted with the WCB. Security deposits are required from each individual employer, during and long after they stop self-insuring, to protect the interests of the remainder of the self-insurance community who would bear the burden of any security deposit shortfalls in the event of default. Under the current program structure, there are no other methods available to secure these claims, and once they are incurred under a self-insurance program, they remain under that program until there are no payments left to be made. Currently, products such as portfolio transfers are not available. With portfolio transfers all or part of claims incurred under a self-insured program can be transferred to the private insurance market, thus relieving the self-insurer of long-term claim exposure and the security deposit requirement.

In addition to ensuring that self-insurers post these security deposits, the WCB must also ensure that the banks and surety companies that post the security deposits on the self-insurer's behalf maintain sufficient creditworthiness standards as well. Should an active or inactive self-insured employer default and the banks or surety companies fail as well, the claims would be unsecured, and the self-insured community would be responsible for 100% of the defaulting employers' self-insurance obligations.

Once a default occurs, for either an active or inactive self-insurer, the WCB immediately draws on the security held for that employer to make claims payments. If the security deposit is deemed inadequate, the WCB must take whatever legal recourse is available to protect its position.

Often the security deposit is the only recourse against that employer. In most cases defaults have been in conjunction with the employer's bankruptcy. The WCB has not been successful recovering security deposit shortfalls particularly under the bankruptcy laws since the WCB's claim is given the same status as a general creditor.

Finally, the WCB must also continually monitor the adequacy of the remaining security held for the defaulted self-insured employer (whether they were actively self-insured when the default occurred, or inactive), in order to determine when those amounts will be exhausted, and when the assessment on other self-insurers must begin.

Measuring the adequacy of the security deposit in the event of a default represents a significant challenge. Past experience has shown that projections made when the employer is active may be significantly inadequate once the employer defaults and stops paying claims.[34]

There are a number of reasons for this adverse development, including:

- There are no longer any return-to-work programs so injured workers tend to stay out longer or indefinitely;

[34] The model has not been revised to reflect this increase since doing so would result in substantial increases to all self-insurers, even the strongest. In addition, in light of the impending changes to the program, it did not seem prudent.

- The wages injured workers typically received under their former employer are higher than they will receive from a new employer and, in some cases, the benefit payment is similar or higher than the new employer wages;
- Claimants with older or inactive cases tend to reactivate their cases or visit their doctors to ensure that the case remains in the "active" file and is not lost during the bankruptcy transition.

The Grand Union case shows how assuming that historical loss patterns will continue in bankruptcy can result in grossly understating outstanding claims liability. Shortly before Grand Union's bankruptcy the WCB's estimate of outstanding obligations was approximately $41 million. However, the surety bond posted was valued at $35 million and the WCB requested that Grand Union increase its security deposit by $6 million.

Seven years after the default, the amount paid on these claims since bankruptcy has exceeded $25 million and the outstanding reserves (excluding any potential claims development) are estimated to be $39 million, for a total projected self-insured liability of $64 million. While it is difficult to measure what portion of the shortfall is attributable to changes in claims patterns that occurred as a result of the default, the Grand Union case provides a clear example of inherent limitations in the current security deposit model.

In the event the security proves to be insufficient to cover all remaining liabilities the WCB guarantees the payment through an assessment made against all self-insurers.[35] Although this payment initially comes from the WCB's administrative budget, it is subsequently reimbursed by the entire self-insurance community in the form of increased assessments. The assessment process currently used to guarantee defaults is "pay-as-you-go", based on the amount of cash needed in the current fiscal year to pay claims. As a result the assessment levels are prone to dramatic swings from year to year.[36]

E. __Summary__

As described in this chapter, the current individual self-insurance program has three major challenges to be considered in developing a new model. Most notably: granting indefinite approvals which does not provide adequate control over the credit risk; a complex and often inadequate model for quantifying risk and related security deposit requirements; and a "pay-as-you-go" assessment process for meeting shortfalls when a default occurs and the security is insufficient which often leads to dramatic swings in assessments from year to year.

The following chapter of this report will offer an alternative to the current system, which is to create a self-insurance pool or fund, which will address many of the limitations in the current system.

[35] WCL Section 50(5)(f)
[36] A more detailed discussion on the defaults and related assessment process is presented in Appendix B.

Chapter Five – Pooled Approach

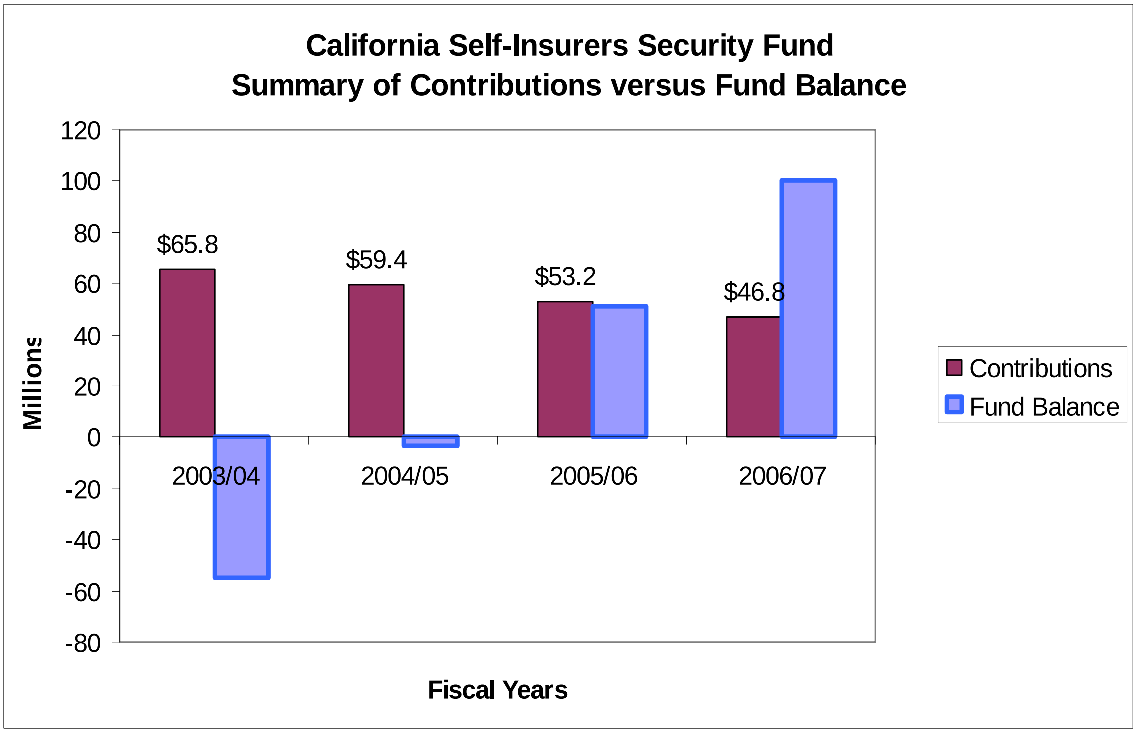
A. Overview

As detailed in the preceding chapter of this report, the current program in the State of New York secures claims using a silo approach, requiring every individual self-insured employer to post a security deposit even though only the deposit posted by a defaulted self-insurer can be used for those defaulted obligations. This silo approach requires employers to collectively arrange for and post billions of dollars in security deposits.

This system results in the annual renewal of billions of dollars in security deposits that will rarely be called upon, and annual fees paid to banks and surety companies that will never be recovered or returned. As a result, the silo approach represents an inefficient use of resources which is compounded by the fact that employers are often required by the banks and surety companies to post additional collateral to secure themselves from the risk of default, driving the employer's imputed cost of security beyond the amount paid for the instrument posted with the WCB.

An alternative to the current system is to create a self-insurance "guarantee pool" to be funded by the amounts that would otherwise have been paid to banks and surety companies for individual deposits into the guarantee pool. In turn, that pool would be used to guarantee claims in the event any self-insured employer defaults on its workers' compensation obligations.

Several other states have moved from a silo approach to a pooled approach over the past few years, most notably California and North Carolina. Specifically, in 2003, California implemented an alternative security program known as the California Self-Insurers' Security Fund ("Fund"). The chart below shows how successful this new program has been.



Prior to implementing the alternative system, the Fund was experiencing frequent defaults of self-insured employers and had accumulated a deficit of approximately $55 million. However, as of June 30, 2006, the Fund has a net surplus of approximately $100 million while concurrently reducing the annual contributions into the fund from $65 million to approximately $47 million over that same period.

Under the pooled approach, only those employers that meet certain minimum creditworthiness standards would be permitted to continue to self-insure as part of the pool. Self-insurers that fail to meet the minimum financial thresholds would be terminated from the guarantee program and required to use one of the other acceptable methods of securing prospective workers' compensation coverage (i.e., State Insurance Fund or private carrier coverage) thereby addressing one of the major shortcomings of the current program.[37]

Active employers that meet the eligibility requirements for participation in the pool would be required to make an annual payment into the guarantee pool and, upon doing so most would have their currently posted security deposit released by the WCB in the first year. This would make available to employers billions of dollars in credit facilities,

[37] The impact on active self-insurers who may not qualify under the new eligibility requirements could be tempered depending upon the financial criteria selected or some other method for securing their claims.

currently used to secure their self-insured workers' compensation obligations, as well as the underlying instruments for those facing strict collateral requirements by banks and surety companies.

Annual fund contributions would grow over time and become a pool of cash that would be used to cover a default by an active self-insurer, or a shortfall created by inadequate security deposit posted by a defaulted inactive self-insurer. It is important to note, however, that this approach can only be successful if eligibility requirements are strictly followed thereby creating a pool of employers with acceptable credit. Otherwise, self-insured employers with poor credit risk would have their security returned thus leaving the program extremely vulnerable to a default.

Inactive self-insurers would continue to post their silo deposits until all of their claims have been paid (or until they dispose of their self-insured obligations through a portfolio transfer mechanism).

Further, depending upon the design of the pool, the amount of exposure that any one active employer can bring to the pool could be capped. For example, the pool may cover a self-insured's obligations up to a $50 or $100 million threshold, and any employer whose outstanding claims liabilities exceeds that threshold may also be required to maintain an incremental silo deposit for amounts above that $50 or $100 million threshold. Alternatively, some type of other financial product (i.e., credit default swaps) could be purchased by the pool for the affected employers, which would protect the pool above those upper threshold amounts on a collective basis, and incremental silo deposits would not be required.

Under this pooled approach, a credit analysis performed by the WCB would determine the probability of default for the participants in the program. In addition, actuarially estimated outstanding self-insured liabilities of the participants and a simulated cash flow analysis would be utilized to determine the ultimate fund balance to be achieved in the pool to ensure the protection of claimants' benefits. Once the overall fund balance target has been established, based on selecting a period for the fund balance to reach its maximum level, estimated annual contribution levels would be determined. These contribution amounts would be adjusted annually based on the performance of the fund (i.e., whether or not the current year had any defaults, interest income, etc.).

Ultimately, instead of paying fees to a bank or surety company for security deposits, all active self-insurers would pay a fee into the guarantee pool. Therefore, the collective $25 million paid for the approximately $1.8 billion of security deposits held by the WCB and any collateral posted would be redirected to the benefit of the plan participants.

Similar to the current program, there would still be three main risks that need to be managed. Outlined below are the recommended methods to mitigate these risks under the pooled approach.

B. Eligibility Criteria

As described above, the current program structure includes a thorough analysis of the financial condition of employers applying for the initial approval to self-insure. However, once approved, ongoing financial rating of active self-insurers is only performed to determine the level of surcharge (if any) that should be added to the annual security deposit requirements of each employer.

Currently, there is no formal renewal process during which the financial condition and self-insurance status of the employers is re-evaluated, a practice that represents one of the most significant differences between current practices in New York and those in many other states. Moreover, this represents a notable difference between current practices and those that must be applied under the pooled approach described herein. Maintaining employers in the current program who are not financially stable presents a risk to other employers who would be responsible for covering the costs of such an employer's default.

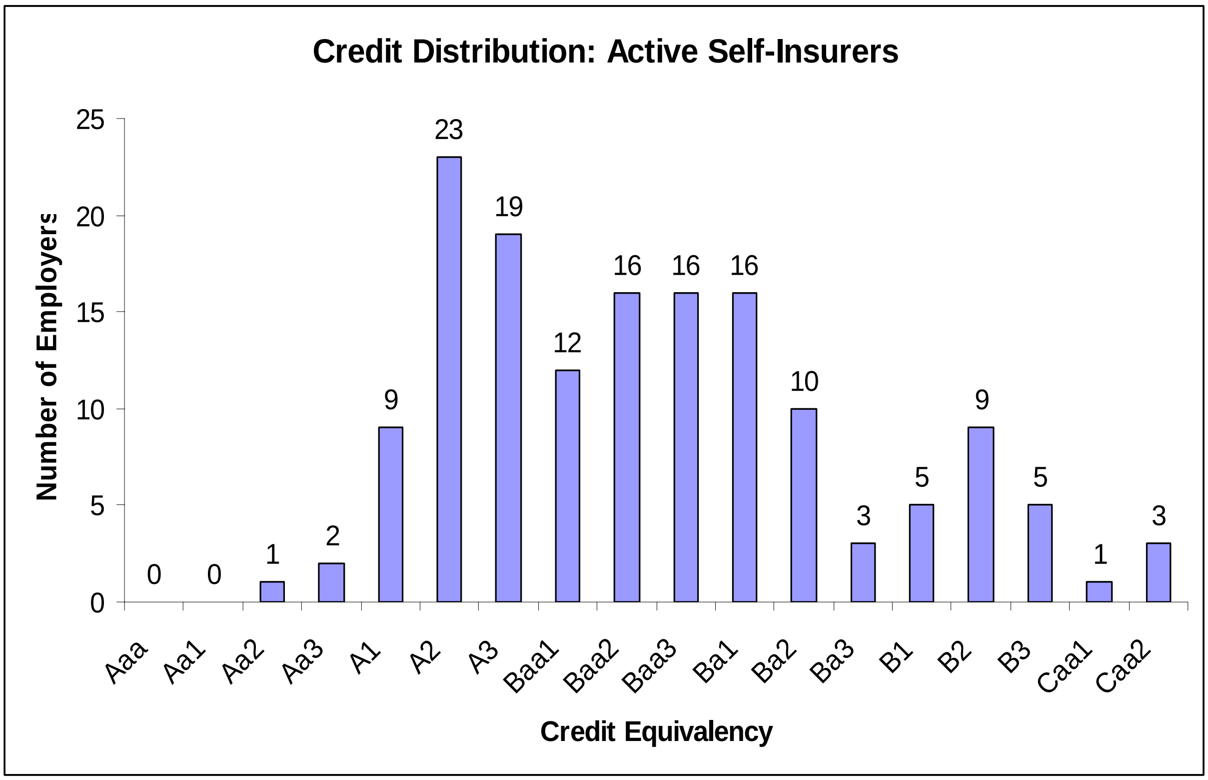
Under the pooled approach, every active self-insurer would undergo an annual renewal process. Renewals would then be granted to every employer who continues to demonstrate compliance with established creditworthiness standards. Conversely, the privilege of self-insurance would be revoked from any employer who fails to meet these standards, and those non-complying employers would be required to obtain prospective coverage through one of the other methods acceptable under WCL Section 50.

There are a variety of financial standards and methods currently used in other states to determine if an employer can self-insure, including, but not limited to: minimum levels of net worth or net income; the results on a variety of financial ratio tests; or certain minimum ratings by one or more of the various statistical rating organizations (i.e., Moody's, Dun & Bradstreet, Standard & Poor's, etc.) or a combination of these standards and methods.

Under the pooled approach, the WCB recommends that the credit risk of each individual self-insurer be used in establishing the financial standards (either for a new applicant or active self-insurer upon renewal). In order to establish each employer's credit risk, the OSI would utilize credit risk assessment tools offered by financial rating agencies. These tools use data contained in the financial statements of each individual self-insurer, their primary industry, and the general economic environment, and uses sophisticated financial modeling and analytics to compare the subject employer's financial attributes to a database of default and loss experience. The credit risk assessment tools will assist the WCB in establishing the probability of default within one year for each employer, and mapping the probability to a credit equivalency score. This score will serve as the basis for accepting that employer into the self-insurance program (for new applicants), or allowing active self-insurers to continue in the program (as part of a renewal process).

Alternative tools may be used to establish creditworthiness, as deemed appropriate by the WCB.

Using the approach described above produces a much wider dispersion of creditworthiness ratings as compared to the current process described in Chapter Four (with a rating scale of 1 to 5). The following offers a summary of how these standards[38] would apply to the current roll of active self-insurers. The table includes published ratings when available, and equivalent ratings derived for non-public self-insurers, using the above-mentioned credit risk assessment tools with information currently available.



As shown, the current roster of active self-insured employers includes a wide cross section of credit risk, as displayed using a credit equivalency like that described above. The level of granularity provided with the use of such a scale would enable the WCB to establish more meaningful creditworthiness thresholds than are currently applied today. For the purposes of this analysis, the threshold was set to allow employers with a rating of B2 or better to participate in the pooled approach. Using this criterion, nine of the current self insurers would be eliminated from the program.[39]

[38] The WCB utilized the Moody's KMV product to establish this rating scale for the current roster of active self-insured employers.
[39] The impact on active self-insurers who may not qualify under the new eligibility requirements could be tempered depending upon the financial criteria selected or some other method for securing their claims.

C. Quantification of Risk

In reviewing the options for determining the exposure for each individual employer and the basis for allocation of costs under the pooled approach, the WCB considered a number of options including continuation of the current actuarial model.

Under the pooled approach, the manner for determining outstanding liabilities (i.e., the exposure of each active employer) and the basis for allocating costs would be accomplished through a WCB directed independent actuarial estimate of total ultimate outstanding workers' compensation liabilities for each self-insured employer.

To further measure the exposure each employer brings to the pool, credit equivalency scores will be established for each self-insurer and applied to their ultimate outstanding workers' compensation liabilities.

With respect to the allocation methodology, as previously discussed, the risks to the guarantee pool fund are attributable to the obligations of active and inactive self-insured employers. Under the pooled active self-insurers pose the predominant risk because under this approach they will be required to post no security deposit; the inactive self-insurers only pose a risk that their security deposit is not sufficient to cover their claims in the event of default. As a result, the WCB is using the methods described in this section to measure the diverse levels of risk and allocate costs accordingly.

Initially, the amount of the contribution into the guarantee pool will be based on the actuarially determined ultimate claim liabilities of each individual active self-insurer, and on the posted security deposit for employers, who are inactive as of the date the program is implemented, multiplied by each employer's respective probability of default. In the example given below, the inactives' total share is further reduced to 30% to reflect the fact that the WCB is still holding security on these inactives.

Pool Apportionment Methodology

	Outstanding Liability (A)	Probability of Default (B)	Expected Default (A)*(B)	Security Credit	Proportional Share ($)	Proportional Share (%)
Active Employers						
Employer A	$100,000,000	0.50%	$500,000	N/A	$500,000	
Employer B	$50,000,000	3.00%	$1,500,000	N/A	$1,500,000	
Employer C	$75,000,000	1.00%	$750,000	N/A	$750,000	
Employer D	$25,000,000	1.00%	$250,000	N/A	$250,000	
Total Active	**$250,000,000**		**$3,000,000**		**$3,000,000**	**74%**
Inactive Employers						
Employer X	$25,000,000	0.10%	$25,000	30.00%	$7,500	
Employer Y	$50,000,000	3.00%	$1,500,000	30.00%	$450,000	
Employer Z	$100,000,000	2.00%	$2,000,000	30.00%	$600,000	
Total Inactive	**$175,000,000**		**$3,525,000**		**$1,057,500**	**26%**
Grand Total	**$425,000,000**		**$6,525,000**		**$4,057,500**	**100%**

Therefore, in this example, the total probable cost of default will be approximately $4 million and the allocation basis would split the contribution requirement between actives (74%) and inactives (26%) based on their respective proportion to the total.

Further, once the total annual allocation amount is split between actives and inactives, that amount is redistributed among the participants in each category based on their proportional expected default to the category total. For example, employer B would pay 50% of the total $3 million allocation since their share is 50% of the expected defaults for the active pool.

One of the most significant administrative burdens in the current system relates to the annual updating of security deposits for every active self-insurer. This requires the use of a complex actuarial model and claims specific detail for every active self-insurer. Under the pooled approach, an independent qualified actuary (who will be chosen by and under contract to the WCB) will determine the reserve estimates, which would obviate the need for the self-insurers to report every claim and significantly reduce the paper-intensive process under the current silo approach.

D. Default Risk

Under the pooled approach, the likelihood of a default for an active self-insured employer would be reduced, because the financial standards would be significantly higher than the current standards and based on a model that predicts the probability of default. If an active self insurer defaults, it is expected that the guarantee pool will be able to absorb most defaults within the existing fund balance.

If a default occurs for an inactive self-insurer, the security on deposit would be called in full and used to pay the claims of the defaulted self-insurer. Even if the security deposit is inadequate, there would be no need for cash until the security deposit was exhausted. At that time, any additional costs would be covered by the pool.

It may take several years for the guarantee pool to reach the desired funding, which will limit the pool's ability to cover losses in the early years or catastrophic losses. Therefore, the WCB recommends that it be given authority to issue revenue bonds. This authority would give the WCB an additional credit facility to ensure the continuation of benefits if the guarantee pool is inadequate. Since the bonds could require repayment over a period of up to 20 years, self-insurers could be protected from violent swings in the assessment rate.

The debt service costs related to the revenue bonds (if necessary) would be paid from the annual contribution assessments paid by all employers into the fund and would be based on the amortization of the debt service on the bonds, not the amount needed from year to year to fund benefit payments, which can fluctuate significantly.

Further, revenue bonds would give the WCB the capacity to solicit bids from the insurance market, to "sell" the portfolio of claims associated with a defaulted self-insurer. This type of loss portfolio transfer would enable the WCB to eliminate all future responsibility for these claims for one premium payment, without recourse back to the self-insurance program. This mechanism could also enable inactive self-insurers to transfer their self-insured obligations into the traditional market.

E. Summary

As described herein, the pooled approach provides for adequate control over the credit risk, by applying stricter financial criteria annually to all program participants. It offers a sound basis for quantifying the risk with the use of uniform actuarial reports. It also protects the remainder of the self-insurance community should a default occur by building a pool which should be able to absorb the default.

The following chapter of this report briefly describes another option considered in the preparation of this report: the enhanced silo approach.

Chapter Six – Enhanced Silo Approach

A. Overview

While Chapter Five presents the recommended alternative funding model for self-insurance, this section of the report describes an alternative that was considered but is not recommended. This alternative, while an improvement over the current approach, would continue to require billions of dollars be maintained as security for the outstanding claims.

This alternative, herein referred to as an "enhanced silo approach," requires self-insurers to continue posting individual security deposits. However, those deposits would be based on a WCB directed independent actuarial evaluation (as opposed to the complex internal actuarial model currently in use). In addition, the most creditworthy self-insurers would be eligible for a reduction in their required security deposit to acknowledge the fact that highly rated employers expose the program to less risk of default. Those employers that do not meet the criteria for a reduction would post the full amount as required by the WCB.

In addition to these individual deposits, each self-insurer would pay a "fee" into a residual default pool, which would grow over time and provide initial funding for defaults until the posted security deposit is liquidated and cover any portion of a default that exceeds the amount of the security deposit, if necessary. Contribution into this pool would be based on the outcome of various cash flow modeling techniques and would be allocated to each employer based on such factors as their relative creditworthiness and the size of their security deposit requirement.

Under this alternative, the WCB would accept loss portfolio transfers which would allow an inactive employer the option of selling off its self-insured obligations, and have its security deposit returned. Employers electing this option would be required to make a contribution to the WCB at the time the claims are sold in order to buy out the future assessments it incurred while self-insured.

If a large default occurs, the amount of the outstanding claims exceeds the individual security deposit, and this loss cannot be absorbed by the residual default pool, the State would have the authority to issue revenue bonds to provide the funding needed to continue benefit payments and level the assessments to the remaining self-insurers who are liable for the shortfall.

The revenue bonds, if necessary, would be repaid through assessments of all employers who maintain any outstanding self-insured liabilities. The assessments used to service the unpaid revenue bonds would be based on each individual self-insurer's relative creditworthiness and its security deposit requirement. The revenue bonds would also give the WCB the option to consider using the proceeds to purchase portfolio transfers for defaults that have already occurred, which effectively fixes the cost of the default at an amount determined by the insurance market.

These portfolio transfers may provide a predictable and cost efficient way to manage defaulted claims by capping claims costs when the transfer is made, and thereby eliminating the risk of adverse claims development.

It is expected that the aggregate cost of this alternative to self-insurers would be no more than the costs of the current system since the credit offsets applied to security deposit requirements of some employers would be lowered, and these savings would be replaced with contributions into the residual default pool. In addition, the revenue bond authority provides for a mechanism to level out payments that would be required in the event of an under-funded default and thus, allows employers to avoid unexpected increases in future assessments.

B. Eligibility Criteria

Under the enhanced silo approach, the WCB proposes that the credit risk of each individual self-insurer be used in establishing the financial standards. In order to establish each employer's credit risk, the WCB will utilize credit risk assessment tools offered by financial credit agencies, in the same manner as set forth in the treatment of the pooled approach in the preceding chapter. Renewals would then be granted to every employer who continues to demonstrate compliance with the established creditworthiness standards. Conversely, the privilege of self-insurance would be revoked from any employer who fails to meet these standards, and those non-complying employers would be required to obtain prospective coverage via one of the other methods acceptable under WCL Section 50.[40]

C. Quantification of Risk

Under this approach, the security deposits posted by every active self-insurer would be based on the creditworthiness of each employer, as well as the WCB directed, independent actuarial estimate of total ultimate outstanding workers' compensation liabilities for each self insured employer. Further, employers with superior credit ratings would be entitled to a reduction in their required security deposit.

Offering discounts to the security deposit requirements for financially strong self-insurers is significantly different from the current practice of fully securing for all employers' outstanding self-insurance obligations and only applying surcharges for those employers with poor credit scores. With the use of stricter creditworthiness standards, it is likely

[40] The impact on active self-insurers who may not qualify under the new eligibility requirements could be tempered depending upon the financial criteria selected or some other method for securing their claims.

that employers who previously received surcharges would not be allowed to continue to self-insure.

D. Default Risk

Under the proposed enhanced silo approach, the likelihood of default for an active self-insured employer would be limited because stricter financial standards would be applied to active self-insurers. If a default occurs for either an active or inactive self-insurer, the security on deposit should prove to be adequate. Even if the security deposit is not adequate, the need for cash would not present itself until the posted security deposit was exhausted, which would give the WCB the ability to use any of a number of alternatives to plan for and fund the future shortfall.

First, the current process of assessing any shortfalls on a pay-as-you-go basis could be continued, although this has historically exposed the self-insurers to wide fluctuations in the assessment amounts. In order to level out the assessments, the residual default pool would be maintained at levels sufficient to absorb small security deposit shortfalls. The pool itself would be funded by annual fees paid by every active and inactive self-insurer. It would be maintained at a funding level based upon the outstanding self-insured obligations and the probability of a default as determined by the financial rating of each self-insured employer.

Similar to the pooled approach, revenue bond authority could give the WCB additional flexibility to plan for its cash flow needs and choose which funding mechanism best fits a given default situation – assessments, revenue bond issuance, loss portfolio transfer, or a combination thereof.

Secondly, under the enhanced silo approach, the apportionment for the default assessment would be based on the same methodology used for determining the contributions into the residual default pool as described above. This provides a more equitable method for curing any defaults, and ensures that there is a sufficient revenue stream should the number of self-insurers decrease as both active and inactive self-insurers would be assessed.

E. Summary

While the enhanced silo approach described herein provides an alternative to the current program which more effectively measures and manages the various risks, the pooled approach described in the previous chapter offers a more cost effective solution, as shown in the following chapter.

Chapter Seven – Quantitative Analysis

A. Background

The quantitative analysis portion of this report describes the expected outcomes for the two approaches, i.e., pooled approach and enhanced silo, and compares the results to the current system. The assumptions used to build those models were tested to determine the level of inherent risks within.

This quantitative analysis is based primarily on a Monte Carlo simulation model. In essence, 10-year financial results for the programs were calculated based on the members of the self-insurance program and their probabilities of financial default. These 10-year financials were then simulated 10,000 times in order to test the impact of different combinations of self-insurer defaults, different economic scenarios, and other key factors.

Overall, these factors were tested to determine what aspects of the proposed program have the most impact on the financial health of the overall self-insurance program (a sensitivity analysis), the impact of varying economic conditions on the proposed program in order to understand its potential risks and rewards (a stress test). We then used this information to formulate options that are most likely to result in a successful program—one that is economically efficient and appropriately conservative.

B. Basic Assumptions

Overall, the quantitative analysis incorporated the following high-level assumptions:

- The total amount spent by active self-insurers to secure their claims in the first three years of the program will not be higher than what their cost of security would have been had there been no change to the current program.[41]

- Under the pooled approach, most active self-insured employers accepted into the new program will have their security deposits released. Further, any collateral pledged to a bank or surety company by a self-insurer to back up their security deposit will be released. The operational savings attributable to freeing up borrowing capacity or reducing opportunity costs have not been quantified, and in some cases will likely be significant.

- Under the pooled approach, in order to protect the pool from the full cost of large defaults, certain very large self-insurers may need to secure a portion of their exposure. In contrast, under the enhanced silo approach, security deposits will continue to be required, but may be reduced based on creditworthiness.

[41] It is expected that the active self-insurers will pay more overall due to the assessments attributable to existing defaults under the current program as discussed in Appendix B.

- Under the enhanced silo approach, in addition to the posting of security by individual plan participants, all self-insurers will pay a nominal amount into a residual default pool that will be used in the event any one self-insurer's security deposit is insufficient. This will replace the current approach of a "pay-as-you-go" funding method.

- Under both models, all inactive self-insurers at the time of conversion to the new program will continue to post the required security. However, it is anticipated that these amounts will decrease over time as the outstanding liabilities are paid off.

- Under both models, all inactive self-insurers will continue to pay assessments in relation to the risk they pose

C. ***Base Models***

Using the assumptions outlined above, and in order to test the program's ability to withstand fluctuations such as number of participants, a "base model" was generated for each approach, which was then used as the standard to measure the effect of changes in the following criteria.

- Eligibility to be in the Program: The risk to the program will be contingent upon the members that are allowed to participate. Therefore, it is important that the program is composed of self-insurers with superior credit risk. In the base models, it has been assumed that the programs will consist of self-insurers with credit ratings of B2 or better.
- Size of the Program: The base models assume that all currently active self-insured employers that meet the eligibility standards will continue in the program. i.e., zero growth in the number of self insured employers.
- Portfolio Transfer Costs: It was also assumed that the pool purchases an insurance policy to transfer the outstanding liabilities associated with any default. The base assumption is that the cost of the portfolio transfer will be 15% above the net present value of the estimated liabilities. This reflects insurance company costs and profit as well as the fact that for the purposes of calculating net present value insurers may be more aggressive in projecting rates associated with future investment income.
- Revenue Bonds: Cash shortfalls will necessitate the use of revenue bonds to cover funds owed. Cash provided by the bonds and the cost of repaying the bonds are reflected in the financials of the pool. For the base model, a bond interest rate of 5.0% was assumed and the length of the bond payout is estimated to be ten years.
- Rate of Return: The rate of return assumed in the base model is 4%.

D. Base Model Results versus Current Program

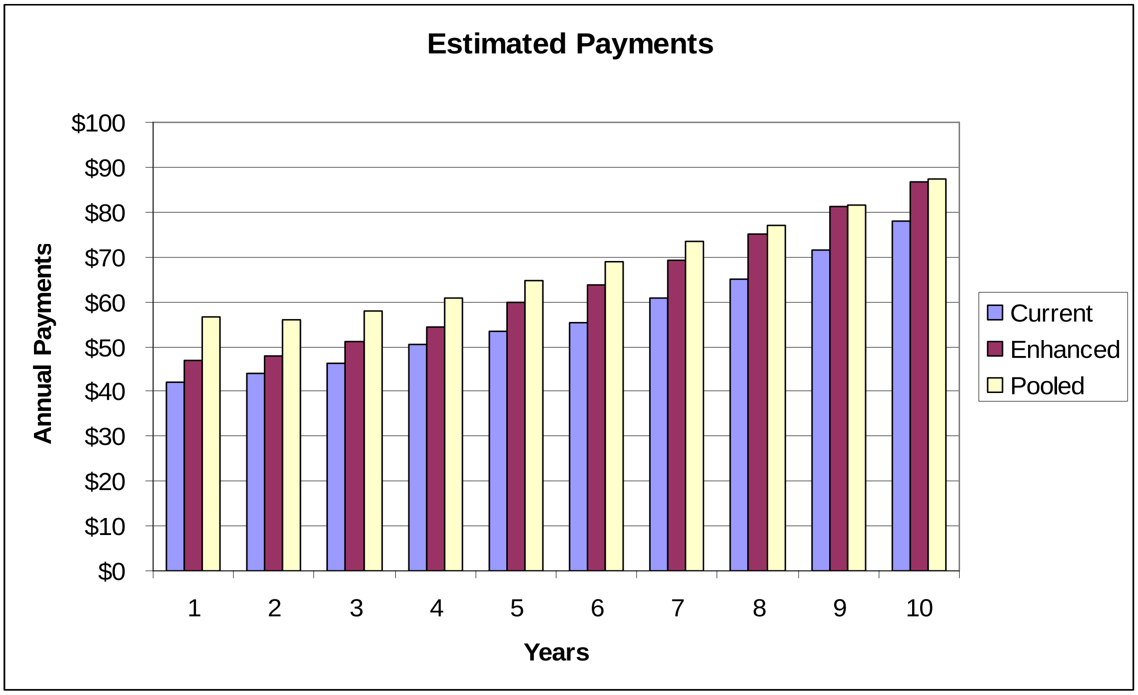
The following chart shows expected ten-year results using the base model assumptions above for both the pooled and enhanced silo approach, as well as the projected costs under the current program:

Cost Comparison of Base Models to the Current Program

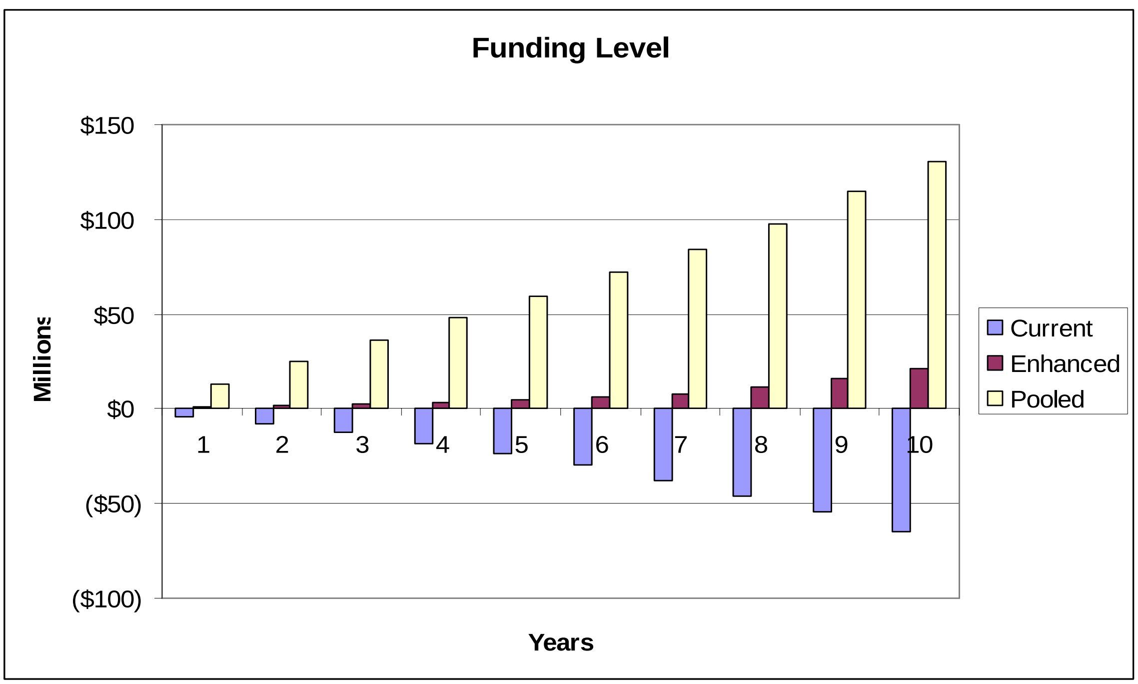
	Ten Year Cost Estimates		
	Employer Type		
	Active	**Inactive**	**Total Costs**
Pooled Approach			
Security Cost	$43	$230	$273
Fund Cost	$232	$178	$410
Total Gross Cost	$275	$408	$683
Less Fund Balance	$74	$57	$131
Total Net Cost	**$201**	**$352**	**$553**
Enhanced Silo Approach			
Security Cost	$229	$229	$458
Fund Cost	$99	$80	$179
Total Gross Cost	$328	$309	$637
Less Fund Balance	$12	$9	$21
Total Net Cost	**$316**	**$300**	**$616**
Current Program			
Security Cost	$457	**N/A	$457
Default Cost	$174	N/A	$174
Total Gross Cost	$631	N/A	$631
Unfunded Liabilities	$70	N/A	$70
Ultimate Cost	**$701**	**N/A**	**$701**
**the model does not include the costs associated with current inactives			

In summary, the readily apparent costs over a ten-year period of the pooling approach, the enhanced silo approach, and the current program are very similar at $683 million, $637 million and $631 million respectively. However, despite the relatively small differences in costs both the pooled approach and the enhanced silo approach, there will be fund balances of $131 and $21 million at the end of ten years, resulting in net costs of $553 and $616 million, respectively. Conversely, under the current program, there will be an unfunded liability of $70 million at the end of that same ten-year period making the ultimate cost of the current program $701 million.

The charts below depict the annual estimated payments over the ten-year period for the three options, as well as the projected funding level for each of those years:



The funding levels for the pooled approach could be adjusted to more closely match those of the enhanced silo approach or the current program if a decision was made to build the fund balance over a longer period or to cap it at a lower fund balance, or a combination of both.



E. Alternative Scenarios Tested

In addition to running simulations using the base model assumptions for both the pooled and enhanced silo approach, the sensitivity of the models to changes in the criteria was also tested. The following is a summary of the changes in fund balance, for both the pooled and enhanced silo approach, for the various criteria tested.

- ***Tighter/Looser Eligibility Standards***: The eligibility standards have a major impact on the health of the program. The current base models assume employers whose financial rating is a B2 or better will be eligible. If the eligibility criteria were loosened to also allow in all B rated companies, the fund balance would deteriorate significantly. Conversely, if the eligibility criteria of the pool were tightened so that only companies with a Bb rating or better were accepted, the fund balance would improve.

	Fund Balance (in millions)	
Scenario	**Pooled Approach**	**Enhanced Silo Approach**
Base (Exclude B3 and below)	$131	$21
Tighter Eligibility (Exclude B1 and below)	$300	$33
Looser Eligibility (Exclude Cs)	($112)	($1)

- ***Base Growth***: The base models assume all currently active members that meet the eligibility standards will continue in the program i.e., zero growth. In order to test the flexibility of the programs, the models were adjusted to reflect positive and negative growth of 10%. On average, the 10% growth had a strong positive effect on the fund balance; the 10% reduction had a relatively minimal negative impact:

	Fund Balance (in millions)	
Scenario	**Pooled Approach**	**Enhanced Silo Approach**
Base	$131	$21
Growth -10%	$95	$17
Growth +10%	$202	$28

- ***Higher Cost for Portfolio Transfers***: It is difficult to predict the premium that insurers will demand for portfolio transfers. The base assumption is that the cost of the portfolio transfer will be higher than the current estimate of the outstanding liabilities within the program by an average of 15% due to profit assumptions and other cost factors. Changing the average cost assumption from 15% to 25% above the net present value liabilities does not significantly affect the health of the fund balance.

	Fund Balance (in millions)	
Scenario	**Pooled Approach**	**Enhanced Silo Approach**
Base (15%)	$131	$21
Higher Cost of LPT (25%)	$134	$16

- ***Revenue Bond Payment Terms***: Changing the revenue bond payment terms from ten to twenty years had little impact on the fund balance and resulted in lower annual employer payments over time where the cost was carried out an additional 10 years.

	Fund Balance (in millions)	
Scenario	**Pooled Approach**	**Enhanced Silo Approach**
Base (10 Year Revenue Bond Term)	$131	$21
20 Year Revenue Bond Term	$137	$27

F. Summary of Quantitative Findings

Based on the expected outcomes modeled in the quantitative analysis, the pooled approach is the most cost effective structure for the individual self-insurance program in New York. While the projected total gross costs of the pooled approach, enhanced silo approach and silo approach are similar when compared over a ten year period, the true costs, taking into account the projected fund balance over the same period, clearly favor the pooled approach. This conclusion remains relatively consistent when alternative scenarios (tighter/looser eligibility standards, positive/negative base growth, higher costs for portfolio transfers and longer revenue bond payment terms) are tested.

Chapter Eight – Recommended Integrated Regulatory and Legislative Solution

A. Recommendation – Pooled Approach

As an alternative to the current system, the WCB recommends the creation of a self-insurer "guarantee pool" as described in Chapter Five of this report. This alternative would redirect the amounts that would otherwise have been paid to banks and surety companies for individual deposits into the guarantee pool. In turn, that pool would be used to guarantee claims in the event any self-insured employer defaults on its workers' compensation obligations.

B. Proposed Legislative and Regulatory Changes

In order to implement the recommended pooled approach, various changes are required to the statutes and regulations that govern the individual self-insurance program. The WCB recommends the following legislative and regulatory changes:

Legislative Changes:

Creation of the Pool: WCL Section 50 currently contemplates a security deposit for each self-insured employer in an amount determined by the Chair. Adoption of a pooled approach would require the amendment of this language in WCL Section 50 to provide for the creation of a self-insurers' security fund and amend any reference to individual security deposit requirements to allow for payments into the pool.

Redefine the Self-Insurance Advisory Committee: WCL Section 50 establishes an Advisory Committee for Self-Insurance. However, the membership and duties contemplated under the current statute require amendments to increase the membership of this committee from the current level of seven members to a total of twelve plus the Chair of the WCB, who will also serve as the Chair of the committee. The new role contemplated for this expanded committee would require members of the committee to provide input to the WCB as it makes final determinations on approval parameters and deposit amounts.

Portfolio Transfer Mechanism: New statutory language is necessary to authorize the WCB Chair to sell off workers' compensation liabilities resulting from the default or insolvency of an individual self-insurer by means of a portfolio transfer policy. Such portfolio transfer policies shall include all remaining unpaid compensation or benefits liability of any type for the period of self-insurance involved and shall be issued for a single complete premium payment in advance by the WCB and all applicable assessments shall be paid at the time of transfer. Should, for any reason, the carrier issuing such a portfolio transfer policy issued to the WCB subsequently become insolvent and unable to pay the remaining liabilities under the policy, the Workers' Compensation Guarantee Fund shall be responsible to fund any remaining liabilities.

Revenue Bond Authority: In the event that the amount of money in the newly created fund is insufficient to cover the cost of the defaults at a given time, the State needs a financial tool to absorb and manage these unanticipated costs. Statutory authority is necessary to allow the WCB to issue revenue bonds on behalf of the self-insurance community, if necessary. These revenue bonds could also be used to cover short-term costs and any long-term costs associated with a portfolio transfer.

Amendment of the Section 50(5) Payment in Lieu of the Self-Insurers' Guarantee Fund: Currently, WCL Section 50(5) authorizes payments by the WCB to claimants of defaulted self-insured employers in the event the security is insufficient. These payments are presently billed on a pay-as-you-go basis. Under the pooled approach, in the event an active individual defaults or an inactive self-insurer's security deposits are insufficient to cover the total ultimate cost of claims, the self-insurers' guarantee fund would cover the cost. The fund could also cover the costs attributable to the administration of the program and included as part of the annual assessment amount, thus greatly reducing, or possibly eliminating, the need for the WCL Section 50(5) provision. As such, WCL Section 50(5) should be amended. WCL Section 50(3) should also be amended to require payments in lieu of security for those employers who meet the financial criteria for the pool.

Regulatory Changes:

Credits for Financial Stability: Under the pooled approach, granting some type of credit or reduction in assessments for the most credit worthy self-insurers, perhaps based on the credit worthiness rating of the employer in a credit rating published by a financial rating agency, is recommended. The WCB will use net worth, net income, financial ratios, various credit ratings, etc. as criteria for determining creditworthiness.

Clarification of "Satisfactory Proof" of Ability to Pay: WCL Section 50 already grants considerable authority to the WCB to specify by regulation what constitutes "satisfactory proof" of the employer's financial ability to pay compensation under the WCL. It is recommended that specific minimum financial requirements be set by adoption of a regulation, such as minimum net worth, after tax net income, credit worthiness ratings, or other criteria, that would further clarify the meaning of this statutory language for initial applicants to qualify. Further, an amendment that requires an initial application and annual renewal, which offers satisfactory proof of the employer's financial ability to pay compensation, would permit the WCB the latitude to adopt regulations specifying the contents of the application/renewal, and what would constitute satisfactory proof of financial ability to pay.

Independent Actuarial Report Submission: The WCB presently prepares its own version of an actuarial analysis of each individual self-insurer's liabilities annually. Amendment of the Board's regulations is necessary to require each individual self-insurer to submit to an actuarial analysis and report prepared by a qualified actuary selected by the WCB.

Since reports could vary, the regulation should specify exactly what information the WCB wishes to receive.

It is recommended that the general program structure be provided for through statutory amendment, while the program details are provided for via regulatory amendment. This will allow the flexibility to adjust as the program and market place evolve.

Appendix A – List of Active Individual Self-Insurers

ABF Freight System, Inc.
Albany International Corporation
Allens, Inc.
American Express Bank Ltd.
American Express Company
Arnot-Ogden Medical Center
Ascension Health
Aspire of Western New York, Inc.
Ball Corporation
Birds Eye Foods, Inc.
BJ's Wholesale Club, Inc.
Bombardier Corporation
Bon Secours Health System, Inc.
Brookdale Hospital Medical Center, The
Brooklyn Bureau of Community Service
Bush Industries, Inc.
Carillon Nursing and Rehabilitation Center, LLC
Cayuga Medical Center at Ithaca, Inc.
CBS Corporation (old Viacom)
Champlain Valley Physicians Hospital
Cliffstar Corporation
Climax Manufacturing Company
Columbia University N.Y., Trustees of
Consolidated Edison Company of New York, Inc.
Cooper US, Inc.
Cornell University
Corning Hospital
Costco Wholesale Corporation
Crawford Furniture Mfg. Corp.
Crouse Health Hospital, Inc.
Cummins Inc.
Curtis Niagara LLC
DCH Auto Group (USA) Inc.
DePaul Group, Inc.
DHL Holdings (USA), Inc.
Di Giorgio Corporation
Dolgencorp of New York, Inc.

Appendix A – List of Active Individual Self-Insures (continued)

E. I. du Pont de Nemours and Company
Eastman Kodak Company (NJ)
Emerson Power Transmission Corp.
Entergy Nuclear Operations, Inc.
ESCO Turbine Technologies - Syracuse, Inc.
Federal Express Corporation
Federated Department Stores, Inc.
FedEx Ground Package System, Inc.
Finger Lakes Regional Health System, Inc.
Flying J, Inc.
Ford Motor Company
Fulton Boiler Works, Inc.
Fulton Group N.A., Inc.
Gannett Co., Inc.
General Motors Corporation
General Nutrition, Inc.
Gleason Works, The
Golub Corporation, The
Great Atlantic & Pacific Tea Co., Inc.
Hannaford Bros., Co.
Harden Furniture, Inc.
Health Quest Systems, Inc.
HealthStar Network, Inc.
Hercules, Inc.
Herr Foods Incorporated
Highland Hospital of Rochester
Hillside Family of Agencies
Hilton Hotels Corporation
HNI Corporation
Hollingsworth & Vose Company
International Business Machines Corporation
International Paper Company
John D. Brush & Co., Inc.
John T Mather Memorial Hospital of Pt Jefferson NY
KeyCorp

Appendix A – List of Active Individual Self-Insures (continued)

KeySpan Corporation
Kistner Concrete Products, Inc.
Krasdale Foods, Inc.
L. & J.G. Stickley, Inc.
Lenox Hill Hospital
Leprino Foods Co.
Libbey Glass Inc.
Lifetime Healthcare Companies
Limited Brands Inc.
Lowe's Home Centers, Inc.
Luvata Buffalo, Inc.(old Outokumpu)
Magna Powertrain USA, Inc.
Marriott International Inc.
McWane Inc.
MeadWestvaco
Memorial Sloan-Kettering Cancer Center
Merrill Lynch & Co., Inc.
Metropolitan Museum of Art, The
National Fuel Gas Company
New Era Cap Co., Inc.
New Process Gear, Inc.
New York Black Car Operators Injury Comp. Fund, Inc.
Niagara Mohawk Power Corporation
Nordstrom, Inc.
NYSARC, Inc. Chautauqua County Chapter
NYU Downtown Hospital
NYU Hospitals Center
O-AT-KA Milk Cooperative, Incorporated
Oldcastle, Inc.
Oneida Ltd.
Orange & Rockland Utilities, Inc.
Oswego Hospital
Our Lady of Lourdes Memorial Hospital
Owens-Corning
Owens-Illinois Inc. (1987)
Parker Hannifin Corporation
Pathmark Stores, Inc.
People, Inc.
Proctor & Gamble Pharmaceuticals, Inc.

Appendix A – List of Active Individual Self-Insures (continued)

Queens Borough Public Library
Raymond Corporation
Rochester Institute of Technology
Rockefeller University, The
Rosina Food Products, Inc.
Roswell Park Cancer Institute Corporation
Ryder System Inc.
Saint-Gobain Abrasives, Inc.
Samaritan Medical Center
Samaritan-Keep Nursing Home, Inc.
Sherwin-Williams Company, The
Shop Vac Corporation
Shopwell, Inc.
Six Continents Hotels
SKF USA, Inc.
St. Barnabas Community Enterprises
St. Joseph's Health System, Inc.
St. Joseph's Hospital Health Center
St. Mary's Hospital at Amsterdam
Stanley Works, The
Starbucks Corporation
Stewart's Shops Corp.
Swift Transportation Co., Inc.
Syracuse University
T. Marzetti Company
Target Corporation
Unifrax Corporation (1997)
United Airlines Inc.
University of Rochester
Upstate Farms Cooperative, Inc.
Verizon New York, Inc.
Viacom, Inc.
Visiting Nurse Service of New York
Washington Mills Electro Minerals
Wegmans Food Markets, Inc.
Wendy's International, Inc.
Weyerhaeuser Company
White Castle System, Inc.
Yellow Transportation, Inc.

Appendix B – Current Defaults

Under the existing program, the self insurance community will be impacted by a significant increase to the self-insurers assessment. The reasons attributable to these increases are outlined below. However, it is important to note that these increases were not contemplated in any of the quantitative analysis performed for this report since they would artificially distort the results. Further, these increases will have to be paid for, regardless of the funding model selected.

Beginning in fiscal year 2008, the self-insurer's assessment will, without remedial action, increase significantly. This large increase is due to increased cost for both the individual and the group self-insurance programs. With respect to the individual program, there are two large individual self-insured employers whose security deposits are anticipated to be exhausted prior to all of the claims being fully paid, and it is expected that this will add almost $6 million per year to the assessment beginning in fiscal year 2009-10. Additionally, there are still 24 defaulted self-insurers from earlier periods whose claims are being administered by a surety company and, of those, it is anticipated that at least six will run out of funds over the next 10 to 15 years, resulting in more costs assessed to the self-insurance community.

Prior to 2006, groups that were discontinued managed to run off their outstanding claims obligations without any financial assistance from the state. However, during 2006, two groups failed to meet all of their obligations so the responsibility to oversee the claims was assumed by the state. In 2006 the cost associated with these two trusts was less than $1 million and is now estimated to be approximately $4 million during 2007 and each year thereafter. A third trust was assumed by the state during 2007 resulting in estimated additional annual costs of approximately $4 million. Finally, a fourth trust is expected to run out of funds in fiscal year 2008-09. Altogether, the total additional costs from defaults will result in estimated additional costs in the tens of millions in the coming year alone. It is expected that bills will begin to be issued on behalf of the defaulted trusts in early 2008, thus beginning to offset the future costs assessed to the entire self-insurance community.

The tools described under the pooling approach such as revenue bond authority and loss portfolio transfers, would be useful in spreading assessments required to meet these defaults over a longer period.