STRAIGHT TALK ABOUT WORKERS COMP

HOW COMP PREMIUMS ARE CALCULATED AND STEPS YOU CAN TAKE TO LOWER YOURS

A reader writes:

"This isn't insurance! It's thievery! My premiums for just a helper and me would be $547 a month. What am I supposed to do? Pay and go broke? Never!"

This Long Island contractor is not alone in his anger. Thousands of other contractors fume when they get their workers compensation bills. With premium hikes averaging 12% per year nationwide and sometimes running as high as 40% in certain states, they have reason to complain. Even the most docile contractor eventually asks two questions: Why are costs so high? and What can I do to lower my premiums?

The answers aren't just academic. Although a large portion of your premium is influenced by costs you can't do much about directly, such as rising medical and legal expenses (see Figure 1), you can affect the factors that determine your particular rates.

How Rates Are Set

Every state writes its own workers compensation laws, but most share the same basic mechanism for setting rates. This mechanism is established by the National Council on Compensation Insurance (NCCI), a nonprofit industry association. NCCI is licensed to set the rates in 31 states and to recommend rates in seven more. It also serves in an advisory role in some states where all workers comp coverage is provided by the state. Even in states that use local rating or advisory organizations, the rating model is generally similar to that used by NCCI.

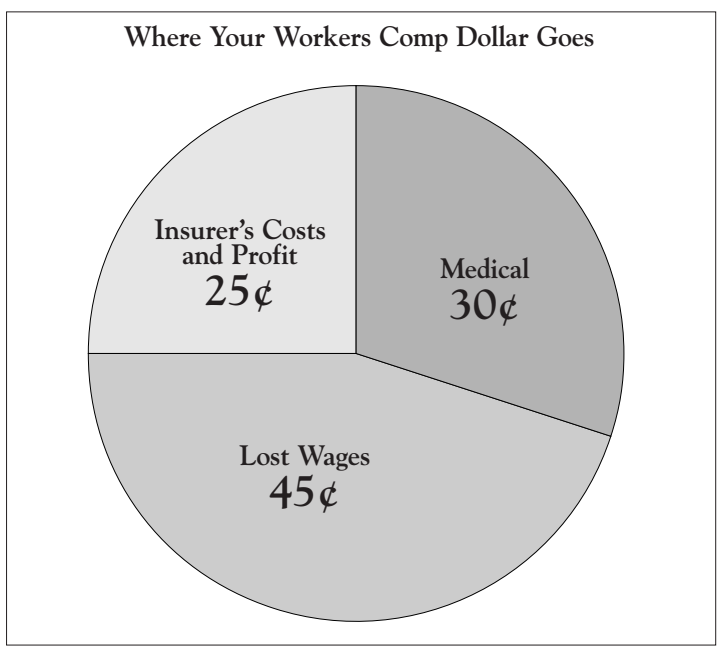

Figure 1. *Health care costs now account for over 30% of your workers comp bill – up from 25% in 1980 and still rising. Similarly, legal costs (counted above as part of insurer's costs) in disputed cases have risen as lawyers become increasingly involved in what was originally a "no-fault" system. Lawyers are now involved in 20% of all comp cases in which workers miss work time – up from 10% in 1980.*

Rating job types. To set rates each year, NCCI first calculates how much insurers paid out in claims (medical costs, wage payments to workers, and expenses of settlement) for the previous year and how much they took in as premiums. They calculate this balance for each of several thousand different employment "safety classification" categories, including single-family residential carpentry and other building trades.

From these balances NCCI projects how much money insurers will need to cover the next year's losses in each category, adds 15% to provide a "fair rate of return," and then gives the resulting rate requests or recommendations to the state regulatory agency. The application is either approved, modified, or denied, in which case NCCI may reapply with another figure.

The resulting *pure premium rate*, or *manual rate*, for each safety classification is expressed in dollars per $100 of payroll. Pure premium rates for carpenters generally run from $5 or $10 per $100 of payroll up to $25 or more per $100 of payroll, depending on the state. In comparison, clerical employees' premiums run as low as 50¢ per $100 of payroll, while those for painters of metal structures over two stories high can run to almost $100 per $100 of payroll.

Rating individual employers. To set an individual employer's premium, the employer's insurance carrier, or NCCI, multiplies the employer's pure premium rate for that employer's safety classification by his company's *experience rating* (or *experience*

BY DAVID DOBBS

Auditing the Auditors: How They Figure Your Premiums

REPORT	POLICY NUMBER	STATE	STATE NO.	CARRIER	CARRIER NO.	CARD SERIAL NO.	ADM. FILE NO.
1	88 88 88	ANY	55	XYZ Insurance Co.	99999	123	

EFFECTIVE DATE	TERM	EXPIRATION DATE	INSURED
7-1-88		7-1-89	XABC Corporation (Address Optional)

COND. | 91 | 92 | 93 | 94 | 95 | 96 | 97 | 98 | OTHER: (1) Risk Identification Number 551234567

EXP. COV	(2) CLASS CODE	(3) EXPOSURE	(4) MANUAL RATE	(5) PREMIUM	(8) CLAIM NUMBER	(9) ACCIDENT DATE OR NO. OF CLAIMS	CLASS CODE	INJ	(10) INCURRED LOSSES: INDEMNITY	(10) INCURRED LOSSES: MEDICAL	(11) OPEN-CLOSED	LOSS COV.	CAT. NO
11	3507	3,868,379	3.56	137,714	880001	9-13-88	3507	2	50,000	12,500	0	11	
11	7380	107,322	2.80	3,005	890002	1-02-89	8810	5	418	4,408	1	11	
11	8742	132,507	.48	636		4	8742	6		562	1	11	
11	8810	502,408	.13	653		5	3507	5	3,034	2,378	1	11	

(6) A - TOTAL SUBJECT PREMIUM				142,008
B - EXPERIENCE MODIFICATION				.85
C - TOTAL MODIFIED PREMIUM (A) X (B)				120,707
D				
E				
F				
G				
RISK TOTALS	STD	4,610,616	XXX	120,707
	OTHER		XXX	XXX
	006	PREMIUM DISCOUNT	XXX	(17,716)
	0900	EXPENSE CONSTANT		120

TOTALS	11	XXXXX	X	53,452	19,848	X	XX	X

DO NOT USE	PREM. SIZE	INDUSTRY GROUP	TYPE	INDUSTRY SCHED.	KEYPUNCH #	VERIFIER #

(7)

(1) The **risk identification number** is used by the industry to identify the employer.

(2) The **class code** column contains the safety classification codes for the employer's employees. Each four-digit number denotes a particular work classification, such as clerical, residential carpenter, etc.

(3) The **exposure** is the amount of premium-basis payroll for each class code. In many states, it is subject to a $25,000 per employee limit. This is one of the most important lines to check for accuracy. Make sure (a) that it includes only those wages paid to workers you are responsible for — your own workers and those of any uninsured subs you use; (b) that workers' wages are charged to the correct class codes (previous column); and (c) that the payroll amounts don't exceed any per-employee limit your state may have.

(4) The **manual rate** is the pure premium rate by which the payroll for each category is multiplied to figure your premium. For residential carpenters, this will probably be somewhere between 10 and 30. There's no use quibbling here, as the rate will be standard to all workers in that category in your state.

(5) The **manual premium** for each class code in your company is derived from multiplying the payroll by the manual rate. These lines are then totaled to give the "total subject premium" to which your experience rating will be applied.

(6) Your **experience rating** is derived by a complicated formula from the basic claims data on the right half of the form.

(7) The **premium** that you will be charged is derived by multiplying the total subject premium by the experience rating.

(8) A **claim number** is issued by your insurer to identify each claim. Claims generating losses (that is, payouts by the insurer) under $2,000 are not listed separately on this form.

(9) The **accident date** is the date on which the injury causing the claim occurred. It is shown for any claim over $2,000. For claims under $2,000, the number of claims is shown in this column. Check both the dates and the numbers of claims carefully against your records to make sure you aren't being charged for nonexistent claims.

(10) The **incurred losses** are split into indemnity (lost wages) and medical payments. For open cases, these amounts include reserves the company has set aside for anticipated future payments.

(11) The **open/closed** column shows the status of the claim. "1" indicates final payment has been made and the claim closed; "0" marks a claim that is still open and expected to generate further losses.

Figure 2. *This is a simplified version of the "unit statistical report" used by the insurance industry to calculate a company's comp premium. It contains both a calculation of the company's pure premium, based on payroll and safety classifications, and the claims data from which the company's experience rating is calculated.*

modification factor). This factor is based on the employer's claims and safety record over the three years ending one year prior to the year for which rates are being set. (That is, for the year 1993, your experience rating will be based on your safety and claims records for 1989, 1990, and 1991.) Figure 2 shows the form on which NCCI tabulates this data.

To avoid having one or two unusually high claims unfairly skew this factor, the formula weighs frequency of claims more heavily than severity. The logic here is that a pattern of safety problems in a company predicts the insurer's risk more accurately than does a single accident, no matter how serious or costly. This is particularly the case with small companies.

To prevent small companies' experience ratings from straying too far from the average, the NCCI formula also uses a complex mathematical weighting factor called "ballast." This formula, which pulls all companies' ratings toward the average, prevents the exaggerated results that could result from relying on a small company's three-year record — statistically, a small body of data.

Once calculated, a company's experience rating is multiplied by the pure premium rate for each employee to determine the company's actual premiums. If your company of four carpenters has a modification rating of 1.2 and the pure premium rate for carpenters in your state is $10 per $100 payroll, you will pay $12 (1.2 x $10) in premiums for every $100 you spend on carpenters' payroll. So if you paid those carpenters $25,000 each for a total of $100,000, you'll pay $12,000 in comp premiums to your carrier.

Sounds Fair, But…

In theory, this system reflects the risks and safety records both of each industry as a whole and of individual employers. It's designed to reward those with good safety records with low rates and penalize those with poor safety records with high rates.

In reality, however, the system has flaws that can unfairly drive a contractor's bills through the roof.

Categories too broad. One frequent complaint voiced by residential contractors is that the category used to classify most residential construction workers, "single-family residential carpentry," is too broad. Framers who walk damp, slippery top plates three stories up share the same classification as finish carpenters or cabinet specialists who rarely get more than two steps up a dry ladder indoors. Depending on the makeup of your crew, then, you may be paying for a higher level of risk than your workers actually run.

Safety Classifications and Rates*

Roofing	39.8%
Carpentry	24%
Plaster/Stucco	18.1%
Painting	17.2%
Landscaping	14.7%
Masonry	14.6%
Drywall	11.6%
Grading	7.9%
Clerical	1%

* California rates for 1990

Figure 3. *Workers comp rates vary with the riskiness of the trade, as illustrated by these safety classifications for the state of California. If some of your workers spend some or all of their time in lower-rate categories, you may be able to reclassify them or even split their classification between categories.*

In addition, some contractors who have checked their carriers' records have found noncarpentry employees, such as office help or drivers, classified as carpenters.

Some contractors have been able to convince their insurers to base premiums on the specific tasks their workers perform: that is, a drywall subcontractor's rate for time spent hanging drywall, a carpenter's rate for carpentry work, a roofer's rate for time spent roofing (see Figure 3). This requires a cooperative insurer and well-documented job-cost breakdowns on your part (see "Job-Cost Accounting," 1/93).

Subs as employees. Insurers also typically classify any uninsured subs as the general contractor's employees, and thus charge the GC premiums against any labor payments to those subs. This can even happen for *insured* subs if the GC doesn't provide proof of comp coverage. In other words, the burden of proof that a given worker isn't his employee falls to the general contractor.

SOME CONTRACTORS HAVE CHECKED THEIR INSURERS' RECORDS AND FOUND NONCARPENTRY EMPLOYEES, SUCH AS OFFICE HELP OR DRIVERS, CLASSIFIED AS CARPENTERS

The insurers do this because workers comp law in most states requires that every worker, except sole proprietors and owners, be covered by workers comp. Lacking some evidence that a given sub is already insured or truly an independent contractor, your insurer will usually consider all labor costs paid to that sub to be on your payroll, and calculate the premiums accordingly. To avoid this you need to provide your carrier with a certificate of the sub's own comp coverage or, if the sub is a sole proprietor, some documentation such as a business license or proof of a business checking account showing that he's independent.

Inaccurate experience ratings. Finally, many employers who have questioned the accuracy of their companies' experience ratings have found them in error. At least one state study, conducted by the New Hampshire Department of Insurance, found that the New England NCCI office had a high error ratio in assigning those ratings. The most common error is erroneous claim information showing higher claim frequency or costs than actually occurred. This is an area in which NCCI is reportedly improving, but which can still drive up an individual employer's rates.

Small contractors can also be hurt by the ballast formulas, because they make it extremely difficult for a small company to have an experience rating lower than 0.90. This bottom end exists to protect the insurers from assigning unrealistically low premiums to many of the small contractors who have three years in a row with no claims.

Unfortunately, this means that the contractor who has gone ten years without an accident gets the same rate as a contractor whose last three years have been safe, but who had a spotty record before that.

Taken together, these inaccuracies can result in significant overcharges on workers comp premiums for small contractors.

Contractors At Fault, Too

The medical, legal, and insurance professions have all done their share to contribute to the workers comp problem. But the light construction industry also bears some responsibility.

Safety first. The primary problem under contractors' control is safety. Although construction will always be hazardous work, the industry is still plagued by too many easily preventable accidents. In addition to causing pain, distress, and disability, these play a major role in keeping construction comp rates high. With the industry's pure premium rates high, a company's individual record can only lower its rates so far.

Few contractors have instituted effective safety programs, despite clear evidence that such programs cut accident rates and help pay for themselves in increased productivity and reduced training and workers comp costs. Many states already require comp insurers to reduce premiums for employers with approved safety programs in place, and more states are doing so every year.

Insurance dodgers. Another major factor pushing rates up is uninsured employers. As described above, when a sub doesn't insure its workers, the cost of doing so is usually passed to the contractor who uses the sub. In addition, an uninsured sub or general contractor can submit lower bids than his competitors, making it harder for contractors who insure their employees to win jobs, turn profits, and survive.

The scammers. Finally, no survey of workers comp problems is complete without a mention of abuse and fraud. In insurance lingo, "abuse" is when an injured worker uses legal maneuvering to inflate the size of a claim; "fraud" is when a worker who isn't injured claims he is. For obvious reasons, both of these drive up costs. Industry experts estimate that from 5% to over 20% of claims are questionable, although there is little hard data.

How to Trim Premiums

Knowledge is power, and knowing how rates work can help you keep yours from getting out of control.

Keep your insurer honest. There are several things you can do to make sure your insurer doesn't overcharge you.

- Verify your safety classification factors. Make sure no employees on your policy are mistakenly put in higher-risk classifications than they deserve. Find out if your insurer will allow workers who split their time between tasks — such as the foreman who spends half his time swinging a hammer and half managing — to have "split" classifications.
- Check your experience rating, and if it's over 1 (or over 0.90 if you've had no claims for four years), insist that your insurer show you why. (One exception: the rating will be no lower than 1.0 if you've been in business less than three years.) In particular, ask for a copy of your claims record so you can make sure that the rating doesn't weigh in claims that didn't actually occur. The answers may get confusing since the formula is quite complex, but by keeping the focus on claims accuracy and insisting on plain-language explanations, you should make headway.
- Check payroll limitations. In many states, the salary that can be counted toward the payroll basis for your premiums has a per-employee limit. Usually this limit is around $25,000, meaning that only the first $25,000 of any individual employee's payroll can be included in the premium formula. Make sure your insurer isn't counting more than that.
- Make sure no subcontractors are incorrectly counted as employees. Get certificates of insurance

for any subcontractors before paying them. For sole proprietors who don't carry insurance, get a copy of their business license, registration, letterhead or check with a d/b/a, tax return, Yellow Pages ad, or other documentation that clearly shows they are operating an independent business. Check your insurer's audit of your payroll to make sure these people aren't included in the payroll basis.

- If you must use uninsured subs, make sure only your labor payments to them (not the materials or other charges) are used in the insurer's premium calculation. To make this easy, insist that your subs give you bills that are broken into labor and material components, and record the two categories separately in your financial records.
- Ask your insurer for a discount for instituting a job safety program — and institute such a program regardless of the answer. Depending on your safety record and luck, the lower injury rate may save you more in avoided increases (through reduced injury and absentee rates) than the program costs.
- Check all individual claims reports and summaries for accuracy.

If these tactics don't get clear answers out of your insurer, or if after the answers you still suspect you're being overcharged, consider hiring a lawyer who understands workers comp to negotiate with your carrier. This can often turn the balance in your favor.

Explore alternatives. There are several alternatives to traditional workers comp arrangements that can save you money.

- If your state allows it and you can get an insurer to issue it, get a comp policy with a "medical-only" deductible option. This lets you handle small, medical-only injuries (those not involving lost time) either out of your own pocket or through a separate health-care plan. This keeps these claims from being counted in your workers comp safety record.
- If you're a larger company, you might save money if you find a health insurer who will give you "on-the-job" coverage, which covers the medical part of the comp coverage, and then buy separate disability insurance for all employees to cover their lost income while they're unable to work. You can also consider covering a week or two's salary yourself if that prevents the filing of a comp claim.

The practicality of these alternative strategies will depend on your own situation and costs, so get an accountant or a good insurance agent to help you crunch the numbers. You should also check with a lawyer or your state insurance board first, as the legality of these strategies varies from state to state. In no event can you legally circumvent the basic intent of the workers comp law, which is to provide medical and income insurance for all job-related injuries.

General practices. Finally, proactive involvement, both in your own company and as a member of the construction industry, can help both your own cause and the industry's:

- To help prevent injuries from becoming legal cases, try to establish genuine, positive rapport with all workers. Except for those involving intentional harm, most lawsuits result from misunderstandings and a perceived lack of goodwill. Goodwill can often be maintained, and a lawsuit avoided, by checking personally with any injured worker, inquiring about health and treatment, and doing anything you can to facilitate proper medical treatment and rehabilitation efforts. This not only strengthens the employer-employee bond (reaping long-term benefits of its own), it also helps speed the worker's return to work.
- Bring the worker back on the job as soon as possible. Even if the worker can't perform his old job again yet, providing active employment can help speed rehabilitation, improve the worker's morale and attitude, and get the worker off the comp insurer's payroll and back on yours.
- Improve safety practices and awareness in your company – either by starting a formal safety program or by paying more attention to the one you already have. Such steps as safety checks or workshops, establishing a "safety foreman," and incentives or kudos for "injury-free" months can improve safety practices both directly, through changed policies, and indirectly, through creating a greater awareness of safety issues.

Finally, it's in every contractor's interest to back meaningful health-care reform and tort (lawsuit) reform legislation. Such proposed legislation is in abundance lately, usually backed by a state building association. Information can be obtained through your state building association, the National Association of Home Builders State and Local Government Affairs Office (800/368-5242), and NCCI's Public Affairs Office (212/560-1000). ■

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