



AUDITOR GENERAL
WILLIAM O. MONROE, CPA



**FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.**

Operational Audit

For the Period January 1, 2003, Through June 30, 2004, and
Selected Actions Taken Prior and Subsequent Thereto

FLORIDA WORKERS' COMPENSATION JOINT
 UNDERWRITING ASSOCIATION, INC.

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SUMMARY

This report provides the results of our operational audit of the Florida Workers' Compensation Joint Underwriting Association, Inc. (FWCJUA). Our audit disclosed the following:

Finding No. 1: Our contracted actuary's review of the FWCJUA's reserves reported as of December 31, 2003, and the rates established in its July 7, 2004, rate filing, concluded that the FWCJUA's actuary determined the best estimate of required reserves using an undocumented and unquantified approach, and established a range of reasonableness that produced an upper bound that is too high in relation to the best estimate of required reserves. In addition, the FWCJUA Board exercised additional conservatism by reporting reserves that were \$8.4 million higher than the FWCJUA actuary's best estimate of required reserves.

Our contracted actuary recommended that the FWCJUA consider using a quantifiable approach to determine required reserves, and using such an approach concluded that: required reserves should be significantly less than the FWCJUA actuary's best estimate of required reserves; the FWCJUA could have established a lower rate for Tier Three policies; and the rates mandated by Chapter 2004-266, Laws of Florida, for Tiers One and Two are too low.

Finding No. 2: Certain provisions of Chapter 2004-266, Laws of Florida, regarding the administration of a \$15 million contingency reserve for funding subplan D cash deficits, need clarification.

Finding No. 3: The FWCJUA did not, of record, demonstrate that its "controllable costs," or compensation paid to its policy administration service provider, were reasonable. Through legislative action, it may be possible to reduce the FWCJUA's costs by making the FWCJUA exempt from Federal taxation. In addition, the FWCJUA has not recently provided for a cost/benefit analysis to determine whether its essential functions are better handled by FWCJUA staff or by independent contractors.

Finding No. 4: The FWCJUA's basis for awarding at-risk compensation to executive staff was not clear because the FWCJUA had not established specific performance evaluation rating factors for each staff member. Also, the basis for the allocation of a special project bonus paid to executive staff was not documented.

Finding No. 5: The FWCJUA has not subjected most of its contractual services to a competitive selection process since 1995. In addition, the FWCJUA had no written agreement with its contracted General Counsel; had an insufficiently detailed written agreement with its independent auditors; made payments to the General Counsel and independent auditors that were not supported by sufficiently detailed invoices; and did not properly bill the contracted service provider for its share of audit costs.

Finding No. 6: The FWCJUA generally did not, of record, monitor the contracted service provider's performance regarding producer commission payments, payroll audits, loss control surveys, or the handling of delinquent accounts.

Finding No. 7: The FWCJUA did not verify producer commissions calculated and paid by its contracted service provider.

Finding No. 8: The contracted service provider did not always perform required preliminary payroll audits, or perform final and cancellation payroll audits within the time frame specified in the FWCJUA's Operations Manual.

Finding No. 9: The contracted service provider did not always perform required loss control surveys, or perform on-site surveys, contrary to the FWCJUA's Operations Manual. Also, the Operations Manual does not address requirements for surveys of policyholders with multiple locations.

Finding No. 10: The FWCJUA's percentage of uncollected written premiums appears to be high, which may be at least partially due to untimely cancellation and final audits or to an insufficiently aggressive collection policy. Additionally, the contracted service provider did not always place delinquent accounts with the designated collection agency within the time frame specified in the FWCJUA's Operations Manual.

Finding No. 11: The FWCJUA has generally not measured the effectiveness of its depopulation methods to ensure it is accomplishing the intent of Section 627.311(5)(c)4., Florida Statutes.

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This report, as well as other audit reports prepared by the Auditor General, can be obtained on our Web site at <http://www.state.fl.us/audgen>; by telephone at (850) 487-9024; or by mail at G74 Claude Pepper Building, 111 West Madison Street, Tallahassee, Florida 32399-1450.

BACKGROUND

The Florida Workers' Compensation Joint Underwriting Association, Inc. (FWCJUA), a nonprofit entity, was created pursuant to Section 627.311(5), Florida Statutes, to provide workers' compensation and employer's liability insurance to applicants who are required by law to maintain workers' compensation and employer's liability insurance and who are in good faith entitled to, but who are unable to purchase, such insurance through the voluntary market. Pursuant to Section 627.311(5), Florida Statutes, the FWCJUA is governed by a 9-member Board of Governors (Board), whose powers and duties are prescribed in Section 627.311(5)(c), Florida Statutes.

Chapter 2004-266, Laws of Florida, directed the Auditor General to perform an operational audit of the FWCJUA. This law required the Auditor General, as part of the audit, to engage an independent consulting actuary who is a member of the American Academy of Actuaries or the Casualty Actuarial Society to evaluate the FWCJUA's rates and reserves.

FINDINGS AND RECOMMENDATIONS

Finding No. 1: Rates and Reserves

Prior to the 2003 legislative session, the FWCJUA, pursuant to Section 627.311(4)(c)22., Florida Statutes, classified its policyholders into three categories referred to as subplans A, B, and C. Subsequently, the Legislature enacted Chapter 2003-412, Laws of Florida, which contained comprehensive changes to workers' compensation laws, including changes to address affordability and availability of workers' compensation coverage for small employers and nonprofit organizations. Specifically, Section 627.311(4)(c)22., Florida Statutes, was amended to create a new classification of policyholders referred to as subplan D. Although Section 627.311(4)(d)1., Florida Statutes (2003), required the FWCJUA to establish actuarially sound rates for its plans, Section 627.311(4)(c)22.d., Florida Statutes (2003), established limitations on surcharges for subplan D policyholders.

The FWCJUA, in its 2003 annual statement, reported a combined deficit of \$4.5 million as of December 31, 2003, for all its subplans. The FWCJUA reported a \$5.3 million surplus for subplans A, B, and C, and a deficit of \$9.8 million for subplan D. According to a letter dated February 27, 2004, from the FWCJUA's Executive Director to the Office of Insurance Regulation¹, the \$9.8 million subplan D deficit was the result of Chapter 2003-412, Laws of Florida, creating a subplan with rates that are not actuarially sound. The letter further stated that if no legislative action was taken, the FWCJUA staff estimated the subplan D deficit would grow to more than \$36 million as of December 31, 2004. The FWCJUA reported a subplan D deficit of approximately \$21 million in its June 30, 2004, quarterly report.

The Legislature enacted Chapter 2004-266, Laws of Florida, which, effective July 1, 2004, replaced the four-subplan system with a three-tier system intended to better define risk for employers and to provide for a premium better associated with risk, and created a contingency reserve to help fund subplan D deficits (see further discussion in Finding No. 2).

The FWCJUA, as of December 31, 2003, reported total reserves (net of reinsurance) of \$41.4² million as follows:

¹ *The Office of Insurance Regulation is under the Financial Services Commission within the Florida Department of Financial Services.*

² *Total reported reserves of \$55.2 million less \$13.8 million contra-liability reported in accordance with statutory insurance accounting practices to show effect of transfer of responsibility to a reinsurance company for claims related to accidents incurred prior to January 1, 2000.*

<i>Reserve Component</i>	<i>Amount (In Millions)</i>
FWCJUA actuary's best estimate (excluding unallocated loss adjustment expense reserve and premium deficiency reserve)	\$25.1
FWCJUA actuary's calculated unallocated loss adjustment expense reserve	4.2
FWCJUA actuary's calculated premium deficiency reserve for subplan D	<u>3.7</u>
Required Reserves per FWCJUA's Actuary	\$33
FWCJUA's additional estimated reserves	8.4
Total Reserves Reported by FWCJUA	<u>\$41.4</u>

Pursuant to Chapter 2004-266, Laws of Florida, the scope of our audit included an analysis of the adequacy and appropriateness of the rates and reserves of the FWCJUA. Accordingly, we contracted with an actuarial firm (referred to in this report as our contracted actuary) to review the FWCJUA's reserves and subplan D deficit reported as of December 31, 2003, on the FWCJUA's 2003 annual statement, and the rates implemented by the FWCJUA as indicated in its July 7, 2004, rate filing.

The results of our contracted actuary's review are included in a report dated November 22, 2004 (Report). In the Report, our contracted actuary concluded that the above-noted legislation enacted during the 2003 and 2004 legislative sessions, which mandated specific rates or rate surcharges for particular subplans or tiers, reduced the FWCJUA's ability to withstand periods of rate inadequacy and, as such, required more conservative judgment on the part of FWCJUA's management in determining rates and reserves. According to the Report, the FWCJUA's actuary used a conservative approach in arriving at its best estimate of required reserves, and the FWCJUA Board exercised additional conservatism by reporting a reserve amount that was \$8.4 million higher than the FWCJUA actuary's best estimate of required reserves.

The FWCJUA actuary's approach for determining the best estimate of required reserves was reportedly in accordance with Standards of Practice issued by the Actuarial Standards Board. Actuarial Standard of Practice No. 9, Documentation and Disclosure in Property and Casualty Insurance Ratemaking, Loss Reserving, and Valuations, promulgated by the Actuarial Standards Board, requires, in paragraph 5.2, documentation of an actuarial work product sufficient for another actuary practicing in the same field to evaluate the work. Standard of Practice No. 9 further states that the documentation should describe clearly the material assumptions and methods.

In the Report, our contracted actuary indicates that the FWCJUA actuary's method does not document the dollar effect of various conservative judgments. For example, the FWCJUA actuary's approach involved hundreds of judgmentally selected estimated amounts for various factors and ultimate losses, many of which were selected after viewing the results of calculations made using one or more alternate methods. In these instances, the FWCJUA's actuary, rather than selecting an amount calculated using one of the alternate methods, judgmentally selected an amount, reportedly after considering, in addition to the results of the calculations, various other relevant factors. However, the Report indicates that the FWCJUA's actuary's report on reserves did not discuss the basis for these judgments (e.g., what relevant factors were considered, and weights assigned to such factors), and did not maintain within its internal work papers documentation of the judgments made or the basis of the

judgments. The Report further states that based on responses to written questions submitted by our contracted actuary, and on discussions with the FWCJUA's actuary, it was not apparent that the FWCJUA's actuary fully complied with Actuarial Standard of Practice No. 9.

Our contracted actuary recommends using a quantifiable approach, such as a probability of outcomes or confidence level approach, rather than introducing conservatism through many judgments as done by the FWCJUA's actuary. For example, using such an approach that provided for a 90 percent confidence level, the calculated amount of reserves would be the amount expected to be sufficient 90 percent of the time.

Our contracted actuary concluded that required reserves should be significantly less than the FWCJUA actuary's \$33 million best estimate of required reserves as of December 31, 2003, as follows:

- Depending on the variability of the FWCJUA's reserves and the confidence level, required reserves (excluding an unallocated loss adjustment expense reserve and a subplan D premium deficiency reserve) should be from \$400,000 to \$10.3 million less than the \$25.1 million determined by the FWCJUA's actuary.
- The FWCJUA contracts with a policy administration service provider to provide "cradle to grave" claims handling service (see Finding No. 3). Pursuant to its written agreement with the FWCJUA, the service provider's service obligations, with respect to policies written during the term of the agreement, continue beyond the termination of the agreement, and the service provider is required to provide for a \$10.3 million performance bond that indemnifies the FWCJUA with respect to such service obligations. Further, we were advised that the service provider reports on its financial statements a liability recognizing the long-term nature of its claims servicing liability. Based on consultation with the Office of Insurance Regulation (OIR), it appears that the FWCJUA, pursuant to statutory insurance accounting practices, may have been required to report a \$4.2 million liability regarding unallocated loss adjustment expense (ULAE) because the service provider agreement does not constitute a "contract of insurance or reinsurance." However, OIR indicated that it may be possible for the FWCJUA to revise its agreement with the service provider to create a "true insurance-based transfer of liabilities," in which case the FWCJUA would not be required to report the ULAE liability. Our contracted actuary believes that it is reasonable to expect that the FWCJUA's service provider will meet its obligation to provide required claims administration services for claims that occurred prior to December 31, 2003 (services for which the service provider has been pre-paid by the FWCJUA), regardless of the future status of the FWCJUA. Therefore, although the FWCJUA may be required to report the ULAE, it is very unlikely that the FWCJUA will ever need to use the ULAE reserve. As such, there is no apparent reason to consider the ULAE reserve in determining the FWCJUA's cash needs for funding subplan D deficits (see Finding No. 2).
- Statutory insurance accounting practices require that an insurer report a liability called a "premium deficiency reserve" with respect to premium received and not earned if the premium to be earned in the future is believed to be insufficient to pay related losses and certain expenses. Our contracted actuary believes that it is not probable that subplan D losses and certain expenses will exceed premium to be earned in the future and, as such, there was no need for the FWCJUA to report the \$3.7 million premium deficiency reserve.

The Report also indicates that the FWCJUA actuary's method of establishing a range of reasonableness produced an upper bound that is too high in relation to its best estimate of required reserves. This was because the

FWCJUA's actuary established the range without eliminating from the best estimate reserves relating to accidents occurring prior to January 1, 2000, even though a reinsurance company had assumed virtually all future responsibility for payments related to such accidents.

Chapter 2004-266, Laws of Florida, requires the FWCJUA to establish an actuarially sound rate for Tier Three policies. As indicated in its July 7, 2004, rate filing, the FWCJUA implemented a rate that was 170 percent above the voluntary market rate for Tier Three policies. Under the approach recommended by our contracted actuary, the rate implemented by the FWCJUA for Tier Three policies should be 127 percent above the voluntary market rate (which would decrease FWCJUA premium collected on Tier Three policies). The difference between the Tier Three rates calculated by the FWCJUA's actuary and our contracted actuary was the result of the differing approaches used to determine required reserves and the following:

- Our contracted actuary used a loss ratio relativity of 1 for Tier Three as compared to the FWCJUA's overall loss ratio, whereas the FWCJUA's actuary judgmentally selected a loss ratio relativity of 1.15. Using data that the National Council on Compensation Insurance, Inc., provided to the FWCJUA's actuary (for use in calculation of the impact of current surcharges by tier), our contracted actuary performed certain analysis of such available data and, based on such analysis, concluded that a loss ratio relativity of 1 would be appropriate, and found no valid basis for the FWCJUA actuary's judgmental selection of a loss ratio relativity of 1.15.
- The FWCJUA's actuary discounted losses in its rate level analysis using a 1.5 percent interest rate, and an assumed 14 year payment pattern, to arrive at a 95 percent discount factor to apply to nominal losses. Our contracted actuary concluded that it was not appropriate to assume the same interest rate for the entire payment pattern and, therefore, used interest rates ranging from 1.75 to 4.2 percent depending on the expected timing of payments (i.e., used lower interest rates for payments expected to be made soon and higher interest rates for payments expected to be made years from now). As a result, using the payment pattern derived directly from the paid loss development factors used to determine ultimate losses, our contracted actuary arrived at a 91.2 percent discount factor.

Chapter 2004-266, Laws of Florida, mandates that for Tiers One and Two, rates be set at 25 and 50 percent above the voluntary market rates, respectively. Under the approach recommended by our contracted actuary, based on data as of December 31, 2003, the rates mandated by Chapter 2004-266, Laws of Florida, for Tiers One and Two should be 71 and 66 percent above the voluntary market, respectively (which would increase FWCJUA premium collected on Tier One and Two policies). Chapter 2004-266, Laws of Florida, provides that when the FWCJUA determines that there is sufficient experience to establish actuarially sound rates for Tiers One and Two, the FWCJUA shall adjust rates, if necessary, to produce actuarially sound rates, provided such rate adjustment shall not take effect prior to January 1, 2007. However, our contracted actuary recommends consideration of actuarially sound rates for Tiers One and Two at the earliest possible date.

Recommendation: The FWCJUA should reevaluate its reported reserves and established rates giving consideration to our contracted actuary's findings and recommendations, and ensure that the FWCJUA's actuary, regardless of the approach used to determine required reserves, document all judgments. The FWCJUA should also consider revising its agreement with the service provider to create a contract of insurance or reinsurance as suggested by the Office of Insurance Regulation (OIR) so that it would clearly not be required to report an ULAE liability. In addition, the OIR should consider providing guidelines regarding the use of a quantifiable approach for introducing conservatism in estimating loss and loss expense reserves. Further, the Legislature should consider enacting legislation that expedites the requirement for Tiers One and Two rates to be determined on an actuarially sound basis.

FWCJUA Response and Auditor General's Clarification

General Discussion

The FWCJUA Board Chairman and Executive Director, in their response to this finding, stated that the FWCJUA believes that the Auditor General's report should clearly and accurately state the findings of our contracted actuary instead of the Auditor General's interpretation of the contracted actuary's statements, and that the Auditor General's findings and conclusions should be clearly distinguished from those of the contracted actuary. The findings and conclusions in this report are ours, and were reached based, in part, on our contracted actuary's report. Where appropriate, we have clearly referenced our contracted actuary's report.

The FWCJUA Board Chairman and Executive Director, in their response to this finding, have, in several instances, indicated that our findings and conclusions are inaccurate. We believe our findings and conclusions to be accurate for the reasons discussed in the finding. In addition, we found certain statements included in the Board Chairman and Executive Director's response that require further clarification. For example:

- The FWCJUA Board Chairman and Executive Director, in their response to this finding, indicated that the Auditor General's contracted actuary does not conclude in its report that the FWCJUA's rates and reserves are inappropriate or unreasonable. On the contrary, our contracted actuary, in its cover letter to its report, stated "As you will see upon reading the report, our estimates of required reserves, of Sub-plan D deficit, and of required rate surcharges, differ significantly from the judgments of the management of the Florida Workers Compensation Joint Underwriting Association (FWCJUA)." Detailed discussion supporting the basis for this statement is included throughout our contracted actuary's report.
- The FWCJUA Board Chairman and Executive Director, in several instances in their response to this finding, refer to the "Auditor General's recommended approach." We have not recommended any approach. Rather, we recommended that the FWCJUA reevaluate its reported reserves and established rates giving consideration to our contracted actuary's findings and recommendations. Apparently, the FWCJUA Board Chairman and Executive Director concur with this recommendation as their response stated that the FWCJUA "has asked its Rates & Forms Committee to consider the Auditor General's contracted actuary's findings and recommendations along with the FWCJUA independent actuary's discussion and conclusions regarding such and to make appropriate recommendations to the Board."
- The FWCJUA Board Chairman and Executive Director, in their response to this finding, state that our "contracted actuary's approach also disregards the requirements of the FWCJUA to comply with statutory accounting principles related to the posting of ULAE reserves and premium deficiency reserves." They also stated that our "contracted actuary doesn't agree that the FWCJUA is required to book a ULAE reserve." On the contrary, our contracted actuary did not conclude that the FWCJUA was not required to report a ULAE reserve. Our audit report acknowledges that the FWCJUA may be required to report a ULAE reserve in accordance with statutory insurance accounting practices; however, the point of our finding is that it should not be used to justify State funding (see discussion in Finding No. 2) as it is very unlikely that the FWCJUA will actually have to use this reserve.

The FWCJUA Board Chairman and Executive Director, in their response to this finding, also stated that "the Auditor General's contracted actuary does not conclude that the FWCJUA's actuary (1) determined the best estimate of required reserves using an undocumented and unquantified approach or (2) established a range of reasonableness that produced an upper bound that is too high in relation to the best estimate of required reserves." Their response, based primarily on input from the FWCJUA's actuary, responds to the following four points:

- Undocumented approach

- Unquantified approach and recommended quantified approach
- Upper bound too high
- Lower rate for Tier 3 policies

As discussed in detail below, in which we address the above points, we believe that our contracted actuary did conclude that the FWCJUA's actuary determined the best estimate of required reserves using an undocumented and unquantified approach and established a range of reasonableness that produced an upper bound that is too high in relation to the best estimate of required reserves.

Undocumented approach

The FWCJUA Board Chairman and Executive Director asserted that the FWCJUA approach was fully documented, and stated that "Each assumption and judgment was clearly identified and labeled, showing relevant historical results, and the value the FWCJUA's actuary selected." They further stated that our contracted actuary was "able to fully understand the calculations from the FWCJUA's actuary report" and "was not only able to evaluate the work, but to fully reproduce it." However, these assertions contradict the FWCJUA Board Chairman and Executive Director's subsequent statement that "We agree the FWCJUA's actuary did not include a discussion for the underlying thought process for each of the assumptions made."

The FWCJUA Board Chairman and Executive Director also indicated that they could not find in our contracted actuary's report where it was said that the approach used by the FWCJUA's actuary was undocumented. Our contracted actuary, on page 8 of its report, stated that the actuarial memoranda in support of the rate surcharge do not specifically identify these judgments, and do not discuss the basis of the judgments (e.g., what other relevant factors might have been considered, and what weights were assigned to such factors). Our contracted actuary's report further stated that in a meeting with the FWCJUA's actuary on November 4, 2004, our contracted actuary was advised that the FWCJUA actuary "does not maintain within its internal work papers documentation of the judgments made or the basis of the judgments."

Unquantified approach and recommended quantified approach

The FWCJUA Board Chairman and Executive Director stated that they believe the term "unquantified" was misused in our report, and that the FWCJUA actuary's work is fully quantified in its report. As described in Finding No. 1, the term "unquantified approach" refers to the FWCJUA actuary's introduction of conservatism through many judgments rather than using a quantifiable approach, such as a probability of outcomes or confidence level approach, as recommended by our contracted actuary.

The FWCJUA Board Chairman and Executive Director also stated that our contracted actuary suggested using a 90 percent confidence level for basing an estimate of the reserve and that they do not believe that FWCJUA management should be constrained to selecting as its "best" estimate the 90th or any other fixed percentile of this "outcomes distribution." The 90 percent confidence level was used for purpose of demonstrating the effect of using a quantifiable approach such as that recommended by our contracted actuary. Neither we, nor our contracted actuary, suggested that FWCJUA management be restrained to selecting a 90 percent confidence level. If the FWCJUA can justify using an alternative confidence level, then the FWCJUA should consider using such a level.

The FWCJUA Board Chairman and Executive Director discussed certain technical concerns they have with the way our contracted actuary constructed its "outcomes distribution." For example, they indicated that our contracted actuary calculated a "mean estimate" using a traditional actuarial approach while substituting unweighted averages of various statistics in place of the values the FWCJUA's actuary selected using judgment, and suggest that our actuary's approach "replaces actuarial judgment with a statistical formula." As is readily apparent from our contracted actuary's report, our contracted actuary exercised professional judgment throughout its process of estimating required reserves. Further, it is our understanding that our contracted actuary did not use the unweighted averages to establish the reserve estimate, but rather used such averages as a quantifiable point of departure for the application of actuarial judgment to arrive at a reserve estimate. This is in contrast to the FWCJUA actuary's procedure of selecting one of the most conservative results from the range of actual results of various methodologies without documenting the basis for such selections.

The FWCJUA Board Chairman and Executive Director also asserted that our contracted actuary's approach did not consider certain parameter and other risks. However, our contracted actuary believes it has considered all relevant risks as required by actuarial standards, and the FWCJUA Board Chairman and Executive Director have not indicated in their response how the FWCJUA's actuary demonstrated appropriate consideration of these risks.

Upper bound too high

The FWCJUA Board Chairman and Executive Director indicated that they could not find in our contracting actuary's report support for our finding that the FWCJUA actuary "established a range of reasonableness that produced an upper bound that is too

high in relation to the best estimate of required reserve” and indicated that their understanding was that the “upper bound” and “best estimate of required reserves” referred to in our finding were the actual amount booked by the FWCJUA and the “90th percentile value of the contracted actuary,” respectively. This understanding is incorrect. As stated in our finding, our contracted actuary concluded that the FWCJUA actuary’s method of establishing a range of reasonableness produced an upper bound that is too high in relation to its best estimate of required reserves. The reason for this, as discussed on pages 3 and 5 of our contracted actuary’s report, is that the FWCJUA’s actuary established a “reasonable range” about its best estimate before eliminating claims occurring prior to January 1, 2000, despite the fact that all FWCJUA liability for such claims was transferred in 2000 to a corporation as a result of the FWCJUA purchasing retroactive reinsurance via a loss portfolio transfer.

Lower rate for Tier 3 policies

The FWCJUA Board Chairman and Executive Director indicated that our contracted actuary’s report does not include enough information to conclude that the FWCJUA could have established a lower rate for Tier Three policies, and discuss what they consider to be four principal sources of difference between the FWCJUA and our contracted actuary. There was little difference between the “Project Loss Ratio for all Risks” used by the FWCJUA actuary and our contracted actuary. The FWCJUA Board Chairman and Executive Director’s statements regarding the other three sources of differences, and our comments related thereto, are as follows:

“Loss ratio relativity for tier 3 risks” – The FWCJUA Board Chairman and Executive Director stated that the 1.15 factor used by the FWCJUA’s actuary is reasonable, even considering the arguments of our contracted actuary. However, although they stated that the FWCJUA expects risks to be worse than average, they do not specifically address why they do not agree with our contracted actuary’s arguments or explain why they expect such risks to be 15 percent greater than average. In addition, they stated in their response that “the 1.15 factor is based solely on judgment and there is considerable uncertainty as to its value.”

“Discount factor for investment income” – The FWCJUA Board Chairman and Executive Director stated that the FWCJUA “uses interest of 1.5% per year, because of the typically low rates of return the FWCJUA receives on its cash balances, because of the tax effect on realizable interest rates, and to compensate for the reduction in risk margin caused by the discounting process.” However, they did not specifically address why the FWCJUA’s actuary assumed a fixed interest rate rather than using a variable interest rate pattern such as that used by our contracted actuary.

“Contingency Factor” – The FWCJUA Board Chairman and Executive Director stated “this is an amount added by the FWCJUA Board to reflect the additional uncertainty resulting from the impact of Florida SB-50A,” but did not provide an explanation as to why a 5 percent factor was used.

ULAE Liability

In response to our recommendation that the FWCJUA consider revising its agreement with its service provider to create a contract of insurance or reinsurance as suggested by the Office of Insurance Regulation so that it would clearly not be required to report an ULAE liability, the FWCJUA Board Chairman and Executive Director stated that they believe that it is cost-prohibitive to implement this recommendation. However, they did not provide specifics on why this was considered cost-prohibitive.

Conclusion

The FWCJUA Board Chairman and Executive Director have extensively analyzed the approach used and recommended by our contracted actuary, and expressed certain concerns regarding the approach. Our contracted actuary’s report concludes on page 12 that for the 1998 through 2002 accident years the “FWCJUA actuary initial ‘best’ estimates are consistently too high, as measured by the FWCJUA actuary as of 12/31/03,” and “The results of ‘best’ estimates performed by the FWCJUA actuary are producing results that seem counter-intuitive.” Based on these facts, which the FWCJUA Board Chairman and Executive Director have not disputed, it appears that the FWCJUA actuary’s approach may be resulting in excessively high estimates of required reserves, which is compounded by the FWCJUA’s consistent reporting of estimated reserves that are significantly in excess of its actuary’s best estimates. As the FWCJUA Board Chairman and Executive Director, in referring to the “outcomes distribution” approach used by our contracted actuary, stated that they “do not disagree that an ‘outcomes distribution’ is a valuable tool for management to use in evaluating its reserves,” we suggest that the FWCJUA consider using a similar approach modified to address their technical concerns.

Finding No. 2: Contingency Reserve

As discussed in Finding No. 1, the FWCJUA reported a deficit of \$9.8 million for subplan D as of December 31, 2003, and according to the FWCJUA, the deficit was expected to grow to more than \$36 million by December 31,

2004. Chapter 2004-266, Laws of Florida, created a \$15 million contingency reserve within the Workers' Compensation Administration Trust Fund, from which the Florida Department of Financial Services is authorized to transfer funds to the FWCJUA if necessary to fund subplan D deficits, or whenever it is determined that subplan D does not have sufficient cash to meet three months' projected needs due to a subplan D deficit.

To receive funds from the contingency reserve, the FWCJUA must submit a transfer request and appropriate supporting information demonstrating that the amount requested for transfer does not exceed the difference (deficiency) between the amount available within subplan D and the amount needed to meet subplan D projected cash needs for the subsequent 3-month period. The FWCJUA's request must be certified by the Office of Insurance Regulation and approved by the Legislative Budget Commission before the actual transfer can occur.

In a letter dated August 11, 2004, the FWCJUA's Executive Director requested a \$3.295 million initial transfer from the contingency reserve to meet projected subplan D cash needs for the period October 1, 2004, through March 31, 2005. The letter was accompanied by an actuarial model showing projected cash balances. The FWCJUA subsequently received a \$574,000 transfer from the contingency reserve on October 25, 2004. In a letter dated October 21, 2004, the FWCJUA's Executive Director requested a second transfer of \$2.008 million to meet projected subplan D cash needs for the period January 1, 2005, through March 31, 2005.

Our review of the provisions of Chapter 2004-266, Laws of Florida, and its application by the FWCJUA, disclosed the need for clarification of that law as discussed below:

- Chapter 2004-266, Laws of Florida, refers to a "subsequent 3-month period," but does not clearly specify when the 3-month period begins. In the August 11, 2004, transfer request, the FWCJUA used a 6-month period beginning October 1, 2004. Although this appears to be in conflict with the provisions of Chapter 2004-266, Laws of Florida, we were advised that this was done to correlate with expected Legislative Budget Commission meeting dates. For the October 21, 2004, transfer request, the FWCJUA used a 3-month period beginning January 1, 2005, as the start of the 3-month period. However, the Legislature may have intended the 3-month period to begin immediately subsequent to the date of the transfer request because, otherwise, the possibility would exist for the FWCJUA to make a transfer request an unreasonably long period of time in advance of the occurrence of a cash deficiency.
- According to the actuarial models showing projected cash balances that accompanied the above-noted transfer requests, the FWCJUA will not incur a subplan D deficit cash balance due to actual cash payouts until March 2005 (the deficit would have been \$82 based on the actuarial model that accompanied the October 21, 2004, letter). As such, based on actual cash payouts, there was no apparent basis for the FWCJUA to have received the \$574,000 transfer on October 25, 2004, since no cash deficit was projected for the 3-month period October 1, 2004, through December 31, 2004. In projecting its cash needs, the FWCJUA determined the need to maintain a \$2.5 million contingency reserve in addition to actual cash payout needs; however, Chapter 2004-266, Laws of Florida, does not clearly provide for such a contingency in determining cash needs.

We were advised that the FWCJUA determined, in consultation with the Office of Insurance Regulation, that \$2.5 million was an appropriate amount to maintain as a contingency reserve because of recent significant actual claims incurred, and a potential liability for a multiple occurrence catastrophic event and fatality, just prior to the August 11, 2004, transfer request.

- In determining its projected cash needs for the transfer requests, the FWCJUA did not consider available surplus cash related to other subplans. The FWCJUA's Operations Manual, as approved by the Office of

Insurance Regulation, prohibits the use of surplus cash related to other plans to fund subplan D deficits; however, Chapter 2004-266, Laws of Florida, does not clearly address this issue.

Recommendation: The Office of Insurance Regulation (OIR) should seek legal clarification from the Attorney General regarding the above-noted issues. Also, the Legislature should consider enacting legislation clarifying these issues.

OIR Response and Auditor General's Clarification

The Commissioner of the Office of Insurance Regulation, in his response to this finding and recommendation, stated that none of the parties involved in the funding process (i.e., the OIR, Florida Department of Financial Services, Governor's Office, House and Senate staff, and the Legislative Budget Commission) have expressed concerns that the language of existing legislation may need to be revised or made subject to interpretation, and, accordingly, OIR does not deem it necessary or appropriate to seek legislative clarification at this time. However, the Commissioner did not point out how current law clearly addresses the issues we identified as needing clarification. The Commissioner, in his response, referred to a provision in Section 35 of Senate Bill 50A (enacted by Chapter 2003-412, Laws of Florida) relating to levy of assessments for subplans C and D. However, the language the Commissioner referred to addressed assessment levies and did not address whether the FWCJUA, in determining its projected cash needs for the transfer requests of State funding, should consider available surplus cash related to other subplans, including surplus cash derived from subplans in existence prior to the enactment of Senate Bill 50A. Further, the language the Commissioner cited was deleted by Chapter 2004-266, Laws of Florida.

Finding No. 3: Outsourcing of Policy Administration and Other Functions

Section 627.311(5)(c)13., Florida Statutes, authorizes the FWCJUA Board to provide the services required by law through employees, reasonably compensated service providers, or a combination thereof.

As of June 30, 2004, FWCJUA staff consisted of eighteen individuals, including four executive positions (Executive Director, Operations Manager, Controller, and Program Manager), nine underwriting positions, two accounting positions, one information systems position, and two customer service representatives. FWCJUA staff develop underwriting and operating rules, procedures, and forms; authorize insurance agents (producers) used to refer employers to the FWCJUA for workers' compensation coverage; determine initial policyholder eligibility and premium amounts; collect advance premiums and deposits, if applicable; bind new policies; prepare reports for the Board and the Office of Insurance Regulation, and others; administer a market-assistance plan to assist in the placement of employers; and prepare and maintain its financial records.

During the audit period, 6,379 policies were bound by the FWCJUA. The FWCJUA outsourced most policy administration functions (other than initial determination of policyholder eligibility, determination of the premium/deposit and collection, and binding) and other major functions to independent contractors. The major functions outsourced, and compensation of contractors used during the audit period, were as follows:

<i>Contracted Function</i>	<i>Compensation</i>
Policy Administration*	\$18,781,770
Legal Services	368,199
Actuarial Services	83,267
Auditing, Tax, and Consulting Services	137,685
Collection Services	105,892
Investment Services	32,802
Total	<u>\$19,509,615</u>

* This amount represents the amount earned by the contractor as recorded in the FWCJUA’s accounting records based on premiums written, whereas the contractor is actually paid based on premiums collected.

Section 627.311(5)(c)17., Florida Statutes, requires that the FWCJUA provide for an annual review of costs associated with the administration and servicing of the policies issued to determine alternatives by which costs can be reduced. In response to our request for documentation of the FWCJUA’s efforts to comply with this requirement, we were advised of some actions taken in recent years to reduce costs, such as moving to less costly office space, and were provided copies of two studies, “White Paper, an Analysis of the Impact of SB 50A” (White Paper) and “FWCJUA Minimum Premium Policy Analysis.” The White Paper indicates some ways in which costs can be reduced, such as a waiver of requirements to pay assessments pursuant to Sections 440.49 and 440.51, Florida Statutes, and cessation of underwriting some policies.

The White Paper defines the FWCJUA’s “controllable costs” as its operating expenses (staff salaries, benefits, and associated professional services such as actuaries, auditors, legal services, etc.) excluding policy administration service provider fees, taxes, assessments, and reinsurance. The White Paper indicates that its “controllable costs” represent only 2.84 percent of premium and are reasonable; however, it does not indicate how the FWCJUA determined that such costs were reasonable. Further, neither the White Paper nor the FWCJUA Minimum Premium Policy Analysis address alternatives by which costs can be reduced for policy administration service provider fees, the largest expense related to administration and servicing of policies.

According to the White Paper, the FWCJUA has paid over \$6 million in Federal income taxes since 1994. One way to reduce these costs would be to qualify the FWCJUA as a tax exempt organization under Section 501(c)(27)(B) of the Internal Revenue Code, although this would require legislative action. There are other states, such as Texas, that have created a workers’ compensation residual market entity that is exempt from Federal income taxes.

The FWCJUA has not, since 1995, provided for a cost/benefit analysis to determine whether it would be more cost effective to have FWCJUA staff handle any of the functions currently being outsourced or to outsource any of the functions currently being handled by FWCJUA staff. While not feasible for certain functions, there are some functions currently being performed by contractors for which it may be economically advantageous to have such functions performed by FWCJUA staff. For example, during the audit period, the FWCJUA paid \$344,021 to the General Counsel for professional services rendered (excluding reimbursable expenses). Excluding flat fee amounts of \$75,000 paid to the General Counsel for legislative matters, the FWCJUA was billed a total of \$269,021 at an average rate of \$272 per hour (based on 987.3 hours for the eighteen month audit period). For legal services, it may be more cost effective to hire a full-time staff attorney to handle responsibilities currently being handled by the General Counsel and other contracted legal staff. We were advised that the FWCJUA is

currently examining the possibility of taking “in house” some of the policy administration functions currently being performed by the service provider, and that FWCJUA staff is evaluating five different options to be considered by the Operations Committee in December 2004.

The FWCJUA did not, of record, provide for a study to determine the reasonableness of compensation being paid to its policy administration service provider. Such a study could include, for example, checking with other residual market insurers in Florida or other states to determine the level of compensation typically paid to policy administration service providers. Nor did the FWCJUA obtain assurance as to the reasonableness of such compensation through the solicitation of fee proposals from other entities offering policy administration services (see Finding No. 5). In response to our inquiry, we were advised that the FWCJUA has periodically reviewed the cost of services provided by its policy administration service provider. However, although requested, we were not provided documentation evidencing such efforts to determine the reasonableness of compensation paid to the service provider. We were also advised that, “It is the FWCJUA’s intent at this time to initiate a process as soon as possible after the first of the year to ensure that the FWCJUA is providing prompt, quality, cost-effective policy administration/managed care services.”

As discussed in Finding No. 1, the FWCJUA reported a \$4.5 million deficit as of December 31, 2003. A review to determine alternatives for reducing costs associated with policy administration and servicing as required by Section 627.311(5)(c)17., Florida Statutes, could disclose ways to help reduce the reported deficit.

Recommendation: The FWCJUA should annually review costs associated with the administration and servicing of policies to determine alternatives by which costs can be reduced as required by Section 627.311(5)(c)17., Florida Statutes, and should document such efforts. The FWCJUA should also perform cost/benefit analyses at regular intervals to determine which functions should be done by FWCJUA staff and which functions should be outsourced. Considering the significance of amounts paid to its contractor responsible for policy administration services, the FWCJUA should also take appropriate action to ensure the reasonableness of compensation paid for such services. The Legislature should consider enacting legislation to qualify the FWCJUA as a tax exempt organization under Section 501(c)(27)(B) of the Internal Revenue Code.

FWCJUA Response and Auditor General’s Clarification

The FWCJUA Board Chairman and Executive Director, in their response to this finding, stated that the FWCJUA already effectively reviews costs annually associated with the administration and servicing of policies to determine alternatives by which costs can be reduced as required by Section 627.311(5)(c)17., Florida Statutes, and cited several examples of cost savings reportedly achieved over the past few years. However, we were not provided documentation supporting the examples described in the FWCJUA Board Chairman and Executive Director’s response. In addition, none of the examples of cost savings related to policy administration service provider fees, the FWCJUA’s largest expense related to administration and servicing of policies.

The FWCJUA Board Chairman and Executive Director also indicated that the FWCJUA demonstrates compliance with Section 627.311(5)(c)17., Florida Statutes, through the process of adopting an annual Business Plan and Forecast. Although the FWCJUA’s 2004 Business Plan includes objectives that, if achieved, could improve the FWCJUA’s financial condition, it does not demonstrate how the FWCJUA has reviewed costs associated with the administration and servicing of policies to determine alternatives by which such costs could be reduced.

Finding No. 4: Executive Compensation

The FWCJUA Board has established four executive positions (Executive Director, Operations Manager, Controller, and Program Manager). In addition to a base salary, these employees may be entitled to additional compensation, referred to as “at-risk” compensation, as established by the Board through an Executive

Compensation Plan, and occasionally are eligible to receive bonuses for completing special projects. A summary of “at-risk” compensation and special project bonuses paid during the 2002 and 2003 years is as follows:

<i>Executive Position</i>	<i>2002 Year</i>			<i>2003 Year</i>		
	<i>“At-Risk” Compensation</i>	<i>Special Project Bonus</i>	<i>Total</i>	<i>“At-Risk” Compensation</i>	<i>Special Project Bonus</i>	<i>Total</i>
Executive Director	\$15,217	\$7,359	\$22,576	\$22,826	\$6,000	\$28,826
Operations Manager	10,490	2,545	13,035	10,910	3,000	13,910
Controller	8,500	1,985	10,485	8,840	3,000	11,840
Program Manager	7,300	1,705	9,005	7,592	3,500	11,092

At-Risk Compensation

According to the Executive Compensation Plan in effect for the 2002 and 2003 years, the maximum available “at-risk” compensation was 15 percent of base salary for the Executive Director, and 10 percent of base salary for the other three executive positions. At a teleconference meeting in December 2002, the FWCJUA Executive Compensation Committee approved paying all four executive staff members 10 percent of their base salary as “at-risk” compensation for the 2002 year. At its December 10, 2003, meeting, the FWCJUA Board (as recommended by the Executive Compensation Committee) approved paying executive staff members the entire amount of “at-risk” compensation (15 percent for the Executive Director and 10 percent for the others) for the 2003 year.

According to the Executive Compensation Plan, executive staff members were entitled to receive “at-risk” compensation “in full, in part, or not at all, based on an evaluation of the timeliness and quality of individual staff members’ performance of the FWCJUA’s annual operations plan” (we were advised that “annual operations plan” refers to the FWCJUA Board’s annually adopted Business Plan). While the Business Plans in effect for the 2002 and 2003 years specify key activities and success factors for the FWCJUA as a whole, they did not provide specific performance evaluation rating factors for each of the four executive positions. Nor was there documentation available evidencing the application of performance evaluation rating factors for each of the four executive positions. As such, it was not apparent, of record, what the FWCJUA Executive Compensation Committee and Board used as a basis for approving payment of “at-risk” compensation for the 2002 and 2003 years.

Special Project Bonuses

At its March 4, 2003, meeting, the Executive Compensation Committee approved the establishment of a special project bonus not to exceed a total amount of \$15,500 (to be allocated among the Executive Director and the other three executive staff members) for the development and implementation of the FWCJUA’s Web site. At its June 4, 2003, meeting, the Executive Compensation Committee was provided documentation demonstrating that specific project goals had been accomplished, and approved paying executive staff the entire \$15,500 bonus to be allocated as follows: Executive Director \$6,000, Operations Manager \$3,000, Controller \$3,000, and Program Manager \$3,500. We were advised that the manner in which the bonus was allocated was recommended by the Executive Director; however, we were not provided documentation evidencing the basis for the allocation, such as evidence of the level of effort expended, or project goals accomplished, by each staff member.

Recommendation: The FWCJUA should develop specific performance evaluation rating factors for each of the four executive positions, and apply such factors to each executive staff member's performance to determine the extent to which they are entitled to "at-risk" compensation. In addition, the FWCJUA should maintain documentation evidencing the basis for allocations of special project bonuses.

Finding No. 5: Contractual Services

The FWCJUA is responsible for establishing internal controls that provide assurance that the process of acquiring services is effectively administered. As a matter of good business practice, procurement of services should be done using a competitive selection process to provide an effective means of equitably procuring the best quality services at the lowest possible cost. In addition, contractual arrangements for services should be evidenced by written agreements embodying all provisions and conditions of the procurement of such services. The use of a formal written agreement protects the interests of the FWCJUA, identifies the responsibilities of both parties, defines the services to be performed, and provides a basis for payment.

Our review of the FWCJUA's procurement of various contractual services disclosed that the FWCJUA's procurement procedures could be enhanced as discussed below.

Competitive Selection

Although the FWCJUA utilized a competitive selection process through requests for proposals (RFP) to initially select most of its contractors, most of those contractual services, including policy administration, have not been subjected to a competitive selection process since 1995.

Written Agreements

The FWCJUA had generally entered into written agreements for contractual services. However, the FWCJUA had no written agreement with its General Counsel, who has provided legal services to the FWCJUA since 1994. Payments to the General Counsel during the audit period (see Finding No. 3) included three lump sum payments of \$25,000 each that were not supported by sufficiently detailed invoices. Invoices supporting these payments indicated that they related to legislative matters, but did not provide a breakdown of hours or hourly rates, and did not provide specifics as to the nature of the work performed.

The FWCJUA entered into a written agreement with an independent certified public accounting firm to provide auditing, tax, and consulting services for the fiscal years ending December 31, 2002, through December 31, 2004. Under the terms of the agreement, the FWCJUA was required to pay the firm a fixed fee each year, based on the dollar volume of premiums during the fiscal year, for completing the audit, preparing a tax return, and providing up to 40 hours of consulting services relating to "various questions and routine matters." Our review of the agreement and invoices supporting payments to the firm disclosed the following:

- The agreement indicated that fees for consulting services (presumably for time in excess of 40 hours) and other accounting or tax services (presumably for tax services other than preparing the tax return) would be based on actual time spent at standard hourly rates; however, although rates were specified for administrative personnel, rates for professional personnel were not specified.

- Invoices from the firm were not in sufficient detail to demonstrate that the FWCJUA, for consulting services, was only billed for time spent in excess of 40 hours. Also, one invoice for consulting services did not provided details as to hours or hourly rates.
- The FWCJUA, for administrative personnel for consulting services rendered, was billed at \$7 per hour rather than the \$5 per hour rate specified in the written agreement.

We noted that some invoices from the firm for consulting services showed a discount. However, because of the lack of specificity in the written agreement and invoices regarding consulting services, as discussed above, we could not determine whether the firm was properly paid, considering the discounts.

Given the lack of a written agreement and sufficiently detailed invoices for legal services, and the problems noted above regarding consulting services, we could not determine, with certainty, the propriety of payments for such services.

Service Provider Agreement

Section 6.8 of the policy administration service provider's agreement provides that the service provider pay its share of any financial audit based on costs calculated by the audit firm to be attributable to the audit firms inspection or examination of the service provider's procedures and records.

The service provider paid the FWCJUA \$18,356 and \$26,559 for its share of the costs of the 2002 and 2003 year audits, respectively, based on invoices the FWCJUA submitted to the service provider. The FWCJUA, in determining the amount to be billed to the service provider, used a methodology that included an adjustment for direct time reportedly spent by the audit firm examining another service provider's records and an adjustment for indirect costs reportedly related to examining the service provider's procedures and records. We were advised that this methodology was approved by the FWCJUA's prior external auditors. However, there was no indication that the FWCJUA's current external auditors had approved this methodology, and the service provider's share of the costs of the 2002 and 2003 year audits, according to documentation submitted to the FWCJUA by its current external auditors, only totaled \$5,891 and \$9,745 for the 2002 and 2003 year audits, respectively. In addition, since Section 6.8 of the service provider's agreement requires that the service provider's share of the audit costs be "calculated by the audit firm," it is not apparent why the FWCJUA would attempt to make adjustments to the audit costs calculated by its current external auditors. As such, the service provider was over-billed \$12,465 and \$16,814 for the 2002 and 2003 year audits, respectively (total of \$29,279).

Recommendation: The FWCJUA, as soon as practical, should undergo a competitive selection process for all of its contractual services, and should do so again at reasonable intervals. Written agreements that clearly specify the nature of the services to be rendered, and the terms of compensation, should be used for all contracted services. The FWCJUA should also obtain adequate invoices for auditing, tax, and consulting services. In addition, the FWCJUA should refund the \$29,279 that was over-billed the service provider.

FWCJUA Response and Auditor General's Clarification

The FWCJUA Board Chairman and Executive Director, in their response to this finding, indicated that most of the contracts for services were initially let between 1995 and 1996 for a period of 3 years, and because of depopulation resulting in significant changes in its volume of policies and premium, as well as expected further depopulation, the Board determined that it was more cost beneficial for the FWCJUA to enter into contract extensions with its vendors, who were performing at acceptable levels, rather than subject these contractual services to a competitive selection process. However, given the significant change in volume of policies and premium, it would appear that there was an even greater need to subject these contractual services to a competitive selection process.

The FWCJUA Board Chairman and Executive Director indicated that they believe that the FWCJUA's written agreement (i.e., multi-year engagement letter) with its independent auditors provided in sufficient detail a description of the scope of services and the basis for all billings that were rendered, and that the services were billed in sufficient detail to indicate the time and level of the individual performing these tasks. Contrary to this assertion, as noted in our finding, the FWCJUA's written agreement with the independent auditors did not specify the rates at which the FWCJUA would be billed for the various levels of professional personnel, and the invoices submitted by the independent auditors were not always in sufficient detail or consistent with the terms of the written agreement. The FWCJUA Board Chairman and Executive Director also indicated that billings submitted by the independent auditors were reviewed and approved by the FWCJUA. Given the inadequacies of the written agreement and billings as noted above, it is unclear as to why the FWCJUA approved all of the billings, including billings for administrative personnel at hourly rates that exceeded the rates specified in the written agreement.

In their response to our finding that FWCJUA had over-billed its service provider \$29,279 for its share of the FWCJUA's audit costs, the FWCJUA Board Chairman and Executive Director stated that the FWCJUA and its contracted service provider agreed in 1998 as to how the audit recovery fees would be calculated with regard to the service agreement, the FWCJUA's independent auditors confirmed the methodology with regard to the indirect cost allocation, and the service provider and the FWCJUA agreed to utilize the methodology as evidenced by the service provider payments. However, as noted in our finding, there was no indication that the FWCJUA's current independent auditors had approved this methodology, and the FWCJUA provided no amendments to its agreement with the service provider or other documentation evidencing the service provider's concurrence with the FWCJUA's interpretation of the terms of the agreement regarding calculation of the service provider's share of the audit costs.

Finding No. 6: Contract Monitoring for Policy Administration

Section 627.311(5)(c)14., Florida Statutes, requires the FWCJUA to provide for service standards for service providers, methods of determining adherence to those service standards, incentives and disincentives for service, and procedures for terminating contracts for service providers that fail to adhere to service standards.

As noted in Finding No. 3, the FWCJUA has outsourced many of its policy administration functions to an independent service provider. Under the terms of the written agreement, the service provider is responsible for initial and renewal policy issuance, calculation of premiums for renewing policies and collection of premiums from policyholders, placement of overdue amounts with a collection agency, payment of fees to producers, payroll audits of policyholders, loss control/prevention services for specified policyholders, claims administration and settlement, and managed care services.

Pursuant to the agreement, the service provider must administer policies in conformance with standards provided for in the FWCJUA's "Plan of Operation" as prescribed in the FWCJUA's Operations Manual. Failure to comply with such performance standards constitutes a failure to fulfill the requirements of the service provider agreement and could result in termination of the service provider or other penalties at the discretion of the FWCJUA Board. The agreement also contains provisions that allow for the FWCJUA's monitoring of the service provider's performance, including a program audit of the provider's services by the FWCJUA or its designee as deemed appropriate by the FWCJUA.

During the audit period, the FWCJUA did not, of record, conduct a program audit, and did not, of record, monitor all aspects of the service provider's performance including, for example, paying producer commissions, conducting payroll audits and loss control surveys, and handling delinquent accounts. Rather, the FWCJUA relied primarily on the service provider's internal processes designed to comply with contract terms, and on the service provider's self-reporting of compliance.

The FWCJUA also relied on audits or reviews conducted by its external auditors, State regulatory agencies, and reinsurers, and complaints, if any, received from external parties such as policyholders, medical providers, or producers. While audits and reviews conducted by external organizations offer limited assurances for some

aspects of the service provider's performance, the objective of the audits and reviews may not include or be targeted to the service provider's performance as it relates to the agreement between the FWCJUA and the service provider. With the exception of payroll audits as they relate to a change in premium, there was no evidence that the service provider's compliance with contractual requirements relating to payment of producer commissions, conduct of payroll audits and loss control surveys, or handling of delinquent accounts was reviewed by outside organizations during the audit period.

Based on the above, it was not apparent how the FWCJUA complied with the provisions of Section 627.311(5)(c)14., Florida Statutes, which requires the FWCJUA to provide for methods of determining adherence to service standards by service providers. The apparent lack of monitoring procedures with respect to payroll audits, loss control surveys, and handling of delinquent accounts may have contributed to the significant instances of noncompliance with the service provider agreement as discussed in Finding Nos. 8, 9, and 10.

Other residual market insurers in Florida and other states use monitoring efforts that include contracting for an audit of the policy administrator's performance, as is done annually by the Florida Automobile Joint Underwriting Association, and periodic on-site audits such as those performed by the National Council on Compensation Insurance, Inc. These methods of monitoring performance by policy administration service providers may be beneficial to the FWCJUA in its monitoring efforts.

Recommendation: The FWCJUA should develop procedures to monitor all aspects of the service provider's performance and should ensure that such procedures are sufficient to ensure the service provider's adherence to service standards. In doing so, the FWCJUA should give consideration to monitoring efforts being used by other residual market insurers in Florida and other states.

FWCJUA Response and Auditor General's Clarification

The FWCJUA Board Chairman and Executive Director, in their response to this finding, indicated that the FWCJUA monitors all aspects of the contracted service provider's performance, concentrating its monitoring efforts on policy issuance, claims handling, and financial reporting, and believes that its current procedures are sufficient to ensure that the service provider is adhering to the FWCJUA's service standards. The FWCJUA Board Chairman and Executive Director also indicated that, in addition to relying on the service provider's internal processes and audits or reviews conducted by others, the FWCJUA interacts with the service provider on a daily basis and reviews both policy and claims files. While we agree that monitoring policy issuance and claims handling is important, we also believe the other performance aspects of the agreement, as described in the finding, are important to monitor. Although we noted documentation of the FWCJUA's review of claims records maintained by the service provider, during the course of our audit we found no evidence of the FWCJUA's review of policy files maintained by the service provider.

The FWCJUA Board Chairman and Executive Director also stated that the service provider recently received the highest performance rating possible from the NCCI on its Servicing Carrier Performance Audit Report dated May 28, 2004, which focused on the underwriting, premium audit, loss prevention, and claims performance standards. However, the FWCJUA did not indicate that FWCJUA policies were reviewed in connection with the NCCI's review of the service provider, and we were not provided a copy of NCCI's report, or other documentation, evidencing that the review included an examination of the service provider's performance as it relates specifically to the FWCJUA's performance standards as prescribed by the FWCJUA's Operations Manual and the FWCJUA's agreement with the service provider.

The FWCJUA Board Chairman and Executive Director further stated that the service provider agreement provides several safeguards that protect the FWCJUA regarding the service provider's performance. We agree that the FWCJUA's agreement with the service provider includes several provisions establishing safeguards to protect the FWCJUA. However, the mere existence of safeguard provisions in the agreement does not provide adequate assurance that the service provider is complying with prescribed performance standards. Monitoring by the FWCJUA will help to assure that those safeguards are actually in place and working effectively.

Finding No. 7: Producer Commissions

As discussed in Finding No. 3, the FWCJUA contracts with a service provider to perform most of its policy administration and claims processing functions, and contracts with producers (i.e., insurance agents) to assist employers in obtaining coverage with the FWCJUA (producers' responsibilities include assisting employers in completing applications, reviewing applications for reasonableness and accuracy, and advising employers in all matters relating to workers' compensation insurance). The service provider calculates producer commissions, and uses amounts collected from insured employers to pay such commissions, as well as claims and other policy administration expenses. During the audit period, the FWCJUA recorded approximately \$2 million in producer commissions, based on written premiums.

The FWCJUA had not established adequate controls to ensure proper payment of producer commissions. Although requested, we were not provided documentation evidencing that the FWCJUA verified the service provider's calculation of producer commissions paid during the audit period. These commissions cannot be recalculated on a global basis (i.e., for the entire month as a whole) because they are calculated on only a portion of each premium; however, they should at least be recalculated on a test basis by FWCJUA staff. Should producers be underpaid, the FWCJUA would likely discover the errors through complaints received from producers; however, overpayments may not be reported to the FWCJUA.

Recommendation: **The FWCJUA should verify, on a test basis, producer commissions paid by the service provider.**

FWCJUA Response and Auditor General's Clarification

The FWCJUA Board Chairman and Executive Director, in their response to this finding, indicated that the FWCJUA verifies producer fee calculations in accordance with Statement on Auditing Standards No. 56 (SAS 56), Analytical Procedures, because this method of verification is reasonable and does not produce redundant costs thereby making more efficient use of its policyholders' monies. SAS 56, paragraph 22, requires the documentation of certain specific analytical procedures; however, no such documentation was provided for our review. Further, in response to our inquiry as to what procedures the FWCJUA uses to verify producer commissions, we were advised by the Executive Director on October 13, 2004, that the FWCJUA does not attempt to recalculate the commissions paid to producers, and relies on audits conducted by its independent auditors and complaints from producers for assurances as to the accuracy of producer fees..

The FWCJUA Board Chairman and Executive Director also indicated that the FWCJUA's independent auditors use similar analytical review procedures to recalculate the annual producer fees and compare amounts reported in our financial statements. However, our discussions with the independent auditors, and our review of the independent auditor's working papers, disclosed that only the producer fees payable (liability as of year-end) is subjected to testing, which does not provide assurance as to proper payment of producer commissions.

Finding No. 8: Payroll Audits

Policyholders' premiums are assessed based on the employers' payroll information as provided by the policyholder. Payroll audits (i.e., examinations of employers' records) are important to verify the accuracy of payroll information. These audits are required for all policyholders at differing intervals depending on premium amount or the business classification of the employer. If payroll audits are not performed, the premium calculated for and collected from the policyholder may be under- or overstated, and for an understated premium for which the policy has expired, an untimely payroll audit could make it difficult to collect the additional premium due unless the policyholder renews the policy.

The service provider furnished us with a listing of all payroll audits completed during the audit period. Using this listing, we reviewed the service provider's compliance with payroll audit requirements noted in the contract. Our review disclosed that the service provider is not always performing these audits or not timely performing the audits, as discussed below.

Preliminary Audits. The service provider, as provided by Part II, Section D.12(b) of the FWCJUA's Operations Manual, is required to conduct preliminary payroll audits for certain premium amounts or business classifications to be conducted within 90 days of the effective date of the policy or upon assignment by the FWCJUA; however, to allow more time for certain seasonal businesses to mature, the service provider may extend this time up to 180 days in order to obtain a more accurate audit. Based on information provided by the service provider, we determined that preliminary payroll audits were not conducted for 50 (7 percent) of 677 noncanceled policies bound by the FWCJUA during the 2003 calendar year for which the service provider was required to conduct a preliminary payroll audit.

Final and Cancellation Audits. The service provider, as provided by Part III, Section D.12(a) of the FWCJUA's Operations Manual, is required to conduct final audits (for expired policies) or cancellation audits (for cancelled policies), and make the final billing or return of premium, within 75 days of the policy expiration or cancellation date. The service provider furnished listings of final and cancellation audits conducted during the audit period. Of the 1,066 cancellation audits conducted, 387 (36 percent) were not conducted within 75 days of the cancellation dates of the policies, including 90 that were conducted from 4½ to 9½ months after the policy cancellation dates. Likewise, of the 1,825 final audits conducted, 190 (10 percent) were not conducted within 75 days of the expiration dates of the policies, including 13 that were conducted from 4½ to 10 months after the policy expiration dates.

We were subsequently advised that the late cancellation or final audits were probably due to policyholders not cooperating with the service provider's attempts to conduct cancellation or final audits. To determine the accuracy of this assertion, we selected from the 577 policies a sample of 30 policies and requested documentation evidencing the service provider's attempts to conduct an audit. For 22 (73 percent) of the 30 sampled policies, we determined that either there was no evidence that the policyholder was uncooperative or actions taken by the service provider (e.g., letters requesting audits or other attempts to contact policyholder) were not timely.

Approximately 79 percent of the final and cancellation audits resulted in amounts due to policyholders totaling \$37.7 million (\$30.2 million due to cancellation audits and \$7.5 million due to final audits). These amounts were held up to 10 months after the policies had been canceled or expired before being refunded to the policyholders. Also, final and cancellation audits resulted in additional amounts due from policyholders totaling \$10.1 million (\$2.5 million due to cancellation audits and \$7.6 million due to final audits). A long delay in billing for additional premiums due disclosed through a final or cancellation audit increases the likelihood that these additional premiums may be difficult to collect due to indifference or relocation of the policyholder.

Recommendation: The FWCJUA should ensure that the service provider timely conducts payroll audits in accordance with the FWCJUA's Operations Manual.

FWCJUA Response and Auditor General's Clarification

The FWCJUA Board Chairman and Executive Director, in their response to our finding as it relates to preliminary audits not conducted, or untimely cancellation or final audits, provide specifics regarding the exceptions disclosed in our finding. However, we were not provided documentation supporting these specifics, and it is not practical for us to attempt to verify these specifics through

reexamination of the service provider's records. Our findings were based on information and records provided by the service provider at the time we conducted our examination.

The FWCJUA Board Chairman and Executive Director, in their response to our finding as it relates to the 30 policies we tested for timely compliance with cancellation and final audit requirements, indicated that 21 of the 30 audits were handled properly in accordance with performance standards. We are uncertain as to the performance standards being referred to by the FWCJUA Board Chairman and Executive Director; however, based on the performance standards prescribed in the FWCJUA's Operations Manual, the results of our test disclosed that for 22 of the 30 policies there either was no evidence that the policyholder was uncooperative or actions taken by the service provider were not timely.

Finding No. 9: Loss Control Surveys

Section 627.311(5)(c)11., Florida Statutes, requires the FWCJUA to establish reasonable safety programs for all policyholders and requires all policyholders to participate in the safety program. The service provider is required to provide policyholders with loss control, safety, and industrial hygiene surveys, consultations, and related services. All policyholders are to be notified of the safety program, and their required participation therein, and are to receive materials that prescribe standardized, industry-specific, safety and loss control practices with which policyholders must comply. Policyholders can request loss control services at any time and on-site loss control surveys are required for all policyholders that meet specified criteria or have premiums greater than \$25,000. Such surveys are required to be completed within the first 150 days of the policy period.

The FWCJUA actuary's report on FWCJUA reserves as of December 31, 2003, indicates that 39 percent of all FWCJUA claims involve indemnity (lost work time) payments. Our contracted actuary (see discussion in Finding No. 1) reported that this percentage is high in comparison to the voluntary market. This may be due to the nature of FWCJUA employers and injured workers (e.g., more hazardous occupations or less cooperative policyholders); however, it could be due, at least in part, to inadequate efforts to ensure compliance with safety programs as discussed below.

The service provider furnished us with a listing of all loss control surveys completed during the audit period. Using this listing, we reviewed the service provider's actions taken for all policies with premiums in excess of \$25,000 bound by the FWCJUA during calendar year 2003. For 22 of the 299 sampled policies (7 percent), the service provider did not conduct the required survey.

In addition, our test of policies bound during the 2003 fiscal year included seven policies that were subjected to a loss control survey. Although Part III, Section D.13(d) of the FWCJUA's Operations Manual indicates that site visits are to be performed for all loss control surveys, we determined that the service provider did not conduct a site visit of all job sites for four of the seven loss control surveys tested as follows:

- In two instances, site visits were not conducted at all locations at which the policyholder did business, including one policyholder that operated at 56 locations throughout the State, but for which the service provider conducted a site visit at only one of these locations.
- In one instance, the service provider's record of the loss control survey indicated that a site visit was not feasible because, reportedly, there was no office or physical address to conduct the loss survey. However, the policyholder is a general contractor that had three jobs in progress. As such, it was not clear why the survey was not conducted at one or more of the policyholder's job sites.

- In one instance, the service provider's record of a loss control survey, conducted for a general contractor, indicated that the survey was conducted at a location other than a job site but provided no explanation as to why a job site visit was not conducted.

Safety programs provide protection for workers and are intended to help reduce loss exposure for insurers. Unless an on-site survey is performed, the FWCJUA cannot be assured that the policyholder is actively participating in the safety program established. We recognize that there may be situations in which job site visits may not be feasible; however, the FWCJUA's Operations Manual does not provide for such situations. Nor does the Operations Manual address circumstances in which site visits may not be necessary for all locations at which policyholders operate, although a total of 436 insured policyholders operated at multiple locations throughout the State during the 2003 year (according to the service provider's records).

Recommendation: The FWCJUA should ensure that the service provider timely and properly conducts loss control surveys in accordance with the FWCJUA's Operations Manual. In addition, the FWCJUA should consider revising the Operations Manual to address circumstances in which site visits are not feasible, and site visit requirements for employers with multiple locations.

Finding No. 10: Delinquent Accounts

All FWCJUA policies are issued for one-year terms. Pursuant to the Operations Manual, the FWCJUA requires the entire premium amount in advance for estimated annual premiums of \$1,000 or less. For those over \$1,000, advanced premiums are calculated at 50 percent of the total estimated annual premium, but not less than \$1,000, with the remaining premium due in three equal payments, payable three, six, and nine months after policy inception. In addition, for estimated annual premiums of \$7,000 or less, the FWCJUA requires a deposit of 50 percent of the total estimated annual premium.

Part III, Section D.11 of the FWCJUA's Operations Manual provides that on large delinquent accounts, where the uncollectible premium is \$100 or more, the service provider shall diligently pursue collection of such accounts for no more than 90 days from the last day of the month in which the final audit billing is sent or 30 days from the date of receipt of the last payment on the account. After that time, the service provider must place large delinquent accounts with a collection agency designated by the FWCJUA.

Our contracted actuary (see discussion in Finding No. 1) reported that the FWCJUA's percentage of uncollected written premium (which averaged 16.3 percent for policy years 1998 through 2001 according to the FWCJUA actuary's analysis of the loss and loss adjustment expense reserves as of December 31, 2003) is substantially higher than the percentage of uncollected written premium reported by residual market workers' compensation insurers administered by the National Council on Compensation Insurance, Inc., in other states. This may be due to different laws or demographic characteristics; however, it may be at least partially due to untimely cancellation and final audits (see Finding No. 8) or to an insufficiently aggressive collection policy.

Our inquiry of two other Florida residual market insurers disclosed that one insurer generally requires the entire premium to be paid in advance. The other insurer indicated that although a payment plan is an option for its policyholders (the FWCJUA also accepts financed deposits or premiums), the finance company utilized pays the insurer for the entire amount due and, if the insured fails to pay, it is between the finance company and the insured. For insureds that do not opt to use a finance company, 40 percent of the premium is due in advance, 30 percent is due 75 days from the policy effective date, and the remaining 30 percent is due 180 days from the

policy effective date. If the insured fails to pay, the policy is canceled within two weeks. These alternative collection methods may be beneficial to the FWCJUA's in its effort to lower its percentage of uncollected premium. Although collecting the entire premium in advance regardless of the premium amount may not be feasible for workers' compensation insurance, increasing the amount of premium for which 100 percent of the premium is required to be paid in advance could help reduce the percentage uncollected premium.

Our audit disclosed that the service provider did not always timely place accounts with the collection agency. We selected a sample of ten large delinquent accounts as of June 30, 2004. We found that two of these accounts, totaling approximately \$250,000, had not been placed with the collection agency (as of the time of our review in October 2004, these accounts been delinquent from 222 to 327 days after the deadline established by the Operations Manual). In addition, four other accounts, totaling approximately \$2 million, were placed with the collection agency from 11 to 98 days after the deadline established by the Operations Manual. Timely placement of accounts with the collection agency enhances the ability of the FWCJUA to collect delinquent accounts, and delays in placing such accounts with the collection agency increases the difficulty in collecting amounts owed due to indifference or relocation of the policyholder.

Recommendation: The FWCJUA should explore alternative means of collecting premiums to help reduce its percentage of uncollected premium, and should consider increasing the amount of premium for which 100 percent of the premium is required to be paid in advance. In addition, the FWCJUA should ensure that the service provider places delinquent accounts with the collection agency in accordance with the FWCJUA's Operations Manual.

FWCJUA Response and Auditor General's Clarification

The FWCJUA Board Chairman and Executive Director, in their response to this finding, stated that the FWCJUA's 4-year average uncollected written premium rate for the 1998 through 2001 policy years is 14.8 percent, and not 16.3 percent as indicated in our finding. To clarify, the 14.8 percent rate cited by the Board Chairman and Executive Director is the rate as computed for the 4-year period 1998 through 2001, and is not an average per-year rate. The 16.3 percent rate cited in our report is the average per-year rate using the rate calculated for each of the four policy years by the FWCJUA's actuary as of December 31, 2003, and was computed in the same manner as the FWCJUA's actuary did in calculating the FWCJUA's average per-year rate for policy years 1994 through 2003, as of December 31, 2003.

The FWCJUA Board Chairman and Executive Director also compared the FWCJUA's 14.8 percent to the 4.8 percent rate calculated for the same policy years for approximately two dozen workers compensation residual market programs that the NCCI administers in other states, and also indicated the uncollectible rate for Florida in 1993 was 16 percent. Based on these percentages, the FWCJUA has not significantly reduced the percentage of uncollected premium since its inception in 1994, and its rate remains substantially higher than the collective average rate for the workers compensation residual market programs administered by the NCCI in other states.

Finding No. 11: Depopulation Program

Section 627.311(5)(c)4., Florida Statutes, requires the FWCJUA to establish programs to encourage insurers to provide coverage to applicants in the voluntary market, including a market-assistance plan (MAP) to assist in the placement of employers.

The FWCJUA has established a variety of means to encourage employers to secure coverage in the voluntary market. For example, by signing the application, employers signify that they are aware that workers' compensation insurance may be available through another insurer at a lower cost through another producer. Also, the producer, in his/her agreement with the FWCJUA, agrees to continually attempt to place the employer

in the voluntary market. Furthermore, information regarding employers insured by the FWCJUA is made available on the FWCJUA's Web site so that the employers may be considered for coverage in the voluntary market. As of September 2004, the Web site MAP had been available for approximately 15 months and 342 producers and 4 insurance carriers had signed on and accessed the MAP.

Though the FWCJUA has developed various approaches in its depopulation program, it has generally not measured the effectiveness of its approaches. For example, the FWCJUA does not know the number of policies absorbed into the voluntary market from its Web site program. According to a report prepared by the service provider, in calendar year 2003, 138 policies (about 3 percent of the 4,314 policies existing at December 31, 2003) were canceled prior to expiration because the insured was placed with another insurer. However, the report does not indicate which of these 138, if any, involved instances in which the insurer became aware of the insured through the FWCJUA's depopulation efforts. Unless such measurements are taken, it is unknown as to whether the FWCJUA has accomplished the intent of Section 627.311(5)(c)4., Florida Statutes.

Recommendation: **The FWCJUA should develop ways to measure the success of its depopulation efforts.**

FWCJUA Response and Auditor General's Clarification

The FWCJUA Board Chairman and Executive Director, in their response to this finding, stated that FWCJUA measures the effectiveness of depopulation on a market share basis rather than on an individual method basis. However, changes in market share may be attributable to factors other than depopulation efforts.

SCOPE AND OBJECTIVES

The scope of the audit included actions and transactions of the FWCJUA during the period January 1, 2003, through June 30, 2004, and selected actions taken prior and subsequent thereto. Pursuant to Chapter 2004-266, Laws of Florida, the scope also included an analysis of the adequacy and appropriateness of the rates and reserves of the association as determined by an independent consulting actuary contracted with by the Auditor General, and an evaluation of costs associated with the administration and servicing of the policies issued by the FWCJUA to determine alternatives by which costs could be reduced.

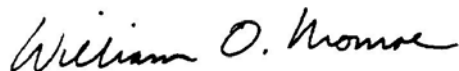
Our objectives were to: (1) determine the extent to which management controls promoted and encouraged the achievement of management's objectives in the categories of compliance with controlling laws, administrative rules, and other guidelines; the economic and efficient operation of the FWCJUA; the reliability of financial records and reports; and the safeguarding of assets; (2) evaluate management's performance in administering assigned responsibilities in accordance with applicable laws, administrative rules, and other guidelines; and (3) make recommendations to the Legislature relating to the FWCJUA's operations.

METHODOLOGY

The methodology used to develop the findings in this report included the examination of pertinent records of the FWCJUA in connection with the application of procedures required by generally accepted auditing standards and applicable standards contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

AUTHORITY

Pursuant to the provisions of Chapter 2004-266, Laws of Florida, and Section 11.45(2)(a), Florida Statutes, I have directed that this report be prepared to present the results of our operational audit of the FWCJUA for the period January 1, 2003, through June 30, 2004, and selected actions taken prior and subsequent thereto.



William O. Monroe, CPA
Auditor General

FWCJUA AND OIR RESPONSES

The FWCJUA and OIR provided written responses to our findings, and those responses are included in this report as Exhibits A and B, respectively. In addition, when necessary, excerpts from the FWCJUA's and OIR's responses with our clarification of the finding are included under the applicable findings above. An excerpt from our contracted actuary's report, which was attached to the FWCJUA's response, is not included in this report but may be viewed on the Auditor General's Web site.

EXHIBIT – A
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.



Florida Workers Compensation
Joint Underwriting Association, Inc.

P.O. Box 48957, Sarasota, FL 34230-5957
 • Tel (941) 378-7400 • Fax (941) 378-7405 • www.fwcjua.com

December 23, 2004

William O. Monroe, CPA
 Auditor General
STATE OF FLORIDA
 G74 Claude Pepper Building
 111 West Madison Street
 Tallahassee, Florida 32399-1450

Dear Mr. Monroe,

Enclosed is the Florida Workers' Compensation Joint Underwriting Association, Inc. (FWCJUA) written statement of explanation concerning your preliminary and tentative findings and recommendations issued on November 23, 2004.

Should you have questions regarding the FWCJUA's written statement of explanation, please contact Laura Torrence at 941-378-7401.

Sincerely,

Ray Neff
 Chair of the Board of Governors

Laura Torrence
 Executive Director

- c: Board of Governors
 Tom Maida, General Counsel
 Jim Watford, Office of Insurance Regulation
 Jim Dwyer, Auditor General's Office
 Ted Sauerbeck, Auditor General's Office
 Marilyn Rosetti, Auditor General's Office

BOARD OF GOVERNORS: Ray Neff, *Chair*; David Webber, *Vice Chair*; Steve Burgess; Patrick Cannassa; Dan Dannenhauer; Elissa Pacheco; Claude Revels; Beth Vecchioli; Laura Wehrle

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
PRELIMINARY AND TENTATIVE FINDINGS DATED NOVEMBER 23, 2004**

Submitted on 12/23/2004

Finding No 1: Our contracted actuary's review of the FWCJUA's reserves reported as of December 31, 2003, and the rates established in its July 7, 2004, rate filing, concluded that the FWCJUA's actuary determined the best estimate of required reserves using an undocumented and unquantified approach, and established a range of reasonableness that produced an upper bound that is too high in relation to the best estimate of required reserves. In addition, the FWCJUA Board exercised additional conservatism by reporting reserves that were \$8.4 million higher than the FWCJUA actuary's best estimate of required reserves.

Our contracted actuary recommended that the FWCJUA consider using a quantifiable approach to determine required reserves, and using such an approach concluded that: required reserves should be significantly less than the FWCJUA actuary's best estimate of required reserves; the FWCJUA could have established a lower rate for Tier Three policies; and the rates mandated by Chapter 2004-266, Laws of Florida, for Tiers One and Two are too low.

Recommendation: The FWCJUA should reevaluate its reported reserves and established rates giving consideration to our contracted actuary's findings and recommendations, and ensure that the FWCJUA's actuary, regardless of the approach used to determine required reserves, document all judgments. The FWCJUA should also consider revising its agreement with the service provider to create a contract of insurance or reinsurance as suggested by the Office of Insurance Regulation (OIR) so that it would clearly not be required to report an ULAE liability. In addition, the OIR should consider providing guidelines regarding the use of a quantifiable approach for introducing conservatism in estimating loss and loss expense reserves. Further, the Legislature should consider enacting legislation that expedites the requirement for Tiers One and Two rates to be determined on an actuarially sound basis.

FWCJUA Response: The Auditor General was required by law to perform an operational audit of the FWCJUA which scope was to include an analysis of the adequacy and appropriateness of the rates and reserves of the association. Given that the Auditor General engaged an independent consulting actuary to evaluate the rates and reserves of the FWCJUA, the FWCJUA believes that the Auditor General's report should clearly and accurately state the findings of the contracted actuary instead of the Auditor General's interpretation of the contracted actuary's statements. The FWCJUA accepts that the Auditor General may interpret its contracted actuary's statements and draw conclusions from such interpretations; however, the FWCJUA believes that the Auditor General's findings and conclusions should be clearly distinguished from those of the contracted actuary.

THE AUDITOR GENERAL'S CONTRACTED ACTUARY DOES NOT CONCLUDE IN ITS REPORT THAT THE FWCJUA'S RATES AND RESERVES ARE INADEQUATE OR INAPPROPRIATE, NOR DOES HE OPINE THAT THE FWCJUA'S RATES AND RESERVES ARE UNREASONABLE.

Further, the Auditor General's contracted actuary does not conclude that the FWCJUA's actuary (1) determined the best estimate of required reserves using an undocumented and unquantified approach or (2) established a range of reasonableness that produced an upper bound that is too high in relation to the best estimate of required reserves. Additionally, although the contracted actuary appropriately stated that the FWCJUA Board exercised additional conservatism by reporting reserves that were \$8.4 million higher than the FWCJUA actuary's best estimate of required reserves, the contracted actuary did not dispute that the FWCJUA booked a reserve amount that is within the FWCJUA actuary's "range of reasonableness." For evidence of such, please refer to the attached report (excluding the technical appendices) prepared by the Auditor General's contracted actuary.

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
 PRELIMINARY AND TENTATIVE FINDINGS DATED NOVEMBER 23, 2004**

Submitted on 12/23/2004

The Auditor General's contracted actuary's report establishes that the determination of rates and reserves relies heavily on judgments, as evidenced by the following excerpts from his report:

- Page 1,C: **"Best" Estimate of Loss and ALAE Reserves Reported by FWCJUA Actuary**
 There is no definition of a "best" estimate. It is within actuarial standards to rely heavily on judgment rather than any specific methodological process.
- Page 1, D: **"Range of Reasonableness"** The FWCJUA actuary provides the FWCJUA Management with a range of reserves around the actuary's "best" estimate that the actuary believes is reasonable. Management is expected to book a reserve amount that is within the FWCJUA actuary's "range of reasonableness."
- Page 2, F: **Judgment is an Integral Part of Establishing Reserves and Rates** It is important for the reader to understand and appreciate that determination of reserves and/or rates is not an exact science. Booked reserves and/or rates are in part the result of management's judgment. Furthermore, booked reserves and/or rates are not the result of a single judgment, but rather are the culmination of many individual judgments that lead up to the final result.
- Page 8, D: **Management Discretion** It is standard practice in the property-casualty insurance industry that reserves are determined by management, and management is encouraged to be conservative (high) in determining reserves in order to increase the likelihood that funds will be available to pay claimants when due. The FWCJUA differs from traditional insurance companies in several respects. In many instances, those differences suggest that reserves should be set at a level higher than the same management might set reserves for a traditional insurer, given the same premium and loss data.

The Auditor General's contracted actuary's report also clearly establishes that his estimates are based upon judgments and that the judgments made by the FWCJUA are not incorrect, as evidenced by the following excerpts from his report:

- Page 4, 2: **PICC's Estimate of Outstanding Liability** There are judgments that are the foundation of PICC's estimate.
- Page 11, B: Where PICC results differ from results as arrived at by the FWCJUA, **PICC IS NOT SAYING THAT THE FWCJUA JUDGMENTS ARE INCORRECT** (emphasis supplied). Rather, PICC is simply providing its results based on its own independent judgments.

To put the Auditor General's contracted actuary's report in perspective, the report merely offers for consideration a different approach for determining the FWCJUA's reserves and/or rates based upon the contracted actuary's own independent judgments regarding reasonableness. Further, the contracted actuary very clearly cautions anyone reading his report from relying upon it to make financial decisions, as evidenced by the following excerpt from his report:

- Page 2, G: **Cautions** Anyone reading this report is advised that the reader may contact PICC for additional explanation of the report's contents. If the reader intends to make any judgments or decisions regarding the FWCJUA, the reader is advised to obtain its own expert analysis. **PICC ACCEPTS NO RESPONSIBILITY FOR ANY FINANCIAL DECISIONS MADE THAT ARE BASED ON THIS REPORT** (emphasis supplied).

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
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Submitted on 12/23/2004

The FWCJUA has been advised by its actuary that there are technical defects in the Auditor General's contracted actuary's approach which we will discuss later in this response. Moreover, the contracted actuary's approach also disregards the requirements of the FWCJUA to comply with statutory accounting principles related to the posting of ULAE reserves and premium deficiency reserves. As reflected in the contracted actuary's report:

Pages 1 & 2,E. **"Statutory Accounting Principles" (SAP)** State insurance law and regulation requires reporting to the state of financial information prepared under SAP. The primary purpose of SAP is to provide financial reporting that is sufficiently conservative (i.e., understate income and/or owners equity) to minimize the likelihood that an insurer will be unable to pay its obligations. In some instances, SAP will require recording of reserves that would not be required under generally accepted accounting principles (GAAP).

The Auditor General's contracted actuary doesn't agree that the FWCJUA is required to book a ULAE reserve for its "cradle to grave" claims administration services; and thus, he disregards the FWCJUA's entire \$4.2 million ULAE reserve, even though \$1.3 million is not "duplicate expense" but rather a reclassification from the service carrier payable account to the ULAE account. The contracted actuary's report indicates the following with regards to the ULAE reserve:

Page 3, 1(c): **Components of FWCJUA Reserves** ULAE is **allegedly** required by SAP even though the FWCJUA purchased "cradle to grave" claims administration services from the Servicing Carrier.

Page 5, 3: **Reserve for Unallocated Loss Adjustment Expense (ULAE)** PICC believes that it is reasonable to expect that the Servicing Carrier will meet its obligation to provide the required claims administration services for claims that occurred prior to 12/31/03 (services for which Travelers has been pre-paid by the FWCJUA) regardless of the future status of the FWCJUA. **Thus, as a practical matter, the \$4,200,000 ULAE reserve held by the FWCJUA is unnecessary** (emphasis supplied).

As confirmed by the FWCJUA's independent auditor, an insurer is required to record an additional liability for claims handling and other expenses (ULAE) that have been contracted out to a third party by Interpretation 02-21 of the NAIC's Emerging Issues Working Group which states, "... the liability for unpaid loss adjustment expense should be established regardless of any payments made to third party administrators, management companies or entities...". Based on its estimated liabilities for unpaid loss adjustment expense, the FWCJUA calculated and recorded a liability for unpaid ULAE in its financial statements at December 31, 2003 in accordance with statutory accounting principles.

Additionally, the Auditor General's contracted actuary doesn't believe that the FWCJUA is required to post a premium deficiency reserve because there exists a probability of over 50% that Subplan D future premium will be sufficient to pay the related losses and expenses, as evidenced in his report:

Page 5, 5. **Premium Deficiency Reserve (PDR)** A PDR is required under SAP (not GAAP) when it is "probable", not just "possible", that actual losses and expenses associated with unearned premium will exceed the unearned premium when it is earned (subsequent to 12/31/03). The FWCJUA's calculation of its PDR is dependent upon its booked reserve. **PICC replicated the FWCJUA's PDR calculation substituting PICC's average estimate of ultimate losses, and determined that no PDR is necessary** (emphasis supplied). PICC concluded that there exists a probability of over 50 percent that Subplan D premium to be earned in the future will be sufficient to pay related losses and expenses.

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
PRELIMINARY AND TENTATIVE FINDINGS DATED NOVEMBER 23, 2004**

Submitted on 12/23/2004

As confirmed by the FWCJUA's independent auditor, the premium deficiency reserve is required by Statement of Statutory Accounting Principles No. 53, *Property Casualty Contracts-Premiums*, when anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve. Based on its estimated liabilities for unpaid claims and loss adjustment expenses, the FWCJUA calculated and recorded a premium deficiency reserve in its financial statements at December 31, 2003 in accordance with statutory accounting principles. Additionally, the same basic calculation is a requirement for property and casualty insurance companies in accordance with accounting principles generally accepted in the United States ("GAAP"). Statement on Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, requires that a "...a premium deficiency reserve shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums". Both bases of accounting require that the known losses of an existing contract (i.e.-policy) be recognized once that loss is determinable and reasonably estimable. The FWCJUA complied with established reporting guidance in establishing its premium deficiency reserve at December 31, 2003.

Further, the Auditor General's contracted actuary's report indicates on both pages 17 and 34, that Subplan D would generate a deficit with zero loss dollars; therefore, even utilizing the contracted actuary's estimates, the FWCJUA would be required by statutory accounting principles to recognize a premium deficiency reserve. The contracted actuary actually does calculate a \$927,000 premium deficiency reserve utilizing his approach as demonstrated in Technical Appendix C, Schedule 1- Sheet 1 of his report; however, he does not document why he did not utilize his calculation in his estimate of outstanding liability.

At this point, we will substantially quote the FWCJUA's independent actuary, Milliman USA, as we respond to the following four points made in the Auditor General's finding:

1. Undocumented approach
2. Unquantified approach and recommended quantified approach
3. Upper bound too high
4. Lower rate for Tier 3 policies

The following discussion will show that:

- The FWCJUA approach is fully documented.
- The FWCJUA approach is quantified.
- The Auditor General's recommended approach is not required by any accounting standards the FWCJUA's independent actuary is aware of.
- The Auditor General's recommended approach is explicitly addressed as not being required by the American Academy of Actuary's Actuarial Standard of Practice (ASOP) number 36.
- The Auditor General's recommended approach is not in common use.
- The Auditor General's recommended approach suffers from technical flaws so serious that its results cannot be relied upon to accurately reflect the concepts it presents.

Discussion Prepared by FWCJUA's Independent Actuary: Before dealing with the specifics of each of these, some background is important to place these issues in context. Much of the discussion revolves around actuarial and management estimates of the FWCJUA's loss and loss adjustment expense reserves. These reserves are provisions to pay for future workers compensation benefits, medical costs, and associated expenses for covered accidents occurring on or before the valuation date (December 31, 2003).

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
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Submitted on 12/23/2004

Because these costs result from events that will take place in the future (the accident has occurred, but events affecting the ultimate cost have not), they cannot be known with certainty. Consequently, a reserve estimate considers both the estimated amount and the resulting uncertainty of that amount.

Actuarial techniques to estimate reserves are essentially simplified models of a complex underlying reality. They are called "methods," having names like "development method," "Bornhuetter-Ferguson method," etc. Each method uses historical data combined with "assumptions" to produce a result (estimate of a reserve). Assumptions include "development factors," "tail factors," "loss ratios," "trend rates," etc. They are typically selected by an actuary after reviewing relevant statistics using the actuary's experience, training and judgment. Actuarial reserving is really a modeling exercise, the method is equivalent to a model, and the assumptions are equivalent to "parameters." Since methods are understood to be simplified models of an underlying reality, they are not expected to model that reality perfectly. Different models (methods) then, will model some aspects of the underlying reality better than others, but no single model is expected to model all aspects of it. Consequently, actuaries are encouraged to apply more than one model and evaluate the results. Uncertainty exists at each level in the analysis. The following points regarding methods should be noted:

- No single model completely describes the underlying reality.
- All models collectively do not completely describe the underlying reality.
- Even if a model did completely describe the underlying reality, the parameters of each model are estimates themselves and subject to uncertainty.
- Even if a model did completely describe the underlying reality, and even if the parameters were known with certainty, the actual results would still be different because they depend upon future events which have not taken place.

The contracted actuary's approach purports to express a result after all sources of uncertainty have been included. We will show that the contracted actuary completely ignored major sources of uncertainty and consequently underestimates the true amount of uncertainty.

The concerns we have with the Auditor General's recommended approach may appear quite technical, particularly to those without a statistical background. Unfortunately, this results because the recommended approach itself is highly technical. However, the key concept involved is relatively simple. Before we make our technical response, we would like to give an illustration to make this point.

Suppose we are presented with the series of numbers: 3,3,3,3,3; and asked to estimate the next number in the series. The intuitive response would of course be 3. Suppose now, however, we are given the series 4,1,3,5,2. We might again select 3, the average of the series, but certainly we had to think about it longer and perhaps do some math before we were comfortable with the answer. We would be substantially less certain of our answer here than with the first series. Finally, if the series were 1,2,3,4,5, we would likely select 6, the next number in a series that appears to be increasing by 1 each time. In fact, with this last series, we might go so far to say that the average of 3 is probably not the next number in the series.

Our technical difficulty with the contracted actuary's approach is that the approach is equivalent to always selecting 3 for each of the examples above, and more importantly to always use the same quantification of uncertainty around each of the answers. This is so counterintuitive that it cannot possibly be correct.

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With respect to the term "undocumented:" The best estimate of the required reserves was calculated in a report that described each of the following:

- The purpose and scope of the assignment
- The results of the analysis
- The data relied upon
- The methodology employed
- Limitations concerning the use of the results and risk factors affecting the estimates

In addition to the text, the report includes exhibits and appendices that fully documented the calculations from the source data to the final result. Each assumption and judgment was clearly identified and labeled, showing relevant historical results, and the value the FWCJUA's actuary selected.

The approach the FWCJUA's actuary used employed methods that are all commonly used in actuarial reviews and are instantly familiar to practicing actuaries. The derivation of the methods are documented and explained in the actuarial literature.

The FWCJUA's actuary has never experienced any others not understanding its reports from the FWCJUA staff, its Board, or its independent auditors. It is clear from his analysis that the contracted actuary was able to fully understand the calculations from FWCJUA's actuary report, and in fact was not only able to reproduce them, but to substitute their own judgment where they felt that was reasonable. This would not have been possible if the approach were "undocumented."

We reviewed the report of the contracted actuary, and could not find where it was said that the approach used by the FWCJUA's actuary was "undocumented." That report did discuss Actuarial Standard of Practice No. 9 (ASOP 9), Documentation and Disclosure in Property and Casualty Insurance Ratemaking, Loss Reserving, and Valuations. Section 5.2 of that document provides the following guidance:

- Documentation should be sufficient for another actuary practicing in the same field to evaluate the work.
- The documentation should describe clearly the sources of data, material assumptions, and methods.
- Any material changes in sources of data, assumptions, or methods from the last analysis should be documented. The actuary should explain the reason(s) for and describe the impact of the changes.

We believe FWCJUA's actuary report fully complied with these requirements, because, the contracted actuary was able to not only evaluate the work, but to fully reproduce it. In fact, the contracted actuary used the FWCJUA actuarial report as the basis of its own work, substituting its own judgment for many of the material assumptions.

What the report of the contracted actuary actually said was that "... it is not apparent to [the contracted actuary] that the FWCJUA actuary **has fully complied with this standard.**" In our view this is in no way equivalent to the use of an "**undocumented approach.**"

This complaint arises because the FWCJUA actuarial report showed only the actual assumptions used (i.e., the factors that go into the calculations, selected loss ratios, etc.), and the results of the judgments made, as is required by ASOP 9. Apparently, what the contracted actuary also wanted was a detailed discussion of the thought process underlying each judgment. We agree the FWCJUA's actuary did not include a discussion for the underlying thought process for each of the assumptions made. In our view, this discussion is not required by the standards of practice (presumably the second bullet above), instead the

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FWCJUA's actuary shows the result of the judgment (which are all assumptions) and exhibits clearly laying out, identifying each method, and showing the source of our selections.

With respect to the term "unquantified:" We believe that this term is misused as it is contained in the Auditor General's report.

It is our understanding that the term "unquantified" results from alternative methodology suggested by the contracted actuary. We believe that the Auditor General intends to define a "quantified" approach as one in which:

1. Averages are substituted for the actuarial judgment we used in many places; and
2. Conservatism in the reserve estimate should be separately calculated and explicitly disclosed.

Consequently the Auditor General apparently believes that any approach that does not meet these two criteria is "unquantified."

This definition of the word "quantify" is commonly accepted to mean "to express as a number or measure or quantity."

On its face, the FWCJUA's actuary's work is fully quantified in the FWCJUA's actuary's report. As mentioned above the details of the calculation are shown from the raw data to the final reserve estimate. Each step is shown, and the judgmental items are clearly identified with terms like "selected" with the amount (quantity) shown.

Comparison of Auditor General's approach to established standards: Semantics aside, the approach recommended by the Auditor General is not required under any actuarial or accounting standard for the reporting of insurance company loss reserves that we are aware of.

Under insurance company accounting rules, it is the obligation of the management of the company to book its "best" estimate for its loss and loss adjustment expense obligations. As part of the work the FWCJUA's actuary does for the FWCJUA in issuing a statutory statement of opinion, it is the FWCJUA's actuary's obligation to issue an opinion as to the reasonableness of the reserve as booked by management.

As nearly as we can ascertain, there is no commonly understood meaning of the word "best" in this context, and we are unaware of any accounting or actuarial standards that define it. There is, however, ample reference to the concept of "conservatism" in the Statement of Statutory Accounting Principles (SSAP) published by the National Association of Insurance Commissioners (NAIC). In the preamble of that document, conservatism is defined in paragraphs 29 and 30.

"29. Financial reporting by insurance companies requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

30. Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in

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recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus."

Issue paper 55 of that same document, dealing specifically with loss and loss adjustment expense reserve estimates, repeats paragraph 29 above, verbatim.

Thus, it is clear that loss and loss adjustment expense reserves are intended to be conservative. We don't disagree with this concept, and we don't believe the Auditor General does either.

That same standard deals with the issue of ranges and best estimates as it applies to loss and loss adjustment expense liabilities. Paragraph 12 of Issue Paper 55 reads as follows:

"12. For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims, (including IBNR for death claims and accident and health claims) is subject to future events, no single claim or loss and loss/claim adjustment expense reserve can be considered accurate with certainty. Management's analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and low estimate, the best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's range shall be realistic and therefore shall not include the set of all possible outcomes but instead only those outcomes that are considered reasonable."

The method used by FWCJUA management was to consider an upper bound of reserves by considering the impact on total net reserves of increasing the "tail" factor by 50% of its value. Since all values are impacted by the tail factor selection, any variability in this value affects all years and is a major risk factor for insurance companies writing long-tailed lines such as workers compensation. The range was therefore determined using a "scenario" based approach, and the scenario (tail development is higher) was not believed to be unlikely. Management booked its best estimate within this range.

We do not believe that the incorporation of the amount of risk relating to uncertainty in the tail factor is disputed by the contracted actuary, since their analysis incorporated the same adjustment.

We believe that testing the sensitivity of potential reserve values to separate and non-unlikely alternative assumptions is completely within the accounting guidelines issued by the NAIC. We furthermore believe that it is the most common method in use by insurance companies today in arriving at management's best estimate.

In fact, Actuarial Standards of Practice No. 36, Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves states:

"The actuary may use various methods or assumptions to arrive at expected value estimates. In arriving at such expected value estimates, it is not necessary to estimate or determine the range of all possible values, nor the probabilities associated with any particular values."

Thus, what the Auditor General appears to require is clearly not required under ASOP 36.

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The Auditor General is apparently recommending a procedure that is not required by any actuarial or accounting standard, is one that we do not believe is in common use, and finally is one that suffers from technical defects.

Technical Concerns with Auditor General's Recommended Approach: The Auditor General's recommended procedure is as follows:

1. Estimate a value for the reserve called the "mean estimate" using the traditional actuarial approach, but substitute an unweighted average of various statistics in place of the value the actuary would be inclined to otherwise select using judgment. In other words, take the judgment out and substitute a deterministic model, one where the result is solely determined by the underlying data.
2. Shift this "mean estimate" by a factor representing the impact of "parameter risk" (discussion to follow). In this case, the parameter risk adjustment was conceptually identical to the adjustment to the tail factor used by FWCJUA management in establishing its range.
3. Postulate an underlying statistical model for the remaining variability of claim liabilities and simulate the full distribution.
4. Base management's best estimate upon a "selected" percentile of this full distribution. Call this value the "Confidence Level." For the FWCJUA, the contracted actuary is suggesting that the 90% Confidence Level might be appropriate.

Because the contracted actuary uses the term "Confidence Level" to describe percentiles of the distribution simulated in step (3), the FWCJUA's actuary concludes that this distribution is intended to represent the "outcomes distribution." An "outcomes distribution" is intended to represent the full range of possible loss reserve payouts (outcomes), along with their associated probabilities. The outcomes distribution must therefore include all sources of uncertainty.

We do not disagree that an "outcomes distribution" is a valuable tool for management to use in evaluating its reserves. In fact, the outcomes distribution has long been an aspect of actuarial research, and recent activity in this regard is increasing. There is research relating to how one would calculate the outcomes distribution, and relating to what management would do with one if it were available. The idea that management's best estimate could be based on a percentile of this distribution is not new, but there are also other possibilities.

However, we do not believe that the FWCJUA management should be constrained to selecting as its "best" estimate the 90th or any other fixed percentile of this "outcomes distribution." Such a requirement is not imposed on any other insurance company, is not required by accounting or actuarial standards that we are aware of, and is not a good idea generally. If it were decided to use a percentile of the outcomes distribution as the result, such a decision should only be made after the distribution is calculated and evaluated. A simple example shows why. Suppose the loss reserves represented consisted of a situation that would pay zero 95% of the time, but \$100 million 5% of the time (reserves for some excess of loss reinsurance contracts might have these characteristics). The 90th percentile of this distribution is zero, yet few would argue that a zero reserve was appropriate. For any selected fixed percentile, it is always possible to construct examples of distributions where its selection would be unreasonable. Consequently, the distribution should be observed before the percentile is selected. However, if we wait to calculate the outcomes distribution, and then select the percentile, the approach lacks the rule-based "quantification" that makes it seem appealing in the first place.

It is clear that the current standards contemplate management's use of conservatism, and management's implicit consideration of risk in selecting its best estimate. Those standards

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do not require first determining an estimate with no conservatism and risk, then evaluating an explicit risk margin.

We also have several technical concerns with the way the contracted actuary constructed its outcomes distribution.

1. We disagree that the reserve estimate that is produced by replacing actuarial judgment with an unweighted average of various statistics for development factors, loss ratios, mean outstanding reserves, and reserve indications of various methods in fact produces what is considered as a "mean estimate" as that term is used by the contracted actuary. In our view, this is equivalent to always selecting the "3" as the result in the simplified examples given in the introduction. Such a process replaces actuarial judgment with a statistical formula. If it were possible to calculate reserves in such a manner, there would be no need for actuaries to provide statutory statements of opinion. Application of a formula would do. Such a practice is not in common use, and we are unaware of any published articles in peer reviewed actuarial journals that advocate such an approach. In fact, the Auditor General's actuarial report paradoxically does not advocate the removal of actuarial judgment in the reserve setting process, something their recommended procedure most emphatically does. The only way to reconcile these two positions, i.e., use averages whenever presented with alternatives, and still maintain full use of actuarial judgment is if the judgment of the contracted actuary coincides with the averages in every instance. If this is the case, then our judgment is different from that of the contracted actuary and we disagree as to the starting point, the "mean estimate."
2. The amount to include for "parameter risk" does not include all sources of parameter risk, and consequently understates the true amount of parameter risk. In our view, the Auditor General's approach is equivalent to placing the same degree of uncertainty around the "3" selection, regardless whether the underlying series looked like the first, second, or third in the example given in the introduction. It is true that the tail factor affects each of the reserves produced using the actuarial methods employed, so that the tail factor risk is 100% correlated with the starting amount. Below, we list some of the other risks that have not been considered by the contracted actuary. We believe these risks are substantial.
 - a. Uncertainty from each method not completely describing the underlying reality.
 - b. Uncertainty in the resulting from the average of averages development factors not being the true development factors.
 - c. Uncertainty from the selected trend factors not being the true trend factors.
 - d. Uncertainty that the average of averages trended loss ratios not being the true loss ratios as those are used in the Bornhuetter-Ferguson technique.
 - e. Uncertainty from the variation in the results of each method. This element alone is a major source of uncertainty that is easy to quantify. Such variation is obvious considering the range in estimates provided by the alternative actuarial methods. Furthermore, since where applicable each method used the same trends, loss ratios, development factors, and tail development factors, the variation in results is not caused by variation of these underlying parameters. The contracted actuary gave each method equal weight, because the actuary did not know which of them was a better model of the underlying reality. Equal weight implies an equal probability for each

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potential realization. For net indemnity and net medical losses alone, the contracted actuary gave the paid loss Bornhuetter-Ferguson method a weight of between 1/6 and 1/5. Thus, the model of the underlying reality implied by this method is expected to be a reasonable estimate of the true reality at least 16.67% of the time. Consequently, the 83.33 percentile of the "mean estimate" distribution is at least the estimate of the paid loss Bornhuetter-Ferguson method. For indemnity and medical alone, for the years after the LPT alone, this difference is approximately \$11 million above the estimate of the Auditor General including the tail parameter risk, and \$12 million above the contracted actuary's "mean estimate."

90% Net Ind + Med Ult Contracting Actuary Tech Appdx B C-1 + B-1: Paid BF	\$26,862	90% Net Ind+Med Ult Contracting Actuary Tech Appdx B C-1 + B-1: Paid BF	\$26,862
Contracting Actuary Tech Appdx B 90% Selected Avg C-1 + B-1	15,906	"Mean" selected avg Contracting Actuary Tech Appdx A C-1 + B-1	14,961
Difference	\$10,956	Difference	\$11,901

Since the upper percentiles of the "outcomes" distribution will always be higher than the same upper percentiles of the "parameter" distribution (due to the additional process risk), and since this is just one of several sources of parameter risk, we can conclude that the 90th percentile of the outcomes distribution needs to be at least \$12 million above the mean. The 90th percentile value given by the contracted actuary is only \$3.8 million above his mean.

- f. Outstanding claim counts were assumed to be Poisson distributed. While the Poisson distribution is frequently used for claim counts generally, the true distribution of outstanding claims is unknown and consequently won't be perfectly modeled by a Poisson process. The Poisson distribution has the mean equal to the variance. Consequently, it was modeled with a single parameter equal to the number of open + expected IBNR claims in each year. However, since the parameter of the Poisson distribution is subject to uncertainty itself, there is additional variation that was not modeled. Additionally, it is not uncommon for some closed workers compensation claims to reopen. The variation in the outcomes distribution resulting from this potential source was not modeled.
- g. The outstanding claim severity distribution was assumed to be lognormally distributed, with a CV of 3.0. The CV is one parameter of the lognormal distribution, the mean is the other. Uncertainty in the mean was modeled only as a result of the shift in the tail factor. It was not modeled as a result of variation in other parameters affecting the mean, such as that discussed in (a) above. Uncertainty in the CV was tested by the contracted actuary and resulted in alternative values for loss reserves considerably higher than those produced by the CV of 3.0. However, it is unclear whether the contracted actuary believes each of these is permissible, and whether he is advocating that the reserve should be booked at the 90th or 95th percentile.

It has been our experience in modeling workers compensation claims generally that a lognormal distribution with a CV of 7 and higher fits much better than one with a CV of 3. We tested a fit of a lognormal distribution

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with an unconstrained mean to the average of NCCI Florida ELPF's. These values represent the charge for loss limitations in retrospective rating. NCCI calculates these values by first conducting a study of size of loss distributions, which normally encompass several years of experience across multiple states. It is possible to fit any size of loss distribution to these charges and thereby obtain an approximation to the underlying loss distributions that NCCI used to create the charges. We undertook such an exercise, and found that a lognormal distribution with a CV of 15 fit substantially better than a lognormal distribution with a CV of 7, which in turn fit substantially better than a lognormal distribution with a CV of 3. However, in no case does the lognormal distribution fit equally well across its entire range, implying that the severity distribution NCCI believes applies to workers compensation is not lognormal at all.

The issue, however, is not what the workers compensation size of loss distribution is generally, but what is the distribution of the remaining reserve conditional on a claim being open or IBNR as of the valuation date. Thus, even if a lognormal distribution was viewed as a suitable approximation to the workers compensation size of loss distribution generally, it is not immediately clear why it would also be a suitable approximation for reserves.

- h. The discussion above serves to illustrate the difficulties in appropriately modeling "parameter risk." It is precisely due to this difficulty that methods that are based on an "outcomes distribution," are not widely used in practice. The "outcomes distribution" is inherently difficult to calculate. The contracted actuary, inappropriately in our view, sidesteps this inherent difficulty by assuming parameter risk only equal to the tail factor adjustment previously mentioned.

Because of the way the contracted actuary first shifted the mean of the outcomes distribution (for the tail parameter risk), then modeled process risk, the resulting distribution is not truly an "outcomes" distribution. This is because the mean of the outcomes is not equal to the "mean estimate," as is necessary for any true "outcomes distribution." We are unaware of any supporting actuarial literature that suggests that uncertainty as to the scale of the loss severity distribution could be incorporated through a "mean shift" as appears to have been done by the contracted actuary. In fact, Philip E. Heckman and Glenn G. Meyers in their award winning paper "The Calculation of Aggregate Loss Distributions from Claim Severity and Claim Count Distributions" (PCAS LXX, 1983) suggest a way to model parameter risk that is inconsistent with the approach described by the contracted actuary.

In the Heckman-Meyers paper, uncertainty to the scale of the loss severity distribution is introduced through a parameter "b" called the "mixing parameter." Under the Heckman-Meyers approach, it can be demonstrated that the CV of the "outcomes distribution" (this is different from the CV of the severity distribution discussed above) must increase when the mean of the loss severity distribution is uncertain (i.e., has positive variance $b > 0$). However, under the contracted actuary's approach as described, it can be demonstrated that the CV of the "outcomes distribution" remains unchanged with the scale shift intended to represent parameter risk. Therefore, even from the one source of parameter risk intended to be modeled (tail factor risk), the contracted actuary does not model it in such a way that is consistent with the established literature on the subject.

Instead, it is a hybrid distribution whose observations reflect process risk only with a scale shift. We are unaware of any literature that suggests management would want

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to book its reserves on the basis of percentiles (or any other statistic) of this hybrid distribution. Also, since it is not truly an "outcomes distribution," it is improper to refer to the percentiles of such a distribution as a "Confidence Level." Such a term used as used in this context implies that the distribution is an "outcomes distribution."

With respect to the phrase "established a range of reasonableness that produced an upper bound that is too high in relation to the best estimate of required reserves" We could not find this in the contracting actuary's report and are assuming this relates to the post Loss Portfolio Transfer (LPT) years only. We are further assuming that the "upper bound" refers to the actual amount booked by the FWCJUA. We are assuming that the "best estimate of required reserves" refers to the 90th percentile value of the contracted actuary, calculated with a CV of 3 as described above. The qualifier "too high" we believe arises because the amount booked by the FWCJUA is substantially higher than the amount indicated by the 95th percentile value of the contracted actuary computed with a CV of 15.

We disagree with this statement, however, because we disagree that the stated percentiles of the distribution of the contracted actuary are equivalent to the same percentiles of the true "outcomes distribution," because of the reasons addressed above. Specifically, we believe that the "mean estimate" which determines the overall scale of the outcomes distribution is too low because it is based on unweighted averages of historical statistics that do not comport with our actuarial judgment. We also believe that the upper percentiles of the true "outcomes distribution" have substantially higher values because of additional sources of parameter risk not considered. Finally, the distribution of the contracted actuary is a hybrid distribution, and is not an outcomes distribution.

With respect to the phrase "the FWCJUA could have established a lower rate for Tier Three policies:" We believe the rates as established by the FWCJUA for tier three policies are reasonable. There are four principal sources of difference between the FWCJUA and the contracted actuary with respect to this item. We compare values below:

	Source of Difference	FWCJUA	contracted actuary	Impact on Rate	Cumulative Impact on Rate
1	Projected Loss Ratio for all Risks	53.0%	52.6%	-.5%	-.5%
2	Loss ratio relativity for tier 3 risks	1.15	1.00	-8.1%	-8.5%
3	Discount factor for investment income	.95	.912	-2.3%	-10.6%
4	Contingency Factor	.05	0	-6.0%	-16.0%

It is somewhat surprising, given the difference in loss reserves, that the projected loss ratio for all risks, item (1) is as similar as it is. It is our understanding that the value of the contracted actuary includes a specific margin for risk equal to the 90th percentile value (calculated with the model above). The FWCJUA's value includes the normal conservatism included within the reserve estimates as calculated by the FWCJUA actuary, but not the additional reserves included by management. We believe that if the contracted actuary included all aspects of uncertainty in its 90th percentile value, it would be higher than the amount selected, and perhaps so much higher that a Tier 3 rate higher than the FWCJUA rate would result. Consequently, we do not believe that the contracted actuary's report included enough information to form a conclusion as to the Tier 3 rate.

With respect to item (2), this is a judgment factor that implies that the loss ratios for tier three risks are 15% worse than average. Tier three is constructed from risks with high experience

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modification factors (greater than 1.1) or from rated risks with lost-time claims or medical only loss ratios greater than 20% during the during the period subsequent to that included in the experience modification factor, or from non-rated risks with lost time claims or medical only loss ratios greater than 20% over the past three years. The FWCJUA expects these risks to be worse than average, but acknowledges that there is no directly applicable data to test this hypothesis. This is because the JUA could not assemble a three year loss history on each of its accounts (many risks remain in the JUA for only one year), and data could generally not be observed for the period beyond the experience included in the experience modification factor. Therefore, the 1.15 factor is based solely on judgment and there is considerable uncertainty as to its value.

The contracted actuary believes that the tier three risks will have loss ratios approximately equal to the average, because these risks receive higher surcharges under the current program, the higher experience modification factors generate additional premium, and these some of these risks may also be subject to additional ARAP charges.

We believe the 1.15 factor is reasonable, even considering the arguments of the contracted actuary, but concede that this is an inherently unknowable factor that can only be observed once the experience for tier three is collected.

With respect to item (3), the chief difference is the use of different interest rates used to calculate the discount factor. The FWCJUA uses interest of 1.5% per year, because of the typically low rates of return the FWCJUA receives on its cash balances, because of the tax effect on realizable interest rates, and to compensate for the reduction in risk margin caused by the discounting process. We understand that the contracted actuary used interest rates with the payment pattern of losses. We do not believe that these values were tax-effected (The FWCJUA is taxable, consequently will only net an after tax amount on investments), and contained no reduction to compensate for the lessening of the risk margin caused by discounting, but need to confirm this with the contracted actuary.

With respect to item (4) this is an amount added by the FWCJUA Board to reflect the additional uncertainty resulting from the impact of Florida SB-50A. We point out, however, that the contracted actuary does believe that a 5% surplus provision, which would have the same impact as the 5% contingency provision, is reasonable.

In summary, the FWCJUA's independent actuary has concluded in its discussion presented above that:

- The FWCJUA approach is fully documented.
- The FWCJUA approach is quantified.
- The Auditor General's recommended approach is not required by any accounting standards it is aware of.
- The Auditor General's recommended approach is explicitly addressed as not being required by the American Academy of Actuary's Actuarial Standard of Practice (ASOP) number 36.
- The Auditor General's recommended approach is not in common use.
- The Auditor General's recommended approach suffers from technical flaws so serious that its results cannot be relied upon to accurately reflect the concepts it presents.

The FWCJUA does, however, evaluate its rates and reserves annually and has asked its Rates & Forms Committee to consider the Auditor General's contracted actuary's findings and recommendations along with the FWCJUA independent actuary's discussion and conclusions regarding such and to make appropriate recommendations to the Board.

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Finally, in consultation with both its independent auditor and reinsurance broker, the FWCJUA believes that it is cost-prohibitive to implement the Auditor General's recommendation to eliminate the need for the ULAE reserve by amending the service provider agreement to become a "contract of insurance;" however, the FWCJUA shall explore requesting a Preferred Practices ruling from OIR that would not require the FWCJUA to comply with statutory account principles for purposes of booking a ULAE reserve. The final two recommendations have not been directed to the FWCJUA; therefore, the FWCJUA shall not respond other than to say that it concurs with expediting actuarially sound rates in Tiers 1 & 2.

Finding No 2: Certain provisions of Chapter 2004-266, Laws of Florida, regarding the administration of a \$15 million contingency reserve for funding subplan D cash deficits, need clarification.

Recommendation: The Office of Insurance Regulation (OIR) should seek legal clarification from the Attorney General regarding the above noted issues. Also, the Legislature should consider enacting legislation clarifying these issues.

FWCJUA Response: This finding and recommendation is not directed to the FWCJUA; therefore, there is no FWCJUA response.

Finding No 3: The FWCJUA did not, of record, demonstrate that its "controllable costs," or compensation paid to its policy administration service provider, were reasonable. Through legislative action, it may be possible to reduce the FWCJUA's costs by making the FWCJUA exempt from Federal taxation. In addition, the FWCJUA has not recently provided for a cost/benefit analysis to determine whether its essential functions are better handled by FWCJUA staff or by independent contractors.

Recommendation: The FWCJUA should annually review costs associated with the administration and servicing of policies to determine alternatives by which costs can be reduced as required by Section 627.311(5)(c)17., Florida Statutes, and should document such efforts. The FWCJUA should also perform cost/benefit analyses at regular intervals to determine which functions should be done by FWCJUA staff and which functions should be outsourced. Considering the significance of amounts paid to its contractor responsible for policy administration services, the FWCJUA should also take appropriate action to ensure the reasonableness of compensation paid for such services. The Legislature should consider enacting legislation to qualify the FWCJUA as a tax exempt organization under Section 501(c)(27)(B) of the Internal Revenue Code.

FWCJUA Response: The FWCJUA already effectively reviews costs annually associated with the administration and servicing of policies to determine alternatives by which costs can be reduced as required by Section 627.311(5)(c)17., Florida Statutes, and documents such efforts.

Each year the FWCJUA adopts a Business Plan & Forecast. This process by its very nature requires the FWCJUA to review its annual costs, and we believe it meets the requirements of Section 627.311(5)(c)17. FWCJUA objectives consistently have focused on maintaining rate adequacy; minimizing the operating loss; maintaining solvency without a policyholder assessment; pursuing sound investments; managing uncollectible premiums within acceptable limits; maintaining a dynamic, responsive organization capable of responding to market fluctuations in a timely manner; developing the methods and procedures to implement an assessment; if one ever becomes necessary; and promoting loss prevention and safety in the workplace of our policyholders. By concentrating on this objectives, the FWCJUA believes it is controlling the costs associated with the administration and servicing of policies. Further, the Board receives quarterly status updates regarding the implementation of the Business Plan & Forecast it adopts each year.

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Case in point, the primary focal point and principal challenge as documented in the FWCJUA's 2004 Business Plan was to successfully address the growing Subplan "D" statutory deficit and any resultant solvency issues that may arise. Our 2004 results clearly demonstrate that the FWCJUA met and exceeded its objectives. With the passage of House Bill 1251, it should be abundantly clear that (1) the nature and magnitude of the growing Subplan D deficit and resultant solvency issues were timely and effectively framed; (2) credible, workable legislative remedies were proposed by the FWCJUA; and (3) through the active and aggressive pursuit of legislative opportunities, the FWCJUA was able to capitalize on "bonus deliverables" and better position itself to meet its mission. Bonus deliverables include an experience-based rating structure; "actuarially sound" minimum premiums, albeit subject to caps in Tiers 1 & 2 until 1/1/07; common managing interest language strengthening the voluntary market prohibition from issuing a policy to any person who is delinquent in the payment of premiums, assessments, penalties, or surcharges owed to the FWCJUA; and all our long-standing legislative initiatives regarding assessments.

Be assured that the FWCJUA regularly reviews and evaluates its expenses, and implements appropriate measures to operate in an efficient manner. Among other things, the FWCJUA maintains staff levels which are as low as can be maintained while still providing quality customer service levels. The following are a few of the larger cost savings achieved over the past few years:

- a) Moved office location from downtown high-rise to a small office park near Interstate 75. Since the 1996 move, **\$175,000 has been saved annually.**
- b) **Approximately \$40,000 a year saved** on telecommunications, overnight mail and office supplies by finding new vendors and renegotiating current prices.
- c) Audit fees were reduced by switching from a Big 6 accounting firm to a very reputable local firm. **This resulted in savings of approximately \$35,000 to \$50,000 per year.**
- d) Implemented computer and equipment efficiencies, thereby **saving hundreds of labor hours each year.**
- e) Implemented email and website capabilities which dramatically reduced long distance phone calls, network faxing and mailings, thereby **saving both labor hours and money on long distance phone calls and mail services.**
- f) The Operations Manual is now located on the FWCJUA website. The FWCJUA no longer prints and mails the Manual and related updates to all authorized producers. The cost of printing and mailing was approximately \$20 per manual. **During 2003, the FWCJUA saved approximately \$10,000.**
- g) Annually all employee benefits are reviewed and the FWCJUA tries to obtain the best available rates.
- h) The FWCJUA has always closely monitored its staffing levels – eliminating the need for unnecessary hiring and laying-off of employees because of the various business volume changes.
- i) Risk assumption analyses conducted over the last two years resulted in modifications to the FWCJUA's reinsurance programs for 2003 and 2004, **resulting in savings of approximately \$6.7 million through 9/30/4.**
- j) 2004 reinsurance and policy administration rates were negotiated in 2003 with provisions that permitted rate reductions if the FWCJUA was successful in securing rate relief during the 2003 Legislative Session. Given the tier rating structure introduced by HB 1251, this proactive strategy will produce significant reductions in operating expenses. Through 9/30/04, the FWCJUA has **saved just over \$33,000** given the limited amount of earned premium it has recognized under the tier rating structure.
- k) Developed an acceptable cash flow model to enable disbursements from the contingency reserve by the Legislative Budget Commission (LBC). **Thus far, the FWCJUA has received its two requested transfers from the WCATF totaling \$2,582,000.**

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The FWCJUA believes it can easily quantify expense savings of at least 20%. Some savings, such as reductions in labor hours, are somewhat more subjective and, therefore, not as easy to accurately quantify. The FWCJUA believes, however, that when all cost-savings measures are considered, it has likely saved as much as 30% in overall expenses.

At its December 8th meeting, the Operations Committee reviewed staff's executive summary of a study it conducted to evaluate 5 various service options and to identify the approach to be utilized to ensure the delivery of prompt, quality, cost-effective policy administration/managed care services beyond 12/31/05. The purpose of the study was to examine available policy administration options that would: 1) ensure that the FWCJUA continues to provide quality service to its policyholders; 2) increase the efficiency of the FWCJUA; and 3) enhance the data management capabilities of the FWCJUA.

After discussing the study, the Operations Committee agreed that given the current and projected size of the FWCJUA, it would not be cost effective to pursue the three options designed to build the necessary systems to support taking policy administration "in-house." Further, the Committee agreed that the "bundled" policy/claims administration services currently performed by our current service provider should be "tested" in the open market, with organizations that are qualified to perform these functions to ensure that the charges for these services are reasonable and that the FWCJUA is not over-looking any innovative ways to process the business. The Committee further agreed that the FWCJUA should initiate in first quarter 2005 a selective bid process, such as a "request for proposal or an "invitation to negotiate," to potential service providers with a proven ability to service workers compensation residual market business and Florida claims at a highly acceptable level of performance. It was the consensus of the Committee that the FWCJUA should solicit bids from such pre-screened potential providers for a contract period of three years with a maximum of two providers.

At its December 17, 2004 meeting, the Board discussed the recommendation of the Operations Committee and agreed that a selective bid process should be initiated for policy administration/managed care services. Accordingly, the Board passed a resolution adopting Operations Committee's recommendation to initiate a selective bid process within the first quarter of 2005 for "bundled" policy administration/managed care services to identify no more than two providers with a proven ability to service both workers compensation residual markets and Florida claims at a highly acceptable level of performance for which the FWCJUA shall contract for said services for a contract period of three years. Staff has been directed to develop the selective bid process and implement prior to March 31, 2005.

Finally, the FWCJUA will continue to perform cost/benefit analyses at regular intervals to ensure the appropriateness of its delivery systems to include the reasonableness of its resultant expenses.

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Finding No 4: The FWCJUA's basis for awarding at-risk compensation to executive staff was not clear because the FWCJUA had not established specific performance evaluation rating factors for each staff member. Also, the basis for the allocation of a special project bonus paid to executive staff was not documented.

Recommendation: The FWCJUA should develop specific performance evaluation rating factors for each of the four executive positions, and apply such factors to each executive staff member's performance to determine the extent to which they are entitled to "at-risk" compensation. In addition, the FWCJUA should maintain documentation evidencing the basis for allocations of special project bonuses.

FWCJUA Response: This recommendation has been referred to the FWCJUA's Executive Compensation Committee for consideration with its subsequent findings and recommendations referred to the Board.

Finding No 5: The FWCJUA has not subjected most of its contractual services to a competitive selection process since 1995. In addition, the FWCJUA had no written agreement with its contracted General Counsel; had an insufficiently detailed written agreement with its independent auditors; made payments to the General Counsel and independent auditors that were not supported by sufficiently detailed invoices; and did not properly bill the contracted service provider for its share of audit costs.

Recommendation: The FWCJUA, as soon as practical, should undergo a competitive selection process for all of its contractual services, and should do so again at reasonable intervals. Written agreements that clearly specify the nature of the services to be rendered, and the terms of compensation, should be used for all contracted services. The FWCJUA should also obtain adequate invoices for auditing, tax, and consulting services. In addition, the FWCJUA should refund the \$29,279 that was over-billed the service provider.

FWCJUA Response: While it is true that the FWCJUA has not subjected most of its contractual services to a competitive selection process since 1995, it is important to note that most of the contracts let at that time were for a period of 3 years, typically beginning mid-1995 or with the 1996 calendar year. This is important to acknowledge, because the FWCJUA had written premium of approximately \$70 million with 10,300 policyholders in 1995, but had depopulated drastically in accordance with its mission during the 3-year period under which the contracts were in force. Year-end numbers in 1998 and 1999 were \$9 million in written premium (excluding major fraud) with 1,400 policyholders and \$6.4 million in written premium with 600 policyholders, respectively.

Given the size of the FWCJUA at that time and the fact that the FWCJUA was anticipating further depopulation, the Board determined that it was more cost beneficial for the FWCJUA to enter into contract extensions with its vendors who were performing at acceptable levels of performance. As the FWCJUA began to repopulate in 2002, the FWCJUA targeted the policy administration/managed care contract for a competitive selection process in 2003 to ensure that the charges for these services were reasonable, rather than because it was displeased with the performance of its contracted service provider.

The FWCJUA subsequently postponed the competitive selection process for policy administration/managed care services in both 2003 and 2004 given the passage of Senate Bill 50A in 2003 and House Bill 1251 in 2004, both of which substantially impacted the operations of the FWCJUA overnight. The FWCJUA's focus rightfully shifted to implementing the new laws with minimal disruption to our policyholders during this tumultuous time. It should be noted, however, that the FWCJUA is anticipating initiating a competitive bid process within the first quarter of 2005 for policy administration/managed care services.

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In response to concerns regarding the FWCJUA's engagements with our independent auditors and General Counsel, the FWCJUA believes these engagements are being responsibly managed. The Auditor General's, Auditor Selection Task Force, concluded that "a written contract may include an engagement letter signed and executed by both parties". The FWCJUA entered into a multi-year engagement letter with its independent auditor which provided in sufficient detail a description of the scope of services and the basis for all billings that were rendered. Subsequent to the execution of the engagement letter, the Audit Committee and Board of Governors made specific requests for additional services relating to the implementation of the 2003 legislative changes and the related expanded reporting requirements. These services were billed in sufficient detail to indicate the time and level of the individual performing these tasks and were reviewed and approved by the FWCJUA. Further, all payments made to the General Counsel were supported by sufficient detail as well. Legal services are secured on an hourly basis while legislative services are secured on a flat-fee basis and the invoices appropriately reflect these arrangements.

Further, the recommendations to undergo competitive selection processes for services and to enter into written agreements for the contracted services has been referred to the appropriate FWCJUA committees with specific service provider oversight with their subsequent findings and recommendations referred to the Board.

Finally, the FWCJUA and its contracted service provider agreed in 1998 as to how the audit recovery fees would be calculated with regard to the service agreement. At that time, the FWCJUA's external auditor confirmed the methodology with regard to the indirect cost allocation and the service provider and the FWCJUA agreed to utilize the methodology as evidenced by the service provider's payments. The external auditor provides the direct cost and the FWCJUA's Controller puts together the worksheet showing the calculation of the service provider's portion of the audit. Accordingly, the FWCJUA has not over billed the service provider and a refund of \$29,279 is not due to the service provider. The contracted service provider concurs with the FWCJUA's position on this matter; and therefore, no refund will be made by the FWCJUA to its contracted service provider as such action would be financially irresponsible.

Finding No 6: The FWCJUA generally did not, of record, monitor the contracted service provider's performance regarding producer commission payments, payroll audits, loss control surveys, or the handling of delinquent accounts.

Recommendation: The FWCJUA should develop procedures to monitor all aspects of the service provider's performance and should ensure that such procedures are sufficient to ensure the service provider's adherence to service standards. In doing so, the FWCJUA should give consideration to monitoring efforts being used by other residual market insurers in Florida and other states.

FWCJUA Response: The FWCJUA does monitor all aspects of the contracted service provider's performance including the handling of producer fee payments, payroll audits, loss control surveys and delinquent accounts and believes that its current procedures are sufficient to ensure that the service provider is adhering to the FWCJUA's service standards.

First, it is important to recognize that the FWCJUA concentrates its monitoring efforts on accurate policy issuance, effective claims handling and accurate financial reporting. All of these items are required under the service agreement with our contracted service provider and are crucial elements to the FWCJUA's results. From a cost/benefit standpoint, the FWCJUA believes it gets the "most bang for the buck" by closely monitoring these elements of performance, and thus, our procedures for monitoring these performance aspects are both thorough and well documented. We were pleased to see that the Auditor General's report must agree as there were not any findings or recommendations related to these critical performance areas.

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Second, in addition to relying on the contracted service provider's verified internal processes and audits or reviews conducted by others as noted by the Auditor General, the FWCJUA interacts with the service provider on a daily basis and reviews both policy and claim files in detail as it participates in the process of providing quality services to our policyholders. Operational file reviews on a case-by-case basis, by their very nature, are random and, more importantly, measure responsible compliance on a "real time" basis so that any identified deficiencies may be corrected immediately. The FWCJUA believes this type of monitoring is productive, cost effective and provides a meaningful method of determining adherence to our service standards. Further, it is the position of the FWCJUA that its service provider is performing at a commendable level. Please refer to our responses to Findings 8, 9 and 10 regarding the contracted service provider's handling of payroll audits, loss control surveys and delinquent accounts. With regard to our monitoring efforts related to producer fees, please see our response to Finding 7.

To respond further to the Auditor General's concern that audits performed by others may not be relevant or may only offer limited assurances regarding performance, it should be noted that the FWCJUA's performance standards for its contracted service provider are not unique. As a matter of fact, they are virtually the same as those utilized by the approximately two dozen states where the National Council on Compensation Insurance (NCCI) administers workers compensation residual markets, because they generally represent "best practices" for this type of business. Given that the FWCJUA's service provider provides similar services under contract in approximately 16 of these other workers compensation residual markets administered by NCCI and that a majority of such contracted business is serviced utilizing the same internal systems and similar processes out of the same office as the service provider utilizes for servicing the FWCJUA business, the FWCJUA believes it can rely on the results of the audits performed by NCCI under its Carrier Audit Program. Recently, the FWCJUA's service provider received the highest performance rating possible from NCCI, Commendable Performance, on its Servicing Carrier Operational Performance Audit Report dated May 28, 2004 which focused on the underwriting, premium audit, loss prevention and claims performance standards.

Finally, it should be noted that the service agreement between the FWCJUA and its service provider provides several safeguards that protect the FWCJUA regarding the service provider's performance. These safeguards include complete access to the service provider's records by FWCJUA staff and its designees (e.g., auditors, reinsurers, collections vendor-partner, etc.). In addition, various reports are submitted to the FWCJUA by the service provider. Some of these reports include statistics on whether the service provider met the performance standards (e.g., the number of final audits issued in and out of standard). Additionally, the FWCJUA's contracted service provider is also required to maintain it and does maintain a performance bond to protect the FWCJUA in the event of non-performance.

Finding No 7: The FWCJUA did not verify producer commissions calculated and paid by its contracted service provider.

Recommendation: The FWCJUA should verify, on a test basis, producer commissions paid by the service provider.

FWCJUA Response: The FWCJUA verifies producer fee calculations in accordance with Statement on Auditing Standards No. 56 (SAS 56), *Analytical Procedures*, because this method of verification is reasonable and does not produce redundant costs thereby making more efficient use of our policyholders' monies.

Producer fees are processed using the automated system maintained by the service provider. Individual fee calculations were tested during the implementation of this system and subsequently as system changes have been made. The service provider's controls have been evaluated as

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effective. Therefore, a reasonable monitoring control over the effectiveness of the producer fee calculation process is the performance of routine analytical review procedures. Statement on Auditing Standards No. 56 (SAS 56), *Analytical Procedures*, provides that analytical procedures are an effective audit procedure when the nature of the data is available, reliable and predictable. All of the conditions have been met. The outcome is predictable based on the written premium and approved producer fee rates. The FWCJUA personnel perform analytical review procedures each month as a routine procedure during the month-end closing procedures. Unexpected variances are then investigated and issues are resolved at that time. Additionally, our independent auditors use similar analytical review procedures to recalculate the annual producer fees and compare to amounts reported in our financial statements.

Finding No 8: The contracted service provider did not always perform required preliminary payroll audits, or perform final and cancellation payroll audits within the time frame specified in the FWCJUA's Operations Manual.

Recommendation: The FWCJUA should ensure that the service provider timely conducts payroll audits in accordance with the FWCJUA's Operations Manual.

FWCJUA Response: The service provider conducted timely audits in 95 % of all required audits. Based on how service providers' performance is measured in most other residual markets countrywide, this is an excellent result and it would be deemed "**Commendable Performance**" under other residual market service provider rating processes, e.g., NCCI's Carrier Audit Program.

The Preliminary and Tentative Findings were based on using summary data of policies' effective, expiration and cancellation dates and dates audits were completed. Due to the complexities of scheduling and completing audits with policyholders, coordinating audit completions around the State of Florida and balancing audit resources affected by legislative change that prompted extraordinary audit activity, the detailed underwriting file must be reviewed to determine compliance. The following findings which reflect a very satisfactory level of expected performance can be substantiated with evidence from the service provider's files.

Preliminary Audits

677 policies required preliminary audits and 636 or 94% were completed in accordance with the performance standard. The report used by the auditor displayed summary data, which does not show the work that was actually done on the files. A comparison of the effective date of the policy to the date of audit completion is not sufficient to determine if the performance standard was met.

A detailed review of these files, which can be substantiated with documentation, indicates that 9 of the 50 preliminary audits the report indicates were out of compliance with the performance standard were in standard due to the following circumstances:

- 2 policies in the sample did not require a preliminary audit because the policy premium was below the qualifying threshold.
- 4 policies did not require a preliminary audit since a final audit was being conducted on a prior policy term.
- 1 policy was canceled flat before the audit could be conducted
- 2 were completed timely

According to our analysis, there were 41 preliminary audits or 6% of the 677, that were not completed or were not completed timely, some of which were scheduling problems that were not adequately documented.

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Final and Cancellation Audits

A detailed analysis of these files shows a pattern that is expected for Workers Compensation Residual Market, which is unique among other lines of insurance. When an employer needs Workers Compensation Insurance, and can not obtain the insurance in the voluntary market, they apply to the FWCJUA with an estimate of payroll by class codes. As the policy term develops, actual exposure, and premium owed may differ from estimates based on the actual operations of the employer. The final audit confirms the actual exposure.

In some cases, employers may not allow the service provider to conduct an audit, or may only present partial records. In those cases, the service provider follows Florida rules, notifies the FWCJUA that the account is "uncooperative" with audit and may not be entitled to coverage, initiates cancellation, and estimates the premium owed. In some cases, the employer may have legitimate reasons to delay an audit, or have difficulty scheduling the audit. Delays may be followed by a final refusal to cooperate with the audit, or partial records presented. The service provider's files document these types of delays, which are legitimate and compliant with performance standards.

The service provider's files show compliance on the following accounts which were included in the 387 cancellation audits the report notes as out of standard:

99 audits were completed in standard since the audit was conducted within the required timeframe from the date of the insured's request of cancellation. In these cases, the insured had replaced coverage, and provided proof of coverage earlier than the date they requested the cancellation, which allows the cancellation date to be back dated.

59 audits were completed in standard, although conducted beyond the performance standard. The files document that the employers were initially uncooperative with an audit but subsequently permitted an audit to be conducted.

48 audits were delayed through understandable reasons caused by the insured, including health, death, and business issues.

41 audits were actually estimated audits since the insured was uncooperative and did not allow an audit. The date shown as audit completion was the date the estimate was completed.

34 audits were completed within standard, although the report lists them as out of standard.

According to this analysis, **90%** of the cancellation audits were completed in accordance with performance standards. There were **106** cancellation audits of the indicated 387, that were not completed timely, some of which were scheduling problems that were not adequately documented.

The service provider's files show compliance on the following accounts which were included in the **190** final audits the report notes as out of standard.

98 audits were completed in standard. The files document that the employers were uncooperative with an audit and the uncooperative status was documented within the performance standard for completing the audit.

41 audits were delayed through understandable reasons caused by the insured, including health, death, and business issues.

6 audits were completed within standard, although the report lists them as out of standard.

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According to this analysis, 98% of the final audits were completed in accordance with performance standards. There were 45 final audits of the indicated 190, that were not completed timely, some of which were scheduling problems that were not adequately documented.

The finding relative to the sample provided to the auditor to test the uncooperative with audit assertion, was reviewed. Following a complete file review, we have concluded there is documentation in 16 (7 cancellation and 9 final audits) of the 30 files that the employer was uncooperative at some point in time with allowing the audit to be completed. This is indeed a high percentage of uncooperative insureds but not necessarily unique in the residual market and it is a common situation that delays audit completion. Of the 30 audits initially deemed out of standard the service provider has documentation to indicate 21 policies were handled properly in accordance with performance standards.

With regards to the finding of a long delay in billing for additional premiums or returning unearned premiums, a review of accounts on the list reflect the returns and billings were conducted timely from the initial audit or uncooperative status. Many of the audits resulted in revisions or the insured becoming cooperative after the initial audit/uncooperative status. The audit completion date on the reports provided to the Auditor General reflected the latest audit or revision that was completed making it appear that there were delays in billing/returning premiums from the cancellation or expiration date.

Finding No 9: The contracted service provider did not always perform required loss control surveys, or perform on-site surveys, contrary to the FWCJUA's Operations Manual. Also, the Operations Manual does not address requirements for surveys of policyholders with multiple locations.

Recommendation: The FWCJUA should ensure that the service provider timely and properly conducts loss control surveys in accordance with the FWCJUA's Operations Manual. In addition, the FWCJUA should consider revising the Operations Manual to address circumstances in which site visits are not feasible, and site visit requirements for employers with multiple locations.

FWCJUA Response: As indicated in the Preliminary and Tentative Findings 93% of the Loss Control surveys were performed in accordance with performance standards. Based on how service providers' performance is measured in most other residual markets countrywide, this is a very good result and it would be deemed "**Satisfactory Performance**" under other residual market service provider rating processes, e.g., NCCI's Carrier Audit Program.

The service provider's records indicates that 2 of the 22 surveys noted in the report as not completed, were documented as non-compliant with documented attempts to complete the survey.

The service provider employs professional level loss control engineers. In certain limited circumstances, using professional judgment, an engineer may decide that a job site visit is not necessary. We depend on the service provider to make these judgments similar to those judgments when evaluating an employer's workplace for loss prevention purposes.

The FWCJUA Safety Committee has been asked to review the performance standards relative to safety and loss control and determine whether to recommend that the Board adopt revisions to "address circumstances in which site visits are not feasible, and site visit requirements for employers with multiple locations."

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Finding No 10: The FWCJUA's percentage of uncollected written premiums appears to be high, which may be at least partially due to untimely cancellation and final audits or to an insufficiently aggressive collection policy. Additionally, the contracted service provider did not always place delinquent accounts with the designated collection agency within the time frame specified in the FWCJUA's Operations Manual.

Recommendation: The FWCJUA should explore alternative means of collecting premiums to help reduce its percentage of uncollected premium, and should consider increasing the amount of premium for which 100 percent of the premium is required to be paid in advance. In addition, the FWCJUA should ensure that the service provider places delinquent accounts with the collection agency in accordance with the FWCJUA's Operations Manual.

FWCJUA Response: The FWCJUA's maintains an aggressive collection policy. Our efforts to minimize uncollectibles have effectively reduced Florida's traditionally high workers compensation residual market uncollectibles by 120% as compared to national workers compensation residual markets, even while maintaining substantially higher rate differentials.

As a point of clarification, the FWCJUA's 4-year average uncollected written premium for policy years 1998 through 2001 is not 16.3% as indicated on page 16 of the audit report but rather 14.8% (Uncollected Premium of \$4,376,863 divided by Written Premium of \$29,598,194). This compares to the countrywide 4-year average uncollected written premium for the same policy years of 4.8% where NCCI administers approximately two dozen workers compensation residual market programs.

The following uncollected written premium information was obtained from NCCI, including data for the previously NCCI-administered Florida Workers Compensation Insurance Plan (FWCIP), the FWCJUA's predecessor. It provides a clear picture of Florida's uncollected premium situation in comparison to national workers compensation residual markets.

As of Date	State	Policy Year	Uncollectible Percentage	FL Percentage Difference over National
12/31/03	FL (FWCIP)	1992	16.5%	334%
12/31/03	National (excludes FL)	1992	3.8%	
12/31/03	FL (FWCIP)	1993	16.0%	344%
12/31/03	National (excludes FL)	1993	3.6%	

As of Date	State	Policy Years	4-Year Average Uncollectible Percentage	FL Percentage Difference Over National
12/31/03	FL (FWCIP)	1990 - 1993	15.4%	328%
12/31/03	National (excludes FL)	1990 - 1993	3.6%	
12/31/03	FWCJUA	1998 - 2001	14.8%	208%
12/31/03	National (excludes FL)	1998 - 2001	4.8%	

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
PRELIMINARY AND TENTATIVE FINDINGS DATED NOVEMBER 23, 2004**

Submitted on 12/23/2004

Also, when comparing uncollected premium percentages for the FWCJUA to other states, one must also consider the FWCJUA's considerably higher rate differential. The example below demonstrates the impact that a higher rate differential may have on uncollected premium.

UNCOLLECTED PREMIUM PERCENTAGE EXAMPLE				
	Voluntary Market	1993 – FWCIP	National Average Residual Market	2004 FWCJUA
Rate Differential from Voluntary Market	0%	26%	50%	170%
Written premium	\$5,000	\$6,300	\$7,500	\$13,500
Additional Billed Premium at Audit	\$2,000	\$2,520	\$3,000	\$ 5,400
Additional Billed Premium Percentage	40%	40%	40%	40%
Insured's Final Payment	\$2,000	\$2,000	\$2,000	\$ 2,000
Uncollected Premium	0	\$ 520	\$1,000	\$ 3,400
Uncollected Premium Percentage	0%	8%	13%	25%

Both the Office of Insurance Regulation and the Legislature have expressed concerns regarding the affordability of FWCJUA coverage from time to time; however, we will certainly confer with OIR regarding this recommendation to increase the current premium threshold of \$6,500 for which accounts are required to submit the equivalent of 100% of their total estimated annual premium (TEAP) at policy inception.

Finally, the ten delinquent accounts mentioned on page 17 of the audit report provide case studies for the challenges inherent in managing Workers Compensation Residual Market accounts. Employers often end up in residual markets due to poor financial status; poor payment histories have adverse loss experience or are in a hazardous business. Billings are often delayed or deferred due to legitimate or illegitimate disputes over premium owed because of classifications, payroll, use of uninsured subcontractors, etc. Also, at times, the service provider will establish a short payment plan to allow the employer to maintain its current coverage if the employer shows good intent to pay.

The FWCJUA agrees that a timely referral to the collection agency enhances the possibility of collection, but it is no guarantee. As can be observed in several of the policies erred, there are insureds that will probably never pay, unresponsive insureds and others that use delay tactics to prolong the collection of premium. A variety of situations occur and a review of the detailed underwriting file is necessary to determine whether there were legitimate reasons for a referral delay to the collection agency. In the six cases cited there were a couple of accounts where the Hurricane Emergency order effected the date referred and others where the account referral would be deemed timely following billings. There also were a couple of cases where the referral was delayed without any legitimate documented explanation.

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
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Submitted on 12/23/2004

Finding No 11: The FWCJUA has generally not measured the effectiveness of its depopulation methods to ensure it is accomplishing the intent of Section 627.311(5)(c)4., Florida Statutes.

Recommendation: The FWCJUA should develop ways to measure the success of its depopulation efforts.

FWCJUA Response: The FWCJUA measures the effectiveness of depopulation on a market share basis rather than on an individual method basis, because our approach to depopulation is multi-faceted and not readily quantifiable.

It is the responsibility of the FWCJUA to "establish programs to encourage insurers to provide coverage to applicants of the plan. . . ." To discharge this statutory obligation, the Board adopted a Market Assistance Plan (MAP) which was originally filed with and approved by the Florida Department of Insurance in 1994, and has since been modified from time to time to enhance the depopulation efforts. The purpose of MAP is to provide access to, and assist in the placement of, workers' compensation and employer's liability coverage in the voluntary market for employer's applying for or securing coverage through the FWCJUA.

Currently, the MAP makes two depopulation reports available to insurers and to producers authorized to submit business to the FWCJUA. The depopulation reports identify the "MAP Account Profiles" for: (i) employers for which the FWCJUA bound coverage in the prior month and (ii) employers currently written by the FWCJUA with policy expiration dates three months from the current month. The FWCJUA also provides a "keep out" report that identifies the "MAP Account Profiles" for employers applying coverage through the FWCJUA. All three reports were available upon requests made to the FWCJUA. Effective May 30, 2003, however, the reports became accessible through the FWCJUA's website thereby greatly enhancing the ease of access to the reports.

As of December 7, 2004, there were 368 active registered users signed up to access the FWCJUA's MAP reports, with website hits against the MAP home page totaling 6,023. Both producers and insurers are accessing the "MAP Account Profiles." It should be noted, however, that 99 percent of the active registered users are producers and they are responsible for 96 percent of the web site hits.

In addition to the MAP reports, the FWCJUA's market assistance efforts have always included, and will continue to include, personal assistance in the placement of workers' compensation coverage in the voluntary market for employers applying for or securing coverage through the FWCJUA. Over the years, FWCJUA staff has become familiar with the specific underwriting guidelines of several Florida-authorized insurers and agents who specialize in writing certain exposures (i.e., roofing operations, construction operations, retail operations, and USL&H exposures). If the FWCJUA believes that an employer may meet the underwriting guidelines informally provided by these insurers or agents, the FWCJUA will contact the insurer or agent, as the case may be, to discuss the employer's account profile to determine whether the insurer or producer might be willing to assist the employer in possibly securing voluntary coverage. If so, the FWCJUA helps to facilitate the transfer of information between the employer and the insurer or agent during the attempt to secure voluntary coverage for the employer.

Further, on December 15, 2004, the FWCJUA implemented a website reporting mechanism for voluntary quotes to further ensure that the FWCJUA remains the market of last resort consistent with its MAP. Additionally, the FWCJUA plans to further modify its MAP, effective January 2005, to implement the "MAP Partnership Program" that will provide greater access to, and assistance in the placement of, coverage in the voluntary market for employers applying for or securing coverage through the FWCJUA. This program will permit the FWCJUA to more formally search a greater number of voluntary market carriers, on a consistent basis, for each employer applying for or securing FWCJUA coverage. Pre-release testing of the program indicates that the FWCJUA

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
PRELIMINARY AND TENTATIVE FINDINGS DATED NOVEMBER 23, 2004**

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can anticipate assisting with the placement of voluntary market coverage for approximately 17.8 percent of its applicants. Given the nature of these two additional depopulation programs, data relevant to the specific effectiveness of the FWCJUA's market assistance through these methods shall be much more readily available in quantifiable form.

In addition to the formal MAP program, the FWCJUA has established a variety of policies to encourage employers to secure coverage in the voluntary market. For example, the FWCJUA allows for the cancellation of insurance policies on a pro-rated basis, thereby removing a substantial financial obstacle which might otherwise impede the movement of employers to the voluntary market. Further, the FWCJUA requires producers who submit business to the FWCJUA to contractually agree to continually attempt to place employers in the voluntary market. Also, the FWCJUA requires all employers applying for coverage to signify by signing the application for coverage that they acknowledge that coverage may be available with other insurers through another producer at a lower cost and that an offer of voluntary coverage makes them ineligible for FWCJUA coverage. The establishment of these and other similar practices and procedures reflect the Board's on-going commitment to depopulate the FWCJUA.

The Board has also offered recommendations to the Florida Legislature regarding FWCJUA depopulation. On February 13, 2004, the FWCJUA Board of Governors formally adopted its position regarding potential legislation affecting the FWCJUA. Among other things, the statement addressed the issue of depopulation incentives. In the statement, the Board offered the following potential solution regarding depopulation:

"Depopulation Incentives. The depopulation of the FWCJUA is unquestionably in the best interests of FWCJUA policyholders. Immediately following the creation of the FWCJUA in 1994, Florida's workers' compensation residual market experienced rapid and dramatic depopulation. While current FWCJUA policy counts continue to be far below their 1994 levels, further depopulation should be a continuing goal. Providing additional encouragement and incentives to the voluntary market to take-out and keep-out residual market business seems to be the most effective way of doing that.

Current law provides that voluntary market carriers may take policies out of Subplan D, charging the policyholder rates no greater than those offered by the FWCJUA in Subplan D for a period of two years after the take-out. Policies taken out of the FWCJUA in this fashion do not count against so-called "consent to rate" limitations contained in section 627.171, Florida Statutes. The Board suggests consideration be given to expanding this incentive program.

The Board recommends that the current depopulation program be expanded to all FWCJUA subplans. Thus, voluntary market carriers could take-out policies from any FWCJUA subplan, and write that business at rates no greater than the FWCJUA rates applicable to the policyholder, without the policy counting toward the section 627.171 limitation. Additionally, the Board suggests that the two-year consent to rate moratorium be extended to five years, so that voluntary market carriers could continue to write the take-out business for five years, so long as the policyholder and the carrier were willing to continue doing business under that rating arrangement."

**EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS' COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.**

**FWCJUA WRITTEN STATEMENT OF EXPLANATION TO AUDITOR GENERAL'S
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Submitted on 12/23/2004

The 2004 Law expanded the application of the statutorily mandated Subplan D depopulation program to all FWCJUA applicants and policyholders. As expected, the statutory revisions to the depopulation program generated interest among several workers compensation voluntary market carriers, and the FWCJUA continues to work with those carriers to place or keep employers in the voluntary market.

The FWCJUA's Board is encouraged by the increasing willingness among insurers in the voluntary market to avail themselves of depopulation incentives authorized by the 2004 Law. Further, the Board believes that the FWCJUA is strategically positioned, with the website MAP report access, the website reporting mechanism for voluntary quotes, and the MAP Partnership Program, to readily facilitate the placement of workers' compensation coverage in the voluntary market for employer's applying for or securing coverage through the FWCJUA.

Given the FWCJUA's multi-faceted approach to depopulation, we can not readily quantify the results of each individual depopulation method thus, we report on "global" depopulation in the form of the attached market share report.

This finding and recommendation, however, shall be referred to the FWCJUA's MAP Committee for consideration with its subsequent findings and recommendations referred to the Board.

EXHIBIT – A (CONTINUED)
RESPONSE FROM
FLORIDA WORKERS’ COMPENSATION JOINT
UNDERWRITING ASSOCIATION, INC.

FWCJUA COMPARABLE DATA	2004 FWCJUA PROJECTED 12/31/2004	2003 FWCJUA RESULTS 12/31/2003	2002 FWCJUA RESULTS 12/31/2002	2001 FWCJUA RESULTS 12/31/2001	2000 FWCJUA RESULTS 12/31/2000	1999 FWCJUA RESULTS 12/31/1999	1998 FWCJUA RESULTS * 12/31/1998	1997 FWCJUA RESULTS 12/31/1997	1996 FWCJUA RESULTS 12/31/1996	1995 FWCJUA RESULTS 12/31/1995	1994 FWCJUA RESULTS 12/31/1994	1993 FWCIP RESULTS 12/31/1993
Written Premium (Calendar Year)	\$54,980,036	\$64,462,672	\$25,645,248	\$6,696,022	\$5,035,549	\$6,431,378	\$14,182,389	\$13,862,990	\$27,748,666	\$69,102,344	\$73,305,743	\$328,159,749
Premium Volume at 1993 Assigned Risk Rates	\$26,032,214	\$29,037,240	\$8,864,586	\$2,536,372	\$1,907,405	\$2,047,557	\$6,185,080	\$7,827,775	\$16,786,852	\$46,068,229	\$51,478,752	\$328,159,749
Residual Market Share (Calendar Year)	1.7%	2.0%	< 1%	< .3%	< .2%	< .2%	< .3%	< .7%	< 1.3%	2.6%	3.8%	12.7%
Policies Issued Effective that Year	5,586	4,178	1,140	662	522	623	1,427	3,171	6,654	10,339	13,933	48,430

* 1998 Written Premium includes \$5.8M for 8 suspected fraud cases.

2003 voluntary premium was \$3.2B - used for 2003 & 2004 market share.

EXHIBIT – B
RESPONSE FROM
FLORIDA DEPARTMENT OF FINANCIAL SERVICES
OFFICE OF INSURANCE REGULATION



DEPARTMENT OF FINANCIAL SERVICES
OFFICE OF INSURANCE REGULATION

KEVIN M. McCARTY
 COMMISSIONER

FINANCIAL SERVICES
COMMISSION

JEB BUSH
 GOVERNOR

TOM GALLAGHER
 CHIEF FINANCIAL
 OFFICER

CHARLIE CRIST
 ATTORNEY GENERAL

CHARLES BRONSON
 COMMISSIONER OF
 AGRICULTURE

December 14, 2004

Mr. William O. Monroe, CPA
 Auditor General
 State of Florida
 G74 Claude Pepper Building
 111 West Madison Street
 Tallahassee, Florida 32399-1450

Re: Preliminary and Tentative Audit Findings – Operational Audit of Florida Workers
 Compensation Joint Underwriting Association (FWCJUA)

Dear Mr. Monroe:

Chief Financial Officer Gallagher forwarded a copy of your letter dated November 23, 2004, regarding referenced operational audit to the Office of Insurance Regulation (Office) for review and comment.

As you are aware, the Office is responsible for the regulation of certain aspects of the FWCJUA. The Office is aware that the FWCJUA must provide responses to your preliminary and tentative auditing findings and recommendations; therefore, we have restricted our responses to those findings that are directly pertinent to the Office, specifically, Finding No 1 and Finding No 2.

The Office has reviewed the summary, background information and tentative and preliminary Finding No 1 and Finding No 2 that were forwarded within the enclosure to your letter of November 23, 2004. The enclosed information, comments and responses are keyed to these preliminary and tentative audit findings and related recommendations.

I appreciate the opportunity to review and respond to preliminary and tentative findings.

Sincerely,

Kevin M. McCarty

cc: Tom Gallagher, Chief Financial Officer, Department of Financial Services
 Paul Mitchell, Chief of Staff, Department of Financial Services

Enclosure

EXHIBIT – B (CONTINUED)
RESPONSE FROM
FLORIDA DEPARTMENT OF FINANCIAL SERVICES
OFFICE OF INSURANCE REGULATION

Auditor General Report

FWCJUA Preliminary and Tentative Audit Findings

The Office of Insurance Regulation (Office) has reviewed the summary, background information, and preliminary and tentative findings associated with the operational audit of the Florida Workers' Compensation Joint Underwriting Association, Inc. (FWCJUA). The information and comments that follow address Finding No 1: Rates and Reserves and Finding No 2: Contingency Reserve that are documented in the audit report that was forwarded as an enclosure to the Auditor General's letter dated November 23, 2004.

Finding No 1: Rates and Reserves

This finding relates to the rate making and reserving methodology that is employed by the FWCJUA. Within this finding the Auditor General commented upon the practice of establishing a reserve for unallocated loss adjustment expense (ULAE) when the responsibility for those future expenses are passed on to Travelers as a result of the FWCJUA's service agreement with Travelers.

Based upon internal discussions within the Office, as well as consultation with the National Association of Insurance Commissioners, the Office has taken the position that under statutory accounting guidelines ULAE reserves cannot be removed from the books of the insurer by means of a contract even if the contract is secured by the FWCJUA, using a performance bond for this purpose. The "contract of insurance" that is referred to in Statutory Accounting Issue Paper 55 (page IP 55-10 at the top) was not meant to include performance bonds; rather, it was meant to include payments made to persons or entities that are considered covered losses under an insurance contract, or policy.

It is the Office's position, then, that the FWCJUA must establish a ULAE reserve under statutory accounting for future expenses for handling claims on current and past insurance contracts, recognizing that credit cannot be given for adjusting and other expense transfers between entities when the expenses are transferred through expense prepayments. Credit can only be given when adjusting and other expenses are transferred through a contract of insurance or reinsurance.

Finding No 2: Contingency Reserve

This finding refers to the contingency reserve provide by HB 1251 (Chapter 2004-266, Laws of Florida) to fund the deficit in the FWCJUA subplan "D". Within this finding the Auditor General has three basic findings: (1) the 3-month period in the statutes; (2) the use of a contingency reserve; and (3) the ability of the FWCJUA to use surplus cash from the other subplans and tiers to fund subplan "D" deficits. Each of these findings is addressed separately below.

- The first finding addressed funding deficits in subplan "D". Chapter 2004-266, Laws of Florida, contains the mechanisms for the FWCJUA to access cash from the Workers'

EXHIBIT – B (CONTINUED)
RESPONSE FROM
FLORIDA DEPARTMENT OF FINANCIAL SERVICES
OFFICE OF INSURANCE REGULATION

Compensation Administrative Trust Fund (WCATF) to fund the deficit in subplan "D". This Law provides:

After the contingency reserve is established, whenever the board determines subplan "D" does not have a sufficient cash basis to meet 3 months of projected cash needs due to any deficit in subplan "D," the board is authorized to request the department to transfer funds from the contingency reserve fund within the Workers' Compensation Administration Trust Fund to the plan in an amount sufficient to fund the difference between the amount available and the amount needed to meet subplan "D"'s projected cash need for the subsequent 3-month period. The board and the office must first certify to the Department of Financial Services that there is not sufficient cash within subplan "D" to meet the projected cash needs in subplan "D" within the subsequent 3 months. The amount requested for transfer to subplan "D" may not exceed the difference between the amount available within subplan "D" and the amount needed to meet subplan "D"'s projected cash need for the subsequent 3-month period, as jointly certified by the board and the Office of Insurance Regulation to the Department of Financial Services, attributable to the former subplan "D" policyholders. The Department of Financial Services may submit a budget amendment to request release of funds from the Workers' Compensation Administration Trust Fund, subject to the approval of the Legislative Budget Commission.

In order to implement this law, the Office has worked with the FWCJUA, the Department of Financial Services (DFS), the Governor's Office, the House and Senate staff of the Legislative Budget Commission, and the Legislative Budget Commission (LBC). All parties in this group have worked in harmony with each other in order to ensure that the FWCJUA has sufficient cash to meet its obligations to subplan "D" policyholders and claimants. Each party in this group has responsibilities and procedures that may affect the timing of requests for cash and the actual transfer of funds. The timing is driven to a large extent by the LBC meeting schedule; therefore, all other parties establish their deadlines in order to have their proposals prepared for specific LBC meetings. The use of this approach among all parties involved has permitted the group to effectively manage to work within the 3-month language specified in the Law. We are not aware that any party within the group that is involved in the current process – FWCJUA, the Governor's Office, DFS or LBC -- has ever expressed any concerns that the currently established process and procedures would not work without legislative changes.

- The second finding indicated by the Auditor General is the use of a contingency fund for the FWCJUA in its cash flow model. The FWCJUA still has over 2,000 policies in force in subplan "D". Many of these policies will not expire until May 2005. Accidents are still occurring, and will continue to occur, under these policies until the last policy has expired. It is difficult to predict needed payout on existing claims; however, it is nearly impossible to predict on a monthly or quarterly basis the future occurrence of accidents and the cash needed to pay related claims. The occurrence of large claims is even more difficult to predict. The FWCJUA, has recently experienced an unusual number of large claims in contrast to the number of large claims experienced in previous years. In order to

EXHIBIT – B (CONTINUED)
RESPONSE FROM
FLORIDA DEPARTMENT OF FINANCIAL SERVICES
OFFICE OF INSURANCE REGULATION

efficiently handle large claims, additional cash can sometimes create cost saving options. In summary this means that some cushion is needed to avoid the consequences of the FWCJUA running out of cash. If the FWCJUA depletes the cash in subplan "D", there will be no funds to pay injured workers and health care providers or to return premium to employers that are due a refund. All parties would agree that these are unacceptable results, thus the \$2.5 million contingency fund is necessary and provides an essential cushion to prevent these undesirable results.

- The third finding indicated by the Auditor General is that the FWCJUA did not consider available surplus cash related to other subplans. The commingling of funds from the other subplans or tiers to fund subplan "D" deficits does not appear to be expressly authorized by Florida Statutes.

Senate Bill 50 A which created subplan "D" contained the following provisions in section 35 of the bill:

2. The plan may issue assessable policies only to those insureds in subplan "C," and subplan "D." Subject to verification by the department, the board may levy assessments against insureds in subplan "C" or subplan "D," on a pro rata earned premium basis, to fund any deficits that exist in those subplans. Assessments levied against subplan "C" participants shall cover only the deficits attributable to subplan "C," and assessments levied against subplan "D" participants shall cover only the deficits attributable to subplan "D." In no event may the plan levy assessments against any person or entity, except as authorized by this paragraph."

Based on this provision FWCJUA policyholders were issued policies with the assessable language that include the statement that deficits in subplan "D" would be funded only by policyholders in subplan "D" and deficits in subplan "C" would be funded by policyholders in subplan "C". This is very clear legislative intent and is designed to keep the subplans' experience separate. To use any existing surplus from subplan "C" for subplan "D" would violate this statute and also violate the provision of policies that have been issued to policyholders. Additionally, prematurely removing funds from subplan "C" increases the likelihood that an assessment would have to be made for subplan "C" policyholders.

When HB 1251 passed there were three funding mechanisms for subplan "D" deficits. These were: (1) a \$10 million appropriation from the WCATF; (2) a \$15 million contingency fund to be set up in the WCATF and accessed on a cash needs basis; and (3) an assessment to all workers' compensation policyholders which is the so-called "below-the-line" assessment. The \$10 million appropriation from the WCATF to fund any deficit in the plan, which would have applied to any subplan or tier, was vetoed. The \$15 million funding on a cash needs basis is clearly restricted to subplan "D" deficits. The only other funding mechanism for subplan "D" is the below-the-line assessment, which may be required at a future date to fund any remaining subplan "D" deficit. HB 1251 could have contained authorization to use the surplus from the other subplans or tiers for the subplan "D" deficits but this would have been contrary to Senate Bill 50 A, and

EXHIBIT – B (CONTINUED)
RESPONSE FROM
FLORIDA DEPARTMENT OF FINANCIAL SERVICES
OFFICE OF INSURANCE REGULATION

would not be fair to the policyholders in subplan “C”, or in tiers 2 and 3 which were required to pay much higher premiums than those in subplan “D”.

The Auditor General’s recommendations associated with Finding No 2 states: “The Office of Insurance Regulation (OIR) should seek legal clarification from the Attorney General regarding the above noted issues. Also, the Legislature should consider enacting legislation clarifying these issues.”

None of the parties involved in the funding process– FWCJUA, Governor’s Office, DFS, LBC -- have expressed any of the concerns that were raised by the Auditor General’s audit staff, including concerns that the language of existing legislation may need to be revised or made subject to further interpretation. Accordingly, the Office does not deem it necessary or appropriate to seek legislative clarification on this matter at this time.

**State of Florida
Auditor General**

**Actuarial Review
of
Florida Workers Compensation
Joint Underwriting Association**

Preferred Insurance Capital Consultants, LLC
Boca Corporate Center
2101 NW Corporate Boulevard, Suite 415
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November 22, 2004

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I. INTRODUCTION AND DESCRIPTION OF ASSIGNMENT

A. General Introduction

Chapter 2004-266, Laws of Florida, signed into law by the Governor on May 28, 2004, requires the Auditor General to engage an independent consulting actuary to evaluate the rates and reserves of the FWCJUA (Florida Workers Compensation Joint Underwriting Association), established pursuant to Section 627.311(5), Florida Statutes. The evaluation of the rates and reserves must include, for Sub-plan "D," a determination of the adequacy of the reserves established, including an estimate of any deficits incurred or anticipated. The evaluation shall also include, for all sub-plans, an analysis of the impact of the rates identified in the most recent rate filing by the FWCJUA on anticipated reserves.

B. Relationship of Reserves, Deficit, and Rates

Determinations of the following values are all partially dependent upon the "best" estimate of required loss and allocated loss adjustment expense (ALAE) reserves reported by the FWCJUA actuary:

1. Amount of reserves booked by the FWCJUA,
2. Amount of deficit reported by the FWCJUA, and
3. The rates implemented by the FWCJUA

C. "Best" Estimate of Loss and ALAE Reserves Reported by FWCJUA Actuary

There is no definition of a "best" estimate. It is within actuarial standards to rely heavily on judgment rather than any specific methodological process.

D. "Range of Reasonableness"

The FWCJUA actuary provides the FWCJUA Management with a range of reserves around the actuary's "best" estimate that the actuary believes is reasonable. Management is expected to book a reserve amount that is within the FWCJUA actuary's "range of reasonableness."

E. "Statutory Accounting Principles" (SAP)

State insurance law and regulation requires reporting to the state of financial information prepared under SAP. The primary purpose of SAP is

to provide financial reporting that is sufficiently conservative (i.e., understate income and/or owners equity) to minimize the likelihood that an insurer will be unable to pay its obligations. In some instances, SAP will require recording of reserves that would not be required under generally accepted accounting principles (GAAP).

F. Judgment is an Integral Part of Establishing Reserves and Rates

It is important for the reader to understand and appreciate that determination of reserves and/or rates is not an exact science. Booked reserves and/or rates are, in part, the result of management's judgment. Furthermore, booked reserves and/or rates are not the result of a single judgment; they are the culmination of many individual judgments that lead to the final result.

G. Cautions

The calculations, analysis, and conclusions contained in this report are of a highly technical nature. There are "Assumptions and Notes" and "Caveats and Limitations" sections in this report which we urge be given close attention.

Anyone reading this report is advised that the reader may contact PICC for additional explanation of the report's contents. If the reader intends to make any judgments or decisions regarding the FWCJUA, the reader is advised to obtain its own expert analysis. PICC accepts no responsibility for any financial decisions made that are based on this report.

II. EXECUTIVE SUMMARY

A. Reserves as of 12/31/03

1. Components of FWCJUA Reserves

The total reserves of the FWCJUA can be viewed as having the following components:

a.	Loss and ALAE – FWCJUA Actuary	\$38,900,000
b.	Additional Loss and ALAE – FWCJUA Mgmt.	8,400,000
c.	ULAE (a SAP reserve)	4,200,000
d.	Contra-Liability for LPT	(13,800,000)
e.	<u>Premium Deficiency Reserve</u>	<u>\$3,700,000</u>
f.	Total Reserve (sum of (a) through (e))	\$41,400,000

Item (a) is the result of the FWCJUA actuary's "best" estimate of unpaid loss and ALAE liabilities for all claims under FWCJUA policies that occurred on or before 12/31/03. This estimate does not include any reduction for the fact that all FWCJUA liability for claims occurring prior to 1/1/2000 was transferred in 2000 to American Reinsurance Corporation as a result of the FWCJUA purchasing retroactive reinsurance called a loss portfolio transfer (LPT).

Item (b) is the additional reserve for losses and ALAE booked by the FWCJUA's management, over and above the "best" estimate of the FWCJUA's actuary.

Item (c) is allegedly required by SAP even though the FWCJUA purchased "cradle to grave" claims administration services from the Servicing Carrier. As a result, the FWCJUA income statement and balance sheet record this same cost twice: once through the payment to the Servicing Carrier, and; a second time as a reserve for an amount that in all probability will never be paid.

Item (d) is the offset booked by the FWCJUA to reflect the same amount of reserves included in item (a), but for which the FWCJUA has no material liability.

Item (e) is a reserve required by SAP (but not GAAP), if it is expected that unearned premium as of 12/31/03 can not reasonably be expected to be sufficient to pay the losses and expenses associated with the unearned premiums when the premiums are earned.

2. *PICC's Estimate of Outstanding Liability*

No reasonable reserve can be large enough to cover every possible contingency. It is PICC's opinion that a lower bound for FWCJUA reserves is an estimate based on the average indicated reserve (i.e., it is expected that 50% of the time it is a reserve that turns out to be too high, and 50% of the time it is a reserve that turns out to be too low). It is PICC's opinion that a reserve expected to be too high 90% of the time, and too low 10% of the time (i.e., a reserve at the 90% confidence level) is appropriate for the FWCJUA. It is also PICC's opinion that a reserve calculated at the 90% confidence level, and assuming a substantially higher than typical of workers compensation insurers variance in claims costs, is a reasonable upper bound for FWCJUA reserves.

Below is a summary of PICC's recommended reserve as of 12/31/03 for losses and ALAE.

Lower Bound (Est. based on averages)	\$11,000,000
Recommended Reserve (90% confidence level)	\$14,800,000
Upper Bound (90% conf. level, incr. variance)	\$18,800,000

PICC estimates that a reserve for loss and ALAE of approximately \$14,800,000 would be reasonable to meet the FWCJUA's actual net liabilities as of 12/31/03. This estimate is based on analysis and assumptions described later in this report. PICC notes that alternative assumptions discussed with the FWCJUA actuary may have the effect of increasing PICC's estimate. But, even with alternative assumptions, also discussed later in this report, PICC's estimate of a reasonable reserve would still be under \$18,800,000.

There are judgments that are the foundation of PICC's estimate. The most important of these judgments are:

- a. It is reasonable to use the methodologies performed by the FWCJUA actuary, substituting average results of the methodologies for the numerous instances where the FWCJUA actuary utilized "actuarial judgment" in its selection from the range of actual results of the methodologies.
- b. It is reasonable to apply a statistical approach to introducing conservatism to the estimate of reserves that would be sufficient in lieu of selecting a conservative reserve.

- c. With respect to the statistical approach used by PICC to introduce conservatism, the parameters of the approach are reasonable.

3. Reserve for Unallocated Loss Adjustment Expense (ULAE)

PICC believes that it is reasonable to expect that the Servicing Carrier (Travelers) will meet its obligation to provide the required claims administration services for claims that occurred prior to 12/31/03 (services for which Travelers has been pre-paid by the FWCJUA) regardless of the future status of the FWCJUA. Thus, as a practical matter, the \$4,200,000 ULAE reserve held by the FWCJUA is unnecessary.

4. Treatment of LPT

As a practical matter the FWCJUA's liability for claims that occurred prior to 1/1/2000 is zero. Whether the FWCJUA initially provides no reserve for claims occurring prior to 1/1/2000, or instead includes a reserve for such claims and then posts an offsetting contra-liability, would have no material effect on the FWCJUA's booked reserves if the FWCJUA were booking the "best" estimate. However, establishing the "reasonable range" about the "best" estimate before eliminating the claims prior to 1/1/2000 results in a much higher upper bound of the "reasonable range", and a reserve selected by the FWCJUA that is more likely to be excessive in light of the true liabilities of the FWCJUA.

5. Premium Deficiency Reserve (PDR)

A PDR is required under SAP (not GAAP) when it is "probable", not just "possible", that actual losses and expenses associated with unearned premium will exceed the unearned premium when it is earned (subsequent to 12/31/03). The FWCJUA's calculation of its PDR is dependent upon its booked reserve. PICC replicated the FWCJUA's PDR calculation substituting PICC's average estimate of ultimate losses, and determined that no PDR is necessary. PICC concluded that there exists a probability of over 50 percent that Subplan D premium to be earned in the future will be sufficient to pay related losses and expenses.

B. Sub-Plan D "Deficit" as of 12/31/03

As shown in the table below (provided by the FWCJUA), the FWCJUA reported a deficit as of 12/31/03 for Sub-plan D of approximately

\$9,900,000. Income was \$1,900,000, and losses and expenses totaled \$11,800,000 (\$1,900,000 - \$11,800,000 = negative \$9,900,000).

SECTION A - INCOME		
(1)	Net Premiums Earned	1,918,206
(2)	Net Investment Income	2,161
(3)	TOTAL EARNED INCOME	1,920,367
SECTION B - LOSSES AND EXPENSES		
(4)	Losses Paid	49,539
(5)	Case Reserves	254,904
(6)	IBNR	2,058,853
(7)	Total Losses	2,363,296
(8)	Loss Expenses Paid - ULAE	1,566,069
(9)	Loss Expenses Paid - ALAE	1,099
(10)	Loss Expenses Incurred	1,567,168
(11)	Underwriting Expenses	4,143,269
(12)	Premium Deficiency Reserve	3,711,435
(13)	TOTAL LOSSES AND EXPENSES	11,785,168
	SECTION C - ENDING 12/31/03 SURPLUS / (DEFICIT)	(9,864,801)

The fundamental problem with the above table provided by the FWCJUA is that there is a mismatch of income compared to losses and expenses. While Sub-plan D written premium as of 12/31/03 was \$9,900,000. Only \$1,900,000 was earned as of 12/31/03 and reported as income. However, expenses were reported as if all of the written premium was earned. While such reporting may be consistent with SAP in theory, it is not consistent with the true economic status of Sub-plan D.

In the FWCJUA's deficit calculation, reported income was \$1,900,000 and the major components of losses and expenses were:

Losses	\$2,400,000
Loss Adjustment Expenses (LAE)	1,600,000
Underwriting Expenses	4,100,000
<u>Premium Deficiency Reserve</u>	<u>3,700,000</u>
Total Losses and Expenses	\$11,800,000

Under the deficit calculation as of 12/31/03, as provided by the FWCJUA, if there were zero losses in Sub-plan D, and if the PDR is unnecessary, there would still be a deficit of approximately \$3,800,000 (= \$1,900,000 – \$1,600,000 – \$4,100,000). PICC has not offered an alternative calculation of the Sub-plan D deficit, if any, because:

- ✓ The incurred but not reported (IBNR) component of losses is based on the booked reserves, which PICC believes are higher than reasonable,
- ✓ There is an economic mismatch when comparing as of 12/31/03, premium earned to pre-paid expenses that have not been earned by the vendor (this includes almost all LAE and a substantial portion of the underwriting expenses),
- ✓ PICC anticipates that a disproportionate share of FWCJUA general administrative expense has been assigned to Sub-plan D policies.

C. Rates

Legislation enacted in 2004 requires separate rates for FWCJUA policyholders assigned to Tiers 1, 2 and 3. HB-1251 mandates that for Tiers 1 and 2, rates be 125% and 150% of voluntary market rates, respectively. There is no provision for actuarially sound rates for Tier 1 and Tier 2 prior to January 1, 2007. PICC recommends consideration of introducing actuarially sound rates for Tiers 1 and 2 at the earliest possible date (which would require new legislation).

In the FWCJUA's latest rate filing dated July 7, 2004, the only actuarial analysis provided by the FWCJUA is for Tier 3 rates. The table below displays a comparison of the current surcharges, and the indicated surcharges calculated by PICC:

<u>Tier</u>	<u>Current Surcharge</u>	<u>PICC Indicated Surcharge</u>
1	25%	71%
2	50%	66%
3	170%	127%

PICC has several issues with the FWCJUA rate calculation for Tier 3. By far, the major cause of difference rests with the fact that the rates are based on the FWCJUA actuary's "best" estimate of ultimate losses contained in its reserve study, which is substantially higher than PICC's estimate.

Based on the FWCJUA's historical record and the FWCJUA's actuarial judgment, the FWCJUA anticipates that 14.1% of premium will be

uncollectible in 2004. PICC used that assumption in arriving at its indicated rate surcharges. Uncollectible premium is a direct cause of higher rates and potential deficit. By comparison, the countrywide percentage of uncollectible premium has averaged 3.3% over the last 5 years in approximately two dozen states where NCCI operates workers compensation assigned risk programs.

D. Management Discretion

It is standard practice in the property–casualty insurance industry that reserves are determined by management, and management is encouraged to be conservative (high) in determining reserves in order to increase the likelihood that funds will be available to pay claimants when due. The FWCJUA differs from traditional insurance companies in several respects. In many instances, those differences suggest that reserves should be set at a level higher than the same management might set reserves for a traditional insurer, given the same premium and loss data. While PICC concurs that FWCJUA management should be conservative in determining reserves and rates, PICC believes that: (a) the degree of conservatism should be presented in a quantified manner, and (b) reserves as of 12/31/03, and rates implemented in 2004, are more conservative than necessary.

E. Documentation of Judgments used to Determine Reserves and Rates

1. Documentation of Actuarial Analysis

The FWCJUA actuary, in determining its “best” estimate of indicated reserves, its estimate of a reasonable range of reserves, and its calculation of Tier 3 rates, makes numerous assumptions and judgments, some of which are inconsistent with the results of underlying calculations. The actuarial reports on reserves, and the actuarial memorandum in support of the rate surcharge do not specifically identify these judgments, and do not discuss the basis of the judgments (e.g., what other relevant factors might have been considered, and what weights were assigned to such factors). Responses to written questions submitted by PICC as to the basis of judgments included responses such as “actuarial judgment.” In a meeting with the FWCJUA actuary on November 4, 2004, PICC was advised that the FWCJUA actuary also does not maintain within its internal work papers documentation of the judgments made or the basis of the judgments.

PICC notes that Actuarial Standard of Practice No. 9, Documentation and Disclosure in Property and Casualty Insurance

Ratemaking, Loss Reserving, and Valuations, promulgated by the Actuarial Standards Board, requires, in paragraph 5.2, documentation of an actuarial work product sufficient for another actuary practicing in the same field to evaluate the work. Standard of Practice No. 9 further states that the documentation should describe clearly the material assumptions and methods. Based on the responses provided to written questions submitted by PICC, and on the discussions with the FWCJUA actuary, it is not apparent to PICC that the FWCJUA actuary has fully complied with this Standard.

2. *Documentation of Management Decisions in Determining Reserves*

PICC requested information from the FWCJUA with respect to how Management selected its booked reserves from the various options within the “range of reasonableness” provided by the FWCJUA actuary. Management provided agendas and minutes from Board meetings covering several years. Such documentation clearly indicated that the Board had available the reports prepared by the FWCJUA actuary. However, those documents did not provide information as to how the Board arrived at the specific amount it decided to book for reserves.

III. EXTENDED CONCLUSIONS

A. Discussion of Process for Preparing Actuarial Review

The approach implemented by Preferred Insurance Capital Consultants, LLC (PICC) has been to utilize the calculations and analysis provided by the FWCJUA and/or the FWCJUA's consulting actuary in determining reserves and rates, and to make adjustments. PICC has concentrated in this review on reserves booked as of 12/31/03 because the FWCJUA advised PICC that the FWCJUA does an annual year-end study of required reserves, and uses the results of that study to determine subsequent quarterly financial reporting (a practice not uncommon in the insurance industry). Thus, conclusions relevant to estimates of ultimate losses and loss adjustment expenses, and to projected ultimate loss ratios do not change with respect to subsequent quarterly reports (e.g., as of the following March 31, June 30, and September 30).

There are four Technical Appendices (A through D) included with this report. Each of the appendices uses the FWCJUA actuary's calculations as a starting point. PICC changes are identified by **bold** font. Parts not in bold are intended to be unchanged from calculations provided by the FWCJUA actuary.

A brief description of each of the enclosed technical appendices is provided below,

Technical Appendix A – provides calculation of indicated reserves as of 12/31/03 based on an “average” or “mean best” estimate basis, and compares those results to the results of calculations done by the FWCJUA actuary.

Technical Appendix B – is similar to Technical Appendix A, except that PICC's calculation of indicated reserves as of 12/31/03 based on an “average” or “mean best” estimate basis is adjusted to reflect “parameter variance”, and compares those results to the results of calculations done by the FWCJUA actuary. In addition, Technical Appendix B provides results that include provision for parameter variance and for “process variance” at selected confidence levels.

Technical Appendix C – provides for Sub-plan D, calculation of indicated premium deficiency reserve and indicated deficit as of 12/31/03 on an “average” or “mean best” estimate basis, and compares those results to the results of calculations done by the FWCJUA actuary. Technical Appendix C also provides the same calculations at a 90% confidence level

Technical Appendix D – provides indicated rate surcharges for Tiers 1, 2 and 3.

B. Judgment is an Integral Part of Establishing Reserves and Rates

It is important for the reader to understand and appreciate that determination of reserves and/or rates is not an exact science. Booked reserves and/or rates are in part the result of management’s judgment. Furthermore, booked reserves and/or rates are not the result of a single judgment, but rather are the culmination of many individual judgments that lead up to the final result.

PICC has not attempted to analyze each of the literally hundreds of judgments underlying the reserves booked or rates calculated by the FWCJUA. Instead, PICC has substituted average indications for each of the many judgments, and then compared its results to reserves booked by the FWCJUA. Among the many judgments, stated or unstated, is a decision on what degree of conservatism is appropriate when establishing reserves. PICC has selected as its reserve and/or rate level that amount which PICC expects to be sufficient and/or redundant 90% of the time. PICC’s approach to building in a provision for conservatism is discussed later in this report.

Where PICC results differ from results as arrived at by the FWCJUA, PICC is not saying that the FWCJUA judgments are incorrect. Rather, PICC is simply providing its results based on its own independent judgments.

C. Review of Reserves as of 12/31/03

The table below provides a comparison of “best” estimates of required reserves as calculated by the FWCJUA actuary with actual reserves booked by the FWCJUA:

As of Dec. 31:	FWCJUA Actuary's "Best"	FWCJUA Management Booked	Booked as Pct. of "Best"
1999	23,800,000	35,500,000	149%
2000	20,800,000	32,600,000	157%
2001	21,900,000	32,000,000	146%
2002	28,800,000	36,600,000	127%
2003	<u>43,100,000</u>	<u>51,500,000</u>	<u>119%</u>
	138,400,000	188,200,000	136%

A “best” estimate of required reserves is the result of subtracting payments to date from the “best” estimate of ultimate losses. Thus, the “best” estimate of required reserves is in fact driven by the “best” estimate of ultimate losses. The table below compares for the latest five accident years, the estimate by the FWCJUA actuary of the ultimate losses as of accident year end, to the FWCJUA actuary’s estimate for each accident year as of 12/31/03. This table indicates that FWCJUA actuary initial “best” estimates are consistently too high, as measured by the FWCJUA actuary as of 12/31/03.

(a)	(b) <u>Est. by FWCJUA Actuary</u> Dollars in Thousands Est. of Ult. Loss & LAE At Accident Year End	(c) Est. of Ult. Loss & LAE At 12/31/2003	(d) Overstatement of Initial Estimate as % of 12/31/03 Est. = [(b)-(c)]/(c)
Accident Year			
1998	7,150	5,800	23%
1999	3,150	2,050	54%
2000	2,800	2,350	19%
2001	3,000	1,910	57%
<u>2002</u>	<u>9,300</u>	<u>5,310</u>	<u>75%</u>
Total / Average	25,400	17,420	46%

The results of “best” estimates performed by the FWCJUA actuary are producing results that seem counter-intuitive. Several examples relating to results obtained from the FWCJUA actuary’s reports are listed below, and refer to the table on the following page.

Row (11), cols. (f) and (g) – for accident year 1994 the average case reserve is decreased by \$29,250, and the average IBNR per case is increased by \$165,500.

Row (12), cols. (c) and (d) – the average reserve per claim for accident year 1995 is \$736,600 (= \$80,000 + \$656,600). The reinsurance limits the total cost of the claim, including amounts already paid, to a maximum of \$500,000 per claim.

Row (22), cols. (f) and (g) – for all years combined the average case reserve increased by \$5,405, and the average IBNR per case increased by \$102,094

Net Indemnity and Medical Losses from FWCJUA Actuary's Reports

	(a)	(b)	(c)	(d)	(e)	(f)	(g)
	Accident Year	No. Open Indemnity Claims	Avg. Case Reserve Per Open Claim	Avg. IBNR per Open Claim	Ratio of IBNR to Case Reserves	Change in Case Reserve per Open Claim	Change in IBNR per Open Claim
As of 12/31/02							
(1)	1994	4	82,750	346,250	418%		
(2)	1995	10	31,800	226,000	711%		
(3)	1996	13	15,462	135,692	878%		
(4)	1997	3	3,667	327,000	8918%		
(5)	1998	7	77,857	62,000	80%		
(6)	1999	5	27,800	69,800	251%		
(7)	2000	8	21,375	107,375	502%		
(8)	2001	9	26,000	184,889	711%		
(9)	2002	36	16,222	186,583	1150%		
(10)	Total / Avg.	95	26,674	172,768	648%		
As of 12/31/03							
(11)	1994	4	53,500	511,750	957%	(29,250)	165,500
(12)	1995	5	80,000	656,600	821%	48,200	430,600
(13)	1996	13	11,000	165,692	1506%	(4,462)	30,000
(14)	1997	3	14,000	315,000	2250%	10,333	(12,000)
(15)	1998	3	92,667	209,333	226%	14,810	147,333
(16)	1999	3	24,667	109,000	442%	(3,133)	39,200
(17)	2000	4	32,250	90,750	281%	10,875	(16,625)
(18)	2001	4	48,500	215,500	444%	22,500	30,611
(19)	2002	12	13,500	284,083	2104%	(2,722)	97,500
(20)	2003	121	19,223	123,364	642%		
(21)	Total / Avg.	172	23,035	168,285	731%		
(22)	Excl. AY 2003	51	32,078	274,863	857%	5,405	102,094

Below, PICC provides a review of the FWCJUA's booked reserves as of 12/31/2003. Loss and loss adjustment expense reserves are addressed net of reinsurance. The FWCJUA entered into a retrospective reinsurance agreement (also called a loss portfolio transfer, or LPT) with respect to accidents occurring prior to 1/1/2000. Statutory accounting suggests that net loss and loss adjustment expense reserves be booked as if the LPT did not exist, and then record a "contra liability" (essentially, an asset) to reflect the net losses and loss adjustment expenses that will be recovered from the reinsurer. As a matter of simplification, PICC has compared the

FWCJUA reserve net of the contra liability, to PICC's indicated reserves at both a 90% confidence level and a 95% confidence level, excluding accidents that occurred prior to 1/1/2000 (because the FWCJUA's net liability for accidents occurring prior to 1/1/2000, for all practical purposes, is zero).

Statutory insurance accounting requires that an insurer establish a "premium deficiency reserve" with respect to premium received and not earned if the premium to be earned in the future is believed to be insufficient to pay losses and certain expenses. The FWCJUA calculates its rate adequacy based on the reserves it has established for loss and loss adjustment expense. As a result, if the loss and loss adjustment expense reserve is overstated, the premium deficiency reserve will be overstated, and vice versa. PICC has replicated the FWCJUA's calculation of indicated premium deficiency reserve with one change: substituting expected loss ratios for Sub-plan D consistent with PICC average indication of ultimate losses. Based on PICC's calculation, PICC concludes that the premium deficiency reserve booked by the FWCJUA is unnecessary.

Table A below displays a comparison of FWCJUA booked reserves with what PICC concludes would be an acceptable reserve. PICC's conclusion is that while the FWCJUA booked total reserves of \$41,400,000 (see column (C), row (6)), a reserve of \$14,800,000 would have been adequate. The difference of \$26,600,000 PICC attributes to additional "conservatism" on the part of FWCJUA management.

Table A

(all amounts in thousands)

	(A)	(B)	(C)
	Loss & ALAE (a)	ULAE (b)	Loss & LAE (c) =(A)+(B)
(1) JUA Actuarial Estimate Prior to LPT	38,900	4,200	43,100
(2) JUA Booked Prior to LPT			51,500
(3) JUA Contra Liability for LPT			13,800
(4) JUA Reserve Net of All Reinsurance =(2)-(3)			37,700
(5) JUA Premium Deficiency Reserve			3,700
(6) JUA Total Reserve = (4)+(5)			41,400
(7) PICC Avg. Indicated Reserve	22,600		22,600
(8) PICC Reserve at 90% Confidence Level			34,700
(9) PICC Avg. Indicated Reserve for Years 2000 - 2003			11,000
(10) PICC Reserve at 90% Conf. Level for Years 2000 - 2003			14,800
(11) PICC Reserve at 95% Conf. Level for Years 2000 - 2003			15,800
(12) Diff. Between JUA Total Reserve and PICC Reserve at 90% = (6)-(10)			26,600
(13) Diff. Between JUA Total Reserve and PICC Reserve at 95% = (6)-(11)			25,600

The evaluation of the rates and reserves must include, for sub-plan "D," a determination of the adequacy of the reserves established, including an estimate of any deficits incurred or anticipated. Sub-plan D came into existence as a result of Florida Senate Bill 50-A enacted in 2003. The FWCJUA estimated that as of 12/31/2003 Sub-plan D had incurred a deficit of \$9,900,000 on net earned premium of \$1,900,000. The FWCJUA reported that it had written approximately 1,800 Sub-plan D policies as of 12/31/03. Technical Appendix C, Schedule 2, Sheet 4

displays the calculation of the deficit (columns (a) through (c)) provided by the FWCJUA.

Table B, below provides an overview of the same information provided in Technical Appendix C, Schedule 2, Sheet 4.

Table B

	Amount Per Policy	% of Net Premium Earned
a. NET PREMIUM EARNED	\$1,066	- - -
b. NET LOSSES INCURRED:	\$1,313	123%
c. Loss Adjustment Expenses	\$871	82%
d. Servicing Carrier Fees Paid and Payable	\$1,304	122%
e. Commissions Paid and Payable	\$244	23%
f. Gen. & Admin. Expense Paid and Payable	\$423	40%
g. Dpt. of Labor Assessments Paid and Payable	\$317	30%
h. Sub-Tot. Expenses Excl. Prem. Deficiency Rsrv.	\$3,159	297%
i. Premium Deficiency Reserve	\$2,062	193%
j. TOTAL EXPENSES INCURRED	\$5,222	490%
h. GAIN (DEFICIT)	(\$5,480)	(514%)

With respect to net losses incurred and premium deficiency reserve (items (b) and (i) above), PICC separately addresses the actuarial reasonableness of the amounts reported by the FWCJUA. However, it is important as respects the remaining entries to recognize that there is a mis-match of revenue and expenses created by the intricacies of “statutory accounting.”

While total premium written is approximately \$9,900,000, or about \$5,500 per policy, only \$1,900,000, or approximately \$1,066 per policy is earned. And, only earned premium is considered in the revenue part of the FWCJUA’s deficit calculation. In the deficit calculation the full year’s worth of expense is recorded for each policy for unallocated loss adjustment expense (ULAE), and for all underwriting expenses. The result is the appearance that on average each policy will produce an underwriting loss of \$5,480, or 514% of premium. However, with the passage of time, earned premium will increase, but the annualized ULAE and underwriting

expenses will remain the same for policies written through December 31, 2003.

The full calculation of the Sub-plan D deficit calculated by the FWCJUA, displayed in Technical Appendix C, Schedule 2, Sheet 4 shows that the revenue part of the deficit calculation is essentially net premium earned (i.e., earned premium net of reinsurance premium ceded), which is displayed in row (6). Net premium earned per policy is approximately \$1,066.

Columns (d) through (f) in Technical Appendix C, Schedule 2, Sheet 4 are arithmetic added by PICC to help the reader appreciate some of the nuances of the FWCJUA calculation. For example, note that the calculation records underwriting expenses of \$4,351 dollars per policy (row (28)), and total expenses per policy of \$5,222 (row (29)), against earned premium per policy of \$1,066.

Technical Appendix C, Schedule 2, Sheet 1 provides a recalculation of the indicated deficit as of 12/31/2003 for Sub-plan D, with only two differences from the calculation provided by the FWCJUA. First, the estimate of ultimate losses displayed in row (14) is replaced by PICC's mean estimate adjusted to a 90% confidence level. This first change has two components: IBNR Reserves – Direct (i.e., incurred but not reported) in row (9), and; IBNR Reserves – Ceded. The second change is that the FWCJUA's calculation of the Premium Deficiency Reserve (row (27)), is replaced with PICC's calculation at a 90% confidence level. These two changes alone reduce the indicated deficit from \$9,900,000 to approximately \$6,700,000.

Technical Appendix C, Schedule 2, Sheet 2 provides a recalculation of the indicated deficit as of 12/31/2003 for Sub-plan D, again with only two differences from the calculation provided by the FWCJUA. First, the estimate of ultimate losses displayed in Table C, row (14) is replaced by PICC's mean estimate. This first change also has two components: IBNR Reserves – Direct (i.e., incurred but not reported) in row (9), and; IBNR Reserves – Ceded. The second change is that the FWCJUA's calculation of the Premium Deficiency Reserve (row (27)), is replaced with PICC's calculation on a mean estimate basis (i.e., no premium deficiency reserve is needed). These two changes alone reduce the indicated deficit from \$9,900,000 to approximately \$5,400,000.

Perhaps even more telling when considering the relevance of the FWCJUA deficit calculation is the result when one replicates the calculation assuming that Sub-plan D policies incur zero losses. Under this scenario, the FWCJUA calculation would still produce a deficit of

approximately \$3,800,000 as of 12/31/03. The calculation is provided in Technical Appendix C, Schedule 2, Sheet 3.

D. Review of Latest Rates Implemented by the FWCJUA

This project also requires that: “The evaluation shall also include, for all sub-plans, an analysis of the impact of the rates identified in the most recent rate filing by the FWCJUA on anticipated reserves.” The most recent rate filing by the FWCJUA is the one submitted by the FWCJUA on July 7, 2004.

HB-1251 mandates that for Tiers 1 and 2, rates be 125% and 150% of voluntary market rates, respectively. In the FWCJUA’s filing, the only actuarial analysis provided by the FWCJUA is for Tier 3 rates. The FWCJUA calculates an indicated rate differential to be applied to voluntary market (i.e., NCCI) rates of 2.699, which the FWCJUA rounds to 2.70. The calculated rate differential is then converted to a 170% surcharge on voluntary market rates for Tier 3 policyholders.

The FWCJUA rate filing in part depends upon the FWCJUA actuary’s estimate of ultimate losses as calculated in its reserve study. In PICC’s analysis of indicated rates for the FWCJUA, PICC utilizes the structure of the analysis submitted by the FWCJUA. However, PICC departs from the FWCJUA analysis in two important respects:

PICC relies upon its own estimate of ultimate losses by accident year, and after selecting an average expected cost, adjusts that expected cost to a 90% confidence level.

In some instances, the FWCJUA has calculated indicated results and then substituted its judgment for indicated results. PICC has consistently used the average indicated results. However, by substituting the average result and then adjusting that result to a 90% confidence level, PICC is in fact offering an explicit measure of conservatism in lieu of the unquantified conservatism resulting from judgments utilized by the FWCJUA.

Table C, on the following page, provides a comparison of the current FWCJUA rate surcharges by Tier with indicated rate surcharges calculated by PICC.

Table C

Tier	Current	Surcharges	
		Indicated by PICC	
		Mean	@90% CL
1	25%	50%	71%
2	50%	46%	66%
3	170%	100%	127%

CL = Confidence Level

IV. ANALYSIS

A. Discussion of Management Judgment in Setting Reserves and Rates

1. *Review of Reserves as of 12/31/03*

Readers of this report must understand that booked reserves for any property casualty insurer (e.g., the FWCJUA) are always only an estimate of outstanding liabilities, not a certainty. Actual future payments may be more than the reserves booked, or they may be less than the reserves booked. The likelihood that actual future payments will exactly match booked reserves is virtually zero.

In part because booked reserves are only an estimate, around which substantial uncertainty exists, insurers are required by statute and regulation to maintain adequate policyholder surplus. Policyholder surplus is approximately equivalent to “owners’ equity” in traditional accounting terminology. Even if across several years, the aggregate of reserves is consistent with future payments, it is expected that for some years, actual loss payments will exceed reserves, and that surplus will be available to meet those additional payments. In other years, actual payments will be below booked reserves, and the “excess” can be used to replenish surplus.

Actual future payments vary from the mean best estimate of reserves required to pay actual future payments for two reasons:

- a. Parameter Variance – that is, one or more of the assumptions and calculated values used to determine the mean best estimate of required reserves turns out to be inconsistent with the actual results when the results finally become known. For example, a trend of 2% is expected, and actual inflation raises costs by 5%.
- b. Process Variance – that is, all assumptions and calculated values turn out to be correct, but random variation causes an actual result to occur that is different from the expected result (in colloquial terms, unexpected good or bad luck occurs). By analogy, if a fair coin is tossed 100 times, 50 is the mean best estimate of the expected number of heads, but due to random variation (luck), out of 100 tosses it is possible that only 40 heads appear.

If a booked reserve is the mean estimate, there is a slightly higher than 50% probability that actual future payments will be less than

the booked reserve, and a slightly less than 50% probability that actual payments will be more than the booked reserve. By booking a reserve higher than the mean estimate, the probability is increased that actual payments will be less than the reserve, and the probability is decreased that actual future payments will be greater than the booked reserve.

2. Surplus

For whatever policyholder surplus is recorded by the FWCJUA at a point in time (e.g., 12/31/03), if the loss reserve as of that point in time turns out to be larger than the actual future payments for which the reserve was set aside, then the policyholder surplus at the point in time was understated (and if the loss reserve was understated, the policyholder surplus was overstated).

The major purposes of surplus are to:

- a. Have money available to pay losses at times when actual loss payments turn out to be greater than the loss reserves set aside to make those payments.
- b. Fund short-term periods of rate inadequacy if such conditions exist.
- c. Provide sufficient surplus to support increases in annual written premium.

With respect to payments turning out to be larger than reserves, if a traditional insurer does not have sufficient money reserved and/or in surplus to pay claims, the insurance department will liquidate the insurer. If the FWCJUA does not have sufficient money reserved and/or in surplus to pay claims, the FWCJUA is required to assess policyholders for the deficiency. Thus, being a JUA does not by itself cause any disadvantage, as compared to a traditional insurer, as respects the need to have adequate loss reserves and a reasonable amount of surplus.

With respect to short-term periods of rate inadequacy, in some ways the FWCJUA historically has been in a stronger position than traditional insurers in Florida. That is because the FWCJUA had the authority to change its rates immediately, as compared to insurers that must all use NCCI rates that are subject to prior regulatory approval. Legislation in 2003, and in 2004, that mandates specific rates or rate surcharges for particular sub-plans

or tiers of employers reduces the ability of the FWCJUA to withstand periods of rate inadequacy, and thus requires more conservative judgment on the part of FWCJUA management in areas where statutes do not prohibit judgment.

With respect to supporting increases in premium volume, the FWCJUA is at a substantial disadvantage when compared to traditional insurers for the simple reason that an insurer has control over how much business it writes, and the FWCJUA has zero control over how much business it writes. Subject to eligibility requirements, the FWCJUA must write every employer that applies for coverage. If traditional insurers restrict their willingness to write in Florida, all business rejected by traditional insurers ends up in the FWCJUA. Thus, the FWCJUA must maintain a substantially stronger than average surplus. Being the insurer of last resort, by itself, does not affect the need to have more, or less, adequate loss reserves.

3. *Rates and Rating Plans*

The combination of rates and rating plans determines the ultimate premium charged to a FWCJUA policyholder. Premium is intended to cover the expected ultimate cost of claims, expenses of the insurer, and, for private insurers, a reasonable return on the surplus (equity) necessary to support the insurance operations. The FWCJUA has several characteristics that are inherently different from private insurers:

- a. The FWCJUA is not able to control the number of insureds, or amount of premium, it will be called upon to write. Instead, the FWCJUA must write the insurance for all of the employers rejected by the private insurers.
- b. The FWCJUA de facto must charge premiums that are higher than the private insurers for at least the following reasons:
 - i. The FWCJUA by its nature should never be competing with private insurers for business.
 - ii. The employers insured by the FWCJUA on average, although not necessarily for each individual employer, have higher expected costs per \$100 of payroll (i.e., per unit of exposure).

4. Assessments Levied on FWCJUA Policyholders

The Florida statutes permit assessments on Tier 3 policyholders. That is, the FWCJUA may determine that the premium of a group of employers was inadequate, and it is necessary for the FWCJUA to go back to those policyholders and levy a pro-rata assessment, whether or not they are still currently insured by the FWCJUA. This is a right that the FWCJUA appropriately makes great effort to avoid exercising.

B. Net (of Reinsurance) Reserves Booked as of December 31, 2003

1. Overview of the Process

Each year, the FWCJUA has an actuarial consulting firm (the same firm since the FWCJUA was established in 1994) prepare a report that provides the consultant's "best" estimate of required reserves, and a "range of reasonableness" for booked reserves. The FWCJUA then books a reserve that is within the consultant's range of reasonableness. The range of reasonableness has both a lower bound and a higher bound. Each of the bounds is determined by the judgment of the FWCJUA actuary. The FWCJUA actuary sets the lower bound at 90% (90% is a judgment) of the reserve indicated by the actuary's "best" estimate of the required reserve. The FWCJUA actuary sets the higher bound as the reserve that would result if the actuary increases its selected "tail" loss development factors by 50% (which is also a judgment).

The FWCJUA management executed a retroactive reinsurance contract in August 2000, commonly called a loss portfolio transfer, or LPT. Under this LPT, the FWCJUA paid a fixed dollar amount to American Reinsurance Corporation (AmRe), and AmRe assumed virtually all future responsibility for payments on accidents occurring prior to 1/1/2000. The FWCJUA actuary determines its estimate of indicated reserves without reduction for losses that will be reimbursed by AmRe. The FWCJUA books reserves without reduction for losses that will be reimbursed by AmRe, and then books a "contra" liability (i.e., a negative liability, which is analogous to an asset) to reflect elsewhere on its balance sheet the fact that liability for losses on the balance sheet are not net of expected reimbursements from AmRe.

Because a multi-step process is used by the FWCJUA to account for its liabilities, PICC has addresses each of the steps separately. The steps are:

- a. Establish mean estimate of indicated reserves;
- b. Establish range of reasonableness;
- c. Establish booked reserve; and
- d. Reduce liability to be net of LPT.

2. **Mean Estimate**

A “mean estimate,” is an estimate that is the average or most likely outcome from among a variety of possible actual results. Such an estimate is sometimes called a “mean best estimate” (actuarial literature suggests using the terms “mean” and “best” together, is redundant), or “best estimate.” This estimate usually assumes that all of the inputs and assumptions are correct. It is PICC’s understanding that the FWCJUA’s actuary when making assumptions or selections in arriving at its “best” estimate, tends to be “conservative” (higher indicated reserve).

Establishing an estimate of indicated reserves requires numerous actuarial judgments. PICC in its evaluation of the adequacy of FWCJUA’s actuarial best estimate of required reserves did not attempt to analyze each of the literally hundreds of judgments made by the FWCJUA’s actuary. Instead, PICC substituted average results for each of the numerous judgments made by the FWCJUA actuary.

PICC implemented the same methods to calculate indicated ultimate losses that were implemented by the FWCJUA actuary, but used averages rather than judgment selections made by the FWCJUA actuary. New exhibits created by PICC are annotated accordingly.

Technical Appendix A displays PICC’s calculation of required reserves based on the average of the various methodologies implemented by the FWCJUA actuary. When reviewing Technical Appendix A, the reader should be aware that the appendix is a spreadsheet supplied by the FWCJUA actuary, and modified by PICC. Each modification implemented by PICC is printed in **bold**.

Below is an over view of the numerous actuarial judgments implemented by the FWCJUA actuary to arrive at its “best” estimate of indicated reserves.

- a. Age to Age Loss Development Factors (LDFs) – there are 10 years of LDFs based on FWCJUA experience, plus a “tail” LDF. Each dollar loss component is addressed separately for indemnity and medical, and separately for gross of (prior to) reinsurance and net of reinsurance. Further, the FWCJUA actuary decided to analyze loss development in six month, rather than annual, increments that doubles the number of judgment decisions to be made. To determine incurred loss LDFs reflects 84 separate judgments by the FWCJUA actuary ($(10 \times 2 + 1 = 21) \times 2 \times 2 = 84$). The FWCJUA actuary uses several separate development patterns for FWCJUA loss dollars data: (1) incurred loss development; (2) paid loss development; and (3) case reserve development. There are 252 judgments solely for development of loss dollars ($84 \times 3 = 252$).
- b. Age to Age Claim Count Development Factors (CDFs) – the FWCJUA actuary determines CDFs for (1) total claim count development; (2) ratio of claims closed with indemnity payment to claims closed with any payment development; and (3) number of indemnity incurred claims development. Solely for claim count related development there are 63 separate judgments ($21 \times 3 = 63$).
- c. Allocated Loss Adjustment Expense Development Factors (ALAEDFs) – the FWCJUA actuary determines ALAEDFs for paid ALAE, and for the ratio of paid ALAE to paid indemnity losses, which results in 44 additional actuarial judgments.
- d. Selection of Ultimate Losses Based on Results of Multiple Methods – for the 7 oldest years of FWCJUA experience the FWCJUA actuary implements 5 different methods. For the 3 newest years of FWCJUA experience the FWCJUA actuary implements 6 different methods. From the results by year, actuarial judgment determines the best estimate of ultimate losses (i.e., 10 judgments). The methods are applied separately for indemnity and medical losses, separately by net and gross of reinsurance, resulting in a total of 40 judgment selections of ultimate losses.
- e. There are numerous judgments implemented as respects premium development, collectibility of premium due, and a variety of other judgments.

PICC in its evaluation of the adequacy of FWCJUA's actuarial estimate of required reserves did not attempt to analyze each of the literally hundreds of judgments made by the FWCJUA's actuary. Instead, PICC noted that with respect to selection of Age to Age Development Factors (AADFs), the FWCJUA actuary was judgmentally making its selection of each AADF after viewing the results of average AADFs calculated based on a variety of averaging methods. PICC then made its selection of each AADF such that the unweighted average of the results of the FWCJUA actuary's averaging methods was always PICC's selected AADF.

Similarly, after determining selected AADFs, the FWCJUA actuary calculated indicated ultimate losses using several methods, and then judgmentally selected ultimate losses, year by year on both a net and gross of reinsurance basis, separately for indemnity and medical losses.

PICC implemented the same methods to calculate indicated ultimate losses implemented by the FWCJUA actuary, but used average of averages AADFs rather than judgmentally selecting AADFs as was done by the FWCJUA actuary. And, rather than judgmentally selecting estimated ultimate losses as was done by the FWCJUA actuary, PICC's "selection" by year, gross and net of reinsurance, and by type of loss, was in all instances the unweighted average of the results from the various methods implemented by the FWCJUA actuary to estimate ultimate losses.

3. *Range of Reasonableness*

A mean estimate of an indicated reserve is one where it is expected that approximately 50% of the time, the actual future payments will exceed the estimate, and approximately 50% of the time actual future payments will be less than actual future payments. PICC has differed from the FWCJUA actuary in how to address the probability that in some years actual losses will exceed indicated reserves.

- a. PICC first calculated indicated reserves based on selection of "average" results in each step of the calculations performed by the FWCJUA actuary.
- b. PICC then recalculated indicated reserves as described in (a) above, but with the "tail" loss development factors increased by 50%. The purpose of this calculation is to introduce an upper bound factor to reflect parameter

variance. PICC selected this procedure to reflect parameter variance because the process was already being used by the FWCJUA actuary in establishing that actuary's upper bound.

- c. PICC used the results from (b) above to then account for process variance. Accounting for process variance is often done by application of "Monte Carlo" computer simulation. PICC ran such simulations of the indicated reserves including the "tail" loss development factor adjustment, 1,000 times. Running the computer simulation requires certain inputs:
 - i. An expected distribution of losses by size of claim. PICC used the Lognormal distribution, a common choice among actuaries for workers compensation.
 - ii. An expected distribution of claim frequency. PICC used the Poisson distribution, a common choice among actuaries for workers compensation.
 - iii. An expected coefficient of variation (CV). PICC used a CV of 3.0, a common choice among actuaries for workers compensation. This is essentially a measure of the variability among individual claims of outstanding loss from one claim to the next,
 - iv. An expected number of claims. PICC used the number of open claims, including IBNR claims (as calculated by the FWCJUA actuary).
 - v. An expected average severity. PICC calculated this value by dividing the indicated reserve including the 50% "tail" adjustment by the number of open claims.

Technical Appendix B, Schedule 1, Sheet 2, column (3) displays PICC's indicated reserves net of reinsurance and net of the LPT at a variety of confidence levels.

It is preferable that item (iii.) above, the CV, be calculated using the FWCJUA's historical data. PICC did not have access to the individual claim data necessary to separately calculate a CV based on FWCJUA data. Instead, PICC assumed a CV of 3.0. PICC's assumption is based on the experience of its staff related to other workers compensation insurers and self-insurers (albeit, not JUAs).

PICC’s assumption is also based on reviews of reports by other actuarial consulting firms indicating CVs in the range of 1.5 to 3.0 for workers compensation. Finally, PICC’s assumption of a CV of 3.0 is based on its experience “curve fitting” to match a size of loss distribution with excess loss factors published by NCCI in an assignment for a reinsurer a few years ago.

In a discussion on November 4, 2004 with the FWCJUA actuary, that actuary stated that it was his experience that a CV of 7.0, or even 15.0, were reasonable expectations of the CV underlying the FWCJUA size of claim distribution. While PICC has not seen data that would support the FWCJUA actuary’s assertion, nonetheless PICC performed a sensitivity analysis on alternate assumptions for the CV.

The table below provides indicated reserves at mean, 90% and 95% probability levels based on CVs of 3.0, 7.0, and 15.0 for comparison with the total reserve net of LPT booked by the FWCJUA.

	Assumed CV		
	3.0	7.0	15.0
	(dollars in thousands)		
Booked	41,400	41,400	41,400
PICC:			
Mean	11,000	11,000	11,000
90%	14,800	16,700	18,800
95%	15,800	19,200	24,700

As can be observed in the table above, if the FWCJUA actuary’s assumption about the CV inherent in the FWCJUA’s claim data is correct, PICC’s assumption of a CV of 3.0 would understate the indicated reserve at higher probability levels. Two further conclusions can also be drawn from the above table.

An accurate analysis of the CV is of lesser importance at lower probability levels. For example, at 90% the difference between the result at a 3.0 CV, and the result at a 15.0 CV is \$4,000,000. At 95% the difference is \$8,900,000. This difference also demonstrates that as one progressively requires a higher level of probability, the required reserve increases exponentially (as does the probability that the reserve will ultimately turn out to be substantially excessive).

Second, the booked reserve is substantially higher than the net reserve calculated by PICC using a 15.0 CV at the 90% and 95% probability levels.

4. *Booked Reserve for Losses and Loss Adjustment Expense Net of LPT*

Because of the LPT executed by the FWCJUA, for all practical purposes, the FWCJUA has zero expected liability for accidents that occurred prior to 1/1/2000. While booking reserves for accidents occurring prior to 1/1/2000 may comply with statutory accounting practices, the effect is to overstate the true liabilities of the FWCJUA, particularly given that the FWCJUA selects a reserve level greater than its actuary's "best" estimate.

5. *Relationship of Reserves to Surplus*

In general terms, for each dollar that loss reserves are overstated (or understated), true policyholder surplus is understated (or overstated). For example, if loss reserves are overstated by \$1,000,000, then true surplus is understated by approximately \$1,000,000.

The FWCJUA Annual Statement (AS) for the year ending 12/31/03 displays a negative Surplus (page 3, line 35) of \$4,500,000. That is, the AS is indicating that as of December 31, 2003 FWCJUA resources necessary to pay claims is inadequate by \$4,500,000. PICC disagrees that the FWCJUA was in a deficit position as of December 31, 2003.

C. Sub-Plan D Deficit as of 12/31/03

1. *Definition of "Deficit"*

"Webster's New World Dictionary", Third College Edition, copyright 1988, defines the word "deficit" as the amount by which a sum of money is less than the required amount; specifically, an excess of liabilities over assets, of losses over profits, or of expenditure over income.

Taking the portion of the definition: "the amount by which a sum of money is less than the required amount" leaves to judgment the quantification of "required amount." As noted earlier, reserves are an estimate of liabilities, and subject to significant variance. And thus, it would seem reasonable to include in the required amount

some provision for the possibility that actual losses end up being an amount larger than the mean estimate of the indicated reserve.

Taking the portion of the definition: “specifically, an excess of liabilities over assets” would require that the most probable outcome as respects reserves versus future payments should be the measure of liabilities.

2. Mean Estimate Versus 90% (or Other) Confidence Level

PICC has utilized the framework of the deficit calculation provided by the FWCJUA, with certain changes, to provide estimates of the Sub-plan D deficit as of 12/31/03. Under one scenario PICC uses the estimate of ultimate losses from the reserve study based on “average of averages” without the introduction of confidence level analysis. Under a second scenario, PICC replicates the first scenario, but introduces its estimate of ultimate losses at a 90% confidence level. Under a third scenario PICC calculates the indicated deficit using the FWCJUA’s process, but assuming that zero losses are incurred by Sub-plan D policyholders.

Technical Appendix C, Schedule 2, Sheet 4 displays the FWCJUA’s calculation of the Sub-plan D deficit (\$9,865,000).

Technical Appendix C, Schedule 2, Sheet 2 displays PICC’s indicated deficit (\$5,383,000) using FWCJUA’s calculation, and substituting PICC’s average of averages estimate of ultimate losses.

Technical Appendix C, Schedule 2, Sheet 1 displays PICC’s indicated deficit (\$6,677,000) using FWCJUA’s calculation, and substituting PICC’s 90% confidence level estimate of ultimate losses.

Finally, Technical Appendix C, Schedule 2, Sheet 3 demonstrates that the FWCJUA calculation of the Sub-plan D deficit would be \$3,789,000 even if the policyholders in Sub-plan D had zero losses.

PICC believes it is beyond the scope of its actuarial assignment to support the selection of one result over the other in determining the deficit. Rather, evaluation of the deficit depends upon the funding level (of losses, and of expenses) that the reader finds appropriate.

D. Current Rates

The FWCJUA's rate level analysis is dependent in part on the FWCJUA's actuarial analysis underlying required reserves as of 12/31/03. PICC has implemented FWCJUA's rate level analysis, but introduced changes (identified in **bold**) as displayed in Technical Appendix D. The changes are as follow:

1. *Estimate of Ultimate Losses*

PICC has used its estimate of ultimate losses based on average of averages in lieu of judgment selections introduced by the FWCJUA actuary. PICC has then adjusted its results to a 90% confidence level.

2. *Relativity of Expected Losses by Tier*

The FWCJUA actuary judgmentally selected a loss ratio relativity of 1.15 for Tier 3 as compared to the FWCJUA overall loss ratio. PICC analyzed data for FWCJUA policies that NCCI provided to the FWCJUA actuary (for use in calculation of the impact of current surcharges by tier) and found no valid basis for this judgmental selection. Although insureds placed in Tier 3 are expected to have higher losses than insureds placed in Tiers 1 and 2, Tier 3 premiums will also be higher due to experience modification factors above 1.10. ARAP surcharges will increase Tier 3 standard premiums even higher. PICC found that the loss ratios for Tier 3 insureds based on premiums modified to reflect loss experience were not demonstrably worse than the loss ratios for Tiers 1 and 2.

In response to a follow up data request, the FWCJUA actuary provided to PICC a file that the FWCJUA actuary had obtained from NCCI containing data by risk for policies becoming effective from 1994 through October 2002. The FWCJUA actuary had implemented a "probabilistic model" applied to policies that became effective between 1/1/01 and 10/31/02 (22 months).

PICC conducted two comparisons to review the likely reasonableness of the FWCJUA actuary's assumption that a 1.15 factor should be applied in determination of the Tier 3 expected loss ratio and resultant Tier 3 surcharge (FWCJUA actuary's Actuarial Memorandum, Exh. II, Sheet 1, Row (10)).

- a. Using the data from 1994 through October 2002, PICC compared the loss ratio (losses divided by premium after

experience rating) of all risks with a experience rating modification greater than 1.10 (a Tier 3 eligibility requirement – over 90% of the Tier 3 volume is expected to be in Tier 3 because of this criterion) to the loss ratio of all remaining risks.

- b. Using the data from January 2001 through October 2002, and the assignment of risks to Tiers using the FWCJUA's probabilistic model, PICC compared the loss ratio of risks expected to be assigned to Tier 3 to the loss ratio for all other risks.

Neither of the above two comparisons supported a Tier 3 loss ratio relativity above 1.00. Accordingly, in PICC's calculation of the indicated surcharge, PICC substituted a Tier 3 loss ratio relativity factor of 1.00 for the FWCJUA actuary's assumed factor of 1.15.

3. *Expense Provisions Underlying Current Tier 3 Rates*

PICC accepted the expense provisions underlying the FWCJUA actuary's calculation of the rate surcharge for Tier 3, and assumed that the same expense provisions apply to all three Tiers.

4. *Provision for Contingency*

The FWCJUA actuary introduced a 5% of premium provision for "contingency." There was no support for why such a value should be 5% as compared to any other number (e.g., 0% or 10%), other than "judgment." PICC omitted this provision because PICC's estimate of losses is at the 90% confidence level, which by definition includes quantified provision for contingency.

5. *Provision for Surplus*

The FWCJUA actuary introduces a 0% of premium provision for "surplus." This is mathematically equivalent to not having any provision for growth of surplus. PICC believes it would be appropriate for the FWCJUA to anticipate future premium volume, and to adjust the provision for surplus to a higher value when it anticipates premium growth, and to a lower (including negative), when it anticipates that future premium writings in the FWCJUA will decrease. PICC concludes while such analysis is appropriate, it is beyond the scope of this project, and PICC accepted the 0% provision for surplus growth at this time.

6. *Investment Income*

The FWCJUA discounts losses in its rate level analysis using a 1.5% interest rate, and an assumed 14 year payment pattern to arrive at a 95% discount factor to apply to nominal losses. PICC uses interest rates ranging from 1.75% to 4.2% depending on the expected timing of payments (lowest interest rates for payments expected to be made soonest, higher interest rates for payments expected to be made years from now), and the payment pattern derived directly from the paid loss development factors used in the analysis to determine ultimate losses. PICC calculates a discount factor of 91.2%.

7. *Tiers 1 and 2*

Because HB-1251 mandates rate surcharges for Tiers 1 and 2, the FWCJUA did not file indicated surcharges for these two Tiers. PICC used the same process as it used for Tier 3 to calculate indicated surcharges for Tiers 1 and 2. To state the obvious, Florida statute sets the surcharges for Tiers 1 and 2, and the indicated surcharges for Tiers 1 and 2 are provided only for informational purposes.

V. ADDITIONAL OBSERVATIONS

A. FWCJUA Reserves and Rates Need to be “Conservative”

Both the FWCJUA and PICC conclude that booking of reserves, and determination of rates, need to be done on a conservative (i.e., higher than mean expected) basis. There is a fundamental difference in approach as respects both reserving and ratemaking by the FWCJUA as compared to PICC. That difference is that the FWCJUA has introduced conservatism by implementing many judgments that, when combined in a single analysis, produce a conservative result. The FWCJUA process does not allow quantification of the dollar effect of the various conservative judgments.

PICC, on the other hand, recommends introducing conservatism by utilizing a probability of outcomes or confidence level methodology. A fundamental difference between the two approaches is that with the FWCJUA approach it is very difficult for anyone to evaluate how much of a reported deficit, or rate increase, is due only to the unquantified level of conservatism, while in the PICC approach the level of conservatism is explicitly identified.

B. Expenses in Operating the FWCJUA

It is outside of the scope of this actuarial assignment to specifically evaluate the expenses of the FWCJUA that are a combination of internal administrative expenses, and expenses charged by the servicing carrier. However, the fact that Sub-plan D would generate a deficit with zero loss dollars does suggest that the FWCJUA should look at whether both internal administrative expenses and servicing carrier expenses can be reduced.

C. Uncollectible Premium

The cost of uncollected premium is shifted to FWCJUA policyholders who do pay their premium. The percentage of written premium recorded by the FWCJUA as uncollectible is substantially higher than the percentage of uncollectible premium recorded by other state assigned risk programs.

NCCI staff advised PICC that uncollectible premium cited for other states were reported in accordance with the NAIC’s instructions for the annual statement. It is PICC’s understanding that the FWCJUA’s reporting of uncollectible premium is determined in the same manner, and thus the percentage of uncollectible premium to total premium reported by the FWCJUA is comparable to percentages in other states.

It is outside of the scope of this actuarial assignment to specifically evaluate the causes of uncollectible premium, and the efficiency of actions by the FWCJUA to remedy the problem. However, the disparity as compared to other states does suggest that improvement is possible.

D. “Medical Only” Versus “Lost Time” Claims

“Medical Only” (MO) claims are those where the injured workers receive medical treatment and return to work before becoming eligible for indemnity payments. “Lost time” (LT) claims are those where the injured workers receive both medical treatment and indemnity payments. NCCI data indicates that in the Florida voluntary market, approximately 23% of all claims are LT and that on average, LT claims cost 73 times the average cost of MO claims.

The FWCJUA actuary’s report on reserves as of 12/31/03 indicates that 39% of all FWCJUA claims involve indemnity payments. The comparatively high proportion of FWCJUA claims requiring indemnity payment may be due to the nature of FWCJUA employers and injured workers (more hazardous occupations, less cooperative policyholders, etc). However, it is possible that part of the reason for the high proportion of LT claims being paid by the FWCJUA rests with either the administration, or the servicing carrier, or both. PICC recommends that effectiveness of claim adjustment be given additional attention.

VI. ASSUMPTIONS AND NOTES

- A. Time Periods - The experience is categorized by accident year, and includes claims incurred through December 31, 2003 of the indicated year. The valuation date for the study is December 31, 2003.
- B. Data Specifications - Claim amounts are shown as dollars, unless otherwise indicated.
- C. Consistency - The conclusions are predicated on the assumptions that the selected reporting, reserving, and payment patterns, frequency and severity trends, and claim distributions apply, and will continue to apply, to the program (insured book of business). The risk exposure covered by the program as well as the claim reserving, management, and settlement practices are assumed to be consistent over time, except as noted.
- D. Discounting - The conclusions, except where specifically stated, do not include any discount for future investment income.
- E. Contingency Margin - The conclusions do not include any unstated margin for unanticipated contingencies.
- F. Trend - There are several instances in both the reserve study and rate filing prepared by the FWCJUA actuary where trend factors are used and attributed to NCCI. PICC in its analysis used the same trend factors used by the FWCJUA actuary without independently evaluating the reasonableness of trend factors used by the FWCJUA actuary. However, PICC notes that in some instances the trend factors used by the FWCJUA actuary are not consistent with trend factors approved by the Florida Office of Insurance Regulation.

VII. CAVEATS AND LIMITATIONS

- A. Entire Document - The study conclusions are developed in the accompanying text and exhibits, which together comprise the report.
- B. Distribution - The report in draft format was prepared for the sole use of the Auditor General, and distribution to others without our prior written consent is unauthorized. With our consent, the draft report may be distributed only in its entirety.
- C. Data Reliance - The data for this study was provided by the FWCJUA and/or the actuary for the FWCJUA. In the study, we relied on the accuracy and completeness of this data without independent audit. If the data is inaccurate or incomplete, our findings and conclusions may need to be revised.
- D. Management Reliance - Information concerning the risks insured, underwriting, and pricing was provided by Laura S. Torrence, Executive Director and Secretary of the FWCJUA, Laura Reay Lopez, Treasurer for the FWCJUA, and the FWCJUA's actuary. In the study, we relied on the accuracy and completeness of this information without independent verification. If the information is inaccurate or incomplete, our findings and conclusions may need to be revised.
- E. Reinsurance - All reinsurance was considered to be valid and fully collectible, as asserted by the FWCJUA. We made no assessment, and do not express any opinion, concerning the appropriateness of this assertion. PICC does note that American Re-Insurance Company (reinsurer for the LPT) is "A" rated by A. M. Best, and is an authorized reinsurer for workers compensation by the Florida Office of Insurance Regulation.
- F. Loss – Related Balance Sheet Items – The loss reserve analysis may have implications for other loss-related balance sheet items. These other items may include contingent commissions, retrospective premium adjustments, policyholder dividends, premium deficiency reserves, minimum statutory reserves, deduction for unauthorized reinsurance, and income taxes. We made no assessment, and do not express any opinion, concerning reserves for these other items, except as respects the indicated premium deficiency reserve for Sub-plan D.

- G. Underlying Assumptions - In addition to the assumptions stated in the report, numerous other assumptions underlie the calculations and results presented herein.
- H. Study Foundations - The study conclusions were based on analysis of the available data and on the estimation of many contingent events. Future costs were developed from the historical claim experience and covered exposure, with adjustments for anticipated changes.
- I. Significant Digits - Numbers in the exhibits are generally shown to more significant digits than their accuracy suggests. This has been done to simplify review of the calculations.
- J. Assets - We have assumed that the reserves are supported by valid assets, which have appropriate maturities and sufficient liquidity to meet the cash flow requirements of the FWCJUA. We make no guarantee that FWCJUA surplus will prove sufficient to pay its outstanding claims.
- L. Uncertainty - Due to the inherent uncertainties inherent in the estimation of future costs, it cannot be guaranteed that the estimates set forth in the report will not prove to be inadequate or excessive and actual costs may vary significantly from our estimates.
- M. Unanticipated Changes - Unanticipated changes in factors such as judicial decisions, legislation actions, claim consciousness, claim management, claim settlement practices, and economic conditions may significantly alter the conclusions.
- N. Best Estimate - These caveats and limitations notwithstanding, the conclusions, i.e. reserves at a mean, and at a 90% confidence level, and at other confidence levels represent our best estimate of the actuarial status and funding requirements of the program as of the date of this report.
- O. Lack of Data and New Situations – Only certain FWCJUA loss and LAE development data was available to us for use in this assignment. Therefore, we relied on some data aggregated by rating organizations and statistical agents as provided in the reports of the FWCJUA actuary. We assumed that this experience is applicable to the FWCJUA.