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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

January 24, 2017

Mr. Kenneth R. Theobalds
Chairman of the Board
New York State Insurance Fund
199 Church Street
New York, NY 10007

Re: Report 2015-1A-001

Dear Chairman Theobalds:

Our Office examined[1] premiums the New York State Insurance Fund (NYSIF) charged two policyholders, North Shore Hospital (North Shore) and King Kullen Supermarket (King Kullen), under a Third Party Administrator (TPA) agreement with Risk Management Planning Group (RMPG), now known as York Risk Services Group. During the period 2001 through 2012, NYSIF charged North Shore and King Kullen more than $215.6 million and $30.3 million in premiums, respectively. During the same period, NYSIF also provided discounts of more than $118.7 million and more than $6.6 million to North Shore and King Kullen, respectively.

The objectives of our examination were to determine if NYSIF: (i) effectively addressed the risk of RMPG serving in conflicting roles of insurance broker and TPA for North Shore and King Kullen policies; and (ii) followed its policies and standard industry practices when calculating premiums and providing discounts to North Shore and King Kullen.

A. Results of Examination

We found NYSIF did not effectively address the risk of RMPG serving in conflicting roles or follow its policies and standard industry practices when calculating $245.9 million in combined premiums and providing $125.3 million in combined discounts for North Shore and King Kullen.

NYSIF allowed RMPG to: represent North Shore and King Kullen as its broker to negotiate favorable insurance rates with NYSIF; and represent NYSIF as the TPA to administer the insurance claims. NYSIF provided no evidence that it established procedures to effectively guard

[1]We performed our examination in accordance with the State Comptroller's authority set forth in Article V, Section 1 of the State Constitution, as well as Article II, Section 8, and Article VII, Section 111 of the State Finance Law.

against the increased risk that RMPG may not fairly represent information pertinent to NYSIF's premium pricing decisions (i.e., reserves) in an effort to garner lower premiums and discounts for these policyholders. In fact, with respect to RMPG's role as the TPA, an independent claims and financial audit of RMPG in 2010 and multiple reviews of RMPG's practices by an outside consultant in subsequent years concluded RMPG under reserved for claims of these policies. In response, NYSIF adjusted the reserves of the select claims that were audited. Despite the evidence of RMPG under reserving, NYSIF failed to conduct a comprehensive review of North Shore and King Kullen to ensure proper reserves for all claims, and failed to ensure RMPG established controls to prevent under reserving.

Importantly, NYSIF failed to follow its own internal policies and standard industry practices to determine premiums and discounts related to the North Shore and King Kullen policies: NYSIF did not take into account additional administrative expenses associated with North Shore and King Kullen policies; according to independent reviews at the request of NYSIF, NYSIF repeatedly did not receive reliable claim reserves from RMPG; NYSIF exceeded certain maximum allowable discounts pursuant to internal NYSIF policies; NYSIF did not consider experience ratings when determining discounts; and NYSIF failed to document why it deviated from established policies as required by internal procedure and could not explain during our examination why it had deviated. NYSIF priced North Shore and King Kullen premiums without critical information to ensure the premiums collected would be sufficient to cover the ultimate cost of the claims. Discounts totaling $118.7 million for North Shore and $6.6 million for King Kullen were provided despite the missing information and without required documentation to support the decisions.

In addition, we found NYSIF officials did not evaluate the financial impact of the TPA agreement with RMPG for the North Shore and King Kullen policies, including the administrative expenses associated with those policies. NYSIF collected $245.9 million in premiums from North Shore and King Kullen and projects its liabilities on those policies total $273.1 million. The liabilities do not include NYSIF's administrative expenses for these policies. North Shore and King Kullen are no longer active NYSIF policyholders. However, NYSIF must continue to pay for all North Shore and King Kullen claims filed during the years they were actively insured with NYSIF.

Finally, NYSIF undercharged North Shore and King Kullen up to a cumulative $14.1 million for workers' compensation assessments, which amounts to an additional discount on top of the $125.3 million.

We shared a draft report with NYSIF officials and considered their comments (Attachment A) in preparing this final report. The comments of the State Comptroller on NYSIF's response are included in Attachment B. In response to the draft report, NYSIF stated they disagreed with our findings and recommendations. However, in response to our examination, NYSIF officials stated they reminded underwriting staff that pricing decisions must be recorded in the underwriting system and officials would monitor adherence to this requirement through its Internal Audit process. NYSIF also advised that after the examination scope period, it established a new model for pricing policies. As a result, NYSIF proposed a significantly lower discount for North Shore and eliminated the discount for King Kullen. North Shore and King Kullen did not renew their policies with NYSIF at these revised discounts.

B. Background and Methodology

NYSIF is a self-supporting agency of the State of New York (State) that provides a guaranteed source of workers' compensation insurance coverage to employers within the State. NYSIF's operating income is derived solely from insurance premiums and investments. The law requires NYSIF to price premiums at the lowest possible rates while maintaining a solvent fund and reasonable reserves and surplus in the event of unanticipated costs.

RMPG provides services as an insurance broker for policyholders. As an insurance broker, RMPG gathers pertinent information from its clients, assesses their insurance needs and negotiates with insurance companies to find the most suitable insurance at the lowest price. Policyholders pay RMPG a broker's fee for these services.

In 2001, RMPG proposed bringing its clients to NYSIF for workers' compensation insurance coverage and to administer the policies for NYSIF at no charge to NYSIF. NYSIF accepted RMPG's proposal in 2001 and commenced the TPA arrangement. NYSIF did not memorialize the agreement in writing until 2004.

Under the TPA agreement, NYSIF determines the amount to charge policyholders for insurance premiums. This includes whether to provide any discounts. In evaluating whether to provide a discount, NYSIF should use a variety of data including the New York Compensation Insurance Rating Board (NYCIRB) rates, NYSIF policies and standard industry practices. NYSIF also should ensure it receives accurate reserves information from the TPA (RMPG) for policies.

In its response to the draft version of this report, NYSIF indicated that in 2012, with the help of a paid consultant, NYSIF created a new pricing model for medium to large policies like North Shore and King Kullen. NYSIF further stated premiums determined under this model are now subjected to three to four layers of review before a final premium is approved. Our Office has not conducted tests to determine if the model ensures premiums are priced appropriately and underwriting decisions are sufficiently documented.

To perform our examination, we reviewed NYSIF policies and procedures, the TPA agreement, NYSIF records, and other documentation relevant to the premiums charged and discounts provided to North Shore and King Kullen. We also interviewed officials from NYSIF, RMPG, the

Workers' Compensation Board (WCB), NYCIRB, the Department of Financial Services (DFS), and the Department of Labor (DOL).

We requested a standard letter from NYSIF management to represent, to the best of their knowledge, all records and pertinent data were made available and that all relevant matters have been disclosed to our auditors. NYSIF management did not provide this or any appropriate, alternative representation, which leaves open the question whether NYSIF is aware of additional information relevant to the examination that was not disclosed. Also, NYSIF took issue with our staffs' well-established audit practice to hold interviews with, and obtain information directly from, pertinent NYSIF management and staff without the presence of or intervention from a third party—in this case from NYSIF's "audit response team." These actions by our auditors are consistent with generally accepted government auditing standards and allow our auditors to have increased reliance on the information obtained.

We provided NYSIF with written preliminary findings of our examination on August 1, 2016 and a draft copy of this report on November 17, 2016 and asked officials to respond to the findings' accuracy and completeness. This is a customary part of the examination process to ensure the factual accuracy of findings and to enable the entity under examination to provide any further information relevant to the matter. NYSIF officials stated the amount of discounts we cited is the approximate amount of the discounts provided to North Shore and King Kullen, but declined to address the reasons for the discounts. We considered comments NYSIF officials provided on other matters as we prepared this report.

C. Details of Findings

1. Conflicting Roles

NYSIF allowed RMPG to serve as both the representative broker for North Shore and King Kullen and the representative insurance administrator (TPA) for NYSIF. As the broker for these policies, RMPG had an obligation to secure suitable insurance at the lowest possible premium for its clients. As the TPA for NYSIF, RMPG had an obligation to provide accurate information to NYSIF. This enables NYSIF to charge appropriate premiums to cover the ultimate cost of claims for the North Shore and King Kullen policies plus proper reserves.

NYSIF did not pay RMPG for its services as administrator under the TPA agreement, but North Shore and King Kullen paid RMPG broker fees. Despite this arrangement, there is no evidence that NYSIF established sufficient means to effectively guard against the increased risk that RMPG would have acted in the best interest of North Shore and King Kullen as opposed to NYSIF. As a result, these conflicting roles increased the risk that RMPG may not have fairly represented information pertinent to NYSIF's premium pricing decisions in an effort to garner lower premiums and discounts for its clients. In addition, the independent consultant's consistent findings that

RMPG under reserved for claims, as discussed later in this report, bears out concerns that NYSIF did not effectively guard against this risk.

2. Failure to Follow Established Policies and Standard Industry Practices

We found that NYSIF consistently failed to follow established internal policies and industry practices when calculating $245.9 million in premiums and providing discounts totaling $125.3 million to North Shore and King Kullen. Specifically, NYSIF priced North Shore and King Kullen premiums without critical information (e.g., administrative expenses, accurate reserve information), to ensure premiums collected would be sufficient to cover the probable costs of claims. NYSIF also exceeded the maximum discounts allowed for hospitals, and failed to sufficiently document all underwriting decisions or deviations from established policies.

a. Administrative Expenses

When pricing premiums, it is standard industry practice to consider the anticipated costs of future claims, which includes administration expenses, and the combined loss ratio. The combined loss ratio is the measure of the premiums an insurer earns relative to the total it paid and expects to pay out in claims, plus its administrative expenses.

We requested the NYSIF Chief Financial Officer provide us with the combined loss ratios for North Shore and King Kullen policies. The CFO stated, "We do not have the information, accordingly, we are unable to complete your request." We also asked NYSIF to provide us with the total claim expenses for the policies at the times NYSIF made the premium decisions. NYSIF did not provide us with this information. Therefore, NYSIF priced North Shore and King Kullen premiums without information critical to ensuring the premiums collected would be sufficient to cover claims liabilities and related administration expenses.

b. Failure to Maintain Proper Reserves

Insurance companies set aside money, known as reserves, to provide funding for anticipated losses over the life of a claim. In its role as TPA, RMPG was responsible for, among other things, setting reserves for North Shore and King Kullen policies. According to the NYSIF underwriting manual, accurate reserving is vital to the fiscal health of NYSIF and improper reserving practices result in inaccurate premium pricing. If an insurance company under reserves for claims, it will not charge enough premium to cover the total costs of all potential claims. A continued practice of under-reserving could lead to a shortfall, which would require the insurance company to use funds from other sources to cover the cost of claims. As of April 2016, premiums charged to North Shore and King Kullen have totaled $245.9 million, while NYSIF projects liabilities of $273.1 million.

NYSIF engaged an independent claims and financial audit of RMPG in 2010. Auditors concluded RMPG generally under reserved for claims. In addition, NYSIF hired an outside consultant to review reserves for North Shore and King Kullen claims. For external audits conducted during the period 2011 through 2014 the consultant found RMPG under reserved for claims on both policies. NYSIF took corrective action on the specific claims the consultant examined to ensure a more appropriate reserve. However, NYSIF did not effectively address the risk RMPG's conflicting roles poses to the premium setting process, and the potential that it is the cause of RMPG's practice to under reserve North Shore and King Kullen claims.

NYSIF's Director of Underwriting confirmed RMPG was under reserving for claims. Despite having this information, NYSIF continued to rely on RMPG's reserve calculations to determine premiums and provide discounts to North Shore and King Kullen which were never justified in writing as required by NYSIF policy.

c. Failure to Adhere to Maximum Discount for Hospitals

According to NYSIF policies from 2009, the maximum discount allowed for hospitals is 20 percent. However, during the period 2001 through 2012, NYSIF provided North Shore with discounts that ranged from 25 to 45 percent. NYSIF did not provide any written documentation to support these decisions as required by agency policy, and a consultant NYSIF engaged in 2012 to develop a model to price premiums for medium to large policies described the RMPG TPA policies as "way underpriced." The consultant specifically characterized the discounts NYSIF gave to North Shore as a "sweetheart deal."

d. Consideration of Experience Ratings

Standard industry practice also calls for insurance companies to evaluate an employer's experience rating when setting premiums. This is an indicator of the safety of an employer's work environment and reflects the amount of losses of an individual employer compared to the amount of losses of similar employers. NYSIF obtains experience ratings from NYCIRB. NYSIF's underwriting manual requires evaluation of an employer's experience rating for at least the previous three years when determining premiums.

King Kullen's experience rating was significantly higher than that of similar employers during the period 2008 through 2012 (a high rating indicates higher than average employee workplace claims). As a result of the higher experience rating, DOL required King Kullen to participate in a workplace safety and loss prevention program and implement a plan to improve worker safety and reduce workers' compensation costs.

Despite these high experience ratings, NYSIF provided King Kullen with discounts that ranged from 10 to 30 percent and did not document the reasons for the discounts. The Director of

Underwriting did not have examples of other policyholders with high experience ratings that also received similar discounts.

e. Failure to Document Deviations from Established Policies and Procedures

In total, North Shore and King Kullen received more than $118.7 million and more than $6.6 million in discounts, respectively. We found the Director of Underwriting did not document his rationale for providing discounts to North Shore or for deviating from NYSIF policy when providing North Shore with discounts exceeding the maximum allowed for hospitals. In addition, the Director of Underwriting did not sufficiently document his decisions to provide discounts to King Kullen, despite King Kullen's high experience rating.

When questioned by our auditors during the course of this examination, which spanned more than two years, the Chairman of the NYSIF Board of Directors, the Director of Underwriting, the Actuarial Director, and the CFO could neither provide a sufficient explanation for providing North Shore and King Kullen with these levels of discounts nor recall the circumstances that warranted them. Further, NYSIF officials provided no explanation for the discounts during the time we provided them for comment on our written, preliminary findings and draft report for this examination.

3. Financial Impact of NYSIF's Pricing and Discount Decisions

Despite the potential risks associated with having the TPA as both broker and administrator, NYSIF officials did not evaluate the financial impact of the TPA arrangement with RMPG for the North Shore and King Kullen policies. For example, NYSIF did not quantify the associated administrative expenses and could not provide the combined loss ratios when we asked for them for both of these policies. NYSIF collected $245.9 million in premiums from North Shore and King Kullen and projects its liabilities on those policies total $273.1 million. The liabilities do not include NYSIF's administrative expenses for these policies. North Shore and King Kullen are no longer active NYSIF policyholders. However, NYSIF must continue to pay for all North Shore and King Kullen claims filed during the years they were actively insured with NYSIF.

NYSIF officials have stated that the projected deficit of $27 million (the amount that projected liabilities exceed premiums collected) should not be considered a loss because it does not take into account the investment income earned on the premiums. There is no record that investment income was considered in the NYSIF premium determinations and NYSIF's underwriting manual does not indicate that investment income is a factor in determining premiums.

NYSIF appears to have priced premiums and made decisions to provide discounts to these policies without knowing or considering the full financial impact of these decisions and without providing any record – pursuant to NYSIF policy – of why the decisions were appropriate at the time they were made. Therefore, it cannot be concluded from the information provided to us that an unsubstantiated amount of investment earnings can mitigate NYSIF's failure to properly price North Shore and King Kullen premiums or to provide unjustified discounts. It cannot be concluded in retrospect that investments can address NYSIF's failure to properly price North Shore and King Kullen premiums or to provide unjustified discounts.

4. Undercharged WCB Assessments

WCB protects the rights of employees and employers by ensuring the proper delivery of benefits to those who are injured or ill, and by promoting compliance with the law. WCB pays for its administrative expenses with fees assessed on and collected from insurance carriers, including NYSIF. During our examination period of 2001 to 2012, NYSIF funded this assessment by collecting an additional premium from each policyholder based on a fixed percentage, established by NYCIRB.

NYSIF would have collected up to $13.3 million from North Shore and $748,000 in premium from King Kullen intended for WCB assessments had it not applied questionable discounts to these policies. The combined $14.1 million amounts to an additional discount, on top of the $125.3 million for North Shore and King Kullen.

Recommendations

1) *NYSIF must ensure:*

   a) *premiums are appropriately priced.*
   b) *discounts and surcharges are warranted.*
   c) *all underwriting decisions are documented, including those that deviate from NYSIF's policies.*

2) *NYSIF should develop strong internal controls that include oversight of NYSIF underwriting staff, including the Director of Underwriting, when setting premiums.*

3) *NYSIF should monitor policies administered by RMPG and consistently review RMPG's compliance with the TPA agreement which includes adequately setting reserves.*

4) *NYSIF should conduct an independent review of the North Shore and King Kullen policies to ensure appropriate reserves for existing claims.*

We thank the management and staff of the New York State Insurance Fund for the courtesies and cooperation extended to our auditors. We would appreciate your response to this report by February 24, 2017, indicating any actions planned to address the recommendations in this report.

Sincerely,

Bernard J. McHugh
Director of State Expenditures

Enc: Attachment A
Attachment B

cc: Eric Madoff, Executive Director and CEO
Shirley Stark, Deputy Director
William O'Brien, General Attorney
Howard Feldman, Principal Attorney
Kenneth Shulman, Director of Internal Audit

NYSIF New York State Insurance Fund

December 19, 2016

Bernard J. McHugh
Director of State Expenditures
Office of the State Comptroller
110 State Street
Albany, New York 12236

Re: Draft Report 2015-1A-001

Dear Mr. McHugh:

The New York State Insurance Fund ("NYSIF") writes in response to Office of the State Comptroller ("OSC") Draft Report 2015-1A-001. In substance, the report criticizes the pricing for two of NYSIF's former policyholders and the involvement of their broker, Risk Management Planning Group ("RMPG"), as a third party administrator for the claims under the policies.

NYSIF strongly disagrees with OSC's findings and recommendations. OSC's Draft Report is marred by multiple misunderstandings of the workers' compensation insurance business and NYSIF's practices, and its disregard of contradicting facts.

First, the Draft Report is outdated and contains information and recommendations that are not reflective of NYSIF's current operations. NYSIF no longer insures those two policyholders and has not done so since March 2014; NYSIF has proactively monitored RMPG, particularly since 2010, and RMPG does not serve as a third party administrator on any policy issued after March 2015; and in 2012 NYSIF created and began using a sophisticated computer model to guide pricing decisions and now uses it for all medium to large policies.

Second, the report demonstrates a fundamental misunderstanding of how insurance policies are priced, how to evaluate pricing decisions, and how to measure the ultimate profit or loss on any individual policy.

Fundamental Flaws of the Draft Report

OSC began this audit in April 2013, which when started was "an examination of the Third Party Administration ["TPA"] Agreement between the New York State Insurance Fund and Risk Management Planning Group." The focus of the examination apparently then shifted to the pricing of the workers' compensation ("WC") insurance policies on which RMPG served as TPA. There were ten such policies. OSC requested extensive information relevant to pricing on all of them.

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After a more than three-year audit, OSC has issued its Draft Report. The Draft Report makes findings only with respect to two of those ten policies (North Shore Hospital ("North Shore") and King Kullen Supermarket ("King Kullen")). NYSIF has not insured North Shore or King Kullen since June 2013 and March 2014, respectively. Nor does NYSIF continue to use RMPG as a TPA on any new policy year. The last time NYSIF issued a policy for which RMPG was a TPA was March 2015.

* Comment 1

The Draft Report concludes that the two policies were underpriced. However, as discussed below, this is belied by the fact that when NYSIF raised its prices on these policies, the insureds cancelled with NYSIF and got insurance elsewhere, presumably because another carrier was willing to charge less than NYSIF.

* Comment 2

OSC concludes that the two policies were underpriced principally on the calculation that there was a $27 million "deficit" of premiums collected versus $273.1 million of claims liabilities over a twelve year period. However, this calculation takes no account of investment income. For a given WC insurance policy year, while all the premium is collected in that year (other than premium that might be found due on a later audit), only a fraction of the claims liabilities for that year are paid out in the first year. In substance, NYSIF, and other WC insurance carriers, invest the premium and earn income for many years. The income on a policy thus includes not only the premium but also the associated investment income. That income can be substantial. NYSIF estimates that the investment income associated with the premiums on the North Shore and King Kullen policies through October 2016 approximates $30 million.

* Comment 2

* Comment 3

OSC's conclusion that the two policies were underpriced also ignores a fundamental inherent aspect of the insurance business, as well as the special statutory mandate that NYSIF has. Insurance by its nature involves averages and predictions of future events, which are inherently uncertain. No carrier prices its product to assure that it "makes money" on every policy. Inevitably, some policies, in retrospect, turn out to "lose money," however that is calculated, if actual losses turn out to be more than anticipated; conversely, other policies "make money" when losses come in less than expected. That is the nature of insurance.

* Comment 2

In particular, NYSIF is required by law to charge WC premium "at the lowest possible rates" consistent with a solvent fund. Workers' Compensation Law § 89(1). NYSIF's purposes are to be the WC insurer of last resort and also to help reduce workers' compensation costs for New York employers by serving as a competitive force in the WC insurance market. NYSIF writes approximately 160,000 WC policies a year. If NYSIF priced its policies with a view to assuring that every one of them "makes money," it would substantially overcharge on many policies, contrary to its mandate and mission. On its overall book of business, NYSIF's underwriting is excellent. For example, NYSIF's WC Fund had positive net income (premium, investment income and other income less claims losses incurred, administrative expenses and other expenses) in each of the last six fiscal years.

Given the inherent uncertainties in underwriting a WC insurance policy, there is no one determinable correct price. Certainly, OSC's apparent view that one can judge the appropriateness of premium pricing decisions by comparing them *after the fact* to liabilities is misguided. Other than that flawed measure, the Draft Report makes no finding as to what OSC believes the "proper" charge on these policies should have been. To the extent OSC's position is that NYSIF ought simply to have written these policies at what is known as standard rates,

* Comment 4

*See State Comptroller Comments, Attachment B

without any discounts therefrom, under OSC's calculation, OSC's $27 million deficit would have been a $98 million surplus.

* Comment 4

Finally, NYSIF notes that, recognizing the inherent uncertainties in pricing, in 2012 (before this audit began), it took substantial steps to further improve its pricing decisions, in particular with regard to large policies. As OSC is aware, in 2012, NYSIF, with the assistance of outside actuarial consultants, created and began using a Large Policy Pricing Model program; NYSIF currently uses the Large Policy Pricing Model for all policies where the annual standard premium is $300,000 or greater. The Model integrates a number of different data elements into a pricing algorithm. The results of the Model's analysis are now subject to three successive levels of independent review before a pricing decision is finalized, and for policies of more than $1 million of standard premium, there is a further fourth review by a team from the Underwriting, Actuarial and Finance Departments. NYSIF has explained and demonstrated the Model to OSC. Nonetheless, the Draft Report makes no mention of NYSIF's development and implementation of the Large Policy Pricing Model.

* Comment 5

RMPG's Role as Third Party Administrator

The Draft Report notes that RMPG's roles as TPA and as broker created a risk that RMPG might not fairly present information relevant to pricing – specifically, setting reserves on claims for future losses. However, NYSIF has long identified and implemented vigorous and extensive steps to guard against such risks. In 2010, NYSIF on its own initiative commissioned an extensive independent audit of the relationship with RMPG. NYSIF took corrective action on all of the audit findings that required correction. In particular with respect to claims reserving, NYSIF retained its authority over reserving, and exercised it. Starting in 2011 and continuing to date, NYSIF retained another independent auditor to systematically and periodically review RMPG's claims reserving, not only with respect to North Shore and King Kullen but all of the accounts on which RMPG served as TPA. In July 2016, NYSIF added a second independent auditor to augment the review process.

* Comment 2

* Comment 6

NYSIF's review process is very thorough. NYSIF carefully determines the claims to be reviewed. NYSIF constructs the audits precisely with an eye to comprehensively include *all* claims that could have a material impact on pricing decisions or the accuracy of NYSIF's overall reserves. That is, NYSIF's audits include all claims in the relevant period on which compensation payments to the injured workers were made. Those claims that are not specifically reviewed are highly unlikely to have a material impact. On those claims where NYSIF's auditors disagree with RMPG's reserve figure, the reserves are adjusted in accordance with NYSIF's instructions. RMPG is also informed of the rationale for the adjustments, in order to improve RMPG's reserving practices going forward. Further, in addition to these independent audits, since approximately 2001, NYSIF has dedicated two Claims Supervisors to overseeing RMPG's administration of claims; these supervisors focus on RMPG's claims handling, settlement strategy, reserving and overall compliance with NYSIF's policies and procedures.

* Comment 6

Administrative Expenses

OSC alleges that NYSIF priced the North Shore and King Kullen policies without knowing or taking into account NYSIF's administrative expenses. This is incorrect. Since 2008, the standard rate on a WC policy is calculated by a formula that multiplies "loss costs" (the amount

*See State Comptroller Comments, Attachment B

of anticipated losses, on an industry-wide basis, for the kind of work at issue, as determined by the New York Compensation Insurance Rating Board) by a Loss Cost Multiplier ("LCM").[1] The LCM is a factor that includes, among other things, an insurer's overhead (administrative) costs, on an enterprise-wide basis. Via the LCM, which is a component of the standard rate, an insurer's administrative costs are included in the pricing decision.[2] As permitted by law, NYSIF either charges the standard rate, provides a discount off the standard rate, or applies a surcharge to the standard rate. Thus, no differently than for any other policy, NYSIF's enterprise-wide administrative costs were in fact included in the pricing decisions on North Shore and King Kullen.

* Comment 7

During the audit, OSC requested "the administrative expenses for King Kullen and North Shore," which was understood to be a request for the administrative expenses incurred specifically for those two policies. NYSIF cannot calculate the administrative costs that are specifically and uniquely incurred on an individual policy,[3] and NYSIF's Chief Financial Officer responded accordingly. Notably, however, because RMPG was administering the claims on those policies, at the policyholders' expense, North Shore's and King Kullen's "share" of NYSIF's administrative costs were materially lower than a pro rata share of NYSIF's enterprise-wide administrative costs. Approximately 53 percent of NYSIF's administrative costs are for claims handling. Since RMPG was performing the claims handling, NYSIF did not incur those costs on these policies. The shifting of claims handling costs from NYSIF to the policyholders would necessitate a discounting of the standard rate, or the policyholders would effectively be paying twice for claims handling.

* Comment 7

<u>Alleged Underpricing</u>

OSC also alleges that the RMPG TPA policies, and in particular the North Shore policy, were underpriced. However, this ignores the simple fact that when NYSIF raised its prices, the policyholders cancelled and got their insurance elsewhere – presumably, because another carrier priced the insurance at a less expensive rate. For the 2013 policy year for North Shore, NYSIF raised its price by reducing its discount from 45 percent to 25 percent. North Shore then cancelled the policy mid-year in favor of insuring with another carrier. Similarly with King Kullen, for the policy year 2014-2015, NYSIF reduced the offered discount to zero. King Kullen promptly elected to get coverage elsewhere.[4]

* Comment 2

The Draft Report attributes statements to a NYSIF consultant. The consultant had been retained to assist in the creation of the Large Policy Pricing Model (not, as the Draft Report states, to

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[1] The formula for the standard rate also includes, where appropriate, an "experience modification" factor, which is discussed below.

[2] Prior to 2008, each carrier filed its standard rate with the Department of Insurance (which is now part of the Department of Financial Services). NYSIF's administrative costs were included in NYSIF's filed standard rates. As under the loss costs/LCM system, NYSIF's administrative costs were thus included in pricing decisions.

[3] Many administrative expenses are not attributable to specific policies, and regarding the others NYSIF does not record the amount of time spent by personnel on a policy-by-policy basis.

[4] While the Draft Report states that King Kullen's discounts ranged from 10 to 38 percent, the maximum discount provided was 30 percent, for the 2007-2008 policy year.

* Comment 8

*See State Comptroller Comments, Attachment B

"evaluate [NYSIF's] premium pricing practices" in general), and his purported comments were made in the course of a meeting in 2013 the purpose of which was to explain the Model to OSC. The consultant, who was not an underwriter but an actuary, had not been involved in the pricing of the North Shore or other "TPA" policies prior to the use of the Model for the 2013 North Shore policy and could not have been commenting on the pricing decisions as of the time they were actually made. Rather, he appears to have been referring to the fact that actual losses later turned out to be greater than anticipated, so that from that *retrospective* view, the policies may seem to have turned out after the fact to be favorably priced from the insured's perspective. (This disregards the significant investment income NYSIF earned on the premiums; it is not clear if the consultant's comments even took that into account.) As noted above, that necessarily is often the case, and is an intrinsic part of the insurance business.

* Comment 9

Alleged Cap on Discount

OSC asserts that NYSIF's policies preclude a discount of more than 20 percent for a hospital. This is incorrect. The 20 percent rule to which OSC refers is merely a ceiling on the independent authority of the line underwriter, not a cap on the discount that NYSIF can offer.

* Comment 10

Loss Experience Ratings

OSC also asserts that any discount for King Kullen was improper because its loss experience was higher than the norm for its industry and it was required to participate in a safety and loss prevention program, and that NYSIF did not "consider experience ratings when determining discounts." This, too, is incorrect. First, King Kullen did participate in the safety and loss prevention program. It successfully completed it. And more fundamentally, the Draft Report again misunderstands the pricing process. Higher than industry-norm losses are accounted for by what is known as an "experience modification" factor. This upward experience modification factor is included in the standard-rate-calculation formula, operating to increase what the standard rate premium would otherwise be. As noted above, the standard rate is a base calculation that NYSIF either adopts or decides to discount or surcharge; a discount, by its nature, is an adjustment to the standard rate. Thus, King Kullen's comparative loss experience, via its experience modification factor, was in fact included in its pricing decisions. There is simply no rule or prohibition that, if the standard rate includes an experience modification, no discount to the rate can be given. Indeed, a flat rule to that effect could doubly punish a policyholder unfairly for its loss experience, first, by increasing its standard rate, and then by automatically precluding any possibility of any discount to the standard rate.

* Comment 2

* Comment 11

Recording of Pricing Decisions

OSC notes that pricing decisions for North Shore and King Kullen were not always adequately recorded in the underwriting system in the specific manner set out in NYSIF's underwriting manual. However, as noted above, since 2012 NYSIF has been using a computer-based Large Policy Pricing Model. The Model's algorithm produces a range of potential prices (which may include discounts). The factors that lead to that range of prices are an integral part of the Model. After multiple levels of review, NYSIF's price decision is made. The computer modeling is retained. Thus, for large policies the price decision and the considerations underlying it are reflected in NYSIF's systems. Further, NYSIF has reminded underwriting staff that pricing decisions must be recorded in the underwriting system in the manner and to the extent set forth

*See State Comptroller Comments, Attachment B

in the underwriting manual, and NYSIF will monitor adherence through its Internal Audit process.

Alleged Assessment Undercharges

Finally, OSC contends that NYSIF undercharged North Shore and King Kullen million for assessments NYSIF paid the Workers' Compensation Board because NYSIF purportedly underpriced the premium. OSC's figure appears to be predicated on the view that the "proper" premium charge should have allowed no discount whatsoever. As noted earlier, however, if the premium charges had been at standard rates (without any discount), OSC's calculated "deficit" would have been a $98 million surplus. The additional associated investment income also would have been substantially higher than it is. The Draft Report does not substantiate OSC's suggestion that these policies ought to have been written at standard rates.

* Comment 2

* Comment 12

OSC's Recommendations:

OSC makes a number of recommendations regarding NYSIF's policies and procedures. NYSIF's specific responses are set forth below.

"*1) NYSIF must ensure:*

a) premiums are appropriately priced.
b) discounts and surcharges are warranted.
c) all underwriting decisions are documented, including those that deviate from NYSIF's policies."

(a) and (b):

NYSIF devotes great attention and substantial effort to making the best pricing decisions possible, consistent with the information then available and its statutory mandate to offer the lowest possible responsible prices. As noted above, NYSIF's results are excellent, with the WC Fund consistently having positive net income. With respect to large policies, since 2012, NYSIF has used a computer-based Large Policy Pricing Model to support the process, and now uses it for all policies of $300,000 or more in annual standard premium. The results of the Model's analysis and any associated pricing recommendation are then reviewed, successively at at least three levels, before a price is quoted.

(c):

As set forth above, for all policies of $300,000 or more in standard premium, all pricing decisions are documented by virtue of the Large Policy Pricing Model process. Further, underwriting staff has been reminded that pricing decisions must be recorded in the underwriting system in the manner and to the extent set forth in the underwriting manual. Adherence will be monitored through NYSIF's Internal Audit process.

"*2) NYSIF should develop strong internal controls that include oversight of NYSIF underwriting staff, including the Director of Underwriting when setting premiums.*"

NYSIF has long-established and detailed procedures for the pricing of policies, including multiple levels of supervisory oversight of underwriting staff. Moreover, with regard to any policy with standard premium of $300,000 or more, the process involves both computer modeling and collaborative and multiple reviews.

"*3) NYSIF should monitor policies administered by RMPG and consistently review RMPG's compliance with the TPA agreement which includes adequately setting reserves.*"

As set forth above, NYSIF has carefully monitored RMPG's TPA services, including, in particular, reserve setting, for many years. NYSIF continues to do so as RMPG handles legacy claims under the policies that are in run off.

"*4) NYSIF should determine whether continuing to write policies under the TPA agreement with RMPG is in the best financial interest of NYSIF.*"

* Comment 13

NYSIF no longer writes policies on which RMPG serves as a TPA, and has not done so since March 2015.

"*5) NYSIF should conduct an independent review of the North Shore and King Kullen policies to ensure appropriate reserves for existing claims.*"

As set forth above, NYSIF has retained, and continues to use, independent consultants to review the reserves on claims for appropriateness.

Yours truly,

William O'Brien

William O'Brien
General Attorney

cc: Kenneth R. Theobalds
Eric Madoff

State Comptroller's Office Comments on Auditee Response

1. OSC requested information about pricing on all ten TPA policies. OSC then judgmentally narrowed our examination scope to the North Shore and King Kullen policies. OSC has not examined the remaining eight TPA policies and, accordingly, expresses no opinion on them.

   NYSIF notes the length of time to conduct the examination. That was due, in part, to both the complexity of the issue as well as the time needed for NYSIF to provide information. While some information was provided right away, other information was delayed as long as 16 months after OSC request. Staff from both OSC and NYSIF also worked together for long periods to ensure the OSC auditors received the most appropriate information for the examination.

2. NYSIF is incorrect that OSC concluded or alleged in the Draft Report that the North Shore and King Kullen policies were underpriced. OSC's position is that NYSIF did not follow its procedures when pricing North Shore and King Kullen policies. NYSIF neither justified in writing nor offered OSC an explanation for the large discounts. The report cites that an independent consultant hired by NYSIF asserted the policies were underpriced. In response, NYSIF took several actions 6 to 11 years after insuring King Kullen and North Shore. Actions included a new Large Policy Pricing Model in 2012, the introduction of three to four successive levels of review prior to a final pricing decision, and the addition of a second independent auditor in 2016 to augment the RMPG review process. As NYSIF stated, the pricing calculated under the new Large Policy Pricing Model in 2013 reduced North Shore's discount from 45 percent to 25 percent and, in 2014, reduced King Kullen's discount to zero. This would support the consultant's characterization of the policies prior to the new model as underpriced. OSC has not evaluated the proposed discounts for North Shore (25 percent) and King Kullen (none) thus, accordingly, refrains from opining on their appropriateness.

3. In response to OSC's disclosure that claims exceeded premiums on North Shore and King Kullen policies by $27 million, NYSIF asserted it earned an estimated $30 million in investment income on the policies. NYSIF did not provide OSC with the data to support this amount, nor did the NYSIF policies shared with OSC indicate investment income was a component of rate setting. While income earned from investing premiums can be substantial, it is not guaranteed. Looking at the outcome of investments in retrospect does not address the underlying issue that NYSIF did not follow its policies and standard industry practices when calculating premiums and providing discounts to North Shore and King Kullen. Finally, while NYSIF estimates investment income of $30 million against the projected deficit of $27 million, NYSIF has yet to calculate and disclose the cost of additional administrative expenses it incurred since 2001 for the North Shore and King Kullen policies, as described in Comptroller's note 7 below.

4. OSC understands that any given policy may not "make money." OSC simply found that NYSIF failed to follow its policies and procedures, including documenting the justification for deviating from them. We agree with NYSIF's assertion that there is no one determinable correct price for premiums and OSC makes no finding as to what the proper charge on these policies should have been. It has never been OSC's position that NYSIF ought to have written the North Shore and King Kullen policies at standard rates. Our position has consistently been that NYSIF must ensure premiums are appropriately priced, discounts and surcharges are warranted, and all underwriting decisions are documented, especially those that deviate from NYSIF's policies. The insurance industry uses historical data, including prior loss development, to determine future pricing. However, NYSIF provided no documented evidence or analysis to OSC auditors to support pricing decisions and discounts for the North Shore and King Kullen policies contrary to NYSIF policy that such underwriting decisions be documented in writing.

5. We adjusted the report to reflect the implementation of NYSIF's Large Policy Pricing Model.

6. NYSIF claims to have long identified and implemented vigorous and extensive steps to guard against the risk that in its dual role as broker and third party administrator, RMPG may not fairly present information relevant to pricing to NYSIF. These steps included dedicating two Claims Supervisors to oversee RMPG since 2001, an extensive independent audit in 2010, and the retention of an independent auditor beginning in 2011 to review specific claims NYSIF believes would have a material impact on pricing decisions. Despite these efforts, the independent auditor found RMPG under reserved for claims from 2009 through 2014.

   NYSIF stated that as a result of the independent audits, claims reserves were adjusted and RMPG was informed of the rationale for the adjustments to improve its reserving practices going forward. Yet, the independent auditor hired since 2009 continued to identify a systematic practice of RMPG under reserving. In July 2016, after we had discussed our findings with NYSIF, officials added a second independent auditor to augment the review process. In addition to the added layer of oversight, NYSIF must ensure there are appropriate controls in place to minimize the risk of under reserving on open North Shore and King Kullen claims going forward.

7. We understand that the TPA, RMPG, would cover certain administrative expenses for processing claims. However, NYSIF covers all other administrative costs, including expenses associated with ongoing oversight of the TPA. While NYSIF argues that it has accounted for some of its administrative expenses with the Loss Cost Multiplier (LCM), officials advise they are unable to calculate the value of the total administrative expenses associated with the RMPG TPA policies. These include not only the costs of the claims themselves, but added costs for two Claims Supervisors to oversee RMPG's administration of claims, and independent auditors and consultants to conduct a comprehensive review and to review RMPG's policies and practices. In addition, the

independent consultant reports found NYSIF also incurred expenses associated with RMPG's poor claims handling, such as fines for untimely payments. Accordingly, NYSIF did not determine whether officials included correct assumptions for administrative costs in determining either premiums or discounts for North Shore and King Kullen.

8. We adjusted the report to reflect the King Kullen discounts ranged from 10 to 30 percent.

9. We adjusted the report to reflect NYSIF's purpose for retaining the consultant.

10. NYSIF asserts the 20 percent maximum discounts provided to hospitals is a ceiling on the independent authority of the line underwriter, not a cap on the discount that NYSIF can offer. NYSIF policy for hospitals provided to OSC auditors states "a maximum State Fund discount of 20 percent can apply." Elsewhere, the policy further states that "all exceptions must be noted in [the NYSIF system] with the reasons for the exception." NYSIF did not provide OSC with evidence of any written documentation or an explanation to justify the discounts provided to North Shore, including those that exceeded the ceiling.

11. While King Kullen's experience rating was taken into account by the application of the experience modification factor to the standard rate, NYSIF appeared to ignore it when providing discounts. King Kullen participated in the Code Rule 59 safety and loss prevention program due to high experience ratings. King Kullen hired RMPG as the safety consultant that ultimately prepared the report indicating King Kullen's completion of the program. King Kullen's poor experience ratings met the threshold for the Code Rule 59 program from 2008 through 2013. According to NYSIF's underwriting manual, "In general, similar risks with below average losses will enjoy a reduction in premium as a result of experience rating while risks with above average losses will experience the converse." It is contrary to the purpose of applying an upward experience modification factor to the standard premium for NYSIF to then apply large discounts. The fact that NYSIF reduced King Kullen's discount to zero after using the new pricing model further illustrates this point.

12. We adjusted the report to reflect the amount of premium NYSIF would have collected from North Shore and King Kullen would be "up to" a combined $14.1 million intended for workers compensation assessments.

13. We removed this recommendation from the final report. While the recommendation was specific to RMPG, the concept is universal to TPA agreements. Therefore, to the extent that NYSIF finds itself engaged with other TPAs, officials should determine whether writing policies through a TPA is in the best financial interest of NYSIF.