Colorado Office of the State Auditor
Pinnacol Assurance
Executive Compensation
July 2003

Background

Pinnacol Assurance (Pinnacol) was created as a political subdivision of the State of Colorado and shall operate as a domestic mutual insurance company (CRS 8-45-101) to provide workers compensation insurance. Part of Pinnacol's business is to serve as the State's insurer of last resort, covering the insurance needs of employers who cannot find insurance elsewhere. Most states have established entities such as Pinnacol to insure employers in high-risk industries. These entities are commonly called "state funds", and typically these entities pay no state insurance premium tax. Pinnacol also competes with private sector insurance companies for workers compensation business from employers that are not in high-risk industries.

Pinnacol has been in troubled financial condition for over 20 years. The company was in a $7 million deficit position in 1998. During the 1990's, the National Association of Insurance Commissioners (NAIC) strengthened its directives on required capital. Because Pinnacol's financial condition failed to meet the NAIC's capital standards, in accordance with Section 8-45-111, C.R.S., Pinnacol was required to develop a surplus recovery plan (plan). This plan was approved by the Commissioner of Insurance (Commissioner), and Pinnacol continues to operate under this plan. Through 2002 Pinnacol has met the initial surplus targets in the plan and is ahead of schedule in meeting its ultimate surplus goals, with the policyholders' surplus at the end of 2002 at $215 million. According to Pinnacol's management, Pinnacol has not paid any dividends to policyholders in almost 20 years. As a domestic mutual insurance company, Pinnacol's Board of Directors has a fiduciary responsibility to ensure that surplus targets are achieved, expenses minimized, and policyholder premiums are maintained as low as possible.

In gathering salary and bonus information on Colorado's largest quasi-governmental entities, it came to our attention that the amounts paid to Pinnacol's executive team had grown significantly. We followed our initial review with an analysis of compensation data provided by Pinnacol and information on salaries and bonuses paid by Colorado domestic insurers on file at the Division of Insurance. Based on our review, we question the use of the Long-Term Incentive Plan. Our concerns are discussed below.

Executive Compensation Plan

Pinnacol's compensation package includes salary, bonus, long-term incentive, retirement and health benefits. Like many other state and local government entities in Colorado, Pinnacol's executive staff are covered by the Colorado Public Employees' Retirement Association. Regarding cash compensation, Pinnacol's executive compensation plan has three components: base salary, annual short-term bonus, and long-term cash incentives. In 2000 the Board established a long-term incentive plan to award "Option Appreciation Rights" for three-year performance periods. The Rights vest equally over the three years. Cash payments are determined by a formula based on Pinnacol's performance and vested rights are paid out each year. There are still outstanding Rights for the performance periods beginning in 2001 and 2002. This plan was revised by the Board in 2003, and the new plan replaced Rights with one cash payment at the conclusion of a three-year performance period.

Levels of Compensation

In 2002, total compensation for the top eight executives ranged from a low of about $175,000 to a high of $419,000. For 2003 total compensation, after the exercising of Rights, is expected to range from about $206,000 to $530,000 per executive. Compensation has escalated rapidly. Over the three-year period, compensation to these executives will increase from approximately $1.56 million to $2.28 million, or almost $720,000 (46% increase). The CEO's cash compensation projected through the year ended December 2003 is expected to be $530,000, as compared with $298,000 in 2001, a 78% increase. In 2000, prior to the establishment of a Long Term Incentive Plan, the CEO's total compensation was about $191,000. Therefore, in the four years from 2000 through 2003 there has been an increase of 177% in CEO compensation.

We compared Pinnacol's executive compensation to other large Colorado quasi-governmental entities. As with other quasi-governmental entities, Pinnacol has a clear public mission. We also compared state workers' compensation funds nationally. We found the following:

> *Quasi-Governmental Entities*: We requested executive compensation information from the Public Employees' Retirement Association (PERA) and the Colorado Housing and Financing Authority (CHFA). PERA and CHFA currently have assets of about $25 billion and $2.5 billion, respectively, compared to Pinnacol's assets of $1.2 billion. Like Pinnacol, both PERA and CHFA have significant financing and operational risks. In 2002, compensation for PERA and CHFA's top seven executives ranged from about $79,000 to $258,000, as compared to $175,000 to $419,000 for Pinnacol.
>
> *State Workers Compensation Funds*: Pinnacol forwarded us information provided to the Board as it set compensation levels. The information included a comparison of Pinnacol to other State Workers Compensation Funds for base salary and incentive pay. The average CEO compensation in 2002 for this group was $268,000 (including incentive pay), compared to $419,000 for Pinnacol.

In setting compensation levels, Pinnacol relied primarily on national compensation data and local data provided by Mountain States Employers Council in line with its Executive Compensation pay philosophy. Related specifically to its long-term incentive plan, Pinnacol provided us with salary and incentive information for The St. Paul Companies, CNA Financial Corporation, The Hartford, RTW Inc. and Farmers Group, Inc. We are concerned about the comparability of these five companies in determining appropriate incentive plan levels for Pinnacol executives since all are significantly larger and more complex than Pinnacol.

Performance Incentives

The goal of executive bonus plans typically is to provide incentives to maximize performance and retain key executives. In our opinion, it is not clear that the levels of compensation currently paid by Pinnacol are appropriate or necessary to meet these objectives. Regarding performance, Pinnacol's initial Long-Term Incentive Plan provided compensation based on policyholders' surplus or "bottom line" growth. During 2002, Pinnacol's surplus grew by $71.8 million, about $71.3 million of which came from investment income and net realized and unrealized gains and losses according to the audited statutory financial statements. Pinnacol's investment portfolio is managed by the State Treasurer.

Regarding the value of incentives related to retention, we note that Pinnacol's key executives have been with the organization for an average of 13.5 years, and the CEO has been with the company close to 20 years. Most would appear to be strongly committed to Pinnacol and its mission and have been with the entity throughout its troubled years.

Development of the Pinnacol Compensation Plan

We discussed our concerns with Pinnacol's management and members of the Pinnacol Board of Directors. The Board reports that members of its Compensation Committee have spent a significant amount of time and worked with a national compensation specialist to develop an appropriate compensation package, including a long-term incentive plan, that addresses the Board's compensation philosophy. The Board's Executive Compensation Pay Philosophy states, in part:

> *It is the Company's policy to target executive base salary and annual incentive compensation levels in relation to pay rates that are typical at organizations with which the company competes for senior management talent. The competitive market generally includes other leading insurance, healthcare and financial service companies primarily in the Denver metro as well as national companies of comparable employment size/operating expenses.*

We note the difficulty of implementing this philosophy and emphasize the problems associated with compensation benchmarking. Divisions of Insurance records indicate significantly varying compensation levels among the top insurers and HMOs doing business in Colorado. CEO compensation ranges from several hundred thousands to millions of dollars. Often the Board of Directors takes an active role in management and may be compensated in a similar manner. Further, insurance companies and HMOs can report compensation on an allocated basis if their organization includes holding companies. With these caveats in mind, it is instructive to note that one of the largest and most successful private-sector players in Denver's healthcare market, with more than double the premiums of Pinnacol, compensates its Regional President at a level equivalent to Pinnacol's CEO.

In addition to its goal of staying competitive with private sector salaries, the Board believes that Pinnacol's executive compensation package, specifically the long-term incentive plan, is important in setting measurable goals for management's performance. Board members are pleased with recent results and believe that they result from compensation incentives. In fact, Board members serving on the Compensation Committee indicate that the Board did not anticipate the strong financial results and corresponding level of sustained bonuses. Consequently they revised the Long Term Incentive Plan and "raised the bar". For 2003, the Board has a new plan in place that ties compensation to a combination of measures, rather than solely to increases in policyholders' surplus.

Summary

We believe that the Pinnacol Board of Directors should reevaluate its executive compensation plan, with particular emphasis on the long-term incentive plan. In view of Pinnacol's public mission and tax-favored status, we believe that comparison to other state workers compensation funds and Colorado quasi-governmental entities is important. In addition, the Board should review compensation information on other entities regulated by the Colorado Division of Insurance to ensure that it considers regional compensation levels. We recommended that the Board reevaluate the Long Term Incentive Plan prior to approving another incentive cash award for a new performance period. We held discussions with the Board and members of the Board's Compensation Committee. The Board notes that it will evaluate the Long-Term Incentive Plan regularly and will reevaluate the plan prior to approving another cash award for a new performance period.

Report Control No. 1511