STATE OF CALIFORNIA

WORKERS' COMPENSATION RATE STUDY COMMISSION

COMMISSION REPORT

COMMISSIONERS:

DENNIS J. AIGNER, Ph.D., CHAIRMAN
PATRICIA A. CHESHIER, Ph.D.
STEWART L. LONG, Ph.D.
WILLIAM E. NEELEY, Ph.D.
MELCHIOR D. POWELL, Ph.D.
SUSAN D. SCHAEFER, Ph.D.
JAMES C. VAN HORNE, Ph.D

EXECUTIVE DIRECTOR:

RICHARD H. SOPER, CMC

VOLUME I
EXECUTIVE SUMMARY REPORT

MARCH 1992

STATE OF CALIFORNIA
WORKERS' COMPENSATION RATE STUDY COMMISSION

COMMISSION REPORT

VOLUME I
EXECUTIVE SUMMARY

DENNIS J. AIGNER, Ph.D., CHAIRMAN

SPECIAL NOTICE:

Library of Congress Catalog Card Number has not been applied for.

Printing: March 1992 First Impression

OTHER VOLUMES:

In addition to this Volume, the Workers' Compensation Rate Study Commission Report includes the following four Volumes:

VOLUME II
COMMISSION STAFF REPORT
SOPER & ASSOCIATES

VOLUME III
COMMISSION STAFF REPORT
SOPER & ASSOCIATES

VOLUME IV
SUB-CONTRACT RESOURCE REPORT
MILLIMAN & ROBERTSON, INC.

VOLUME V
SUB-CONTRACT RESOURCE REPORT
AIS RISK CONSULTANTS, INC.

STATE OF CALIFORNIA
WORKERS' COMPENSATION RATE STUDY COMMISSION

MEMBERS OF THE COMMISSION

COMMISSIONERS:

DENNIS J. AIGNER, Ph.D., DEAN (Commission Chairman)
University of California, Irvine
Graduate School of Management
Irvine, California

PATRICIA A. CHESHIER, Ph.D., PROFESSOR
California State University, Sacramento
Department of Insurance & Finance
School of Business & Economics
Sacramento, California

STEWART L. LONG, Ph.D., PROFESSOR
California State University, Fullerton
Department of Economics
Fullerton, California

WILLIAM E. NEELEY, Ph.D., PROFESSOR
California State University, Stanislaus
Department of Public Administration
Turlock, California

MELCHIOR D. POWELL, Ph.D., DEAN
California State University, Long Beach
Graduate Center for Public Policy and Administration
Long Beach, California

SUSAN D. SCHAEFER, Ph.D., PROFESSOR
California State University, Hayward
Department of Management & Finance
School of Business & Economics
Hayward, California

JAMES C. VAN HORNE, Ph.D., PROFESSOR
Stanford University
Graduate School of Business
Stanford, California

EXECUTIVE DIRECTOR

RICHARD H. SOPER, CMC
Soper & Associates
Palos Verdes Peninsula, California

DENNIS J. AIGNER, Ph.D., Chairman
Commissioner

Dennis J. Aigner is Professor of Management and Economics and Dean of the Graduate School of Management at the University of California, Irvine, (UCI). He came to UCI in August of 1988. He was formerly Professor of Economics and Chairman of the Department of Economics at the University of Southern California in Los Angeles. He received his BS and Ph.D. degrees in Agricultural Economics from UC Berkeley and holds an MA in Applied Statistics from that same institution. He was on the teaching faculties at the University of Illinois and the University of Wisconsin-Madison prior to his appointment at USC in 1976.

The publication record of Professor Aigner includes several books and numerous articles on statistical and econometric methodology. He is founding editor of the Journal of Econometrics.

Recently, Professor Aigner was appointed to the National Research Council's Committee on the National Energy Modeling System, which will conduct a two-year evaluation of the DOE's energy modeling and forecasting program. In August, 1990, Governor Deukmejian appointed him to the Worker's Compensation Rate Study Commission.

PATRICIA A. CHESHIER, Ph.D.
Commissioner

Patricia A. Cheshier is Professor of Insurance and Finance at California State University, Sacramento (CSUS). She received her B.A. in Economics, an M.B.A. and a Ph.D. in Risk Management and Insurance from the University of Nebraska - Lincoln in 1982. She taught at the University of Nebraska - Lincoln and Oklahoma State University prior to her appointment at CSUS.

At CSUS, Professor Cheshier has served on numerous school and university committees. She is an Associate Editor of the Journal of Insurance Issues and co-recipient of an Insurance Education Foundation grant to teach high school business and economic teachers about insurance. She also does risk management consulting and has served on three Boards of Directors, including Health Control, a mid-West HMO.

Professor Cheshier has written articles and presented numerous papers on various insurance topics including health care issues, Proposition 103, oil pollution liability and other public policy issues.

Professor Cheshier is Executive Director of the American Risk and Insurance Association; Past President of the Western Risk and Insurance Association; a member of the International Insurance Society; Risk and Insurance Management Society (RIMS) and the Greater Sacramento Employee Benefits Council. Governor Deukmejian appointed her to the Workers' Compensation Rate Study Commission in 1990.

STEWART L. LONG, Ph.D.
Commissioner

Stewart L. Long is Professor of Economics and Director of the Institute for Economic and Environmental Studies at California State University, Fullerton. He also is the Chair of the campus Academic Senate. He was the Coordinator of Fullerton's graduate program in Environmental Studies during 1985-1991. He served as statewide president of a faculty union -- the United Professors of California -- during 1981-1983. He received his B.A. in economics from Hunter College in New York City and his M.A. and Ph.D. in economics from the University of Illinois at Urbana-Champaign. His areas of specialization are the economics of broadcasting, environmental economics, and labor economics. His published research includes articles in Antitrust Law and Economics Review, Journal of Economic Issues, and Social Science Quarterly. In 1979-1981 he was awarded grants by the U.S. Department of Labor and the Rockefeller Foundation to study the labor market impact of undocumented workers in Los Angeles. His most recent project was the preparation of a Source Reduction and Recycling Element for the City of Fullerton's General Plan. He is a member of the American Economic Association, the Western Economic Association, and the Association of Environmental Professionals.

WILLIAM E. NEELEY, Ph.D.
Commissioner

William E. Neeley is Professor of Public Administration at California State University Stanislaus where he teaches courses in financial administration and organization theory. He has been a Professor of Politics and Public Administration, 1976 - present; a Director of the Master of Public Administration program, 1986-1990 and was Assistant Professor of Political Science, University of Nevada, Reno from 1974-1975.

Professor Neeley obtained his B.A. in Political Science from the University of Washington in 1966 and his Ph.D. from the University of Nevada, Reno in 1978. He has done post doctoral study at University College, Cork, Ireland.

Professor Neeley has written numerous articles and conference papers on local government administration and finance as well as on language and nationalism. He was an invited presenter at international conferences in Ireland and Bulgaria.

Memberships include: American Society for Public Administration; American Political Science Association; National Association of Schools Public Policy and Administration; American Conference on Irish Studies; American Association of University Professors and the California Faculty Association.

MELCHIOR D. POWELL, Ph.D
Commissioner

Melchior D. Powell is Dean of the Graduate Center for Public Policy and Administration, California State University, Long Beach. Previous appointments include: Director, Office of Research Management, Appalachian Regional Commission, 1972-73; Associate Professor, University of Northern Colorado, 1971-72; Director of Contract Research, National Association of Counties, 1967-71; City Attorney, City of Greenbelt, Maryland, 1966-67 and Lieutenant, U.S. Navy, 1959-63.

Professor Powell received his Ph.D. in Government and Politics from the University of Maryland, 1968; his J.D. from the University of Baltimore, 1966; his M.A. in Governmental Administration from George Washington University, 1963 and his B.S. in Social Sciences from New Jersey State College at Jersey City in 1957.

Research Projects have included: "Analysis of Criminal Justice Planning Techniques," U.S. Department of Justice; "Los Angeles County Transportation Commission Public Policy Impact Study," U.S. Department of Transportation; "Analysis of Sub-State Regional Delineation Practices, "U.S. Department of Agriculture; "Analysis of Planning Techniques Utilized for Multi-County Economic Development Planning," U.S. Department of Commerce; "Administrative Aspects of Local Solid Waste Management," U.S. Department Health and Human Services; "Management Methods for Controlling Erosion and Sediment in Urban Areas," U.S. Department of the Interior and "Study of State and Local Capacity for Managing Highway Safety Standards," U.S. Department of Transportation.

Professor Powell currently holds offices of Vice President for North America, International Association of Schools and Institutes of Administration; Executive Secretary, Western Governmental Research Association.

Professor Powell is a Past Governing Board Member of the American Society for Public Administration; National Association of Schools of Public Administration and Affairs. Past Presidencies include the Urban Affairs Association; Western Governmental Research

Association; Maryland Chapter, American Society for Public Administration; Los Angeles Metropolitan Chapter, American Society for Public Administration.

Other memberships include the American Bar Association; Town Hall of Los Angeles; International Personnel Management Association; International City Management Association and Society of Research Administrators.

SUSAN D. SCHAEFER, Ph.D.
Commissioner

Susan D. Schaefer received a Bachelor of Arts degree in Economics (1963) from Stanford University, and M.B.A (1965) and Ph.D. (1973) degrees from the Stanford Graduate School of Business. Since 1970, she has been a member of the faculty of the Department of Management and Finance, School of Business and Economics, California State University, Hayward, where she holds the rank of Professor. She is a member of the American Psychological Association, the Academy of Management, and the Industrial Relations Research Association.

Her teaching areas include management, human resources, and business research methods. Her research and consulting interests include the roles of women and minorities in business, international human resources, recruitment and selection processes, and management training (particularly in motivation and leadership). Dr. Schaefer has been active in faculty governance through the Academic Senate and the California Faculty Association, both on the Hayward campus and statewide.

JAMES C. VAN HORNE, Ph.D.
Commissioner

James C. Van Horne is A. P. Giannini Professor of Finance, Stanford University, and has done most of his work in corporate finance, financial intermediation, interest rate theory and behavior, and the application of quantitative techniques to problems in finance. In addition to university service, he has worked in the private sector and for the federal government.

At Stanford since 1965, Professor Van Horne has served as Director of the M.B.A. Program, Associate Dean of Academic Affairs, and on numerous faculty committees both within the Graduate School of Business and within the University. During 1975-76, he served as Deputy Assistant Secretary of the U.S. Treasury.

Professor Van Horne received his A.B. degree from DePauw University, M.B.A. and Ph.D. degrees from Northwestern University; and an honorary Doctor of Science from DePauw University.

Professor Van Horne is author of Financial Management and Policy, 9th edition (Prentice-Hall, 1992), Fundamentals of Financial Management, 8th edition (Prentice-Hall); Financial Market Rates and Flows, 3rd edition (Prentice-Hall, 1990); two other books and some sixty articles of finance, economic and management journals.

Professor Van Horne is Past President, American Finance Association and Past President, Western Finance Association and a member of Financial Management Association and American Economic Association in addition to the above; on the Emerging Markets Advisory Committee of the SEC. Associate editor, Journal of Fixed Income, and past associate editor of several journals. Professor Van Horne is a member of the Board of Trustees, DePauw University and also serves on the Board of Directors of Sanwa Bank California, Montgomery Street Income Securities, Inc., and of BB&K Fund Group.

MEMBERS OF THE COMMISSION STAFF
SOPER & ASSOCIATES

Consulting Team:

RICHARD H. SOPER, CMC, Executive Director
Principal (Los Angeles area)
Project Manager

GLENN M. SHOR, Ph.D., M.P.P.
Senior Associate Consultant (San Francisco area)
Assistant Project Manager

SUSAN M. WRIGHT, J.D.
Senior Associate Consultant (Sacramento area)

LEROY A. LOSEKE, CPCU, ARM, AIC
Senior Associate Consultant (Los Angeles area)

LORI B. ARLEN, M.B.A., CFA
Statistical Analyst (Los Angeles area)

BENJAMIN K. DAVIS
Research Assistant (San Francisco area)

Administration/Report Production Team:

VIRGINIA R. SUNDT
Director of Administration (Los Angeles area)

LORI R. DANIELS
Assistant Director of Administration (Los Angeles area)

JOAN E. ALLINSON
Project Coordinator (Los Angeles area)

CAROL J. SAKANASHI
Project Coordinator (Los Angeles area)

SOPER & ASSOCIATES
P. O. Box 3727
Palos Verdes Peninsula
California 92074

Tel: (310) 544-4049
FAX: (310) 544-0498

ACKNOWLEDGEMENTS

The Workers' Compensation Rate Study Commission wishes to acknowledge those individuals who generously shared their expertise in the course of the public meetings; those who came to testify and shared their experiences working within the workers' compensation system and those members of the media who attended the meetings and reported on progress, developments and findings.

Therefore, the Workers' Compensation Rate Study Commission wishes to acknowledge and thank the following workers' compensation stakeholders who contributed their time and energies to the Commission endeavors.

The following represents the individual workers' compensation stakeholders listed in alphabetical order by organization (public meeting, witness testimony and media):

Public Meeting Participation or Provision of Resource Information:

Aetna Insurance Company
    Jim Chett
Alliance of American Insurers
    Peter Gorman, Marialee Neighbors, Jim Stickles
American Insurance Association
    Mark Webb, Wayne Wilson
Applied Risk Management, Inc.
    Irv Nicholas
Assembly Insurance Committee
    Diane Griffiths, Sandra Michikin
Assemblyman Burt Margolin's Staff
    Richard Thomason
Association of California Insurance Companies
    Barry Carmody, Karen Herr
Builders Exchange Compensation Council
    Ron Glover
California Applicants Attorneys Association
    Mark Gerlach
California Casualty Insurance Company
    Thomas Brown
California Chamber of Commerce
    Roxanne Gould
California Department of Industrial Relations
    Lloyd Aubry, Christine King, Cora Lee, Kirsten Stromberg, Casey Young

California Department of Insurance
Angela Chrisman, Masako Dolan, Beverly Hunter
California Farm Bureau
Carl Borden, Roy Gabriel
California Manufacturers' Association
Willie Washington
California Self Insurers Association
Joe Markey
California Trucking Association
Paul Mahan
California Workers' Compensation Institute
William Molmen
Californians for Compensation Reform
Jose Hermocillo, Lori Kammerer, John Wilson
Fireman's Fund
Debby Nasowsky
Governor Wilson's Staff
Craig Wilson
Home Insurance Company
Creighton White
Independent Insurance Agents & Brokers
Robert Levering, Lee Lewis, Craig Sturges
Industrial Indemnity
Lawrence Mulzan
Kemper National Insurance Brokers
Patrick Donnelly, Ken Kaye
Kessler Insurance Brokers
Ron Bloom
Marsh & McClennan, Inc.
Robert Piretti
Merchants & Manufacturers' Association
Alan Edelstein
National Association of Independent Insurers
Alister McAlister, Sam Sorich
Safety Mutual
Richard Elkin
Senate Industrial Relations
Neil Burraston
Stanford Consulting Group, Inc.
Jane Nettesheim, Blaine Nye, Patrick Sullivan
State Compensation Insurance Fund
Ann Conradsen, Aaron Davis, Michael Kavanaugh, Diane Lawrence, Geri Madden, Jim Neary
Unicare Financial Corp.
Russell Leatherby, John Masek

Wausau Insurance
Jerry Scheibl
Western Association of Insurance Brokers
Bill Bolton
William E. Mercer Meidinger Hansen
Craig Johnson, John O'Connell, Dan White
Workers' Compensation Insurance Rating Bureau of California
David Bellusci, Robert Mike, Pete Murray
Zenith Insurance
John Richman, Ken Tomlinson

Witness Testimony:

Alliance of American Insurers
Keith Bateman, Barry Hoschek, Rodger Lawson
American Insurance Association
Tom Brown, Mark Webb
Association of California Insurance Companies
David Appel, Tom Conneely
Association of California Insurance Companies
Barry Carmody, Ken Fujino, Don Young
Association of California Water Agencies (JPIA)
Jerry Stockett
Burger King
Mark Gerlach, Richard Brening
California Applicants Attorneys' Association
Mark Gerlach, Merle Rabine
California Federation of Labor, AFL-CIO
Tom Rankin
California Self Insurers' Association
Joe Markey, Joan Spiegel
California Webbing Industries
Steven Kelen
Center for Labor Research
Bruce Poyer
Independent Insurance Agents & Brokers of California
Robert Levering
Industrial Medical Council
Dr. Ira Monosson
Landry Personnel Group (CalTemps)
Lee Landry
McCarthy, Kevin - Attorney at Law
National Association of Independent Insurers
Nancy Schroeder

Pacific Actuarial Consultants/CSAC
Wendy Johnson
Patterson Frozen Foods
Paul Fanelli
J.C. Penney Company
Donna Mosley
Schools Excess Liability Fund
John Wilson
State Compensation Insurance Fund
Norm Hansen, Brad Richmond
State of California Office of Benefit Assistance & Enforcement
Christine Baker
State of California Office of Self-Insurance Plans
Mark Ashcraft
State of California Division of Workers' Compensation
Casey Young
Unicare
Russell Leatherby
Valley Pizza, Inc. (Round Table Pizza)
Allen Toy
XL Manufacturing Company
John Rush
Washington State Fund
William White
Workers' Compensation Insurance Rating Bureau of California
David Bellusci, Robert Mike
Zero Corp.
John Godbold

Media Representatives:

BNA - California
Tom Durkin
Business Insurance
Joanne Wojcik
Business Journal
Tom Davey
Comstock's Magazine
Jack Woodward
Sacramento Bee
Mary Lynne Vellinga
Underwriters' Report
Ron Lent
Workers' Compensation Executive
John McCann

The Workers' Compensation Rate Study Commission would like to express a special acknowledgement to the following workers' compensation stakeholders who assisted with the final draft review of Executive Summary Report, Volume I into the late evening of final meeting on March 20, 1992: Tom Durkin of BNA - California; Jerry Scheibl of Wausau Insurance Companies; Mike Kavanaugh, Jim Neary and Geri Madden of The State Fund.

The Workers' Compensation Rate Study Commission Executive Director is solely responsible for omission of any individuals warranting recognition with respect to serving as valuable resources, providing advice and review or functioning as an expert in the broad, encompassing workers' compensation stakeholder fields.

TABLE OF CONTENTS

VOLUME I
EXECUTIVE SUMMARY REPORT
DENNIS J. AIGNER, Ph.D., CHAIRMAN

COMMISSION REPORT

VOLUME I
COMMISSIONER'S REPORT
DENNIS J. AIGNER, Ph.D., CHAIRMAN

TABLE OF CONTENTS
SUMMARY

REPORT PAGE EXPLANATION

Every page of the Report is identified with the volume and section number, section name and page number. The only exceptions are the reports prepared by the economic and actuarial sub-contract resources. The following is a detailed explanation of the "Page Header", "Exhibit 2.10" and "Page Footer":

HEADER EXPLANATION:
Lines one and two identify the State and Commission.
Line three identifies the Report volume and individual section number.
Line four is the name of the specific section.

STATE OF CALIFORNIA
WORKERS' COMPENSATION RATE STUDY COMMISSION
REPORT VOLUME II SECTION 2.0
WORKERS' COMPENSATION RATE STUDY COMMISSION MANDATE ANALYSIS

2.7 SELF-INSURANCE

Self-insurance is allowed in California for public agencies and approved private businesses meeting financial and claims processing standards. Self-insured employers must post bonds equal to 135% of their incurred liability, and are required to belong to a self-insurers' security fund that operates on an assessment basis to cover losses of bankrupt self-insurers. Generally between 15% and 25% of private sector payroll comes under self insurance coverage. See Exhibit 2.10, "Portion of Payroll Under WC Self-Insurance California, 1958-Present". Self-insurance coverage appears to rise during times when insurer profitability is high.

EXHIBIT 2.10
PORTION OF PAYROLL UNDER WC SELF-INSURANCE
CALIFORNIA, 1958-PRESENT

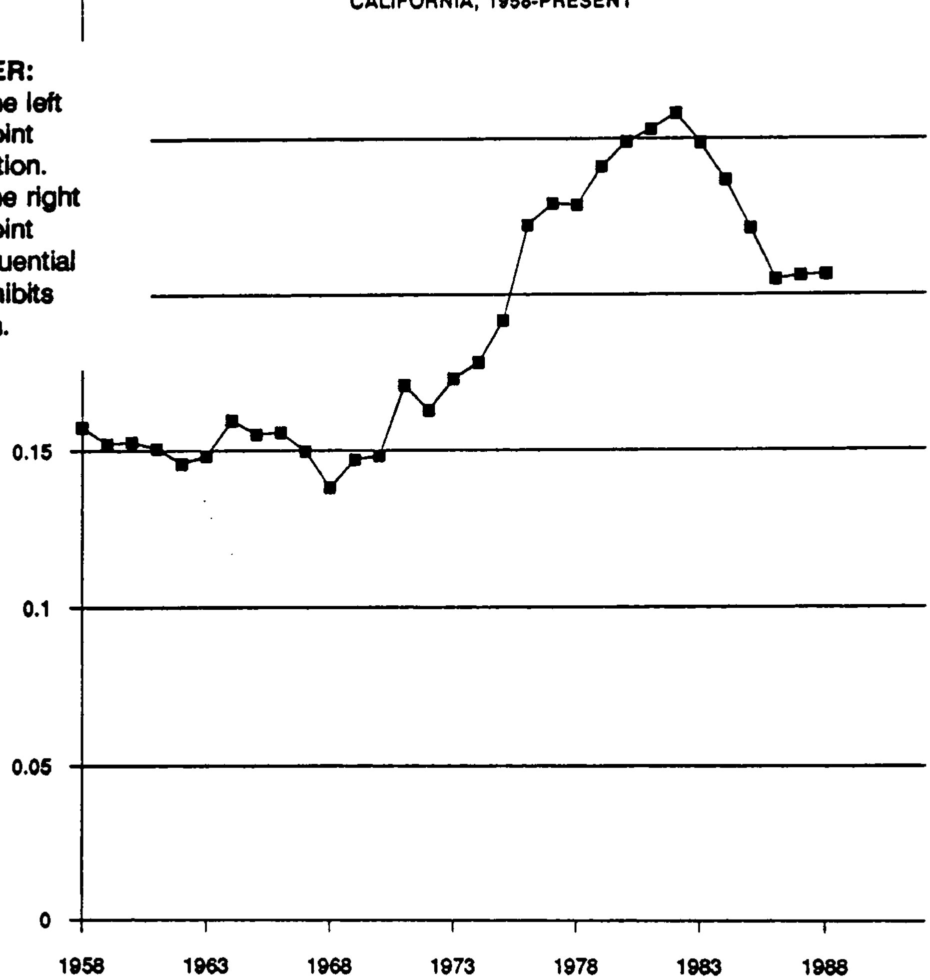


EXHIBIT NUMBER:
The number to the left of the decimal point indicates the section. The number to the right of the decimal point indicates the sequential numbering of exhibits within the section.

PAGE II-2.0-18

PAGE NUMBER EXPLANATION:
Each page is identified with a Roman numeral indicating the volume, the section number and an individual page number. The last number is the consecutive page numbering within the section.

COMMISSION REPORT

VOLUME I
COMMISSIONER'S REPORT
DENNIS J. AIGNER, Ph.D., CHAIRMAN

TABLE OF CONTENTS
UNABRIDGED

APPENDICES

PREFACE

PREFACE

While the charge of the commission is the rate making process, this process does not exist in isolation of broader issues involving workers' compensation in the State of California. Throughout our explorations, it became clear that perceived problems went well beyond the ratemaking process. Indeed, this process is inextricably interwoven with other aspects. In this preface we point out some of the problems we see, recognizing that workers' compensation reform is broad in scope, and that the important cost savings are beyond the rate making mechanism.

BENEFITS AND COSTS

Many people, and certainly this commission, are interested in seeing increased benefits and the holding down of costs. Yet there seems to be little incentive in the system to attack basic cost drivers. Most participants simply pass along cost increases, some of which arise from abuse of the system. That is to say, many players simply do not have the incentive to challenge cost drivers. In fact, some benefit from increased costs, either directly or in passing them along with more margin to themselves.

Yet it is the cost of worker's compensation that so often is cited as a perceived reason for finding California an undesirable place to locate a business or in which to continue a business, particularly a manufacturing one. We are not prepared to distinguish perception from reality, or to argue that workers' compensation is the only factor influencing dissatisfaction. However, there does appear to be a perceived problem which, if taken to the extreme, would cause a significant shift from higher skill manufacturing jobs to lower skill service jobs within the State.

COST DRIVERS

Medical costs are increasing rapidly, as we all know. Clearly this is the most significant cost driver, as such costs escalate at around 13 percent a year. In the case of workers' compensation, evaluation and documentation costs (medical/legal reports) are rising rapidly and little discipline appears to occur. Medical cost increases show no sign of abating, and it is a problem affecting overall health care delivery nationwide.

California provides broad coverage under workers' compensation, more so than in most other states. Mental stress claims are increasing. These claims, known as mental/mental, involve some kind of psychologically diagnosed problem. Mental/physical and physical/mental are not documented separately from physical claims, but fragmentary evidence suggests that they are increasing rapidly as well. Vocational rehabilitation costs are rising, whereas the success rate, as defined by job placement, is declining. However laudatory the broad coverage in California, it contributes to higher incidence of indeterminate injuries and to higher overall costs than in states which do not compensate for some of these claims. In addition, two related cost drivers are affected.

Litigation costs are increasing. These legal costs borne by the applicant (employee in reduced benefits) and the defense (insurer and ultimately the employer). Increases in stress, trauma and other indeterminate injuries has resulted in more legal costs relative to the nation overall. This, together with other things, drives a wedge between what the employer pays in premiums and what the employee receives in benefits. Workers' compensation was originally designed as a no-fault system, but it has evolved into a highly litigious one.

Fraud is an important cost driver, particularly as it relates to stress and back injury claims. This is aided and abetted by unscrupulous recruiters of disaffected employees, processing centers for phoney claims, and so called "medical clinics." Falsified billings are a major problem, and one which the insurance industry appears to largely ignore as long as "seemingly" proper documentation occurs. There are inadequate incentives to challenge a potential fraud item. The costs are merely passed on, with employers ultimately bearing them via a worsened experience modifier. The legislation to curb fraud (1991) is to be applauded. Whether this is sufficient remains to be seen. Some states, such as Oregon, seem to have gone further. Fraud not only is costly, but it adversely affects the public's perception of a system that has very important societal benefits. In this atmosphere, there is greater divisiveness between the various players in the workers' compensation system than needs to occur.

Coverage gaps are a final cost driver. A number of claims under workers' compensation are for off-the-job injuries. They are non-employment related, but end up receiving workers' compensation benefits. One way to curtail this is to more sharply define compensable injury. Another is to consolidate off-the-job medical coverage with workers' compensation coverage. In some cases, workers' compensation is used as a substitute for unemployment insurance. The claim is against the previous employer, oftentimes with distortion. Thus, worker's compensation extends certain coverage for which it was not intended. It is not that this coverage is unimportant, the question is who should bear the cost?

THE CHALLENGE AHEAD

These then – medical, broadened coverage, litigation costs, fraud and coverage gaps – are the major cost drivers. In addition, there are insurance company expenses and profits. The commission, of course, addresses the latter in subsequent sections. Most of the real cost containment opportunities lie outside the rate making process. While rate making is integral to the overall problems facing workers' compensation in California, all aspects should be considered if reform is to be meaningful.

Reducing the conflicts between the various players through proper incentives would help cost containment. This is merely to say that a better alignment of objectives could produce an effective challenge to the unrelenting cost increases which occur. In final analysis, the employee must be protected and have the ultimate ability for legal redressment. Still much can be done to provide incentives for cost containment while at the same time providing fair and equitable benefits to the injured worker.

Increased safety and fewer injures also mean lower costs, so proper incentives for safety are very important. These are addressed in this document. Safety, as it relates to workers' compensation is but part of a broader picture involving state and federal occupational health and safety programs as well as standards.

The challenge then is to bring costs into some type of containment while at the same time providing injured workers with proper benefits. We are all dedicated to this task.

PREFACE3.JCV

SECTION 1.0

EXECUTIVE SUMMARY

SECTION 1.0

EXECUTIVE SUMMARY

1.1 COMMISSION BACKGROUND

The Workers' Compensation Insurance Rate Study Commission was established by the California Legislature in September 1989 (Chapter 892 of the Laws of 1989) as part of an overall reform package in workers' compensation. Pursuant to section 11746 of the Insurance Code (amended in 1991), the Commission is mandated to evaluate the present workers' compensation insurance ratemaking process and the relative effectiveness of workers' compensation insurance ratemaking systems in other states.[1]

The Commission shall include an analysis of all aspects of the current system by which minimum rates are established in California, including an analysis of the extent to which this system fosters or discourages competition between insurers. The Commission is mandated to analyze those states which use an exclusive state fund to provide workers' compensation insurance to employers, and the advantages and disadvantages of establishing such an exclusive state fund in California.

The Commission is also asked to recommend whether the functions of the California Workers' Compensation Insurance Rating Bureau should be performed by the State Department of Insurance. Finally, the Commission is expected to address whether public self-insured employers in California should be permitted to purchase aggregate excess insurance from legally admitted California insurers.

EXHIBIT 1.1
WORKERS' COMPENSATION RATE STUDY COMMISSION MANDATE

Insurance Code Section 11746

Chapter 892 of the Laws of 1989; amended by Chapter 1308 of Laws of 1990.

The Commission shall evaluate, in its entirety, the present workers' compensation insurance ratemaking process and the relative effectiveness of workers' compensation insurance ratemaking systems in other states, and other similar matters affecting workers compensation insurance ratemaking as the commission deems appropriate. The commission shall include an analysis of all aspects of the current system by which minimum rates are established in California, including an analysis of the extent to which this system fosters or discourages competition between insurers. It shall include an analysis of the states which use an exclusive state fund to provide workers' compensation insurance to employers, and the advantages and disadvantages of establishing an exclusive state fund in California. It should also include an analysis of whether the functions currently performed by a licensed rating organization should instead be performed by the Department of Insurance. It shall also include an analysis of whether public self-insured employers should be permitted to purchase aggregate excess insurance from insurers admitted to transact workers' compensation insurance in California and whether Section 703.5 should be modified or repealed.

The commission shall consider in its evaluation the extent to which the present California workers' compensation ratemaking systems and proposed alternatives meet the following goals:

A. Provides appropriate and expeditious claim services to injured employees.

B. Assures security of the payment of benefits from the insurer to injured workers.

C. Provides financial incentives to insured employers to maintain safe operations.

D. Provides the lowest net cost to insured employers consistent with the protection and services provided and the losses and expenses incurred.

E. Provides a fair and equitable distribution of the costs of the system to insured employers reflecting, to the extent consonant with sound principles of insurance, the actual losses and expenses of individual employers.

F. Encourages availability of insurance to all sizes and classifications of employers to assure a stable, predictable, and competitive insurance market.

G. A reasonable rate of return.

1.2 COMMISSION FINDINGS OVERVIEW

Sections 11736 and 11737 of Division II, Part 3, Chapter 3, Article 2 of the Insurance Code are the basis of the State's existing minimum rate law. "An insurer shall not issue, renew, or continue in force any workers' compensation insurance under a law of this state at premium rates which are less than the rates approved or issued by the Commissioner. If the Commissioner approves or issues such a system of merit rating, insurers may apply it to any risks subject thereto, but shall show basis rates no less than the rates under the classification approved or issued by the Commissioner. Any reductions from the basis rates on account of the application of such system of merit rating shall be clearly set forth in the insurance contracts or policies or endorsements attached thereto."

The workers' compensation insurance ratemaking process in California includes phases of data gathering, data analysis, classification of businesses, actuarial projection, assessment of market conditions and competitive forces and determination of final approved rates for all insurance carriers. Individual insurance carriers submit standardized data on claims against their insured businesses to a central insurer-operated private Rating Bureau, whose function is to assist the State's Insurance Commissioner in determining final rates for workers' compensation insurance. The Bureau tabulates the claims and expenses data into preapproved industrial classifications; it determines aggregate levels of ultimate costs and revenues by applying various techniques of actuarial and financial analysis; it adjusts for changes due to newly enacted legislation, administrative rule and judicial orders; and, presumably based on this analysis, it makes recommendations for changes in overall rates, and between categories of work. These recommendations are submitted to the Insurance Commissioner for review, and upon approval, rates to policyholders are adjusted by individual carriers.

Proponents of the minimum rate law contend that the law provides the most economical method for establishing rates and provides for stability, availability and affordability; protects small employers; is the best system to maximize incentives for employers to provide a safe place to work; is the most equitable, through use of policyholder dividends; provides a reasonable, and not excessive, profit to providers.

Opponents of the minimum rate system, on the other hand, contend that the law provides for rates that are significantly higher than necessary to assure adequacy in the premium level for all insurers; is no longer needed to ensure insurer solvency because most insurers operate on a multi-line, multi-state basis and cannot be spared from insolvency by the existence of minimum rates for only one line; is inequitable to a major portion of policyholders who do not meet the requirements of most insurers for dividend payout, even though they pay rates set high enough to provide for such payout; permits inefficient insurers to remain in business; and, finally, provides disincentives to insurers for cost saving measures by basing rates on average industry-wide results and an arbitrary expense loading factor.

California and Missouri are alone among the states with a minimum rate provision, but this particular form still falls within the general category of "administered" pricing systems that dominate workers' compensation ratemaking in the United States.

Historically, virtually every state that permitted private workers' compensation insurance utilized administered pricing. All insurers adhered to uniform rates, filed by a rating bureau that received the prior approval of the state insurance commissioner or department. In most states, the National Council on Compensation Insurance (NCCI) was the main rating or advisory organization, while several states, including California used independent rating organizations. There were many justifications for rate regulation, including assuring solvency, and fixing a price that would assure availability of coverage for all employers, regardless of size and risk.

Many states allowed deviations from the bureau rates, either prospectively, or retrospectively. Some states tried to encourage price and service competition among insurers by allowing individual carriers to request rates in some or all categories of work that were lower or higher than the bureau level. Several had always allowed deviations from bureau rates if the insurer(s) wishing the deviation could give assurance that the rates were reasonable, and adequate but not excessive. Some states recognized that it was administratively cheaper to write some risks than others, and allowed or mandated premium discounts or expense constants that were set according to size of the account.

Beginning in the 1980s, several states began to shift from administered pricing to various competitive rating mechanisms. These variations encouraged and/or allowed more market competition into rates. For example, the new laws often restricted cartel-like rating bureaus from filing fully developed rates, and many did away with requiring prior approval of the insurance regulator before rates could be used. Several studies have appeared over the past fifteen years that lay the foundation for this movement toward more open competition.

In 1977, a Justice Department Task Force on Antitrust Immunities report on The Pricing and Marketing of Insurance concluded that "workers' compensation appears to be one line of property/casualty insurance which is perhaps most conducive to total state deregulation and full exposure to market controls; there is relatively greater predictability and stability in the industry, the buyers of the service are generally informed, there is potential for vigorous price competition, and there are economic incentives to employ loss controls."

A U.S. House of Representatives Small Business Subcommittee hearing on competitive ratesetting in 1982 included testimony from a former Federal Insurance Administrator that reform of ratesetting practices related to insurer investment income and competitive rating could result in 15-20 percent reductions in workers' compensation premiums. Testimony of then-Minnesota Insurance Commissioner Markman stressed that competitive rating should not mean the abandonment of state regulatory authority. Any competitive rating law should specify that rates not be excessive, inadequate, or unfairly discriminatory, with the state insurance department given the responsibility of discontinuing any rate that does not meet the standards. Finally, the commissioner stressed that competitive rating was not a panacea for all workers' compensation problems. It did not guarantee that prices would go down, or even that they would not rise above their current levels.

Also in 1982, a U.S. General Accounting Office report theorized that competitive ratemaking could reduce the costs of workers' compensation insurance for most employers, although smaller firms might encounter higher premiums and greater difficulty in obtaining coverage. In a follow-up report entitled Initial Experiences with Competitive Rating in 1986, GAO found that between 1981 and 1985, 10 states enacted competitive rating laws under which each insurance company generally prepared and filed its own workers' compensation rates and used them without first obtaining state approval.

GAO found that both the average cost and the size of the assigned risk pools declined in most states. The declines were greater in states that had initiated competitive rating laws. But is was not determined whether competitive rating laws were the only reason for this greater decline. The only evidence GAO offered about the effect on small business was a study in Michigan which found that the initial effect on most small businesses was at least as favorable as the effect on larger businesses. Only the smallest businesses, those with fewer than 5 employees, did not experience a decline in rates.

In their 1986 review, GAO found no evidence that competitive rating had altered market structures; there were no discernible differences in concentration ratios before and after the introduction of competition. Nevertheless, GAO recognized that a complete assessment required sufficient time to allow the observation of rate and availability trends through all phases of the underwriting cycle.

In June 1989, the National Association of Insurance Commissioners (NAIC) adopted the recommendation of the Advisory Organization Activities Working Group that advisory organizations (i.e. rating bureaus) should be prohibited from filing "fully developed" rates in all property/casualty lines except workers' compensation. The NAIC decided to look at workers' compensation separately.

During the summer and fall of 1989, the Working Group met and heard public testimony on the desirability and feasibility of loss costs in workers' compensation. Insurers and advisory organizations (rating bureaus) testified that going to a loss costs system was feasible; nevertheless, they predicted that employers and employees would be adversely affected. They argued that dividends and deviations already made workers' compensation pricing competitive, and that the lack of access to fully developed bureau rates would cause some insurers to withdraw from the market, particularly those who wrote workers' compensation as an "accommodation" to policyholders buying other types of coverage. In contrast, insurance regulators from Michigan and Oregon testified that loss costs systems worked well in their states, and benefitted policyholders. Consumer representatives testified that competition could be increased through prohibition of filing final rates. Agents and buyers cautioned that if there was a trend toward loss costs, care to minimize market dislocations was necessary.

In December 1989, the NAIC Working Group recommended that workers' compensation not be treated differently than other property/casualty lines of insurance and that states should prohibit the filing of fully developed rates. In the interim, steps should be taken to implement a system of reporting detailed management information on all claims; to develop a system of data monitoring to ensure the quality of ratemaking and claims-related data; and to do an economic analysis of the impact of implementation of loss cost systems on state workers' compensation insurance markets.

In December 1990, NAIC's Working Group accepted a Milliman and Robertson study indicating the feasibility of moving to loss costs for workers' compensation. It also received an NAIC staff study that evaluated the experience of the 10 states which had already implemented loss costs in workers' compensation, and which considered the market implications of extending such a system to all states. The study found no evidence to indicate that state workers' compensation insurance markets have either significantly benefitted from or been hurt by loss costs systems. The study also concluded that there was no reason to believe the experience of other states would be different if loss costs were implemented nationwide.

Regulation of the workers' compensation insurance industry is based on the premise that social welfare goals are not likely to be accomplished through competitive market forces. The Commission's analysis of the economics of the workers' compensation insurance industry suggests that the goals could be achieved efficiently in a more competitive market with a minimum of regulation. Experience in other states (for example, Michigan and Illinois) which have moved toward a more competitive market environment indicates that employer costs usually fall when regulatory constraints are eased; cutthroat competition resulting in widespread insurer insolvency and lack of availability have not occurred.

Among the goals that have been identified, the Commission believes that market stability, insurer solvency and profitability have been overemphasized to the point of regulatory paternalism. Stable markets are not necessarily static, and insurance company managers are rational, profit maximizing individuals. Reasonable assurances of insurer solvency can be accomplished by less obtrusive means.

Proponents of regulation argue that other goals of workers' compensation would suffer in a more competitive market, because employers make their decision solely on the basis of price (resulting in cutthroat competition, insolvency, etc.). Even if the purchase decision were based solely on price, this argument ignores the price ramifications inherent in, for example, safety incentives. Insurers have an incentive to encourage workplace safety to reduce loss costs regardless of how rates are set; in fact, the incentive becomes even more important if competition results in lower rates and margins. Employers have fundamental incentives to provide safe working conditions; workers' compensation enhances these incentives, especially so if employers of all sizes have greater freedom to use their safety record as a bargaining chip in negotiating with competing insurers.

Improvements in employee claim servicing can likewise pass through to insurance pricing in a competitive market. While excess costs and fraudulent claims are beyond the scope of our analysis, superior claim processing service has the potential to reduce such costs by keeping employees well informed about the status of their claims and preventing small claims from mushrooming into costly litigation. A competitive market provides greater incentives for insurers to become proficient in the identification of fraudulent claims; in the absence of a minimum rate law, these insurers can then compete on the basis of lower prices to employers.

By stressing a system that promotes much more open competition than the current ratemaking system in California, the Commission is obviously recommending against the establishment of an exclusive state fund. The competitive system being recommended places much more emphasis on "up-front" pricing and relies on loss costs to set floor rates.

Insurers are free to compete above the floor rate without prior approval from the Insurance Commissioner subject only to limitations on unfair discrimination. Pricing below the floor is possible too, but requires prior approval. This is to guard against predatory pricing, yet allow extremely efficient providers to compete even more aggressively.

The Rating Bureau retains its role for central data collection, development of loss costs and determination of rating classifications, but no longer would it produce fully developed rates. The State Fund is left to fend for itself in the competitive market, but the establishment of a small assigned risk pool is recommended in order to handle the overflow of risks (businesses) that may not be able to buy workers' compensation insurance on the voluntary market except at exorbitant prices. The Commission has left unspecified some aspects of how this is to be accomplished, recognizing that it is a matter of social policy to determine what sorts of risks (businesses) ought to be protected in this way. Finally, the Insurance Commissioner is instructed to do an annual study of how the system is working to accomplish its goals so that appropriate modification can be made, if needed, before major problems arise.

The remainder of the Commission's recommendations relate to less sweeping reforms. These involve quality of service audits and the purchase of aggregate excess insurance, and the disadvantages faced by small firms under the current ratemaking system were it to be retained against the Commission's recommendations. Most importantly, as is presented in the Preface to this report and is amplified by the Commission's final recommendation, any change in the ratemaking system in California is unlikely to produce significant cost savings compared to the savings that may be had by addressing the system's main cost drivers, those being medical costs, legal costs, broadness of coverage, fraud and the shifting of costs for off-the-job injuries to worker's compensation.

An integrated health care insurance system combining workers' compensation, disability and general medical insurance may be the means to address these issues and the nation's need to provide health coverage to the approximately 34 million people presently without any form of health insurance. Whether this will happen sooner or later, no doubt there would be significant reliance on market mechanisms, and therefore the changes we recommended to facilitate open competition in California's workers' compensation insurance market will be consistent in principle if not in complete detail.

1.3 WORKERS' COMPENSATION RATE STUDY COMMISSION RECOMMENDATIONS

The following recommendations have been developed and are endorsed by the Workers' Compensation Rate Study Commission.

The recommendations are based on research which is documented in the Commission Report. In each case, each recommendation was reviewed at a public Commission Meeting and was voted on by individual Commissioners. Every recommendation except number 6 and number 11 passed unanimously. The vote on number 6 was 5 yes, 1 no and 1 not voting. On number 11 the vote was 5 yes, 2 abstaining. In every case voting was only conducted when a quorum of the Commission was present.

The Commission recommendations are as follows:

1. The Commission recommends abolition of the existing minimum rate law, replacing it by open competition with floor rates approved by the Insurance Commissioner based on loss costs provided by the Workers' Compensation Insurance Rating Bureau. Prior approval from the Insurance Commissioner would be necessary to price below the floor rate. (Reference Section 3.0)

   The Commission also recommends:

   a. Reliance on a uniform classification system.

   b. The Insurance Code provisions applying to unfair discrimination be extended to workers' compensation insurance. All insurers shall report any individual risk rating plans and the rates used to the Insurance Commissioner.

   c. In determining floor rates, the State Compensation Insurance Fund data be included in their entirety.

2. Contingent on recommendation #1 being adopted by the Legislature, the Commission recommends the establishment of an assigned risk pool. The costs would be allocated across all workers' compensation insurers in California on the basis of prorata market share. (Reference Section 1.0)

   a. It is the intent of the Commission that requirements for admission to and rates for the assigned risk pool be designed so that the percentage of total premium volume in this category is very low.

   b. The Commission recommends that the level and extent of self-insurers' contribution to cost of the assigned risk pool should be studied and an appropriate decision reached.

c. The Commission recommends a tiered assigned risk plan, similar to that used in the State of Michigan.

3. If recommendation #1 is not adopted by the Legislature, the premium level required for participation in experience and retrospective rating plans should be lowered to allow more employers to participate. (Reference Section 4.0)

4. The Workers' Compensation Insurance Rating Bureau should continue in its role as a quasi independent organization for determining rating classifications and loss costs. The Commission believes that there would be no advantage to siting this function within the Department of Insurance.

   The Workers' Compensation Insurance Rating Bureau should initiate a more systematic approach to handling employer complaints. Direct contact staff should be designated to handle the various types of inquiries. Systematic records should be kept on each inquiry, particularly as to the type, disposition and the speed with which the disposition is made. Particular attention should be paid to the responsiveness to small employers. Consideration should be given by the Bureau to designating an ombudsman to help employers who have problems. (Reference Section 6.0)

5. It is recommended that the insurance code be modified to allow all workers' compensation self-insured employers (public and private) to purchase workers' compensation aggregate excess insurance and that (Reference Section 8.0):

   a. only those carriers admitted to write insurance in the State of California should be allowed to write aggregate excess insurance

   b. a study might be undertaken to consider requiring workers' compensation aggregate excess insurance for certain categories and designated sizes of workers' compensation self-insured employers.

6. The Commission recommends against establishment of an exclusive state fund in California. (Reference Section 7.0)

7. The availability of safety groups which provide group purchasing power to small firms should be expanded and publicized by the Department of Insurance. Insurers should be encouraged to develop and promote such safety groups. (Reference Section 4.0)

8. If recommendation #1 is not adopted by the Legislature, then the Commission recommends the institution of a system of premium rebates and/or deductible plans for small firms. (Reference Section 4.0)

9. With respect to quality of service, the auditing process should be used to assure satisfactory performance of statutory duties. Provision of loss control/safety and benefit services should be explicitly evaluated and results disseminated. (Reference Section 5.0)

10. The Commission recommends that the Commissioner of Insurance issue an annual report evaluating state of competition in the workers' compensation insurance market. (Reference Section 1.0)

11. Because the important cost savings in workers' compensation are beyond the ratemaking process, the Commission recommends that the workers' compensation system be reevaluated on terms broader than the ratemaking mechanism (Reference Preface Section).

C101T07F.DJA

SECTION 2.0

ANALYSIS OF CALIFORNIA RATESETTING LAW COMPARED TO SYSTEM UTILIZED BY OTHER STATES

SECTION 2.0

ANALYSIS OF CALIFORNIA RATESETTING LAW COMPARED TO SYSTEMS UTILIZED BY OTHER STATES

2.1 HISTORICAL BASIS OF RATESETTING

This is not the first time that California has considered the issue of regulating workers' compensation insurance rates. In 1913, the California Industrial Accident Board (IAB) studied various systems of insurance oversight and decided to attempt regulation through public enterprise competition.[1] Seeing private insurers operating without regulation as an obstacle to successful implementation of the compensation law, the Board cited examples in Wisconsin, where a mutual insurance association was organized under the laws of the state, and in Michigan, where a "tentative, optional" state insurance fund was set up. The Board concluded that state competition with private insurance carriers could equalize rates for compensation and liability coverage; a state-run insurance carrier would stand "ready to accept all risks brought to it at what it costs the State to do the business, leaving the field free to other responsible carriers to operate with so much of profit as they may be able to make by doing the business more efficiently and at less cost than the State can do it."[2] The IAB stressed that "the State should invade the sphere of private enterprise" in order to secure "just rates for employers and just treatment for injured workers."

The IAB proposed State Compensation Insurance Fund (SCIF) was to be assisted by a State Workmen's Compensation Insurance Rating Bureau (WCIRB) to provide advisory rates, with the intent "that the insurance rates shall be the most effective police force for making places of employment safe." Instead of a large bureaucracy, SCIF would be small, with an annual budget of $68,000, and a 25 person staff. The WCIRB would operate with little additional staff (four clerks and two stenographers) on a $12,500 annual budget.

2.1.1 INTEREST GROUP RESPONSE

A. INSURERS

Large insurers tried to scuttle the State Insurance idea before it had a chance to prevail. Soon after the release of the IAB proposal, the state's second largest liability insurer in 1912, sent letters to agents and other insurers urging vigorous opposition to the measures. "If you are selling casualty insurance, do you intend to sit idly by and allow the State to establish a business which eventually will abolish this source of income for you?" The letter went on to state that encroachment in the compensation area would eventually lead to State insurance in other areas as well. The Insurer predicted that if the 100,000 people "interested" in the insurance business in California were to unite, State insurance could be defeated. Insurer representatives sought to ally themselves with employers by charging that the employees' interest in the workers' compensation area was to see "how much he can get out of the industries of California."[3]

B. EMPLOYERS

Perhaps spurred by the accident insurers, the California Employers Federation was set up in early 1913 by large employers to "pull the teeth" from the compensation act (known after its author as the "Boynton Bill") and other Labor bills pending in the Legislature.[4] Among other amendments to the compensation provision, the employers proposed that indemnity benefits pay 50% rather than 65% of lost wages. Several conservative newspapers around the state kept up an attack on the Boynton Bill after its introduction. The San Diego Union called it "a sop to the Labor Unions."[5] The Los Angeles Times said the bill would "paralyze production in California and perpetuate the stranglehold of the State political machine."[6] And the San Francisco Chronicle criticized the plan as a dangerous scheme to centralize power in the proposed Industrial Accident Commission.

C. LABOR

While disappointed by compensation levels and waiting periods, labor was extremely pleased by several parts of the IAB proposal, particularly those concerning state insurance and safety regulation. In arguing for an alternative source of compensation insurance coverage, the San Francisco Labor Council charged that the private casualty insurers had dictated employment practices for employers, frequently calling upon them "to discharge workers who refused to allow the insurance adjusters to defraud them out of compensation." The inclusion of a state fund would allow employers to take out insurance at fair rates.

The establishment of a state safety bureau, moreover, would be "tantamount to the passage of hundreds of minor safety acts," enabling the IAC "to regulate industries as effectually as the Railroad Commission regulates public utilities."[7] For this and other reasons, organized labor, represented by the State Federation of Labor, saw the Boynton Bill as the "greatest achievement" of the 1913 session.

2.2 LEGAL BASIS OF RATESETTING

2.2.1 OVERVIEW

Division II, Part 3, Chapter 3, Article 2 (sections 11730-11744) of the Insurance Code covers workers' compensation rate supervision, and Article 3 (Sections 11750-11759) covers rating organizations.

2.2.2 RATE REGULATION

Section 11732 gives the responsibility of rate regulation to the Insurance Commissioner. "The Commissioner shall approve or issue, as adequate for all admitted workers' compensation insurers, a classification of risks and premium rates relating to California workers' compensation insurance. He may also approve or issue a system of merit rating. Such classification and system shall be uniform as to all insurers." Changes in classification or systems are allowable after a hearing to determine the effect of such changes on the adequacy or inadequacy of rates. (Section 11734).

A. MINIMUM RATE LAW

Sections 11736 and 11737 are the basis of the State's minimum rate law.

> "An insurer shall not issue, renew, or continue in force any workers' compensation insurance under a law of this state at premium rates which are less than the rates approved or issued by the Commissioner. If the Commissioner approves or issues such a system of merit rating, insurers may apply it to any risks subject thereto, but shall show basis rates no less than the rates under the classification approved or issued by the Commissioner. Any reductions from the basis rates on account of the application of such system of merit rating shall be clearly set forth in the insurance contracts or policies or indorsements attached thereto."

Proponents of the minimum rate law contend that the law:

1. Provides the most economical method for establishing rates and provides for stability, availability and affordability

2. Protects small employers

3. Is the best system to maximize the incentive for employers to provide a safe place to work

4. Is the most equitable, through use of policyholder dividends

5. Provides a reasonable, and not excessive, profit

Opponents of the minimum rate system contend that the law:

1. Guarantees a profit to the industry by setting minimum rates above those necessary to pay losses and expenses

2. Provides for rates that are significantly higher than necessary to assure adequacy in the premium level for all insurers

3. Is no longer needed to ensure insurer solvency because most insurers operate on a multi-line, multi-state basis and cannot be spared from insolvency by the existence of minimum rates for only one line

4. Is inequitable to a major portion of policyholders who do not meet the requirements of most insurers for dividend payout, even though they pay rates set high enough to provide for a dividend payout

5. Permits inefficient insurers to remain in business

6. Provides disincentives to insurers for cost saving measures by basing rates on average industry-wide results and an arbitrary expense loading factor

B. DEVIATIONS ARE NOT ALLOWED

Premiums may not be modified or deviated from because of combination with other insurance policies (section 11732.2) or combination with workers' compensation experience in another jurisdiction (section 11732.3). No rate discounts are allowed through reduction of the uniform "expense provision" approved by the Commissioner (sections 11732.4 and 11732.5).

Past legislative bills have proposed to allow insurers to issue workers' compensation insurance policies at less than the minimum rates if the discount is approved in advance by the Insurance Commissioner. (See for example, AB 2608 -1986 session.) These measures retained the Commissioner's role in establishing minimum rates, but would have permitted insurers to issue policies at lower rates if they could convince the Commissioner that the discounted rates would not be inadequate, excessive, or unfairly discriminatory.

C. EXPENSE PROVISION IS UNIFORM

The expense provision is a uniform factor which the Insurance Commissioner includes in the rates promulgated annually. The expense provision has been justified as ensuring that carriers have adequate funds up front to:

1. pay for costs of adjusting claims, other underwriting expenses, dividends, and taxes; and

2. fund pre-tax profits and surplus contribution requirements. Until 1990, the factor was proposed to the Insurance Commissioner by the Workers' Compensation Insurance Rating Bureau which based its recommendation on its own analysis of monies needed to adequately fund each element of the expense provision.

Throughout the 1980s, the expense factor was set at 35%, leaving investment income and 65% of the premium amount available for payout of medical and indemnity benefits. As part of the 1989 Reform Act, the exact level of the expense provision was put into statute. For 1990, the rate was 34%, in 1991 it was 33%, and for 1992, it is 32.8%. Proponents of the change argued that the incremental reduction would assist in funding some of the benefit increases passed in the Reform. Others criticized the change as inappropriate since it precluded the newly elected Insurance Commissioner from establishing an expense rate that seemed reasonable. Other opponents of the change charged that even the reduced rate was too high, and should have been reduced further if it were to be in statute. Another argument against the change was that it would do little to reduce employer costs, since while it would initially lower rates, it would ultimately be reflected in a reduction of dividends available for return to policyholders.

D. DIVIDENDS

Insurers are expressly allowed to issue "participating" policies and to rebate dividends to policyholders under such policies, as long as these dividends are fully funded by surplus accumulating on California workers' compensation policies. (Section 11738) Under Section 11738.5 (SB 475 (Beverly) passed in 1987), insurers are required to submit an annual report of dividend payments to the Workers' Compensation Insurance Rating Bureau, for use by the Bureau in preparing an annual dividend report for the Insurance Commissioner showing the aggregate experience. The information submitted by individual insurers for this purpose is confidential and not subject to public disclosure.

Bills in the Legislature in recent years have proposed to collect and make available more information about the practices of insurers in returning dividends to their policyholders. For example, SB 1617 (1986 session) proposed to require each insurer to submit to the Insurance Commissioner an annual report showing the amount of premium and investment income used for the payment of dividends and the distribution of those payments to employers by size and loss ratio. Nothing in the current Insurance Code allows or encourages direct regulation of the dividend plans used by individual carriers in participating policies.

E. PENALTIES FOR NONCOMPLIANCE

Violations of the article by any broker, agent, or employee of an insurer is a misdemeanor offense, while violations by an insurer may be punishable by suspension or revocation of that carriers permission to write workers' compensation and/or liability insurance in the state.

2.2.3 RATING ORGANIZATIONS

The purpose of Article 3 is to regulate "concert of action between insurers" in collecting and tabulating data and other ratemaking information. Each insurance carrier is required to belong to one, and only one, rating organization for workers' compensation.

2.3 FORMAL PROCESS OF RATESETTING

2.3.1 THE PRESENT RATEMAKING PROCESS IN CALIFORNIA

The workers' compensation insurance ratemaking process in California includes phases of data gathering, data analysis, classification of businesses, actuarial projection, assessment of market conditions and competitive forces, and determination of final approved rates for all insurance carriers. Individual insurance carriers submit standardized data on claims against their insured businesses to a central insurer-operated private rating bureau, whose function is to assist the state insurance commissioner in determining final rates for workers' compensation insurance. The bureau tabulates the claims and expenses data into preapproved industrial classifications; determines aggregate levels of ultimate costs and revenues by applying various techniques of actuarial and financial analysis; adjusts for changes due to newly enacted legislation, administrative rule and judicial orders; and, presumably based on this analysis, makes recommendations for changes in overall rates, and between categories of work. These recommendations are submitted to the Insurance Commissioner for review, and upon approval, rates to policyholders are adjusted by individual carriers.

2.3.2 THE WORKERS' COMPENSATION INSURANCE RATING BUREAU (WCIRB)

A. ORGANIZATION

All companies writing workers' compensation insurance in the state are required to be a member of a rating bureau, and the WCIRB is and has been the only rating bureau in the state since its inception in 1915. The Governing Committee serves as the Bureau's Board of Directors. It reviews the work of the Actuarial Committee, the Classification and Rating Committee, and all subcommittees and special committees established by the Governing Committee. An annual duty of the Governing Committee is to recommend rate level changes and other amendments to the rate regulations of the Insurance Commissioner.

B. PUBLIC MEMBERS OF GOVERNING BOARD

Until 1987, there were no "public" representatives overseeing the Rating Bureau. There were eight representatives of insurance companies on the Governing Committee, seven representing private companies and one representing the State Fund. Effective in 1988, public representatives appointed by the Insurance Commissioner were first added to the WCIRB's governing committee by AB 1704 (Peace). Initially, there were two public members added to the eight existing insurer members, one each representing organized labor (from the California Labor Federation AFL-CIO) and insured employers (from the Plumbing-Heating-Cooling Contractors of California). In the 1989 Reform Act, two additional "public" members were added. Appointed by the Insurance Commissioner was one person representing the California Farm Bureau, and the other representing the Teamsters Union.

The 1989 Reform Act also authorized the public members to hire expert actuarial and other staff, and granted an appropriation of $100,000 per year (indexed with inflation.) Hiring such assistance required a majority vote of the public members, whose opinions sometimes differed. The actuary hired by the public members is authorized to participate in meetings of the Actuarial Committee.

Voting records of the governing board membership indicate that proposals for rate increases are nearly always supported by private insurer members (exception: a 1991 vote in which one insurer voted against an increase on the grounds that it was inadequate), always opposed by labor members, and usually supported by employer members.

C. BUDGET

The California Workers' Compensation Insurance Rating Bureau is primarily supported by assessments on member insurance companies. As the State Compensation Insurance Fund is the largest insurer of workers' compensation in the state, it is the largest contributor to the operating costs of the Rating Bureau. Fines levied against members who fail to submit unit statistical reports and individual case reports to the Bureau on a timely basis. Bureau revenues for 1990 totalled $15.6 million, with expenditures of $13.2 million. The Bureau operated in 1990 with a staff of 289 employees.

2.3.3 INSURANCE DEPARTMENT BUDGET

The operating expenses of the California Department of Insurance are appropriated annually by the Legislature from the Insurance Fund. The Department collected over $1 billion in gross premium and surplus line taxes in 1990, which accounted for about 2% of total state revenue. The "gross premium" tax is actually applied after adjustment for dividends returned to policyholders.[8] (Tax rate is 2.46% of gross premium minus dividends returned or credited to policyholders.) It also collected $65.7 million in license, examination and miscellaneous fees to support operations. Expenditures for 1990 were $59 million with an authorized staff of 800 employees.

Applying the 2.46% gross premium tax rate to the $8.3 billion in workers' compensation premiums for 1990 generates approximately $205 million in tax revenue.

2.4 RATEMAKING DECISIONS 1974-1991

2.4.1 TIMELINE

The ratemaking process in workers' compensation is exempt from the Administrative Procedures Act (APA), because its function is setting rates, prices, or tariffs. There are no strict statutory procedures like those required of regulatory action under the APA.

Under the APA, it usually takes 9 months from first official notice to final decision. The average time between notice of the filing and final decision in workers' compensation ratemaking cases between 1983 and 1990 was 65 days.

The formal public review of proposed changes in workers' compensation rates and regulations occurs in a narrow time period that now typically begins with the end of the Legislative session in mid-September and ends with a December decision of the Commissioner. (This allows enough time for carriers to promulgation new rates as of January 1.) On or about September 20, the Workers' Compensation Insurance Rating Bureau files a letter with its recommendations to the Commissioner. Along with the rate filing, the Bureau submits, under letterhead of the Department of Insurance, a regulatory document called the "Initial Statement of Reasons." A hearing date is set and notices sent to those who have been involved in the process before, and to those on the Insurance Commissioner's formal mailing list. The hearing is not listed under Public Notices in general circulation newspapers. The Commissioner usually holds a public hearing about a month later, and makes a decision within another 6 weeks. Rates and other regulatory changes are typically effective January 1.

As seen in Exhibits 2.1, 2.2, and 2.3, commencing on the following page, the number of public hearings per rate change application dropped by half during the Deukmejian Administration compared to the earlier Brown Administration. The time spent evaluating the evidence presented (days between public hearings and decision by the Insurance Commissioner) also dropped considerably during this period.

2.4.2 OUTCOMES

Exhibits 2.4, 2.5 and 2.6, commencing on the following page, show summary information on rate decisions from 1974 to 1991. Rates rose significantly during this period, with most of the increase occurring during the term of Governor Deukmejian. Using 1974 as an index year, rates rose over 220% over the period. Overall, during both the Deukmejian and Brown Administrations, the Rating Bureau was granted increases of about half of what was requested. During the Brown Administration, however, most proposals were either fully allowed, or fully disallowed.

There was higher variability in percentage of requested rate approved, suggesting that there was more attention to either approving increases in full or denying them, rather than granting some percentage of what was asked for.

The latest ratemaking decision (1991) was the first by an elected insurance commissioner in California. The timeline for review of the petition was not markedly different than other previous filings, but the outcome was quite different. The Commissioner allowed only 1.2% of a proposed 11.9% increase. In so doing, he denied the portion of the rate increase due to seemingly adverse claims trend experience in the wake of the 1989 reforms. The Commissioner did not allow the WCIRB to include loss trend information from the State Compensation Insurance Fund to determine the rate changes necessary for all insurers without first receiving a study of the reasons why the State Fund experience had deteriorated so much in recent years. The Commissioner took issue with changes in methodology used by the Bureau in developing a proposed rate increase, and indicated that scrutiny of such methodology would be increased in the future. The decision showed concern that dividend practices of insurers tended to discriminate in favor of larger employers, to the disadvantage of smaller firms. The Commissioner required the Bureau to conduct and include in its next rate filing a study of the impact of experience modifications and dividends on net premiums by employer size, actual losses

EXHIBIT 2.1
AVERAGE NUMBER OF HEARINGS PRIOR TO RATE DECISION BY ADMINISTRATION

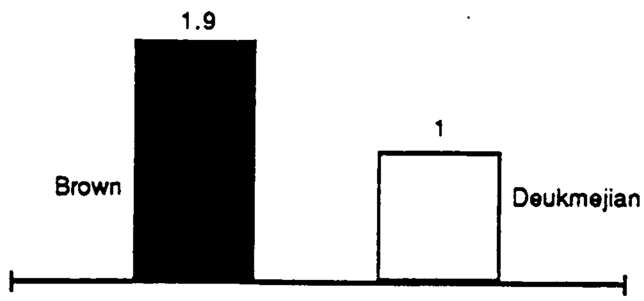


EXHIBIT 2.2
AVERAGE NUMBER OF DAYS BETWEEN PUBLIC HEARING AND RATE DECISION BY ADMINISTRATION

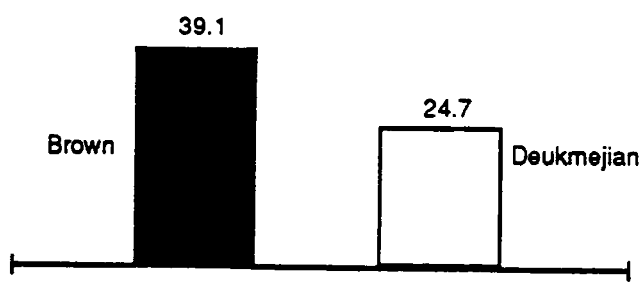
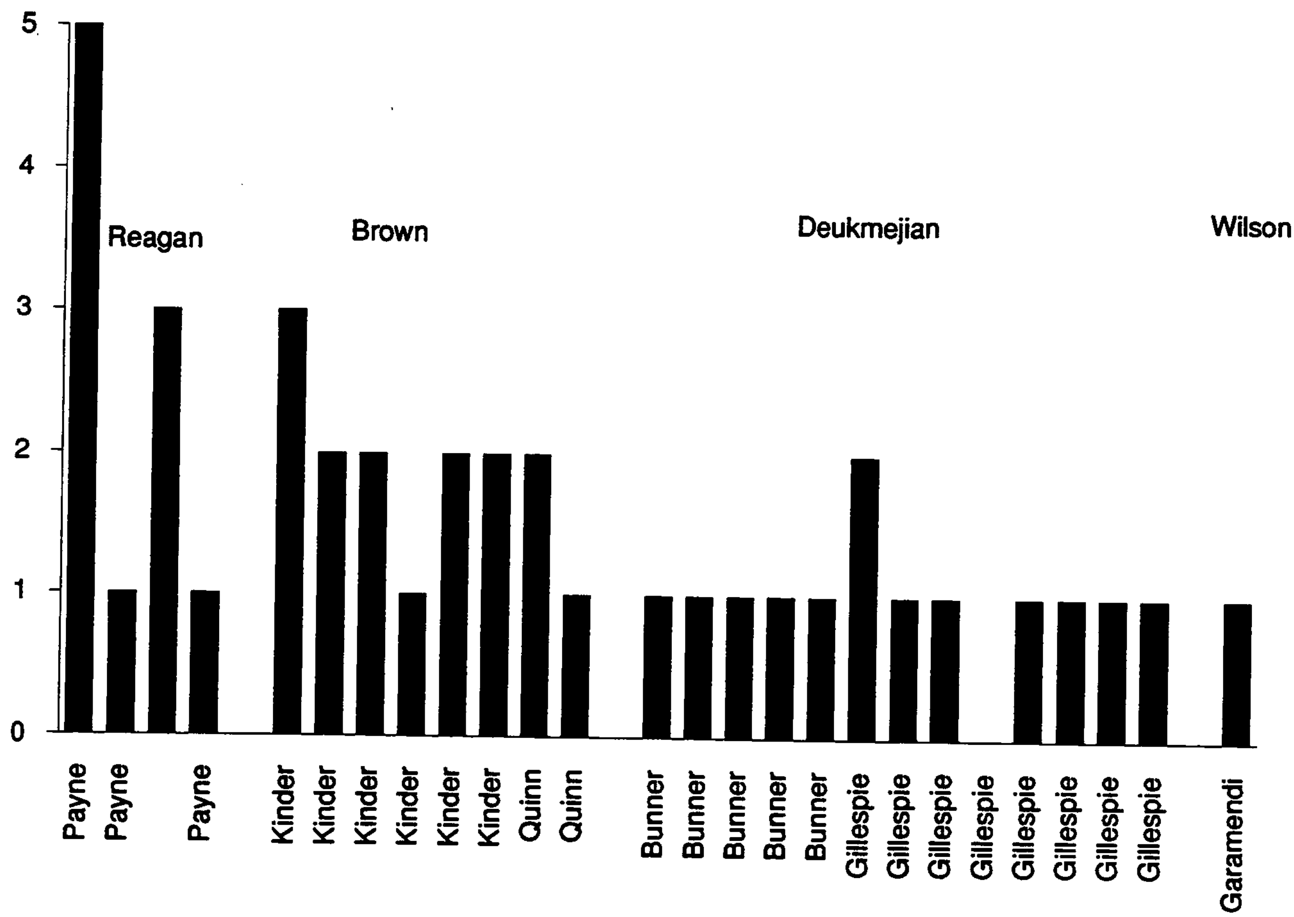


EXHIBIT 2.3
NUMBER OF PUBLIC HEARINGS IN RATE CASES 1972-1991
CALIFORNIA WORKERS' COMPENSATION INSURANCE



2.4.2 OUTCOMES (Continued)

and level of manual premium rates. The study is also required to address whether the criteria for setting the minimum premium for eligibility for experience rating show be changed.

This decision was also the first that included input from the actuarial expert hired by the Rating Bureau's public members. In a letter to the Public Members, their actuary indicated the nature of the methodological changes made by the Rating Bureau in the filing, and determined what the rate level increases should be if the methodologies had not been changed. This is the first time in recent California history that an independent actuary reviewed the filing and had input into the ratesetting process.

EXHIBIT 2.4
INDEX OF AVERAGE PREMIUM RATES 1972-1991
1972=100

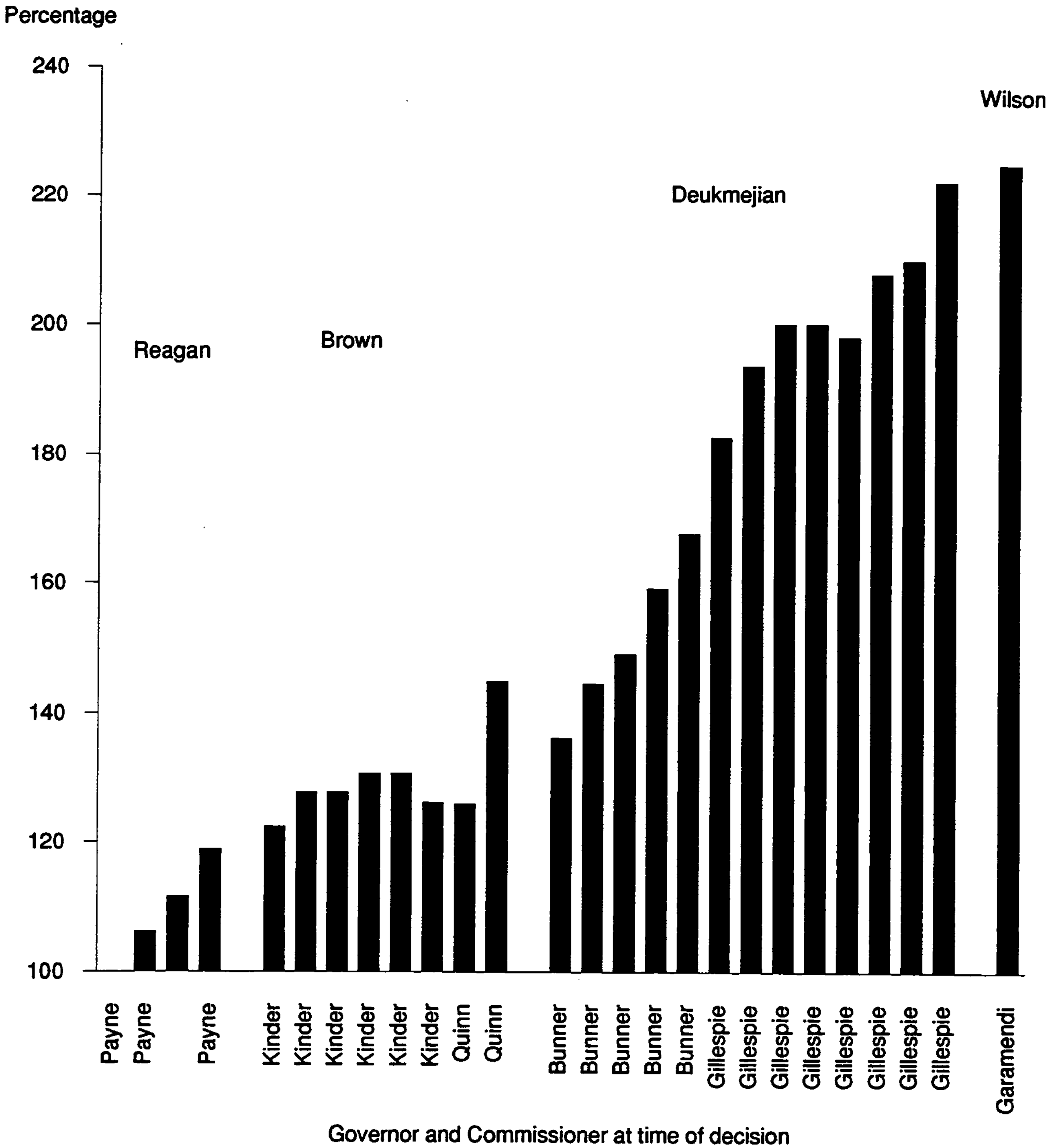


EXHIBIT 2.5
PROPOSED AND ALLOWED RATE CHANGES, 1972-1991
WCIRB FILINGS AND DEPARTMENT OF INSURANCE DECISIONS

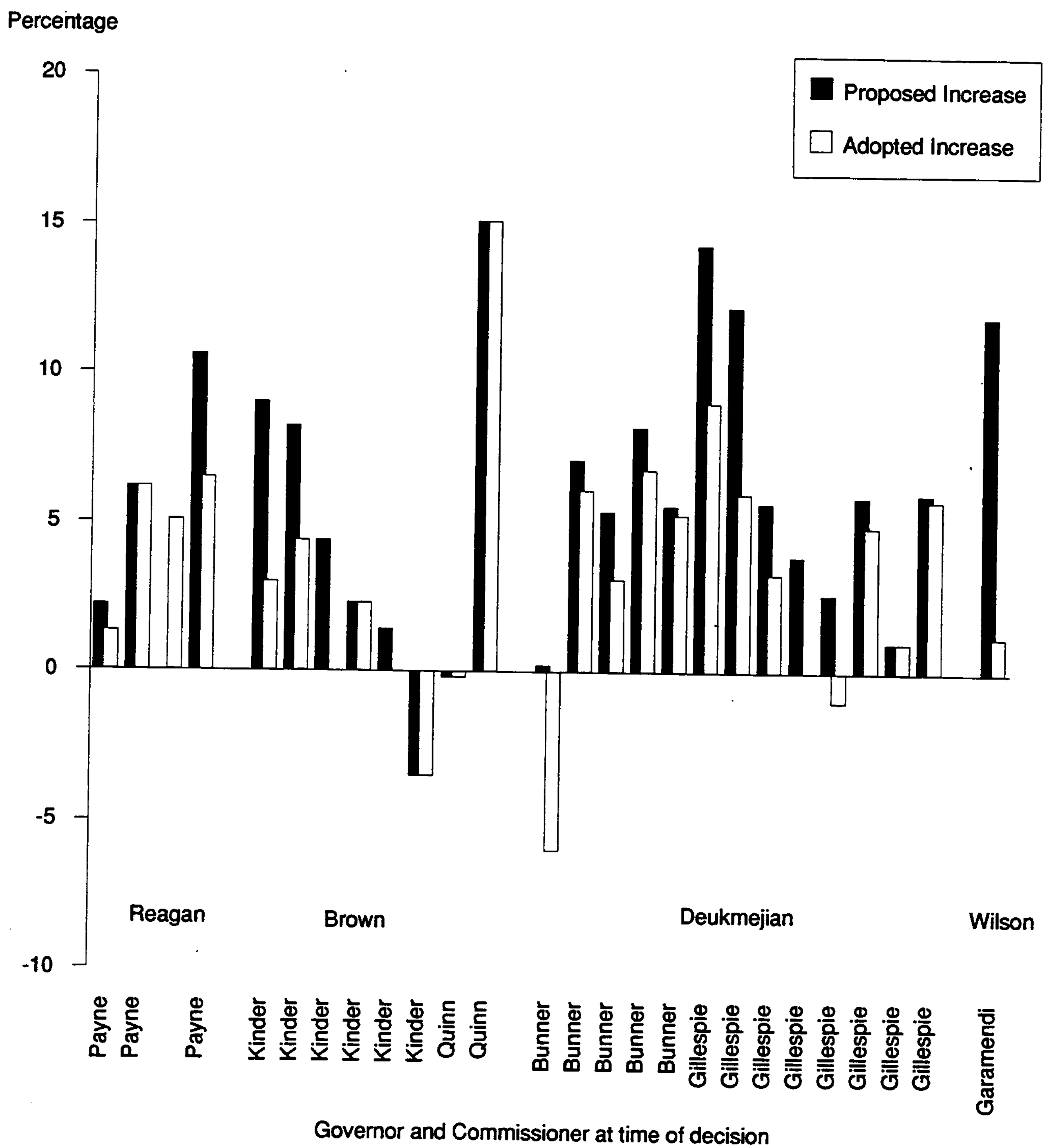


EXHIBIT 2.6
HEARING STATISTICS 1973-1991

Year	Number of Hearings	Days from hearing to decision	Proposed Increase (%)	Approved change (%)	Insurance Commissioner
73	5	42	2.2	1.3	Payne
74	1	37	6.2	6.2	Payne
74	3	37		5.1	Payne
74	1	9	10.6	6.5	Payne
76	3	85	9.0	3.0	Kinder
77	2	59	8.2	4.4	Kinder
78	2	69	4.4	0	Kinder
79	1	10	2.3	2.3	Kinder
79	2	23	1.4	0	Kinder
80	2	11	-3.5	-3.5	Kinder
81	2	21	-0.2	-0.2	Quinn
82	1	35	15.1	15.1	Quinn
83	1	42	0.2	-6.0	Bunner
84	1	28	7.1	6.1	Bunner
85	1	12	5.4	3.1	Bunner
85	1	30	8.2	6.8	Bunner
86	1	24	5.6	5.3	Bunner
86	2	11	14.3	9.0	Gillespie
87	1	30	12.2	6.0	Gillespie
87	1	40	5.7	3.3	Gillespie
88	0	4	3.9	0	Gillespie
88	1	42	2.6	-1.0	Gillespie
89	1	29	5.9	4.9	Gillespie
90	1	4	1.0	1.0	Gillespie
90	1	28	6.0	5.8	Gillespie
91	1	44	11.9	1.2	Garamendi
average	1.5	30.6	5.6	3.3	
stddev	1.0	20.3	4.7	4.4	
Ave. Brown	1.9	39.1	4.6	2.6	
stddev Brown	0.6	28.4	5.9	5.6	
Ave. Deukmejian	1.0	24.7	6.0	3.2	
stddev Deukmejian	0.4	13.3	4.0	4.0	

2.5 INTRODUCTION TO RATING SYSTEMS OF OTHER STATES

2.5.1 BACKGROUND: WORKERS' COMPENSATION INSURANCE RATEMAKING

Several studies have addressed alternative ratesetting processes.

A. A Justice Department Task Force on Antitrust Immunities report on "The Pricing and Marketing of Insurance (January, 1977) concluded that "Workers' compensation appears to be one line of property/casualty insurance which is perhaps most conducive to total state deregulation and full exposure to market controls; there is relatively greater predictability and stability in the industry, the buyers of the service are generally informed, there is potential for vigorous price competition, and there are economic incentives to employ loss controls."

B. A U.S. House of Representatives Small Business Subcommittee hearing on competitive ratesetting (1982) included testimony from a former Federal Insurance Administrator that reform of ratesetting practices related to insurer investment income and competitive rating could result in 15-20 percent reductions in workers' compensation premiums. Testimony of then-Minnesota Insurance Commissioner Markman indicated that going to a system of competitive rating would accomplish seven aims:

1. Do a better job of establishing prices at a level satisfactory to both insurers and employers

2. Respond faster to changes in underlying costs

3. Not be subject to political decision making by regulators with the consequent distortion of results and dislocation of markets

4. Cause insurers to improve in efficiency, thereby making for a healthier and stronger industry which would in turn better serve its customers

5. Cause safety, claim, audit, rehabilitation, and underwriting services to become more effective and efficient

6. Reduce insurers' motivation to rely on rates generated by rate service organizations, and

7. Cause insurers to be more flexible and more adaptive to the needs of individuals.

Minnesota's Commissioner stressed that competitive rating should not mean the abandonment of state regulatory authority. Any competitive rating law should specify that rates not be excessive, inadequate, or unfairly discriminatory, with the state Insurance Department given the responsibility of discontinuing any rate that does not meet the standards. Finally, the commissioner stressed that competitive rating was not a panacea to all workers' compensation problems. It did not guarantee that prices would go down, or even that they would not rise above their current levels.[9]

C. In response to Congressional requests, a 1982 U.S. General Accounting Office report theorized that competitive ratemaking could reduce the costs of workers' compensation insurance for most employers, although smaller firms might encounter higher premiums and greater difficulty in obtaining coverage. In a follow-up report on "Initial Experiences with Competitive Rating" in 1986, GAO found that between 1981 and 1985, 10 states enacted competitive rating laws under which each insurance company generally prepared and filed its own workers' compensation rates and used them without first obtaining state approval. GAO found that between 1982 and 1984, both the average cost and the size of the assigned risk pools declined in most states, with declines greater in states that had initiated competitive rating laws. These results were consistent with effects anticipated in 1982. The only evidence that GAO offered about the effect on small business was a study in Michigan which found that the initial effect on most small business was at least as favorable as the effect on larger business. Only the smallest businesses, those with fewer than 5 employees, did not experience a decline in rates.

In their 1986 review, GAO found no evidence that competitive rating had altered market structures; there were no discernible differences in concentration ratios before and after the introduction of competition. Nevertheless, GAO recognized that a complete assessment of its impact required sufficient time to allow the observation of rate and availability trends through all phases of the underwriting cycle. Their analysis found that even in states without competitive rating competition could occur with offerings of premium discounts or rebates which reduced net costs relative to initial premium quotes. GAO felt that some states adopted competitive rating in an attempt to more accurately reflect true net costs up front; some state officials "believed that lower initial premium quotes would make them appear more attractive to employers considering whether to locate in their state or a neighboring state." [10]

D. In June 1989, the National Association of Insurance Commissioners (NAIC) adopted the recommendation of the Advisory Organization Activities Working Group that advisory organizations (i.e. rating bureaus) should be prohibited from filing "fully developed" rates in all property/casualty lines except workers' compensation. The NAIC decided to look at workers' compensation separately.

During the summer and fall of 1989, the Working Group met and heard public testimony on the desirability and feasibility of loss costs in workers' compensation. Insurers and advisory organizations (rating bureaus) testified that going to a loss costs system was feasible; nevertheless, they predicted that employers and employees would be adversely affected. They argued that dividends and deviations already made workers' compensation pricing competitive, and that the lack of access to fully developed bureau rates would cause some insurers to withdraw from the market, particularly those who wrote workers' compensation as an "accommodation" to policyholders buying other types of coverage. In contrast, insurance regulators from Michigan and Oregon testified that loss costs systems worked well in their states, and benefitted policyholders. Consumer representatives testified that competition could be increased through prohibition of filing final rates. Agents and buyers cautioned that if there was a trend toward loss costs, that care to minimize market dislocations was necessary.[11]

In December 1989, the NAIC Working Group recommended that workers' compensation not be treated differently and that states should prohibit the filing of fully developed rates, but that in the interim that steps be taken to:

1. implement a system of reporting detailed management information on all claims;

2. develop a system of data monitoring to ensure the quality of ratemaking and claims-related data; and

3. do an economic analysis of the impact of implementation of loss cost systems on state workers' compensation insurance markets.

Some group members expressed concern that loss costs systems could create adverse impacts on the availability of coverage and on loss prevention activities.

E. In December, 1990, NAIC's Workers' Compensation Advisory Organization Activities Working Group accepted a Milliman and Robertson study indicating the feasibility of moving to loss costs for workers' compensation. It also received an NAIC staff study that evaluated the experience of the 10 states which had already implemented loss costs in workers' compensation, and which considered the market implications of extending such a system to all states. The study found no evidence to indicate that state workers' compensation insurance markets have either significantly benefitted from or been hurt by loss cost systems. The study also concluded that there was no reason to believe that the experience of other states would be different if loss costs were implemented nationwide.

After consideration of staff and consultant reports, the working group reaffirmed its position that workers' compensation insurance be treated no differently than other property/casualty lines with respect to implementing open competition or loss costs systems. "A loss system in workers' compensation insurance is feasible and should not have significant negative effects on the marketplace." The working group recognized a loss cost system in workers' compensation should have several special provisions because of its unique aspects. Also, the working group recommended that the conversion of workers' compensation insurance to loss costs should be targeted for 1994. This was to allow sufficient time for preparation of a loss cost system in workers' compensation insurance and conversion of the other property/casualty lines to loss costs.

2.6 EVALUATION OF ALTERNATIVE RATEMAKING SYSTEMS

In states that allow competition between insurance carriers (i.e. non-exclusive state fund states), there are two basic forms of ratemaking. These are administered pricing systems and competitive pricing mechanisms. Historically, virtually every state that permitted private workers' compensation insurance utilized administered pricing. All insurers adhered to uniform rates, filed by a rating bureau, that received the prior approval of the state insurance commissioner or department. In most states, the National Council on Compensation Insurance (NCCI) was the main rating or advisory organization, while several states, including California, have used independent rating organizations.[12] There were many justifications for the rate regulation, including assuring solvency, and fixing a price that would assure availability of coverage for all employers, regardless of size and risk.

Many states allowed deviations from the bureau rates, either prospectively, or retrospectively. Some states tried to encourage price and service competition among insurers by allowing individual carriers to request rates in some or all categories of work that were lower or higher than the Bureau level. Several had always allowed deviations from Bureau rates if the insurer(s) wishing the deviation could give assurance that the rates were reasonable, and adequate but not excessive. Some states recognized that it was administratively cheaper to write some risks than others, and allowed or mandated premium discounts or expense constants that were set according to size of the account.

Beginning in the 1980s, several states began to shift from administered pricing to various competitive rating mechanisms. These variations encouraged and/or allowed more market competition into rates. For example, the new laws often restricted cartel-like rating bureaus from filing fully developed rates, and many did away with requiring prior approval of the insurance regulator before rates could be used. (A commissioner usually retained the power to issue orders to desist from using rates after formal review.) Because the rates could be adjusted without department approval, it was thought that they could be more responsive to changes in claims costs or overhead expense differences.

A categorization of various rating alternatives and brief discussion of the experience of selected states under each alternative follows. It is interesting to note that there are significant differences both between alternative ratemaking structures, and within the categories.

2.6.1 ADMINISTERED PRICING WITHOUT DEVIATIONS

There are currently five non-exclusive state fund states which have not enacted a competitive rating statute, and which do not allow prospective deviations from prior approval rates. These states are California, Massachusetts, New Jersey, Texas and Wisconsin. Each of the states (except Texas - see description below) has an independent rating bureau; none use the National Council on Compensation Insurance for rate filings or data compilations. These states have generally attempted to enforce Bureau rates and rules on all insurers, allowing only retrospective rating variations, such as dividends, as ways to compete on price. Even in these states, however, the use of dividends is quite variable. In California in 1990, private insurers rebated 11% of premium to policyholders; in Massachusetts only 2.4%, and in Texas 1.9%.

A. CALIFORNIA

(For more complete information on California, see subsections 2.1-2.5 of this section.)

California has a state fund that acts both as the insurer of last resort, and as a competitive carrier. It currently allows no prospective (beginning of policy year) downward deviations from the published manual rates. The "minimum rate law" does not prohibit companies from adjusting their prices upward if they feel the insurance commissioner is granting too low an increase in the minimum rate.

Although the Insurance Code allows it (Section 11730), there is currently no program to allow adjustment of manual rates based on "schedule rating." Schedule rating is a type of merit rating plan that gives premium credits and (at least theoretically) debits to rated firms depending on degree of hazard control in their physical plant, administrative controls, access to medical care, and other factors.

The only formal system of merit rating today is "experience rating" which gives credits and debits depending on the size, hazardousness, and claims experience of the individual employer.

California insurers have traditionally used dividends to further reward certain employers. Only Idaho insurers rebated more of the premium dollar to policyholders as dividends in 1990 than did California insurers.

The change from a Republican appointed Insurance Commissioner to an elected Democrat with acknowledged political ambitions has greatly altered the playing field in the California insurance regulatory area.

B. TEXAS

Texas is unique among states in that the State Board of Insurance gathers statistical data directly from insurance carriers and performs the function of calculating modifiers, reviewing policies, and maintaining the classification system. These tasks are performed by the NCCI or independent rating bureau in all other states. Texas is also one of only three states in which workers' compensation coverage is not mandatory.

While technically not allowing deviations, employers with large premium volume and good loss histories can receive premium discounts. Policyholders purchasing all their insurance from one carrier are sometimes able to get a reduction. Employers with good experience rating or otherwise representing a good risk are able to receive reductions. Rates in Texas are translated into premiums for individual employers through expense constants (a flat charge ($85 in 1989) covering the cost of issuing and recording the policy, payroll audits, etc.), minimum premiums in some rate classes, loss constants (a flat $10 charge added to premiums which are less than $500), and premium discounts for premiums of more than $5,000, reflecting the fact that, as a percent of premium, the expense associated with writing a large policy is less than that for smaller policies. Employers are also eligible for experience rating modifications, and retrospective rating plans. Finally, many Texas insurers have historically paid dividends to policyholders. Between 1980 and 1986, the percent of premium paid as dividends fluctuated from 2.7% to 7.3%.

Rates rose quickly in Texas in the late 1980s, but not as fast as insurers thought necessary. When private carriers refused to write them, many small employers were forced into the assigned risk pool, and were not eligible for experience rating. Many small but safe employers felt they were subsidizing poor risks.

In mid 1988, Texas's ratemaking formula allowed a total expense factor of 18.6 percent of the premium dollar. This factor was kept down by requiring insurers to contemplate an underwriting loss of 7.6% percent, with the rationale that investment income was sufficient to allow underwriters to pay some of the expense overhead themselves and still earn a profit of 15% on premiums.

Calls for ratemaking reform in 1988 included pressure for more progress in developing safety programs to reduce workplace injury. A special program was introduced to address problems at "extra-hazardous" employers whose injury frequencies were substantially higher than expected. Employer and insurer would be notified, and then the employer must obtain, within 30 days, a safety consultation. A safety plan is developed and the state monitors its progress, assessing the employer for costs involved. While the emphasis is on voluntary compliance, employers who refuse to implement plan are subject to civil penalties as well as OSHA enforcement.

Texas is one of several states in the process of adopting a state fund to write workers' compensation coverage. There has also been a trend toward adoption of competitive rating.

C. WISCONSIN

Wisconsin is usually cited as one of a handful of states that is not in crisis, and that has relatively well functioning system of workers' compensation. The system is known for tight oversight and close supervision of claims by the state administrative agency.

Wisconsin meets 15 of the 19 essential recommendations of the National Commission on Workmen's Compensation, a figure higher than all states except New Hampshire, Ohio and Vermont. It has relatively high maximum benefit rates and relatively high frequency of claims,yet has had only a gradual rise throughout decade on premium rates. The state ranked 38th on one recent premium rate comparison.

2.6.2 ADMINISTERED PRICING WITH DEVIATIONS

Deviation statutes allow insurers considerable flexibility to alter their rates either across the board, or in specific classes of coverage. Individual insurers seeking deviations are required to justify their request and demonstrate how their claims experience or expenses differ from the broad-based experience of the rating organization's filing. Most states allow deviations from rates only. This follows language adopted by the National Association of Insurance Commissioners in the "All Industry" Casualty and Surety Rate Regulatory Bill in 1946. In some states, rating laws permit insurers to deviate from rates and rating elements. Thus, insurers may be permitted to file deviation from class rates, schedules, rating plans or rules, or class of risks, or combinations thereby. Some states only require formal prior approval for rate deviations with respect to premiums higher than approved maximum rates, but do not require prior approval for downward deviations. Some require a formal hearing on the application of each deviation, others do not. Other alternatives include not requiring prior approval for a deviation if final rates stay within a band of plus or minus a percentage of the approved rate.[13]

A. NEW YORK

New York is similar to California in that it has a state fund and no assigned risk plan, and there is no indexing of benefits. Benefit increases to adjust for inflation only occur by acts of the Legislature.

Insurer members of a rate service organization may apply to deviate from rates filed on its behalf. The commissioner must approve or deny the request based upon the requirements of the insurance code. Deviations are approved for periods of at least one year. New York also has a rate study commission underway.

B. FLORIDA

Under Florida law, carriers may file uniform percentage decrease or increase for classes of insurance. Deviations require prior approval of commissioner and a determination that resulting premiums would not be excessive, inadequate, or unfairly discriminatory. Deviations must be renewed annually, and can be canceled by the Department.

C. NORTH CAROLINA

In North Carolina, insurers cannot issue policies that do not conform to rules, classifications, schedules and standards of the Rating Bureau, unless they have the prior approval of Insurance Commissioner. Deviations must be uniform by class of insurance. The commissioner must approve if deviations do not render the rates excessive, inadequate or unfairly discriminatory. Deviations may be terminated only after 6 months, and with 15 days notice. Bureau rates can be exceeded on any specific risk provided that the higher rate is charged with the approval of the Commissioner and with the knowledge and written consent of the insured. Deviations for workers' compensation and employers' liability insurance shall apply uniformly to all classifications.

2.6.3 COMPETITIVE RATING: LOSS COSTS/PURE PREMIUMS

Five states (Kentucky, Maryland, Michigan, Minnesota, and Rhode Island) have instituted competitive rating systems in which the advisory/rating organization files loss costs only and no prior approval of rates by the Insurance Department is required. In 7 states (Colorado, Connecticut, Hawaii, Louisiana, New Mexico, Oregon and South Carolina) prior approval is required but the rating organization files only loss costs.

There appears to be no clear trends pointing either to success or failure of the loss cost variation. A recent report by the NAIC research director includes case studies on four loss cost states that suggests differing results in competitiveness, concentration ratios, loss costs, and market performance. He finds evidence that, in the short run, the imposition of a loss cost system decreases rates, but that the long term results reflect less dramatic reductions. In general, he concludes that none of the histories indicated severe market dislocations or extreme practical problems of implementation, but also that there were no dramatic improvements in market performance. He notes that the imposition of loss costs may lead to more, rather than less, oversight by regulatory officials in order to assure that insurers are educated about their responsibilities, and that severe market dislocations are avoided. This final view echoes the 1982 thoughts of the Minnesota Insurance Commissioner, cited in Section 2.5 above, that competitive rating should not mean the abandonment of state regulatory authority.

A. MICHIGAN

Michigan adopted a file and use open rating system in 1983.. Among state loss costs systems, Michigan's is the most restrictive, requiring insurers to file their own rates, rating rules and policy forms, and restricting the rating organization (the Data Collection Agency) to collect and distribute pure premium data only. No adjustments for trend or loss adjustment expenses are allowed. Insurers are required to file their own minimum premiums, experience rating plans, expense constants and premium discount plans. The insurance commission switched from a role of regulating price to regulating marketplace behavior and level of competition. Rating bureaus were abolished to prevent cartel pricing.

Klein's study for the National Association of Insurance Commissioners found that Michigan's experience has been generally favorable. Annual reports have shown that the market remains competitive, and special studies indicate that competition and market performance improved initially after competitive rating was introduced. He showed that in Michigan the number of insurers writing workers' compensation coverage went from 115 in the year before the loss cost system was developed to 109 in the year after, and stayed relatively stable after that. Loss ratios were also relatively constant. Concentration ratios did increase after the introduction, with part of the concentration attributed to significant growth in the market share of the Michigan State Accident Fund.

After the introduction of competitive rating, dividend rates fell dramatically between 1982 and 1989. The residual market experience has been mixed, but as of 1989, Michigan's residual market share was only 41% of the national average.

B. MINNESOTA

Minnesota's reform and switch to competitive ratemaking in 1983 occurred after a study comparing Minnesota with Wisconsin found Minnesota's premium rates to be higher, spurred by significantly higher rates of litigation. The early experience of deregulation was heavily criticized in a December, 1989 state Department of Commerce Study which found: a) tremendous instability of rates in Minnesota (and other deregulated states), with rates rising and dropping with greater frequency than in regulated states; b) little relationship between the rates and loss ratios of insurers; c) basic errors in the calculation of loss reserves by insurers; d) a subsidy of high risk employers by small companies in the assigned risk pool; and e) a loss of public confidence in the system. The study concluded that rates should again be regulated. In 1990, an Oregon study found Minnesota's insurance rates to be the highest in the country.

Klein's study found that Minnesota experienced a larger decline in number of insurers writing workers' compensation, and a corresponding increase in the concentration ratios of larger carriers.

C. OREGON

Oregon operated an exclusive state fund until 1966, when it allowed private insurance coverage for workers' compensation. In 1982, the system of administered pricing was dropped, eliminating mandatory adherence to NCCI rates and adopting an "open competition - modified file and use system. In 1987, the file and use system was repealed, with the result that insurers' rate filings are now again subject to prior approval.

Oregon's system initially created a strong competitive response. The initial filing of the State Accident Insurance Fund (SAIF) was below the pure premium level advised by the rating bureau. According to Klein, this induced other carriers to file inadequate rates to remain competitive. Loss ratios jumped from 80% in 1982 to 129% in 1984, while dividends to policyholders fell from 22% to less than 1% in 1986. The system then began experiencing increasing costs: Oregon employers paid the eighth highest premiums in the nation in 1988, and 1990.

By the end of the decade there was evidence of problems in the system. By 1990, system was experiencing rampant litigation involving dueling doctors, with half of all disabling claims going through a hearing process that nearly always involved litigation with lawyers getting 25% of award. Millions were spent on medical exams that provided no health benefits.

Small Businesses were also affected. SAIF lost $49 million in 1988 and another $30 million in 1989. A recent change in philosophy now has SAIF acting more like a private insurer, picking and choosing the most attractive businesses. In August 1989 SAIF canceled 7,000 policies and raised premiums for 36,000 others. This affected more than half state's employers and drove many into the state's assigned risk plan. When State insurance commissioner refused to agree to a minimum premium of $1000, SAIF said it would cancel coverage for another 20,000 small businesses. Currently competition appears to be lacking. SAIF has 70% of employers, but only a minority of firms with more than 20 employees. Liberty Mutual Northwest, Portland has 44% of market held by private insurers, 10 times larger than nearest competitor.

D. RHODE ISLAND

While technically a competitive rating state, in Rhode Island the system only fully applies to the two companies that have more than 1% of the insurance market. All others, including the Assigned Risk Plan which has upwards of 90% of the Workers' Compensation market, may have fully developed rates filed by the rating organization, although adherence to those rates is not required.

Information from Rhode Island suggests that severe problems arise when rates in the assigned risk market are not perceived as adequate by insurers. According to filings with state regulators, assigned risk plan carriers currently spend very little on loss control. Only 2 participating carriers spent over 1% of premium on safety, while 14 of 17 others spent less than 1/2 of 1%. Despite going to a system of limited competitive rating, Rhode Island still has significant problems of availability.

2.6.4 COMPETITIVE RATING: ADVISORY RATES

In several states, competitive rating exists but the rating organization continues to file advisory final rates. The rating laws of these jurisdictions prohibit mandatory adherence to these rates, but do not compel individual insurers to file their own loss development trends or rates. Georgia, Illinois, Montana, and Vermont are examples of this arrangement.

A. GEORGIA

Georgia established a file and use system in 1984. Prior to its inception, Georgia used a prior approval system that allowed some competition due to the use of schedule rating. In 1985, the U.S. General Accounting Office found that despite the move to a competitive system, there was little deviation from the rates; 90 percent of the insurance companies still relied on advisory rates promulgated by the NCCI. More recently, a 1988 Texas analysis found that considerable upward deviation was taking place in Georgia, with rates having increased as much as 80%. Georgia's rates appeared to have soared during the late 1980s. Between 1974 and 1990, manual rates increased 274%, 8th highest among the states.

B. ILLINOIS

Before moving to implementation of competitive rating, Illinois had allowed schedule credits of up to 25 percent. Under the state's current rating plan, allowable deviations are plus/minus 60 percent from the manual rate. The state currently requires carriers to participate in a data bank compiling loss data statistics. Industry cartels are prohibited to prevent price collusion.

FOOTNOTES

1 Industrial Accident Board of California, "Program for Workmen's Compensation Legislation, 1913." The Board laid out four policy alternatives in the area of insurance regulation: 1) the status quo - leaving the question of rate setting to the competition of the private marketplace. According to their research, such a policy existed in Great Britain, Russia, Spain and Greece but the members stated that it resulted in extortionate rates or "a savagery of competition" that drove hard bargains with injured persons or threatened the carriers' solvency. 2) Compulsory state insurance had been seriously attempted in Norway and Washington state, but the IAB said neither of these systems included coverage of all workers, and to do so would require "an army of officials" to administer. "To make a state monopoly inclusive of all employments would create a bureaucracy of intolerable proportions and high cost, while not to include under the protection of a compensation law all who labor is to fail of safeguarding the state from poverty due to industrial accident." 3) State Control of Insurance Carriers was dismissed by the IAB as "unworkable," a scheme which was abandoned by those jurisdictions that had attempted it. Instead, the IAB proposed 4) Competitive State Insurance, an idea borrowed from New Zealand (where Board member Will French was born) and other states of continental Europe.

2 IAB,"First Report to Governor," 1912, p. 14.

3 Labor Clarion, February 21, 1913, p. 8; Report of Insurance Commissioner, State of California, 1912, Table #11 "Showing Business of Liability Insurance for the Year 1912," p. 86; quoted in Labor Clarion, March 28, 1913, p. 10.

4 Labor Clarion, March 28, 1913, p. 10.

5 Labor Clarion, May 14, 1913.

6 Labor Clarion, April 17, 1913.

7 Paul Scharrenberg, "Labor View of Legislature," Labor Clarion, 5/16/13, p.

8 Communication with Jim Neary, State Compensation Insurance Fund.

9 Committee on Small Business, Subcommittee on General Oversight, U.S. House of Representatives, Hearing on "Worker Compensation Ratemaking Reform," February 18, 1982. The major insurance trade associations and carriers, including NCCI, Liberty Mutual, AIA, and AAI, declined to testify at the Congressional hearing, with some indicating that ratesetting practices were the domain of the state Insurance Departments and were not an appropriate area of inquiry by Congress.

10 GAO/OCE 87-1, p. 3.

11 Description adapted from Robert Klein, National Association of Insurance Commissioners, "Market Effects of Loss Costs Systems in Workers' Compensation," (draft 11/14/91).

12 The discussion in this section is in part adapted from Robert Klein, National Association of Insurance Commissioners, "Market Effects of Loss Costs Systems in Workers' Compensation," (draft 11/14/91).

13 For more information on deviations, see National Council on Compensation Insurance, "Workers' Compensation Insurance Rating Laws 1990" (June 1, 1990).

C102T08F.GMS

SECTION 3.0

COMPETITION, REGULATION AND RATEMAKING IN THE WORKERS' COMPENSATION INSURANCE INDUSTRY IN CALIFORNIA

SECTION 3.0

COMPETITION, REGULATION AND RATEMAKING IN THE WORKERS' COMPENSATION INSURANCE INDUSTRY IN CALIFORNIA

3.1 COMPETITION, REGULATION AND RATEMAKING OVERVIEW

California comprises the nation's largest market for workers' compensation insurance. The workers' compensation market is regulated to some extent in every state in that all employers are obligated to provide coverage for their employees, and benefit levels are set by the state government (and, in some cases, by the federal government). Within this framework, the California regulations are neither the most nor the least restrictive.[1] The Commission evaluated workers' compensation insurance regulation from a competitive standpoint. This involves two primary issues:

A. The ability of a competitive versus a regulated market to provide efficient service, and the relative competitiveness of the market for workers' compensation insurance in California; and,

B. The impact of ratemaking on the primary workers' compensation constituencies--insurers, employers, and employees

3.2 COMPETITION AND REGULATION

3.2.1 THE ECONOMICS OF WORKERS' COMPENSATION INSURANCE

Regulated markets are, by definition, not perfectly competitive. A decision to regulate is made when a perceived risk exists that market dynamics will not produce public policy goals. Given the desirability of the goal, the benefits of regulation are more highly valued than the costs of reduced competition. In the case of workers' compensation insurance, regulators opted to tolerate higher costs primarily to achieve the benefit of reliable future payments. Thus, regulation has taken the form of setting rates adequate to assure long-term insurer solvency.[2] This emphasis is also a function of the potentially long-term nature of workers' compensation claims and benefits. There can be a lag of years between the time of injury and the ultimate disposition of a claim against the insurer. Permanent disabilities call for long-term benefits.

The workers' compensation insurance industry is unique in being a social welfare program largely provided by the private sector. Since its origins in the Industrial Revolution, its goal, most broadly stated, is to allocate the social costs of workplace safety to employers, by requiring them to provide workers' compensation insurance coverage for the benefit of their employees.[3] This requirement alone sets up several fundamental conflicts, among them: (1) the purchaser/decision maker is the employer, not the employee/beneficiary; and (2) economic efficiency dictates that the social costs of injuries should be allocated to those responsible while workers' compensation insurance is, by design, an administrative no-fault system.

The Commission considered a range of possible market structures to evaluate the economics of the workers' compensation insurance industry:

A. Perfect competition

B. Monopolistic competition

C. Oligopoly

D. Monopoly

These represent a spectrum of product/market characteristics, rather than discrete categories, and markets do not necessarily fit neatly into one and only one classification. While perfectly competitive markets are virtually non-existent, the market for workers' compensation insurance in California is more accurately described as a competitive market rather than an oligopoly or monopoly.

The basic product is the standard workers' compensation insurance policy used by all insurers; its terms are not complex, and information is widely available. However, it is not the highly homogeneous product of perfectly competitive markets. Workers' compensation insurance is essentially a service, rather than a homogeneous commodity.

Because of mandatory coverage, aggregate demand for workers' compensation insurance is static and highly price inelastic; that is, aggregate demand is insensitive to price. The quantity demanded would not increase if the price were reduced nor would aggregate demand decrease in the face of price increases.[4]

On the supply side, workers' compensation insurance is supplied by a large number of private insurers.[5] Entry barriers are low; capital and surplus requirements are not onerous; there is no significant investment required in plant and equipment; the same facilities can be used to write several lines of insurance. Therefore, the threat of entry prevents incumbent insurers from charging prices which would result in excess profits.

Given these product, demand and supply characteristics, the Commission considered the behavior of buyers and sellers in the market. While aggregate demand is fixed, the demand facing individual insurers is more price elastic; if an individual insurer increases prices, it will lose customers, and vice versa. An argument has been made that an insurer's only alternative in the face of this price sensitivity is to lower prices. However, insurers can and do differentiate their product to develop market power in the form of customer loyalty. For example, if an insurer establishes a reputation for superior claim processing services or safety programs, loyal customers may be willing to pay higher premiums rather than switch insurers solely on the basis of price.[6]

As a general rule, individual insurers cannot raise prices without losing market share. Insurers colluding as a group cannot raise prices without attracting entry. Individual insurers may lower prices as a temporary strategy to gain market share, or as a group to deter potential entry. However, rational insurers would not maintain prices at a level which would eliminate profit altogether.

Oligopoly is characterized by a small number of competing firms on the supply side. Each seller recognizes the interdependence of its strategy with the policies of other sellers. However, as the number of competitors increases, strategic interaction causes prices to converge toward marginal cost. In the case of workers' compensation insurance, the number of competing insurers is large (even if it were not, entry is not difficult), and insurers are able to differentiate their products. Thus, the Commission concluded that the workers' compensation insurance industry lies toward the competitive end of the market structure range. Thus, market forces will result in service provided to employers at an average price approaching average cost, and market failure is not a likely consequence of deregulation.

3.3 OBJECTIVES OF WORKERS' COMPENSATION INSURANCE

The Commission next considered the stated goals of workers' compensation insurance in California, and evaluate the potential for their efficient achievement in a competitive versus a regulated market.

3.3.1 SERVICING OF EMPLOYEE CLAIMS

"Secure, appropriate, and expeditious" claim servicing implies that insurers be able to pay (solvency) an appropriate benefit in a timely manner. Enhanced price competition could increase insolvency. Regulation, however, is no guarantee against insolvency, because of insurers' operations in other states and in other lines of business not affected by one state's workers' compensation laws. Other means of averting insolvency could have less impact on competition, for example, raising the capital and surplus requirements for insurers (trading off enhanced solvency with higher barriers to entry) and increasing disclosure requirements for multistate, multiline insurers. The risk is mitigated through the use of insurance guarantee associations similar to the FDIC, funded by insurer assessments sufficient to guarantee future benefits in the event of insolvency.

While employer/purchasers of workers' compensation insurance have little direct incentive to expend resources monitoring insurer solvency, benefit levels, or claim processing services valued by employee/beneficiaries, the reputational effects of providing inadequate coverage could impair an employer's ability to compete in the labor market.

An argument is made that a regulated market forces insurers to compete on non-price attributes, such as claim processing services, cost containment, rehabilitation programs, etc., and that these services would suffer in a more competitive environment. However, if these services are valued by employees, and therefore by employers, demand will continue. Moreover, it is perfectly plausible that the costs of providing superior claim servicing, for example, could result in lower loss experience[7] for a net benefit to the insurer. Insurers would have strong incentives to provide such services, and competition would cause these savings to be shared with employers resulting in lower prices for equivalent or superior claim servicing efficiency in a competitive market.

3.3.2 FINANCIAL INCENTIVES FOR EMPLOYERS SAFE OPERATIONS

For employers to internalize the costs of workplace safety, the cost of maintaining safe operations (plus lower premiums) cannot exceed the cost of higher premiums (plus the cost of less safe operations).[8] Otherwise there is no incentive for employers to incur the costs of loss prevention programs. In a regulated market, employer safety costs affect premiums by means of retrospective adjustments, subject to measurement error, regulatory lag, and, in the case of policyholder dividends, significant insurer discretion. If prices in a competitive market were more immediately responsive to employer outlays on workplace safety, there would be greater incentives to incur such costs.

Again, non-price competition in a regulated environment has implications for workplace safety incentives. If regulated insurers compete by offering safety programs, greater price competition could reduce safety if the incentives of a competitive pricing structure are inadequate. As in the case of claim servicing, however, if safety programs reduce losses for a net gain to the insurers, the financial incentives to provide such programs are strong, and the gains will be shared with employers in a competitive market.

3.3.3 FAIR DISTRIBUTION OF COSTS TO INSURED EMPLOYERS

Fairness dictates higher premiums for riskier classifications, e.g., a steel mill versus a CPA firm. Within an industry, premiums should vary according to workplace safety. The pricing of risk and safety factors, whether in a regulated or a competitive market, would not reward higher risk with lower premiums.

The effects of market structure on the fair distribution of costs is less clear for firms of different size. Insurer costs per employee are lower for large firms because of economies of scale in servicing, (for example, a small number of large steel mills than a large number of small ones). If the marginal cost of servicing smaller firms is higher, the price should be higher. In California's regulated market, ex-ante premiums do not vary by firm size; however, retrospective adjustments are generally available only to large firms, so small firm premiums are, in fact, higher for a given risk. Whether ex-post premiums are equal to marginal costs is not clear; the regulated system may embody discrimination based on firm size. Adjustments for large firms would be greater (ex-post premiums lower) if small firm premiums had to rise to reach a competitive rate determined by marginal cost, and vice versa. A more competitive market is better able to price at marginal cost than a regulated market, but whether this would result in higher or lower net premiums for different size employers depends on the direction of any cross-subsidies currently in place.

3.3.4 AVAILABILITY TO ALL EMPLOYERS

In a competitive market, with risk appropriately priced, voluntary coverage would be available to all employers. Even very risky employers (for example, the firm clearing Kuwaiti mine fields) could find coverage, although there would probably be few insurers competing for this market segment and the price would be high.

In a regulated market, risky employers, through the nature of the work (e.g., asbestos removal) and/or negligence, are subsidized by lower risk employers through the residual market mechanism unless it is actuarially sound. The residual market consists of employers whom private insurers are unwilling to cover voluntarily. This market is serviced through an assigned risk pool and/or a state fund. Regulated rates for these high-risk employers must be inadequate for the risk assumed, otherwise, private insurers would provide coverage voluntarily. This is consistent with higher losses and lower profitability in the residual market.

In a competitive market, the cost of workers' compensation insurance could be so high that risky firms would no longer be profitable at their current price structure. Depending on the value placed by society on their goods and services, some high risk businesses would fail if they had to significantly raise their prices to pay for appropriately priced workers' compensation insurance. This prospect may be unpalatable from a public policy point of view. Therefore, the cross-subsidy effect notwithstanding, regulation requiring insurer participation in an assigned risk pool could still be implemented within a more purely competitive market to assure availability to all employers. This was the route taken by Michigan in its more openly competitive market. A 1991 study of the Michigan market suggested an inverse relationship between insurer profitability and the size of the assigned risk pool in a less regulated market: insurer profitability increases, insurers become more willing to accept higher risks voluntarily, and the assigned risk pool contracts; as insurer profitability decreases, they become more reluctant to cover high risk employers voluntarily, and the pool will grow.

Firm size is also a factor in availability of coverage. Large employers have the option of self-insurance, which solves the problem of availability , and could be the lower cost alternative, although in a competitive market, the cost of self-insuring should be close to the cost of purchasing insurance. (Self-insurance also provides safety incentives since all costs are internalized.) Small firms lack the self-insurance option, and the 1991 Michigan study found that small firms were disproportionately represented in the assigned risk pool, although small and/or high risk employers could usually obtain coverage by implementing insurers' risk management suggestions. Notwithstanding, small firms within a particular risk classification can use pooling to find coverage (and rate adjustments) similar to large firms.

3.3.5 STABLE, PREDICTABLE MARKET

The regulated market provides employers with reasonable certainty regarding workers' compensation costs from year to year. Even with shocks, regulatory lags have a smoothing effect, so that changes are more gradual. Rates and availability in less regulated insurance markets are more volatile, but follow a relatively predictable cyclical pattern, as market forces operate to correct imbalances.

3.3.6 REASONABLE RATES OF RETURN TO INSURERS

The profitability of workers' compensation insurers is a function not only of income from the underwriting transaction (premiums, losses, expenses, and dividends), but also of income from the investment of reserves and capital. The difficulty of allocating this income across lines of insurance and across states (for multistate insurers) makes the calculation of rate of return for a single insurer's workers' compensation line in one state virtually impossible. However, unless rates of return are at least equal to the cost of capital, capital will flow out of workers' compensation into other lines of insurance, other industries, or out of a regulated state into a less regulated state. Thus, availability of voluntary coverage by private insurers and new entry indicate that rates of return are at least adequate. And, conversely, inadequate regulated rates, or rate suppression, lead to lack of availability and exit.

While rate of return regulation (as in public utilities) is not appropriate, and not typical, in this market, adequate rate regulation implies rates of return sufficient to keep insurers in business. In a competitive environment, insurers set prices in the expectation of providing a reasonable rate of return, based on superior inside information (superior to the information available to regulators). Adequate rate regulation suggests that regulators believe competition among insurers would result in rates so low that their rate of return would be insufficient to attract capital, an exceedingly pessimistic assessment of the business judgment of insurance company managers. An equally pessimistic view of regulators might suggest that they pay too high a price (provide excessive rates of return) for solvency. However, excessive returns will attract new entry, and competition among incumbents and new entrants will drive returns down to a "reasonable" level again whether through up-front price competition or competition in services and ex-post adjustments. Thus, market forces will result in reasonable rates of return whether the market is regulated or not, although a more competitive market will accomplish the adjustment more efficiently.

3.4 COMPETITIVENESS OF THE CALIFORNIA MARKET

With few exceptions, markets meeting the theoretical criteria of perfect competition do not exist. The Commission assessed the state of competition in the (regulated) California market using the structure-conduct-performance framework. The California market was evaluated relative to the markets for workers' compensation insurance in six other states and to competitive benchmarks in other industries.[9]

3.4.1 MARKET STRUCTURE

The California market is characterized by a relatively homogeneous product, the standard policy used by all insurers. Information about the nature of the product is available to buyers and sellers. State capital and surplus requirements are very low, and present no barrier to entry. The absence of barriers is supported by a higher rate of increase in the number of insurers in California than in the comparison states.

A competitive market is characterized by a large number of buyers and sellers, each accounting for only a small percentage of the market. The California market for workers' compensation insurance is both the largest and the fastest growing in the country, with 142 insurance groups writing coverage in 1990. The changing composition of the list of the eight largest insurers and the differences in growth rates across insurers are indications of dynamic competition.

The California market is substantially unconcentrated as evidenced by concentration ratios below those in other states, and comparable to ratios in other industries widely regarded as competitive. The Herfindahl-Hirschman Index for the California market has been well below the benchmark of 1000 considered to be unconcentrated, and, in fact, has declined by 3.2 percent over 1986-1990.

3.4.2 MARKET CONDUCT

In a competitive market, prices are set by market forces and reflect the marginal costs of providing services. Strong evidence that switching costs are low provides indirect evidence that prices in California may be driven toward marginal costs. California employers can and do switch insurers: 54 percent of all employers had switched insurers in the past 5 years, with large employers more likely to switch. Forty-one percent of these employers switched to obtain a better "price" (net cost).[10] The ability of to switch insurers for better prices and/or services suggests that price adjustment mechanisms in the California market (rating plans, policyholder dividends) may approach the ability of a competitive market to equate price with marginal costs. That is, the act of switching implies that the employer perceives its current premium exceeds its estimate of the marginal cost of the service provided.

3.4.3 MARKET PERFORMANCE[11]

Workers' compensation insurance prices have been more stable in California than in comparison states. Voluntary as opposed to residual coverage is available to a larger share of California total premiums than elsewhere. (Since the California state fund is competitive, it is difficult to determine what proportion of its coverage is voluntary rather than residual; voluntary coverage may, in fact, be understated.) As in the Michigan study, the size of the residual market appears to be inversely related to insurer profitability.

Operating returns have been higher in California than for the U.S. workers' compensation insurance industry as a whole (entry data supports the notion that insurers find California a desirable market), while total returns have been comparable to (slightly lower than) the nationwide all-industries average return.

3.5 THE IMPACT OF RATEMAKING PROCEDURES ON WORKERS' COMPENSATION INSURANCE CONSTITUENCIES

The Commission next briefly reviewed ratemaking procedures used in California (and elsewhere) and evaluated their effects on the primary constituencies of workers' compensation insurance: insurers, employer/purchasers, and employee/beneficiaries. (The analysis omitted secondary constituencies such as regulators and administrators, and providers of services.)

3.5.1 MANUAL RATES

The manual rate is the first step in the rate-making process. Total premiums at current rates are compared to expected losses and expenses to assess the need for change in the overall average rate. The statewide average rate is then distributed across risk classifications to create a benchmark rate for each class, from which adjustments are made based on insurer and employer circumstances. (Refer to the discussion of rating bureaus in the following subsection.)

Manual rates reward insurer inefficiency if up-front expense loading is excessive. However, their uniform applicability to all insurers provides efficient providers with opportunities for large profits and/or the ability to compete more favorably on the basis of ex-post adjustments. Manual rates provide employers with an umbrella price beneath which they can evaluate adjusted rates and negotiate with insurers. Employees benefit from a rate designed to assure solvency and greater security of promised payments.

3.5.2 EXPERIENCE RATING PLANS

The manual rate is modified by an experience rating factor reflecting the employer's actual losses over a recent period relative to expected losses of a typical employer in the same classification. The weighting used in the calculation is such that for larger employers, the employer's actual losses fully determine the adjustment. For smaller employers, the premium is fully determined by the expected losses of the typical firm; that is, there is no adjustment based on firm-specific experience. Experience rating is mandatory in California and is based on the California loss experience alone in the case of employers with multistate operations.

Experience rating systems introduce a regulatory lag by their reliance on employer experience over a prior three-year period. For example, a firm that suffered a year of unusually high losses would be penalized until that year's experience worked its way through the system. Likewise, a firm which has dramatically improved workplace safety in the most recent year would not see the full benefits of the adjustment until the fourth year.

Efficient insurers benefit from experience rating plans because the adjustment is employer specific, and the same adjustment must be used by all insurers. For firms with an above average safety record, experience rating plans benefit large employers more than small because of the greater weighting of firm specific experience for large firms. (For employers with a below average safety history, large employers would be penalized more than small.) Within the large employer group, experience rating plans provide direct incentives for workplace safety improvements, although the built-in lag in the adjustment calculation reduces responsiveness. Employees benefit from increased incentives for safety enhancement, and to the extent that large employers account for a majority of covered employees, most employees benefit from experience rating.[12]

3.5.3 RATING ORGANIZATIONS

In California, both manual rates and experience ratings are developed by the Workers' Compensation Insurance Ratemaking Bureau (WCIRB); all other adjustments are negotiated between insurer and employer. The WCIRB is a self-regulated, quasi-independent organization representing all insurers; it collects and analyzes data on premiums, losses, expenses, and risk classifications, and works closely with state regulators. The efficiency of centralized data collection benefits all insurers by minimizing duplication of efforts. It is especially important for small insurers who lack the resources to collect the and analyze the data independently.

Most, although not all, states have centralized rating organizations. They differ, however, with respect to the types of rates set, and insurers' license to deviate from these rates. Some provide advisory rates only, which insurers may (1) adopt without deviation; (2) modify to reflect insurer-specific circumstances; or (3) ignore and use independently developed rates. In some states, insurers must have prior approval of deviations from board rates, or they may only have to file alternative rates before using them ("file and use") without approval. Rates may take the form of pure premium rates, which reflect loss experience only without allowance for insurer expenses; individual insurers then modify the pure premium rates according to their own expenses.

The data collection and analysis functions of rating bureaus are not controversial. It is their authority to set rates which causes concern. An argument is made that such rate setting is a form of institutionalized collusion among insurers, who have an incentive to keep rates high. While rate changes must generally be approved by the Insurance Commissioner, the possibility that the entire amount of a rate increase will not be approved may encourage the insurer-controlled rating bureau to inflate the rates submitted.

3.5.4 PREMIUM DISCOUNT SCHEDULES

Once the manual rate is adjusted for experience, many states (not California) apply a premium discount to adjust for fixed costs and economies of scale. Large firm premiums are adjusted downward by a percentage increasing with the level of standard premium.

Percentage discounts for premium ranges are fixed by regulators, so efficient insurers cannot compete by offering larger discounts.[13] Premium discounts are specifically designed to benefit large employers by recognizing the lower administrative costs of servicing them. The plans have no impact on employees.

3.5.5 RETROSPECTIVE RATING PLANS

Retrospective rating adjustments are made retroactively to reflect an employer's experience during the period the policy was in effect. Retrospective plans are voluntary and available only to firms with a minimum level of standard premiums. Only one retrospective plan is currently permitted in California.

The contractual nature of retrospective plans allows insurers to use them competitively in bargaining. Employers benefit from a direct, although ex-post, reward for improved workplace safety. The benefits, however, are available to large firms only. Large firm employees benefit from the increased incentives for safety.

3.5.6 DEVIATIONS

Deviations represent flat percentage adjustments that must be applied by an insurer to all its insured employers. California permits surcharges but does not allow deviations.

While there is little competitive advantage to upward deviations where rates of return are adequate, their availability could forestall rate suppression problems if regulated rates are inadequate. Surcharges could affect the size of the assigned risk pool by enabling insurers to charge higher rates for higher risks, but only to the extent that some insurers could find it profitable to specialize in high risk employers exclusively (since an insurer must apply the same deviation to all its insured employers). Insurers who cover a broad range of risks could not apply the surcharge discriminatively to higher risk employers. Where downward deviations are allowed, their significance depends on how binding are the rates to which the deviations are applied. There is no bias on employer size, since they must be applied to all employers, and there is no impact on employees.

3.5.7 SCHEDULE RATING PLANS

Schedule rating adjustments reflect firm-specific characteristics, such as superior management or safety programs relative to other employers in the same classification. Often based on physical inspection of the workplace, schedule ratings represent an insurer's estimate of an employer's expected future losses. California abolished schedule ratings in 1973 on the basis that higher OSHA safety standards had made them redundant. Schedule rating was particularly valuable in being available to small or new employers who were not eligible for experience rating or other adjustments. Employees could benefit from improvements to workplace safety, and insurers could realize gains (to be shared with employers) if the loss reductions as a result of schedule rating inspections exceeded the cost of providing the service.

3.5.8 POLICYHOLDER DIVIDEND PLANS

Like retrospective rating plans, policyholder dividends are back-end adjustments reflecting experience during the policy period. Dividend plans, however, are not contractual and the adjustment amount is at the discretion of the insurer. Policyholder dividends are used extensively in California (in the absence of some of the adjustments allowed elsewhere) and have become a significant instrument of insurer competition.

Insurers benefit from the discretionary aspect of policyholder dividends. While insurers can use past dividend payout patterns as a bargaining tool ex-ante, they are non-binding, except in terms of reputational effect. (California regulations prohibit guarantees of dividends in advance.) This arbitrary aspect makes policyholder dividends less reliable to employers in forecasting their costs, and large employers have greater leverage in extracting higher dividends than small firms. Studies have shown that dividends generally do reflect loss experience during the policy period, providing financial incentives for employers to maintain safe operations. However, they are also affected by insurer profitability and factors beyond the control of employers. Employees benefit if the connection between losses and dividends is sufficient to encourage workplace safety improvements.

3.5.9 SUMMARY

A 1992 study by Milliman and Robertson found that the level of benefits (set by the various states, and in some cases, by the federal government) was the largest single determinant of employer costs of workers' compensation insurance. The ratemaking process is complex, not costless, and imperfect. On the basis of this and other evidence, the Commission concludes that the incremental value of changes in ratemaking procedures is not likely to be large.

3.6 CONCLUSIONS

Regulation of the workers' compensation insurance industry is based on the premise that social welfare goals are not likely to be accomplished through competitive market forces. The Commission's analysis of the economics of the workers' compensation insurance industry suggests that the goals could be achieved efficiently in a more competitive market with a minimum of regulation.

Experience in other states (for example, Michigan and Illinois) which have moved toward a more competitive market indicate that employer costs fall when regulatory constraints are eased; cutthroat competition resulting in widespread insurer insolvency and lack of availability have not occurred.

Among the goals that have been identified, it is suggested that market stability, insurer solvency and profitability have been overemphasized to the point of regulatory paternalism. Stable markets are not necessarily static, and insurance company managers are rational, profit maximizing individuals. Reasonable assurances of insurer solvency can be accomplished by less obtrusive means.

Proponents of regulation argue that other goals of workers' compensation would suffer in a more competitive market, because employers make their decision solely on the basis of price (resulting in cutthroat competition, insolvency, etc.). Even if the purchase decision were based solely on price,[14] this argument ignores the price ramifications inherent in, for example, safety incentives. Insurers have an incentive to encourage workplace safety to reduce loss costs regardless of how rates are set; in fact, the incentive becomes even more important if competition results in lower rates and margins. Employers have fundamental incentives to provide safe working conditions; workers' compensation enhances these incentives, especially so if employers of all sizes have greater freedom to use their safety record as a bargaining chip in negotiating with competing insurers.

Improvements in employee claim servicing can likewise pass through to insurance pricing in a competitive market. While excess costs and fraudulent claims are beyond the scope of this analysis, superior claim processing service has the potential to reduce such costs by keeping employees well informed about the status of their claims and preventing small claims from mushrooming into costly litigation. A competitive market provides greater incentives for insurers to become proficient in the identification of fraudulent claims; in the absence of a minimum rate law, these insurers can then compete on the basis of lower prices to employers.

The distribution of costs in competitive market would be negotiated among market participants rather than allocated by regulators. Without arbitrarily imposed rates and adjustments, insurers would have greater latitude to compete. Employers would have greater stake in negotiating for the best possible combination of price and service, and appropriately priced coverage would be available to all without cross subsidies.

FOOTNOTES

1 Regulatory structures range from state-mandated rates (a monopolistic state fund) and administered pricing (as in California) to competitive pricing of various types.

2 The impetus for regulation in California during the early 1900s, according to the Stanford Consulting Group, was "intense price competition" which "became reckless," and "one insurer [emphasis added] eventually became insolvent."

3 An argument could be made that employers would purchase workers' compensation insurance even in the absence of this requirement in order to compete more effectively in the labor market. The only regulation necessary would be that they disclose the provision of coverage to prospective employees. Employers have clear incentives to maintain safe operations in addition to reputational effects in the labor market, including the costs of recruiting and retraining to replace disabled workers.

4 Because regulation is on a state-by-state basis, it is conceivable that higher prices could reduce aggregate demand within a state if employers found it advantageous to relocate to obtain lower premiums. This is apparently happening in California now.

5 California was supplied by 142 carriers in 1990. The average number of carriers writing coverage in California, Florida, Illinois, Oregon, Michigan, New York and Texas during 1990 was 133.

6 The potential for such services to reduce costs resulting in higher insurer profits and/or lower costs to employers is discussed below.

7 Worker uncertainty about the compensation claim is critical to the decision to hire an attorney; claim processing improvements in the form of increased information concerning the claim as well as promptness of payment thus have the potential to reduce claim costs. Improvements in the administration of employee claims may also yield benefits in identifying fraudulent claims more effectively.

8 The net costs of safe/unsafe operations include all costs and benefits, not only those related to workers' compensation insurance premiums.

9 This section is based on the Milliman and Robertson evaluation of the competitiveness of the California market.

10 Significantly, 38 percent switched to obtain better service, and 30 percent switched because of unsatisfactory services. Thus, employers seem to place a high value on service. This indicates that price is not the only basis for competition. (Employers often cited more than one reason to switch.)

11 Performance measurement for individual states is confounded by disclosure problems in the case of multistate, multiline insurers.

12 Arguments against extending experience rating to small firms include high administrative costs, and fairness to larger firms; that is, the higher probability that claims will occur in a large firm simply because more employees are exposed to risk.

13 The discounts vary by stock versus non-stock insurance companies in response to their differing dividend payout patterns. Since insurers do have discretion over dividends, there remain competitive opportunities within a premium discount schedule system.

14 Recall that service was the second most cited reason for switching insurers.

15 Dividends will be less important since they will no longer serve as a major element of price competition.

C103T07F.DJA

SECTION 4.0

PROSPECTIVE VERSUS RETROSPECTIVE PRICING

SECTION 4.0

PROSPECTIVE VERSUS RETROSPECTIVE PRICING

4.1 PROSPECTIVE VERSUS RETROSPECTIVE PRICING OVERVIEW

4.1.1 INTRODUCTION

The Rate Study Commission is charged with reviewing the extent to which California's ratemaking system fosters or discourages competition among insurers. The Commission believes that this charge translates into a determination both of whether there should be more competition in the pricing of workers' compensation insurance policies, and of whether the timing of the competition should be changed.

4.1.2 MINIMUM RATE LAW

Under current California law, a minimum premium rate is set, subject to prior approval by the Commissioner of Insurance, for each of over 400 work classifications. The Insurance Code states that "an insurer shall not issue, renew, or continue in force any workers' compensation insurance at premium rates which are less than the rates approved or issued by the Commissioner." The minimum (or "manual") rates determine the initial price that employers pay for workers' compensation based on the following three factors:

A. The overall amount needed to fund benefits and administration for the coming year

B. The distribution of these costs among rate classifications

C. The individual variation in employer rates based on their experience modification.

4.1.3 RETROSPECTIVE PRICING

Because of the minimum rate law, virtually all price competition among carriers shifts to the tail end of the policy, through dividend rebates to policyholders. The competition on price, then, is according to a retrospective view that incorporates several factors, including the loss experience of the insured, the costs involved in writing and servicing the policy, and the insurer's own overall financial successes (including underwriting and investment income) during the policy period.

According to proponents of the current law, retrospective pricing allows insurers to better know the cost of coverage for a specific insured, and refund excess premiums accordingly. They argue that instituting front-end price competition will drive down costs in ways that will adversely affect some policyholders, by restricting claims services, reducing loss control activities, and reducing the incentives of injury prevention currently offered by dividend rebates. Some fear that removing the cushion offered by the minimum rate law will reduce availability of coverage to small employers as some carriers drop out of the market or restrict coverage to larger employers.

There is a general impression that under the current law there is some cross subsidization of smaller employers with good safety records whose insurance accounts are costly to write as a percentage of premium; many assume that under a more competitive system, their costs would rise dramatically. A concurrent fear is that attention to reducing costs will have the effect of discouraging legitimate claims. One observer characterized a consequence of this as "an untreated scratch leading to gangrene." Others have expressed the fear that claims may be dissuaded through intimidation in order to reduce costs. Overall, there are fears that cutting expenses in the short run may have negative long-term effects on overall claims costs.

4.1.4 PROSPECTIVE PRICING

Prospective pricing involves an approach of price competition at the beginning of the policy period. Such competition would allow buyers of insurance (individual employers and insurance producers) to shop for the best combinations of price and service. Presumably, better risks could demand, and receive, lower prices and improved service. By allowing and/or encouraging insurers to set the price for individual risks prospectively, it is argued, insurers will market and service more efficiently, will have more incentive to assist policyholders in cost controls, will have greater incentives to engage in injury prevention, and will set costs so that some employers are not unfairly subsidizing the insurance costs of others.

The following sections discuss the issues of pricing and type of rate competition through looking at: the adequacy of workers' compensation rates in California; the differential effects that pricing and rating systems have on different sizes of employers, and particularly on small employers; the context of efficiency and competitiveness of various rating systems; an evaluation of the fairness of the system with respect to costs and benefits; and the effect of various rating designs on issues of workplace safety and health.

4.2 RATE ADEQUACY

4.2.1 RATE ADEQUACY OVERVIEW

To consider the adequacy of workers' compensation rates in California, the following four primary factors were selected as measurements:

A. Profitability

B. Efficiency

C. Solvency or stability of the market

D. Market entries and exits

While other measurements might be appropriate, some data for each of these is available. Under a minimum rate law, a sensitive issue would be if the rates were actually more than adequate. None of these measurements can directly answer the question of excessive rates, but each can suggest whether the rates are adequate or inadequate.

In determining the profitability of private carriers of workers' compensation in California, several reports were referenced.

4.2.2 PROFITABILITY - MILLIMAN AND ROBERTSON STUDY

The Milliman and Robertson study to determine profitability of California insurers makes use of significant adjustments for its comparison of profitability. Income sources include earned premium as well as investment income on reserves and surplus. The adjustment for investment income on reserves was due to the fact that while California accounted for 19.3% of countrywide workers' compensation premiums, it holds only 16% of reserves. The report, then, uses the 16% reserve figure. This is a significant adjustment, as debate continues as to what percentage figure should be used. Finally, the analysis also adjusts for the effects of the Tax Reform Act of 1986.

Exhibit 4.1, "Estimated Return on Net Worth for California Workers' Compensation Insurance 1980-1989 (Based on Loss and Expenses Data from WCIRB.)" and Exhibit 4.2, "Estimated Return on Net Worth for California Workers' Compensation Insurance 1980-1989 (Based on Loss and Expense Data from Non-WCIRB Sources.)" display the results. Exhibit 4.1 uses data from the Workers' Compensation Insurance Rating Bureau (WCIRB), while Exhibit 4.2 uses data from non-WCIRB sources. Depending on the data source, unweighted average rates of return on net worth adjusting to GAAP for 1980-89 are 11.10% and 12.98%, respectively. (The difference is primarily due to the Loss Adjustment Expense ratio to premium of 9.7% used by the WCIRB, and 8.1% countrywide average.)

The question becomes whether this is an adequate, inadequate or excessive rate of return. Traditional financial theory indicates this return must be compared to industries of similar risk. Depending on the source of information and comparison, at least for 1985-89, the unweighted rates of return from the Milliman and Robertson study average 8.15% or 8.96%. Comparing these to sample returns from other industries (Exhibit 4.3, "Comparative Profitability Return on Shareholder Equity") suggests either adequate or inadequate rates of return, but not necessarily excessive rates of return.

4.2.3 PROFITABILITY - STANFORD CONSULTING GROUP

The Stanford Consulting Group uses a different method of comparison estimating required premiums in the market using a Capital Assets Pricing Mechanism (CAPM) methodology and comparing that figure with earned premiums (figures do not include investment income). Exhibit 4.4, "Earned Premiums versus Required Premiums California Experience" and Exhibit 4.5, "California Workers' Compensation Insurance" also suggest that workers' compensation rates are adequate for insurers.

4.2.4 PROFITABILITY - NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS REPORT ON PROFITABILITY BY LINE BY STATE

Comparative data from the National Association of Insurance Commissioners Report on Profitability by Line By State for 1985-1989 is shown in Exhibit 4.6, "A Reasonable Rate of Return to Insurers" and Exhibit 4.7, "Profitability Results California and Countrywide Workers' Compensation". These data indicate that California's profitability in workers' compensation exceeds the national average. Admittedly, the national experience is dragged down by some states experiencing extremely poor results. Nevertheless, these data suggest that, on average, rates are not inadequate in California.

4.2.5 PROFITABILITY - AIS RISK CONSULTANTS

Finally, in the AIS Risk Consultants study, profitability in the California market among workers' compensation insurers is examined. The source of most of the data was the Workers' Compensation Insurance Rating Bureau. The study indicates that: 1) there are differences between insurers with respect to profitability in the California market; 2) these differences are not explained by type of insurer; and 3) of the components of operating profit, differences in losses were the most significant item. (This was also suggested by a different Milliman and Robertson study.) A weaker correlation was found to exist between profits and expenses. The association of investment income and dividends with profits was only marginally significant.

In conclusion, all the available studies indicate that the workers' compensation insurance business is profitable in California.

4.2.6 EFFICIENCY

One measure of efficiency is the expense ratios of the various providers. According to Exhibit 4.8, "Expenses as Percentage of Earned Premium", Exhibit 4.9, "State Compensation Fund Allocation of Expenses, 1972-1988" and Exhibit 4.10, "Breakdown of Expenses by Class of Carrier," the State Compensation Insurance Fund is more efficient than either stock or mutual insurers, since expenses as a percent of premium are significantly less than those of private carriers. While some might suggest that this argues for a change to an exclusive (monopolistic) state fund, other factors must be considered.

In particular, the expense ratio is calculated under the current minimum rate law and efficiency may change under a different system.

Furthermore, all businesses have the option of insuring with the State Compensation Insurance Fund but their current market share is about 23%. Other factors, must be influencing the choice of compensation insurance carrier. (These could include the practice by businesses of buying all insurance coverage from one agent, and the fact that, under current law, independent agents receive no commission from the State Fund for sending them business. In addition, the State Compensation Insurance Fund only sells workers' compensation insurance, and some businesses may prefer, or get a better package, by buying all insurance coverage from the same source.) Data from the Milliman and Robertson report on competitiveness (Exhibit 4.11, "Top 8 Groups Writing Workers' Compensation in California" and Exhibit 4.12, "1990 CWCI Employers Survey") suggest that there are perceived price and service differences between all carriers.

Differences on claims handling, timeliness of payments and service support would also be relevant measures of efficiency, yet are harder to obtain or predict. Further, despite some apparent successes with exclusive state funds elsewhere, the evidence does not support a finding that an exclusive state fund is a more efficient system.

4.2.7 STABILITY AND SOLVENCY

Because workers' compensation is a mandated coverage for the benefit of third parties (injured and ill workers), the solvency of providers and the availability of coverage seem to be extremely important to this line of insurance. While price stability may not be a goal in all lines of insurance, testimony from employers and insurers seems to suggest that price stability is nevertheless important.

According to the Milliman and Robertson study on competitiveness, Exhibit 4.13, "Average Annual Premium Level Changes: 1986-1990" indicates California has more price stability than in 5 comparative states. While the price of stability may be marginally higher premiums, the current system appears to provide stability.

In California, workers' compensation is available to virtually all employers. The State Fund is both a competitor with private carriers and the insurer of last resort. Both the Milliman & Robertson and AIS Risk Consultants studies estimate that the involuntary market to be somewhere between 13% and 20% in 1990. This compares to an average of over 25% in NCCI administered pools (Exhibit 4.14, "Workers' Compensation Insurance Assigned Risk Pool Market Shares"). The figure is impossible to specify because the State Fund does not distinguish which of its policyholders are underwritten because they could find no other coverage, and which are the result of successful competition.

4.2.8 MARKET ENTRY AND EXIT

Entry and exit in the market, and especially the cause of exit is relevant to a discussion of solvency. Between 1986 and 1990, there was a net increase of 16 insurance groups writing workers' compensation in California (Exhibit 4.15, "Number of Groups Providing Workers' Compensation in California"). Some exits from the market are not determinable. For example, several workers' compensation carriers have announced they are restricting their business in the Los Angeles basin. As to insolvent insurers, a preliminary analysis indicates only three with more than 25% of their business in workers' compensation. The market seems to automatically shift the high risk employer to the involuntary market and the cost is distributed by including the loss costs in the minimum rate. This seems to result in a stable and solvent market.

Using profitability, efficiency and solvency as criteria, the Commission's studies indicate that rates are adequate for insurers and not volatile. These attributes may come at the cost of slightly higher premiums.

EXHIBIT 4.1
ESTIMATED RETURN ON NET WORTH FOR CALIFORNIA WORKERS' COMPENSATION INSURANCE 1980-1989
(BASED ON LOSS AND EXPENSES DATA FROM WCIRB.)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
EARNED PREMIUMS ($millions)	2,309.0	2,449.0	2,395.0	2,789.0	3,244.0	3,536.0	3,963.0	4,612.0	5,374.0	5,953.0
I. UNDERWRITING RESULT										
A. Loss and Expense Components										
1. Losses incurred	51.90	51.70	52.30	58.70	66.70	72.60	75.20	71.60	66.00	64.00
2. Loss adjustment exp.	8.08	8.50	9.35	9.11	9.25	9.50	9.97	10.66	11.09	11.27
3. Commission & brokerage	7.51	7.12	7.36	8.18	7.18	6.85	6.98	6.81	6.98	6.44
4. Other acquisition expenses	2.82	3.15	3.57	3.89	4	3.62	3.1	2.95	3.09	3.25
5. General expenses	5.62	6.02	7.50	7.85	6.68	6.15	5.73	5.79	5.73	5.62
6. Premium & other taxes	2.66	2.61	2.48	2.58	2.59	2.69	2.74	2.8	2.83	2.76
7. Policyholder dividends	13.70	16.60	18.80	17.40	15.30	14.90	12.70	10.70	9.30	11.8
B. Pre-Tax Underwriting Result	7.71	4.30	-1.36	-7.71	-11.70	-16.31	-16.42	-11.31	-5.02	-5.14
C. Post-Tax Underwriting Result	4.16	2.32	-0.73	-4.16	-6.32	-8.81	-8.87	-11.49	-7.71	-8.06
II. INVESTMENT INCOME FROM RESERVES										
A. Pre-Tax Return from Reserves	8.30	9.47	10.58	10.31	10.55	10.79	10.62	10.36	10.11	10.90
B. Post-Tax Return from Reserves	6.25	7.13	7.96	7.76	8.11	8.05	7.89	8.03	7.94	8.65
III. INVESTMENT RETURN ON CAPITAL AND SURPLUS										
A. Pre-Tax Return from Cap & Surp	4.24	4.72	5.58	6.07	6.61	9.05	9.41	6.77	6.63	7.95
B. Post-Tax Return from Cap & Surp	3.29	3.66	4.33	4.71	5.13	7.07	7.25	5.11	5.14	6.07
IV. TOTAL POST-TAX RETURN ON PREMIUM	13.70	13.11	11.56	8.31	6.92	6.31	6.27	1.65	5.37	6.66
V. TOTAL POST-TAX RETURN ON SURPLUS	25.21	22.94	18.84	14.29	12.59	10.66	9.91	2.56	8.32	9.32
VII. TOTAL POST-TAX RETURN ON NET WORTH	20.76	18.89	15.52	11.91	10.03	8.96	8.24	2.05	6.85	7.80

1980-1989 Average Return on Net Worth:

Unweighted	11.10
Weighted	8.66

Sources:

- California WCIRB (loss and expense components, reserves)
- A.M. Best Company, Executive Data Survey (earned premium, paid and incurred losses, reserves)
- A.M. Best Company, Aggregates & Averages (investment return on countrywide workers compensation reserves and capital and surplus, surplus-to-net worth factor)

EXHIBIT 4.2
ESTIMATED RETURN ON NET WORTH FOR CALIFORNIA WORKERS' COMPENSATION INSURANCE 1980-1989
(BASED ON LOSS AND EXPENSE DATA FROM NON-WCIRB SOURCES.)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
EARNED PREMIUMS ($millions)	2,348.5	2,497.1	2,441.7	2,802.7	3,287.3	3,615.0	4,140.2	4,724.5	5,484.0	6,055.0
I. UNDERWRITING RESULT										
A. Loss and Expense Components										
1. Losses incurred	52.10	51.10	52.30	58.80	67.70	72.10	74.90	70.40	65.60	65.50
2. Loss adjustment exp.	6.50	7.00	7.40	7.70	8.20	8.50	8.90	9.30	8.50	9.00
3. Commission & brokerage	5.50	5.50	5.90	6.30	6.00	4.90	4.70	5.30	5.00	4.60
4. Other underwr exp	11.90	13.40	14.70	15.80	15.20	14.10	13.20	12.80	12.80	12.80
5. Policyholder dividends	12.80	14.90	18.30	17.20	16.40	14.90	11.10	10.40	9.90	11.20
B. Pre-Tax Underwriting Result	11.20	8.10	1.40	-5.80	-13.50	-14.50	-12.80	-8.20	-1.80	-3.10
C. Post-Tax Underwriting Result	6.05	4.37	0.76	-3.13	-7.29	-7.83	-6.91	-9.03	-5.45	-7.23
II. INVESTMENT INCOME FROM RESERVES										
A. Pre-Tax Return from Reserves	8.30	9.47	10.58	10.31	10.55	10.79	10.62	10.36	10.11	10.90
B. Post-Tax Return from Reserves	6.25	7.13	7.96	7.76	8.11	8.05	7.89	8.03	7.94	8.65
III. INVESTMENT RETURN ON CAPITAL AND SURPLUS										
A. Pre-Tax Return from Cap & Surp	4.24	4.72	5.58	6.07	6.61	9.05	9.41	6.77	6.63	7.95
B. Post-Tax Return from Cap & Surp	3.29	3.66	4.33	4.71	5.13	7.07	7.25	5.11	5.14	6.07
IV. TOTAL POST-TAX RETURN ON PREMIUM	15.59	15.16	13.05	9.34	5.95	7.29	8.23	4.11	7.63	7.49
V. TOTAL POST-TAX RETURN ON SURPLUS	28.69	26.53	21.27	16.06	10.83	12.32	13.00	6.37	11.83	10.49
VII. TOTAL POST-TAX RETURN ON NET WORTH	23.62	21.84	17.51	13.39	8.63	10.36	10.82	5.11	9.73	8.77

1980-1989 Average Return on Net Worth:

Unweighted	12.98
Weighted	10.11

Sources:

- A.M. Best Company, Executive Data Survey (earned premium, incurred losses, policyholder dividends)
- A.M. Best Company, Aggregates & Averages (loss adjustment expenses, commission & brokerage, other underwriting expenses, investment return on countrywide workers compensation reserves and capital and surplus, surplus-to-net worth factor)

EXHIBIT 4.3
COMPARATIVE PROFITABILITY
RETURN ON SHAREHOLDER EQUITY

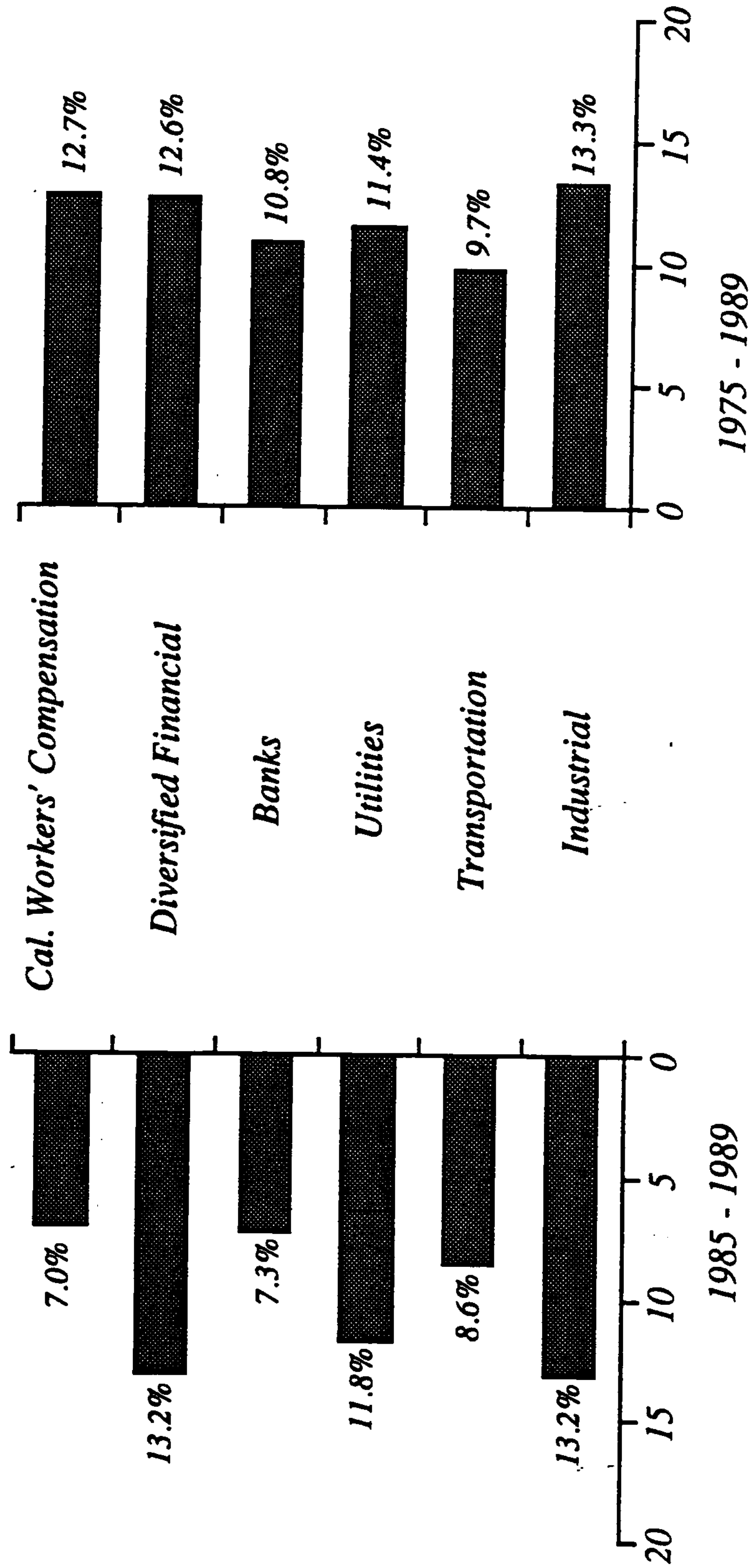


EXHIBIT 4.4
EARNED PREMIUMS VERSUS REQUIRED PREMIUMS
CALIFORNIA EXPERIENCE

Year	Required Premiums (RP) ($MM)	Dividends (D) ($MM)[a]	Earned Premiums (EP) ($MM)	Ratios	
				EP/RP	EP/(RP + D)
1980	1,957	353	2,765	1.41	1.20
1981	2,244	432	2,891	1.29	1.08
1982	2,510	516	2,810	1.12	0.93
1983	3,415	560	3,251	0.95	0.82
1984	4,272	628	3,843	0.90	0.78
1985	4,031	539	3,615	0.90	0.79
1986	4,280	461	4,142	0.97	0.87
1987	4,584	487	4,725	1.03	0.93
1988	5,016	542	5,490	1.09	0.99
1989	5,433	674	6,055	1.11	0.99
1990	5,979	752	6,599	1.10	0.98

A.M. Best Co.

Dividends were estimated as those implied by Best's statewide loss ratio for workers' compensation carriers and Best's statewide loss ratio based on earned premiums less policyholder dividends.

Required Premiums were estimated as those estimated by a CAPM-derived model of required underwriting margins. The Appendix describes the methodology used to estimate the parameters of the model.

EXHIBIT 4.5
CALIFORNIA WORKERS' COMPENSATION INSURANCE

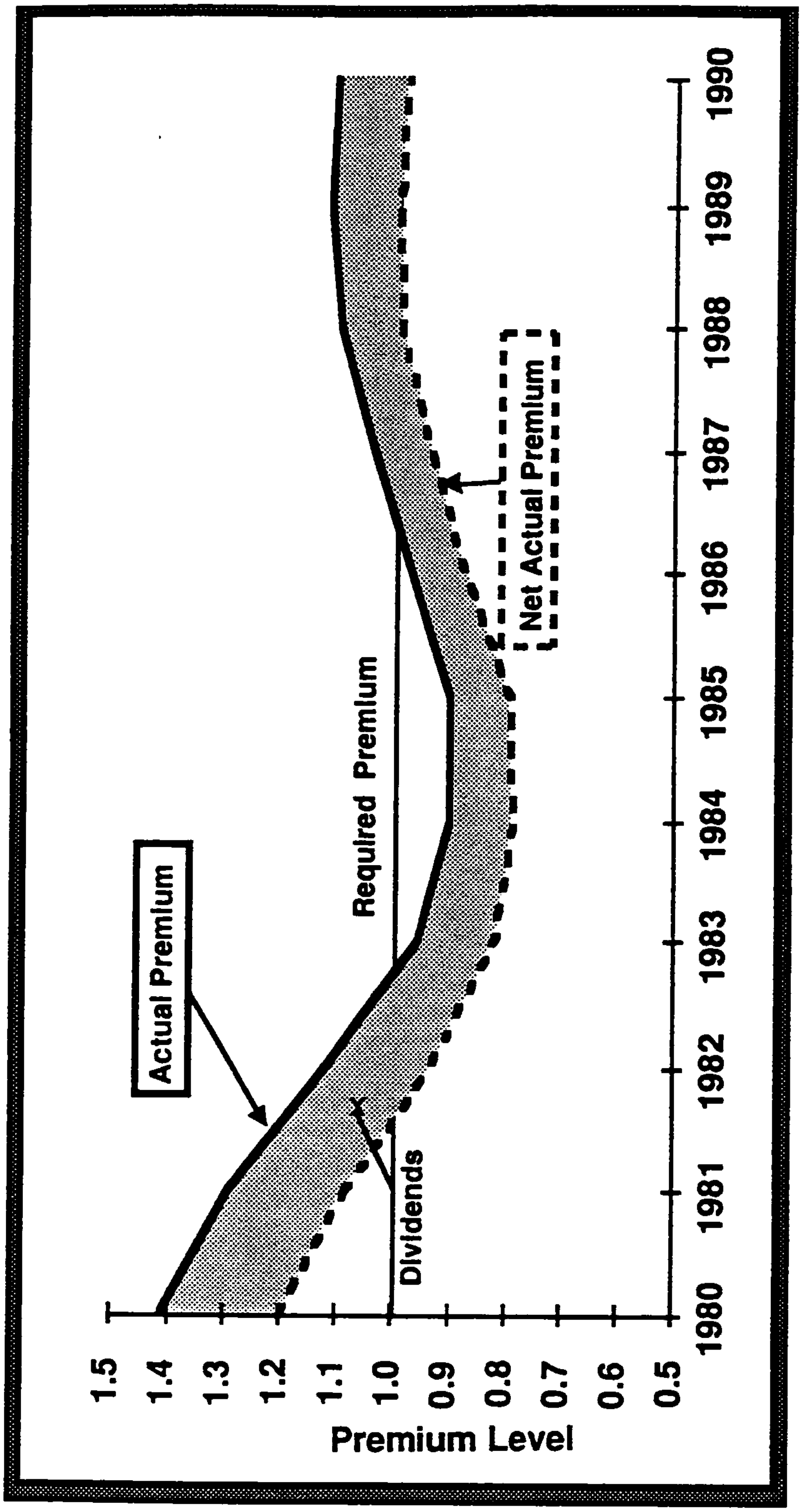


EXHIBIT 4.6
A REASONABLE RATE OF RETURN TO INSURERS

	1985	1986	1987	1988	1989	average 1985-89
NV	54.7	17.2	30.7	53.7	36.9	38.6
ND	3.4	39.1	42.8	56.1	49.2	38.1
OH	49	19.2	30.1	41	38.9	35.6
WY	32.7	26	36.6	36.4	20.4	30.4
DC	29.1	28.4	33.4	31.5	25.8	29.6
WA	19.4	2.5	51.4	30.7	43.2	29.4
HA	22.8	25.5	19.9	21.5	13.4	20.6
KY	9.9	29.7	15	15.5	12.7	16.6
MD	18.1	17.7	19.4	17.3	8.8	16.3
WV	23.2	-16.4	74.7	-22.4	19.6	15.7
NY	21.1	16.7	15.3	11.3	13	15.5
DE	14.5	10.9	18.3	12.9	17.3	14.8
NJ	18.2	11	15.1	9.4	10.3	12.8
MI	17.6	14.6	13.4	7.5	9.1	12.4
UT	10	21.2	11.8	16.9	-0.9	11.8
IL	10	12.4	12.3	11.6	9.8	11.2
MN	7.2	5.3	7.6	12.4	14.9	9.5
PA	17.5	12.2	10.2	3.7	2.7	9.3
California	**6.8**	**6.6**	**8.9**	**11.8**	**9.1**	**8.6**
CT	14	8.7	4.2	5.1	7.7	7.9
VA	7.5	12	7.5	7.1	3.4	7.5
AZ	8.6	8.4	13.7	1.1	5.5	7.5
ID	3.4	11.8	7.4	6.8	7.6	7.4
WI	4.3	2	8	9.8	12.3	7.3
VT	13	2.9	2.5	10.3	3.8	6.5
IA	9.6	3.6	2	1.9	14.6	6.3
SC	9.2	1.1	8.8	7.8	4.5	6.3
OK	-0.3	12.5	13.4	2.8	2.4	6.2
AR	8.7	5.1	6	5.4	4.5	5.9
NH	4.7	4.6	9.5	6.4	3.2	5.7
Countrywide	**7.2**	**5.5**	**5.3**	**2.3**	**2.9**	**4.6**
NE	12.8	6.3	5.1	0	-2	4.4
IN	7.6	5.3	2.1	-0.1	4.6	3.9
KS	5.3	5.3	2.3	6.7	-0.2	3.9
MO	5.3	4.6	6.5	-1.6	0.9	3.1
NC	3	8.9	3.1	-2.6	1.8	2.8
OR	2.6	0.3	4.1	-1.5	2.4	1.6
SD	10.1	4.9	-4.2	-4.9	1.8	1.5
MS	1	0.9	2.6	-5.6	5	0.8
AL	6.8	5	4.1	-10	-6.1	0
TN	4.5	0.7	-0.7	-3.1	-2	-0.1
CO	4.2	-0.9	3.5	-3.8	-4.4	-0.3
GA	-3.6	-4.7	1.6	-2.7	0.3	-1.8
MA	7.9	-1.3	-8	-14.3	-5.9	-4.3
NM	-4.1	0.1	0.9	-13.6	-19	-7.1
MT	-15.8	-33	-19.2	16.5	15.2	-7.3
FL	4.3	-2.4	-10.7	-19.1	-18.9	-9.4
TX	-12	-6.4	-9.3	-15.6	-11.2	-10.9
LA	-2	-14.3	-14.7	-19.9	-15.3	-13.2
RI	-7.2	-7.4	-15	-24.7	-22.2	-15.3
ME	-27	-36.3	-29.3	-28.4	-36.2	-31.4

Source: National Association of Insurance Commissioners

EXHIBIT 4.7
PROFITABILITY RESULTS
CALIFORNIA AND COUNTRYWIDE
WORKERS' COMPENSATION

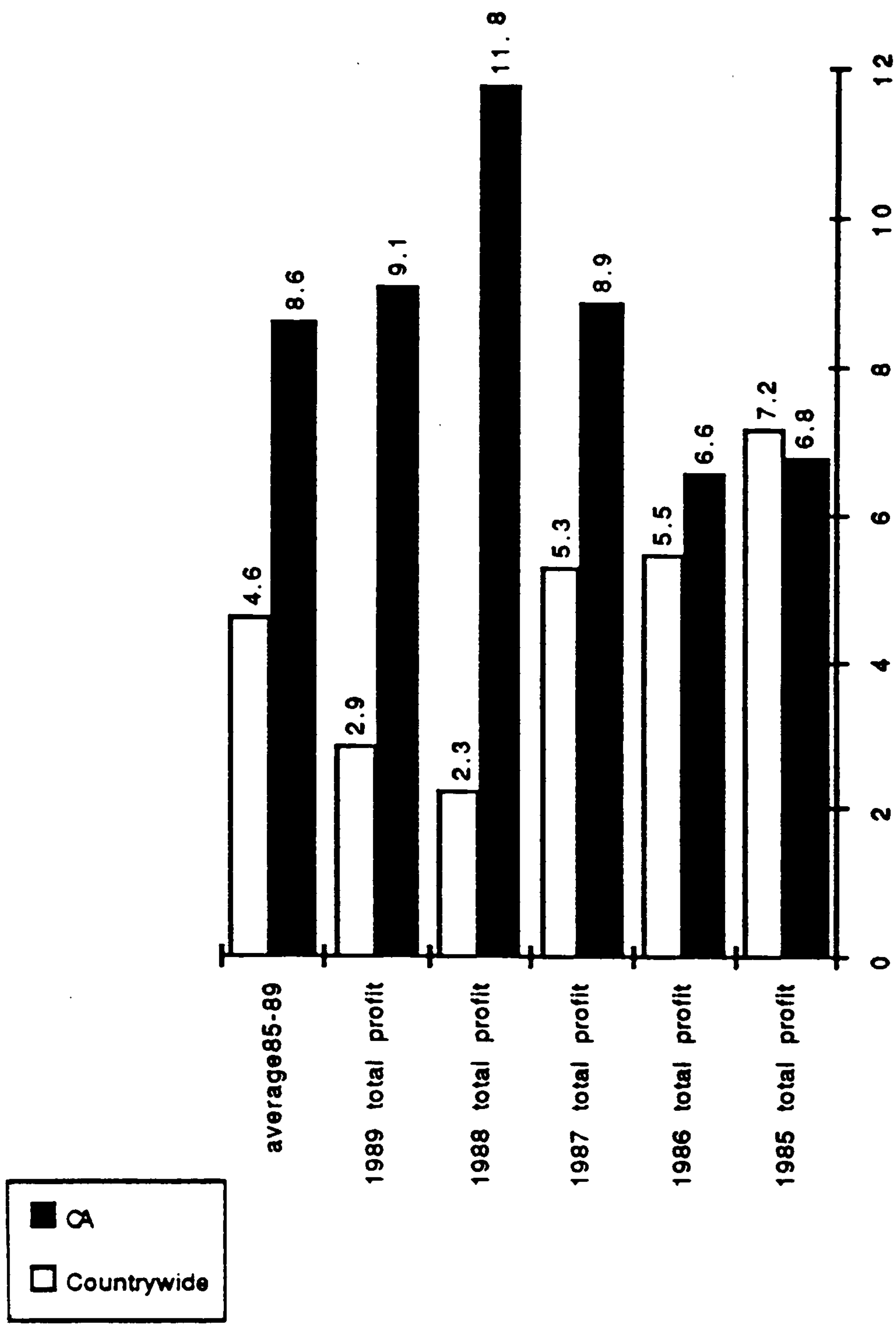
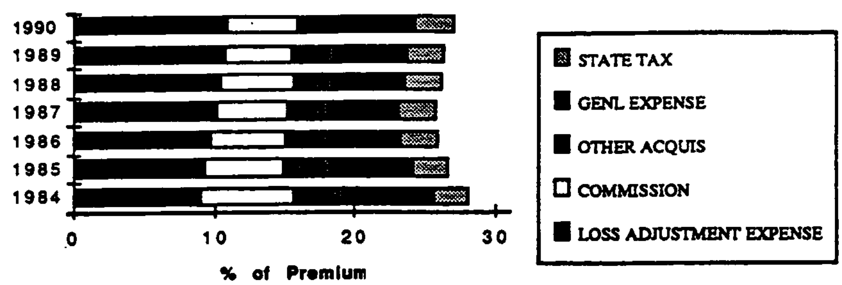
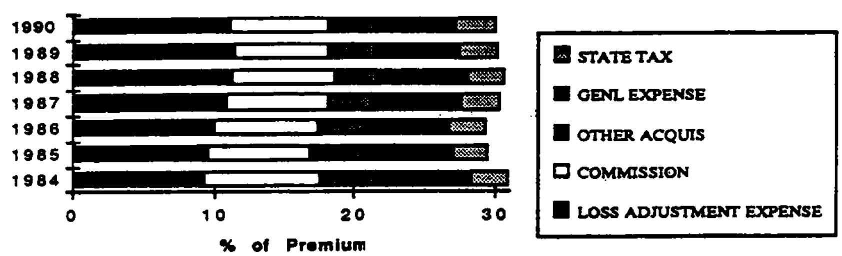


EXHIBIT 4.8
EXPENSES AS PERCENTAGE OF EARNED PREMIUM

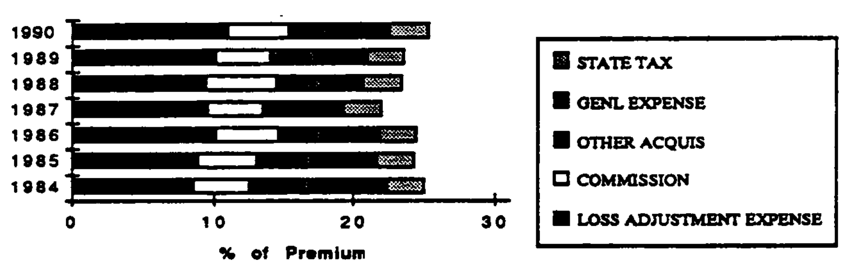
Expenses as % of Earned Premium
California, 1984-1990, All Companie



Expenses as % of Earned Premium
California, 1984-1990, Stock Companie



Expenses as % of Earned Premium
California, 1984-1990, Non-Stock Companie



Expenses as % of Earned Premiun
California, 1984-1990, State Fun

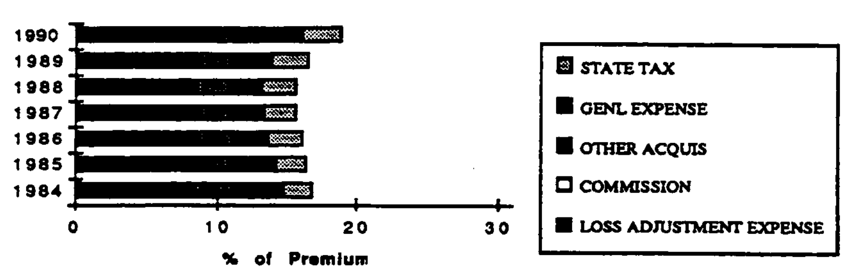


EXHIBIT 4.9
STATE COMPENSATION FUND
ALLOCATION OF EXPENSES, 1972-1988

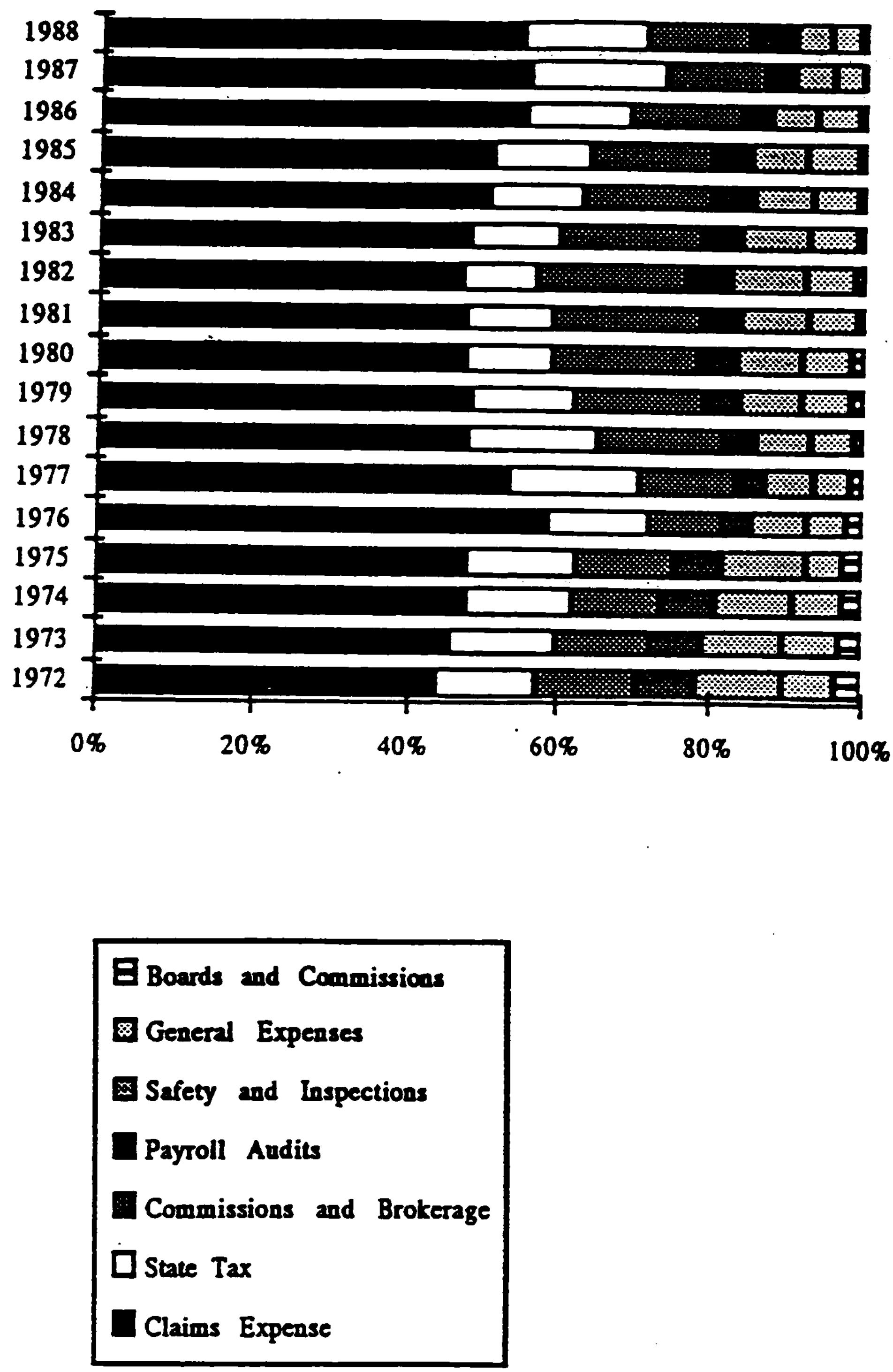


EXHIBIT 4.10
BREAKDOWN OF EXPENSES BY CLASS OF CARRIER

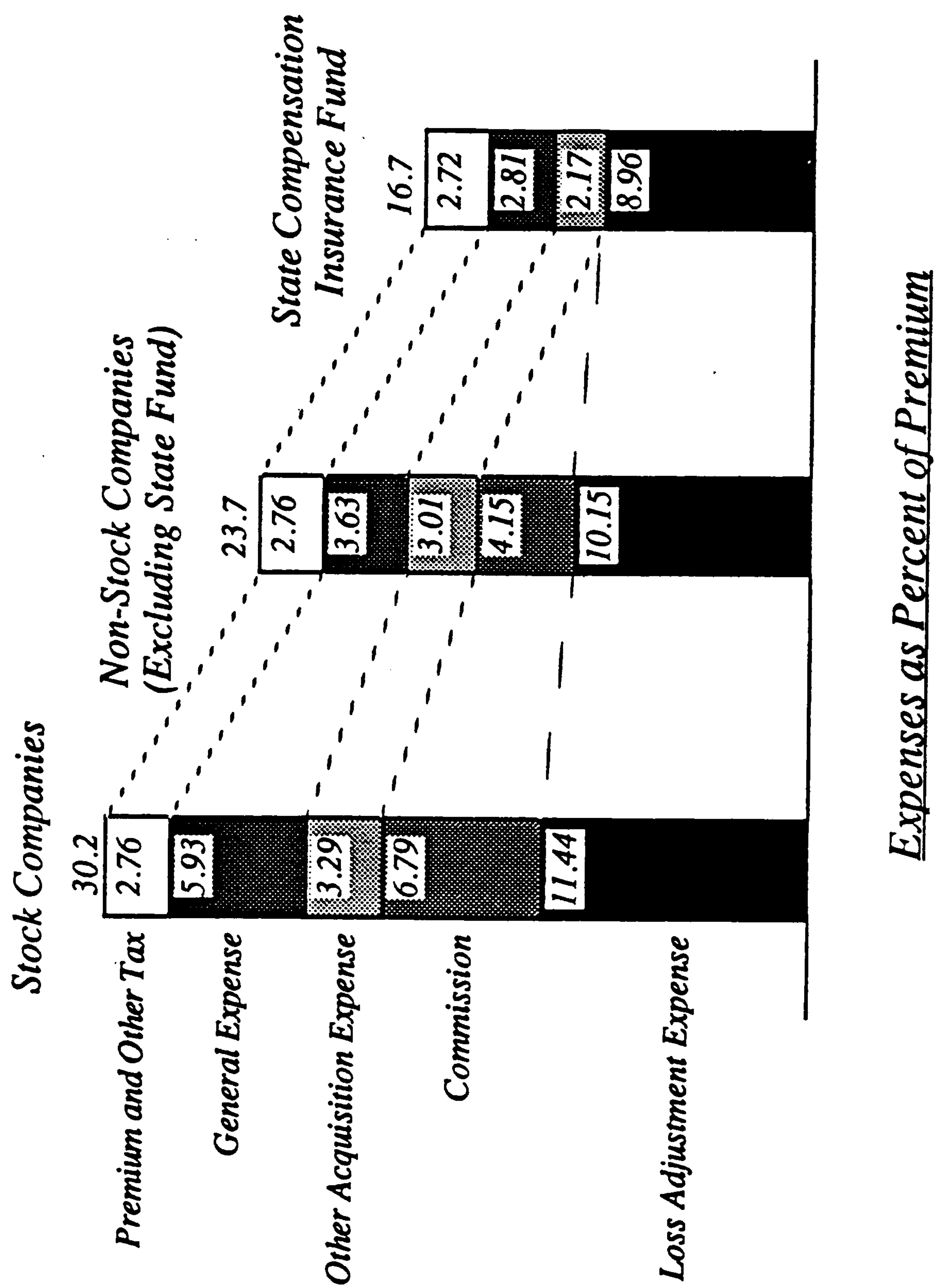


EXHIBIT 4.11
TOP 8 GROUPS WRITING WORKERS' COMPENSATION IN CALIFORNIA

MARKET SHARE RANK	1986	1987	1988	1989	1990
1	State Fund	State Fund	State Fund	State Fund	State Fund
2	Liberty Mutual	Crum & Forster	Liberty Mutual	Fremont General	American Internat'l
3	Crum & Forster	Liberty Mutual	Crum & Forster	Liberty Mutual	Liberty Mutual
4	Nationwide	American International	CIGNA	Crum & Forster	Fremont General
5	American International	CIGNA	American International	American International	Crum & Forster
6	Fremont General	Nationwide	Transamerica	Republic American	Penn Central Group (Republic American)
7	CIGNA	Republic American	Republic American	Transamerica	Transamerica
8	Republic American	Transamerica	Nationwide	CIGNA	CIGNA

EXHIBIT 4.12
1990 CWCI EMPLOYERS SURVEY

SURVEY QUESTION	PROPORTION RESPONDING AFFIRMATIVELY
Have you changed workers' compensation insurers in the past 5 years?	54%
What was the reason?	
Better price	41%
Wanted better service	38%
Service unsatisfactory	30%
Better dividends	20%
Changed agents/agents recommendation	22%
Changing other insurance coverage	14%
Coverage cancelled	11%
Firm merged or bought out	2%
Insurer went out of business	2%
Reserves too high	3%
Didn't deliver promised programs	1%
Miscellaneous	1%
Don't know/Not sure	6%

EXHIBIT 4.13
AVERAGE ANNUAL PREMIUM LEVEL CHANGES: 1986-1990

	Average Change	Standard Deviation	Range
Total Premium Level Change:			
California	6.9	7.6	16.5
Florida	10.1	11.1	29.4
Illinois	10.8	6.5	17.5
Michigan	6.3	12.7	29.2
New York	11.3	12.6	34.1
Oregon	10.5	10.4	26.7
Texas	12.7	11.1	25.0
Premium Level Change Excluding Benefit Changes:			
California	6.8	7.4	16.5
Florida	16.8	9.3	21.8
Illinois	9.5	7.0	15.7
Michigan	6.8	14.0	33.4
New York	3.6	7.8	21.4
Oregon	7.8	5.4	12.4
Texas	16.9	9.8	24.0

Source: NCCI.

EXHIBIT 4.14
WORKERS' COMPENSATION INSURANCE
ASSIGNED RISK POOL MARKET SHARES

Year	California: Estimated Per Table 17 Column (1)	California: Estimated Per Table 17 Column (2)	NCCI Administered Pools (31 States)
	(1)	(2)	(3)
1980	9.0%	10.8%	13.7
1981	4.7	6.0	11.0
1982	3.8	5.0	8.5
1983	4.3	5.8	6.5
1984	4.1	5.7	5.8
1985	6.6	8.8	10.3
1986	11.9	14.6	17.2
1987	13.2	15.5	20.2
1988	13.7	16.1	20.9
1989	13.8	16.5	23.3
1990	16.6	20.4	25.3

NOTES:

- *Market shares are per written premium.*
- *Market shares in columns (1) and (2) were estimated using the regression coefficients in Table 17, California loss experience, and prevailing yields on three-year U.S. Treasury bonds.*
- *Market shares in column (3) are from NCCI Management Summary, excluding Arizona and Oregon due to the presence of competitive state funds.*

SOURCES: *A.M. Best Company, Federal Reserve System, NCCI, M&R Analysis*

EXHIBIT 4.15
NUMBER OF GROUPS PROVIDING WORKERS' COMPENSATION IN CALIFORNIA

YEAR	NUMBER OF GROUPS
1986	126
1987	132
1988	140
1989	143
1990	142
% Increase 1986 - 1990	**12.7**

Source: A.M. Best Company, Executive Data Services, various editions

4.3 SIZE OF FIRM

4.3.1 FIRM SIZE OVERVIEW

Workers' compensation insurance in California looks very different to firms of various sizes. Indeed, large, medium and small firms exist in quite different workers' compensation environments.

4.3.2 THE LARGEST FIRMS

The largest firms have a very broad range of options. They may in many instances self-insure. They have access to insurers who specialize in large accounts. They have the benefit (and of course the risk) of experience ratings. They may receive dividends based on their safety performance, as well as on the economies of scale in underwriting and servicing their accounts. They are able to benefit from on-site safety and health education programs provided by their insurance providers.

4.3.3 MEDIUM SIZED FIRMS

Medium sized firms also have a wide range of workers' compensation options, even though they may not have the self-insurance options, and probably would not receive as elaborate on-site safety education programs.

4.3.4 SMALL SIZED FIRMS

Small sized firms, contrasted to medium and large ones, are confronted with very few options. All pay the manual rate. Individual small firms do not receive dividends or the benefits (and risks) of experience ratings. They cannot partake of the advantages of self-insurance. Some are able to gain the collective benefit of participating in safety groups, although it is unclear as to the actual availability of safety groups across the state and across industrial sectors. Not very much on-site aid is available for safety improvement and indeed there is very little in the system to provide small firms with safety incentives. Many small firms in some categories report that the cost of workers' compensation insurance is making it difficult or impossible to function in California. Anecdotal evidence suggests that some owner operated businesses don't employ additional workers because of the costs of workers' compensation.

Small firms are obviously at a competitive disadvantage in purchasing the protection they are mandated to provide. Although this is true, a free marketplace certainly does not demand that a "level playing field" be provided in all areas of public policy. But when law mandates the purchase of a product or service, the public interest is best served by policies which do not place small firms at great competitive disadvantage to larger ones, or, even worse, make the conduct of business by the small firm in California impossible.

4.4 COMPETITIVENESS AND EFFICIENCY OF INSURANCE PRODUCT DELIVERY

4.4.1 COMPETITIVE RATING OVERVIEW

In the context of the workers' compensation insurance industry, competitiveness is rarely viewed in the broad terms of a free market (or market forces) controlling prices and level of product. On the contrary, the concept of competitiveness has taken on a particularly narrow definition within the industry. The evaluation of competitiveness reflects existing and historical public policy efforts to provide for employee protection in the event of work-related injuries.

Prior to 1980, every state which permitted participation by private insurance carriers had a system that administered the pricing of insurance. Most systems employed uniform rates, filed by a rating bureau, with prior approval by a state insurance department. The remaining states provided insurance through exclusive state insurance funds. The "administered pricing" systems generally did not allow deviations from the uniform rates and competition between carriers was virtually non-existent.

In 1980, the National Association of Insurance Commissioners adopted a model competitive rating act which included workers' compensation insurance. Sixteen states subsequently enacted legislation establishing competitive rating or loss costs systems for workers' compensation insurance.

Of the sixteen states that have adopted competitive and/or loss cost systems, five states utilizing competitive rating have rating organizations that file loss costs only: Kentucky, Maryland, Michigan, Minnesota and Rhode Island. Four states utilize competitive rating, and the rating bureaus file advisory final rates only: Georgia, Illinois, Montana and Vermont. Seven states require prior approval for rates, but their respective rating bureaus file loss costs only: Colorado, Connecticut, Hawaii, Louisiana, New Mexico, Oregon and South Carolina. Rhode Island is unique in the latter category in that the rating bureau files loss costs for insurers with <u>more</u> than one percent of market share and files rates for insurers with <u>less</u> than one percent of market share.

4.4.2 ARGUMENTS SUPPORTING COMPETITIVE RATING

The arguments for competitive rating are essentially the same today as they were a decade ago. The results of lower costs for insurance will generally:

A. Heighten economic development

B. Keep business (and jobs) in the state

C. Promote efficiency in the provision of insurance

D. Lower premiums paid by businesses

Proponents of open competitive pricing systems maintain that advisory/rating organizations have the effect of "fixing" rates too high in order to maximize profits of insurance companies, and/or protect their inefficiencies (or other inefficiencies beyond the control of the carriers).

An additional, while contrasting, argument favoring a switch to loss costs is that fixed rates can be detrimental to insurer solvency because regulatory systems may make it difficult for insurers to adequately raise rates when their costs are actually rising. This claim may have less relevancy in California where only minimum rates are established for work classifications and insurers may apply surcharges on any risk without prior approval. At present, it appears that surcharging has had a limited role with less than one percent of total premium surcharged. The evidence suggests that private carriers will decline business rather than attempt to surcharge it to what they consider an adequate rate.

Small businesses in California are particularly interested in the adverse impact of the administered pricing system on their premium costs and the dividend practices of insurers. Recent filings by the Workers' Compensation Insurance Rating Bureau for approval by the Insurance Commissioner include a loading to support rebates of 10% - 15% of premium in the form of dividends. These rebates disproportionately go to larger businesses since private carriers typically exclude individual small businesses from their dividend plans. Also, a relatively high eligibility threshold means that the Rating Bureau does not assign an experience modification factor to most small businesses. The net impact of these two practices is that small businesses with good loss ratios are disadvantaged.

4.4.3 ARGUMENTS SUPPORTING ADMINISTERED PRICING SYSTEMS

Economists have maintained that perfect market competition may not be possible in the real world of business. Hence, the concept of "workable competition" has been developed as a means of evaluating an appropriate level of government intervention to maximize a balance between profit and benefit. The governmental intervention that has evolved is in the form of an administered pricing system, generally utilizing the services of a rating or advisory organization.

Supporters of a "workably" competitive market/rating bureau intervention system maintain that rating bureaus are necessary to collect and analyze cost information for insurance carriers, and that insurers need actuarial data from as wide a base as possible in order to accurately project losses and expenses.

Proponents of regulated, uniform rating also argue that rate setting is necessary to protect the solvency of existing insurers, that unrestrained competition among insurers will result in inadequate rates (and income), and endanger financial solidity to the point that they will not be able to pay all claims they have contracted to cover and pay.

The argument regarding data collection also reflects an impression that the increased costs of insurers calculating their own final rates will increase burdens of regulators required to process each carrier's rate filings. Accordingly, the additional burden on regulators will reduce service to new entrants, thus reducing entry by new competitors and, consequently, will have the effect of decreasing competition rather than increasing competition. Also, smaller insurers will be less competitive because of costs required to calculate their own rates.

An additional argument is that competition in pricing already exists because of the use of dividend plans and other adjustments to premiums. However, the unavailability in California of dividend plans for small business limits the application of this latter argument.

Finally, an underlying public policy argument for administered pricing is that an adequate base price is necessary to assure availability of coverage to small or marginal employers who are mandated to maintain coverage.

4.4.4 ARGUMENTS SUPPORTING EXCLUSIVE STATE FUNDS

Possible benefits of exclusive state funds are: savings realized because a sales force is not required; acquisition costs are not required; administration is less complex than other systems; information is easier to utilize and a rating bureau is not required; surpluses can be used to reduce premium rates; and there are savings to employers because profits are not charged. Other claims include an expectation that the fund's principal motivation is service to employers and to workers, and also the assurance that workers' compensation insurance will be available.

Reportedly, overhead costs for exclusive funds are lower, a focus on a single line of insurance is probably more efficient, all areas and employers of a state are assured of availability, there is the expectation that revenue in the system will remain in the state, they experience fewer claims per employee and write fewer policies per employee, and they may be providing a higher level of service to employers and employees.

With regard to financial solvency, supporters of exclusive state funds maintain that "no state fund has ever gone insolvent," "been taken over by a regulatory agency," or "ever been tapped to pay state fund losses." Although not a specific advantage, exclusive state funds have fewer rating classes, and they generally allow lower eligibility requirements for experience rating, make less use of dividends, and do not provide discounts.

An exclusive state fund might allow efficiencies with an integrated system of data gathering, safety program enhancements, and reduced costs. Advertising costs would be eliminated, payment of premiums could be standardized and simplified, more intensive educational efforts could be realized, and the possibility of higher benefits to workers could become a reality.

Balanced against these potential advantages are the inherent inefficiencies that accompany bureaucracies not governed by market forces and those associated with the social allocation of resources.

4.5 FAIRNESS WITH RESPECT TO BENEFITS IN RELATION TO COSTS

4.5.1 BENEFIT AND COST RELATIONSHIP

It is generally agreed that private insurers must earn adequate profits, that workers should receive adequate benefits in a timely manner, and that employers should pay fair premiums. It is also apparent that, in California, the costs of insurance to the employer are relatively high in comparison to benefits received by the injured employee. Evidence indicates that the system is not equitable from the perspective of the employee, it is relatively high in costs to the employer, but it is adequate in profitability for insurers.

4.5.2 LOW BENEFIT LEVELS FOR EMPLOYEES

The California system of private insurers, a successful competitive state fund, and a rating system, appears to operate in balance despite the realization of relatively high costs and low benefit levels for employees. By example, in 1991, California ranked 37th of 51 states and D. C. in maximum weekly benefits to claimants for temporary disability, and ranked as low as 48th from 1984 through 1989. Because California is a high wage state, it is ranked 45th on the amount of lost wages replaced by temporary disability benefits. Average benefit levels to survivors in fatality cases show a similar pattern. It should be noted, however, that while statutory benefit levels are low, the breadth of benefits in California tends to be greater than in other states.

On the other hand, claims frequency appears higher than average in California. Of states reporting claims frequency to the National Council on Compensation Insurance, California ranked 5th of 40 states in overall frequency of claims per 100,000 workers, and 9th of 42 states on utilization of temporary disability benefits.

4.5.3 PROFITS FOR INSURERS

A comparison of states by the National Association of Insurance Commissioners in 1989 indicated that profits for insurers in California amounted to 9.1 percent, ranking California 20th among 51 jurisdictions, while the average total profit for all 51 jurisdictions in 1989 was 2.9 percent. During the period 1985 through 1989, California's profit rate was 8.64 compared with 4.64 for all 51 jurisdictions. (See Exhibit 4.7)

4.5.4 COSTS FOR EMPLOYERS

Research also suggests that net costs to employers is comparatively high in California. By example, in 1988, California ranked third among 51 jurisdictions in a ranking of 44 types of nonagricultural employers. Data also indicated that the average cost for insurance in California has increased considerably over time. In one study, average costs for California employers in 1958 amounted to less than one percent (.707) of payroll, compared with 3.075 percent of payroll in 1988. This same survey, comparing 21 states for 44 classes of employers, placed California at the top as the highest average cost state in terms of payroll paid for worker's compensation premiums. More recent data put California somewhat lower down the list, especially when controlling for costs net of dividends, but the state remains relatively costly nevertheless.

4.6 SAFETY IN RELATIONSHIP TO PROSPECTIVE VERSUS RETROSPECTIVE PRICING

4.6.1 ISSUE OVERVIEW

The Commission considered the question of whether the current retrospective pricing system encouraged safety in the workplace. There are two methods of retrospective pricing that provide incentives for workplace safety. The first method is the retrospective rating plan that involves the retrospective adjustment of the annual premium based on a company's actual safety record during the year it was insured. Since the adjustment can be either upwards or downwards, it potentially provides a strong safety incentive. However, an employer must have at least a $25,000 premium to participate in retrospective rating. This combined with the risk of an upward adjustment results in only a small proportion of employers choosing this retrospective pricing method. So, while in theory it could be a helpful tool, in practice it is not widely used.

The second method involves the payment of end-of-year dividends to employers that have relatively fewer compensation claims. Both the testimony of stakeholders and the data on dividends indicated that for relatively large employers the dividend system provides incentives to maintain a safe workplace. However, two aspects of dividend plans create some cause for concern over the safety issue.

First, dividends are only offered to large employers. This is because insurance companies usually establish minimum premium requirements to be eligible for participation in a dividend plan. According to the Rating Bureau, approximately 70% of California employers producing approximately 90% of the earned premium are eligible for policyholder dividends. There are no published statistics showing what percentage of those eligible actually receive dividends. However, most small employers are not eligible for dividend plans.

Second, while the dividend system rewards employers insured by a specific insurer based on those employers' relative safety records, it does not guarantee that the relative safety records of employers across different insurers will be similarly rewarded. This is because the dividends paid by any specific insurer are a function of both the employers' relative safety record and financial decisions by the insurer. The result is a situation where a relatively safe Employer A insured by Company X may receive a smaller dividend than a relatively less safe (but otherwise equivalent) Employer B insured by Company Y. Testimony from employers indicated that this uncertainty about the actual dividends that would be paid, even to claim-free employers, is a source of employer discontent with retrospective pricing. On the flip side, there is also evidence that some employers with poor loss experience still receive dividend payments.

4.6.2 THE ROLE OF THE SELF-INSURANCE OPTION

Current estimates are that approximately 35% of total California payroll is covered by self-insurance. The option of self-insurance may provide some degree of restraint on pricing by private insurers. However, the high financial requirements for becoming a self-insured entity, combined with the risk involved, seem to have deterred any large scale movement towards self-insurance. Some would argue that self-insurance is the ultimate incentive for safety in that the employer bears all the costs of workplace injury and illness. However, since employers who become self-insured tend to be those with relatively safe workplaces to begin with, it is unlikely that the self-insurance option itself greatly increases the overall level of workplace safety.

4.6.3 WORKERS' COMPENSATION DEDUCTIBLE OPTION

Large deductible workers' compensation plans have recently been introduced by several major insurance companies. The insurance companies have requested approval of such plans from insurance regulatory bodies of nearly every state. To date, approximately thirty-five states have approved this relatively new approach to workers' compensation insurance.

Under a large deductible plan, the insurance company initially charges the employer an upfront handling fee which includes the carrier's expenses for overhead, profit, taxes, bureau fees and the like. The employer agrees to reimburse the carrier for losses up to the amount of the deductible that is selected by the policyholder. The insurance company retains the responsibility for management and payment of all claims from the first dollar. The plans filed by the major insurance companies have generally involved a minimum deductible of $100,000 and minimum annual premium of $500,000.

A "deductible plan" approach would be both attractive and workable for the small to medium-sized employers in California. This approach, combined with the safety groups, could provide an opportunity to obtain the advantage of the volume purchasing power and benefit of having an excellent claims history.

The regulatory bodies must decide if the concept is contrary to state laws. If they are, then consideration must be given to modifying the state statutes to permit deductible rating plans. This concept could be part of the reform of workers' compensation as it would generate improvement in the overall situation for small and medium-sized employers in California.

4.6.4 OTHER OPTIONS TO PROMOTE SAFETY

There are several other options to promote safety that could be implemented either within the current retrospective pricing system or within a prospective pricing system. One option, utilized in the state of Washington and elsewhere, provides for premium discounts for small employers who have no, or relatively few, accidents. (As discussed previously, such a plan may require safeguards to assure that legitimate claims are not discouraged.) While critics argue that this type of "experience rating" for small employers is not actuarially sound, it is nevertheless a financial incentive to maintain a safe workplace.

Another option, utilized in several states (including Delaware, Oklahoma and Massachusetts), allows premium discounts for employers who institute (and document) health and safety programs in the workplace. Again, such discounts are available even to small employers who are not eligible for experience rating or dividend plans.

Another potential option would be to require all licensed workers' compensation insurance companies to provide health and safety programs to all the employers they insure, regardless of size. An alternative would be to designate a state agency to provide such services to all employers.

4.7 CONCLUSIONS

Evidence presented to the Commission indicates that workers' compensation premium rates have been adequate for insurers. Insurer profitability is in line with rates of return in other industries, and appears higher in California than the national average for this line of insurance. There was no evidence presented to the Commission that rates have been inadequate.

On the issue of insurer efficiency, the Commission found that the State Compensation Insurance Fund operated with generally lower expenses than either stock or mutual carriers. The difference between types of companies is partially explained by lower commissions and brokerage fees, and partially by reductions in loss adjustment expenses. The Commission was not, however, convinced that such efficiency advantages would necessarily hold up under a change to an exclusive state fund for workers' compensation.

The Commission finds that through the mix of public and private companies, the market for workers' compensation is relatively stable and makes its product available to all employers. The price of coverage appears relatively stable, at least compared to some other states. On the other hand, there remains the issue of whether this stability is worth the apparently higher prices of California coverage.

During recent years, California has seen a net increase in the number of insurers writing workers' compensation coverage. There are, however, unknown levels of partial exits from the market, such as when companies refuse to write coverage in certain work classifications or geographical regions. As of the present, there appears no widespread problems of insurer exit from the market.

The Commission has concerns that the market for compensation coverage differs by size of employer. The service, availability of coverage, and injury prevention incentives appear to disproportionately neglect smaller employers. While large and medium size firms appear to find a broad market for coverage and service, most small firms are limited in their ability to find a vibrant market, and cannot demand levels of claims handling and safety services available to larger companies.

A deductible plan approach would provide an option to the small and medium sized employers that have an excellent claim history for many years. There would still be a need for the assigned risk plan as this concept would only be available to the established employers that have a superior claims history and are financially sound. Thereby, being able to reimburse the insurance company as the losses are paid.

The Commission finds that many other states have adopted the recommendations of the National Association of Insurance Commissioners and are moving toward more competitive systems of premium rate regulation. There is an ongoing debate of the relative merits of competitive versus administered pricing schemes, and the Commission has considered the tradeoffs involved in changing from the present system.

The Commission notes that there are also benefits and downsides of changing to an exclusive state fund for California. Research does not appear to support the contention that the creation of an exclusive state fund in California would reduce overall costs for employers. There is the possibility that benefit levels for employees might increase, and that the quality of benefit delivery to employees would be improved, but this would occur only if the bureaucracy created were efficient and responsive. A principal concern strongly forwarded by insurers, and equally rebutted by proponents of state funds, is that exclusive state funds are in poor financial condition, and in particular, in worse financial condition than competitive state funds.

The Commission has received evidence that complicates the conventional wisdom that California is a high cost, low benefit state. Benefits to individual injured workers are limited to low maximum levels. However, utilization of the workers' compensation system appears relatively high in California due to the broad scope of injuries and illnesses eligible for compensation. Similarly, the costs to employers are very high when compared on a gross basis, but dividends to policyholders appear to reduce cost somewhat. Some observers argue that in relation to total benefits paid, ultimate employer costs are not out of line. Overall, however, indications are that the costs of the system are higher than necessary.

On the issue of safety and injury prevention, the Commission finds that safety incentives are disproportionately focused on larger employers, and that smaller employers receive neither the financial incentives nor the safety services necessary to accomplish improvement. This conclusion is particularly important with respect to dividend practices of insurers, and the patterns of loss control and health and safety services offered to policyholders. The Commission finds that while dividends appear to be the strongest incentive offered by insurers, they are sensitive to external financial conditions as well as to the safety and injury experience of individual employers. Uncertainty about dividends even in a relatively safe workplace was a major source of employer discontent with the system.

The Commission finds that there are several options available to promote more awareness of and incentives for injury and illness reduction. These include reducing the thresholds of participation in experience related incentive programs, and giving incentives for engaging in prevention work. The Commission also is interested in plans that would increase the amount and type of loss control services offered to small employers, whether through insurance carriers or direct governmental services.

SECTION 5.0

QUALITY OF WORKERS' COMPENSATION SERVICE

SECTION 5.0

QUALITY OF WORKERS' COMPENSATION SERVICE

5.1 INTRODUCTION

Quality of service is a major factor to be considered when an employer selects an insurance company to provide workers' compensation insurance.

Services provided can be of two types. Preventive services include such activities as safety and environmental reviews and surveys, safety training, disease control and reviews and statistical compilations for regulatory purposes. Benefit services are activities which occur when a loss is incurred, such as processing, investigating, settling or litigating claims, securing medical and rehabilitative assistance for injured employees, and facilitating communication among the parties.

The correct combination of services is essential if the program is to provide service and expense containment. In addition, certain self-insured services can be performed in-house by the employer. Larger workers' compensation frequently manage their own claims and provide their own comprehensive loss control services.

Certain insurers are willing to provide "unbundled" services. In addition, some insurers can provide a complete package program which includes claims administration, loss control and excess insurance. In many cases, larger insurance brokerage firms are also able to provide effective workers' compensation "unbundled" services. Specific areas of focus included claim review, reserving analysis and loss control management.

5.2 WORKPLACE SAFETY IN CALIFORNIA

In January, 1992, the National Safe Workplace Institute released the results of a study indicating that California may have one of the safest workplaces in the nation, but it is still far from being the ideal place to work. California scored 81 out of a possible 116 points. According to Joseph Kinney, the institute's director, the Workplace Safety Study, the first of its kind by the National Safe Workplace Institute, includes a state-by-state analysis and profile. It was designed to identify "the interplay between prevention, compensation and enforcement". The report continues, "even though California scored the highest in the National Safe Workplace Institute ranking for workplace safety with 40 out of a possible 50 points for prevention, its workers' compensation insurance costs are the second highest in the nation."

In comparison to the United States as a whole, California has higher injury/illness incidence rates on total cases, and lost workday cases (those that would be eligible for compensation benefits), but lower rates of lost workdays. In comparison to the Pacific Region states, California has relatively low total case incidence rates, particularly in the large industry categories of construction, manufacturing, trade, and services. In comparison to all states participating in BLS sample, California ranks near the middle in most measures of occupational injury and illness incidence.

It is difficult to conduct business in today's competitive environment. Employers must be aware of, and take advantage of, any service that is available to assist them in providing that competitive edge. Safety and loss prevention are major factors that must be included in any successful operation. The passage of Senate Bill 198, which made changes to Title 8 of the California Code of Regulations, can help increase business efficiency and profitability. This change requires that every California employer have in place, by July, 1991, a written Injury and Illness Prevention Program which puts into practice all the elements of a safety program.

5.3 PREVENTIVE SERVICES

Customers and authorities often look to a company's attention to safety responsibilities as an indicator of the quality of the company. A clear, published safety policy would be a very positive indicator. It is important that the top management of an organization makes reducing accident probability a high priority. The organization can greatly reduce the cost of workers' compensation insurance by establishing a safety program to prevent the claims from occurring. This not only eliminates the cost of medical treatment and the payment of lost wages, it eliminates intangible costs, such as reduction in production, the cost to hire replacement workers, the cost for the supervisor to complete accident forms, and overall general disruption in the workplace.

5.3.1 EMPLOYEE VIEWS

Employees probably cannot distinguish between the efforts of their employer and the insurers with respect to safety services; however, they are interested in safety. Safety awareness is becoming more and more an integral part of employee activities at the workplace. Employees are becoming more aware of environmental issues, and if employers do not provide satisfactory solutions, employees may seek assistance from other sources.

5.3.2 EMPLOYER VIEWS

A recent study by the California Workers' Compensation Institute, "Employer Views of Workers' Compensation in California," indicates that 55% of employers stated they were receiving safety evaluations, 41% received safety programs and 24% job modification assistance. Of those note receiving such services, thirty-percent said they would like to receive safety evaluations, 26% would like to receive safety programs and 16% job modification advice. However, overall only 3% of employers indicated that they are dissatisfied with the safety help offered to them by their insurers.

Large and medium sized employers were more likely to want more help than small employers, though large employers were far more likely to be receiving it. As was noted above, California is a state with a good safety record. If it cannot be claimed that the rate system directly affects safety, it is equally true that it would be hard to claim that the system retards or hinders safety efforts. Nevertheless, it seems clear from testimony and other evidence that safety efforts provided by insurers are heavily weighted toward larger employers. This is understandable to the extent that "preventable" injuries represent important economies of scale for safety programs, and as the size of the organization decreases, the less likely it is that a particular accident type will occur with enough frequency to be considered preventable. It may be that small employers do not want any more safety services. It is not clear, however, whether small employers are knowledgeable in this area. Some may not know that safety assistance is available. Others, who have not experienced a recent loss, may not be aware of the impact that a preventable accident may have on their future rates. Or, they may be resigned to being too small to qualify for experience rating even if they are safe.

There is conflicting testimony regarding the effect of dividends. While some insurers and employers believe the promise of dividends is a safety incentive, others recognize that the dividend more frequently reflects the business success of the insurer rather than the loss control record of the employer. There is more agreement that the experience modification factor serves as an incentive for those who are eligible to receive it.

5.3.3 SAFETY SERVICES

Safety services are available to employers from various organizations which service workers' compensation programs, such as insurance companies, insurance agents and brokers, and companies providing claims services to self-insureds. In addition, CAL-OSHA, the National Safety Council, trade associations and safety consultant services are among other sources of safety and loss control information. Historically, legislative and regulatory processes have been used as the "sticks" to require safe practices. We hope that reduced loss costs, and adjustments in the ratemaking process, can serve as positive incentives for servicers to provide, and for employers to seek, safety services.

5.4 BENEFIT SERVICES

Once an injury is reported by the employee, the employer and the workers' compensation insurance company must respond. The employer, after reporting the claim to the insurance company, should be available to assist the employee in obtaining the necessary benefits.

The insurance company is obligated to pay promptly benefits to the legitimately injured worker, to investigate questionable claims, to control losses, to coordinate with the injured employee's treating physician, and to involve rehabilitation services when necessary.

5.4.1 EMPLOYEE VIEWS

The principal study of workers' views of workers' compensation services was done ten years ago (by the California Workers' Compensation Institute). Admittedly, the system has changed slightly; however, the changes are so recent that a "new" study would not pick up many workers whose cases had been handled entirely on the post-1989 system. Also, to the extent that the reforms potentially increase the number of different entities (doctors, agencies and so forth) which an individual case might involve, it is unlikely that perceptions of simplicity or efficiencies of the system have improved from the workers' point of view. Some dissatisfaction with the system stems from the amount paid in benefits and settlements. Still, only a minority of workers rank the insurance company "good" or "excellent" on answering questions or keeping the worker informed of the overall handling of the case. Similarly, only a minority thought the employer did well on providing information, and a bare majority stated that they received their benefits on time. There is independent data to support the contention of slow payment; however, many slow payments currently seem related to disputed claims. Over half of the injured workers reported that they did not hear from anyone about their injury for three weeks or more after it occurred. Thirty-three percent of the injured workers reported that they had to initiate the first contact themselves. Of those who consulted an attorney, seventy-five percent did so only after a month or more had passed. Twenty percent did not hire the attorney until a year or more after the accident. Inability to get timely help and information seemed to motivate getting outside help. The majority reported that they felt the attorney's fees were fair.

A 1989 Study of Public Opinion of the Workers' Compensation Appeals Board similarly cited delays, heavy case load and inefficiencies in processing cases. Additionally, a recently established state audit procedure has revealed delays and errors in the handling of cases by some insurers.

5.4.2 EMPLOYER VIEWS

Employer satisfaction with the workers' compensation system was studied in the California Workers' Compensation Institute study previously cited. While most employers report an "average" level of satisfaction, employers with recent experience with a loss are more likely to be dissatisfied. Like employees, employers are most likely to be dissatisfied with financial aspects of the system; primarily the overall cost to the employer, the cost of fraud and the costs of some benefits. Forty-percent of employers expressed satisfaction with claims handling, however, sixty-percent expressed dissatisfaction with claims handling at least some of the time. The vast majority of these claims concern settlement of questionable claims, over reserving of claims and claims staff turnover. Delayed payments to an employee or to providers caused dissatisfaction for less than ten percent of the employers surveyed. "Communication" is an area of dissatisfaction expressed by a majority of employers. The inability to obtain enough information about their claims and an unsatisfactory explanation as to why claims were paid are the examples cited most frequently. Interestingly, in contrast to much of the testimony we heard and this study's finding about fraud as a major problem, the employers surveyed rarely questioned their own claims, the majority believing that most were valid. The communication complaints could probably be related to the information complaints of the workers. Employers may be frustrated when they cannot get information to pass on to the employee.

The study also indicates that employers who know most about workers' compensation insurance are the least satisfied with it. Much of the testimony we heard assumed that the absence of prospective rate competition forced insurers to compete on the basis of service. On the other hand, the fact that "everybody will charge you the same rate" seems to mean that many employers buy a broker's recommendation as part of an insurance package. Employers may not be aware that another insurance company might provide additional services, i.e., status reports on individual cases, monthly claim reports and assistance in analyzing loss trends.

5.5 SELF-INSURER VIEWS

Self-insurers also cite service and claims philosophy issues when providing reasons for electing to self-insure for workers' compensation liability. Testimony indicates that self-insurers believe they can reduce the frequency of claims, and the majority have been successful. Self-insurance gives the organization better control and a cash flow benefit. Self-insurers also have the ability to use their own employees to handle claims, which provides them greater control of the claims management function.

There are approximately seven hundred master self-insurers in the private sector and two-thousand-fifty in the public sector. The Division of Workers' Compensation estimates that self-insurers account for approximately thirty-five percent of the market with the remaining sixty-five percent being in the standard workers' compensation marketplace.

Self-insurers believe they can pay only for their own losses, and that they are also able to minimize the expenses associated with the handling of claims. Self-insureds can establish parameters with the claims administrator, and be provided with whatever claim information they request.

5.6 SMALL EMPLOYER PROBLEMS

It is generally assumed that small companies with fewer employees have proportionately more work injuries than large corporations. This is somewhat difficult to establish, as many small companies do not maintain accurate records of their loss experience.

The study conducted by the California Workers' Compensation Institute indicates that smaller employers may perceive premiums as out of scale with actual experience because, even though they have few or no claims, their premiums are based on the average risk for their industry, usually with no experience modification. Half of the employers paying less than $15,000 in annual premium said they had no claims in the past three years, compared to only two percent of those who paid $100,000 or more. For small employers, chance is likely to be a significant determinant of whether an accident occurs.

Small employer problems include:

A. A company does not have the budget or the need for a specialized safety person on it's staff.

B. A company does not have a sufficient amount of workers' compensation accidents to justify spending the money necessary for a safer operation, or is unable to quantify the benefits of spending more on safety.

C. Other problems within organization have a higher priority than safety.

D. A company may be unaware of available safety services (since most insurers state they provide safety services to small employers only on request), or of the existence of safety groups in its industry.

5.7 CONCLUSIONS

There is a broad range of appropriate services available for the medium and large employer, as well as the knowledgeable sophisticated organization. Traditionally, the small employer has had difficulty in obtaining effective loss control and claims management services. Contributing factors to small employer service inadequacies include: inadequate funding from the small premium base, insufficient amount of worker compensation claims to justify the spending of time and money on the subject, higher priorities than the safety issue, and the fact that it is difficult to quantify effectiveness of spending money for accident prevention work. The Commission concludes:

A. There is a definite need for improved communications to employers, especially small employers, as to the options available to employers with regard to access to safety groups, assistance with loss control and assistance with the establishment of safety programs.

B. Employers must be made aware of insurance company services that are available for loss prevention, claims analysis and claims services.

C. An information center should be established in the Department of Insurance with information concerning safety groups, services available from insurance carriers, and a listing of outside sources for assistance with a particular problem in developing a safe workplace.

D. For other employers, the Commission concludes that a wide range of services are available. There is great variation in satisfaction with services received; it is to be hoped that increased competition will enable dissatisfied employers to seek new carriers, and encourage insurers to offer improved services. Similarly, injured workers report dissatisfaction with services provided to them. State auditing procedures may serve to improve performance in claims handling.

SECTION 6.0

WORKERS' COMPENSATION INSURANCE RATING BUREAU (WCIRB)

SECTION 6.0

WORKERS' COMPENSATION INSURANCE RATING BUREAU (WCIRB)

6.1 BUREAU OVERVIEW

The Rating Bureau was formed in 1915, and is one of thirteen states to have an independent local rating organization. It serves a number of important functions:

A. Classification of employers into one of approximately 450 rating categories

B. Determination of the experience modifier for each employer (small employers having less than about $7,000 in annual premiums receive no experience modifier)

C. Review and approve applications for retrospective rating and premium adjustments

D. Propose to the California Insurance Commissioner rate increases, in the form of an overall weighted average manual rate

E. Establish manual rates for each of the employer rating classifications. While the Bureau affords the insurance industry a reasonably high degree of self regulation, final authority rests with the Insurance Commissioner.

6.2 EFFICIENCY

In carrying out these functions, the Rating Bureau appears to be relatively efficient in its administration. The major operating responsibilities are:

A. Policy examinations, where all individual policies are checked as to classification, manual rate, experience modifier and estimated payroll

B. Classification and inspection, where classifications of employers are determined

C. Rating and statistical reports, where individual policy experience is analyzed and documented in what is called a unit statistical report

D. Systems program and computer operations, where data and information are entered and managed. The Bureau has strong data processing and computer capabilities, and costs appear to be controlled. Increased computerization in recent years has resulted in productivity gains, more timely service, and better information.

Selected data and statistics having to do with efficiency are shown in Exhibit 6.1, Selected Data and Statistics on the Rating Bureau (WCIRB), located on the following page. More detailed, and additional, information is found in annual reports of the Rating Bureau. As shown in the table, the number of employees has grown at a slower rate than many operational activities. Expressed differently, the Bureau has added services and functions at a faster rate than employees. Bureau expenditures are comprised of operating expenses (mostly employee salaries and benefits) and capital expenditures, which run about 5 percent of total expenditures. During the last ten years, total expenditures per employee have grown at slightly over five percent, modestly in excess of inflation as represented by the consumer price index. Expenditures, as a percent of total premiums in the state, declined from 0.249% in 1981 to 0.158% in 1990. During the last several years, this ratio has fluctuated, so the reduction was accomplished through 1987. Clearly, expenditures of the Rating Bureau are not a significant cost driver in the total picture.

On the basis of our review, the Bureau appears to be efficient in carrying out its functions. Management is mindful of the need for cost control and efficiency. The eight insurers on the governing committee approve the Bureau's annual budget, and they exercise considerable discipline on salaries and head count. While one should always strive for greater efficiency, substantial correction is not needed.

6.3 FAIRNESS

A more difficult issue to judge is that of fairness. In this regard, we recognize that the basic cost drivers are beyond the reaches of the Rating Bureau to affect, at least directly. Therefore, the question is whether the rating classifications, manual rates, and experience modifiers are fair across the spectrum of employers. Given the time constraints on the commission, it is not possible to test ratings across categories. On the basis of evidence presented and a review of the processes used to determine classifications, relativity between classes, and experience modifiers, it would appear that they are set in a sound manner. There are a number of checks and balances that move the system toward accuracy and fairness.

The number of formal appeals of classification, experience ratings, and retrospective ratings is small, relative to the approximately 570,000 insured employers in the state. For specific details refer to Exhibit 6.2, Bureau Appeal Activities concerning the last five years, appeals to The Bureau's Classification and Rating Committee. (Located on Page I-6.0-4)

EXHIBIT 6.1
SELECTED DATA AND STATISTICS ON THE RATING BUREAU (WCIRB)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Policy Documents Processed (000s)	1,138	1,148	1,197	1,226	1,322	1,388	1,524	1,615	1,655	1,726
per employee (in thousands)	4.4	4.5	4.7	4.9	5.4	5.5	5.9	5.8	5.9	6.0
Policy Info. Correspondence (000s)	147	129	126	148	149	157	222	248	314	386
per employee (in thousands)	0.57	0.51	0.50	0.59	0.60	0.62	0.86	0.89	1.12	1.34
Employer Inspections Conducted (000s)	24	25	26	22	22	24	25	25	25	28
Test Audits Conducted (000s)	5	6	6	5	4	5	5	5	5	6
Statistical Reports Processed (000s)	596	608	582	598	695	733	730	734	754	768
per employee (in thousands)	2.3	2.4	2.3	2.4	2.8	2.9	2.8	2.6	2.7	2.7
Experience Ratings Issued (000s)	92	98	94	92	85	105	105	117	108	144
per employee (in thousands)	0.36	0.38	0.37	0.37	0.34	0.42	0.41	0.42	0.39	0.50
Employees	256	255	253	250	247	252	258	279	280	289
growth (percentage per year)		-0.4%	-0.8%	-1.2%	-1.2%	2.0%	2.4%	8.1%	0.4%	3.2%
Expenditures (in thousands)	$7,403	$8,048	$8,391	$8,527	$8,663	$9,358	$10,407	$11,667	$12,199	$13,171
growth (percentage per year)		8.7%	4.3%	1.6%	1.6%	8.0%	11.2%	12.1%	4.6%	8.0%
per employee (in thousands)	$28.9	$31.6	$33.2	$34.1	$35.1	$37.1	$40.3	$41.8	$43.6	$45.6
Bureau Expenditures/Premiums	0.249%	0.282%	0.247%	0.218%	0.199%	0.179%	0.163%	0.157%	0.154%	0.158%

EXHIBIT 6.2
BUREAU APPEAL ACTIVITIES

	1986	1987	1988	1989	1990
Request for Hearing by Employer	37	55	73	62	72
Request Withdrawn	22	20	41	29	44
Appeals Heard	15	25	32	33	28

Withdrawn appeals are those where the appellant decides to withdraw after a meeting with the Bureau's staff. The small number of formal appeals is consistent with the notion of fairness across various employers. Recognize, however, the appeals process is time consuming and cumbersome for the employer.

Most inquiries as to classification, experience modifier, etc. never reach the appeals stage. For the most part these inquiries are handled by people in the experience rating, classification, or legal areas of the Bureau. We are told by the Bureau that most inquiries are from employers with less than 100 employees. Many calls are resolved simply by explanation of a method of calculation or of a function of the Bureau. If an employer is still unsatisfied, he or she is asked to express the problem in writing. Upon receipt, the staff investigates the problem, sometimes sending a person to the employer. A staff decision is reached, which can be appealed. The Bureau has no systematic record of complaints and their resolution (before the appeals process). It determined, upon our request, that for the period, January 15, 1990, to November 15, 1991, there were 2,253 written responses to employer complaints and inquiries. The majority of these (1,171) were as to classification, followed by experience modifier (852). The Bureau estimates that there are approximately 500 employer inquiries/complaints per month dealt with by the Classification and Inspection Department and 200 per month by the Experience Rating Department. While generalizations are not possible on the basis of fragmentary evidence, there are concerns with the Bureau's handling of complaints, particularly those from small employers of the type who testified.

6.4 GOVERNANCE

The Governing Committee of the Bureau oversees the management of the organization, much as does a board of directors. It meets roughly eight times a year. It has twelve members serving staggered two-year terms, eight representing insurers and four representing the public. The latter are the result of the Workers' Compensation Reform Act of 1989. Prior to 1990, there were only two public members. Half the public members are representatives of labor unions, the other half being of employers; both sets are appointed by the Insurance Commissioner. While the system is new, so far there has not been a tendency to appoint people representing larger employers.

It would seem that the interests of smaller employers are represented on the Governing Committee, although how well is difficult to tell. Likewise, it is not possible to tell how well the interests of employees are represented through the labor union members on the Committee. With respect to major substantive issues, we are told that nearly three-quarters of the attention at meetings goes to the overall manual rate, with lesser time devoted to classification and experience modifier issues. We are told by the Bureau that both sets of public members are active in discussions of actuarial assumptions concerning the overall manual rate.

6.5 RATE PROPOSALS

The procedure by which overall manual rate increases occur is that the Rating Bureau proposes a new weighted average manual rate for the year, the Insurance Commissioner reviews the proposal and then decides. In a sense, the Bureau serves in a position of "reasoned" advocacy for the insurers. Through 1992, the focus is on the 67.2 percent loss ratio (losses/premiums) mandated by the legislature. Under this system, the Bureau projects loss expenses. In turn, this is a function of average experience state-wide, together with likely cost increases.

There is no market discipline as to total dollar losses projected. These losses, together with the mandated loss ratio, determine the amount of manual rate necessary for the forthcoming period. The only market discipline comes from less efficient insurers exiting the market, because the margin for everything else, 32.8 percent, is insufficient for them. In the past, before the mandated loss ratio, the Bureau projected average expenses for insurers state-wide. Such a procedure creates a pricing umbrella for insurers, but that was consistent with enabling legislation which placed an emphasis on solvency and stability of the system over the long haul. The ultimate authority for rate increases rests with the Insurance Commissioner, and members of the Commissioner's staff come to meetings of the Bureau concerning a new manual rate. As a result, the Bureau's proposal comes as no surprise.

In reviewing the procedures for estimating costs going into manual rate proposals, by and large they seem appropriate. Actuarial judgments necessarily must be made, for there is considerable uncertainty as to loss projections. A good deal of analysis goes into the process, and retrospective testing improves the process. Still in a world of changing accident mixes, costs and economic activity, there is uncertainty. All that we can ask is that the process be managed intelligently and that it be adaptive to change. For the most part, this appears to be the case.

In determining an overall manual rate, the Bureau weights the State Fund's experience at one-half of its market share. This is based on the notion that while part of its business is the residual market, where losses are high, the other part is business in direct competition with private carriers. In 1988 and 1989 the State Fund had unusually high losses, owing to changes in reserve procedures and to other things, and this experience was omitted from the calculations. In 1990, loss experience was less but still high. It no longer was considered an anomaly and included, again at one-half weighting. The weighting is arbitrary, as no precise formulation exists to establish it. Overall, the State Fund has higher losses, but lower expenses (higher operating efficiency) than to private carriers. Typically, the former more than offsets the latter.

With a change toward considerably more open competition in rate making, the experience of the State Fund should be fully weighted.

C106T03F.JCV

SECTION 7.0

EXCLUSIVE STATE FUNDS

SECTION 7.0

EXCLUSIVE STATE FUNDS

7.1 BACKGROUND ON STATE FUNDS

Twenty-five states now have state workers' compensation insurance funds in operation or they have been authorized. Most state funds were authorized in the early years of workers' compensation. However, since 1983, six states, Minnesota, Rhode Island, New Mexico, Texas, Louisiana and Maine, have begun or authorized state funds. These newer funds are or will be "competitive" with private insurance companies. The most recent funds have been welcomed by many private insurance companies as a means of reducing their exposure in states that they perceive allow inadequate workers' compensation premium rates. The newest funds have been created in states experiencing high ratios of losses and expenses to premiums and states with large assigned risk pools. The introduction of a state fund may be a mechanism by which the state takes over some of the financial responsibility of these pools.

Six states do not allow private insurance companies to write workers' compensation insurance and maintain "exclusive" state funds. Exclusive funds also operate in every Canadian province and in Puerto Rico and Guam. In the United States the following states operate "exclusive" (monopolistic) workers' compensation state funds:

Nevada
North Dakota
Ohio
Washington
West Virginia
Wyoming

State funds are the largest writers of workers' compensation coverage in every state in which they do business except Pennsylvania and Minnesota. The South Carolina Fund is unique in that it offers coverage only for governmental units.

California has had a state fund since 1913, when workers' compensation became mandatory. California's fund has become the "insurer of last resort" and functions both in the voluntary market and residual market. Since its first year of operation, California's State Fund has been the largest writer of workers' compensation coverage in the state.

The Workers' Compensation Rate Study Commission subcontract resource, AIS Risk Consultants, was requested to analyze the condition of exclusive state funds and compare those findings to that of competitive state funds. AIS Risk Consultants examined three (3) main areas of state funds operations including: financial condition, efficiency, and overall rate structure.

Based on AIS Risk Consultant's analysis and findings, the following general patterns emerged:

A. Exclusive state funds, based upon traditional measures of insolvency, appear to be in worse financial condition than competitive state funds.

B. Based upon three measures of efficiency, exclusive state funds appear to operate more efficiently than competitive state funds.

C. The overall rating structure for exclusive state funds appears to be somewhat less flexible than for competitive state funds.

D. During the last several years, rate changes for exclusive state funds have been in the range of 10% per year. This is not significantly different than the country-wide rate changes for workers' compensation.

E. Virtually all of the state funds, both exclusive and competitive, provide a range of services to their policyholders. These services cover claims management, loss control, cost containment, rehabilitation and safety.

7.2 STATE FUND TYPES AND GEOGRAPHIC LOCATION

Exhibit 7.1, "State Fund Types and Geographic Location" is located on the following page. The Exhibit lists the states by the various type of fund.

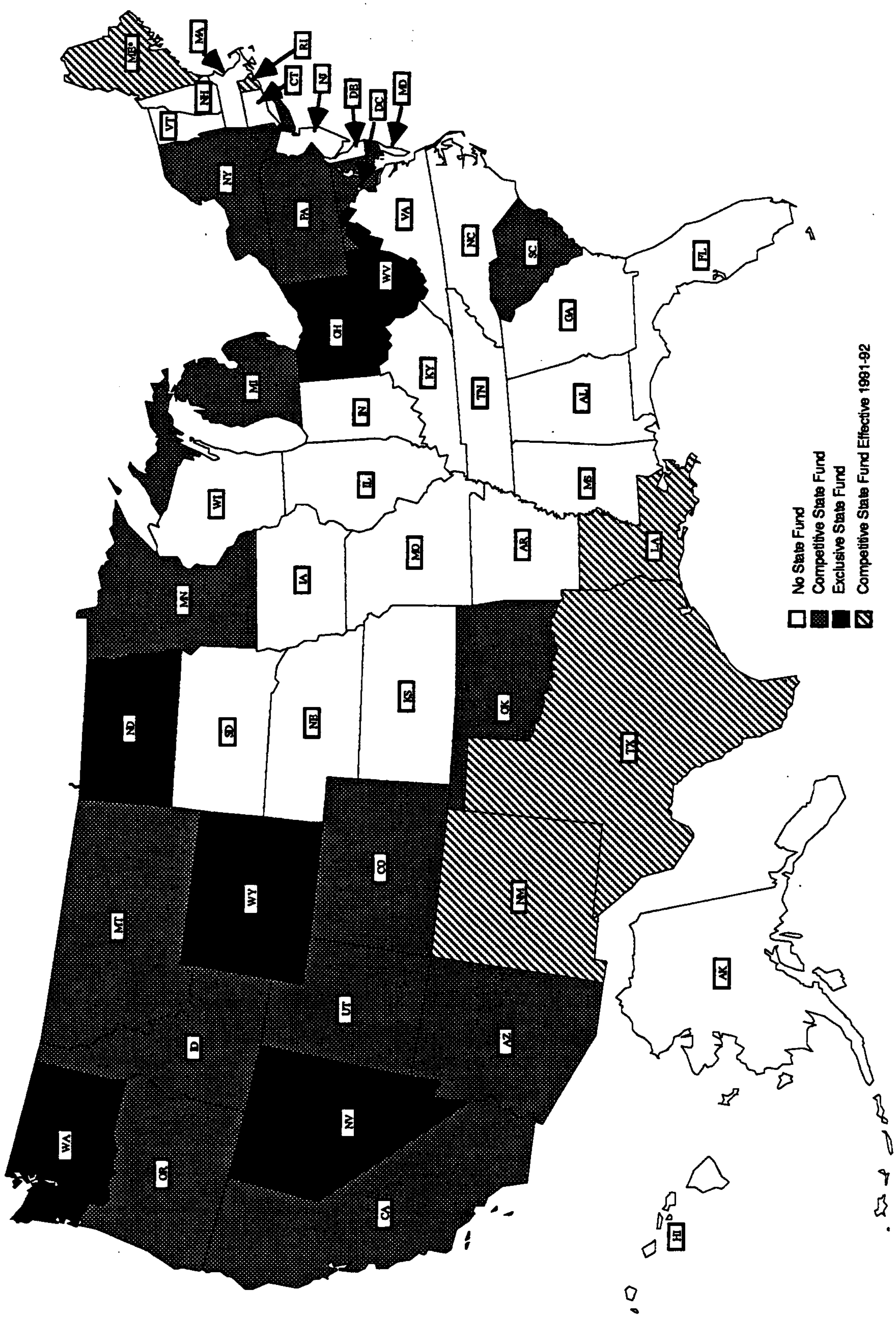
A. No State Fund - 25 states

B. Competitive State Fund - 13 states

C. Exclusive State Fund - 6 states

D. Competitive State Fund effective 1991-1992 - 3 states

EXHIBIT 7.1
STATE FUND TYPES AND GEOGRAPHIC LOCATION



7.3 ANALYSIS OF WITNESS TESTIMONY

At the various public Commission meetings, testimony was received from interested witnesses concerning the State Compensation Insurance Fund in California. All of the witnesses would be considered as workers' compensation stakeholders.

The witness testimony ranged from strongly supporting an exclusive state fund to maintaining the present system with the State Fund acting as a competitive state fund. The material that was provided by the witnesses providing the testimony was analyzed by the Commission.

7.4 CONCLUSIONS

Research does not appear to support the contention that the creation of an exclusive state fund in California would reduce overall costs for employers. There is the possibility that benefit levels for employees might increase, and that the quality of benefit delivery to employees would be improved. A principal concern strongly forwarded by insurers, and equally rebutted by proponents of state funds, is that exclusive state funds are in poor financial condition, and in particular, in worse financial condition than competitive state funds. Research appears to indicate that four of the six exclusive state funds are financially insolvent, and a fifth has recently suffered large operating losses.

On the other hand, the competitive state funds appear to have experienced financial conditions that are mixed, from poor to sound. While competitive state funds are subject to the same market cycles experienced by private carriers, with greater obligations in providing an assured market, the California State Compensation Insurance Fund appears to have offset its higher losses with lower expenses, apparently resulting from operating efficiencies, savings on commission expenses, and investment performance.

The implementation of an exclusive (monopolistic) state fund in California is, therefore, considered inappropriate. It is suggested that the State Compensation Insurance Fund in California should continue to operate as a competitive state fund. In addition, an assigned risk pool should be considered to accommodate the businesses, especially the small businesses, in obtaining affordable workers' compensation insurance coverage under open competition.

C107T06F.RHS/LAL

SECTION 8.0

WORKERS' COMPENSATION AGGREGATE EXCESS INSURANCE

SECTION 8.0

WORKERS' COMPENSATION AGGREGATE EXCESS INSURANCE

8.1 ISSUE BACKGROUND

On September 24, 1991, SB 2650 was approved by the Governor. This bill amended Section 11746 of the Insurance Code as it related to the responsibilities of the Workers' Compensation Rate Study Commission. In addition to evaluating the ratemaking process, in its entirety, the Commission was directed to analyze:

> "...whether public self-insured employers should be permitted to purchase aggregate excess insurance from insurers admitted to transact workers' compensation insurance in California and whether Section 703.5 should be modified or repealed."

To this end, the Commission heard testimony during its monthly public meetings from a variety of public and private sector employers, insurance carriers and other interested parties.

8.1.1 INSURANCE CODE

The following Exhibit 8.1, Insurance Code Section 703.5, provides an excerpt of the Code for review. Specifically, item (a) has been emphasized as to the relationship of purchasing workers' compensation aggregate excess insurance in the State of California code pertaining to such activities.

EXHIBIT 8.1
INSURANCE CODE SECTION 703.5

Insurance Code section 703.5 provides:

> "Any person, including but not limited to persons licensed or certificated under this code or exempted from regulation under this code, who as a part of any business advertises as, or holds himself out as, qualified to advise the public concerning insurance or qualified to administer workmen's compensation for employers and who in connection with or as part of any such business also, with or without consideration, (a) <u>suggests or recommends to an employer, or advises an employer, that the employer purchase aggregate excess or aggregate stop-loss workmen's compensation insurance, or (b) names or suggests to an employer, or advises an employer of, a nonadmitted insurer from whom such aggregate excess</u>

or aggregate stop-loss workmen's compensation insurance might be purchased, is guilty of a misdemeanor." (emphasis added)

8.1.2 SWEEPING CODE PROHIBITION

This code section makes it a crime to discuss the purchase of aggregate excess insurance or aggregate stop-loss coverage by risk management professionals, third party administrators or other insurance professionals. Such a sweeping prohibition may violate the rights and privileges granted under the First Amendment of both the United States and the California Constitutions. Placing the constitutional argument aside, there does not appear to be good rationale for the existence of this code section from a public policy standpoint. When this statute was passed, the climate of the times was different: the coverage provided by workers' compensation insurance was different and self-insurance was not as predominant as it is today (one-third of the workers' compensation marketplace). The guarantee funds were not in existence for self-insurance, and regulations were not as defined as they are now.

Furthermore, this workers' compensation insurance code provision is unique in the United States. California and Ohio are the only states with such a restrictive provision concerning the purchase of additional insurance protection by the employer. It is inconceivable to prohibit insurance brokerage firms, agents and direct writers from advising clients of sound risk and insurance management practices when this is a method of doing business in all other states (except Ohio). With this exception, the existence of insurance codes which preclude an insurance consumer from adequate excess coverage beyond the risk bearing capacity is virtually non-existent in the United States.

8.2 COVERAGE DEFINITION

Currently, in California, it is possible to purchase workers' compensation excess coverage at a specific amount. Aggregate excess coverage would also serve a beneficial role in implementing an effective risk management program. However, in California the coverage is not allowed. The following is a summary of the definitions concerning specific excess coverage and aggregate excess coverage:

8.2.1 SPECIFIC EXCESS COVERAGE

With specific excess coverage, the self-insurer assumes a predetermined amount of the loss (retention) arising out of any one (single) occurrence and the excess insurer indemnifies the self-insurer for any losses in excess of the retention level up to the limit of the specific excess insurance policy.

A typical arrangement is to have a $1 million to $5 million limit per occurrence in excess of a self-insured retention of $250,000. As the first million dollars of specific excess insurance will cover most exposures, increasing the limit to $2 million or to $5 million to protect against a catastrophic loss or occupational disease problem is generally a practical consideration. Obviously, the increase in cost will reflect the amount of the self-insured retention level, type of business, prior loss experience as well as other pertinent underwriting considerations.

8.2.2 AGGREGATE EXCESS COVERAGE

Aggregate excess insurance protects against catastrophic loss experience by providing a cap on loss possibilities for the entire policy term and aggregate insurance policy limit. Aggregate limit of liability is a provision in an insurance contract limiting the maximum liability of an insurer for a series of losses in a given time period, i.e. a one year policy period for the insurance contract. This maximum limit of liability is payable by an insurance carrier to the policyholder during any given policy period.

Aggregate excess coverage is generally written to cover losses which exceed the self-insured retention level thus penetrating the threshold of aggregate excess insurance coverage. The premium rating or development normally is a percentage of the manual premium. The manual premium is what the insurance company would charge before discounts, dividends or participation. This may be calculated differently from one insurer to another. It may or may not reflect experience rating charges or credits.

The aggregate coverage can be written by the insurer providing specific excess coverage. Often, this is done through the use of a single policy. The retention and limits of the specific coverage will be reflected in the underwriting and rating of the aggregate excess insurance.

8.2.3 WORKERS' COMPENSATION LACKS LIMIT OF LIABILITY

The standard workers' compensation policy does not contain any specific limit of liability with respect to the workers' compensation obligations of an employer, although specific limits are applicable to the employers liability section of the coverage. Without the benefit of aggregate excess insurance coverage the employer is exposed to loss potentials far greater than what can be construed normal risk bearing magnitude capabilities. In case of a catastrophic accident, (i.e., earthquake), series of losses or occupational disease problem, it is possible to exhaust all of the excess coverage and pay losses far higher than ever contemplated.

8.3 ANALYSIS OF WITNESS TESTIMONY

During the course of the Commission meetings, testimony was received from interested witnesses concerning the need for aggregate excess insurance.

No testimony was given by insurance carriers, their representatives or other related organizations. No rationale was offered in support of this particular code section.

During the testimony, several witness hypothesized as to the rationale that went into this legislation. This included:

A. If such coverage were available, there would be a mass exodus from the insurance marketplace into self-insurance

B. Employers would be less likely to be concerned about safety because this coverage was in place

C. Such coverage would undermine the structure of the current rate structure

Each of these issues will be analyzed based on testimony received and evidence presented to the Commission.

8.3.1 MOVEMENT FROM INSURANCE TO SELF-INSURANCE

Many other states require self-insured entities to purchase aggregate excess insurance. It is viewed as a prudent risk management device to cap losses and secure the payment of benefits. Lack of coverage availability has not restricted those companies that wanted to make the move from insurance to self-insurance.

Secondly, there has not been a mass exodus into self-insurance. Those companies that consider self-insurance do so mainly from a cash flow point of view -- they are large enough that it makes economic "sense" to pay their own losses and obtain the benefit of the cash flow.

8.3.2 SAFETY

There was no evidence submitted to support the argument that a self-insured employer would be less likely to be concerned about safety if it purchased aggregate excess insurance.

The recently adopted Senate Bill 198 requires employers to formulate and implement as well as maintain an active injury prevention program. This new legislation provides for an effective employer safety program with definite organizational guidelines as well as legal remedy and penalties for non-compliance.

8.3.3 SUCH COVERAGE WOULD UNDERMINE THE CURRENT RATE STRUCTURE

This "fear" has not been supported by any evidence and this has not been the situation in all the other states which permit aggregate excess insurance. A considerable amount of testimony was received from insurance carriers and their representatives, and none of their presentations included any comments, concerns, fears or predictions about the effect within California if Insurance Code section 703.5 were repealed.

8.4 RISK MANAGEMENT CONSIDERATIONS

It is an accepted professional practice to provide a method of capping losses over normally anticipated probable maximum loss as a result of pure risk exposures. In the case of comprehensive general liability insurance, purchase of excess coverage in the form of an umbrella program is an on-going practice. The practice is to provide an excess umbrella program over the primary insurance and the scope of coverage is normally a "following form" (nearly identical) coverage arrangement.

In the area of property insurance, it is possible, in a multiple property location schedule, to employ blanket insurance protection which provides excess benefits to the insured. This is a standard method of providing maximum insurance limits greater than any single scheduled location, yet still interfacing with the scheduled property values payable to any one loss occurrence.

Providing a cap of insurance coverage over workers' compensation is a normal practice in virtually every state with the exception of California and Ohio. In these two states, it is not legal to purchase admitted workers' compensation aggregate excess insurance.

In California, which is subject to moderate to severe seismic activity, it would seem prudent for the employer to have the option to secure financial protection in the form of workers' compensation aggregate excess insurance, particularly in the case where they have a concentration of self-insured employees in one area subject to one catastrophic loss exposure. In addition, the employer has other major areas of exposure concerning a need for aggregate excess insurance. These areas include, but are not limited to, the perils of occupational disease or an unusual series of severe losses.

8.5 REQUIREMENT OF AGGREGATE EXCESS INSURANCE

A number of states require workers' compensation aggregate excess coverage for self-insurers. States reportedly requiring excess aggregate coverage include, but are not necessarily limited to:

Iowa
Louisiana
Massachusetts
Maine
Montana
Rhode Island

In addition, requirements for aggregate excess insurance for certain categories and sizes of workers' compensation self-insurers exist in the following states:

Arkansas
Hawaii
Indiana

In California, it would seem prudent not only to permit the purchase of workers' compensation aggregate excess insurance, but to require it in certain high financial risk categories of self-insurers for the protection of the employee as well as the investor. It would be judicious to complete a feasibility study to consider requiring workers' compensation aggregate excess for certain categories and designated sizes of self-insurers.

Other than California, Ohio remains the only other state to prohibit purchase of workers' compensation aggregate excess insurance.

8.6 AGGREGATE EXCESS MARKETS

Currently, the insurance code stipulates that workers' compensation aggregate excess may only be purchased from insurance carriers which are non-admitted in the California insurance marketplace. In addition, the subject non-admitted coverage may be purchased from a direct writer or through a non-California insurance brokerage firm.

This restriction of only allowing non-admitted insurance has made it necessary for both public and private sector entities to rely on companies normally not permitted to do business in California. Furthermore, this restriction complicates the issue of solvency by the fact that in the event of a catastrophic loss the subject non-admitted company insurance company cannot rely on the California Insurance Guarantee Association (CIGA).

The admitted workers' compensation carriers already doing business in the State of California for the most part have a proven record of financial stability. The primary workers' compensation insurance business in California is written by forty-two insurance companies including the State Fund representing a market share of approximately 85%. The current legislation precludes these proven carriers from participating in the warranted market activities of providing the aggregate insurance.

The traditional excess and re-insurance markets should be available to insure workers' compensation to aggregate excess insurance in California. This would be the traditional way of handling excess insurance.

It is assumed that the aggregate excess coverage for workers' compensation could be written similar to the umbrella, on a layered basis, for general liability insurance. This would provide for a large market of admitted workers' compensation carriers in California to participate as well as providing protection from the California Insurance Guarantee Association for the employee.

8.7 CONCLUSION

When this statute was passed, the climate of the times was different: the coverage provided by workers' compensation insurance was different and self-insurance was not as predominant as it is today (one-third of the workers' compensation marketplace.) The guarantee funds were not in existence for self-insurance nor were regulations as defined as they are now.

It would seem that if there was a reason for this legislation at one time, it is no longer a valid one. Quite the contrary, this legislation prohibits discussion and purchase of a prudent piece of insurance in today's marketplace. Brokers cannot advise employers and employers cannot seek this market for fear of committing a misdemeanor. Such a restriction seems outmoded and impractical.

APPENDICES

A. COMMISSION REPORT CONTENTS OVERVIEW

VOLUME II - Continued

VOLUME III
COMMISSION STAFF REPORT
SOPER & ASSOCIATES

TABLE OF CONTENTS

VOLUME IV
SUB-CONTRACT RESOURCE REPORT
MILLIMAN & ROBERTSON, INC.

TABLE OF CONTENTS

VOLUME V
SUB-CONTRACT RESOURCE REPORT
AIS RISK CONSULTANTS, INC.

TABLE OF CONTENTS

VOLUME V - Continued

COMMISSION REPORT ORGANIZATION

The Workers' Compensation Rate Study Commission Report is organized as follows:

	Pages	Sections	Exhibits
Volume I Executive Summary	152	11	23
Volume II Commission Staff Report Soper & Associates	426	15	197
Volume III Commission Staff Report Soper & Associates	426	4	17
Volume IV Sub-Contract Resource Report Milliman & Robertson, Inc.	256	7	71
Volume V Sub-Contract Resource Report AIS Risk Consultants, Inc.	524	10	269
Total	1,784	47	577

C10AT09F.RHS

- NOTES -

STATE OF CALIFORNIA
WORKERS' COMPENSATION RATE STUDY COMMISSION

- NOTES -

STATE OF CALIFORNIA
WORKERS' COMPENSATION RATE STUDY COMMISSION

- NOTES -

STATE OF CALIFORNIA
WORKERS' COMPENSATION RATE STUDY COMMISSION

- NOTES -

STATE OF CALIFORNIA
WORKERS' COMPENSATION RATE STUDY COMMISSION

- NOTES -

PURCHASE OF COMMISSION REPORT

The California Open Meeting Laws concerning public documents sales and open meetings allow for recovery of printing, distribution and associated overhead expenses which are outside the project contract obligation. Consequently, additional copies of the report may be purchased.

The purchase price simply includes printing, associated overhead expenses, packing and distribution expense as well as State of California sales tax. Note that no expenses associated with project administration, such as overhead or research are included in the price of reproduced Commission Reports which are for sale.

The Workers' Compensation Rate Study Commission Report is organized as follows:

	Pages	Sections	Exhibits
Volume I Executive Summary	152	11	23
Volume II Commission Staff Report Soper & Associates	426	15	197
Volume III Commission Staff Report Soper & Associates	426	4	17
Volume IV Sub-Contract Resource Report Milliman & Robertson, Inc.	256	7	71
Volume V Sub-Contract Resource Report AIS Risk Consultants, Inc.	524	10	269
Total	1,784	47	577

Requests may be made for copies of the Commission Report from:

Request by Mail directed to:

Richard H. Soper, CMC, Executive Director
Workers' Compensation Rate Study Commission
Soper & Associates
P. O. Box 3727
Palos Verdes Peninsula, CA 90274

Telephone: (310) 544-4049

Request by FAX directed to:

Richard H. Soper, CMC, Executive Director
Workers' Compensation Rate Study Commission
Soper & Associates
FAX Number: (310) 544-0498

The purchase price of one set of the Commission Report shipped (five volumes, approximately 1,784 pages, 47 sections and 577 exhibits) is $146.00 which includes packing and distribution cost and sales tax. All checks should be made payable to "Soper & Associates". The purchase of the Commission Report set is subject to prepayment prior to shipping.

IMPORTANT: Please note that the Commission Report price is subject to change without notice due to possible fluctuations in reproduction and distribution cost factors.

APPENDIX A

COMMISSION REPORT CONTENTS OVERVIEW

The Workers' Compensation Rate Study Commission Report is formulated in three major divisions which are organized into five volumes as follows:

Commissioner's Report
Volume I
Executive summary, recommendations, findings and conclusions.

Commission Staff Report
Volumes II and III
Commission staff report encompassing supportive information, comparative data, research and public meeting minutes (Appendix).

Sub-Contract Resource Reports
Volume IV
Reports of the retained sub-contract consultants; Milliman & Robertson, Inc.
New York, New York
Volume V
Reports of the retained sub-contract consultants; AIS Risk Consultants, Inc.
Freehold, New Jersey

The following Exhibit AI-1, "Commission Report Contents Overview", has been prepared as a topical outline overview of the Commission Report and is organized by report volume and indicated primary sections:

EXHIBIT AI-1
COMMISSION REPORT CONTENTS OVERVIEW

VOLUME I
EXECUTIVE SUMMARY REPORT
DENNIS J. AIGNER, Ph.D., CHAIRMAN

TABLE OF CONTENTS

VOLUME I - Continued

VOLUME II
COMMISSION STAFF REPORT
SOPER & ASSOCIATES

TABLE OF CONTENTS