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# California Commission on Health and Safety and Workers' Compensation

# Background Paper

## State of the Workers' Compensation Insurance Industry in California

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### Background

In California, approximately two-thirds of total payroll in the state has been covered for workers' compensation through insurance policies, while the remainder is through self-insurance. There are more than 100 private for-profit insurers and one public nonprofit insurer – the State Compensation Insurance Fund (SCIF).

These insurers are overseen by the California Department of Insurance (CDI), whose mission is to

- Protect consumers and the financial security of injured worker benefits
- Foster a vibrant, stable, marketplace
- Maintain an open, equitable regulatory process, and
- Fairly and impartially enforce the law.

To accomplish its principal objective of protecting insurance policy holders in the state, the Department examines insurance companies to ensure that operations are consistent with the requirements of the Insurance Code.

CDI plays a significant role to conserve, rehabilitate or liquidate licensed California financially distressed and insolvent insurance companies under appointment by the courts in order to provide for a stable and consistent insurance market. The agency's 2001 Strategic Plan specifies that one of its particular goal is to "Minimize financial insolvencies of insurers".

*Minimum Rate Law*

Until a few years ago, California's workers' compensation insurance rates were regulated by the Insurance Commissioner under the minimum rate law passed in 1915. Under this law, an insurer could not issue, renew or continue workers' compensation insurance at premium rates that were less than the rates approved by the Insurance Commissioner. The Commissioner, through its statistical agent, the Workers' Compensation Insurance Rating Bureau (WCIRB), gathered and analyzed premium and losses data, classified businesses, did actuarial projections, and determined final, fully developed, premium rates that included all the costs of benefits and administrative overhead. The final premium could be lower depending on the dividends paid by insurers at the end of the policy period.

In 1993, the workers' compensation reform legislation repealed California's 80-year-old minimum rate law and replaced it beginning in 1995 with an open-competition system of rate regulation in which insurers set their own rates based on "pure premium advisory rates" developed by the WCIRB. These rates, approved by the Insurance Commissioner and subject to annual adjustment, are based on historical loss data for more than 500 job categories.

Under this 'open rating' system, these recommended, non-mandatory pure premium rates are intended to cover the average costs of benefits and loss adjustment expenses for all employers in an occupational class, and thus provide insurers with benchmarks for pricing their policies. Insurers typically file rates that are intended to cover other costs and expenses, including unallocated loss adjustment expenses.

## Insurance Market Before Reform

California workers' compensation direct written premium peaked at nearly $9 billion in 1993, the same year the legislature enacted a major overhaul of the system. Adoption of open rating, which took effect in January 1995, was a key provision of that reform. However, beginning in mid-1993, prior to the conversion to open rating, the legislature and the Insurance Commissioner approved a series of rate decreases. The first, mandated by the Legislature, called for a reduction of 7% in workers' compensation rates. Then, with the state experiencing a major economic recession and workers' compensation claim frequency and claim costs declining for the first time in years, the Insurance Commissioner followed the legislated rate reduction with a 12.7% reduction in January 1994 and a 16% reduction in October 1994, just before the minimum rate law was eliminated and open rating took effect. As a result, by 1994, statewide premium was down to $7.7 billion, and by 1995 – the year open rating took effect – written premium was already down to $5.7 billion – a decline of over 35 percent in 2 years.

## Insurance Market after Reform

Subsequent to the repeal of the minimum rate law effective January 1995, changes were noted in the actions of insurers and employers.

*Price Competition*

While declining claim costs and the mandated premium rate reductions initiated the decline in the total California workers' compensation premium, open rating apparently spurred competition among insurers seeking to retain or add to their market share. Some insurers attempted to increase their market share by writing coverage at low prices that eventually proved to be below loss costs. This deregulated market kept premium rates near their historic lows throughout the latter half of the 1990s, even though losses were no longer declining.

In addition, the commercial market was able to solicit and quote public agencies for the first time. Prior to open rating, a public agency could either insure with State Fund, or self insure. Since so few public agencies were insured previously, the WCIRB data on them was very scant and probably not representative, especially in urban areas. This caused some significant under pricing, which led public agencies especially schools to go back to full insurance.

Total premium volume did begin to edge up after 1995, as California's booming economy added many new jobs, driving up covered payroll. By 1997, however, industry wide losses exceeded premiums, and the situation for many insurers was deteriorating. As the link between the price of insurance and loss costs became more and more tenuous, some insurers left the state, others ceased writing workers' compensation or were merged or acquired by other carriers, and still others, including several of the largest insurers in the state, became insolvent and had to be taken over or supervised by the state. As a result, the workers' compensation market became much more concentrated than in the past, with only a few insurers - aside from State Fund, mostly large, national carriers - accounting for the lion's share of statewide premium.

*Changing Insurers*

WCIRB identified some trends in employers changing insurers pre and post open rating. WCIRB estimates that before open rating, about 25% of California employers with experience-modifications (x-mods) changed insurance carriers each year. Post open rating, about 35% of the employers did so, and the first quarter of 2001 shows that half of the employers changed carriers. It should be noted, however, that in many post open rating cases employers had no choice but to change insurers as the market had deteriorated to the point that many carriers – including several of the largest workers' compensation insurers in the state -- ceased to exist or stopped writing workers' compensation in California.

*Reinsurance*

After open rating, many carriers shifted the risk of their workers' compensation claims to other insurance companies, some of whom were inexperienced with the California workers' compensation insurance market. According to Professor Aigner of the University of California at Santa Barbara, and the Workers' Compensation Executive many carriers used reinsurance aggressively in order to mitigate the risk of having to make large future payoffs. Backed by reinsurance treaties that lowered the reinsurance level to $50,000 or less from the more typical $500,000 to $1 million, some primary workers' compensation carriers offered extremely low rates that proved to be inadequate in the face of soaring losses. Some reinsurance companies also sold off their risk to other reinsurers in a process called "retrocession." During 1999, several major reinsurance pools experienced financial difficulty and ceased operations.

**Profitability of Insurance Companies**

Profitability of insurance companies as measured by the National Association of Insurance Commissioners decreased with deregulation. In the late 1980s, workers' compensation insurers in California had profit levels of nearly three times the national average. With open rating, California insurers have lower than average profit margins, and during the late 1990s had the lowest return in the nation. Several indicators including those discussed below pointed to a decrease in the profitability of the insurance industry.

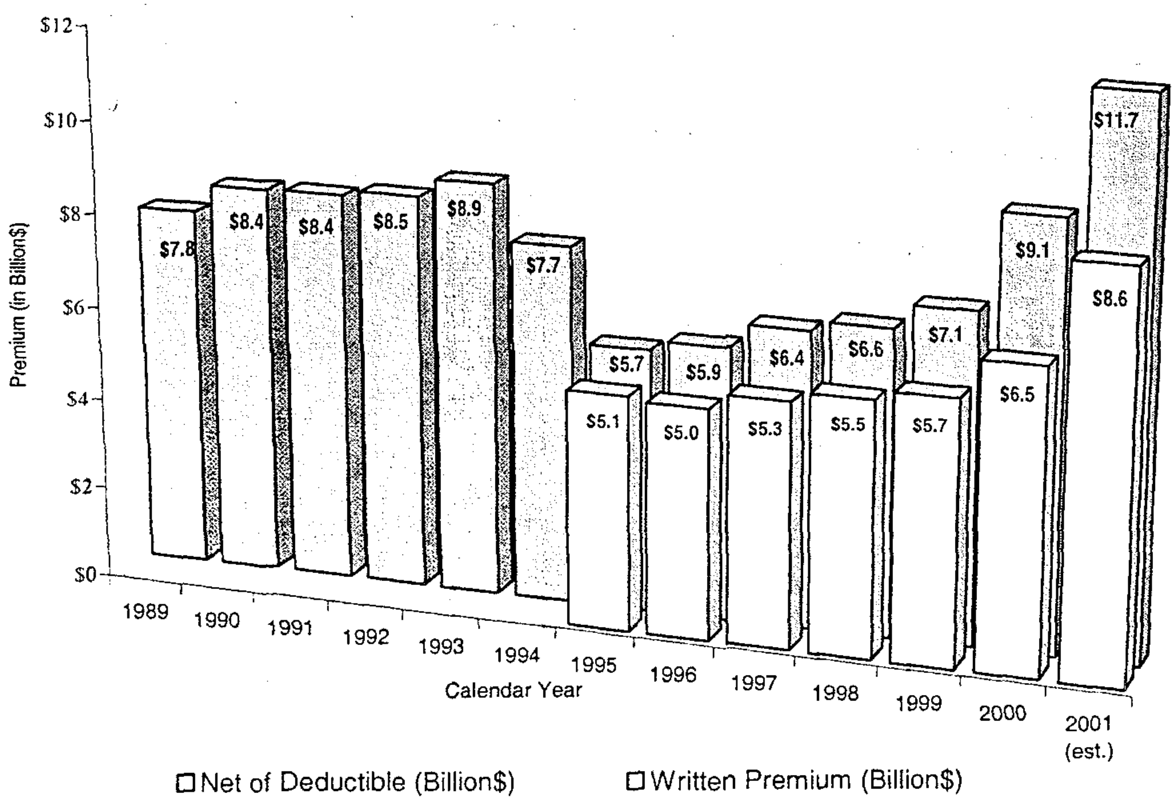
*Premiums*

Immediately after the reform and the elimination of the minimum rate law, in part from reasons discussed above, workers' compensation insurance premiums continued to decline. The total written premium declined from a high of $8.9 billion in 1993 to a low of $5.7 billion ($5.1 billion net of deductible) in 1995. The written premium grew slightly from 1996 to 1999 due to growth of insured payroll, an increase in economic growth, movement from self-insurance to insurance and other factors, rather than increased rates. But even with well over a million new workers covered by the system, the total premium paid by employers remained below the level seen at the beginning of the decade.

At the end of 1999, the insurance commissioner approved an 18.5% pure premium rate increase for 2000 and the market began to harden after 5 years of open rating, though rates remained less than two-thirds of the 1993 level. Since then, the market has continued to firm, with the Insurance Commissioner approving a 10.1% increase in the advisory rates for 2001, and a 10.2% increase for 2002. Rates continue to move up, and with the expansion of covered payroll, the WCIRB estimates total written premium will end up at or near its all-time high in 2001.

A chart showing the California workers' compensation written premium and a history of the workers' compensation pure premium advisory rates since the 1993 reforms follows. Please note that these amounts are exclusive of dividends.

**California Workers' Compensation Written Premium**
**(in Billion$, as of September 30, 2001)**




Source: Workers' Compensation Insurance Rating Bureau of California

## Advisory Workers' Compensation Pure Premium Rates
### A History since the 1993 Reform Legislation

**1993**

*Insurance Commissioner approved:*
Pure premium rates reduction of 7% effective July 16, 1993 due to a statutory mandate.

**1994**

*WCIRB recommendation:* No change in pure premium rates.
*Insurance Commissioner approved:*
Two pure premium rate decreases: a decrease of 12.7% effective January 1, 1994 and a second decrease of 16% effective October 1, 1994.

**1995**

*WCIRB recommendation:*
7.4% decrease from the pure premium rates that were in effect on January 1, 1994.
*Insurance Commissioner approved:*
A total 18% decrease to the pure premium rates in effect on 1/1/94 was approved effective January 1, 1995 (including the already approved 16% decrease effective October 1, 1994).

**1996**

*WCIRB recommendation*: 18.7% increase in pure premium rates.
Insurance Commissioner approved: An 11.3% increase effective January 1, 1996.

**1997**

*WCIRB recommendation*: 2.6% decrease in pure premium rates.
*Insurance Commissioner approved:* A 6.2% decrease effective January 1, 1997.

**1998**

*WCIRB recommendation*: The initial recommendation for a 1.4% decrease was later amended to a 0.5% increase.
*Insurance Commissioner approved:* A 2.5% decrease effective January 1, 1998.

**1999**

*WCIRB recommendation*: The WCIRB initial recommendation of a 3.6% pure premium rate increase for 1999 was later amended to a recommendation for a 5.8% increase.
*Insurance Commissioner approved:* No change in pure premium rates for 1999.

**2000**

*WCIRB recommendation*: An 18.4% increase in the pure premium rate for 2000.
*Insurance Commissioner approved:* An 18.4% increase effective January 1, 2000.

**2001**

*WCIRB recommendation*: The WCIRB initial recommendation of a 5.5% increase in the pure premium rate was later amended to a recommendation for a 10.1% increase.
*Insurance Commissioner approved:* A 10.1% increase effective January 1, 2001.

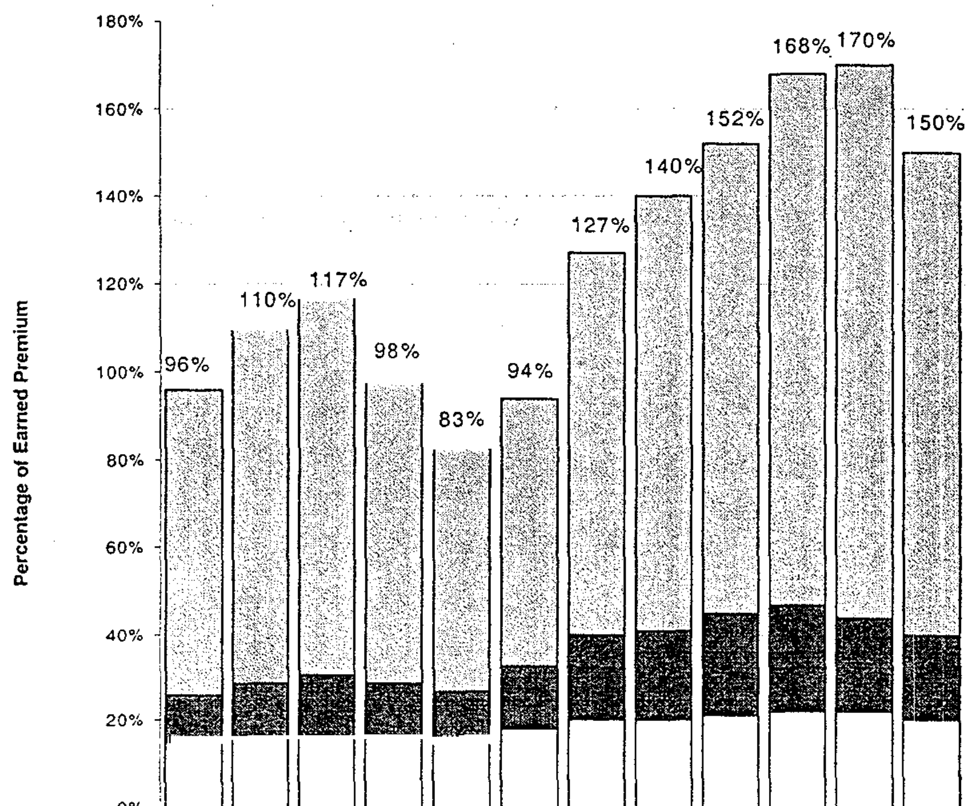
**2002**

*WCIRB recommendation*: The WCIRB initial recommendation of a 9% increase in the pure premium rate was later amended to a recommendation for a 10.2% increase. WCIRB filed a mid-term recommendation that pure premium rates be increased by 10.1% effective July 1, 2002 for new and renewal policies with anniversary rating dates on of after July 1, 2002.
*Insurance Commissioner approved:* A 10.2% increase effective January 1, 2002. A decision is pending on mid-term increase request.

### *Combined Loss and Expense Ratios*

The accident year combined loss and expense ratio, which measures workers' compensation claims payments and administrative expenses against earned premium has been increasing greatly since 1993. In accident year 2000, insurers' claim costs and expenses amounted to $1.50 for every dollar of premium they collected – and that was an improvement over the record high of $1.70 noted in 1999. In fact, the ratios seen in the past 4 years (as shown in the graph below) are the highest ever recorded by the industry since WCIRB began collecting data.

**Combined Loss and Expense Ratio**




| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Losses | 70% | 81% | 86% | 69% | 56% | 61% | 87% | 99% | 107% | 121% | 126% | 110% |
| Loss & Adjustment Expenses | 11% | 13% | 15% | 13% | 12% | 15% | 20% | 21% | 24% | 25% | 22% | 20% |
| Other Expenses | 15% | 16% | 16% | 16% | 15% | 18% | 20% | 20% | 21% | 22% | 22% | 20% |
| Combined Loss and Expense Ratio | 96% | 110% | 117% | 98% | 83% | 94% | 127% | 140% | 152% | 168% | 170% | 150% |

Source: Workers' Compensation Insurance Rating Bureau of California

### *Under-Reserving*

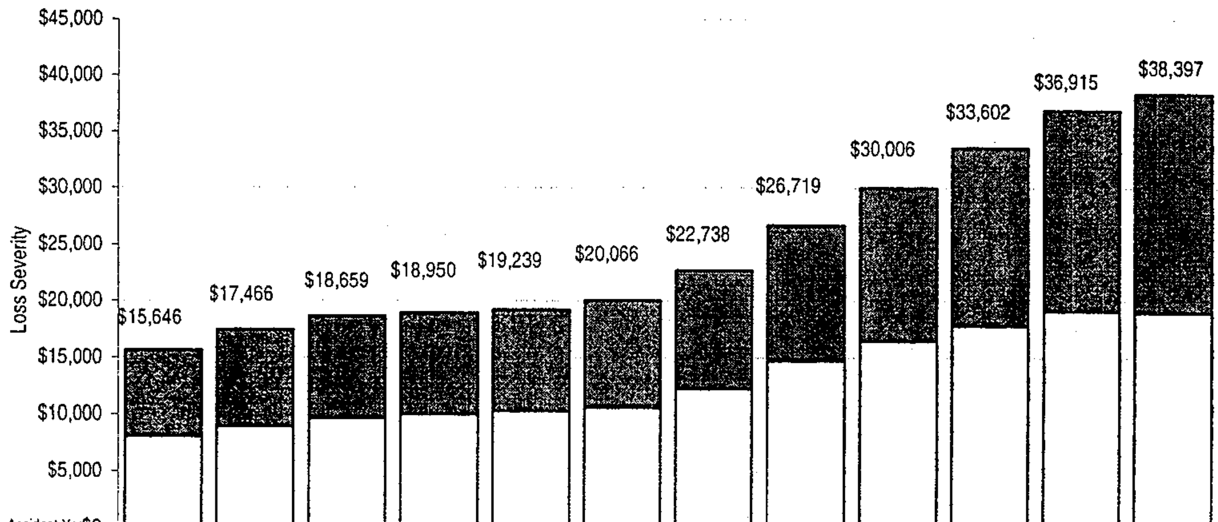
Furthermore, a serious under-reserving of claims was noted. As of December 31, 2000, the WCIRB estimated that the amount of statewide reported reserves were $7.1 billion below the estimated ultimate cost of incurred claims.

According to many, these unprecedented results are explained, at least in part, by inadequate pricing due to an extremely competitive insurance market. According to WCIRB, for most of the second-half of the 1990's insurers were, on average, pricing their policies well below the pure premium rate level. (Pure premium rates provide only for losses and loss adjustment expenses and include no provision for other insurer expenses.)

*Average Claim Costs*

At the same time that premiums and claim frequency were declining, the total amount insurers paid on indemnity claims jumped sharply due to increases in the average cost of an indemnity claim, which rose dramatically during the late 1990s. According to the WCIRB, both average indemnity and medical claim costs have shown increases over the last several years, as shown on the following graph.

**Estimated Ultimate Total Loss per Indemnity Claim by year of accident as of September 30, 2001**




| Accident Year | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Medical | $7,600 | $8,515 | $9,009 | $8,955 | $8,911 | $9,418 | $10,503 | $12,020 | $13,552 | $15,809 | $17,809 | $19,395 |
| Indemnity | $8,046 | $8,951 | $9,650 | $9,995 | $10,328 | $10,648 | $12,235 | $14,699 | $16,454 | $17,793 | $19,106 | $19,002 |
| Total Loss | $15,646 | $17,466 | $18,659 | $18,950 | $19,239 | $20,066 | $22,738 | $26,719 | $30,006 | $33,602 | $36,915 | $38,397 |

Source: Workers' Compensation Insurance Rating Bureau of California

The WCIRB predicts that the average cost of a 2000 indemnity claim will be $38,397, which is a up 4% since 1999 and 100% since 1993.

Please note that the WCIRB's estimates of average indemnity claim costs have not been indexed to take into account wage increase and medical inflation.