

**The California Commission
on Health and Safety
and Workers' Compensation**



Report on Self Insurance Groups

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Report on Self Insurance Groups

Introduction

This report is prepared in response to the October 6, 2008 request by Assembly Member Joe Coto, Chair of the Assembly Insurance Committee, as shown in Attachment A. Mr. Coto requested that the Commission on Health and Safety and Workers' Compensation analyze the statutory and regulatory oversight of workers' compensation self insurance groups and make recommendations to ensure the viability of these programs. This report finds that California already has substantial protections in place, but further improvements can strengthen the program. Statutory and regulatory changes are recommended.

Summary of Findings and Recommendations

Self insurance groups have the potential to serve the interests of California employers and employees by promptly providing workers' compensation benefits to injured workers at reasonable cost while enabling and encouraging employers to improve safety and provide the earliest appropriate return to work for injured employees.

Self insurance groups also have the potential to drive up costs and disrupt the delivery of benefits when poorly managed. At the least, the members or former members of an underfunded group may be exposed to unexpected costs to make up for the shortage. At worst, responsibility for payment of a failed group's obligations may be shifted to employers who were not connected with the failed group, and benefits to injured workers may be interrupted and delayed during the collapse of the group.

The purpose of this report is to review what legislation or oversight might be needed to preserve group self insurance as an option for eligible employers and to assure that the risks are held to a reasonable minimum. California already has regulations designed to protect against the most obvious risks of financial failure and default by self insurance groups. This report recommends additional steps for improved solvency, security and oversight.

Findings:

- Since the time private group self insurance was first authorized in California, this state had protections against fiscal mismanagement superior to most states:
 - Program administrators have never been permitted to act as claims administrators.
 - Funding for loss reserves has always been required at a higher confidence level than required elsewhere.

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- California has, as of March 2, 2009, adopted regulations which will enhance regulatory oversight and protection against the problems that have occurred in other states:
 - The new regulations prohibit certain additional conflicts of interest among service providers and require disclosure of certain other conflicts.
 - Requirements for funding loss reserves are applicable separately to each and every program year.
 - Requirements for funding loss reserves include unallocated loss adjustment expense.
- The regulatory system is not as strong as it could be to manage the risk of defaults:
 - The regulatory office does not have sufficient expert resources to examine the actuarial and fiscal integrity of self insurance groups (SIGs).
 - The Self Insurers' Security Fund (SISF) does not have access to information needed to identify and mitigate the fund's exposure to risks of default by SIGs.
 - There are no minimum qualifications required for group administrators.
 - Disclosure of SIG financial condition to prospective members is not currently required.
- If the regulator and SISF have access to adequate information, if SISF has the ability to trigger enforcement or corrective action by the Director, and if prospective members are provided with appropriate information, then public disclosure of SIG financial information is not likely to further enhance the security of SIGs for participating employers, for the injured employees of participating employers, or for the security fund.
- Provisions of the Corporations Code prohibiting distributions by nonprofit corporations are arguably in conflict with the practice of SIGs that return surplus contributions to members in the form of dividends or refunds.

Legislative Recommendations:

- Authorize SISF, upon approval by the Director of the Department of Industrial Relations, to create separate accounts within the fund for SIGs and for individually self-insured employers and to allocate expenses and liabilities between the two accounts.
- Authorize SISF as well as the Director to conduct or obtain independent audits and examinations of any aspect of the books and operations of SIGs.
- Authorize the Director and SISF to share confidential information with each other.
- Provide that if SISF recommends corrective action or enforcement action, the burden of proof shall be on a SIG to demonstrate to the Director that its estimates of future liability are adequate and that it is in compliance with statutory and regulatory requirements.
- Confirm that member financial records are confidential and shall not be disclosed by the Director either publicly or to SISF.
- Provide that financial and actuarial information obtained by the Director or SISF is exempt from public disclosure, except that aggregate or statistical information that is not

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individually identifiable may be publicly disclosed and the compliance status of any SIG may be publicly disclosed.

- “Compliance status” is intended to include the rosters of active SIGs and member employers already published by OSIP, as well as the identity of SIGs which have and have not timely filed reports or complied with requirements such as funding loss reserve and timely filing reports or paying security deposits.
- Either amend the Corporations Code to permit SIGs to return surplus funds to members or expressly provide that surplus funds from any program year may only be used to reduce contributions required for a different program year.
- Establish a judicial procedure to consolidate all state court litigation arising from the insolvency of a SIG into one liquidation proceeding.

Regulatory Recommendations:

- Require that every member or prospective member and the agent or broker for every member or prospective member shall be provided a copy of the group’s most current financial report and other prescribed reports, provided that a SIG may first require that the member, prospective member, agent, or broker executes a nondisclosure agreement in a form approved by the Director.
- Adopt regulations as necessary to carry out the statutory provisions, including:
 - Criteria for the publication of status information on SIGs that are out of compliance with statutory or regulatory requirements;
 - Guidelines for statistical information that can be released without revealing confidential information about identifiable SIGs; and
 - Amendment of Regulation 15405, Confidentiality, to permit sharing confidential information with authorized representatives of SISF.
- Make group administrators accountable for performance:
 - The Director should establish qualifications and licensing for program administrators, as it has for third-party adjusting agents (TPAs). Consider increased prohibitions against conflict of interest. The new regulations prohibit certain conflicts such as the roles of program administrator and the certified public accountant (CPA). Weigh the arguments that may be made for or against prohibitions of other potential conflicts, such as actuary and program administrator.
- Audit additional aspects of performance beyond claims adjusting:
 - A complete independent audit should not be limited to the accuracy of the financial statement. It should include key points of regulatory compliance such as the identity and terms of all reinsurance, the identity and essential terms of all

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service provider contracts, and regular records of key actions by the Board of Trustees as well as the composition and structure of the Board.

- Evaluate potential changes to the audit process:
 - Consider randomly selecting claims for audit to reflect a cross-section of the case inventory and then extrapolating the results of the audit to the entire case inventory for purposes of requiring increased deposits and revised actuarial projections.
 - Evaluate which aspects of SIG operations can best be reviewed by claims auditors and which by the independent CPAs who prepare the certified, independently audited financial statement.
 - Adopt requirements for the format of independent audits to include the selected items, which may include but need not be limited to reinsurance, contracts with service providers, freedom from prohibited conflicts of interest, reliable processes to assure required disclosures of group financial information to members and prospective members, management of funds in accordance with regulations, and collection of contributions due from members.
- The Director should disapprove reinsurance coverage that results in an unreasonable concentration of risk in a small number of reinsurers that would endanger the entire SIG program in the event of collapse of one reinsurer.
- Require each SIG to file its rate plan and adhere to its rate plan. Clarify whether experience modification or any other reduction from a uniform rate for each classification in a SIG is permitted.
- Enhance the independence and fiduciary responsibility of trustees:
 - Require that trustees receive approved training or otherwise demonstrate understanding of the fiduciary duties of trustees and the operations of workers' compensation group self insurance.
 - Review Board minutes for adherence to procedures.
 - Ensure that Board members are involved in communications between the Director or the OSIP Manager and the group administrators.
- Unhesitatingly enforce regulations, even if enforcement requires shutting down a group:
 - New York waited too long to act in some cases, until the requisite remediation was too onerous for some groups to remain viable.
 - A small number of California SIGs have reported deficits. These should be corrected forthwith. Corrective action should take into consideration any pattern which may occur, such as chronic deficits in a single group or multiple groups administered by a particular administrator.
 - Existing regulations do not clearly specify the time in which a group must correct any deficiencies before the group may be ordered to take specific actions.

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- Prohibit false or misleading statements in marketing materials. Require specified disclosures in marketing materials. Adopt a procedure to enforce regulations of content of marketing materials.
- Establish contractual arrangements with persons or organizations that can be swiftly appointed by the Director to act as group administrators, TPAs, auditors, accountants, and actuaries in the event the need arises.
- Continue long-term discussions of whether requirements of capital and surplus should supplement or replace the requirement of reserving to the 80% confidence level as a means of cushioning against adverse loss development.

History of Private Group Self Insurance in California

Self insurance groups (SIGs) in the private sector are a comparatively new phenomenon in California. Private sector employers in California must secure the payment of their workers' compensation obligations either by obtaining workers' compensation insurance or by obtaining from the State a certificate of consent to self insure. Since the early years of the workers' compensation system, individual employers with sufficient financial capacity have been able to obtain the State's consent to self insure. Public entities have also been permitted to self insure, either individually or in groups called joint powers authorities (JPAs) for decades. Private group self insurance, however, was not authorized by statute until 1993, and the first private sector SIG in California was approved effective January 1, 2002.

By the end of 2007, SIGs reported over \$5.2 billion in covered payroll, nearly 6% of the total payroll covered by all private sector self insurance. There were 28 active SIGs in California as of February 2009, ranging from groups of three members up to a group of 743 members. One SIG reported over \$1.1 billion in covered payroll. In 2007, SIGs paid an aggregate of \$21,610,856 in indemnity benefits and \$28,786,674 in medical benefits.¹ This growth has taken place under a statutory framework that added only a few words to the statutes governing individually self insured employers and under regulations that were likewise based largely on the regulations that were designed for individually self insured employers.

Both the market for group self insurance and the regulatory oversight of group self insurance are now undergoing a first stage of maturation. Some SIGs are closing or undergoing changes as their business models prove to be poorly suited to the current economic climate. An extensive overhaul of the regulations was adopted effective March 2, 2009, after more than three years of work by the Department of Industrial Relations (DIR) and its Office of Self Insurance Plans (SIP, commonly called "OSIP"). At the same time, other states with longer histories have provided examples of what can go terribly wrong when SIGs are not adequately regulated and supervised.

In the context of these changes, and mindful of the widely publicized failure of several large self insurance trusts in state of New York, the Chair of the California Assembly Insurance Committee requested this analysis by the Commission on Health and Safety and Workers' Compensation (CHSWC).

¹ Sources: Office of Self Insurance Plans website and e-mail correspondence 1/8/2009.

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Methodology

This report is based on CHSWC staff interviews and discussions with stakeholders and experts, reviews of statutes and regulations and public documents and literature, and reviews of confidential records by CHSWC staff and by an independent consultant. Additional input was received at an April 16, 2009 meeting of SIG administrators as well as representatives of the Self Insurers' Security Fund and CHSWC staff. Public comments were received at CHSWC meetings and following the April 30, 2009 release of a draft version of this report.

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Lessons Learned from Others

New York State has a long history of group self insurance leading up to some well-publicized failures. A task force was appointed to recommend reforms for that state's group self-insured trusts. As of September 1, 2009, the New York task force did not have a timetable for when its report would be prepared.² The Director of Self Insurance for the State of New York Workers' Compensation Board, however, generously shared her informal impressions with CHSWC staff when work on this CHSWC report began in October 2008:

- Require actuarial opinions. Financial statements according to generally accepted accounting principles (GAAP) are not sufficient by themselves, and the loss projections can be poor. Actuaries acting on behalf of group administrators can produce misleading reports. Proposed New York regulations will require independent actuarial review every three years.
- Require year-specific accounting. It would have made wholesale change in reserves apparent sooner, and it would have made the suppression of loss reserves harder to hide.
- Restrict what is acceptable as an asset to cover the liabilities, particularly receivables. Also watch for unrealistic discount rates on future liabilities.
- Some groups were financially troubled for years and failed to take adequate corrective action. Groups only wanted to correct deficits by adjusting rates going forward. Deficits grew until the rates they would have had to charge would have been prohibitive. New rules may require that members for a given fiscal year will be billed immediately to fund a deficit in any fiscal year.
- Watch the reserve pick. Incremental adjustments to reserves are not alarming, but sudden large changes should not become necessary if the reserve pick is realistic.
- “Do not underestimate the importance of an active board of trustees.” Many problems were attributed to groups that were broker-driven. The regulators learned not to meet with a “group” unless at least some trustees were present. Watch for conflict of interest when the group administrator is being paid a percentage of annual contributions regardless of how well or poorly the group is funded. Conduct trustee training and annual meetings with the regulators to emphasize fiduciary responsibility. It would be good to have licensing for group administrators and have the ability to act against the administrator, not just against the group.
- Require filing a rate plan 90 days before it becomes effective. When New York began asking for the rate plans, some groups could not furnish a rationale for their rates.

² “WCC: Group Trusts Remain a Problem” reprint from workcompcentral.com, September 1, 2009.
<http://www.allbusiness.com/government/government-bodies-offices-regional-local/12841865-1.html>

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- Limit the return of surplus contributions. Previously, distributions were restricted only if they would cause insolvency. New rules in New York allow return of surplus beginning two years after end of fiscal year, and then only allow 25% of surplus to be returned per year.

At the close of our conversation in October 2008, the New York regulator observed that contrary to popular perceptions, the state had not experienced a total melt down. There were still approximately 60 groups, most of them healthy.

It appears that problems have continued to unfold following that conversation. A CHSWC staff count of the groups reported on the New York Workers' Compensation Board website in March 2009, observed that out of 65 groups, only 22 were operating with no fiscal issues and no restrictions. Another 13 groups have no fiscal issues but have voluntarily terminated and are in runoff. The other 30 groups all have some sort of fiscal issues:

- Seven are underfunded have been terminated, one of these with an assessment on the former members.
- Thirteen are underfunded and operating under restrictions.
- Ten are insolvent and their members are being assessed or sued for collection of the group's deficits.

Evidently, many New York groups were headed for trouble long before most California groups were created. It can take years for the consequences of inadequate oversight to unfold, and the damage can progress inexorably despite the insights of the current regulator. There is little comfort in the arguments of some California SIGs that there has never been a SIG failure in this state.

On the other hand, there is comfort in the fact that California regulations from their beginning have reflected many of the lessons learned in states with years of experience. California prohibits a group administrator from acting as the group's claims administrator, requires year-specific accounting, requires actuarial reports and audited financial reports, restricts the investment of funds, requires a security deposit of 135% of expected future liabilities, and requires each group to carry funding at a high confidence level. The most serious mistakes of other states have been already been avoided, and at this early stage in California's history of group self insurance, it is not too late to correct the smaller vulnerabilities that remain.

The first lesson learned by comparison to other states is that California has gotten group self insurance off to a good start.

Understanding the Nature of Group Self Insurance

Group self insurance has certain characteristics of insurance and other characteristics of stand-alone self insurance, as well as characteristics unique to group self insurance. Like insured employers, members of a self insurance group (SIG) pay in advance to cover their projected liabilities for workers' compensation benefits. Like self insured employers, members remain at risk. Unlike employers in either of the other models, members of a SIG are jointly and severally liable for the amounts required to pay the liabilities of all the members of the group, and they may be assessed to cover any shortfall in the group even if their own experience is loss-free. None of the three models are purely one type, since each model also involves some combination of deductibles, experience ratings, dividends, deposits, and reinsurance. Each model is ultimately backed by a guaranty fund, either the California Insurance Guaranty Association (CIGA) for insurers or the Self Insurers' Security Fund (SISF) for self insured employers and SIGs. The group self insurance model, however, is unique, and it creates its own challenges for legislative and regulatory oversight. Across the country, the methods for overseeing group self insurance are still being invented.

The reason the state takes on the challenge of overseeing a program for group self insurance is that this model has the potential to save money and reduce the adverse impacts of industrial injuries for both employers and injured workers. Furthermore, group self insurance may be able to serve public policy goals by providing appropriate incentives to participating employers. One of the persistent problems for policymakers has been the inability to deliver incentives to insured employers. For example, the permanent disability benefit adjustment known as "bump-up/bump-down" does not apply to small employers, in part because it would be the insurance company, not the employer, which would receive the direct savings when a disabled worker has been returned to the job. Return to work involves relationships and legal obligations apart from workers' compensation. Workers' compensation insurers are rightfully reluctant to become overly involved in those relationships. Smaller employers may be left with insufficient incentives and insufficient resources to carry out public policy goals. Effective return-to-work programs are more likely to be found in large self-insured employers, where the economic benefits directly reach the employer and human resources departments can carry out enlightened personnel policies. Group self insurance has the potential to deliver similar incentives and resources directly to smaller employers. While this paper will focus on the negative aspects and hazards of group self insurance, it bears mention that the viability of group self insurance is in the interests of California employers and workers.

Although group self insurance is not regarded as "insurance" for purposes of the Insurance Code and is not under the jurisdiction of the Department of Insurance, it is, in essence, insurance. Group self insurance is fundamentally different from stand-alone self insurance. Group self insurance has the defining characteristic of insurance, which is the transfer of risk of an occurrence from one entity to another in exchange for a payment in advance of the occurrence.

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Despite the name “self insurance,” individual or stand-alone self insurance is not insurance; it is self-funding. When there is no transfer of risk in exchange for payment of consideration, there is no insurance. A “self-insured” employer is one that is permitted to retain its own risk upon a showing that it has the financial capacity to make good on its potential liabilities. The workers’ compensation liabilities of a self-insured employer are paid by the employer out of its ongoing revenue or other available funds.

Group self insurance is different from individual self insurance because group members are not required to demonstrate their financial capacity individually or to pay their individual liabilities. The group as a whole must have the financial capacity to make good on the members’ liabilities. It is the solvency of the group, like the solvency of an insurance carrier, which secures the payment of compensation on behalf of the employers covered by the group.

The workers’ compensation liabilities of a member of a SIG are ordinarily paid by the SIG out of funds collected in advance from the members. In a SIG, there is a transfer of primary liability from the member to the SIG in exchange for the member’s payment of a fee. Whether that fee is called “premium” as in conventional insurance or “contribution” as in group self insurance, it is nevertheless consideration paid by the member in exchange for the SIG’s acceptance of the member’s risk of workers’ compensation liabilities.

Unlike conventional insurance, an employer in a SIG may be assessed for additional funds if the assets of the SIG are insufficient to fund the payment of all of the liabilities assumed by the SIG. Any member can be required to cover the unpaid assessments of the others. Surplus funds may be returned to the members. Despite the overlay of these other provisions – joint and several liability, the potential for assessments for deficits, the potential for return of excess funds, the ultimate recourse to joint and several liability for other members’ liabilities – the fundamental characteristic of group self insurance is an insurance transaction.

“The insurance industry sells a unique and important product that is vital to world commerce and individual security. That product is a promise to pay all or part of the costs associated with some future event. The promise is based upon the payment of premiums by a policyholder in advance of the event that triggers an insurer’s promise to pay.”

Failed Promises; Insurance Company Insolvencies, A Report by the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, U.S. House of Representatives, John D. Dingell, Chairman, Washington, D.C., 1990.

The Role of the Regulator

Because group self insurance has the essential characteristic of insurance, the state’s oversight of group self insurance must address the same problems as state’s oversight of conventional insurance. The states that permit group self insurance have chosen varied approaches to

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regulating the arrangement. In 16 states, group self insurance is under the jurisdiction of the insurance agency. In 5 of those states, stand-alone self insurance is also under insurance agency jurisdiction, while in 11 of them, stand-alone self insurance is separately regulated by the workers' compensation agency. California is among the 13 states that have both group self insurance and stand-alone self insurance regulated by the workers' compensation agency.³ There is no reason that either agency, given the necessary resources, could not appropriately regulate group self insurance. Group self insurance in California is regulated by the Director of the Department of Industrial Relations (DIR) through the Office of Self Insurance Plans (SIP, commonly called "OSIP"). The Commission on Health and Safety and Workers' Compensation (CHSWC) does not find a compelling reason to shift group self insurance to the jurisdiction of the Department of Insurance.

For DIR to successfully oversee group self insurance, however, the regulator of the program must approach it with the same concerns as an insurance regulator. Richard E. Stewart, former New York Insurance Superintendent (1967-1970) and former President of National Association of Insurance Commissioners (NAIC), described essential challenges to the insurance regulator as follows:

“[Insurance and banking] share a characteristic that makes them unstable. They take a customer's money first and, in return, give only a promise of money and services some time in the future.

Government's role is to help ensure that the promise of the insurer or banker is kept.

* * *

For purposes of solvency regulation, loss reserves are the crucial entry on a property-casualty insurer's book. They can extend over long periods of time — ten years or more — and can be highly imprecise. Yet loss reserves are what a regulator has to act on. The regulator cannot wait until the cash runs out, which will usually be years after the balance sheet should have shown insolvency. In the meantime, the failing insurance company [or self insurance group] will in desperation have done a lot of damage to itself and others.

Regulators do not like to shut down failed companies. The process is disagreeable and regulators see a company failure on their watch as a black mark. Their natural impulse is to put it off, which means delaying recognition of insolvency. The wide latitude for loss-reserve estimates, plus the long period of reserve uncertainty, makes delay even easier than it used to be. Such delay is an old problem, and it has withstood successive

³ Self-Insurance Regulators' Handbook, 2005, IAIABC, Madison, WI, Table 1-2, citing Self-Insurance Institute of America, August 2003 data. .

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refinements in detection technique, such as early-warning ratios, risk-based capital standards, and closer involvement of credit rating agencies.”⁴

Mr. Stewart’s observations are equally compelling when we insert self insurance group(s) in place of company(ies) in that passage. Examples from New York State show the consequence of allowing a SIG to continue sinking into deficit rather than face the need to levy assessments on members.

A test for California regulators may arise within the next year as groups must come into compliance with new regulations at the same time they deal with a shrinking economy. The reason that compliance with the new regulations may be a challenge is that, through 2007, most groups did not reserve for future unallocated loss adjustment expense (ULAE), and some groups did not believe the 80% confidence level was required for any but the current program year. The new regulations clearly require both funding for ULAE and funding every program year at the 80% confidence level. These regulations are necessary to assure with a high degree of confidence that funding is adequate for all incurred claims and that, in addition to money to pay the claims, there will be money to pay the adjusters to handle those claims. Some groups are already in runoff, paying accrued claims but not currently self-insuring, and their financial status is being examined by OSIP. Thanks in part to the high confidence level already required, most groups can probably adapt and meet the new standards.⁵

California regulators should heed Mr. Stewart’s advice, however, and be prepared to shut down any SIG that is unable to come into compliance with the higher standards. New York began tightening its standards in 2001. Five years later, the state had to begin shutting down failing self insurance trusts. The first two were the Provider Agency Trust for Human Services and the Manufacturing Industry Workers Compensation Self Insurance Trust, both managed by a Wayne, PA subsidiary of AVI International, Inc. One of the trusts had been in operation since 1996 and had accumulated a deficit of millions of dollars. According to New York State Workers’ Compensation Board spokesman John Sullivan, “It is not unanticipated that light would be shown on some trusts as a result of these new financial standards. We look at these as making the system stronger in the long run.”⁶ Later, three New York trusts managed by

⁴ Stewart, Richard E., “The Attorney General, the SEC and the Commissioners of Insurance” *Journal of Insurance Regulation* (2007).

⁵ Generalizations in this report about the condition of SIGs are based on reviews of financial and actuarial reports for 2007. CHSWC has not requested or received any additional financial or actuarial information about any group. No particular groups have been identified as threatened by the regulatory changes. It would be a mistake for the reader to infer that this discussion refers to any particular group. Specifically, CHSWC has no reason to believe that any group that has announced closure or change of administrators is unable to pay fully all of its obligations or to continue as a going concern.

⁶ As quoted in “N.Y. Shuts Comp Trusts,” *Insurance Journal*, January 23, 2006, <http://www.insurancejournal.com/magazines/east/2006/01/23/newsbriefs>

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Compensation Risk Managers (CRM) closed with estimated deficits amounting to \$146 million.⁷ Thanks to a shorter history and better standards from the outset, California SIGs are in far better condition. Nevertheless, regulators may need to impose unpleasant consequences on any groups that are unable to meet the even higher standards recently adopted.

⁷ Kiehl, Ellen D., "Solutions sought for workers' compensation group trusts' liabilities," Professional Insurance Agents resource kit 31247, June 2008, http://www.pia.org/IRC/qs/qs_other/QS31247.pdf

Summary of Regulatory Provisions

A self insurance group (SIG) must be organized as a nonprofit corporation (Rule 15470⁸), governed by a board of trustees (Rule 15475). The SIG must obtain Certificate of Consent to Self Insure, and each member receives an Affiliate Certificate of Consent to Self Insure. Each member must agree to joint and several liability for the workers' compensation obligations of all the other members.

CONFIDENCE LEVELS

The confidence level is an expression of the probability that an estimate of losses will be at least equal to the actual losses. Absolute certainty is not feasible. California SIGs are required to use higher confidence levels than are used in the insurance industry.

Actuaries attempt to project the ultimate losses by a variety of methods. Because of the various uncertainties in these processes, the actuarial projection of the ultimate loss is stated as a range.

A 50% confidence level would be the number which is equally likely to be too high or too low. The insurance industry uses the "expected" loss, which is somewhat greater than a 50% confidence level. This estimate is more likely to be adequate than inadequate. There is a substantial chance of any given year's losses being underestimated, and there is only a limited margin for error to balance out from year to year. Insurers are required to have certain levels of capital and surplus to help cushion against unexpectedly high losses.

California requires that SIGs must be funded at the 80% confidence level, meaning that the actuarially projected losses will exceed actual losses eight out of ten years and fall short only two out of ten years, on the average.

Payment of the workers' compensation obligations of the members is made by the SIG from the SIG's assets. The assets derive from the payment by the members for their coverage. The rates for these payments are not directly regulated, but the amount collected must be adequate to fund the SIG's liabilities estimated at an 80% confidence level. Accounting is required by program year, with funding to the requisite confidence level separately for each program year. As of March 2, 2009, the funding must include unallocated loss adjustment expense (ULAE), so the sufficiency of the funding to administer all incurred claims should no longer rely on a SIG remaining a going concern in future years. A SIG must correct any deficit in the required funding level by some means. Transfer of surplus funds from other program years is permitted. Assessments of members may be compelled by the Director if necessary to correct a deficit. (Rule 15477.)

A SIG is required to keep a deposit with the Director of the Department of

⁸ All references to Rule numbers are to sections of Title 8 of the Code of Regulations, as amended through March 2, 2009. Self insurance regulations are in Subchapter 2, Articles 1 (beginning with Section 15470) through 13.

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Industrial Relations (DIR) in the amount of at least 135% of estimated future liabilities. (Labor Code Section 3701.) If a SIG defaults on payment of compensation liabilities, the Director may turn the deposit over to the Self Insurers' Security Fund (SISF) and require SISF to pay the compensation benefits. (Labor Code Section 3701.3.) SISF would be obligated to make all payments of compensation even if the deposit is exhausted. The ultimate recourse is still against the members of the SIG, but SISF may have to pay benefits on behalf of a failed SIG and pursue collections actions against the members.

As noted, the members agree to joint and several liability. (Rules 15479, 15483.) This means that if some members fail to pay their assessments, the remaining members have to cover the shortfall, a scenario sometimes called "last man standing." Under the usual interpretation of joint and several liability, a creditor such as the Director or SISF may pursue any jointly and severally liable party for the full amount of the obligation.

The ability of the members to respond in damages could be problematic for SISF because regulations do not require any minimum financial capacity for an employer to become a SIG member. A SIG is only required to file independent certified financial statements for enough of its members to demonstrate at least five million dollars in net worth and at least one-half million dollars in net income, or an alternative combination of net worth and net income, as prescribed by Rule 15472. For members other than the core members, financial statements need not be filed. (Rule 15482.1.)

The assets of the SIG will include reinsurance. Every SIG is required to obtain specific excess reinsurance with an attachment point no higher than \$500,000 per occurrence. This is taken into account when calculating the estimated future liabilities. There is no connection between the amount of permissible retained risk and the capacity of the SIG. A SIG may also purchase aggregate excess reinsurance. The original regulations did not prevent one SIG administrator from using its affiliated agency as the broker to place a group's reinsurance with an affiliated captive reinsurance company, all owned by the same holding company. These conflicts of interest are prohibited by the new regulations, although it is not clear how aggressively the prohibitions will be enforced.

In summary, the priority of security for payment of workers' compensation is the assets of the SIG, assessments of the members, the security deposit, and SISF. Depending on the practicalities of collection from members, it may be necessary to draw on the deposit and SISF while collection actions against the members and former members are prosecuted.

Enforcement is based on reviews of documents which SIGs are required to file. Original Rule 15481 adopted in 1994 required an actuarial analysis every two years, and Original Rule 15475 required an audit of the financial accounts of the group by an independent certified public accountant (CPA) every year. As amended March 2, 2009, Rule 15481 more thoroughly

specifies the content of the actuarial report and requires the actuarial analysis to be conducted annually.

Regulations do not expressly require the filing of rates and do not require that rates be subject to approval. Estimated losses are discounted to present value, and the regulations do not specify criteria to approve or disapprove the discount rate that may be adopted by an actuary or accountant. In some SIG records reviewed by the Commission on Health and Safety and Workers' Compensation, the discount rate was much more optimistic than in others.

Regulatory Resources and Expertise, Access to Information

California regulations now require annual actuarial and independent certified financial statements, but the Office of Self Insurance Plans (OSIP) does not have the resources to interpret and evaluate those financial and actuarial reports.

The regulations establish the qualifications for the actuary and accountant and prohibit conflicts of interest of the accountant. The actuary, however, may have a financial interest in the program administrator. The value of imposing any additional protections against conflict of interest is open to debate. Despite the present high standards, there is always a risk that an actuarial or financial report will be mistaken, biased, or willfully misleading. OSIP staff has commendable experience and skill, but not the formal training and expertise that are needed to challenge errors, biases, and falsehoods that may be present in these technical reports. OSIP needs the benefit of a critical review by a qualified expert for every financial and actuarial report.

OSIP could secure these services by contracting with one or more accountants and actuaries to review the reports submitted by self insurance groups (SIGs). OSIP can already require an independent examination at the expense of a SIG, but it needs more continuing evaluation of the reports to indicate when to impose these outside reviews. OSIP should have standing arrangement with accountants and actuaries to conduct audits and reviews of SIGs when necessary in the Manager's discretion. OSIP should also have access to accountants and actuaries to conduct preliminary reviews of reports submitted by SIGs so that the Director will have a better basis for the exercise of that discretion.

The Self Insurers' Security Fund (SISF) should be allowed a larger role in the review of SIGs for two reasons. SISF has the expertise and the resources to assist the regulator by recognizing potential problems and bringing them to the attention of the regulator. Furthermore, SISF would have the opportunity to assure that the regulator is properly carrying out the regulatory functions. It is appropriate for SISF to be the "extra set of eyes" on the regulation of SIGs because SISF is the entity that stands at risk to guarantee payment of benefits if a SIG defaults. Accordingly, CHSWC recommends that SISF be granted all necessary authority to conduct claims reserve audits, financial and operational audits, and actuarial reviews of SIGs, subject to confidentiality

agreements that the Director will require. Upon a recommendation by SISF that a SIG's deposit be adjusted to reflect revised expected future liabilities or a recommendation that other action be taken to bring a SIG into compliance with statutes and regulations or to revoke a certificate of consent to self-insure, the Director should take the recommended action unless after notice and opportunity to be heard, the SIG demonstrates to the satisfaction of the Director that its estimate of future liabilities is adequate and that it is in compliance with applicable statutes and regulations. SISF should have standing to fully participate in any such proceedings. The powers of the Director should be reviewed to determine whether the Director already has the authority to carry out these recommendations or whether an express delegation of legislative authority is required.

Public Disclosure of SIG Information

There is a debate over whether the financial or actuarial reports of SIGs should be disclosed publicly. One of the arguments, loosely stated, is that those who are affected by the action or inaction of the government have an interest in assuring that the government is doing its job. Certainly the trend is toward more openness in government. On the other hand, government regulators routinely have access to confidential private information about regulated persons or entities, and this information is routinely held in confidence. The dispute cannot be resolved simply by generalizations about transparency or privacy, nor by analogies to the disclosures required of insurers or the privacy afforded to stand-alone self-insureds.

CHSWC recommends that the guiding principle should be to maximize the solvency and security of SIGs for the protection of those who are most directly at risk in the event of the insolvency of a SIG. Those are the SIGs' members and the SISF.

The employers who join a SIG or remain in a SIG are relying in part on the State's supervision of the group, and they are directly at risk if the SIG becomes insolvent. Later in this report, it is recommended that financial and actuarial data on each SIG be made available to its members and prospective members and their representatives.

The Self Insurers' Security Fund (SISF) is the other entity most directly affected by the soundness of the regulator's oversight of SIGs. As discussed above, CHSWC recommends that SISF be given direct access to SIGs' financial and actuarial data. The information available to SISF would not include confidential financial information about any group member, only the groups themselves. Under appropriate confidentiality regulations, the data would be provided only to authorized agents of SISF and not to employer members of the SISF or its board.

With full disclosures to SISF and with specified disclosures to SIG members and prospective members, wider public disclosure of SIG financial or actuarial data would probably not further

Report on Self Insurance Groups

enhance the protection against underfunding, the need for employer assessments, or defaults. On the contrary, it would probably expose small SIGs to the destabilizing effects of predatory price competition by larger SIGs and insurance companies.⁹ Unless it is demonstrated that wider public disclosure will actually enhance the security of SIGs, however, the risk of harm from public disclosure of SIG financial information appears to outweigh any potential benefits.

Although individual SIGs' financial information may be kept confidential, the public interest is served by public access to certain information including:

The identities of members of each SIG so that every self insured employer's compliance with Labor Code Section 3700 is publicly documented.

The identities of the group administrator and the claims administrator(s) for each SIG.

Aggregate statistical data on claims experience and administrative costs, comparable to the aggregate statistical data on insurer experience and costs which are published by the WCIRB but simplified commensurate with the smaller scale of the SIG program and the necessity to protect individually identifiable information.

The status of each SIG's compliance with key requirements including but not limited to filing reports, funding loss reserves, and paying security deposits.

⁹ The argument for protecting small SIGs may not hold true for large SIGs that are on a more equal footing with insurers. In fact, consideration may be given to whether sufficiently large SIGs should be required to become mutual insurance companies rather than self insurance groups.

Disclosures to Members

Self insurance group administrators describe varying practices with regard to disclosures to members or prospective members. Rule 15481 requires the disclosure of an actuarial report to the board of trustees and to any member who requests it. CHSWC staff have not located a comparable requirement for disclosure of financial reports to members or prospective members. It appears that a good practice is to disclose these reports to members and prospective members under a nondisclosure agreement that prohibits re-disclosure by the recipient of these confidential reports.

CHWSC recommends that disclosure to members and prospective members and their agents or designated representatives should become mandatory by regulation. Non-disclosure agreements to prohibit distribution of confidential information would be acceptable, but regulations should assure that the non-disclosure agreements do not prevent a member or prospective member from obtaining advice from their own agents, brokers, accountants, attorneys, or other consultants who agree to preserve the confidentiality of the information.

An important reason for disclosure is to reduce potential problems if it becomes necessary to pursue collections actions against members of a SIG in deficit. All collections have inherent difficulties. Referring to the litigation occurring in New York, one group administrator said, “The first thing they forget is that they signed joint and several.” Without full disclosures, members may contend that the financial condition of the SIG was misrepresented to them. Full disclosure to a prospective member, to every member, and to their advisors will both promote member involvement in a group’s affairs and reduce the potential for members to deny liability if collections become necessary.

Marketing

Beyond the specific disclosures recommended in the previous section, marketing should communicate truthful and meaningful information so employers can make informed choices. SIGs are unfamiliar to most employers, so there is a risk of employers not understanding what they are committing to. Employers are vulnerable to being misled by marketing materials that are inaccurate or materials that are technically accurate but contextually misleading.

CHSWC recommends that the Director exercise jurisdiction over the marketing of SIGs and that, if necessary, the Legislature expressly confer that jurisdiction on the Director.

The Director should enact and enforce regulations requiring that all marketing materials be truthful and accurate and not misleading or deceptive. In designing regulations, the Director may

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consider how CDI regulates insurance marketing in California. Examples of marketing oversight tailored to group self insurance may be found in New York and Kentucky.¹⁰

Consideration should be given to the New York example, which forbids “any statements which cannot be measured or verified.” Marketing materials in use in California have been observed to contain express or implied promises of “stability” while at the same time offering “removal from DOI and its oversight.”

Guarantees of dividends should not be permitted or implied, and OSIP should consider requiring written statements to the effect that past performance is no guarantee of future performance.

The Director should consider requiring that all marketing materials include a standard disclosure about a SIG member’s liability for the claims of all SIG members’ employees in the event of insolvencies of the SIG and the other members. This recommendation is based on the fact that employers may not readily appreciate the different consequences of SIG membership compared to insurance. Marketing materials used in California have sometimes minimized these differences with statements like, “If a member decides to leave the group, its claims liabilities stay with the group, just as they would with an insurance company.” That statement is true to a point, but a SIG is not quite like an insurance company because of the potential for subsequent assessments if the group is underfunded. Marketing materials do not always make it clear that a member may be assessed for underfunding of claims that arose in the SIG before the member joined. In another example, a marketing statement asserted that members are only liable for costs incurred in the year of their membership. Rule 15477 however, permits a transfer of funds from a surplus year to a deficit year or special assessment of all members as two of the options for making up a shortage in any calendar year. Rule 15479 provides that each member must agree to assume any compensation liability of any and all other members. Neither of these regulations exempts a member from an assessment or protects a member’s interest in a surplus if there is a deficit outside the period of the member’s membership. None of the marketing materials reviewed by CHSWC disclose that a SIG member might have to pay a share of SISF’s guarantee of payments in the event of default by a large self insured employer.

CHSWC recommends that the Director consider requiring copies of marketing materials be filed with OSIP. The New York regulations allow the regulator to require the submission of marketing materials when a violation is suspected. OSIP may prefer to automatically receive copies for review at its discretion or for review in connection with scheduled audits.

CHSWC further recommends that regulations provide for penalties against both the SIG and the administrator for any false or misleading statements. This recommendation is intended to assure that program administrators are held responsible for the practices which they largely control.

¹⁰ 12 NYCRR §317.18, KRS 304.50-150

OSIP Audits

The Office of Self Insurance Plans (OSIP) has a team of claims auditors that reviews claim files and identifies inadequate reserves among the sampled cases. The auditors also review certain other aspects of SIG operations relating to claims handling. Audits have been successful in finding under-reserved cases and other problems such as improper interference by a program administrator in the activities of the claim administrator. One concern, however, is whether the audit process is being used to maximum effectiveness. At present, a SIG is required to increase its reserves in the cases found to be under-reserved and to increase its deposit to reflect the higher figure for expected future liabilities (EFL). The shortcomings are:

- There is no extrapolation from the audit sample to the full inventory. Supposing that 100 files are audited and 25 are found to be under-reserved by an average of 40%. It is all well and good to require the reserves in those 25 files to be raised and require the SIG to increase its security deposit accordingly. However, if the sample was representative of the full inventory, that would imply that the entire caseload was under reserved by 10%. OSIP auditors do not select the files randomly and in fact select the cases that were most likely to be under reserved. CHSWC recommends that OSIP consider a pilot program of auditing a random sample of cases and applying the audit findings proportionately to the entire case inventory. The pilot could then be compared to the current method of selecting cases for audit.
- There is no adequate incentive for accurate case file reserving. When auditors find cases under-reserved, the consequence is simply to raise the EFL and the deposit to the levels they should have been in the first place. The increased deposit is paid from the SIG's funds. There is no adverse consequence for the third-party adjusting agent (TPA) that sets the reserves or for the group administrator that oversees the TPA and might (but should not) influence the TPA's reserving practices. (This is a behavior discovered by some OSIP claims audits.) CHSWC recommends that OSIP consider a graduated series of incentives directed at the group administrator and the TPA that might range from increased special audits to revocation of the privilege of acting as a SIG Group Administrator or TPA.
- In addition to looking at the adequacy of individual case reserves, OSIP should be examining the loss development and scrutinizing those SIGs that show unusual patterns. This recommendation is based on the New York experience of some groups having to make large increases in claims reserves which the groups were unable to fund. Comparison of a SIG's loss development with the experience of other SIGs and the insurance industry would also be informative when deciding whether to begin returning surplus contributions to members as early as 23 months after the end of a program year.

“Audits” by OSIP generally focus on claims operations, and other references to “audit” in the OSIP regulations generally refer to audited financial statements. Standard GAAP financial reports for non-profits do not require the independent assessment of risk. OSIP should consider adopting more expansive audit requirements to address the particular circumstances of SIGs. One commenter has suggested the National Association of Insurance Commissioners (NAIC) Model Audit Rule, which is said to make all affected companies comply with Sarbanes-Oxley requirements regarding internal controls. Sarbanes-Oxley is reputed to have been effective at making top executives take responsibility for the operations of their companies. A similar requirement could have a salutary effect on the practices of SIG administrators and trustees.

Licensing of Program Administrators

The foregoing recommendation raises another gap in the regulatory structure. While TPAs must be licensed, there is no regulation of who can be a group administrator. The group administrator has a key role, and when unprincipled individuals are in that position, the group administrator can cause untold damage to members and to whomever has to pick up the pieces.

CHSWC staff and consultants have observed that some group administrators run deficits in multiple groups under their management. CHSWC staff and consultants have observed that some group administrators profit from conflicts of interest that other administrators deemed were unethical even before those practices were prohibited. CHSWC staff and consultants have observed that some group administrators employ accountants and actuaries whose opinions push the boundaries of reasonableness.

CHSWC recommends that standards for group administrators should be set, and that when a group administrator consistently violates the standards of practice or engages in prohibited behaviors, the group administrator and its principals should be barred from any role in California self insurance groups.

CHSWC recommends that the Director promulgate regulations to establish qualifications for licensing of SIG administrators and to impose progressive disciplinary measures up to and including loss of license for severe or frequent misconduct.

As will be discussed elsewhere in this report in relation to the advantages of a separate security fund account, the regulated community as a group can be the source of high standards that individual members of the community might otherwise disregard. The Director may be able to take advantage of that process by tying the licensing of group administrators to accreditation by a professional association or by incorporating standards articulated by a professional association of group administrators. The California Alliance of Self-Insured Groups (CA-SIG) may serve as the forum for SIGs and their administrators to articulate appropriate qualifications. The California Association of Joint Powers Authorities (CAJPA) has a risk management

accreditation program¹¹ for JPAs, which are the public sector equivalent of SIGs. That program may be informative or adaptable to the private SIG environment. CHSWC has received suggestions that the accreditation program incorporate elements of the Sarbanes-Oxley Act of 2002 and that it include requirements for SAS 70 audits. Evaluation of these suggestions is beyond the scope of this report. Other resources and public input should be considered.

Security Fund Structure

It is recommended that the Legislature authorize the Director to approve separate accounts within the Self Insurers' Security Fund for self insurance groups and for stand-alone self insured employers, and to allocate liabilities between the accounts.

At present, SIGs are in the Self Insurers' Security Fund (SISF) under the jurisdiction of the Department of Industrial Relations. The California Insurance Guarantee Association (CIGA) is the only other workers' compensation security fund in California, but it is under the jurisdiction of the Department of Insurance and does not include SIGs. Neither fund is a perfect fit for SIGs, but SISF is where they are now, and it is where they best fit unless a separate fund or account is created for them.

There are good reasons to place SIGs in a separate account or fund, but based on discussions among SIG program administrators and SISF representatives, establishing and managing a separate security fund for SIGs would not be practical at this time. A separate account for SIGs within SISF might become feasible within the next year or two, but until that has been determined, SIGs should remain in SISF as currently structured.

In light of the differences between SIGs and individually "self insured" (actually, self funded) employers, ongoing consideration should be given to placing SIGs into a separate account within SISF. A separate account would allow each risk pool to be made up of employers (or groups) that have adopted similar programs for workers' compensation rather than share a risk pool with employers (or groups) that have less in common with themselves. A separate fund or a separate account would facilitate development of distinct techniques for evaluating and responding to the risks that SIGs bring to their security fund. Furthermore, the pooling of risk among SIGs in a separate account will have the salutary effect of promoting higher standards for SIGS.

The reason a separate fund or account would promote higher standards for SIGs is that each SIG would have a stronger interest in the assuring the financial integrity of all SIGs. Any SIG's stake in the solvency of other SIGs is diluted when SIGs comprise only 6% (by payroll) of the SISF pool. A SIG has more to fear from the default of a large individually self insured employer than from the default of another SIG. Not being particularly invested in the fate of other SIGs, the

¹¹ <http://www.cajpa.org/Topics/Accreditation/Pages/default.aspx>.

natural posture of even the best-run SIGs is to advocate light oversight by regulators. The collective expertise of SIGs, in an environment where they are directly concerned with the financial integrity of their fellow SIGs, will probably generate valuable recommendations for high standards and strict oversight.

This dynamic was described by the NAIC *Self-Insurance Regulator's Handbook* (2005,) in the context of individually self insured employers:

Individual self-insured employers may argue against the imposition of security requirements or try to reduce their level. Representatives of self-insured employers (e.g., guaranty funds or advisory bodies) commonly take the opposite stance. All self-insurers may bear the cost of defaults on claims obligations from other self-insureds in a given jurisdiction. They tend to lobby for strict requirements for the right to be self-insured and security instruments for firms without exceptionally strong financial statements.

The same dynamic was demonstrated in a meeting involving most of the California SIG administrators in April 2009. When the question was posed whether to immediately put all SIGs into a separate security fund, participants quickly expressed concerns about what kind of risk they would be taking on, whether other SIGs carried appropriate reinsurance, not knowing what other SIGs “look like,” and wondering how to assess the financial standing of other SIGs. These are exactly the questions that the regulators and the security fund must address.

A risk-sharing pool that concentrates on SIGs would foster the development of effective and practical standards to assure the financial integrity of all SIGs. It may not be feasible to put SIGs into a separate account for some time. CHSWC is recommending that the Director have the authority, not that the authority be exercised hastily. The discussions and analysis in preparation for this evolution will contribute to improving the standards for SIGs.

Rates

Rate regulation is one of the techniques used by insurance regulators that could be applicable to group self insurance. CHSWC staff reviewed the rates charged by a selection of SIGs and found that the majority were within the range of rates charged by insurance carriers. Some rates were below the pure premium recommended by the Insurance Commissioner. These low rates may be appropriate, but they raise concerns. Very low rates may be justified by the results of careful underwriting and exemplary safety, claims management, and return-to-work practices. With the very short history of group self insurance in California, however, it is questionable whether most groups have sufficient experience to warrant large reductions from the experience of the insurance industry. Inadequate rates based on wishful thinking are part of the reason for insolvencies in other states.

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Existing regulations require that each SIG demonstrate sufficient income to fund actuarially projected claim liabilities for each program year at the prescribed confidence level plus administrative expenses and the security deposit. A SIG's solvency is presumed to be impaired and the SIG may be required to post an increased deposit or lose its Consent to Self-Insure if the rates fail to generate sufficient funds to meet these requirements. (Rule 15484.) In effect, this is a "file and use" rate system where OSIP can intervene if rates are inadequate.

Existing regulations do not specifically require that the rate plans be filed with OSIP, although many SIGs either file separate rate plans or include the rate computations in the actuarial reports filed with OSIP. Existing regulations do not require that SIG contribution rates be tied to insurance industry premium rates. Even without any direct requirement, when reviewing a SIG's rate plan or actuarial report, it may be prudent for OSIP to compare the SIG's projections to the advisory pure premiums approved by the Insurance Commissioner (e.g., wcirbonline.org/wcirb/resources/rate_filings/pdf/2010_01_01_rates.xls). OSIP can order an independent actuarial review if the SIG's own report fails to adequately justify its projections. The rates adopted for the insurance industry are no guaranty of solvency, but they may be regarded as reference points, and any lower rates for SIGS should be convincingly justified.

CHSWC recommends that each SIG be required to file its rate plans and to charge rates in accordance with its filed rate plan. Otherwise, the actuarially derived rates will not be the actual rates collected, and the actual contribution rates may be insufficient to fully fund a SIG.

There appears to be some discrepancy in the interpretation of Rule 15476, which prohibits "discounts." That term is not defined in the regulations. CHSWC staff have observed evidence of experience rating practices. These might be construed as being within a SIG's rating plan rather than "discounts" below the rating plan. On the other hand, it has been reported that OSIP interprets the rule to require that a single rate for each classification must apply uniformly to all members of a SIG. CHSWC recommends that the regulation be clarified to remove any uncertainty as to whether prospective rate reductions like experience rating may lawfully be built into rate plans. If the Director is going to allow experience rating, then the regulations should also assure that the experience rating formula is at least as predictive of future losses as the experience modification system developed in the insurance industry. Also, any experience rating plan requires an adjustment to base rates to preserve the actuarial validity of the rate structure (cf., the "on balance adjustment" in the WCIRB rate recommendations).

CHSWC recommends that regulators examine the present value discount rates that are used in projecting loss costs. Seemingly small variations in the discount rate can have a large impact on the adequacy of reserves because loss payouts can occur over many years. Regulators should consider exercising the existing authority to appoint independent auditors and actuaries to review the positions of groups using the more aggressive discount rates, or consider requiring losses to be calculated without discounting.

Distributions and the Corporations Code

There appears to be a conflict between the Corporations Code and the business models of some SIGs.

Because funding is required at a high (80%) confidence level, it is probable that a properly run SIG will be over-funded by the time the losses mature. The regulations contemplate the return of excess funds to the members and prescribe when the excess may be returned (no earlier than 23 months after the end of the program year, per Rule 15477). Current SIG regulations refer to these as “surplus contributions.” The return of surplus funds tied to each member’s loss experience can be one of the incentives that enable SIGs to achieve accident reduction, active claim management, and supportive return-to-work practices. Some SIGs prefer to use the surplus funds as credits against the contributions members would otherwise be required to pay in subsequent years. For those SIGS that use direct payments, at least, it appears that the program design runs up against a prohibition in the Corporations Code.

Pursuant to Rule 15470, a SIG must be organized as a nonprofit mutual benefit corporation, a nonprofit charitable corporation, a nonprofit public benefit corporation, or a nonprofit religious or apostolic corporation, as appropriate for the type of employers in the SIG.

Corporations Code Sections 5410 and 7411 appear to prohibit distributions by nonprofit corporations or restrict distributions to circumstances not applicable here. Section 7411, relating to nonprofit mutual benefit corporations, states in part, “(a) Except as provided in subdivision (b), no corporation shall make any distribution except upon dissolution. [] (b) A corporation may, subject to meeting the requirements of Sections 7412 and 7413 and any additional restrictions authorized by Section 7414, purchase or redeem memberships.”

Some SIG administrators agree and see a need to change the Corporations Code to permit the return of surplus contributions. Some disagree that these returns constitute “distributions.” CHSWC invites the opinions of experts in Corporations law. The legitimacy of distributions is, at best, dubious at present.

So long as there remains an unresolved argument, the more prudent course would be to remove any doubt. Accordingly, CHSWC recommends that either (1) the Director amend Rule 15477 to require surplus contributions to be released only in the form of credits against future contributions, prohibiting distributions except as permitted by the Corporations Code, or (2) the Legislature amend the Codes to provide that notwithstanding any other provision of the Corporations Code, a nonprofit corporation formed for the sole purpose of operating a group workers’ compensation self insurance fund pursuant to regulations promulgated under the authority of Article 1 (commencing with Section 3700) of Chapter 4 of Part 2 of Division 4 of the Labor Code shall not be prohibited by the Corporations Code from making distributions to its members as expressly approved pursuant to those regulations.

Administration of Insolvency

The Director should have standing arrangements with persons or organizations that can be called upon at short notice to take over as administrators or adjusting agents if it becomes necessary for the Director to replace any SIG administrator or adjusting agent. These arrangements will give OSIP the ability to act quickly without having to begin the contracting process after the need has arisen. This need could arise even in situations that do not constitute insolvencies.

One comment to CHSWC has pointed out that steps should be taken to manage the inevitable litigation that will arise if and when there is an insolvency of a SIG. CHSWC has not independently examined this topic, so the comments will be excerpted verbatim:

“Given that an insolvent group may have [members] in a number of different counties, the litigation costs may prove considerable unless there is clarification as to how insolvencies are to be administered. There needs to be a clearly articulated judicial process established to oversee delinquency proceedings, including a mandate that any action to enforce a right of equitable contribution of one group member upon others, as well as any other actions against the trustees or group administrators, be filed in the same court as the delinquency proceedings. This would allow for a judicially supervised liquidation of the group and its attendant disputes.”

The comment refers to Kentucky’s statutes, KRS 304.50-135, and suggests that similar legislation would be required in California. CHSWC recommends this subject for further examination.

Further Study

Too little is known about the actual performance of self insurance groups (SIGs). Their supposed benefits are known only through anecdote. While self-promotional and self-congratulatory statements must always be taken with skepticism, the Commission on Health and Safety and Workers’ Compensation (CHSWC) believes there is truth in the claims that group self insurance can reduce employer costs and improve worker safety and return to work. The same potential may not be realized in all groups. To better evaluate and quantify whether group self insurance is living up to its potential, the performance of SIGs should be objectively studied and compared to the performance of conventional insurance. The Workers’ Compensation Information System (WCIS) operated by the Division of Workers’ Compensation (DWC) will provide a useful database for research once participants fully comply with its data reporting requirements, and OSIP should insist on compliance by all of the entities under its jurisdiction.

Report on Self Insurance Groups

Based on the information currently available, CHSWC believes group self insurance to be a valuable option among the choices available to California employers. The recommendations in this report are intended to enhance the long-term value of group self insurance for California employers and employees.

Report on Self Insurance Groups

ATTACHMENT A

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October 6, 2008

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COMMISSION ON HEALTH
AND SAFETY AND
WORKERS' COMPENSATION

Christine Baker, Executive Officer
Commission on Health and Safety and Workers Compensation
1515 Clay Street, Room 901
Oakland, California 94612

Dear Ms. Baker:

Recently, the State of New York enacted legislation reforming the regulation of workers' compensation self-insurance groups. This was in response to a significant crisis in that segment of the market in which many trusts became insolvent and liabilities extended into the hundreds of millions of dollars. I am very concerned about the potential of such an event happening in California and what protections exist both for employers and injured workers in these programs.

Specifically, I am requesting the Commission undertake an analysis of the statutory and regulatory oversight provisions of California and New York laws and regulations and make recommendations regarding what additional provisions may be required to ensure the viability of these programs. If time and resources allow, contrasting these two state regulatory mechanisms with that envisioned by the National Association of Insurance Commissioners (NAIC) would be helpful. Included in that analysis should be consideration of:

- (1) Regulation of market conduct activity of groups in terms of advertising, representations regarding ultimate exposure under joint and several liability with right of contribution, and the extent to which self-insurance group administrators have a business relationship with any entity contractually providing claims services to the same group;
- (2) Regulation of the solvency of self-insurance groups including data regarding the audit history of self-insurance groups, the results of those audits, the payment of dividends by groups consistent with regulations of the Office of Self-

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Christine Baker, Executive Officer
October 6, 2008
Page Two

Insurance Plans, a summary of excess insurance coverage for these groups, where this coverage is generally placed, and whether the excess insurer is owned by the entity administering the group;

(3) An analysis of the steps to be taken in the event of an insolvency or impairment of the group, including, but not limited to, how obligations are secured by groups in accordance with Labor Code Section 3701, how the Self-Insured's Security Fund enforces joint and several obligations of individual group employers in the event of an insolvency, what steps are taken to secure its obligation for assessments during the time in which it was a member when an individual employer within the group leaves the group, what steps are taken when an individual employer within the group declares bankruptcy to make a claim for potential unfunded liabilities with the estate, and what is the status of an employer who participates in a group when the group is insolvent? (Is it illegally uninsured?)

(4) Transparency of the operations of the group, including what documents are considered public that are required of the group as a condition of doing business?

(5) What is the process by which the Office of Self-Insurance Plans assesses the development of losses from prior coverage years and requires additional security for those years if development is worse than expected at the time the contributions for a given year were calculated? How is the approval of dividends related to the ongoing analysis of loss development?

While I do not expect the identification of any individual group or member of a group as part of your report, I do request sufficient particularity in your analyses to allow the Committee to have a reasonable understanding of the conduct of this business, including its economic impact on California, on employers that are not members of self-insurance groups, and on other elements of the California workers' compensation system.

Finally, please advise us as to the number of states whose regulatory oversight of self-insurance groups is with the Department of Insurance rather than the workers' compensation regulatory agency.

The New York legislation establishes a Task Force on Group Self-Insurance whose recommendations are to be submitted to the Governor and legislative leadership by February 1, 2009. If possible, please review this document as part of this request.

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Christine Baker, Executive Officer
October 6, 2008
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Based on next year's legislative deadlines, it would be ideal if your analysis could be provided to the Committee on or before March 15, 2009, for incorporation into 2009 legislation. If that time frame is too short, I would request an interim report with the final report due in a time frame you can meet.

Sincerely,



Joe Coto, Chair
Assembly Insurance Committee
Assemblymember 23rd District

ATTACHMENT B

Basic Anatomy of a Self Insurance Group

A self insurance group (SIG) is a group of employers organized into a legal entity approved by the State to satisfy the statutory obligations of the members to secure the payment of workers' compensation.

The type of legal entity approved in California is a nonprofit corporation. The corporation is governed by a Board of Trustees which is responsible for all exercise of corporate powers and subject to fiduciary duties to the group. At least two-thirds of the trustees must be officers or employees of group members, and nobody with an interest in any of the group's service providers can be a voting member.

The Board of Trustees employs service providers to perform a range of functions. The following descriptions include some of the prominent service provider roles and some of the prohibitions of conflict of interest.

The Program Administrator, also called the Group Administrator, typically conducts the day-to-day operations and financial affairs of the group, at the direction of the Board. The Program Administrator usually has a role in the selection, contracting, and continuing relations with the other service providers.

A Third-Party Claims Administrator (TPA) handles the claims adjusting function of the group, including estimating reserves on individual claims. Unlike some other states, California does not permit the Program Administrator to have a financial interest in the TPA.

An Actuary evaluates the group's expected liabilities for purposes of setting the rates prospectively and evaluates incurred liabilities for the purpose of determining whether assets are sufficient to satisfy liabilities. The estimate of incurred liabilities also determines the amount of the group's security deposit with the State.

An independent Certified Public Accountant (CPA) prepares an annual audit of the financial accounts and records of the group. California does not permit the Group Administrator to serve as the CPA.

Medical utilization review services and medical bill review services are contracted to work with the TPA.

Safety and loss control services can influence the results of a group. California does not directly regulate the group's relationship with these service providers. Rule 15486.1 provides general qualifications.

An excess insurance carrier provides excess insurance coverage for any individual claim that exceeds the group's retention level. California regulations specify a maximum retention level, which is also the practical minimum retention level, regardless of how large or small a group may be.

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A broker is employed to place the group's excess insurance coverage and other coverages. Potential conflicts of interest are addressed by regulations.

Glossary

- Assessment** An additional amount that self insurance groups (SIG) members may be required to pay if the money received as contributions and as income from investments is insufficient to adequately fund the SIG for payment of liabilities.
- Contribution** Like “premium” paid by an insured employer for a given policy year, the “contribution” paid by a SIG member is the amount the employer pays into the SIG in exchange for the SIG’s promise to pay the employer’s liabilities arising in a given program year.
- Dividend** The casual term for money returned to members by a SIG that has more money on hand than required for funding the payment of liabilities, deposits, and operating expenses. Group administrators avoid “dividend” and prefer the formal term used in regulations, “surplus contributions.”
- Group Administrator** California’s term for Program Administrator, the entity that administers the day-to-day operations of the SIG and possibly the entity that organizes and sets up the SIG. The Group Administrator is one of several key service provider roles. The Group Administrator may also perform other service provider roles unless restricted or prohibited.
- Individual Self Insurance** Also called “Stand Alone Self Insurance” (*q.v.*) or most commonly “Self Insurance,” but not including Group Self Insurance.
- JPA** “Joint Powers Authority” is the name for a group of public sector employers engaged in group self insurance.
- Loss** From an insurer’s perspective, “loss” is the amount paid or payable as benefits in one or more workers’ compensation claims. Alternative meanings should be indicated by an adjective, such as “underwriting loss,” which is an amount by which losses and loss adjustment expenses exceed premiums, or “net operating loss,” which is an amount by which the sum of losses, loss adjustment expenses, and operating expenses exceed the sum of premiums or contributions and investment income.
- Reinsurance** A type of insurance contract in which an employer, insurance carrier, or SIG which has the initial liability for claims (known as the ceding company) purchases insurance to pay the amount of losses that exceed a stated level, known as the retention or attachment point. “Specific excess reinsurance” is reinsurance where the reinsurer pays the liability on any claim that exceeds the attachment point,

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such as any loss over the first \$500,000. “Aggregate excess reinsurance” is reinsurance where the reinsurer pays liabilities that exceed an aggregate amount for a set of claims, typically based on a policy year. Reinsurance typically has an upper limit beyond which the reinsurer has no further liability, but workers’ compensation reinsurance may be “statutory,” in which case there is no upper limit.

Self Insurance A method of securing the payment of compensation without purchasing conventional workers’ compensation insurance coverage. Prior to the advent of Group Self Insurance, there was only one type of self insurance in California. Since the arrival of Group Self Insurance, the term may be prefaced by the adjectives “Individual” or “Stand Alone” to distinguish the original type of self insurance from Group Self Insurance. Unless otherwise indicated by the context, the unqualified term “Self Insurance” still includes only the historical type of self insurance and not Group Self Insurance. “Self Insurance” is synonymous with Individual Self Insurance and Stand Alone Self Insurance (q.v.). As traditionally used, “self insurance” is not insurance at all but is actually self-funding of liabilities. An employer seeking to satisfy its duty to secure the payment of compensation by means of self-funding must first demonstrate its financial capacity and obtain from the Department of Industrial Relations a certificate of consent to self-insure.

Service Provider An entity that provides services that are essential to the operation of a SIG. Typically these include the Group Administrator, the TPA, a medical bill reviewing service, an accountant, an actuary, and one or more insurance brokers. One entity may serve multiple roles unless restricted by law.

Stand Alone Self Insurance Synonymous with “Individual Self Insurance,” also synonymous with “Self Insurance” unless the latter term is used in a context that clearly includes Group Self Insurance. “Self Insurance” in the usual sense is not insurance at all, but rather self-funding of liabilities in a manner that is approved by the state.

TPA Third-Party Administrator or Third-Party Adjuster. A TPA performs all or part of the claims adjusting function for an insurer, a self-insured employer, a JPA, or a SIG. An insurer or self-insured employer may administer its own claims, but a SIG must employ a TPA. California prohibits the Group Administrator from having a financial interest in the TPA.

Suggested Legislation

The report contains several general recommendations for legislation. Shown below are drafts of language that have been suggested to implement some of those recommendations. These drafts are intended as a basis for discussion and may not exactly reflect the recommendations of the Commission on Health and Safety and Workers' Compensation.

Section 3702.11 is added to the Labor Code as follows:

3702.11. (a) Each group self-insurer shall annually file with the Director a certified, independently audited financial statement, prepared by an independent certified public accountant, and a written actuarial report prepared by an independent actuary, who is an Associate or Fellow of the Casualty Actuary Society or a Member of the American Academy of Actuaries, in the form prescribed by the Director. The audited financial statement and actuarial report shall conform with the requirements of regulations adopted pursuant to this part. All financial statements and actuarial reports filed with the Director shall concurrently be provided, in complete and un-redacted form, to the California Self-Insurers' Security Fund. Failure to timely fulfill the requirements of this section shall constitute good cause to revoke the group self-insurer's Certificate of Consent to Self-Insure.

Section 3745 of the Labor Code is amended to read as follows:

3745. (a) The fund shall maintain cash, readily marketable securities, or other assets, or a line of credit, approved by the director, sufficient to immediately continue the payment of the compensation obligations of an insolvent self-insurer pending assessment of the members. The director may establish the minimum amount to be maintained by, or immediately available to, the fund for this purpose.

(b) The fund may assess each of its members a pro rata share of the funding necessary to carry out the purposes of this article. However, no member shall be assessed at one time in excess of 1.5 percent of the benefits paid by the member for claims incurred during the previous calendar year as a self-insurer, and total annual assessments in any calendar year shall not exceed 2 percent of the benefits paid for claims incurred during the previous calendar year. Funds obtained by assessments pursuant to this subdivision may only be used for the purposes of this article.

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(c) The fund may, with the consent of the Director, adopt by-laws establishing an account for private group self-insurers and an account for private individual self-insurers, allocating expenses and liabilities as between the two accounts, and setting different assessments for members of the different accounts.

~~(e)~~ (d) The trustees shall certify to the Director the collection and receipt of all moneys from assessments, noting any delinquencies. The trustees shall take any action deemed appropriate to collect any delinquent assessments.