



# STATE OF CALIFORNIA

*DEPARTMENT OF INDUSTRIAL RELATIONS  
DIVISION OF WORKERS' COMPENSATION*

*A Study of the Effects of Legislative Reforms  
on California Workers' Compensation  
Insurance Rates*



*January 2006*



Bickmore Risk Services

*Version 1.0*

# EXECUTIVE SUMMARY

## Introduction

This Executive Summary contains the major findings and conclusions contained in the study of the effects of the legislative reforms on California's workers' compensation insurance rates. This report has been prepared by Bickmore Risk Services (BRS) under contract with the Department of Industrial Relations and submitted to the Administrative Director of the Division of Workers' Compensation (DWC) in accordance with the provisions of California Labor Code Section 138.65, enacted in 2004 as part of Senate Bill **(SB) 899** (Chapter 34, Statutes of 2004).

The cost savings from the reforms are still very difficult to quantify with a high degree of confidence. The reforms are still relatively new and it will be many years before their financial effects are fully known. This is due to legislative, regulatory, legal and actuarial uncertainty.

## Scope and Purpose

The scope of the study includes an evaluation of the effects of major workers' compensation reform legislation enacted in 2002, 2003, and 2004, specifically Assembly Bill **(AB) 749** (Chapter 6, Statutes of 2002), Senate Bill **(SB) 228** (Chapter 639, Statutes of 2003), **AB 227** (Chapter 635, Statutes of 2003), **SB 899** (Chapter 34, Statutes of 2004), on workers' compensation insurance rates and on the workers' compensation insurance industry in California.

The statutory purpose of the study is to:

1. Identify and quantify savings generated for workers' compensation insurance in California by the legislative reforms;
2. Review workers' compensation insurance rates to determine the extent to which the reform savings were reflected in insurance rates and, if so, by how much;
3. Assess if the effects of the legislative reform savings generated are being used to replenish surpluses for workers' compensation insurance coverage;
4. Review the effects of legislative reforms on the workers' compensation insurance marketplace and competition, as well as rates in California; and
5. Review the adequacy and accuracy of the pure premium rate(s) as recommended by the Workers' Compensation Insurance Rating Bureau (WCIRB) and the pure premium rate adopted by the Insurance Commissioner.

In addition to the statutory requirements for the study, the DWC requested that BRS conduct research and analysis of the effects of workers' compensation reforms in other selected states and the effects of the reforms on the regulatory system in California.

The following topics are excluded from the scope of this analysis:

1. Fairness of benefit levels and medical fees;
2. Quality of and access to medical care;

3. The effects of the reforms on private and public sector self-insured employers, including the State of California; and
4. Sustainable long term analysis of the reforms.

## **A System in Need of Reform**

By 2000 the workers' compensation system in California was in serious need of reform. The overall premium and claims costs were the highest in the nation and the benefits paid to injured workers near the lowest. After a five year long "soft market" immediately following the change from a "minimum rate" regulatory system to an "open rating" system, the workers' compensation market changed dramatically. Employers were faced with even greater premium costs, lack of insurance markets willing to underwrite risks, and ultimately the unprecedented financial failure of 28 insurance companies insuring employers for workers' compensation in California.

As a result of this crisis, the Legislature enacted several workers' compensation reform measures beginning in 2002 and 2003. The most recent reform, SB 899, was enacted in 2004 after the election of the new Governor, Arnold Schwarzenegger, and the alignment of various interest groups which identified the condition of the workers' compensation system as a serious threat to the economic climate in California.

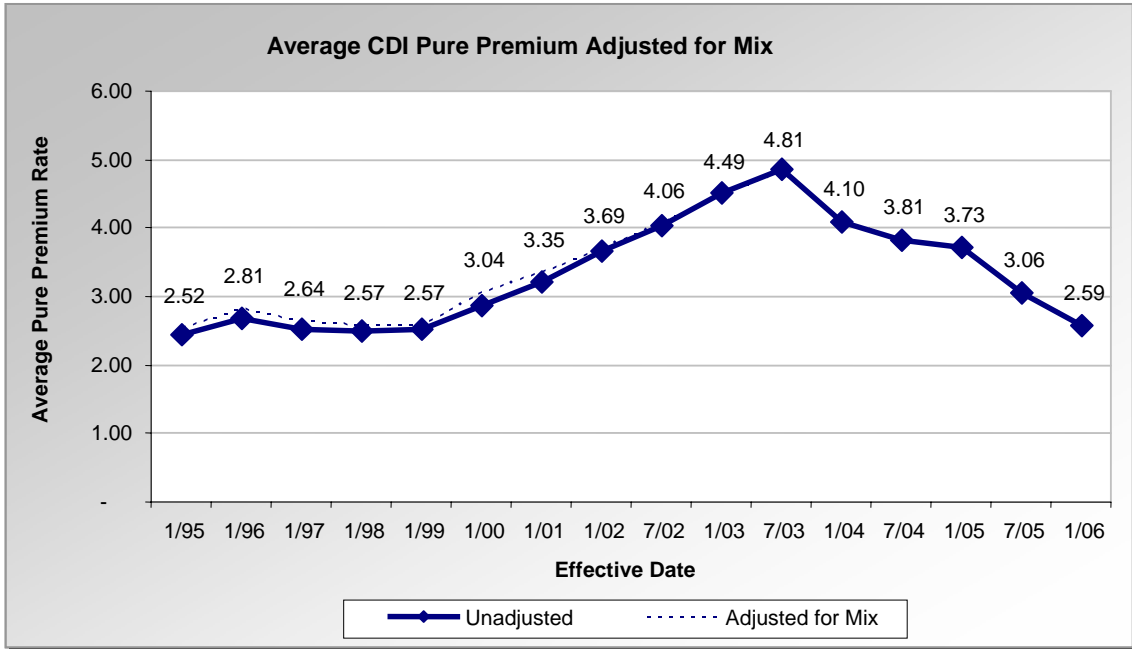
## **Methodology**

The study was initiated with a review of all available, pertinent research done on the California workers' compensation rating and insurance system, beginning with the California Workers' Compensation Rate Study Commission report issued in 1992. Then primary research was conducted through the collection of data and information from such organizations as the California Department of Insurance (CDI), the WCIRB, the Commission of Health, Safety and Workers' Compensation (CHSWC), the University of California Data/Survey Research Center, and the California Workers' Compensation Institute (CWCI). Additional information was collected through interviews with and surveys of insurance and healthcare industry executives, insurance agents and brokers, and employers. In addition, legal research was conducted on major issues which are subject to further legal and regulatory determination. A review of individual claims files of major workers' compensation insurers with significant market share was performed, analyzing over 400 claims.

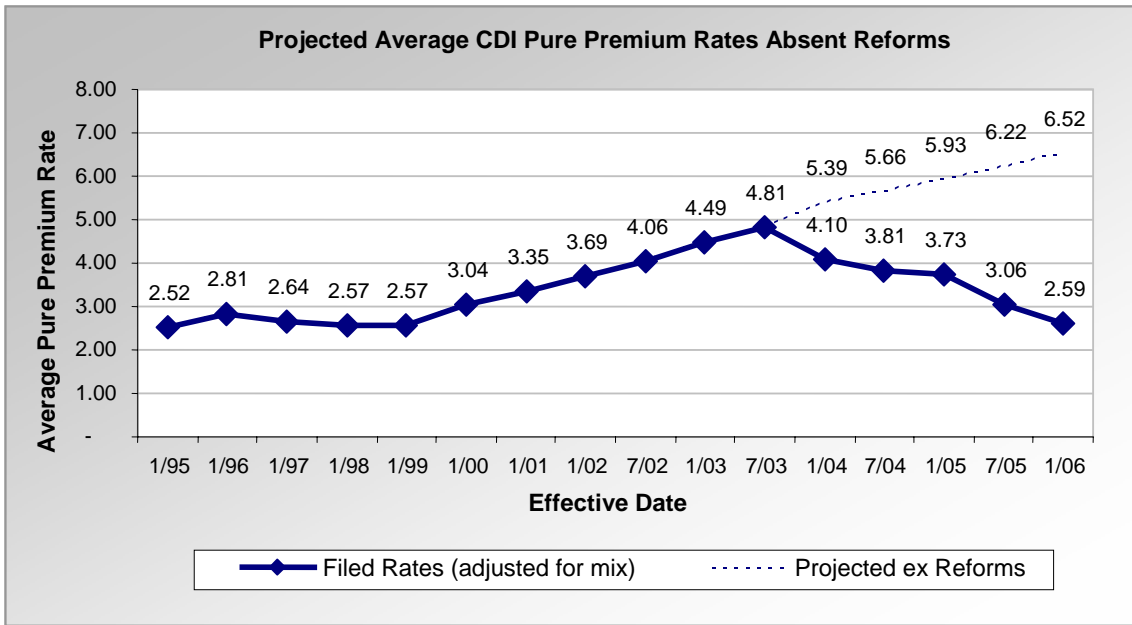
## **Major Findings**

### ***Savings in 2006 Rates***

- Primarily due to the reforms, it is projected that the approved insurance rates have decreased by 46% (from average rates of \$4.81 per hundred dollars of payroll to \$2.59 from July 1, 2003 to January 1, 2006 (a three year period). Rates are now below where they were in 1996. These rates have been adjusted for changes in the mix of payroll by industry.



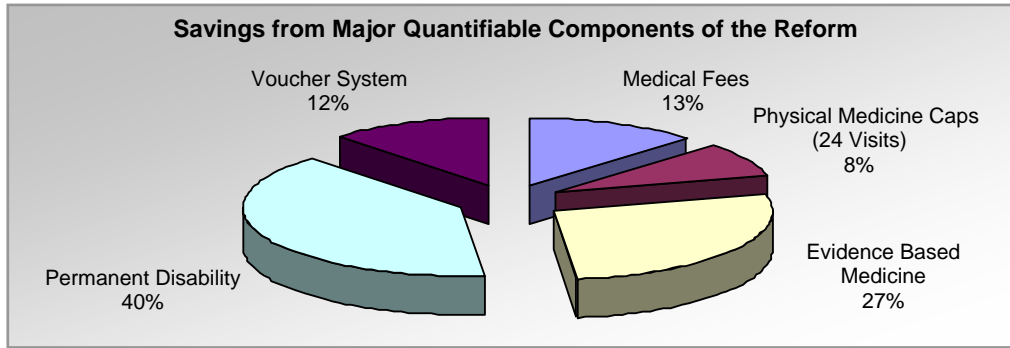
- BRS projects that the difference in approved rates is even greater than the 46%. 2006 loss and loss adjustment expense rates will be approximately 60% less than what they would have been if – absent reforms – rates had continued to increase from 2004 to 2006 (assuming 10% annual rate increases).



- BRS mid-range estimates of claims cost savings from the reforms projected for policies incepting in 2006 are:
  - \$8.1 billion in comparison to 2003 costs; and
  - \$15.0 billion in comparison to what 2006 costs might have been absent reforms.

A degree of uncertainty remains regarding the ultimate cost of claims under the reforms.

- The most significant cost savings are from reductions in the following major areas:



### Reforms Reflected in Insurance Company Rates

As a result of the reforms, insurance companies have:

- Substantially reduced charged rates

Policy Period	Average Insurer Charged Rate per \$100 of Payroll					
	1/03-6/03	7/03-12/03	1/04-6/04	7/04-12/04	1/05-6/05	7/05-9/05
Average Rate	5.79	6.46	6.01	5.75	5.37	4.42

- Not reduced rates as quickly as recommended by the CDI

Policy Period	Cumulative Rate Change from 7/1/03 Rates				
	7/03-12/03	1/04-6/04	7/04-12/04	1/05-6/05	7/05-9/05
Carrier Avg. Rate Reduction*	0.0%	(7.0%)	(11.0%)	(16.9%)	(31.6%)
CDI Approved Rate Reduction	0.0%	(14.9%)	(20.9%)	(22.6%)	(36.6%)

*\*Reflects amount actually charged to policyholders, not filed rates.*

In the current market:

- Insurance company charged rates do not fully reflect the current estimated savings from the reforms. This could be because of concerns related to:
  - Future legislative and regulatory changes that could retrospectively increase costs;

- Future legal decisions which may have a retroactive impact on costs;
  - The potential return of cut-throat pricing; and
  - The unreliability of past actuarial estimates.
- Private insurers are charging lower average rates than the State Compensation Insurance Fund (SCIF).

Percent that Private Insurers Charged Rates are Above (Below) SCIF Rates					
Policy Year	2001	2002	2003	2004	2005
Rate Differential	2.7%	(3.8%)	(9.5%)	(15.1%)	(15.2%)

### ***Impact on Insurance Company Surplus Levels***

Some aspects of the reforms applied retrospectively and are estimated to generate savings on existing claims.

The retroactive savings:

- Have increased insurer surpluses as a result of lower projected claims costs
- Are in addition to savings from the rates discussed in prior sections
- Are not necessarily fully reflected in insurance company filed financials
- Have reduced – and possibly erased – the estimated deficiency of California insurance company filed reserves
- Benefit private insurance companies, SCIF, and California Insurance Guarantee Association.
- Are estimated as follows:

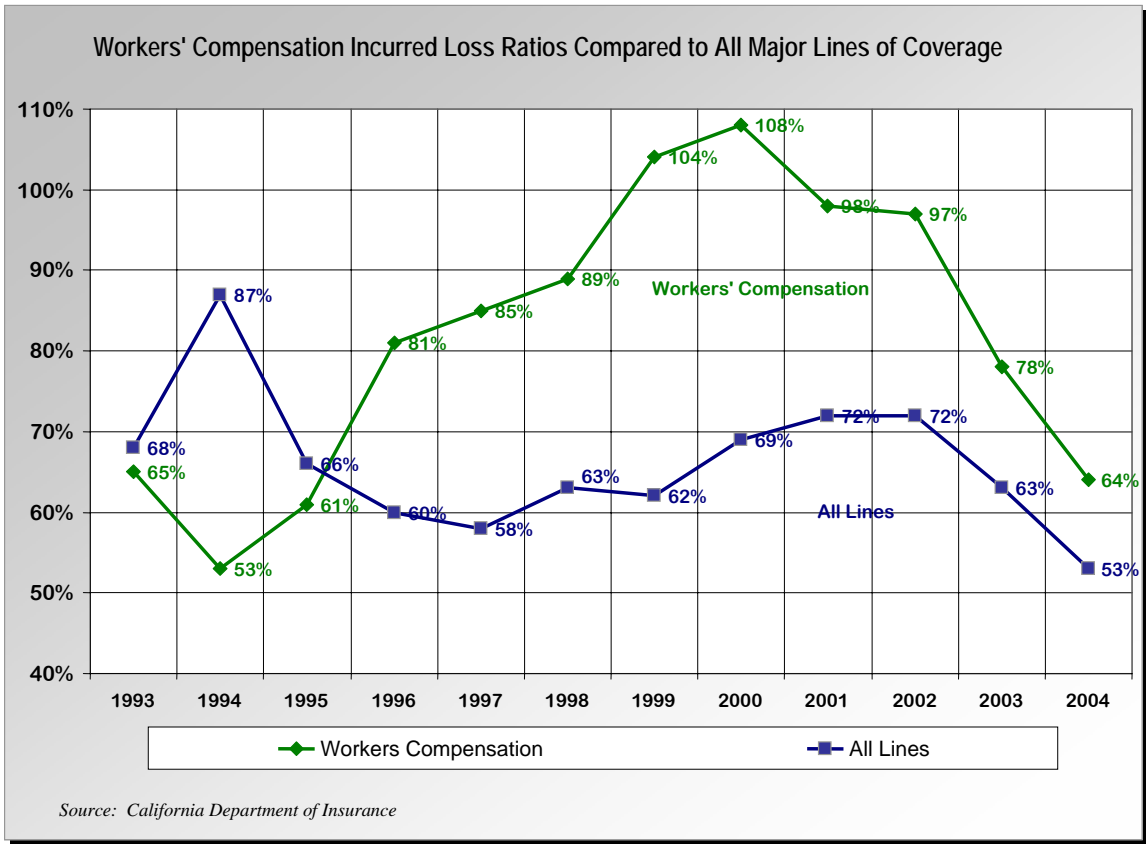
Impact of Reforms on Insurance Industry Reserves (2003 & Prior): (\$Billions)		
Reform	Savings Active Insurers	Savings All Insurers
<b>Medical Fees</b>	\$2.3-\$2.6	\$2.8-\$3.1
<b>Evidence-Based Medicine</b>	\$2.9-\$4.0	\$3.4-\$4.7
<b>Permanent Disability</b>	<u>\$0.2-\$2.8</u>	<u>\$0.2-\$2.9</u>
<b>Total</b>	\$5.4-\$9.4	\$6.4-\$10.7

### ***Insurance Marketplace and Competition***

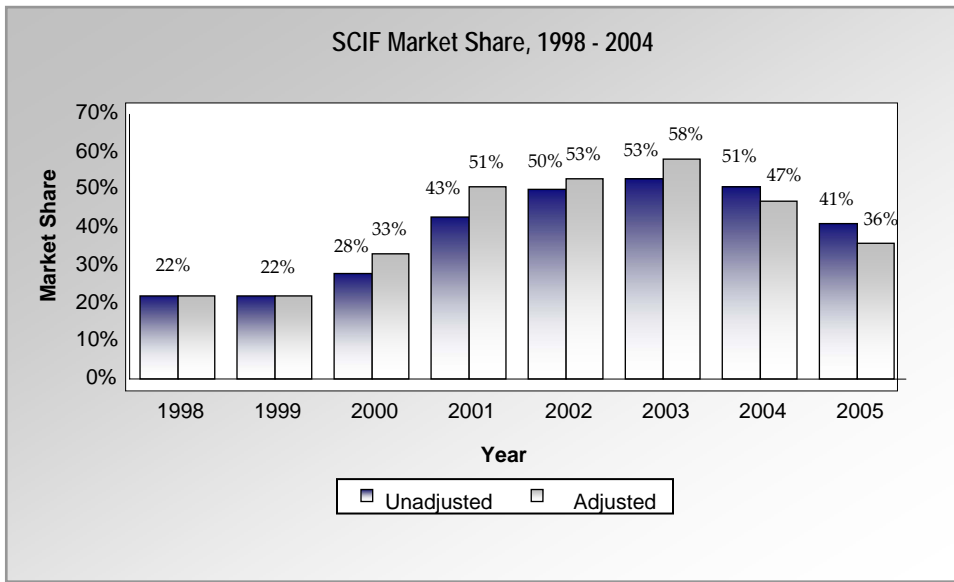
Since the reforms, the California insurance market has become much more competitive:

- Private insurance companies are returning to the California market and increasing their market shares;
- Loss and expense ratios continue to decline, making workers' compensation a profitable line of coverage, likely to attract new markets and capital;
- There is more capital supporting California workers' compensation market; and

- More employers are able to get multiple bids on insurance policies.



SCIF's market share has decreased dramatically.



- The market is still not as competitive as it could be due to:
  - Fewer active insurers than in other states; and
  - SCIF still has a dominant market size

***Comparison to Other States***

California no longer has the highest average filed rates in the United States. As of January 1, 2006, four states have higher average rates: Florida, Montana, Texas, and Alaska.

Pure Premium Relationship to California – Percentage Higher or Lower Approved Pure Premiums at January 1, 2006 Excluding Loss Adjustment Expense			
Higher than California		Lower than California-	
More than 25% Higher	Less than 25% Higher	Less than 25% Lower	More than 25% Lower
Florida	Alaska	Minnesota	Arizona
Montana	Texas		Colorado
			Hawaii
			Massachusetts
			Michigan
			Nevada
			New York
			Oregon
			Wisconsin

*Note: Approved Pure Premiums in California have declined by more than 40% since July 2003.  
Based on comparison of representative sample of classes, adjusted to California's industry mix*

***Adequacy and Accuracy of WCIRB/CDI Rates***

The January 1, 2006, rate reductions recommended by the WCIRB and approved by the CDI:

- Are slightly more conservative (lower) than our middle estimates, but are within the range of reasonable estimates

Estimate	Percentage Rate Change for 2006 Policies		
	BRS	WCIRB	CDI
Low	(5%)		
Middle	<b>(19%)</b>	(15.9%)	(15.3%)
High	(34%)		

- Differ from the BRS' projections primarily because of assumptions related to:
  - Valuation Date of Data: BRS = 3<sup>rd</sup> quarter 2005; WCIRB/CDI = 2<sup>nd</sup> quarter 2005
  - AMA Guides Permanent Disability Schedule
  - Apportionment
  - Evidence-Based Medicine (ACOEM and Utilization Review)



## Other Observations

- Cut-throat competition among workers' compensation carriers could recur. The state should consider assessing the effectiveness of the regulatory system to prevent a recurrence to the major insolvencies which occurred from 2000 to 2004, which would place added financial burden on the California Insurance Guaranty Association (CIGA) and would pass future costs on to employers continuing to operate in the state.
- The state would benefit from monitoring the following on an annual basis:
  - Reasonableness of market pricing (insurer practices that result in pricing that is too high or too low);
  - Insurance market competitiveness by analyzing market share changes;
  - Effectiveness, competitiveness, and financial health of medical provider networks; and
  - Activities in other states and research reports on workers' compensation issues that could be applied in California.
- Cost stability and predictability are keys to fostering a fully competitive environment.
- Insurance companies are concerned about the possibility of future legislative actions and legal decisions that would make losses harder to accurately project and retroactively increase their costs.
- Led by the WCIRB, a very thorough and collaborative plan has been implemented to track the impact of the reforms.
- SCIF still dominates the workers' compensation insurance market in its dual role as a competitive insurer and the insurer-of-last-resort (residual market). This dual role should be reviewed in light of volatile market share shifts and the need for a strong state fund alongside a competitive private market.
- The medical provider network market is:
  - Dominated by a few companies with further consolidation occurring.
  - Becoming vertically integrated to include large cost-control measures in the workers' compensation system such as medical services, utilization review, and bill review.
  - Inclusive of a very broad set of medical providers.

## Report Organization

The report is organized into the following sections:

- I. Background Leading to Workers' Compensation Reforms
- II. Scope and Approach
- III. Claims Savings Generated by Reforms
- IV. Effect of Reforms on Insurance Rates
- V. Effects of the Reforms on Insurance Industry Surplus and Solvency
- VI. Insurance Markets and Competition
- VII. Adequacy and Accuracy of Workers' Compensation Insurance Bureau and California Department of Insurance Rates
- VIII. Evaluation of Reforms in Other States
- IX. Evaluation of Regulatory Structure
- X. Areas of Further Research

### Bibliography

### Appendices

- A. Legal Issues
- B. Accuracy of 7/1/03 Pure Premium Rates
- C. Calculation of Cost Savings from Reforms
- D. Reform Claim Data Review Worksheet
- E. MPN/PPO Interview Questions
- F. Impact of Reforms on Prior Years: Medical Fees
- G. Impact of Reforms on Prior Years: Permanent Disability
- H. Brokerage and Employer Surveys
- I. Rate Change for Policies Incepting in 2006
- J. Historical WCIRB & CDI Rate Changes
- K. State Comparison Matrix
- L. Special Report: 2004 Workers' Compensation Reforms