STATE OF CALIFORNIA

DEPARTMENT OF INSURANCE

300 Capitol Mall, 17th Floor

Sacramento, CA 95814

PROPOSED DECISION

JANUARY 1, 2015 WORKERS' COMPENSATION CLAIMS COST BENCHMARK AND PURE PREMIUM RATES

FILE NUMBER REG-2014-00015

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to the Workers' Compensation Insurance Claims Cost Benchmark and pure premium rates. These regulations will be effective on January 1, 2015.

SUMMARY OF PROCEEDINGS

The California Department of Insurance ("CDI") held a public hearing in the above captioned matter on October 8, 2014, at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number REG 2014-00015, dated August 27, 2014 ("Notice"). A copy of the Notice is included in the record. At the conclusion of that hearing, the Hearing Officer announced the record would be kept open for additional written comment until 5:00 p.m. on Wednesday, October 15, 2014. The record closed on October 15, 2014, at 5:00 p.m.

The CDI distributed copies of the Notice to the persons and entities referenced in the record. The Notice included a summary of the proposed changes and instructions for interested persons who wanted to view a copy of the information submitted to the Insurance Commissioner in connection with the proposed changes. The "Filing Letters" dated August 19, 2014, and September 5, 2014, submitted by the Workers' Compensation Insurance Rating Bureau of California ("WCIRB") and related documents were available for inspection by the public at the Sacramento office of the CDI and were available online at the WCIRB website, www.wcirb.com.

The WCIRB's filing proposes a change in the Workers' Compensation Claims Cost Benchmark and Pure Premium Rates ("Benchmark") in effect since January 1, 2014, that reflects insurer loss costs and loss adjustment expenses ("LAE").

The filings of the WCIRB requested the Commissioner adopt a set of pure premium rates for each classification to be effective January 1, 2015, due to loss and loss adjustment expense experience. In its initial filing, the WCIRB recommended an average pure premium rate of $2.86 per $100 of payroll, which was 11% greater than the average pure premium rates California insurers filed as of July 1, 2014. In its subsequent filing, the WCIRB reduced its recommendation to an average pure premium rate of $2.77 per $100 of payroll, which was 7.9% higher than the average industry-filed pure premium rate as of July 1, 2014.

The CDI accepted testimony and written comments at a hearing in San Francisco on October 8, 2014, and also received exhibits into the record. Members of the public submitted additional materials along with correspondence and documents prior to the hearing. The hearing officer announced the record would close on October 15, 2014. CDI did not receive any additional comments after the hearing and before closure of the record on October 15, 2014, and the matter was submitted for decision at 5:00 p.m. on October 15, 2014. Having been duly heard and considered, the CDI now presents the following review, analysis, and Proposed Decision and Proposed Order.

REVIEW OF WORKERS' COMPENSATION CLAIMS COST BENCHMARK AND PURE PREMIUM RATES FILING

Subdivision (b) of California Insurance Code Section 11750 states that the Insurance Commissioner shall hold a public hearing within 60 days of receiving an advisory pure premium rate filing made by a rating organization pursuant to subdivision (b) of Insurance Code Section 11750.3 and either approve, disapprove, or modify the proposed rate. Subdivision (b) of Section 11750.3 states that a licensed rating organization, such as the WCIRB, shall collect and tabulate information and statistics for the purpose of developing pure premium rates for its insurance company members to be submitted to the Commissioner. Pure premium rates are the cost of workers' compensation benefits and the expense to provide those benefits.

The pure premium rates approved in this process by the Commissioner are only advisory. Insurers are free to accept or ignore the Commissioner's advice and make their own determinations as to the pure premium rates each insurer will use.

CDI Actuaries Ron Dahlquist and Giovanni Muzzarelli provide below in the Actuarial Evaluation a review and analysis based upon the new filing information presented by the WCIRB and the public's comments about the filing. The CDI's actuarial review essentially follows the same approach used for prior pure premium rate filings, but the CDI is now able to review the proposed pure premium rates based upon insurers' actual rate filings. The pure premium rate process serves as an important gauge or benchmark of the costs in the workers' compensation system, but must also reflect the reality of insurer rate filings and the premiums insurers charge to employers.

The pure premium rate process does not reflect an employer's final paid insurance rate or premium. Instead, the purpose of the pure premium process is narrowly tailored to project a specific sub-component of the overall rate. Specifically, the analysis of pure premium in California projects the cost of benefits and LAE for the upcoming policy period beginning January 1, 2015. The term "rate" can be confusing in the pure premium rate context since it is a measurement of claim cost per hundred dollars of employer payroll rather than the rates insurers may charge. The information provided in the current filing shows the following:

- Based upon a review of insurance company rate filings made with the CDI, as of July 1, 2014, insurers are using an average pure premium rate level that is $2.57 per $100 of employer payroll. This figure is lower than the WCIRB's recommended pure premium rate level of $2.77.

- Insurers continue to discount their filed manual rates - the rates that insurers would normally use to price employer premiums before any discounts or surcharges. This discounting results in premiums being charged to employers that are on average close to the cost of claim benefits and adjusting expense. In other words, on average, insurers charge premiums that are not sufficient in the long term to cover the costs of insuring the risk. Insurers filed manual rates are $ 3.80 per $100 of employer payroll, while the rates charged to employers are averaging $2.95. These rates result in a projected 2014 combined ratio of 123%.

- These figures are not predictive of an individual employer's insurance premium. That premium may fluctuate greatly from these figures based upon an employer's business, the mix of employees and operations, and the employer's actual claims experience. It is not possible to determine an individual employer's premium from these figures or from the Commissioner's pure premium determination because the review of pure premium rates represents just one component of insurance pricing.

ACTUARIAL RECOMMENDATION

The WCIRB has proposed an average pure premium rate level of $2.77 per $100 of payroll in its January 1, 2015 rate filing. CDI actuaries' analysis results in an average pure premium rate level of $2.74 per $100 of payroll for reasons set forth in the "Actuarial Evaluation" section that follows. The current industry average level of pure premium rates filed by insurers with the Department is currently $2.57 per $100 of payroll as of July 1, 2014. While the indicated pure premium rate level represents our central estimate, and thus our recommendation, we note that both the WCIRB pure premium rate proposal and the middle estimate of $2.69 from the Public Actuary (Bickmore) are within a reasonable actuarial range.

This WCIRB filing compares its proposed average pure premium rate level to the average industry filed pure premium level. We believe this comparison is useful. It provides an appropriate basis for assessing both the industry's ability to adapt to the proposed pure premium rate level and the size of the potential market impact of such an adjustment.

We note that the WCIRB's proposed pure premium rates are advisory, and insurers are free to make their own decisions as to what pure premium rates they will use in their rate filings. Insurers have proven their willingness over time to exercise their own independent judgment, and we cannot predict the decisions insurers will make with respect to their rate and price levels.

We note that the market currently utilizes a substantial level of schedule credits, averaging something on the order of 20% of manual premium. Collected premiums at actual charged rates in 2013 of $2.89 were, on average, only approximately 5% more than the WCIRB's January 1, 2014 recommended advisory pure premium rates of $2.75, suggesting a high level of competition in the market since advisory pure premium rates make provision only for losses and loss adjustment expenses, and not for other company expenses. While industry collected premiums in the first half of 2014 increased to $2.95, charged rates still do not appear to be at long-term sustainable levels. Our review of the California workers' compensation insurance industry's profitability indicates that the pricing environment continues to benefit from substantial investment income relating to substantially higher premiums in prior years and associated reserves, resulting in an average market price level that is below what would be sustainable without this temporary underlying level of support.

Actuarial Evaluation

The actuarial evaluation will focus on four main components of the analysis: 1) loss development, 2) loss trends, 3) LAE (loss adjustment expense) provision, and 4) the impact of Senate Bill ("SB") 863.

1. Loss Development

The WCIRB utilizes a range of actuarial methods to develop estimates of the medical and indemnity components of ultimate loss. For the January 1, 2015 filing, these various methodologies produced a range from $2.54 per $100 payroll to $2.83 per $100 payroll, relative to the WCIRB's actuarially indicated rate of $2.77.

As shown in Table 1, these methods can be categorized into two main types: paid methods and incurred methods. The paid methods reflect historical payments by accident year, with the various alternative indications reflecting the latest year paid development versus the most recent three-year average, with and without adjustments for changes in insurer mix, and with and without adjustments for reform and for changes in claim settlement rate. Generally the paid methods have performed the best in terms of stability and accuracy.

Incurred methods reflect historical loss payments plus associated case reserves. Due to changes in case reserving practices over time within a given insurer and changes in insurer mix, the incurred methods generally do not produce results that are as stable or accurate as those produced by the paid methods, and thus are not given any weight in the selection process. These methods include a review of latest year versus the most recent three-year average, and with and without adjustments for changes in insurer mix and changes in case reserve adequacy.

The CDI and the Public Members' actuaries agree with the indications developed by each of the methodologies. However, the Public Members' actuary's selected point estimate reflects a weighted average of the paid and incurred methods, whereas the WCIRB selected as its loss development assumption the "latest year paid, adjusted for reform" method.

While the CDI staff shares the Public Members' actuary's concern regarding the recent history of adverse loss development, we support the use of the paid methodology by the WCIRB due to the aforementioned relative historical stability and accuracy. Further, in this filing the WCIRB adjusted its paid methodology to increase expected future medical loss development for more mature evaluation periods, which the WCIRB anticipates will reduce subsequent adverse loss development of medical loss ratios for more recent Accident Years.

Also shown in Table 1 is a comparison of the ranges of the various methods from the 1/1/14 filing versus the current filing. The range of the paid methods is stable while the range of the incurred methods is lowered to that of the paid methods. Table 2 displays the historical adverse loss development in the medical loss ratio, the impact of the aforementioned change in paid methodology reflecting future loss development on mature valuations, and the favorable impact of second quarter loss experience. Table 3 displays the relative impact of these issues.

Table 1

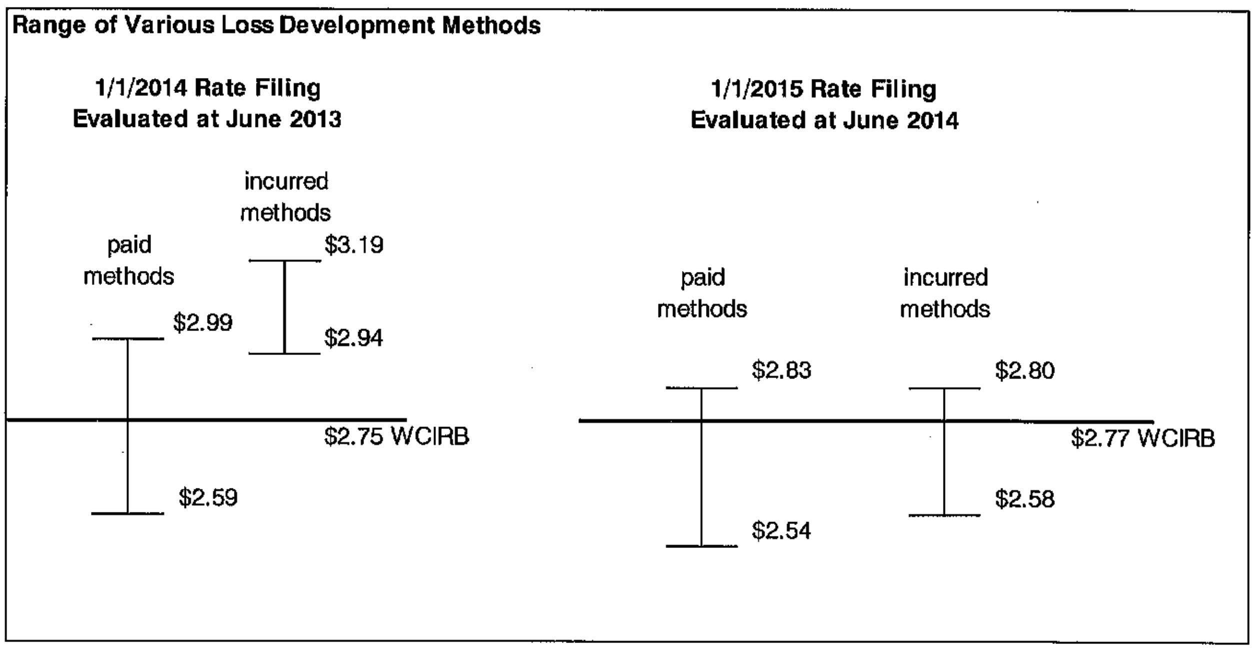
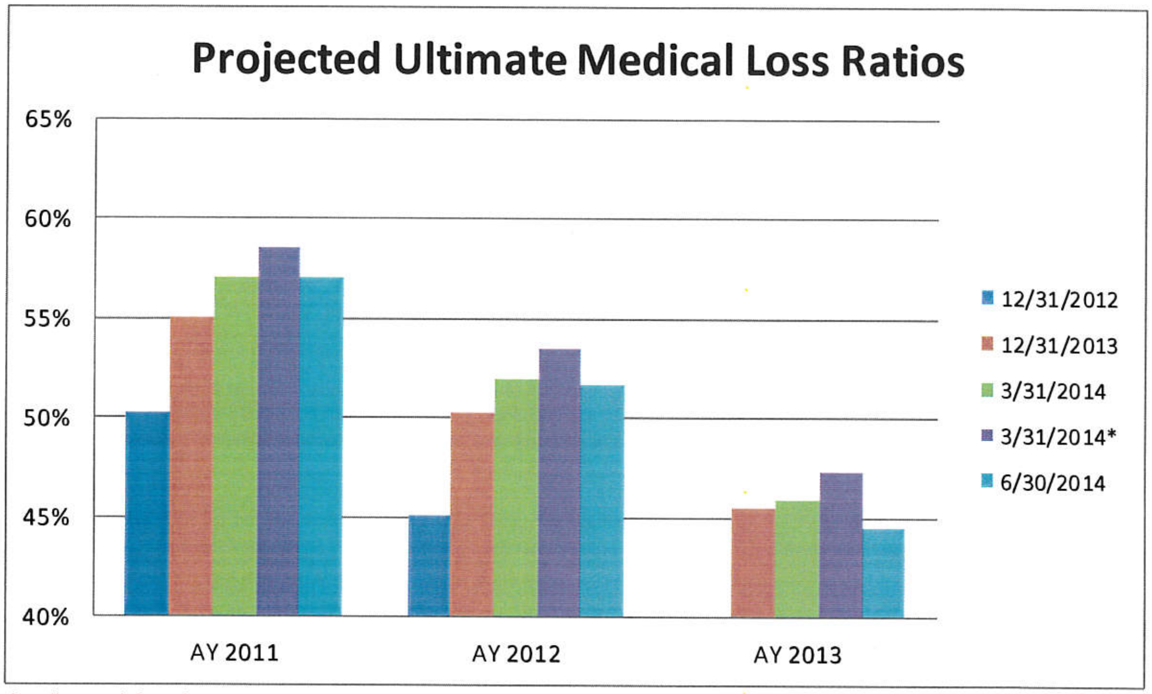


Table 2



* adjusted for change to paid medical loss development for more mature evaluations.

Table 3

WCIRB 1/1/15 PP Rate Filing
Summary of Impacts on PP Rate Indications

	(1) WCIRB		(2) CDI		(3) Bickmore		(4) Industry Filed	
A. Actuarial Indication @ 1/1/14 Filing	2.75		2.70		2.71		2.53	at July 1, 2013
B. Adjusted for class mix	2.74		2.69		2.70		2.57	at July 1, 2014
C1. Expected change due to loss inflation	0.05		0.05		0.16			
updated trend impact	0.00		0.00		(0.10)			
C2. Change in loss experience								
through March 31 data	0.00		0.00		(0.03)			
through June 30 data	(0.09)		(0.09)		(0.05)			
C3. Change in methodology								
adjust paid loss development older AY's	0.09		0.09		0.05			
adjust LAE to exclude State Fund	(0.02)		0.00		0.00			
change pd/inc weights 50/50 to 25/75					(0.06)			
C4. Change in SB 863 assumptions	0.00		0.00		0.00			
D. Actuarial Indication 1/1/15 (= B+C1+C2+C3+C4)								
through March 31 data	2.86							
through June 30 data	2.77	7.9%	2.74	6.7%	2.69	4.7%		% chg vs Industry Filed
		3.0%		2.0%				% chg vs prior CDI
		1.2%						% chg vs prior WCIRB
E. Total SB 863 Impact	(0.02)		(0.05)		(0.22)			
F. Actuarial Indication 1/1/15 ex/ SB 863 (= D-E)	2.79		2.79		2.91			

2. Loss Trends

The WCIRB utilizes a range of trending assumptions to roll-forward the estimates of ultimate losses developed above to the time period reflected in the filing.

The various trend assumptions differ in terms of 1) the particular historical time period used to determine severity and frequency trends, and 2) the point in time at which these trends are applied to roll forward to the future time period of the filing.

As shown in tables 4 and 5, indemnity and medical severity trends over the most recent time frame (2010-2013) have decreased relative to longer-term historical averages (2006-2009), discussed further following the severity and frequency slides.

Table 4

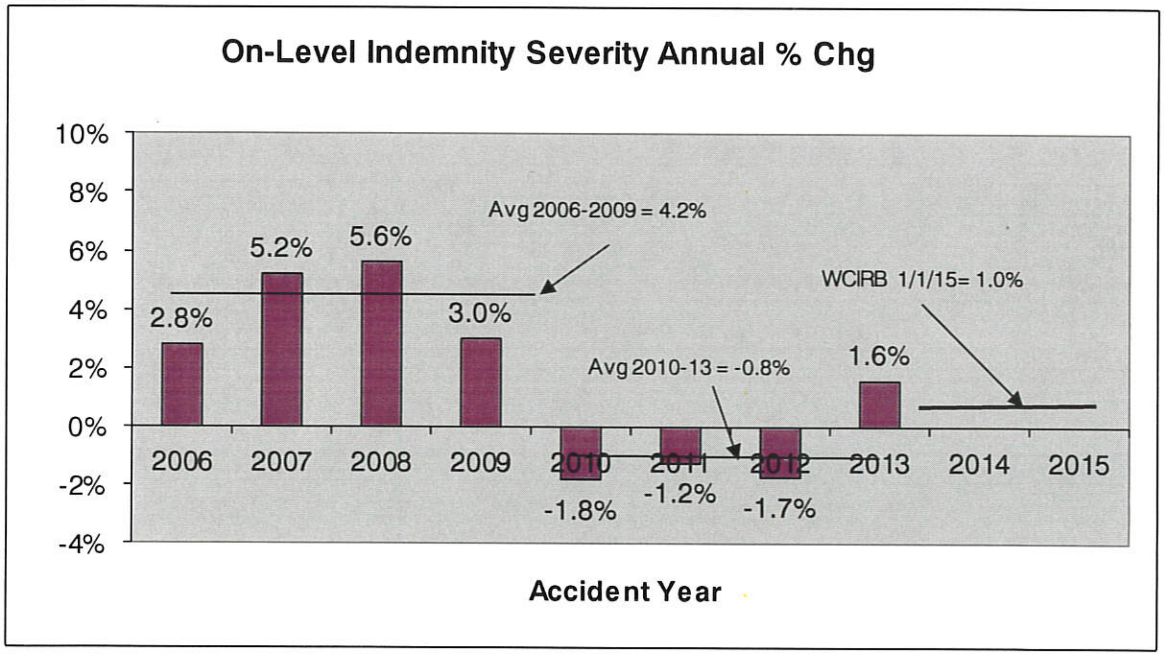


Table 5

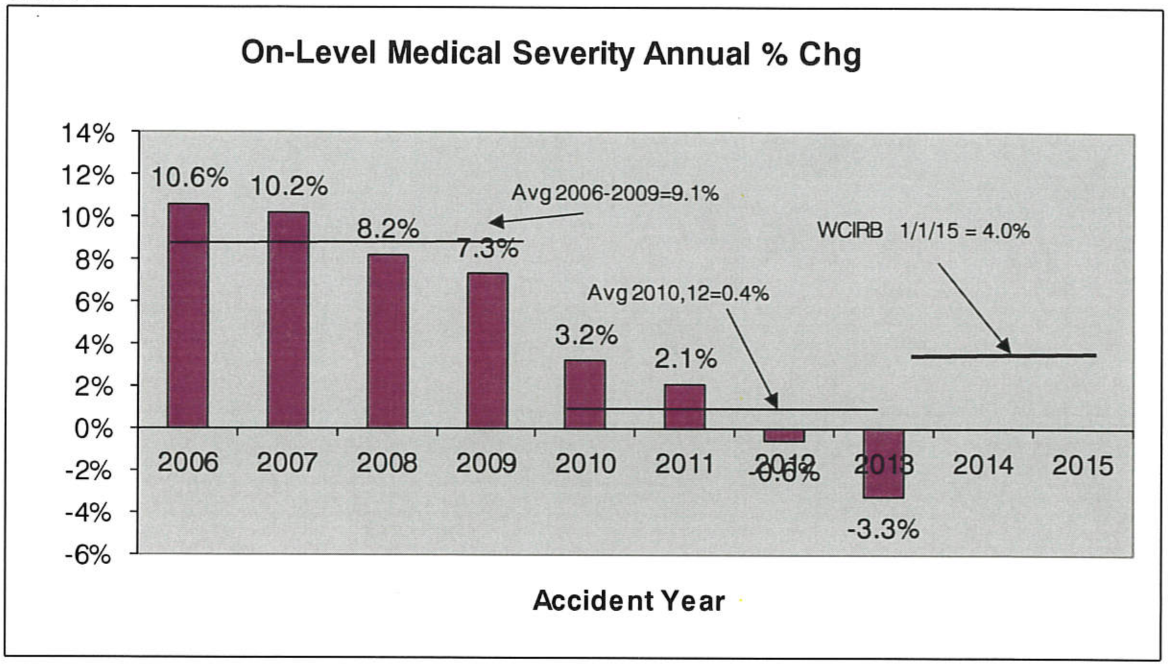
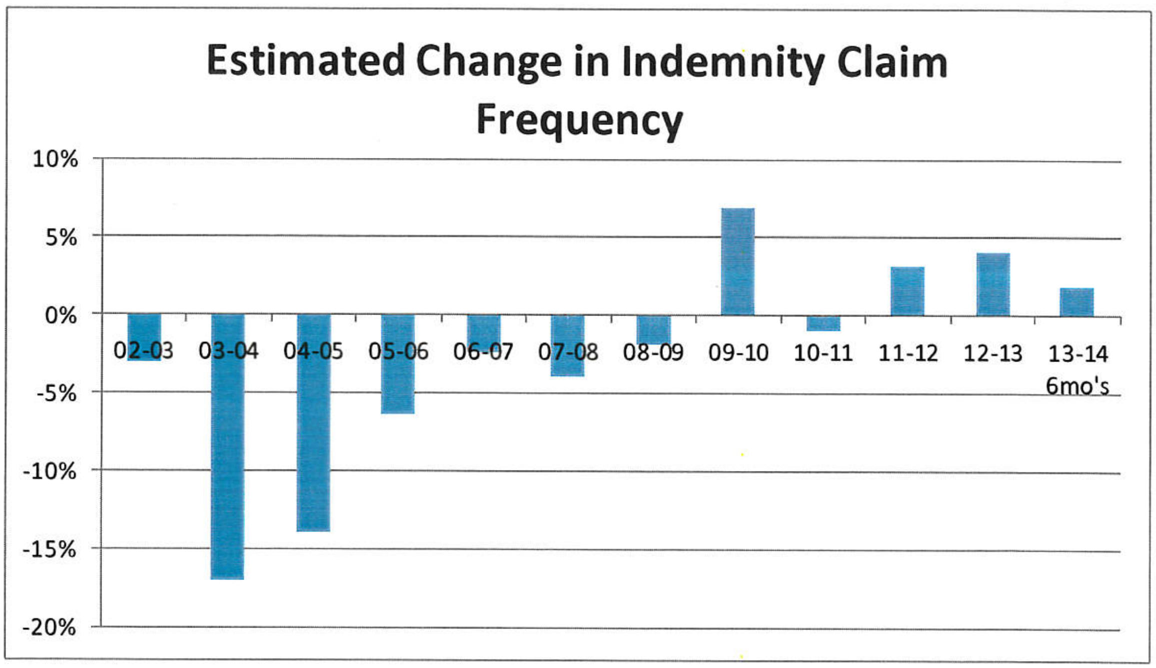


Table 6



We note that the low to negative severity changes indicated for accident years 2010 through 2013 are driven by the unusual increases in frequency shown in Table 6, above, in 2010-2013. The WCIRB is performing ongoing analysis to help determine the driver(s) of this frequency increase. One possible explanation is that this is a result of an increase in small claims that previously were medical-only claims, possibly connected to the state of the economy. The National Council on Compensation Insurance ("NCCI"), which provides data collection and rate development for approximately 35 states and performs a role similar to the WCIRB in California, has noted this increase in frequency nationwide. A second driver may be an observed increase in cumulative injury claims, where claims are made with multiple body parts and can include a psychiatric component.

One public comment received during the hearing stated a concern that the WCIRB was selecting going-forward trends for both indemnity and medical severity that appear high relative to the most recent accident years. The commenter observed that the recent increase in cumulative injury claims, which may be contributing to the increase in frequency, has reached a plateau and thus would have no further impact on the trend going forward. This is not an unreasonable observation and interestingly, is opposite that of the Public Members' actuary as described below. As noted below, one cannot consider severity trends without also considering what is happening with frequency.

The main difference of opinion on the trend issue between the Public Members' actuary and the WCIRB is the use of separate indemnity and frequency trends versus a combined pure premium trend. The WCIRB applies separate trends as previously described, whereas the Public Members' actuary suggests using a combined trend to limit the impact of the increased frequency of small claims in recent Accident Years. As shown in tables 7 and 8 below, the result of the separate trends is a very reasonable continuation of the loss ratio trend for both indemnity and medical, and CDI concurs with the WCIRB's approach.

While we agree with the Public Members' actuary that stability is desired and that the Public Members' approach is more stable, we are concerned that we are in a period of change in which responsiveness to changing conditions is of greater than usual importance. The separate severity and frequency trends are telling us that the environment is changing, and while we do not yet have a full understanding of the changes that are happening, the separate analysis of frequency and severity provides information that the combined trend seems to smooth and to mask.

Table 7

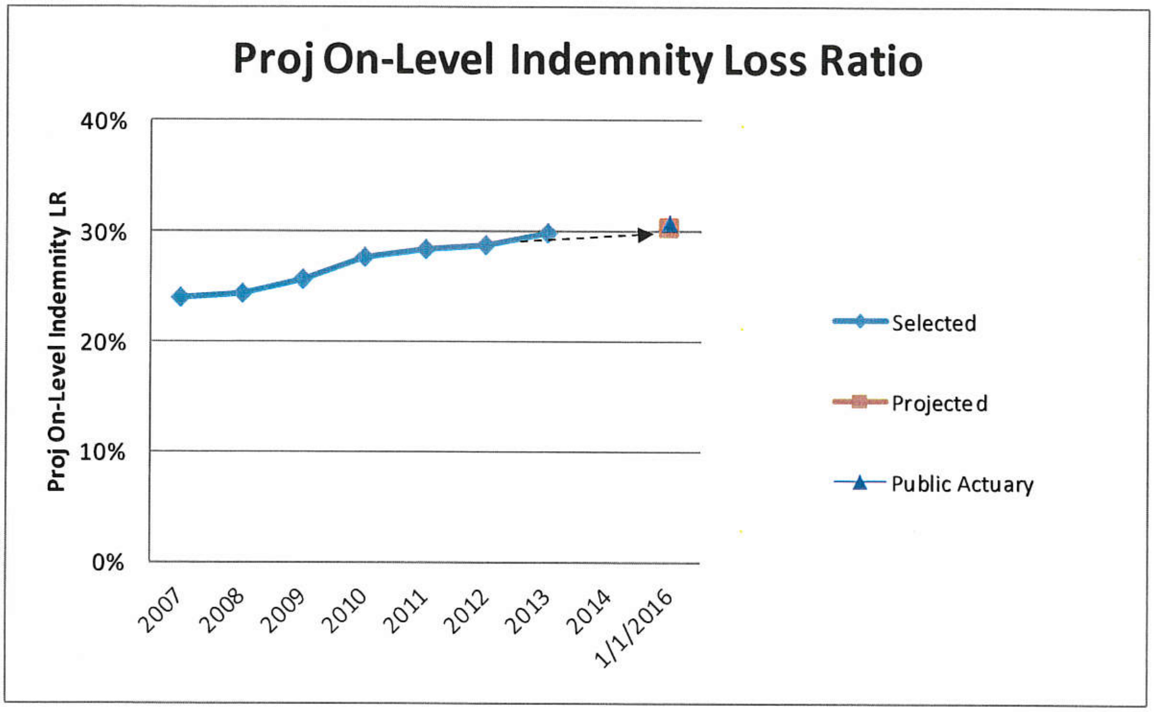
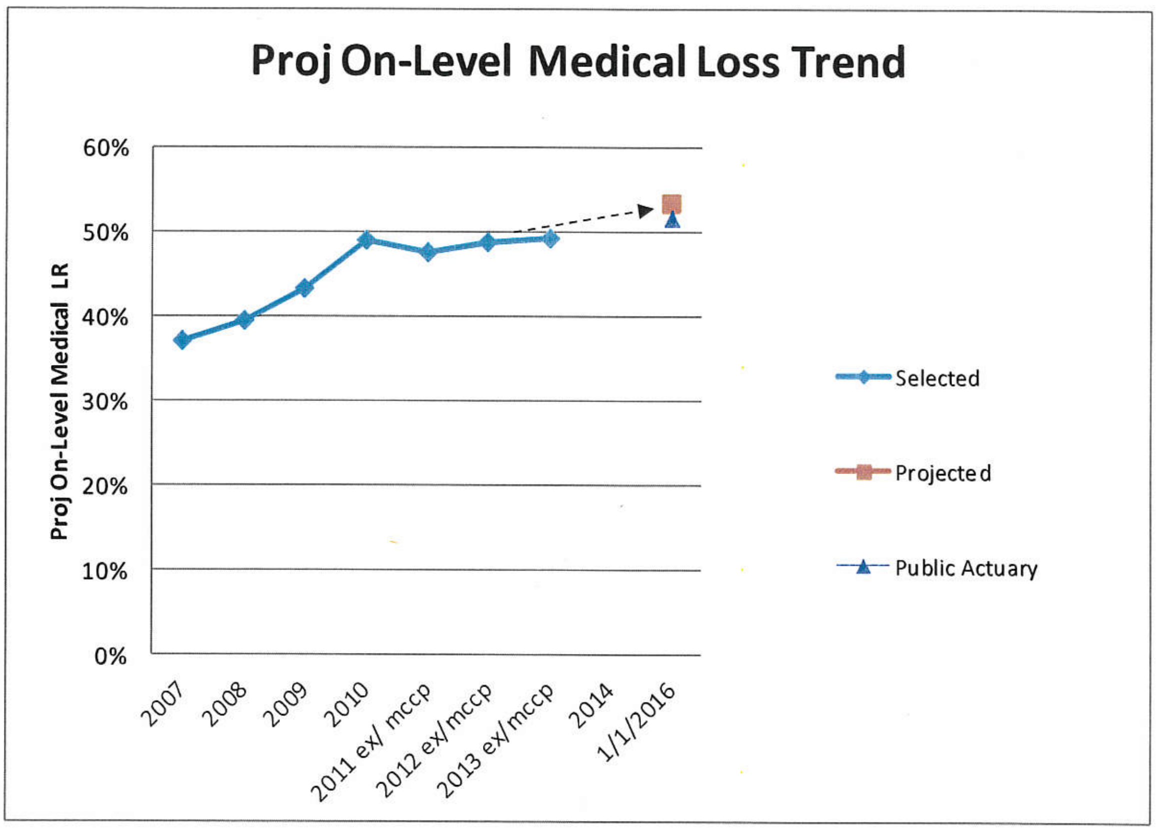


Table 8



We note that the medical loss ratios in Table 8 for Accident Years 2011 and subsequent do not reflect costs associated with medical cost containment ("MCC"), which have been separated from medical losses by the WCIRB in their analysis per direction from the CDI and are now included in loss adjustment expense. As the WCIRB started separating MCC expenses from loss in 2011, medical loss ratios for Accident Years prior to 2011 in the table above still include MCC.

3. Loss Adjustment Expenses

In its determination of the provision for loss adjustment expenses ("LAE") in the proposed rates, the WCIRB developed separate indications for the allocated loss adjustment expense ("ALAE") and unallocated loss adjustment expense ("ULAE"). In doing so, the WCIRB considered the historical ALAE and ULAE experience of all companies in the market, including the State Compensation Insurance Fund ("SCIF").

In prior filings, the WCIRB has reflected the experience of SCIF in its calculations of ALAE and ULAE, albeit on a tempered basis (50% of market share). As CDI staff has noted in prior filing reviews, SCIF's LAE ratios include a significant component of excess expense, and CDI staff actuaries believe this excess expense should not be included in a prospective estimate of industry average costs required to settle claims in the future. The Public Members' actuary concurs with CDI on this issue.

In this filing, the WCIRB has adjusted its methodology to reflect only private carrier data in its evaluation of ALAE and ULAE. CDI staff concurs with this change in methodology.

Table 9

LAE Provision Underlying 1/1/2015 Rate Filing

	All Carriers	Private Carriers	WCIRB Selected
ALAE/Loss	20.7%	22.1%	22.1%
ULAE/Loss	7.4%	5.4%	5.4%
Total ALE/Loss	28.1%	27.5%	27.5%
			WCIRB
Indicated Rate			$2.77

With regard to the trend assumption underlying the ALAE provision, the WCIRB reviews a number of different methods and considers various trend periods as well as trend bases. The trend underlying the selected method is a 6% change in ALAE dollars per indemnity claim per year, the same as in the 1/1/2014 filing.

4. Impact of Senate Bill 863

In developing its actuarially indicated pure premium rates, the WCIRB included its estimate of the effect of SB 863. The net impact of SB 863 as calculated by the WCIRB is a reduction in pure premium rate of 0.9%, or $0.02, resulting in the net filed pure premium of $2.77. The components of this net impact are shown below in Table 10.

Table 10

WCIRB 1/1/15 PP Rate Filing

Summary of SB 863 Impacts in PP Rate Indications

	(1) WCIRB	(2) CDI	(3) Bickmore
A. PD Increase 1/1/13 Filing	0.09	0.09	0.08
B. System Savings 1/1/13 Filing *	(0.21)	(0.24)	(0.34)
C. Net SB 863 Impact in 1/1/13 Filing C=A+B	(0.12)	(0.15)	(0.26)
D. Addn'l PD Increase 1/1/14 Filing	0.05	0.05	0.04
E. RBRVS Impact 1/1/14 Filing	0.05	0.05	-
F. Net SB 863 Impact in 1/1/14 Filing F=C+D+E	(0.02)	(0.05)	(0.22)
G. Change in SB 863 Assumptions 1/1/15 Filing (more favorable lien volume offset by less favorable IMR volume)	0.00	0.00	0.00
H. RBRVS Impact 1/1/15 Filing	0.00	0.00	0.00
I. Net SB 863 Impact in 1/1/15 Filing I=F+G+H	(0.02)	(0.05)	(0.22)

* Note that (.21) equates to $1.5 Billion system savings

In developing its actuarially indicated pure premium rates, the WCIRB included its estimate of the effect of SB 863. This estimated effect was the result of an effort that solicited input and participation from a number of individuals and groups from the industry, government, and the academic community including the Commission on Health, Safety, and Workers' Compensation ("CHSWC"); the California Workers' Compensation Institute ("CWCI"); Bickmore Risk Services ("BRS"); and the CDI. This effort began as the bill was in its developmental stages and took place over a period of several months in 2012. The WCIRB's final actuarially indicated estimates of the effect of SB 863 are the result of this collaborative effort.

The actuarial section underlying the proposed decision and order of last year's filing contains a detailed explanation of the WCIRB's individual assessment of the numerous components of SB 863, as well as comparison with estimates developed by other involved parties - especially Bickmore.

The one component of SB 863 that is calculated for the first time in the current filing is the impact of adopting a new physician fee schedule based on the Resource Based Relative Value Scale ("RBRVS"). The WCIRB reviewed an analysis developed by the RAND Corporation on behalf of the Department of Workers Compensation for this purpose. The WCIRB made several adjustments to the RAND analysis, including reflecting i) the mix of physician services which better matches current accidents covered by insurers, and ii) a more complete mapping of all services.

As a result of the fee schedule changes, some services such as medicine and evaluation & management will see significant fee increases, while others such as surgery and radiology will see significant fee decreases. The WCIRB has factored in a zero impact due to a change in utilization patterns based on changes in relative fees by service, and indicates that there is little research literature available on the topic. We have asked the WCIRB to pursue further study and analysis regarding potential changes in utilization patterns arising from the fee schedule change.

In general, CDI concurs with the WCIRB in its assessment of SB 863, with one exception. The WCIRB does not reflect any medical cost savings due to Independent Medical Review ("IMR"), whereas CDI believes that it is reasonable to expect a 2.5% reduction in medical costs, consistent with our evaluation last year and equivalent to an additional $0.03 savings attributable to SB 863.

We have called upon the WCIRB to do a study of how medical disputes are likely to be settled in California under the new IMR process, how this may be different from the past settlement process, and what cost savings, if any, are likely to occur as a result. This study is in progress, and we look forward to its results. We will also require that the WCIRB study the impact of IMR on actual claim settlements during 2013 and subsequent years. As we have done in the past, we will ensure that any observed savings are included in reductions to the pure premium rates as soon as practically possible.

Relationship of the Proposed Pure Premium Rates to Current Industry Filed Pure Premium Rates, Manual Rates, Final Charged Rates, and Insurer Profitability

Based on data developed by the WCIRB, it appears that the industry average filed pure premium rate level at July 1, 2014 of $2.57 is 7.2% lower than the WCIRB actuarially indicated pure premium rate of $2.77. Further, the average filed manual rate of $3.80 indicates an average loading for expenses and underwriting profit (less investment income offset) of 47.9% of pure premiums or 32.4% of manual premium. Comparing it to final charged rate levels of $2.95 in the first half of 2014 indicates a substantial use of schedule credits or other discounts by the industry, on the order of 20% of manual premium.

We believe that the primary reason why insurers are willing and able to offer such discounts is due to the unusually high level of investment income arising from premiums and reserves associated with policies written in prior years at higher rate and loss levels during the pre-reform era. As indicated in WCIRB's executive summary of this filing, the California workers compensation industry generated a return on net worth of approximately 7.4% in 2011 and 3.9% in 2012. Further, the WCIRB projects loss ratios for Accident Years 2012 and 2013 to be 14 points and 10 points higher than what the industry has booked, respectively. As the industry's held loss and loss expense reserves now appear lower than WCIRB indications across all Accident Years in aggregate, current market pricing appears sustainable in the near-term due to investment income but is not sustainable in the long-term.

DETERMINATION OF WORKERS' COMPENSATION CLAIMS COST BENCHMARK BASED UPON CURRENT FILING

It is the determination of this Hearing Officer, based upon the current filing and public comments received, that the Insurance Commissioner should adopt advisory pure premium rates that are on average 6.6 % greater than the insurance industry's average filed pure premium rate of $2.57 per $100 of payroll (as of July 1, 2014). Stated another way, the Hearing Officer recommends that the Commissioner adopt an average pure premium rate of $2.74 per $100 of payroll. This recommended average rate is proposed to be effective with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2015. The change in the Benchmark is based upon the hearing testimony and an examination of all materials submitted in the record as well as the Actuarial Recommendation and Evaluation set forth above by CDI Actuaries Ron Dahlquist and Giovanni Muzzarelli.

PROPOSED ORDER

IT IS ORDERED, by virtue of the authority vested in the Insurance Commissioner of the State of California by California Insurance Code sections 11734, 11750, 11750.3, 11751.5, and 11751.8, that the WCIRB's filed advisory workers' compensation pure premium rates and Sections, 2353.1 and 2318.6 of Title 10 of the California Code of Regulations shall be amended and modified in the respects specified in this Proposed Decision;

IT IS FURTHER ORDERED that pure premium rates for individual classifications shall change based upon the classification relativities reflected in the WCIRB's filing to reflect an average Workers' Compensation Claims Cost Benchmark and advisory pure premium rate of $2.74 per $100 of employer payroll, to be adjusted to the relative classifications consistent with this Proposed Decision;

IT IS FURTHER ORDERED that the experience rating threshold shall be calculated to reflect the adjustment of the Workers' Compensation Claims Cost Benchmark and advisory pure premium rates; and

IT IS FURTHER ORDERED that these regulations shall be effective January 1, 2015 for all new and renewal policies with anniversary rating dates on or after that date.

I CERTIFY that this is my Proposed Decision and Proposed Order as a result of the hearing held on October 8, 2014, and I recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

November 10, 2014

Patricia Hein
Attorney IV