Improving the Performance of the California Workers’ Compensation Insurance Market

Since insurance rates were partially deregulated in 1995, the California workers’ compensation market has been very volatile. Insurers’ underwriting profits plunged and then rose to historically high levels, premiums have varied widely, and some of the largest workers’ compensation insurers in the state have failed. These trends have been costly to the state’s employers, injured workers, and California residents more generally.

The California Commission on Health and Safety and Workers’ Compensation asked researchers from the RAND Corporation and Navigant Consulting to identify factors contributing to these market swings. The researchers examined a sample of insolvent and surviving insurer groups, interviewed interested parties, and analyzed data to identify the key factors driving the unpredictable market. Using their findings, they made recommendations to help reduce the volatility of the market and the frequency of insolvencies while realizing the benefits of a competitive market.

Key Findings and Recommendations

Claim-Cost Projections Were Inaccurate
For reasons that had little to do with price deregulation, the cost of workers’ compensation claims rose significantly between 1995 and 2002. Delayed recognition of this increase contributed to the insolvencies. Without accurate estimates of expected future claim costs, insurers tended to price policies too low and collect insufficient revenue to cover future claim payments.

To improve the accuracy of cost projections, the authors make recommendations that aim to make the system more predictable and to enable the relevant government and private organizations to better project costs. Principal among them are urging the California legislature to reduce uncertainty about the likely impacts of legislative reforms by writing legislation in more-explicit language and providing the Workers’ Compensation Insurance Rating Bureau (WCIRB) with more-comprehensive data on workers’ compensation claims.

Insurers Priced Policies Below Projected Costs
The pricing practices of insurers during the second half of the 1990s contributed to the surge in insolvencies. Insurers charged prices that were below the already low projections of claim costs, further reducing revenue below future claim costs.

The figure shows the ratio of the premium charged by insurers to the projected claim costs estimated by the California Department of Insurance (CDI). A ratio of at least 1.2 is recommended for insurers to cover the cost of writing the policies and paying claims. As the figure shows, the ratio fell below 1.0 for insurers as a whole between 1995 and 2000, with an even lower ratio for the eight insurers selected for detailed analysis that ultimately became insolvent.

Rather than return to stricter price regulation, the researchers recommend increasing pricing discipline in an open-rating setting. For example, they suggest that the CDI make more...
insurers' profitability concerns.

The authors recommend changes that will better align the incentives created by reinsurance contracts and MGA contracts, such as (1) assessing the adequacy of the requirement that insurers retain at least 10 percent of the risk in a reinsurance transaction and (2) broadening the legal definition of MGA so that firms that take on the insurance functions of an insurer cannot avoid being classified as an MGA and avoid regulations already in place on MGAs.

Arrangements with Reinsurers and Managing General Agents Created Poorly Aligned Incentives

Insurers purchase reinsurance from other insurers to spread risk. But the reinsurance arrangements that arose in the second half of the 1990s contributed to at least some of the insolvencies. The fundamental problem was that the reinsurance arrangement created incentives for insurers to reduce prices, relax underwriting standards, and passively process claims. Also, the arrangements between insurers and managing general agents (MGAs), who are frequently empowered by an insurance company to underwrite policies on their behalf, created conflicts between MGAs' growth goals and insurers' profitability concerns.

The authors propose a number of changes to improve the performance of the RBC system in these circumstances. For example, the CDI and the NAIC should explore the advantages and disadvantages of more-stringent targets for policyholder surplus and modify the RBC system to better reflect the risks faced by insurers whose business is concentrated in states with a difficult workers’ compensation market.

Conclusion

The researchers acknowledge that this complex confluence of events may not happen again and that the key actors may learn from their mistakes. However, memories are short, and many of the same incentives, institutions, and regulatory practices that have contributed to the market volatility and insurer insolvencies during the past 15 years remain in place. It is thus important that the recommendations in the monograph be considered, refined as appropriate, and implemented to help stabilize the workers’ compensation market in the future.

This research brief describes work done for the RAND Center for Health and Safety in the Workplace documented in California’s Volatile Workers’ Compensation Insurance Market: Problems and Recommendations for Change, by Lloyd Dixon, James W. Macdonald, and William Barbagallo, MG-949-CHSWC (available at http://www.rand.org/pubs/monographs/MG949/), 2009, 164 pp., $32, ISBN: 978-0-8330-4921-6. This research brief was written by Kate Giglio. The RAND Corporation is a nonprofit research organization providing objective analysis and effective solutions that address the challenges facing the public and private sectors around the world. RAND’s publications do not necessarily reflect the opinions of its research clients and sponsors. RAND® is a registered trademark.
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