AMERICAN ACADEMY *of* ACTUARIES

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Analysis of Past, Present, and Future Potential Crises

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The American Academy of Actuaries appreciates the opportunity to provide comments to the NCOIL Workers' Compensation Committee on the state of the workers' compensation system. The Academy is nonpartisan, does not take positions on issues, and assists policymakers by presenting clear and objective actuarial analysis. The Academy also works closely with state and federal officials on insurance issues, provides testimony, and comments on proposed legislation and regulations.

In March 2000, the Academy's Workers' Compensation Working Group (WCWG) published a monograph titled "The Workers' Compensation System: An Analysis of Past, Present and Potential Future Crises". This presentation was prepared by the WCWG to briefly summarize our monograph and apprise you of recent developments since its publication.

The National Council on Compensation Insurance, Inc. and other organizations have recently reported alarming financial results for the workers' compensation insurance industry. Countrywide combined ratios now exceed 120% and are worse than the financial results experienced in the last crisis at the end of the 1980s. The key questions today are: is the entire system in crisis, or is the insurance industry just having severe financial difficulties, and are the causes of the current financial troubles different from the ones that caused the crisis of the late 1980s? This presentation reviews the forces that caused the crisis in the late 1980s, discusses changes that have occurred in the past decade and describes the current difficulties facing the system. It also addresses the relationships between crises and reform, economic factors and workers' compensation costs, managed care and claim severity, competitive rating laws and insurance prices, and residual market reforms and the size and profitability of residual market mechanisms.

Crises and Reform

In the past, workers' compensation reforms have usually been enacted in response to a crisis. Typically, business seeks affordable and stable costs, labor wants adequate and prompt benefit payments, the insurance industry desires reasonable profits, and doctors, lawyers, hospitals and others want to preserve their share of the system. These competing interests often force a stalemate in matters of public policy debate until a crisis forces state legislators to take action.

In the 1970s, states adopted changes including higher weekly maximum benefits and escalation of benefits in response to concerns that existing benefits were inadequate. These changes improved benefits to injured workers and significantly increased the cost of the workers compensation systems. However, rating bureaus were unable to predict adequately the size of cost increases resulting from increased benefit utilization and the expanded role of service providers. Also, it was often difficult to obtain regulatory approval of the sizeable rate increases needed to restore rate adequacy, so it took several years for the approved rates to catch up with the underlying increases in costs.

In the 1980s on the other hand, there were relatively few statutory benefit changes enacted. Despite this, costs rose 10%-15% per year, driven by high medical inflation, increased utilization, judicial interpretations, and lingering effects of the 1970s statutory changes. It was difficult for approved rate changes to keep pace with the magnitude of these cost increases, thus loss ratios deteriorated and a crisis ensued. This crisis drove a wave of administrative reforms, benefit reductions, and other system changes that occurred during the early and mid-1990s and contributed to improved insurer profitability. There was little activity in the late 1990s in the area of system reforms. Today, there are several state and federal initiatives under way that may increase benefits, possibly undo some of the previous cost saving reforms, and could ultimately increase system costs.

The Economy and Costs

Although the relationships are complex, changes in the economy can have a significant impact on costs, both with respect to claim frequency and severity. Two of the reasons that the crisis of the 1980s ended and profitability increased in the 1990s were a dramatic decrease in claims frequencies and a reduction in claim severity trends. We are currently nearing the end of one of the longest economic expansions in history, which combined with a severe labor shortage, has led to higher wages and increased automation which contributed to the dramatic drop in claim frequencies and reduction in the duration of disabilities, i.e. it pays more to be at work than out on disability. However, there is concern that the current economic slowdown may increase both the number and duration of claims, perhaps significantly, due to reduced employer investments in safety, increases in overtime, potential layoffs and the lack of available gainful and/or substitute employment.

Managed Care & Claim Severity Trends

The introduction of managed care techniques in the early 1990s also improved workers' compensation insurance results by reducing claim severity trends. In the 1980s, workers' compensation health costs were rising much faster than general medical costs. However, in the early 1990s, states responded to these cost pressures by passing reforms, allowing managed care techniques such as implementation of utilization review and nurse case management. The rate of change in workers' compensation health care costs fell to levels comparable to those in general health care in the mid 1990s. But by the end of the 1990s, these costs once again began rising faster than general health care costs. It is thought that the majority of managed care initiatives and resulting savings may have worked their way through the system by the end of the 1990s. Furthermore, there is a possibility that a backlash against the managed care reforms of the 1990s may further increase workers' compensation costs.

Competitive Rating & Price Competition

The expansion of competitive rating, combined with the elimination of bureau advisory rate inadequacies, has led to greater price competition in the workers' compensation insurance industry. Prior to the early 1980s, insurers operated in an administered pricing environment where rating bureaus filed rates for all insurers. Competition was achieved in substantial part through service and "back end" dividend plans. Starting in the early 1980s, states began passing laws allowing for competitive rating. These changes ranged from allowing schedule rating and deviations from bureau rate levels to banning bureaus from publishing advisory rates that included expenses. While these competitive tools were available, they were not widely used in the latter half of the decade due to regulatory disapproval of requested bureau rate increases.

Both small and large employers benefited tremendously from an expansion of these competitive rating law changes in the early-to-mid 1990s. In hindsight, bureau advisory rate indications tended to overstate the actual costs that emerged during this period, in part due to time lags in data reporting. Many insurers began to look at their own data and form independent opinions, and competitive rating laws allowed these analyses to be reflected in individual company pricing. Price competition became so intense in the latter part of the 1990s that many large employers abandoned self-insurance programs to purchase guaranteed cost policies at very low prices. With the recent unfavorable trends in workers compensation insurance financial results, many employers are now experiencing price increases and alternative market mechanisms are growing once again.

Residual Market Reforms & Results

Residual market reforms during the 1990s eliminated assigned risk plans or helped to reduce their size and operating losses. The long-term viability of these reforms will be tested as residual market mechanisms once again begin to grow during the new decade. Residual market mechanisms are entities that were created or designated to guarantee availability of coverage. During the advent of competitive rating in the 1980s discussed above, residual market pools grew significantly in size because the pool rates approved by regulators acted as a cap on voluntary market rate levels. Because these residual market rates were often severely inadequate, assigned risk pools in many states were essentially insolvent. Private insurance carriers were forced to absorb pool losses and incorporate these costs as additional expenses in their voluntary market risk selection and pricing decisions. This rendered voluntary-market rates more inadequate, in turn causing further growth in the residual market.

In response to the last crisis, some states replaced their assigned risk plans with state funds or other mechanisms. Other states worked to reduce expenses and depopulate the pools by putting servicing carrier fees out to bid and implementing pricing programs aimed at increasing premium. By the end of the 1990s, less than half the states had assigned risk pools, and those that remained had become much smaller and in many cases were self-supporting. Today, both types of residual market mechanisms are growing again, although assigned risk pools are still generally small relative to the size of the voluntary market. In the next decade, rate adequacy in both the voluntary and residual markets will play a key role in determining the size and viability of residual market mechanisms.

Conclusion

In conclusion, the current workers' compensation crisis is primarily a financial crisis for insurers, however, all parties in the workers' compensation system face an emerging crisis due to rising insurance prices and underlying system costs. Competitive pressures during the late 90s have driven insurance prices substantially below the cost of benefits and other expenses and sent industry combined ratios soaring above 120% (exceeding levels experienced in the late 80s). Consequently, in the last two years, insurers have begun to increase prices by raising rates and/or relaxing their use of competitive rating tools. Still, there is a long way to go before prices and costs are reconciled. If the economy continues to deteriorate or if system reforms increase benefits or restrict the ability to manage claims effectively, system costs could rise even faster, requiring greater price increases. As the underlying cost crisis emerges, legislative or regulatory action may be proposed to undo past competitive rating law changes and to limit insurance price increases through rate regulation rather than addressing underlying costs. In considering legislation, the challenge for policy makers is to recognize all of the many different and potentially conflicting interests that arise in this complex system while keeping insurance prices and system costs in balance.