STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 17th Floor
Sacramento, CA 95814

PROPOSED DECISION

JULY 1, 2018 WORKERS' COMPENSATION CLAIMS COST BENCHMARK AND ADVISORY PURE PREMIUM RATES

FILE NUMBER REG-2018-00006

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to the Workers' Compensation Insurance Claims Cost Benchmark and advisory pure premium rates. These regulations will be effective on July 1, 2018.

SUMMARY OF PROCEEDINGS

The California Department of Insurance ("Department") held a public hearing in the above-captioned matter on May 2, 2018, at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number REG-2018-00006, dated and sent on April 9, 2018 ("Notice"). A copy of the Notice is included in the record. The record closed on May 3, 2018, at 5:00 p.m.

The Department 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 letter dated April 10, 2018, along with the filing and related documents submitted by the Workers' Compensation Insurance Rating Bureau of California ("WCIRB"), were available for inspection by the public at the San Francisco office of the Department and were available online at the WCIRB's website, www.wcirb.com.

The WCIRB's filing proposes a change in the Workers' Compensation Claims Cost Benchmark and advisory pure premium rates ("Benchmark") in effect since January 1, 2018, that reflects insurer loss costs and loss adjustment expenses. The WCIRB's filing recommended that the Commissioner adopt an amended set of pure premium rates for each classification to be effective July 1, 2018 due to favorable loss development on older accident years and favorable loss emergence on the 2017 accident year. This information was not available at the time of the January 1, 2018 Pure Premium Rate filing. In its July 1, 2018 filing, the WCIRB recommended an average pure premium rate of $1.80 per $100 of payroll, which is 19% less than the average pure premium rate of $2.22 that California insurers filed as of January 1, 2018.

The Department accepted testimony and written comments at a hearing in San Francisco on May 2, 2018, and also received exhibits into the record. Members of the public submitted additional materials along with correspondence and documents prior to the hearing. The Commissioner announced that the record would close on May 3, 2018. The Department received into the record additional information and documents from the WCIRB and the matter was submitted for decision at 5:00 p.m. on May 3, 2018. Having been duly heard and considered, the Department now presents the following review, analysis, and Proposed Decision and Proposed Order.

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

Subdivision (b) of California Insurance Code Section 11750 states 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 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 permitted under California law to make their own determinations as to the pure premium rates they will use, as long as the ultimate rates charged are adequate to maintain their financial solvency.

The pure premium rate process serves as an important measure of the costs in the workers' compensation system. It 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, that is, to project the cost of benefits and loss adjustment expenses for the upcoming policy period beginning July 1, 2018.

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 actually charge. These figures are not predictive of an individual employer’s insurance premium, which may fluctuate 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.

In the Actuarial Evaluation below, Department actuaries Ron Dahlquist and Mitra Sanandajifar provide a review and analysis based upon the new filing information presented by the WCIRB and the public members’ comments.

ACTUARIAL RECOMMENDATION

The WCIRB has proposed an average pure premium rate level of $1.80 per $100 of payroll in its July 1, 2018 filing. The Department’s staff actuaries’ analysis, as set forth in the following *Actuarial Evaluation* section, results in an average pure premium rate level of $1.74 of payroll. The most recently available industry average level of pure premium rates filed by insurers with the Department is $2.22 per $100 of payroll as of January, 2018. While the indicated pure premium rate level represents our central estimate, and thus our recommendation, we note that both the WCIRB’s estimate of $1.80, and the middle estimate of $1.70 from Bickmore, the public members’ Actuary (“Bickmore”) are within a reasonable actuarial range.

This WCIRB’s 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.

The California workers’ compensation market appears to be both competitive and in strong financial health. Collected premiums in 2017 produced an average charged rate of $2.46, which compares to $2.74 observed in 2016, showing a continuation of a downward trend in charged market rates that has been in progress since the first half of 2015 when the average charged rate was $3.04. The average charged rate of $2.46 (which reflects all insurer expenses) was approximately 25% more than the WCIRB's January 1, 2018 recommended average advisory pure premium rate of $1.96 (which reflects loss and loss adjustment expense only). It was also approximately 25% less than the industry average filed manual rate of $3.28, thus indicating the average effect of schedule rating and other rating plan credits.

The WCIRB estimates the overall industry combined ratio at about 88% for Accident Years 2014-2016 as of December 2017, and a combined ratio of 92% for Accident Year 2017. However, current charged rate levels are somewhat lower than what underlies the aforementioned combined ratios.

Actuarial Evaluation

The actuarial evaluation will focus on the following main components of the analysis: (1) loss development; (2) loss trends; (3) loss adjustment expense ("LAE") provision: allocated loss adjustment expense ("ALAE") and unallocated loss adjustment expense ("ULAE"); (4) the impact of reform legislation contained in Senate Bill 863 ("SB 863"), Senate Bill 1160 ("SB 1160"), Assembly Bill 1244 ("AB 1244"), and Assembly Bill 1124 ("AB 1124"); (5) rate of return; and (6) impact of federal income tax reduction.

Table 1 shows the medical, indemnity, and LAE components of the WCIRB's pure premium rate indications over the past several years along with a comparison with Bickmore's current indication. Table 2 displays the percentage impact of the various differences in assumptions and methods from WCIRB's recommendation as compared to both the Department and Bickmore.

Table 1									Bickmore	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	1/1/15	7/1/15	1/1/16	7/1/16	1/1/17	7/1/17	1/1/18	7/1/18	7/1/18	1/1/18
Medical $	1.41	1.14	1.10	1.00	0.95	0.87	0.84	0.76	0.66	0.76
Indemnity	0.76	0.72	0.69	0.70	0.67	0.64	0.63	0.58	0.57	0.62
LAE $	0.60	0.61	0.63	0.61	0.60	0.51	0.49	0.46	0.47	0.50
Total $	$ 2.77	$ 2.47	$ 2.42	$ 2.30	$ 2.22	$ 2.02	$ 1.96	$ 1.80	$ 1.70	$ 1.88
Industry Avg Filed PP Rate						$ 2.34	$ 2.22			
Industry Avg Filed Manual Rate (with expenses)						$ 3.43	$ 3.28			
Industry Avg Charged Rate (net discounts)						$ 2.56	$ 2.46			

Table 2

	Recommended 7/1/2018 Pure Premium Rates	Impact of Difference in Assumptions & Methods Between WCIRB and Alternative Recommendations						
		Total	Indemnity Development	Medical Development	Indemnity Severity Trend	Medical Severity Trend	Claim Frequency	Loss Ratio Trend
WCIRB	$1.80							
CDI	$1.74	-3.3%	0.0%	-1.7%	0.0%	-1.7%	0.0%	N/A
Bickmore (Middle)	$1.70	-5.6%	0.0%	-2.7%	N/A	N/A	0.0%	-3.0%

1. Loss Development

Some form of the paid loss development method has consistently served as the basis for determining ultimate loss estimates for both indemnity and medical losses in the WCIRB's advisory pure premium rate filings for many years. While focusing on the paid method, the WCIRB has also reviewed the results of other methods, particularly the incurred development method, along with multiple variations on these basic methods. At the same time, Bickmore has been giving equal weight to both the paid and incurred development methods in its analysis. The WCIRB's final selection, however, has always been based on the paid development method.

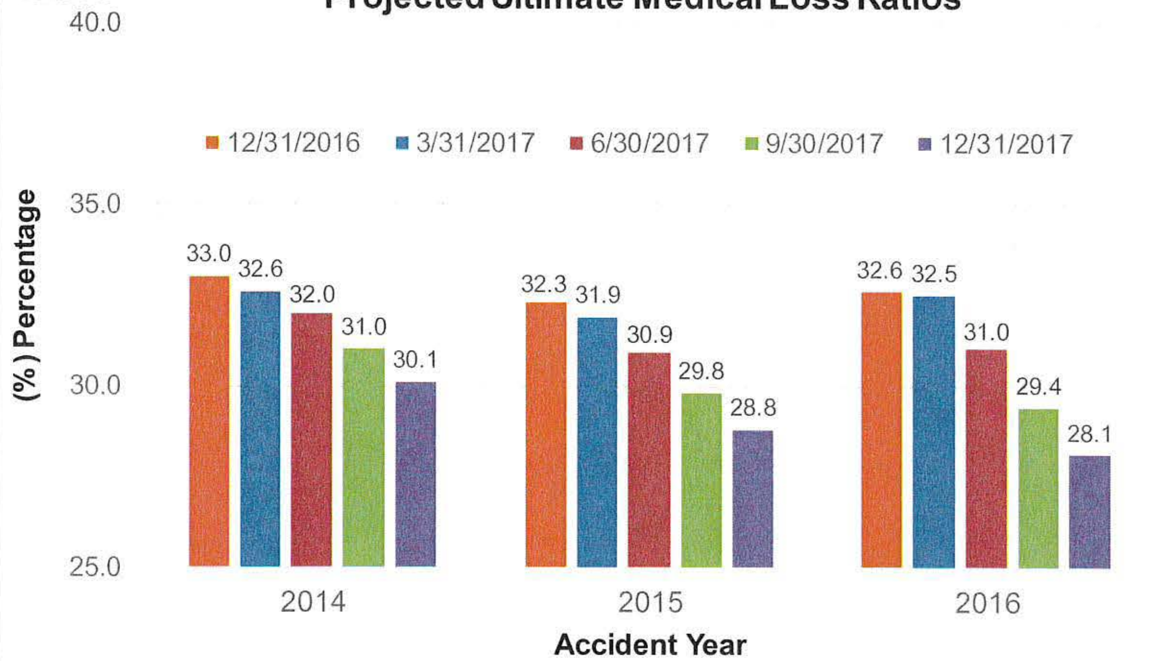
In recent years, particularly after the implementation of SB 863 in 2013, it has become increasingly apparent that claims are closing more quickly than in years past. This phenomenon is very likely to cause the paid development method to overestimate ultimate losses. In order to try to prevent such overstatement, the WCIRB has incorporated a Berquist-Sherman adjustment for changes in claim settlement rates to the historical paid loss triangles for both indemnity and medical losses in its filings.

In past filing reviews, we have outlined the range of estimates produced by the various actuarial methods utilized by the WCIRB, and provided our commentary on the relative merits of the alternatives, while eventually concluding that the WCIRB's reliance on the paid development method, after adjustment for changes in settlement rates and for the effects of reforms, was appropriate.

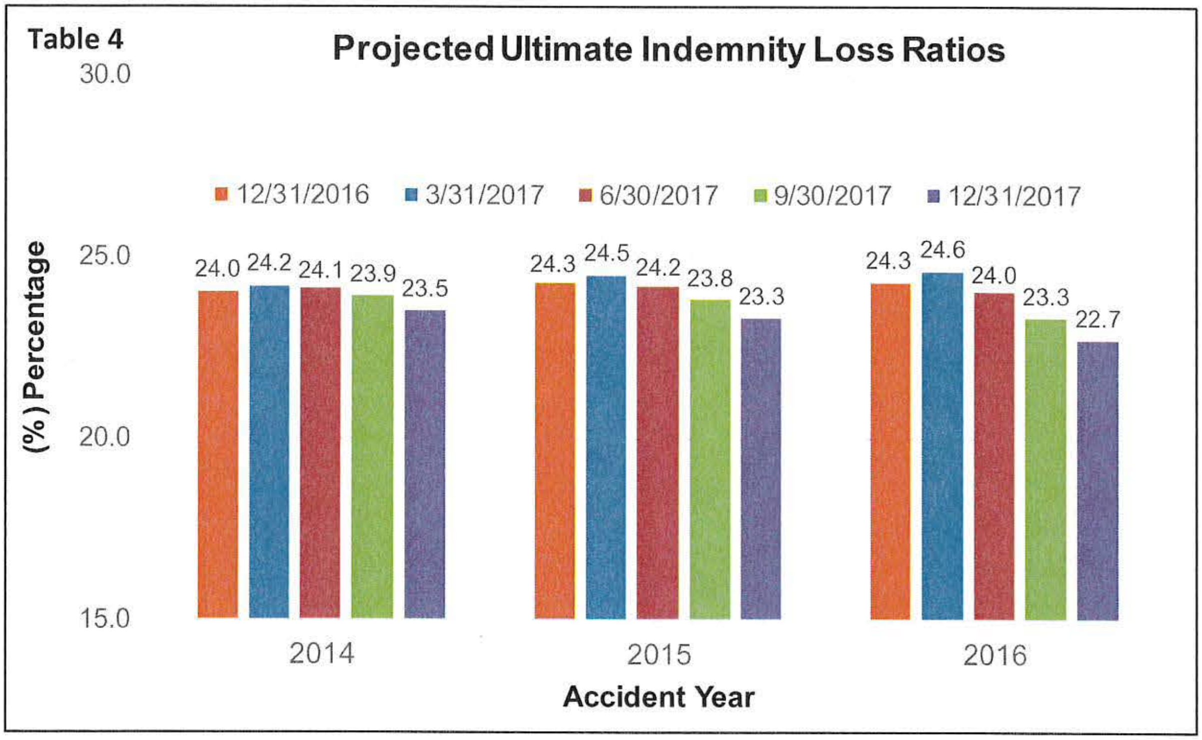
Despite the use of the Berquist-Sherman adjustment, estimated ultimate medical loss ratios have continued to decline. In our review of the WCIRB's January 1, 2018 filing, we noted the implications for overstatement of ultimate medical costs this emerging phenomenon could cause. We observed that the January 1, 2018 filing was the fifth in a row to produce a lower estimate of ultimate medical loss ratios than the prior filing, and noted that this seemed to warrant reconsideration of the choice of loss development methods, as well as a reevaluation of the impacts of the various reforms. We note now that the current filing provides a rather dramatic illustration of the continuation of this trend.

Information provided in the Hearing and in the Executive Summary of the filing demonstrates that the last four quarterly evaluations of the latest three accident years' medical losses have shown substantial downward development (see Table 3), indicating that the evaluations as of 12-31-2016 were overstated by 10% or more. This is despite the use of the Berquist-Sherman adjustments for changing claim settlement rates, and reform impact adjustments for SB 863, SB 1160, and AB 1124 provisions for all five valuations.

Table 3



At the same time, the quarterly estimates for indemnity losses have not shown the same sharp declines in estimated ultimate loss ratios.



It seems clear that something is happening that is causing medical loss development to continue to moderate. While the Berquist-Sherman adjustment for changes in claim settlement rates should be effective in adjusting for such changes that have already taken place, it cannot anticipate future changes in settlement rates or payment patterns.

Moreover, there are several factors that can be expected to have an impact on shortening the payout pattern for medical losses. Bickmore has provided some commentary on this in its review of this current filing. Bickmore cites three reasons for believing future medical paid loss development patterns will be less than what is indicated from historical patterns. These are first, that permanent disability claims are closing more quickly, while the closing rates for temporary disability claims appear to be stable; second, that there has been an increase in the proportion of claims that are closed through compromise and release; and third, that the change in the medical fee schedule to an RBRVS basis should result in higher payments earlier in the life of a claim.

Our evaluation would add to this list the increased use and effectiveness of IMR and the effectiveness of recent lien reforms. While the WCIRB has been able to make an adjustment for the lien reforms, the impacts of IMR, RBRVS, and the increased use of compromise and release settlements on development patterns have been difficult to quantify and are being allowed to work their way through the indications over time.

This leads us to consider the merits of the incurred loss development method.

The primary benefit of the incurred method is that changes in cost levels resulting from changes in the claims environment can be expected to be more quickly recognized in case loss reserves than in paid losses.

In our reviews of prior filings, however, we have declined to give any weight to the incurred loss development method, noting that there are several drawbacks with the use of the method, especially on an industrywide basis for the workers' compensation line of insurance. These drawbacks lie in the challenges associated with formulating the proper adjustments to make the incurred method more accurate, which include the difficulty of adjusting incurred losses for the impacts of the various reforms that have affected the historical data. Making such adjustments to historical paid loss data is relatively straightforward, but knowing how much the reforms have influenced the setting of case reserves across the entire insurance industry would seem to be well-nigh impossible.

There is also difficulty with adjusting historical case reserve data to the current level of case reserve adequacy when there are likely to have been different claims handling procedures and case reserving philosophies across the industry, as well as a changing mix of insurers over time. Sorting these effects out would also be quite difficult.

Despite these impediments to properly adjusting the incurred method, we believe the evidence that the paid development method has been overestimating ultimate medical losses—and can be expected to continue to do so—is so strong that something needs to be done. In situations like this where a primary method is distorted by changes in the historical data, utilizing another actuarial method that is unaffected or at least less distorted by the same changes is a preferred approach.

Accordingly, we believe it is appropriate at this time to give weight to the incurred loss development method for projecting ultimate medical losses. Given the shortcomings identified with the incurred method, we believe that such weight should be limited. We choose to give 75% weight to the WCIRB's paid development method which includes adjustments for reforms and changing claim settlement rates, and 25% weight to the unadjusted incurred development method. This weighting approach should recognize the continuing tendency of the paid development method to overstate ultimate medical losses while still preserving an element of caution that we believe is necessary when estimating future medical costs in California's uncertain workers' compensation environment.

2. Loss Trends

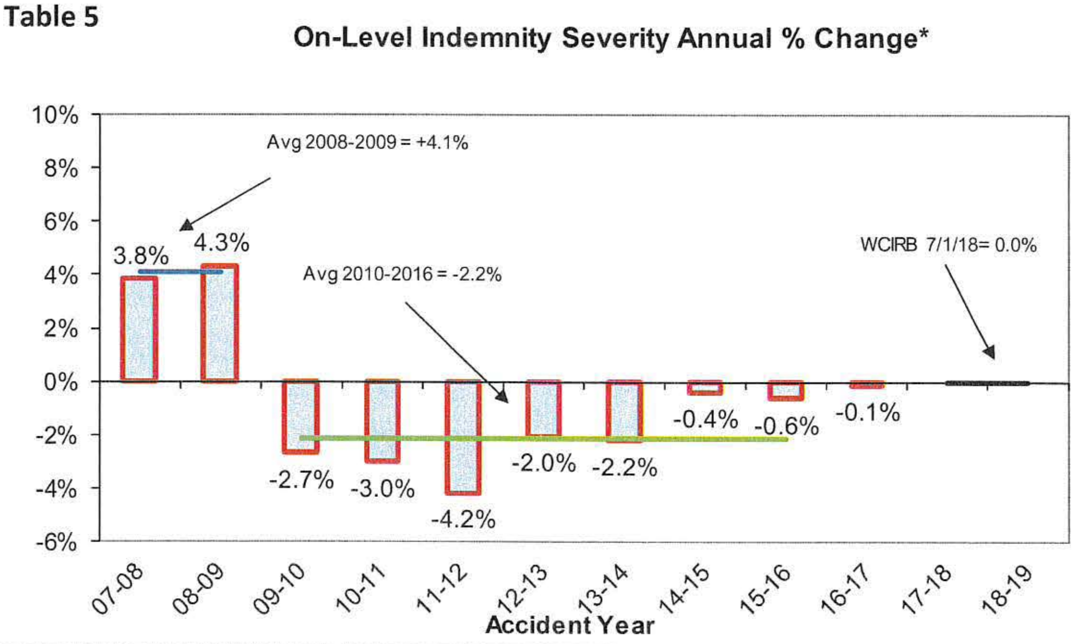
The WCIRB analyzes a range of trending assumptions to roll forward the estimates of ultimate losses developed above to the future time period during which the filing's proposed pure premium rates will be in effect.

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

The preferred method utilized by the WCIRB has been the use of separate trends for frequency and severity and the application of these trends to the latest two years of experience. The WCIRB has conducted studies to determine the merits of alternative assumptions about trends in various environments such as reform, transition, and recession periods, and used the results to guide its selections based on the perceived current state of the environment.

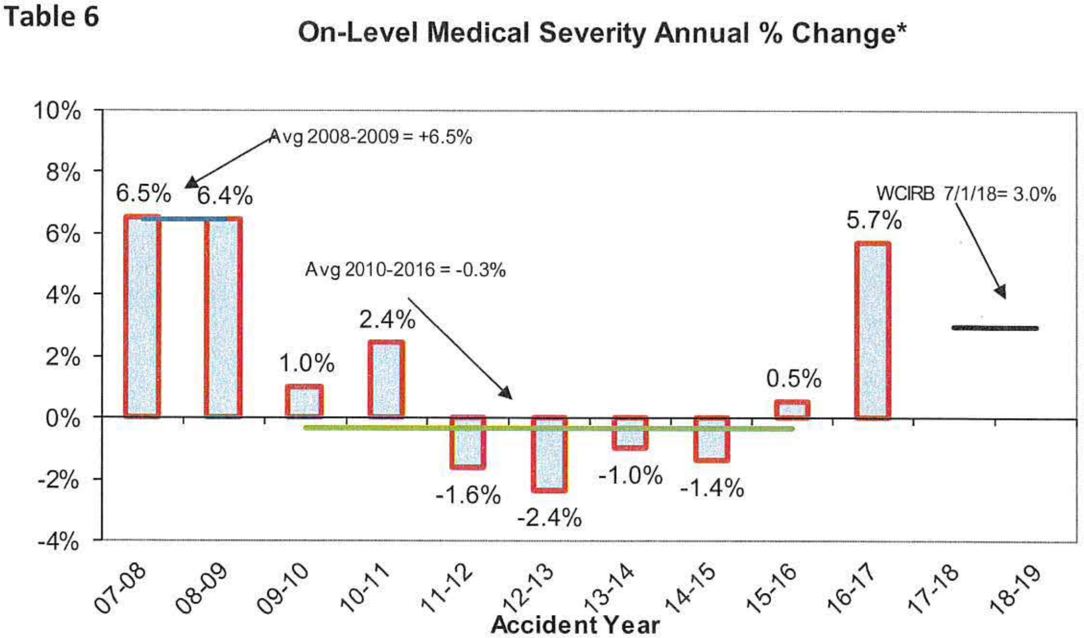
As shown in Tables 5 and 6, indemnity and medical severity trends over the time period 2010-2016 have decreased relative to historical averages prior to 2010, discussed further following the severity and frequency slides, while 2017 shows a relatively flat change for indemnity, and a spike in average medical severity.

Table 5



*Based on Ultimate Indemnity Losses giving 100% weight to the Paid Method

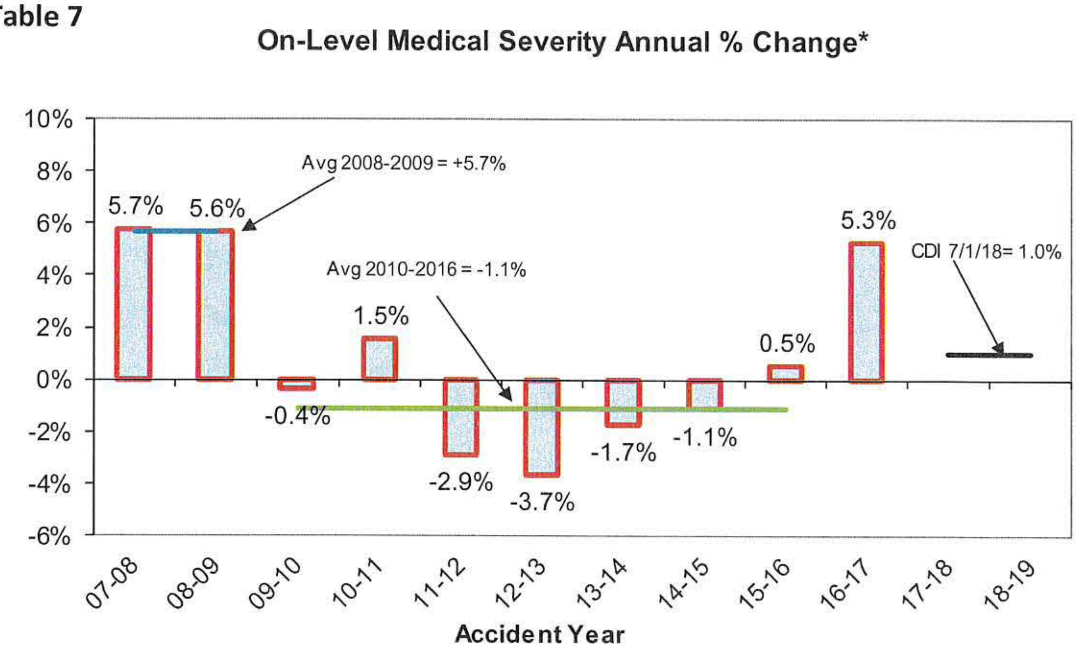
Table 6



*Based on Ultimate Medical Losses giving 100% weight to the Paid Method

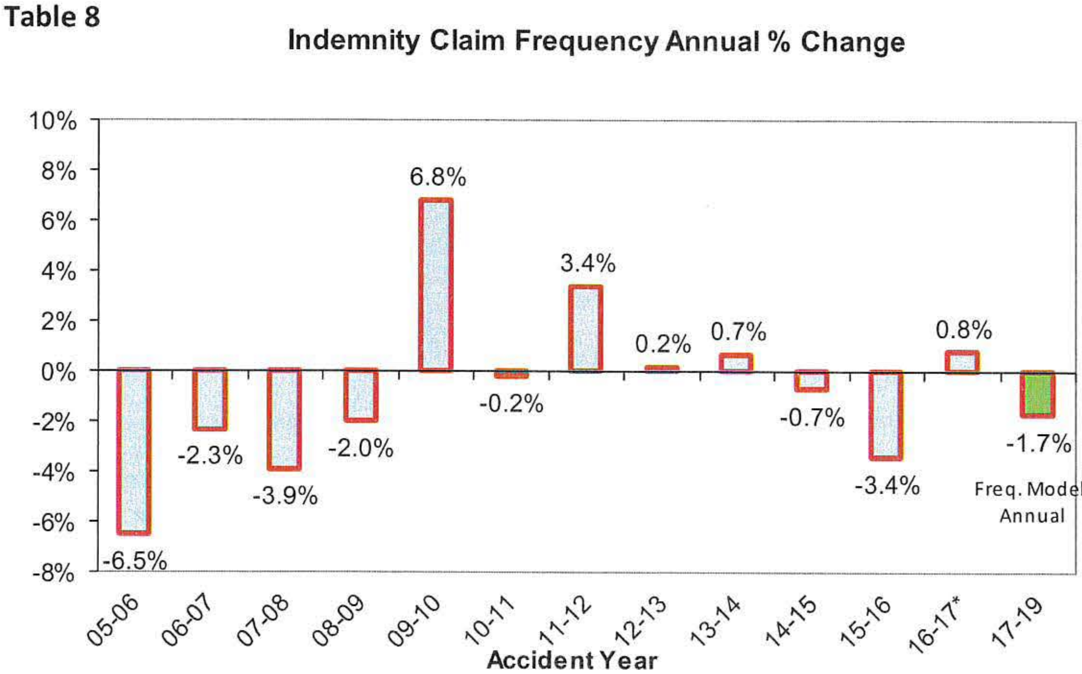
The changes in average medical severities in Table 6, as mentioned in the footnote, are based on ultimate medical losses that use the paid loss development method to project losses to ultimate. Table 7 shows the changes in average medical severities based on the department-selected development method, discussed above, which relies on a combination of the paid and incurred development methods.

Table 7



*Based on Ultimate Medical Losses giving 3/4 weight to the Paid Method and 1/4 weight to the Incurred Method

Table 8



* Based on changes in reported aggregate indemnity claim counts as of 12/31/2017 compared to changes in statewide employment. All other estimates based on unit statistical indemnity claims compared to reported insured payroll.

We note that the low to negative severity changes indicated for accident years 2010 through 2015 have likely been affected by the unusual changes in frequency shown in Table 8, above, starting in 2010. The pattern prior to 2003 was one of steady, small declines in frequency every year. Following the large decrease in 2006 that can be attributed to the residual impact of the previous round of reform legislation enacted in 2003 and 2004, the modest declines in 2007, 2008, and 2009 were in line with the previous long-term trend. In sharp contrast, 2010 saw a large increase in frequency, and the following years until 2014 have mostly shown flat to increasing frequency, returning most recently to the long-term trend of small annual declines. Although the 2017 accident year shows a slight increase in frequency, this data point is still preliminary and should not be relied upon.

In addition, while the estimated changes shown in Table 8 are based on unit statistical plan data for 2016 and earlier periods, for 2017 the estimates rely also on proxies for changes in frequency (i.e. changes in reported aggregate indemnity claim counts compared to changes in statewide employment).

The WCIRB attributes the frequency increases since 2011 to cumulative injury claims, where claims are made with multiple body parts and can include a psychiatric component, and claims in the Los Angeles Basin area. The WCIRB will be performing an in-depth study of the cumulative injury claim patterns later this year in its continued efforts to analyze the driver(s) of the frequency pattern.

In terms of methodology, the difference of analyses of the trend issue between the Public Members' Actuary and the WCIRB is the use of a loss ratio trend versus separate frequency and severity trends. The WCIRB applies separate frequency and severity trends as previously described to the latest two years of the experience period, whereas the Bickmore suggests using a loss ratio trend applied to the latest two years. Both the WCIRB and Bickmore agree on the experience period that the trend is applied to on the basis of a study conducted by the WCIRB in regard to the historical performance of various trending methods. Bickmore's annual loss ratio trend selection is based on an exponential fit of pure premium ratios, using accident years 2013 through 2017.

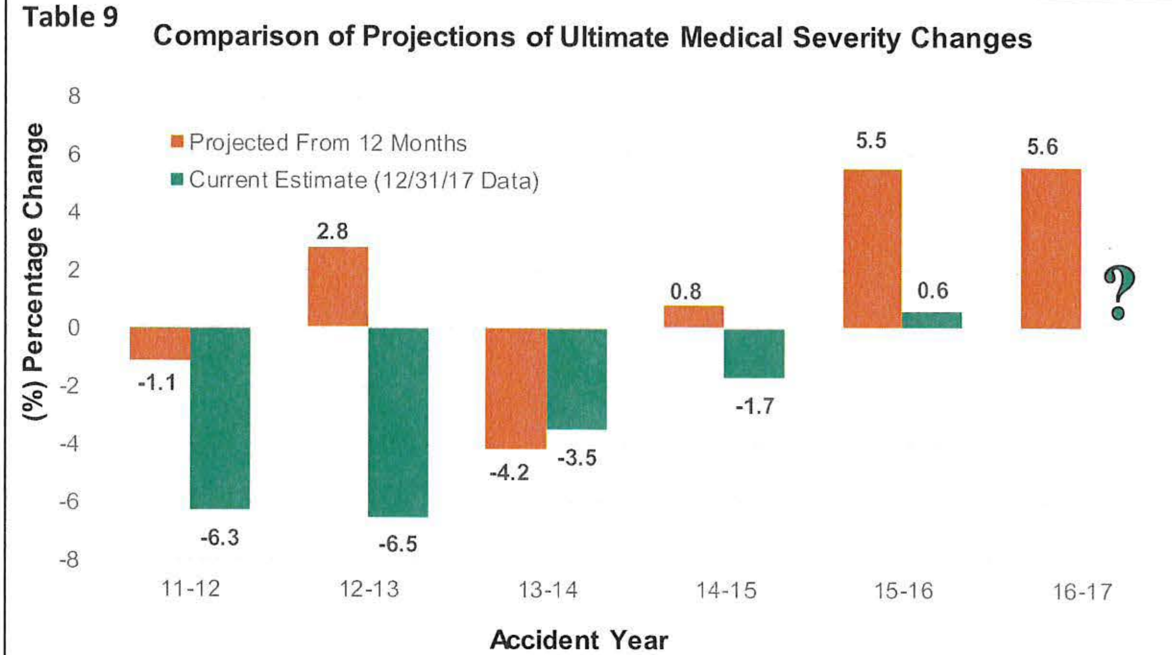
We agree with the WCIRB and Bickmore that the use of two years of experience for the application of the trend is appropriate, as it has also outperformed alternative assumptions based on the WCIRB's most recent study. In examining the merits of the loss ratio trend versus separate frequency and severity trends in various environments, we recognize that separate severity and frequency trends may better reflect the underlying causes in this changing environment. While we do not yet have a full understanding of the changes that are happening, the separate analyses of frequency and severity provides information that the combined trend may smooth or mask.

Following a period of moderate decreases in on-leveled indemnity severity between 2010 and 2014, the recent decreases in indemnity severity have been relatively minimal. While we note here that the 2016 and 2017 indemnity severities showed slight increases based on data as of June 30, 2017, the more recent indicated changes in indemnity severity hover around a flat trend line, and therefore the Department agrees with WCIRB's selection of 0.0% annual severity trend for indemnity.

The Department's staff notes that the medical severity trend of 3.0% selected by the WCIRB is consistent with the January 1, 2018 filing and reflects an anticipation that the spike in the average severity for 2017 is a "turning point" for the pattern seen in the medical severity following the SB 863 reform. The Department's staff appreciates the balance that the WCIRB's Actuarial Committee is trying to achieve in being reactive to the most current trend indications while recognizing the inherent volatility of severities at early evaluations. However, while we are sensitive to the need to avoid missing a "turning point" when past high rates of medical inflation return, we note that the WCIRB's recommended trend assumption is based primarily on one data point: the estimated ultimate severity for the latest accident year. While the magnitude of the increase in medical severity for Accident Year 2017 over that for the previous accident year is higher than the selected 3.0%, this data point is quite green, and past history has shown that such data points can change significantly as they mature. As a case in point, the initial estimated +5.1% medical severity increase for accident year 2016, as shown in the WCIRB's July 1, 2017 filing (based on data evaluated as of December 31, 2016) increased to +5.7% based on data evaluated as of March 31, 2017, dropped to +3.8% based on data as of June 30, 2017, and became almost flat based on data as of December 31, 2017 (see the 15-16 bars in Table 9). Similarly the +4.6% increase in 2014 medical severity based on data as of June 30, 2016, gradually turned into a decrease of 1.1% based on data as of December 31, 2017. The decrease in 2016 medical severity was also accompanied by a decrease in frequency from -1.3% based on data as of December 31, 2016 to -3.4% based on data as of December 31, 2017. While it may be difficult to determine the various interacting forces that such favorable developments in the frequency and severity could be attributed to, the Department's staff believes that the favorable impact of subsequent legislation, such as SB 1160 and AB 1244 following the SB 863 enactment, has been a contributing factor to continue the impacts of the SB 863, and while certain attributes of the SB 1160 and AB 1244, such as the reduction in lien filings have been incorporated in WCIRB's projected ultimate medical losses in this filing, the interaction between these reforms raises the potential to further the realization of the reduction in medical costs, and postponing the "turning point."

The graph below (Table 9) compares the projected changes in medical severity as of 12 months to the current estimate of the change based on data as of December 31, 2017, and reflects the lack of reliability of the estimates at such early stage of maturity.

Table 9



The Department's staff believes that it is important to keep in mind that the workers' compensation system is an adaptive system where the various service providers respond to changes in the environment brought on by reform or court decision. We recognize that particular attention needs to be paid to medical trends, as belated recognition of increasing medical costs has been a major problem in the not-too-distant past. However, the developments over the past year suggest that the reduction in medical costs may still be continuing, at least in the near future, and a "turning point" may not be around the corner. For that reason, the Department is selecting a 1.0% medical severity trend, as shown in Table 7.

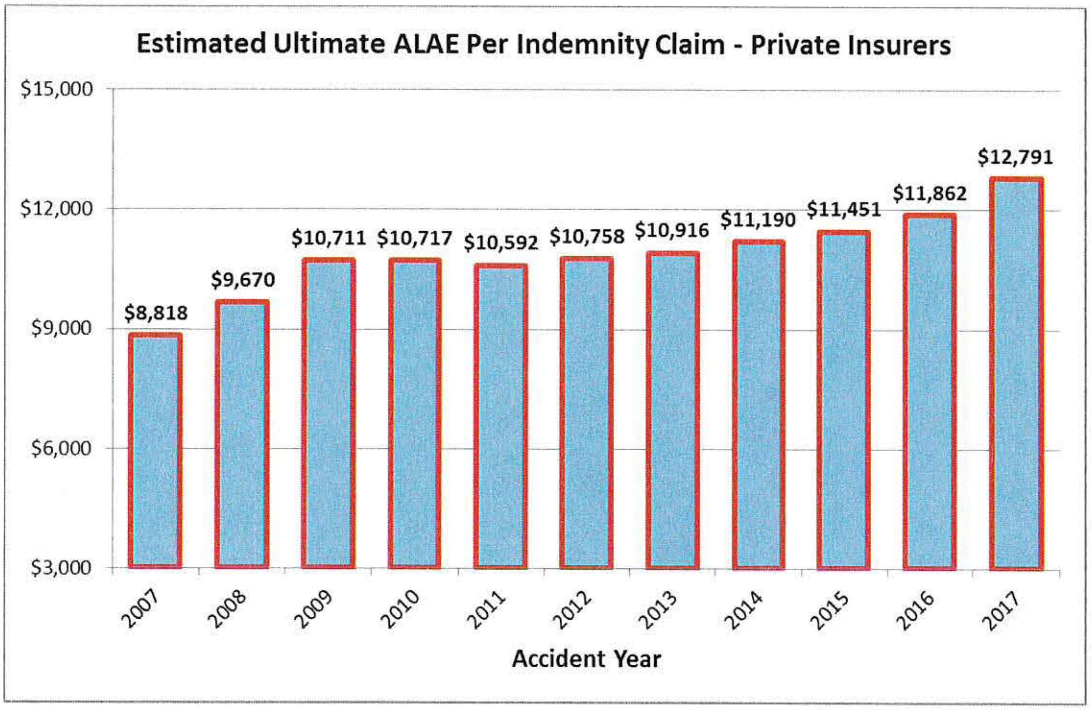
3. Loss Adjustment Expenses

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").

Starting with the January 1, 2015 filing, the WCIRB adopted a change in its methodology to reflect only private carrier data in its evaluation of ALAE and ULAE to avoid distortion due to the impact of the higher expenses of the State Compensation Insurance Fund. The WCIRB has continued to apply this methodology in this current filing. The Department's staff concurs with this methodology.

The estimated ultimate ALAE per reported indemnity claim has increased by 19% following the implementation of SB 863. However, as shown in Table 10, accident year 2017 has had the most dramatic increase since 2009. While there is an expectation that ALAE costs increase during the immediate periods following the reforms, the significant increase in ALAE in 2017 seems to be more than expected.

Table 10



The sharp increase in average ALAE per indemnity claim raises concerns, however, we recognize that the 2017 data point is still immature and we also wonder whether similar to the indemnity and medical losses, the development factors for ALAE would need to be adjusted for the speed up in claims settlement rates.

The WCIRB does not give full weight to this immature data point in its projections of ALAE and adjusts the projected ALAE for the impact of SB 1160 and AB 1244 reforms.

A comparison of the components of LAE between the prior filing and the current filing is shown below in Table 11. Both ALAE and ULAE have increased as a percentage of losses. In comparison, the ratio of medical cost containment program ("MCCP") costs to losses have decreased, reflecting the decline in average MCCP costs per indemnity claim over the recent period.

Table 11

LAE Provision Underlying WCIRB Pure Premium Rate Filings				
	1/1/18 Filing		7/1/18 Filing	
(ALAE ex/MCCP)/Loss	18.3%		18.5%	
MCCP/Loss	4.3%		4.0%	
Total ALE/Loss	22.6%	$0.33	22.5%	$0.30
ULAE/Loss	10.5%	$0.15	11.4%	$0.15
Total LAE/Loss	33.1%	$0.49	33.9%	$0.46
Indicated Pure Premium Rate		$1.96		$1.80

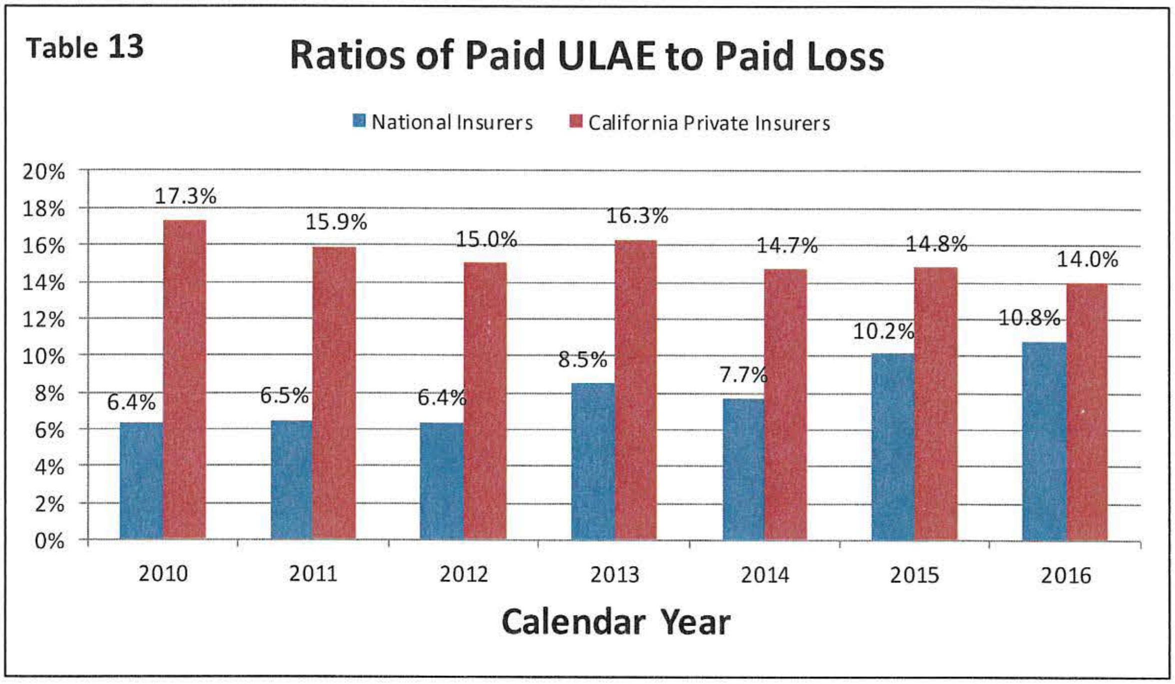
The projected LAE as a percentage of losses considered in the Department's analysis is 35.4% compared to the WCIRB's selection of 33.9%. The higher LAE percentage reflects an adjustment for the differences in projected losses in the denominator of the LAE to loss ratio and preserves the LAE dollar value proposed by the WCIRB in this filing.

As shown in Table 12, there is a substantial increase of about 30% in average ULAE paid per open indemnity claim between calendar years 2012 and 2013. This is the same time frame in which SB 863 went into effect, and based on WCIRB's testimony in the July 1, 2018 hearing, the increase could be attributed to the system changes required for the implementation of the reforms. The modest decrease from 2013 to 2014 is followed by significant increases in 2015 and 2016. The WCIRB links these latter increases in average ULAE per open indemnity claims with a more accurate reflection of the cost of administering claims in California, particularly as it relates to claims handling costs associated with large deductible polices and policies handled by third party administrators, following the modifications to the ULAE data calls promulgated by the WCIRB in 2014.

Table 12 Calendar Year	Number of Open Indemnity Claims at Beginning of the Year		ULAE Paid Per Open Indemnity Claim
	(a)		(b)
2010	360,624		1,676
2011	360,339		1,684
2012	360,391		1,698
~~2013~~	~~365,706~~	3	~~2,192~~
2014	366,420	0	1,947
2015	367,816		2,498
2016	365,874		2,774

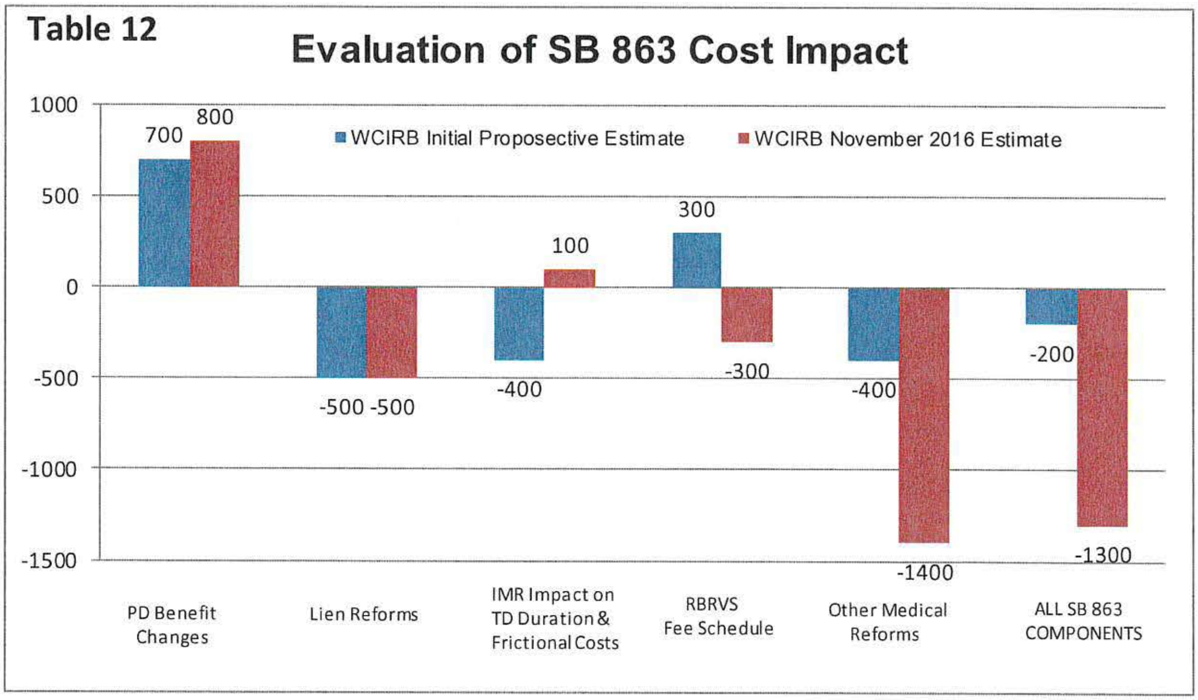
There is an ongoing analysis being performed by the WCIRB regarding the allocation of national carriers' countrywide ULAE expenses to more completely reflect the additional complexity and duration of California workers' compensation claims. This analysis is expected to be completed for the January 1, 2019 filing and is likely to result in a slight increase in ULAE. Table 13 shows a history of ULAE for national insurers versus insurers who insure primarily California employers. Given this expected increase in ULAE, and uncertainty regarding any potential savings of ULAE due to the reduction in liens, the Department's staff finds the ULAE provision included in this filing to be reasonable.

While the projected ALAE has been adjusted for the impact of SB 1160 and AB 1244, the filing does not include any adjustment to the ULAE for the impact of these reforms.



4. Impact of Senate Bill 863, Senate Bill 1160, Assembly Bill 1244, and Assembly Bill 1124

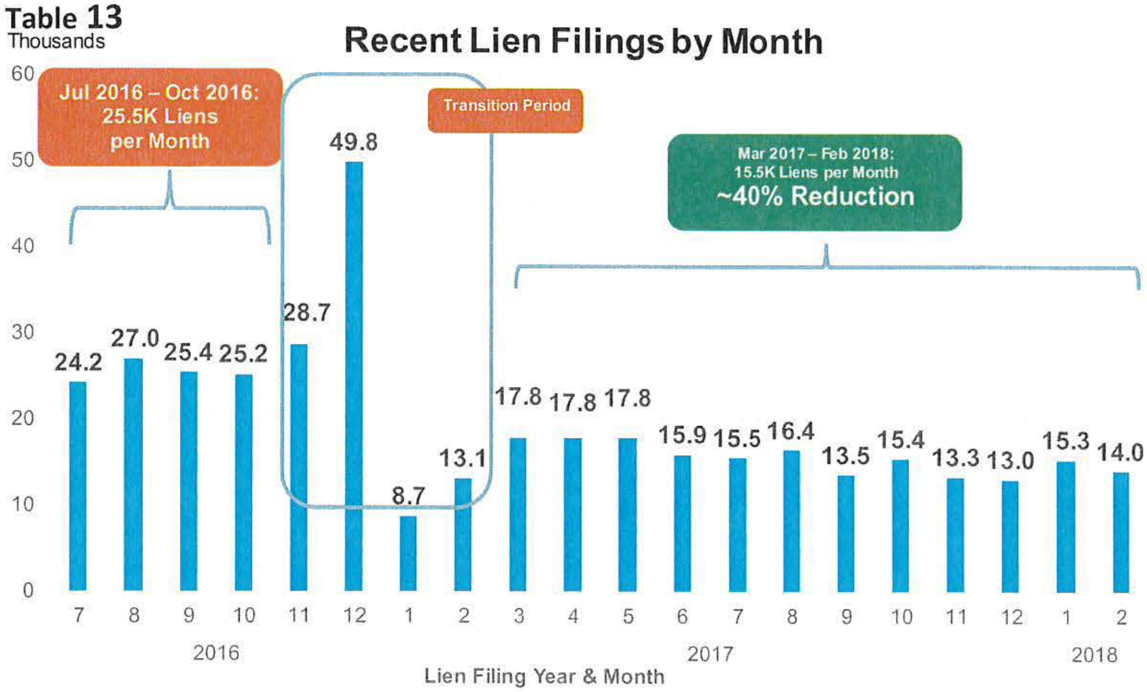
In developing its actuarially-indicated pure premium rates, the WCIRB included its updated estimate of the effect of SB 863. In its November, 2016 SB 863 Cost Monitoring Report, which is the latest retrospective report published, the WCIRB estimated that the various provisions of SB 863 have reduced annual system-wide costs by approximately $1.3 Billion, as shown in Table 12, versus an initial assessment of overall savings of $200 Million. The substantial decreases in medical cost projections which have been noted and reflected in filings over the last couple of years have in large part been attributed to SB 863. In particular, the impact of IMR on medical costs is thought to represent a substantial portion of the "other medical reforms" component. Assuming this to be true, it far outweighs the increase in frictional costs due to IMR. Since it appears that dramatic improvement in medical costs continues to emerge, we recommend that the WCIRB perform another retrospective evaluation of the impact of SB 863.



On September 30, 2016, SB 1160 and AB 1244 were signed into law. SB 1160 includes a number of provisions related to utilization review while SB 1160 and AB 1244 include a number of provisions related to liens. In its January 1, 2017 filing, the WCIRB reviewed the impact of SB 1160 and AB 1244 on losses and loss adjustment expenses for policy year 2017 and estimated the impact at a 0.6% reduction in the indicated pure premium loss costs, which was an approximate savings of $125 million annually relative to overall insured and self-insured California workers' compensation system size of $22.5 billion. The 0.6% favorable impact was based on an estimated reduction of 10% of liens filed.

Lien activity in 2017 and early 2018 indicated that the reduction in lien volume based on more recent data is in the ballpark of 40%. This reduction level assumes the 2nd quarter of 2016 to be the previous norm, before the transition period of late 2016 through early 2017 started, and the new environment is represented by the March 2017 through February 2018. The removal of the transition period from the calculations reflects the concern that the recent reform measures had resulted in many liens being filed before the January 1, 2017 reform effective date, potentially moving some of the 2017 volume into late 2016, and therefore the data for this period is distorted. Table 13 shows the monthly lien filings between July 2016 and February 2018.

Table 13



In this filing, the WCIRB has reflected the 40% reduction in lien volume in the adjustments applied to the medical loss development factors. The impact of this adjustment appears to decrease the indicated pure premium rates by about 1.6%, compared to the 0.6% decrease reflected in WCIRB's January 1, 2018 pure premium rate filing, and the 2.4% decrease reflected in the Department's latest approved filing, where the latter two figures had been based on rough estimates. While the 40% reduction in the number of liens assumed in this filing seems reasonable, we believe the continued monitoring of the number of monthly lien filings and the determination of the new norm in the number of lien filings, as more recent data becomes available, is important.

We also wonder whether in addition to the decrease in the volume of the liens filed, there has been a difference in the average demand and settlement amounts per lien. While as part of its evaluations, the WCIRB has reviewed lien settlement amounts and confirmed that the approximate 25% relationship between settlements and demand amounts identified by the WCIRB in prior research analyses continued to reasonably reflect the relationship between the demand and the settlement, the average demand and settlement amounts over time may provide additional information about the liens for future consideration.

A new drug formulary as directed by AB 1124 was adopted by the Department of Industrial Relations, Division of Workers' Compensation, with an effective date of January 1, 2018. The WCIRB has reviewed the impact of the new drug formulary and has estimated an overall reduction of 0.5% in loss and LAE costs for policies incepting between July 1, 2018 and December 31, 2018.

5. Rate of Return

While workers' compensation insurance rates in California are not subject to prior approval, and the line's profitability is not an element to be considered in the setting of the advisory pure premium rates, we believe it is still a subject of interest worth examining. At this time, however, we can only provide a limited view of the insurance industry's profitability for California workers' compensation insurance. The one source we have that provides an imputed value for the industry's rate of return on equity is the NAIC Profitability Study. This study isn't current; since it relies on information compiled from Annual Statements, it is always a year behind. The most recent study available is for 2016.

Its applicability to the current industry profitability is unclear. Since it utilizes reported financial results based on carried reserves, it can be expected to understate profitability for 2016 because the WCIRB's projections have implied that carried reserves have become increasingly redundant in recent years. On the other hand, prices have declined steadily in the last few years, in parallel with continued declines in pure premium rates.

The 2016 NAIC Profitability Report estimates an 8.7% return on equity for California workers' compensation insurance for the industry as a whole.

While the rate of return standard included in California's prior approval regulations doesn't apply to the workers' compensation line, it can serve as a point of reference for what might be considered reasonable. That standard specifies a maximum after tax rate of return on equity that is 6% plus the risk-free rate. The risk-free rate, as defined in the prior approval regulation California Code of Regulations § 2644.20 was measured as about 1.3% on average for 2016, and has since risen to 2.4% as of April 2018. This would produce a rate of return target of about 7.3% for 2016 and 8.4% as of April 2018. The insurance industry's imputed 8.7% after tax return on equity for California workers' compensation insurance in 2016 appears to be close to what the California prior approval regulations would prescribe if they were applicable in the current economic environment.

The rate of return on equity does not tell the whole story, however. The NAIC's Profitability Report shows that the total return on premium before federal income tax is a very substantial 20.7%, composed of an underwriting profit of 8.5% of premium and an investment yield on premium-supplied funds of 12.2% of premium. The after-tax total return on premium is 16.4%, which is also quite high.

The reason why these very substantial returns on premiums translate into such relatively modest returns on equity is due to the large amounts of equity that appear to be held by

California workers' compensation insurers. The NAIC's Profitability Study displays a premiums-to-surplus ratio of 0.405 for California's workers' compensation line, essentially assigning $5 of equity to every $2 of premium. This surplus allocation appears to reflect reality because the accompanying all-lines summary of the report shows a premiums-to-surplus ratio of 0.66 for the property-casualty insurance industry as a whole, and workers' compensation should require a higher capital allocation than other lines because of its long-tailed nature and inherent volatility. This low premiums-to-surplus ratio results in a "watering down" effect: the 16.4% after-tax return on premiums is reduced to 6.6% on equity after applying the calculated premium-to-surplus ratio of 40.5%. A 2.1% after-tax investment yield on the surplus itself brings the total return on equity to 8.7%.

Even allowing for the need for more equity to support the uncertainty in the large reserve balances that must be held for this line, this relationship seems to imply the industry is overcapitalized for California workers' compensation insurance. The all-lines premiums-to-surplus ratio of 66% reflects the fact that the industry is overcapitalized in total.

6. Impact of Federal Income Tax Reduction

The passage of federal income tax reductions in 2017 will result in reduced costs and increased profits to the insurance industry starting in 2018. We estimate that rate reductions of about 5% would pass these reductions along to policyholders while maintaining a level of profitability roughly equivalent to what is currently being achieved by the California workers' compensation insurance industry. We arrived at this conclusion by applying a simple calendar year model assuming premiums-to-surplus ratios, loss and loss adjustment expense ratios, investment yields, and other expense ratios as shown in the 2016 NAIC Profitability Study. We used an average duration of loss and loss adjustment expense reserves of five years. Federal income tax rates used were 35% on underwriting profit prior to the change and 21% after it, and 28.9% on investment income prior to the change and 18.5% after it. The latter was a simplifying assumption made to avoid the complexities of federal tax law regarding investment income.

Of course, this result must be considered approximate and insurers should make their own evaluation of the impact of the tax law change, but it appears obvious that there is a significant impact.

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 an average pure premium rate of \$1.74 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 July 1, 2018. 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 Department actuaries Ron Dahlquist and Mitra Sanandajifar.

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 11750 and 11750.3 that the WCIRB's filed advisory workers' compensation pure premium rates are amended and modified as detailed in the Proposed Decision, reflecting an average Workers' Compensation Claims Cost Benchmark and advisory pure premium rate of \$1.74 per \$100 of employer payroll;

IT IS FURTHER ORDERED that these regulations shall be effective July 1, 2018 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 May 2, 2018, as well as additional written comments entered into the record, and I recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

Date: May 29, 2018

Patricia Hein

Patricia Hein
Attorney IV