J.H.ALBERT
INTERNATIONAL INSURANCE ADVISORS, INC.

Competitive Rating of Workers' Compensation in Massachusetts

A Report to

The Massachusetts
Workers' Compensation Advisory Council

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INTRODUCTION

The Massachusetts Workers' Compensation Advisory Council has commissioned this study to evaluate the effect implementation of a system of competitive pricing in workers' compensation would have on the Massachusetts insurance market.

Currently, the Massachusetts legislature is considering a bill (H.4047) that would repeal the current administered pricing mechanism and replace it with a form of competitive rating. The Advisory Council is concerned about the effects this particular bill will have on the insurers, employers, and injured workers of Massachusetts. In addition, the Advisory Council seeks to be apprised of any aspects of this bill that are problematic and which areas can be rectified with legislative amendments.

To accomplish this end, the Advisory Council has engaged the services of J. H. Albert International Insurance Advisors, Inc.

The scope of this report includes discussion of the following issues specifically:

a) The advantages and disadvantages of adopting competitive rating of workers' compensation in Massachusetts in the current climate.

b) The effects of competitive rating on the pricing of workers' compensation insurance including rate movement in a "hard" insurance market.

c) The effects of competitive rating on the health of the workers' compensation insurance market in Massachusetts, with particular emphasis on smaller insurance carriers, larger insurance carriers, self-insurance groups and self-insured employers.

d) The effects competitive rating may have on the quality of services provided by carriers to employers and employees (including loss control, claims management, payment of medical benefits, and payment of indemnity benefits).

e) The effects competitive rating would have on the residual market in Massachusetts, how residual market rates should be tied to competitive market rates, and prevention of repopulation of the residual market as the result of competitive rating.

f) Comparison of legislation filed as House 4047 to a representative sampling of competitive rating statutes in other states.

g) Identification of major, relevant and available literature and research on competitive rating published since 1989.

Twenty (20) states chosen by J. H. Albert were contacted. Material obtained from those states, as well as material obtained from other sources, was reviewed.

This report is not designed to be academic in nature. The Council has requested, and we have agreed to supply a clear, concise, easy to understand statement of our conclusions. Much theory and background have been omitted to allow the conclusions to stand out as clearly as possible.

METHODOLOGY

Analysis Team

The following individuals were primarily responsible for this report:

Frank Licata, Project Leader
Martin S. Berman, Consulting Principal
James W. Evans, Jr., Consulting Principal
Suzanne I. Benson, Staff Consultant

Limitations and Reliances

This report includes executive summaries, recommendations and narrative explanations. The comments and recommendations contained in this report are the authors' views as practitioners in the Massachusetts workers' compensation market. J. H. Albert did not do basic research. Because many states have already adopted the competitive rating format, and since much basic research was available, our opinions are based on that pre-existing material, as well as our experience in the field. The comments and recommendations are also based on sources which were obtainable in the very short time period allowed for this report.

Method of Obtaining Information

J. H. Albert contacted the insurance department in 20 states. The states were chosen based on the following criteria:

- Whether or not they were operating under competitive rating.
- Year of conversion to competitive rating.

- Population size.
- Extent of industrialization.
- Workers' compensation market share.
- Whether or not we knew that they had published material on the subject.
- Other factors.

We requested from all states any material they may have relating to the subject of competitive rating in the following categories:

- Minutes of hearings.
- Reports commissioned.
- Copy of law.
- Follow up studies.
- Other.

We reviewed all of the written material which was made available to us. Additionally, some individuals were interviewed.

The 20 states contacted were Alabama, California, Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Texas, Virginia, and Wisconsin.

Information was requested from the following organizations:

- The Massachusetts Workers' Compensation Rating & Inspection Bureau
- The National Association of Insurance Commissioners
- The National Council on Compensation Insurance (NCCI)
- A. M. Best Company
- Standard & Poor's

- The Pioneer Institute for Public Policy Research
- The American Insurance Association
- The Alliance of American Insurers
- California Workers' Compensation Institute
- The Insurance Library of Boston
- John Burton's Workers' Compensation Monitor
- The Workers' Compensation Research Institute
- The Society of CPCU

The following individuals were interviewed to collect data, opinions, and positions on the subject of competitive rating:

- Massachusetts Workers' Compensation Rating & Inspection Bureau
    - Roy Stewart, President
    - Howard Mahler, Chief Actuary

- National Federation of Independent Businesses (NFIB)
    - Caroline Boviard

- Small Business Association of New England (SBANE)
    - Ford Spalding, Vice Chair

- Independent Property - Casualty Insurers of Massachusetts, Inc.
    - James Moran, Vice President & General Counsel
    - James Radley, Eastern Casualty Insurance Company
    - Linda Sallop, Atlantic Charter Insurance Company
    - James Morse, Arrow Mutual Liability Insurance Co.

- Massachusetts Employers Insurance Exchange
  - Donald Barber, President

- Massachusetts Self-Insurers Association
  - Paul Goodrich

- Alliance of American Insurers
  - Edward Donahue, Northeast Regional Manager

- American Insurance Association
  - David Corum, Assistant Vice President

- Liberty Mutual Insurance Group
  - David Kenepp, Manager of Workers' Compensation

- A. M. Best Company
  - Michael Farinella, Senior Research Editor
  - Marvin Shulman, Assistant Vice President

- National Council on Compensation Insurance
  - Barry Llewellyn, Senior Vice President

- California Workers' Compensation Institute
  - Edward Woodward, President

- Professional Independent Insurance Agents of Massachusetts
  - Frank Mancini, Executive Vice President

- National Association of Professional Agents
  - John Partridge, Vice President Member Relations

- Insurance Brokers and Agents of the West
  - Steve Young, Staff Counsel and Vice President

- National Association of Insurance Commissioners
  - Robert Klein, Director of Research
  - Eric Nordman

- James Chelius, Professor of Economics, Rutgers University

- Compensation Advisory Organization of Michigan
  - Jon Heikkinen, Manager Rating and Data Processing

- Michigan Office of Financial Regulation
  - Donald McMahon

- New Hampshire Insurance Department
  - Laurette Gendron, Workers' Compensation Rate Analyst

- Illinois Department of Insurance
  - Frank Weaver, Supervising Insurance Analyst
  - John Gatlin, Insurance Analyst
  - Bob Gossrow, Head Actuary

- New York Insurance Department
  - Anne Kelly, Chief Actuary

- New Jersey Compensation Rating and Inspection Bureau
  - David Hannum, Special Duty Commissioner
- Virginia Bureau of Insurance
  - Sandra Moyer, Senior Examiner
- Wisconsin Bureau of Market Regulation
  - Susan Ezalarab, Director
- Missouri Department of Insurance
  - Kevin Lanahan, Workers' Compensation Specialist
- Pennsylvania Department of Insurance
  - Randy Rohrbaugh, Office of Rate and Policy Regulation
- Maine Bureau of Insurance
  - Eric Cioppa, Workers's Compensation Specialist
- Texas Department of Insurance
  - John Gleba, Chief Actuary
- Minnesota Department of Commerce
  - Craig Anderson, Chief Actuary
- Hawaii Department of Commerce and Consumer Affairs
  - Shelly Santo, Manager Insurance Rate and Policy Analysis
- Delaware Department of Insurance
  - Cathy Mulholland, Director of Company Regulation

- Maryland Division of Insurance\
  - Lars Kristiansen, Associate Commissioner, Legislative and Regulatory Policy

- Rhode Island Department of Insurance
  - Eugene Daignault, Workers' Compensation Administrator

- Connecticut Insurance Department
  - Walter Bell, Property and Casualty Rate Filings

- Alablama Department of Insurance
  - Johnny Johnson, Property and Casualty Unit

SECTION 1.

Discussion of the advantages and disadvantages of adopting competitive rating in Massachusetts in the current climate.

EXECUTIVE SUMMARY

In reviewing the literature and information available to us, we find advantages to competitive rating with few apparent disadvantages . The advantages include:

- Competitive rating would provide a system in which the workers' compensation insurance product would be delivered to employers at a price which is as low as possible consistent with insurer solvency.

- A system of competitive rating would facilitate continued depopulation of the residual market, and could help to prevent recurrence of the crisis of the late '80s and early '90s when the residual market (assigned risk pool) reached over 60% of volume, and generated hundreds of millions of dollars in deficits.

- We do not expect competitive rating to have negative effects on well run small insurance carriers or individual self-insureds. Likewise, competitive rating should not have a negative impact on provision of services to employers or employees.

Disadvantages include the following:

- Pricing of workers' compensation insurance would be less stable than under the current administered pricing system. The extent of the volatility may not be great. However, stability under administered pricing comes from regulators capping prices at a level below what the market dictates, and such regulation comes at a price.

- Competitive rating could also affect the future prosperity and continued existence of self-insured groups. Such groups represent a very small percentage of the workers' compensation market.

Competitive rating has been installed in many states with generally positive results.

Overall, competitive rating would ensure the continuation of a healthy workers' compensation market to the benefit of employers, employees, and efficient insurance companies through assuring adequate prices for the underlying costs. This creates a market where insurance companies can make an acceptable return on investment. However, irrespective of the rating mechanism and its impact on price competition, one cannot ignore the fundamental effect of underlying costs, such as benefit levels, medical and rehabilitation costs, on pricing. It is important to realize that competition is not the sole determinant of pricing and that control of underlying costs can have a therapeutic effect on pricing.

RECOMMENDATIONS

1. The Commonwealth should re-evaluate the administered pricing system for workers' compensation in which approval for use of certain premium rates is required by state regulators to be used by all insurers. The Commonwealth should consider a competitive pricing arrangement where rates are determined by interaction in the marketplace between buyers and sellers (employers and insurers), with certain regulatory controls which will be discussed in Section 6.

2. In designing a pricing system, we believe it is best to allow the market forces to work as freely as possible, with regulators avoiding "micromanagement." Rather, regulators should manage the overall process, insuring that it is functioning to the benefit of the Commonwealth's employers and employees in the large sense.

   Regulators should concentrate on the effectiveness of the market as a whole, with less emphasis on monitoring individual rates charged by any specific insurer, as long as those rates are not excessive, inadequate or unfairly discriminatory. Rather than setting rates, regulators should focus more on determining whether the market is a competitive one.

NARRATIVE

Background To The Competitive Rating Question

Most participants would agree that the Massachusetts workers' compensation market is healthy at the present time. Rates have declined, there is a vigorous voluntary market (private insurers willingly issuing insurance policies), and the residual market (assigned risk pool) is declining in size.

Some would ask, "why disrupt this healthy market by changing it?" Others would ask what steps we can take now to ensure continued health of the market, and prevent a recurrence of the crisis of several years ago?

It is possible that the current situation is only temporary ; problems may recur unless steps are taken to prevent future rate inadequacy. The market is currently healthy because rates are adequate as a result of a series of rate increases (followed recently by rate reductions) and underlying costs , including benefit structures, were changed by a reform act in 1991. However, rate adequacy is relative. As mentioned, there have been two recent rate reductions, and underlying costs are continually subject to inflation. Eventually, costs may once again overtake rates, and market health will be jeopardized. The possibility of a new crisis similar to the one during the '80s and early '90s is real.

State insurance regulators through their organization, the National Association of Insurance Commissioners (NAIC), have suggested that competition in workers' compensation is desirable. Government organizations such as the General Accounting Office (GAO) have also encouraged competition. Many states have instituted competitive rating systems, the first ones doing so in the early 1980s. The results in these states have been largely positive. Currently, Massachusetts and eight other states are the only ones which have not adopted some form of price competition in workers' compensation.

The conclusion of this report is that competitive rating of workers' compensation would help ensure the continued health of the market and that the timing for implementation of competitive rating is good. Competitive rating alone will not assure the continued health of the workers' compensation market; ongoing control of losses and their costs is critical.

Implications for Massachusetts Business Climate

The current state of the workers' compensation market is good for the Commonwealth. It is important to ensure or improve the market conditions The National Association of Insurance Commissioners (NAIC) in a 1993 report summarized the impact of workers' compensation on states' economies:

> "...the workers' compensation rates filed and approved by the insurance commissioner can have significant implications for a states' business climate and economy... Higher workers' compensation premiums have forced firms to raise their prices or change their operations, including curtailing employment and production, relocating or going out of business."

The threat of Massachusetts employers relocating their businesses to other states represents a real competitive problem, as some states have distanced themselves from administered pricing. To the extent that competitive workers' compensation rates offer price or market advantages to employers, Massachusetts will be at a competitive disadvantage under administered pricing in relation to those other states.

History of Rate Regulation

Since the inception of workers' compensation as a mechanism for compensating injured employees in the early 1900s, workers' compensation has been highly regulated. In meeting their legal obligation to provide benefits for injured employees, employers generally contracted with insurance companies to provide the benefits in exchange for an insurance premium. Much of the regulation involved the premium the insurers would be allowed to charge employers for the insurance policy.

Insurance premiums for workers' compensation have been derived by applying a "rate" per unit of payroll,." Rate regulation in all lines of insurance has generally had the goal of ensuring that insurance rates were not excessive, inadequate, easily manipulated or unfairly discriminatory.

Since employers were legally mandated to provide workers' compensation coverage, the practical goals of regulation were to ensure that:

1. coverage was available;

2. coverage was affordable.;

3. and, once premium was paid to an insurer, that insurer remained solvent so that benefits ultimately due to employees would be paid to them.

Practical Effect of Regulation Today

The current rate regulation system for workers' compensation in Massachusetts is "administered pricing." Under administered pricing a rate request is filed by all insurers in concert with their rating bureau (The Massachusetts Workers' Compensation Rating and Inspection Bureau) and rates are either approved by the Insurance Commissioner or some other rate level is mandated by the regulator. Historically, rates which have been approved have been lower than those requested by the Bureau. Once approved, all insurers must adhere to that rate schedule. Downward rate deviations are permitted upon application, but very few insurers have taken advantage of this option.

In reviewing recent history, we find that the administered pricing system is not the only system to address the three goals of regulation outlined above. One could also argue that administered pricing has not guaranteed the achievement of those goals.

1. One goal is the availability of coverage. Regulation of rates may produce effects which are contrary to this goal.

Insurance companies, as all private companies, need to achieve a certain rate of return from their business activities. Otherwise, they will refrain from carrying on those business activities. If insurers were allowed to set workers' compensation rates based on their own costs and market pressures , they would be better able to ensure that they achieve the required rate of return. However, under administered pricing, , where rate increases may not be permitted, one alternative for insurers faced with an inadequate rate of return is withdrawal from the marketplace.

This is what happened between 1988 and 1992 when the voluntary market contracted and the residual market (assigned risk pool) grew, representing almost 65% of statewide premium volume in 1992.

The following chart illustrates how dramatically five major insurers reversed their positions in the Massachusetts workers' compensation market during that period. The top five insurers in 1989 in terms of workers' compensation premium written voluntarily for employers were Liberty Mutual, Aetna, CIGNA, Wausau and AIG. Their total voluntary written premium in 1989 was $317,000,000. By 1992, the total voluntary workers' compensation premium written by these five insurers was down to $154,000,000, a 52% reduction.

Voluntary Premium Written - Massachusetts

Insurer	1989 Volume (millions)	1992 Volume (millions)
Liberty Mutual	$135	$ 86
Aetna	$ 52	$ 14
CIGNA	$ 48	$ 7
Wausau	$ 41	$ 19
AIG	$ 41	$ 28
TOTAL	$317	$154

State control of insurance rates may produce effects contrary to the goal of coverage availability if rates are inadequate and insurers withdraw from the market. One other result, if rates are set artificially high, is windfall profits for insurers which would be harmful to employers.

2. The second goal is coverage affordability. Rates should not be so high that employers, who are required by law to purchase coverage, cannot afford that coverage.

This is a fundamental goal in the compact between employers and employees. Without affordable costs, employers and employees cannot benefit from the certainty of scheduled benefits and limited legal recourse that is the foundation of workers' compensation. However, this affordability may not be achieved for employers as a whole on a long term basis through rate regulation.

Insurance rates must relate to underlying costs (the costs of providing actual benefits to employees). If underlying costs are increasing, regulation cannot effectively in the long term stop rates from increasing as well. If rates are capped by regulators in the face of increasing underlying costs, insurers will flee the market, resulting in an increase in the residual market.

Due to the inadequate rates, the residual market will sustain large deficits. This is what happened in Massachusetts in the period between 1988 and 1992.

The way to make workers' compensation insurance affordable for employers is to control the underlying costs, which involves controlling the costs of providing benefits to employees. A reform package was put into law in 1991 addressing underlying costs, and when the effects eventually worked their way through the system, rates fell.

3. Insurer solvency through rate adequacy is the third goal of regulation.

In the early decades of workers' compensation (beginning in the early 1900s) insurer solvency was a major concern and rate regulation was considered a valid way to address that concern. The system was new and its ultimate costs were not immediately known. Insurers were smaller and less sophisticated, and they did not have efficient data gathering methods. Furthermore, insurance company rating services were not as extensive or as sophisticated as they are now, and guaranty funds were inadequate.

The concern over individual insurer solvency is no longer the important issue it was earlier. Generally, insurers are larger and operate in many, if not all states and many foreign countries. They also write many lines of insurance, so that workers' compensation is a fraction of their total business. For most insurers, it is unlikely that rate regulation of one line of insurance in any one state could cause them to become insolvent.

A separate concern today is for the solvency of insurers operating only in Massachusetts and writing only workers' compensation. Based on the history of competitive rating in other states, we do not believe this is a significant problem, however. No state which we studied has experienced a significant incidence of small insurer failures as a result of competitive rating. Section 3 will address the effects of competitive rating on small insurers.

Impetus For Competitive Rating

For many years it has been theorized that a competitive market in workers' compensation would lead to benefits for the system overall. According to the California Workers' Compensation Rate Study Commission:

> "In 1977, a Justice Department Task Force on Anti-Trust Immunities report on The Pricing and Marketing of Insurance concluded that workers' compensation appears to be one line of property/casualty insurance which is perhaps most conducive to total state de-regulation and full exposure to market controls; there is relatively greater predictability and stability in the industry, the buyers of the service are generally informed, there is potential for vigorous price competition, and there are economic incentives to employ loss controls."[1]

The National Association of Insurance Commissioners (NAIC) - the state insurance regulators themselves - were also looking into the issue of rate regulation in workers' compensation. They had begun questioning the effectiveness and desirability of administered pricing and reviewing alternative forms of competitive rating. In June of 1989 the NAIC issued the opinion that insurance company rating bureaus should be prohibited from filing final rates for property and casualty insurance, but did not immediately include workers' compensation in this opinion. The opinion was expanded to include workers' compensation several months later. This was the first articulation by the NAIC of their concern that insurers could create rates in concert through rating bureaus in administered pricing jurisdictions, without the benefit for consumers of market competition. Several states adopted this recommendation and implemented a competitive rating system.

After several years of debate and review of experience in jurisdictions where alternative rating forms were in place in 1992, the NAIC published an Alternative Model Workers' Compensation Rating Act. This model act provided the language for states which were willing to adopt a system other than administered pricing.

This law provided the mechanism for states to move from the filing of final rates by insurer's bureaus to a system where only "advisory loss costs" would be published. The theory was that insurers, especially small insurers, need to pool data on loss experience in order to have meaningful information upon which to base the price of insurance products, but that they should be able to determine their own expense components without collaboration with other insurers. A bureau would file loss cost rates which would address the loss component of the final rate, and the insurers would add their own expense and profit components, so that an element of rate competition would exist. The idea that the loss cost rate is "advisory" indicates that insurers would not be required to adhere to the loss cost rate, but it would be provided to insurers for informational purposes. This would further enhance the level of competition.

In 1993 the separate Workers' Compensation Model Rating Law was eliminated by NAIC and folded into the all lines Property and Casualty Model Rating Law. This was an acknowledgment that for rate setting purposes, workers' compensation is no different from other lines of insurance.

The NAIC recommendation was influential. Virginia's Bureau of Insurance reported the following concerning the competitive rating bill in that state:

> "The Commission-sponsored HB626 resulted primarily from a position taken in 1989 by the National Association of Insurance Commissioners (NAIC) that insurers' reliance on <u>final</u> rates prepared by rate service organizations was going beyond the appropriate realm of activity for data sharing among companies... In December 1990, the NAIC adopted a recommendation that, no later than 1994, states should adopts appropriate legislative provisions to prohibit rate service organizations...from filing final rates."[2]

<u>Economic Theory</u>

Economic theory states that free competition between buyers and sellers in a market for products or services operates to the benefit of both parties and the economy as a whole. As quoted from the NAIC report Market Conditions in Workers' Compensation Insurance:

"Competition is considered desirable from society's standpoint because it ensures that resources are being used in the best way possible."[3]

The workers' compensation market contains all or most of the attributes necessary for competition to work effectively. According to Robert W. Klein writing in the Journal of Insurance Regulation:

"An important impetus behind competitive rating and workers' compensation insurance has been the heightened effort in many states to lower business costs to promote economic development. Workers' compensation costs have often been identified as a significant area for reform in this effort... Competitive rating has been considered as a means to promote efficiency in providing workers' compensation insurance and lowering premiums without impairing the benefits paid to workers."[4]

This paper will not deal with economic theory in general, or as it relates to workers' compensation insurance. Instead, it will focus on practical experience available on competitive rating of workers' compensation developed in other states.

Experience in Other States

Currently, all but Massachusetts and eight other states have implemented a form of competitive rating in the workers' compensation line. The first states to move to a competitive rating system did so in the early '80s, so that now there is more than ten years experience. Two large industrial states, Illinois and Michigan, made the move in 1983. Michigan is particularly helpful because they periodically publish status reports.

Opponents of competitive rating have expressed several fears. Among them are excessive prices which result in increased costs to employers; inadequate prices (predatory pricing) where insurers try to drive out competitors; insurer insolvency; reduction in services to employers and employees; and, removal of subsidies for small and/or high risk employers. Experience in other states has shown that generally none of these fears have been realized.

Quotations from state insurance department documents follow:

> Illinois: "Indications are that the new law is working to the benefit of both employers and employees."[5]
>
> Michigan: "The data indicates that from the employer's viewpoint, there has been a significant improvement in the Michigan workers' compensation insurance market since the introduction of competitive rating in 1982."[6]

Of the 20 states we contacted, 17 of them had implemented competitive rating as of the date of our contact. All, with the possible exceptions of Minnesota and California, have experienced positive results.

In Minnesota, the experience is not clear. Minnesota adopted competitive rating in 1984. In the late '80s there was concern that their rates were higher than those in the neighboring state of Wisconsin. A report commissioned in 1989 completed by the Department of Commerce indicated that "workers' compensation rates should be strictly regulated." We have reviewed this report and find it unconvincing. At that time, no action was taken as a result of the report.

A report dated February 1994 completed by Milliman & Robertson contradicts the 1989 Department of Commerce report by stating:

> "We conclude that the Minnesota workers' compensation market is a workable competitive market in which workers' compensation insurers are not earning excessive profits. In fact, in 1992 the average insurance carrier in this market earned a significantly lower rate of return than that attained by other insurance and non-insurance markets."[7]

The negative conclusions of the Department of Commerce Report are primarily based on the fact that Minnesota's rates are generally higher than those in Wisconsin. However, this comparison between Minnesota and Wisconsin is meaningless because the differences in benefit levels were not adequately quantified. Further, the approach typifies the state to state competitive analysis found in economic development studies. It does not address the reasons for differences in costs; it only identifies them and suggests rate regulation as one answer to the perceived problem.

Another concern addressed in this report is the lack of consumer information which exists in Minnesota. Such information would include the topics of the existence of competitive rating, how to take advantage of the options, comparative price data and similar issues. While educated consumers are important to the success of a competitive rating system, the lack thereof is not a sufficient reason to repeal competitive rating. Rather, this lack of consumer information should be seen as an opportunity to improve the system to make it work effectively. We will discuss Minnesota's experience with consumer information in a later section of the report.

We understand from sources in Minnesota that procedural change will be made effective January 1, 1996, but that competitive rating will be retained.

In California, where the competitive rating law went into effect on January 1, 1995 the market has experienced widespread rate cutting in the first few months. Some participants in the California market are concerned about insurer solvency. California's pricing situation is addressed in Section 2.

Mechanics of Competitive Rating

In discussing the impact of competitive rating, the various alternative methods of workers' compensation rating must be understood. The reasonable alternatives are outlined below; each approach starts with class rates.

A workers' compensation class rate, when applied to the payroll base, is designed to produce enough premium to cover three components: losses (payments of benefits to employees), insurer expenses, and insurer profit. Under administered pricing, a Rating Bureau, on behalf of all insurers writing workers' compensation, files a rate request designed to include all three components. The request is either approved or modified by the insurance commissioner. When approved, the same rates are used by all insurers.

Rates which include the loss, expense and profit components are called final rates.

One approach of competitive rating is that the Bureau files rates to cover loss costs only, but is not allowed to file final rates. While, insurers need the credibility of collective data to evaluate loss information, they should be able to individually apply their own expense and profit factors. Under this system, a level of competition will exist with respect to the expense and profit components. Competition may be limited to this extent.

A second alternative approach to competition is to allow insurers to deviate from the filed loss cost. In other words, the insurers are free to establish a rate without regulatory approval as long as the market remains competitive.

A third alternative is "schedule rating." In this competitive scheme, base rates, however derived, are subject to schedule credits or debits depending on an insurers evaluation of the employer's exposure. Schedule rating is an important way for insurers to acknowledge an employer's individual characteristics. Under schedule rating, employers are rated not just as members of a class, but also based on their individual merits. Schedule rating focuses on activities and characteristics rather than results. This differs from experience rating which attempts to do the same thing based on the predictive value of past loss experience.

In a system without schedule rating, an employer's premium is determined by applying its payroll to the applicable rate which is dependent upon the employee classifications, and then adjusting that premium by experience modification factors, which are based on the employer's past loss experience. Schedule rating goes a step further by allowing the insurer to credit or debit the premium based on the insurer's subjective evaluation of the employer as a workers' compensation "risk". Insurers take into account the following employer characteristics when considering the various plans: condition of premises, medical facilities, safety devices, employee selection, training and supervision, management cooperation, and management safety organization. Another consideration for the insurer is to determine whether the employer is more likely to be exposed to losses than the average business in that classification. The maximum debit or credit allowed varies from state to state, a common maximum being 25%. Some states, however, do not control the amount of credit or debit permitted. Illinois, for example, has allowed schedule credits up to 60%.

Finally, some competitive rating systems allow insurers to develop their own classification schemes. That is, they are allowed to determine how they will classify and combine various employment activities, rather than relying on traditional NCCI scopes of employment classifications. Currently in Massachusetts, all insurers use the same plan which classifies employees according to their risk of injury or illness through common descriptions of work or employment activity. If classification freedom were allowed, the individual insurers could determine not only the rate for each classification but also the parameters of the classifications themselves.

Involvement of the Insurance Commissioner

One universal component of competitive rating structures is the knowledge that a commissioner of insurance has the right to step in at any time that a market becomes non-competitive. If the market for workers' compensation becomes non-competitive by demonstrating signs of a monopoly for example, a commissioner of insurance has the right to take corrective action such as re-imposing administered pricing. The definition of "non-competitive," which triggers the action, becomes important. Any competitive rating law should include this power.

Section 6 will discuss how this oversight could be included in the legislation. We will discuss the features addressed above that would be most suited to the Massachusetts situation and whether the Bill H4047 addresses them correctly.

SECTION 2.

The effects of competitive rating on the pricing of workers' compensation insurance, including rate movement in a "hard" insurance market.

EXECUTIVE SUMMARY

The effects of competitive rating on the pricing of workers' compensation can be addressed at two levels. In the aggregate, we can speculate on the movements in pricing for the market as a whole. At the same time, the impact on individual employers will be tempered by other considerations. For example, at certain premium levels employers have competitive rating plans available, such as retrospectively rated or other loss sensitive plans, dividend plans, and cash flow plans. Price movements at the market level may have little effect on the workers' compensation costs of those employers. The availability or premium level eligibility of those plans may be affected by the general health of the market, however.

If workers' compensation rates are deregulated, we expect that (i) rates will have a tendency to be more volatile, (ii) rates will ultimately be at a level somewhat lower than where they would be under administered pricing, and (iii) a healthy competitively defined and driven market will be established.

Employers must have market knowledge in order to be intelligent shoppers, and as a result, be able to achieve significant savings.

Experience in some states has shown that in an environment which has adequate rates at the time of deregulation, serious rate cutting has occurred in the initial two years of implementation, but that rates eventually stabilize to a level in line with the underlying costs. If rates suddenly become inadequate due to increasing claims, increasing medical costs, changes in the workers' compensation law, or other reasons, rates could move upward as well. Employers should be aware that this volatility is possible, just as in all other lines of insurance which they purchase. In the long run, this volatility is the price employers will pay for ultimately lower average costs and a continued healthy market.

NARRATIVE

Insurers writing workers' compensation insurance must obtain enough premium from employers to pay the losses (benefits to employees), cover the expenses in providing the product, and earn a reasonable rate of return (profit). In a free market, the insurers themselves determine the appropriate level at which to price their product and the employers (the buyers) determine whether they will pay that price. This interplay between insurers and employers in the market establishes a "fair" price. If the price were excessive, other insurers would bid for the business by offering the same policy at a lower price. Ultimately this competitive process drives the price to a “fair” level.

Under the current administered pricing arrangement, there is no market interplay between insurer and employer with respect to the actual workers' compensation rate (although rating plan price competition does take place in other ways as discussed below). The insurers via their bureau submit a rate request which is intended to encompass losses, expenses and profit for all insurers in the aggregate. The Division of Insurance then evaluates the rate request and grants approval for a rate which is usually lower than the requested amount. In recent years the insurance department has approved rates at a level representing a reduction of between one-third and two-thirds of the original request.

Under administered pricing, once a rate is set by the regulator, all insurers begin using the new rate at the same time. If there are miscalculations in setting appropriate rates, the result is compounded by the number of insurers and policies written, and by the system moving in unison. When adjustments are made, another rate filing is debated, and the system moves as one toward a correction.

Insurers are in a better position than regulators to determine individually what rates are appropriate for their own books of business. Rate making involves many variables and estimates of future conditions. Insurers may underestimate or overestimate appropriate rate levels, but they should be operating independent of their competitors. As a result, when corrections are made, one should not see a large effect on the market. In addition, individual insurer corrections should come at different times and possibly be in different directions. These changes often would offset each other in terms of effect on the overall market. Market movements will be smoother and the market will be self-adjusting.

Under administered pricing, the insurers in the aggregate try to convince the regulator of the extent of their losses and expenses, so that they can be granted a commensurate rate. The process involves negotiation and an adversarial presentation of "evidence" regarding the appropriate rate levels. This makes it difficult to determine the proper level. The observed discrepancy between the requests and the rates granted testifies to the inexactness of the process and possibly the results.

Under competitive rating there would be no need for debate on the subject. The market would adjust rates to the proper level. An insurer attempting to "convince" an employer of the need for an excessively high rate, would be undercut by another insurer willing to take a lower, but still adequate profit. Furthermore, more efficient companies would be able to offer still lower rates, and would be rewarded for their efficiency by a higher volume of business. The market would cause insurers to be more efficient than they are currently. This competitive process, one insurer bidding against the other, forces rates down to as low a level as possible while still insuring a reasonable rate of return for the more efficient companies. This is ultimately beneficial to employers, assuming proper levels of service and benefit payment.

In the long run, rates need to be at a certain minimum level to be adequate. In the short run under competition, rates may initially be lower than an adequate levels, as insurers try to establish market share. Experience in other states has shown that rate cutting may occur immediately following the passage of competitive rating (assuming rate adequacy at the time of implementation), but that rates ultimately stabilize.

At the same time, unregulated rates can increase dramatically under certain conditions. Historically, property and casualty insurance in general has been cyclical, with alternating hard and soft periods. During soft markets, prices can linger below cost for several years as insurers attempt to gain market share and/or hope to make up for losses via investment income. Ultimately, the market turns and insurers need to make up lost ground and prices increase, sometimes well above the level necessary for an adequate rate of return. Under administered pricing these wide swings would not be possible, and that stability can be seen as an advantage of the current system. Much of the advantage is an illusion, however, because although insurers cannot raise rates under administered pricing, they can withdraw from the market.

Under a competitive pricing system, employers need to be aware that volatility is possible, but they have experienced it with other forms of property and casualty insurance and workers' compensation would be no different. Employers would be free to establish a rainy day fund during the soft markets, and should be prepared to pay more during the hard markets.

It needs to be noted that a certain level of rate competition does take place today, even under administered pricing. Insurers are able to file for rate deviations (downward only), although only two or three carriers have actually done so. They are able to offer employers a premium discount based on premium size, which can be approximately 10% of the premium, and they are also able to offer dividends which are paid after policy expiration. If the insured's size is great enough, insurers are able to offer retrospective rating and similar plans. These other plans are designed so that the employer's ultimate cost depends on the level of losses which the employer experiences. With the larger employers, those with at least premiums of approximately $100,000 to $200,000 per year, retrospective rating plans do indeed offer a large measure of competition. For employers smaller than that, however, rate competition would be the primary method of competing.

Some regulators fear that deregulating workers' compensation pricing would cause rates to immediately increase excessively. This is a valid concern. Whether or not rates do go up or down following deregulation depends, however, on the adequacy of current administered rate levels. Currently, rate levels appear adequate in Massachusetts, and it is unlikely that there would be any immediate excessive rate increase following deregulation.

Some studies of pricing effects in other states have been contradictory. The report by Klein entitled Michigan's Experience with Workers' Compensation Insurance, published in The Journal of Insurance Regulation states the following:

> "...it appears that competitive rating has significantly lowered the cost of workers' compensation insurance for employers. Michigan insurers responded to the new rating system with aggressive price competition during its first two years. While rate levels rebounded with the recent turn in the underwriting cycle, it appears that competition may have slowed the overall increase in rates in Michigan."[8]

A separate report entitled "The Impact of Open Competition in Michigan on the Employers Costs of Workers' Compensation" by Hunt, Krueger and Burton states:

> "The exhibit shows that after three years of experience there was a gross reduction of 13.6% in the average cost of workers' compensation insurance in Michigan...
> The data indicates that under open competition, the manual rates charged by carriers are considerably less than the manual rates that would have been charged using the rate-making procedures in place before open competition... Our conclusion is that the impact of open competition on workers' compensation insurance rates in Michigan during 1984 was substantial..."[9]

The same report examined open competition in seven other states:

> "Data provided by the National Council on Compensation Insurance have been used to make rough estimates of the net impact of open competition on insurance rates in the seven other states with open competition for 1984."

The author included a table showing the following results (a positive number indicates percent of reduction of rate as a result of open competition):

State	Estimated Net Impact of Open Competition
Arkansas	2.8
Georgia	7.8
Illinois	12.4
Kentucky	2.4
Michigan	25.9
Minnesota	-0.2 or 0
Oregon	33.8
Rhode Island	-4.3 or 0

Other reports have conflicted with the findings of Hunt, Krueger and Burton, indicating that open competition may not cause a reduction in rates at all, the effect may be neutral, or it may even cause an increase in rates.

Klein of the NAIC in a 1991 report entitled "Market Effects of Loss Cost Systems in Workers' Compensation Insurance" was less enthusiastic about the potential price reductions, but confirmed that negative results were minimal or non-existent:

> "In sum, there is no evidence to indicate that significant market problems have occurred due to loss costs... The lack of apparent market effects does not mean there are no net benefits or costs to lost cost systems over the long run. One of the advantages of loss cost and competitive rating systems is the ability to re-allocate regulatory resources to other areas such as market conduct and solvency. More flexible pricing may also benefit insurers (and ultimately consumers) by forcing them to look more closely at their costs of operation."[10]

Very recently, Timothy Schmidle wrote an article entitled "The Impact of Insurance Pricing Deregulation on Workers' Compensation Costs" which appeared in the September/October 1995 edition of John Burton's Workers' Compensation Monitor. In this, he attempts to summarize and highlight principal findings of other studies and to summarize his own research. The article states:

> "...the principal findings of my research are...that in a variety of models, there is no evidence suggesting that deregulation has resulted in lower workers' compensation costs, thus contradicting the findings of some earlier studies and undermining the argument often made in support of deregulation. There is, in fact, considerable evidence that deregulation has little impact on costs, indicating that states should not view pricing regulation of the workers' compensation market - or the lack thereof - as a major influence on the costs of workers' compensation in the states!"[11]

Given regulations' lack of effect, however, Schmidle did go on to state:

> "State insurance departments currently engaged in administered pricing would probably be better served by devoting their resources to other duties than rate regulation."

Schmidle also quoted Zack Stamp, who wrote on the subject in the January 1991 issue of Best's Review as follows:

> "...because competition does at least as well, if not better than, government rate regulation, why should we pay for a result that we can obtain for free? Clearly, the additional expenditures and already scarce staff resources required for rate regulation could be better spent for solvency surveillance or market conduct programs that benefit consumers."

The contradictory nature of the research on pricing should not unduly confound our coming to a conclusion on this subject. The various reports are consistent. It is clear that workers' compensation insurance pricing depends most heavily upon underlying costs, most importantly the law as it pertains to delivery of benefits to employees. Since all state systems are different with respect to benefits provided, it is extremely difficult to adjust for the costs of such benefits in calculating the impact of a rating structure on price. Additionally, a competitive market does not just automatically deliver favorable results. It depends on employers having good market information and being activists, aggressively shopping for the best product at the best price.

Minnesota is an example of how a competitive rating program can be allowed not to work. Several years after the implementation of competitive rating in that state, the department conducted a survey which found that the majority of employers do not actively compare pricing in procuring workers' compensation coverage. Further, they found that "at least 60% of the employers thought that workers' compensation rates are regulated." In such a situation, competition cannot work effectively. The existence of competitive rating must be effectively communicated to employers and they must be encouraged to negotiate terms with insurers.

The pricing results observed in other states have varied. However, in applying those results and the theory of supply and demand, we conclude that competition gives the Massachusetts market the best chance to achieve the lowest rate consistent with underlying costs. Implementation must be done correctly for those benefits to be delivered. Deregulation can deliver market benefits,such as residual market reduction, elimination of residual market subsidies, increased choice, other than price. Achieving these benefits is worthwhile as an adjunct to price improvements. Experience in other states has shown that deregulation has, as a minimum, no harmful long-term price effects. Resources devoted to regulation should be devoted elsewhere.

Furthermore, the rate studies measure overall effect on rates, averaged among all employers in various classifications. A key point is that under open competition some employers do better than average and some do worse than average, depending on their risk level and the aggressiveness with which they shop for coverage. Competition does give all employers the opportunity to reduce their workers' compensation costs by being active consumers. This opportunity can be looked at as the primary price benefit for employers of open competition.

The California situation is interesting and deserves mention.

California adopted competitive rating of workers' compensation effective January 1, 1995. Since that time the market experienced widespread price cutting, with accusations by some parties of "predatory pricing" and fears of potential insurer insolvencies. Whether the concerns are the result of little more than rumors, or whether they are founded will be discussed. It is fair to say, though, that the market there is currently in a frenzy.

California Insurance Commissioner, Chuck Quackenbush, in legislative testimony made the following comments on February 27, 1995:

> "Open rating has been in place for less than two months. While it is too early to know the exact effect it has had on the insurance market or on the health of individual insurance companies, anecdotal evidence indicates that cutthroat competition is taking place - resulting in plummeting rates. The Department of Insurance is putting the institutional pieces into place so that it can move quickly and efficiently to prevent insolvencies from open rating... At this point in open rating, no one can predict what will happen in the extremely volatile workers' compensation insurance market. The Department has a workable plan allowing it to regulate the workers' compensation market with full support of upper-level management. Open rating provides employers and employees with an opportunity to purchase lower cost insurance; the Department of Insurance will be vigilant and pro-active to ensure the existence of solvent workers' compensation carriers."[12]

At a later date, July 16, 1995, Bob Klein of the National Association of Insurance Commissioners responded to the concerns of a California insurance broker on the Internet as follows:

> "Aggressive competition and price reductions following the introduction of competitive rating in workers' compensation is not unprecedented. It happened in Michigan after competitive rating was introduced in 1983. Of course, the national commercial lines market generally and the workers' compensation markets specifically was soft at that time but the Michigan price cuts went beyond those at the national level. The Michigan state fund (sitting on a large surplus) also was a very aggressive competitor during this period and grew to be the largest writer in the state. After 3 - 4 years, the market stabilized in Michigan and prices rose although not to their pre-1983 levels. I am not aware of any insolvencies that resulted from this. I would be interested to hear what insurers have to say about the motives for this behavior but my impression is that facing a new, uncertain competitive market environment, insurers may be inclined to cut prices even below expected costs for a period of time to be sure they do not lose market share and perhaps even gain some with the hope that they will be well-positioned when prices eventually stabilize at more reasonable levels. There is some literature which suggests that the acquisition and value of private information on individual risks contributes to cyclical insurance pricing and might allow insurers to recoup some of their earlier losses..."

As Klein indicated, increased activity is not uncommon after competitive rating is enacted as insurers jockey for position. Concerned people watching from afar (Massachusetts) should be careful not to get overly concerned about a situation which was not unexpected, and is unlikely to continue. Views from A. M. Best Company, the noted insurance company rating agency, confirm this sentiment.

A. M. Best Assistant Vice President, Marvin Shulman, confirmed that as of September 1995 his company had not "taken negative ratings actions yet. It is not clear that results will justify negative ratings actions. We attempt to see companies through temporary rate dislocations."

Shulman at the time of the interview was in California reviewing insurance companies writing workers' compensation in California, with particular emphasis on the smaller less diversified companies. He did indicate that there has been rate cutting, and that they are seeing increasing loss ratios (less profitability), but that insurers are "still trying to find their way." He noted that insurers are of course free to increase rates as well as decrease them, and will do so if results deteriorate.

Shulman indicated that A. M. Best will continue to monitor the situation and see how insurance companies are reacting. He indicated that for a well positioned insurer to fall into financial difficulty not only must rates be grossly inadequate, but they must remain inadequate for a long period of time. He noted positive indications that the drop in rates was slowing and had found sentiment expressed by insurance company personnel that they would be looking at rate adequacy. He indicated that some insurance companies are willing to let premium volume fall rather than to compete at depressed rate levels, and that this is an indication that there is some common sense left in the market. Also, there are indications of loyalty by employers who are not all moving to the lowest priced offering.

It should also be noted that the California situation is different from Massachusetts in several respects. In California a massive workers' compensation reform law was passed in July 1993, of which the open competition portion, effective January 1, 1995, was only one part. Other changes, which were intended to put controls on underlying costs of workers' compensation, were phased in throughout

1993 and 1994. The annual report of California's Commission on Health and Safety and Workers' Compensation, issued in July of 1995, described the reforms as follows:

> "The reform legislation made sweeping changes to the whole California workers' compensation system, specifically in the areas of insurance, fraud, psychiatric and post-termination claims, medical care, medical - legal evaluations, vocational rehabilitation, alternative benefit delivery systems, benefit levels, injury prevention, disability evaluation, claims adjudication, and information systems. This reform legislation affects not only industrially-injured workers, but the entire workers' compensation community -employers and employees, insurers, medical care providers, applicant and defense attorneys, state government agencies, and members of the public."[13]

In effect, these major changes were made at the same time as rate deregulation. This created uncertainty in the marketplace as insurers needed to protect market share while worrying about what savings would result from the reform package, and how other insurers would reduce rates as a result of those savings. This was a recipe for disorder. In contrast, the major benefit reform package in Massachusetts was completed in 1991, and the market has had time to evaluate its impact and adjust to it.

Additionally, included in the California reform package was a section introducing managed care into the workers' compensation arena, in a much more extensive way than exists in any other state. This attracted the interest of non-workers' compensation entities such as health maintenance organizations (HMOs). Several HMOs entered the market by purchasing small workers' compensation insurers. This added capital to the market, effectively increasing supply which would put downward pressure on prices.

The broad view of the California situation is that it may be unique, the results there were not totally unpredicted, the situation is likely to stabilize, and the situation is too new to understand totally. For these reasons, the California situation should not weigh heavily on the Massachusetts decision.

Market Information

Market information on the part of employers is necessary for a competitive rating system to work effectively. In order for employers to shop for the best price of insurance, they must be aware that price differences do exist and they must have a way to determine what those price differences may be.

Possible problems resulting from lack of market information were discussed by Robert W. Klein in the Journal of Insurance Regulation:

> "...significant consumer information problems could result in suboptimal performance. When consumer information is poor it is possible for firms to sustain supracompetitive prices; but this situation does not necessarily call for rate regulation. Rather, there should be increased efforts to improve consumer information about the market..."[14]

Minnesota experienced problems with lack of market information on the part of employers. This may have been a contributing factor to their lack of satisfaction with competitive rating. A report by the Department of Commerce stated the following:

> "The department surveyed 325 randomly selected Minnesota employers. It found that a majority of employers do not shop around for workers' compensation coverage and that at least 60% of the employers thought that workers' compensation rates are regulated. It concluded that the employers' misconception of the insurance market effectively limits actual competitiveness within the system. For instance, at least one-third of the employers were not aware that workers' compensation rates may vary from one insurer to the next. Further, nearly half of the employers had not switched insurers over the past five years."[15]

Lack of consumer information can throttle a competitive rating system, allowing insurers to obtain rates which are too high. It is competition for business which forces insurers to correctly price their product and competition will only occur if employers/consumers have sufficient market information.

Several states have developed consumer information mechanisms to provide market data to employers:

- Pennsylvania has published a booklet for employers entitled "Your Guide to Workers' Compensation Rate Levels in Pennsylvania." The booklet contains a listing of all insurers writing workers' compensation in the state and their rate levels. Texas has a similar publication.

- Missouri has gone a step beyond that, recognizing that the rates can change from time to time, making publications outdated. A Missouri consumer information brochure explains how it works:

> "Who Sells Workers' Compensation Insurance and How is it Priced?
> Currently in Missouri, approximately 250 insurance companies sell workers' compensation insurance in the voluntary market. Each of these companies is required to file individual rates for each employer job classification for which it offers coverage. Because the rate for each employer classification varies with each insurance company, the Department of Insurance has established an automated 900 telephone number system to assist employers seeking the lowest rates. The 900 number allows an employer to receive information on the ten insurance companies with the lowest rates for a given job classification code. This information may be received via facsimile or mail. The system may be accessed by dialing (telephone number). The current charge is $1 per minute, with an average call costing $3 or $4. You must have your four-digit employer classification code ready when calling."

We believe that consumer information would be helpful for employers. It is an essential component of a successful competitive rating initiative. Further recommendations will be offered in Section 6.

SECTION 3.

The effects of competitive pricing on the health of the workers' compensation insurance market in Massachusetts, with an emphasis on larger insurers, smaller insurers, self-insurance groups and self-insured employers.

EXECUTIVE SUMMARY

The health of the workers' compensation insurance market may be improved under a competitive rating law as opposed to the current administered pricing arrangement.

Larger insurers would commit additional resources to the workers' compensation line in this state, and new insurers might enter, providing more alternatives for employers. Self-insured groups would be negatively impacted, but these groups represent a very small part of the workers' compensation market. Individual self-insureds would not be affected.

Small insurers specializing in workers' compensation in Massachusetts only would not be harmed provided they were well run, efficient and creative.

NARRATIVE

A healthy workers' compensation insurance market is one where large number of insurers are competing aggressively for business, and employers have numerous options at reasonable prices. In other words there is a vigorous voluntary insurance market, with most employers not having to rely on the residual market. A healthy workers' compensation market is also characterized by a declining, or very small residual market.

Deregulation can increase coverage availability. Insurers need, in the long run, to obtain a certain rate of return on their business operations. They maintain that rate of return by adjusting price levels where necessary. Where they are not able to adjust price levels (assuming stable costs), they have no alternative when faced with inadequate rates of return but to exit the marketplace.

In the period between 1988 and 1992 where rates were inadequate, as evidenced by the size of assigned risk pool deficits (although there may have been other contributory factors), insurers fled the Massachusetts market in large numbers. This was a coverage availability crisis exacerbated by perceived rate inadequacy under administered pricing. The ability to set rates as they see fit would allow insurers to continue writing workers' compensation in Massachusetts, contributing to the health of the market. Although this would be the effect for insurers in general, larger and smaller insurers may be affected differently.

Larger insurance companies generally write insurance in states other than Massachusetts, and in lines of insurance other than workers' compensation. They would therefore be less vulnerable to losses incurred in workers' compensation in Massachusetts than would smaller insurers who write only workers' compensation only in Massachusetts.

Larger insurers could accidentally set workers' compensation rates too low, and have them remain low for too long a period of time, suffering substantial losses. Larger insurers could intentionally do this in order to increase market share. A concern of smaller insurers is that large insurers could engage in predatory pricing, through setting prices so low so as to drive out small competitors. This has been a general stated concern in most other states which considered competitive pricing. However, this problem has not materialized in the states which have gone to competitive pricing.

Predatory pricing is a serious concern when small numbers of suppliers are operating in a marketplace. Concentration, that is a small number of carriers writing the predominant share of coverage, is a necessary precondition for predatory pricing to be harmful to the market as the predators can control market prices, increasing them in an environment with no competition to moderate the increases. In Massachusetts, over 250 insurers are currently licensed to write workers' compensation, and no one company has more than 12% of the market. The top four companies currently have captured 38% and the top eight companies have captured 60% (based on 1994 voluntary results).

The low concentration ratios make it unlikely if not impossible for any single insurer, or even several insurers, to attempt to dominate the market. The theoretical technique would be for the aggressive insurer to set prices so low that they drive out all or most competition. No company has enough market share to attempt this. Rates would need to be so low for so long that the insurers would incur massive losses and would attract regulator attention. The technique is only possible in a market characterized by only a few insurers - an oligopoly in economic terms - a situation which does not exist here.

Klein referred to a study of concentration ratios for five selected workers' compensation insurance markets. A significant number is the percentage of total voluntary market share held by the top four insurers. Of the five states studied Klein states:

> "Illinois was the least concentrated with a four-firm concentration ratio of 25.8%... Maine was the most concentrated of the five states with a four-firm concentration ratio of 43.5%... These figures, if representative, suggest that concentration, even in smaller state markets, is not high enough to generate a strong probability of oligopolistic behavior."[16]

As of 1994 the four-firm concentration ratio for Massachusetts was 38%. This is well below the mentioned concentration ratio of Maine, which was still considered satisfactory. In other words, the Massachusetts market may not support the type of aggressive monopolistic behavior which is feared by smaller insurer

A report by the Illinois Department of Insurance commented on market concentration:

> "The Federal Trade Commission has adopted a general view that if the top four sellers in an industry represent less than 50% of sales, or the top eight less than 70% of sales, it is unlikely any seller or group of sellers can control market performance."[17]

Concentration ratios in Massachusetts (as of 1994) are:

Top Four Companies: 38%

Top Eight Companies: 60%

This does not include the substantial self-insurance market. Including that number would reduce concentration ratios further.

After introduction of competitive rating, other states have not found any important increase in concentration.

Furthermore, workers' compensation insurance is not a commodity which is bought and sold solely on price. Loss control service, claims administration service, and other features are equally if not more important to employers. In fact, small insurers should not attempt to compete on price alone. They must participate in niche marketing, and offer superior knowledge and service in order to add value. If they do not offer value, and are judged on price alone, then they will be unable to compete. If they add value and are creative they will thrive.

There are indications from other states that competitive rating can even provide an advantage to small insurers. Under competitive rating the smaller, more efficient insurers with better market intelligence would be able to make quicker more subtle price movements to adjust to changing loss ratios. Under administered pricing the smaller companies may not be able to make these smaller quicker moves, and can be locked in to a deteriorating situation to the point where they can become unable to recover.

This theory is confirmed by published material and discussions held with personnel from A. M. Best Compar According to the September 18, 1995 article, "Best's Rating Views of Small Companies," this nimbleness, market knowledge and ability to make quick moves is an attribute of small insurers:

> "A. M. Best has long recognized the important role small companies play in the insurance industry, and our rating distribution has consistently reflected over the years that bigger isn't necessarily better. In fact, in today's environment, most larger companies are actively restructuring their operations by decentralizing and regionalizing their businesses to get closer to their markets to more effectively underwrite their business and service their agents, a characteristic inherent in small companies... Small companies enjoy certain inherent advantages over large regional and national companies, in terms of better knowledge of their markets..."

Small companies, then, do have advantages over large ones. They are also subject to potential financial problems to which large companies are not subject. In discussing these problems the article stated:

> "Small companies, however, also have inherent negative characteristics related to their size, including...adverse changes in their regulatory climate. Smaller companies have high geographic concentrations of business, often operating with limited products in single states, making them susceptible to natural hazards as well as to adverse regulatory, economic and legislative developments."

According to the authors, the negative regulatory climate and/or regulatory and legislative developments include rate regulation. Rate regulation, that is lack of freedom to set rates as they see fit, is a factor which impacts negatively on insurer financial strength and solvency.

Martin P. Sheffield, one of the A. M. Best Company authors, indicated that when the rating company is evaluating insurers, a major negative factor is "failure of companies to get price adequacy because of regulatory pressures." In summary, deregulation of workers' compensation pricing is a positive factor in the financial strength and solvency of insurers, and it is even more so with respect to small insurers.

To provide further evidence of this, we have asked both A. M. Best Company and Standard & Poor's to provide us with any studies they have made of solvency problems resulting from workers' compensation deregulation. According to our contacts, the two companies reported that neither a study existed nor was it an issue being discussed. The sole exception is that Best is currently doing a study of the pricing situation in California. This is ongoing, and has not yet been published. The apparent reason that no such studies exist is that there exists no trend of small insurer failures as a result of workers' compensation rate deregulation.

Best has also published information indicating that the smaller insurers appear to be thriving in the post-deregulation workers' compensation market countrywide. In a September 11, 1995 article in BestWeek entitled "Workers' Comp Results Continue to Improve in '94," the following market share results were published:

Market Share % - Workers' Compensation					
	1994	1993	1992	1991	1990
Nat'l. Agcy Cos.	52.3	53.4	55.8	58.1	60.0
Reg'l. Agcy. Cos.	27.4	25.5	22.9	20.4	19.3
Total Agency Cos.	79.7	78.9	78.7	78.5	79.3
Direct Writers	20.3	21.1	21.3	21.5	20.7

The chart indicates that regional agency companies, the category including the smallest insurance companies of the three categories, showed a dramatic 42% growth in market share between 1990 and 1994. During this same time period, the other two categories, National Agency Companies and Direct Writers showed declines in market share. This was during an era of workers' compensation rate deregulation. Between 1990 and 1994 sixteen states deregulated, while fourteen others had already done so in previous years. The market share data indicates that rate deregulation did not create a hostile environment for smaller insurers. It either created a hospitable environment, or any negative effects were insignificant and were overcome by other positive factors.

With respect to Michigan, Klein states:

> "Contrary to predictions of its critics, competitive rating has not reduced the number of carriers, indicating that smaller carriers have been able to remain in the market."[18]

Individual self-insured employers would largely be unaffected by the voluntary market pricing mechanism, whether administered pricing or competitive rating. As licensed self-insurers, employers generally retain their risk, paying losses as they occur, with the added protection of excess insurance. Self-insured employers are large in size; if they are not self-insured, they would likely purchase loss-sensitive insurance plans from insurers, such as retrospective rating plans. These loss-sensitive plans are based on actual loss experience during a particular policy year, and the actual premium rate is to a certain extent irrelevant. Given this independence from the proscribed rates, the effect of competitive rating must be judged to be neutral, as such employers can opt back into the market if advantageous or remain self-insured.

Self-insured groups may be affected by changing from administered pricing to competitive rating. These groups have operated primarily as a safety valve, increasing in number when the insurance market does not offer viable alternatives. Membership in self-insured groups can present risks and complications for employers so that some may opt for a reasonably priced insurance policy in lieu of membership in such a group. To the extent that competitive pricing results in lower costs to employers, growth and/or continued existence of self-insured groups may be jeopardized. If self-insured groups offer excellent service, particularly loss control and claims management service, they may be able to carve out a niche for themselves and continue to be an active player in workers' compensation. Competitive rating may exert pressure on these groups to differentiate themselves from standard insurance companies and to successfully convince employers that they offer extra value.

Currently the workers' compensation market in Massachusetts is healthy. Voluntary programs are available to most employers and the residual market is shrinking. This is primarily due to current rate adequacy.

If administered pricing is retained and rates continue to decline while underlying loss costs or expenses increase, the possibility exists for the return of rate inadequacy. Allowing individual insurers to continuously adjust rates to actual costs may help to ensure that the market remains healthy and viable.

SECTION 4.

The effects of competitive rating on the quality of services provided by carriers to employers and employees (including loss control, claims management, payment of medical benefits and payment of indemnity benefits).

EXECUTIVE SUMMARY

Competitive rating would generally not have negative effects on the provision of services to employers and employees.

An intuitive assessment would indicate that services are unlikely to be affected. Experience in other states which have enacted competitive rating has shown that this is the case.

In discussions of competitive rating there has been concern that insurers would reduce or restrict loss control services to employers or payments of benefits to employees. The concern is that downward pressure on prices would force insurers to reduce expenses, including these necessary services. Experience in states which have converted to competitive rating indicates that reduction in service levels has not resulted.

Service concerns can be broken down into two components: loss control and claims management. Loss control refers to insurer services provided to employers to help them prevent accidents and injuries, sometimes called safety activity. Reduction in loss control services to employers would lead to increased claims and so the insurer would be harmed in all but the very short term. Thus, cutback in loss control services would not be a good business practice.

Employers themselves can guarantee proper loss control service by insisting upon it and shopping for it. In recent years employers have become educated about the costs of workers' compensation and the activity necessary to reduce those costs. The more educated employers have asked insurers to detail in their proposals the extent of services to be provided and have negotiated for these services. Loss control has been an important element in workers' compensation decision making. This accent on service prevents insurers from marketing their product on the basis of price alone.

Rate deregulation may encourage insurers to improve loss control services. Some insurers decide to engage in niche marketing. They concentrate on certain classifications, build volume, and develop special loss control expertise. In order to attract business and build a critical mass in these niche categories, insurers must be able to compete on price. The plan is that the insurer will be operating efficiently in those classifications, charging a lower price, but also experiencing reduced losses.

Insurers have done this in the past under administered pricing when they have created so-called "safety groups." However, their primary method of competing to attract business into these safety groups has been dividends which are paid following policy expiration and which cannot be guaranteed. Safety groups would be more attractive to certain employers by reduced up front premiums rather than promised (but not guaranteed) dividends. The increased interest in membership in safety groups should make them stronger, long-term alternatives for certain employers.

The second component of service is payment of benefits to injured employees. One concern has been that as a response to competition, insurers may seek to minimize loss and benefit payments. The might result in harm to injured employees. However, insurers' experience in this area suggests that such a short-term strategy is bad business. The intended result of such economies would not likely be achieved. The experience is that attempting to provide less than statutory benefits or delaying in providing them leads to increased long-term costs and losses. When employees are not paid amounts fairly due them under the law, claim costs generally increase. An elaborate administrative process is available for employees to use when aggrieved about claim settlements and employees often engage attorneys. As claims management has become more sophisticated, the better insurers have learned that lower ultimate claims costs result from proper claims management, including prompt and fair payment of benefits, and quick return of the employee to his or her job. It is clear to insurers that restrictions in this area would not be beneficial and insurers are unlikely to engage in this behavior.

Furthermore, in recent years, employers themselves have become extremely active in claims management. Employers now scrutinize insurer claims practices, and the best employers actually participate in handling of the claims. Poor claims handling due to attempted expense savings by insurers would be immediately apparent to employers who would reject this approach.

Clearly, loss control and claims management are important decisions for employers in selecting an insurance carrier. In this sense, price alone cannot drive the market, and insurers are not free to reduce services.

The information provided to us from the states which have installed competitive rating systems has been free of any concerns about reduction in services. There is only anecdotal mention of this in

California, but the California experience is much too recent to be of benefit, since competitive rating became effective January 1, 1995.

In a report by the California Workers' Compensation Rate Study Commission completed in 1992, the following conclusions regarding services were reached:

> "Proponents of regulation argue that other goals of workers' compensation would suffer in a more competitive market, because employers make their decision solely on the basis of price (resulting in cut-throat competition, insolvency, etc.). Even if the purchase decision were based solely on price, this argument ignores the price ramifications inherent in, for example, safety incentives. Insurers have an incentive to encourage workplace safety to reduce loss costs regardless of how rates are set; in fact, the incentive becomes even more important if competition results in lower rates and margins. Employers have fundamental incentives to provide safe working conditions; workers' compensation enhances these incentives, especially so if employers of all sizes have greater freedom to use their safety record as a bargaining chip in negotiating with competing insurers.
>
> "Improvements in employee claim servicing can likewise pass through to insurance pricing in a competitive market. While excess costs and fraudulent claims are beyond the scope of our analysis, superior claim processing service has the potential to reduce such costs by keeping employees well informed about the status of their claims and preventing small claims from mushrooming into costly litigation. A competitive market provides greater incentives for insurers to become proficient in the identification of fraudulent claims; in the absence of a minimum rate law, these insurers can then compete on the basis of lower prices to employers."[19]

It is reasonable to presume that services will not suffer under competitive rating if there is a healthy, competitive market involving active and informed consumers. Practical experience in other states has shown this to be true.

SECTION 5.

The effects competitive rating would have on the residual market in Massachusetts, how residual markets should be tied to competitive market rates, and prevention of repopulation of the residual market as the result of competitive rating.

EXECUTIVE SUMMARY

We believe that competitive rating would support continued depopulation of the residual market and could help prevent its repopulation.

Residual market prices must be higher than competitive market prices. The residual market should be self-sustaining, with no subsidy of it by the voluntary market. This would mean that rates paid by employers in the assigned risk pool would accurately reflect their costs. Increased premiums would be paid by the small number of employers in the residual market, but this is necessary for overall health of the market. Employers in the residual market would have incentive and ability to remove themselves from the residual market, in this way escaping additional costs. This could even apply to small employers. Some small employers who demonstrate commitment to controlling losses may have increased opportunities. However, one must recognize that smaller employers face structural barriers to competitive opportunities under any pricing scheme, whether administered or competitive.

A removal of the subsidy for assigned risk employers would create additional incentive for safety, benefiting employees.

RECOMMENDATION

For the overall health of the workers' compensation market, subsidies of the residual market by the voluntary market should be eliminated. Employers in the residual market should pay rates which actuarially represent true costs.

NARRATIVE

The residual market, sometimes called the assigned risk pool, is the market of last resort for employers. If employers cannot obtain workers' compensation insurance in the "voluntary" insurance market, they can apply to the residual market for coverage.

Since this market is generally made up of smaller insureds and insureds with higher than average loss experience or poorer than average attention to loss control, the residual market can develop, and has developed, large deficits.

A healthy insurance market is characterized by a large number of insurers willingly offering coverage and a small residual market. The size of the Massachusetts residual market since 1980 has ranged from 10.4% of premium volume in 1984 to 64.7% of volume in 1992. At the present time, the size of the residual market is shrinking again to the extent that it currently equals about 30% of the market.

A healthy market means insurers are willing to voluntarily write insurance and the residual market remains small. Insurers will only voluntarily continue to write business if the rates are adequate for them to pay their losses and expenses and make a reasonable profit. When rates are not adequate, they will discontinue writing workers' compensation business. The relationship between the voluntary market and the residual market is intimate. Results between 1983 and 1994 illustrate the relationship clearly.

In 1984 the residual market represented 10.4% of the market, a satisfactory level. This indicates that rates were high enough for insurers to be generally interested in writing workers' compensation business voluntarily. That year was the beginning of a rate freeze by insurance regulators, however, and the market dynamics began to change.

No rate increases were granted to insurers during the years 1983 through 1987. By the end of 1987, rates had become inadequate as evidenced by the residual market deficit of $140 million in 1986 and

$233 million in 1987. At the same time, the size of the residual market had grown to 21% in 1986 and 34% in 1987.

A rate increase of 19.9% was granted in 1988, but this was too little, too late. Deficits and residual market size were growing between 1988 and 1990 as follows:

Year	Residual Market Deficit	Size of Residual Market as Percentage of Overall Market
1988	$296,000,000	29.5%
1989	$414,000,000	40.1%
1990	$305,000,000	46.3%

Rate increases were granted in 1989 and 1990, with the 1990 rate increase a substantial 26.2%. Regulators were attempting to catch up to the rate inadequacy, but they were constantly behind the problem. Insurers who sensed deteriorating results far in advance of the regulators had no alternative under administered pricing but to exit the market.

After the 26.2% rate increase of 1990, further rate increases of 11.3% and 6.2% were granted in 1991 and 1993. Eventually, rates became adequate to the extent that pool deficits were eliminated in 1992 and 1993 (and the residual market actually attained a surplus), and the residual market is currently shrinking from its 1992 high of 64.7% to a current estimate of about 30% of the market.

All the above illustrates that regulators cannot create artificially low rates without effects on market availability and residual market deficits. Eventually losses in the marketplace have to be funded.

Some have observed that the rigidity and rate-setting inaccuracies of administered pricing lead to a lurching from crisis to crisis. Under competitive rating, insurers have the option to adjust to changes in underlying losses and expenses by increasing (or decreasing) rates frequently and gradually when neeeded. This control allows them to sustain a viable voluntary market and prevents them from withdrawing, which could cause an exodus of employers back into the residual market and begin the cycle once again. Conversely, when losses and/or expenses are declining, insurers are quicker to respond with rate reductions on their own. Competitive rating could prevent another market crisis, similar to the one Massachusetts experienced in the recent past.

Experience in the competitive rating state of Michigan indicates how well this can work. The "Status of Competition" report produced in 1995 by the Compensation Advisory Organization of Michigan states the following:

> "In 1994, the Michigan Workers' Compensation Placement Facility experienced the largest decrease in premium level since its inception. This dramatic reduction in pool premium can be attributed to two factors. First, the Michigan workers' compensation market has become extremely competitive. Secondly, the Michigan workers' compensation placement facility began to issue a Depopulation Report in 1994. Michigan has one of the country's smallest pools when compared to the size of its voluntary market. In 1994, Michigan's pool premium of $116 million represented 10% of the total statewide workers' compensation market whereas the national pool averaged 24% of the total national workers' compensation market."[20]

The California Workers' Compensation Rate Study Commission, referring to a 1986 General Accounting Office (GAO) report on competitive rating also states the following:

> "GAO found that both the average cost and the size of the assigned risk pools declined in most states. The declines were greater in states that had initiated competitive rating laws; but it was not determined whether competitive rating laws were the only reason for this greater decline."[21]

Pricing of Residual Market Risks

An important consideration is pricing of insurance for employers in the residual market. For a voluntary market to operate smoothly under competitive rating, the residual market must be self-sustaining. That is, rates should be adequate to cover all losses and expenses; there should be no long term deficit. This will mean that employers in the pool will pay more than employers in the voluntary market.

A residual market which is not self-sustaining can experience many problems.

First, if rates in the residual market are set artificially low, the residual market will generate a deficit. Currently, when the residual market in Massachusetts generates a deficit, that deficit is spread among all the insurers writing business voluntarily based on their percentage market share. The amount insurers must pay is known as a residual market load. Fear of future residual market loads causes insurers to hold back from aggressively writing large amounts of workers' compensation insurance. This fear should be eliminated so that insurers can freely participate in the market, leading to a more healthy market.

Furthermore, since residual market loads are passed on to employers, many employers turn to self-insurance to escape them. This reduces the base upon which the loads can be spread, exacerbating the problem.

The second concern is with safety incentives. When residual market rates are held artificially low, with the deficits spread among the voluntary market, in a real sense good employers are subsidizing poor employers. Poor employers (those with poor loss experience and/or poor attitudes toward loss control) are not paying their fair share. This subsidy by the good employers may cause residual market employers to be less attentive to loss control and less concerned about a safe workplace. This ultimately harms employees.
The cost of work accidents and injuries should be placed directly at their source, so that resources are applied to prevent accidents and injuries. Subsidies work against this goal.

As stated by James Chelius, Professor of Economics at Rutgers University, and Edward Moscovitch of Cape Ann Economics:

> "When employers in the pool are being subsidized, it is not just a matter of equity. It may not be fair for one group to pay a portion of the bill for another group, but more importantly, it systematically distorts the incentives for prevention and return-to-work for those employers in the pool. With workers' compensation claims not appearing as expensive as they truly are, pool employers receive less of a reward for their investments in safety... Were someone to file a bill in the legislature to place an extra tax on relatively safe employers and to subsidize relatively unsafe employers, it would surely be universally condemned as bad public policy. Yet that is exactly what the workers' compensation does when regulated rates are too low and inflexible, with the result of a substantial assigned risk pool."[22]

Concern is often expressed for small employers who are stated to be in the pool due simply to their size. The argument is that insurers in the voluntary market will not willingly offer coverage to small employers because there would not be enough premium to cover their fixed costs. The concern is that small employers are over-represented in the assigned risk pool, and to a certain extent they are, but it is very important to put the problem in perspective.

We have obtained data from the Massachusetts Workers' Compensation Rating & Inspection Bureau showing numbers of employers, stratified by size, in both the assigned risk pool and the overall market for various years.

It is clear from the data that the only category of employer that is over-represented in the pool is that category involving annual workers' compensation premium of between zero and $999. In 1987-88, 49.7% of all policies in the assigned risk pool were in the zero - $999 category, vs. 43.5% of all policies in the market overall. If the same percentage as in the overall market were to apply to the pool, 3,462 fewer employers would be in the assigned risk pool. This represents 2.9% of the total number of employers purchasing workers' compensation.

Therefore, in the year '87-'88 when the assigned risk pool was relatively small, approximately 2.9% of employers were affected by adverse selection due to their size. As the pool size increases, the number of employers affected by adverse selection decreases. In the 1991-92 period, when the pool was much larger, approximately 1,000 employers in the zero - $999 category were affected.

Also the data shows there is no adverse selection against any other size-based group including the $1,000 - $4,999 category.

Experience has shown that good small employers (well run companies with good attitudes towards safety) can generate interest from insurers, especially if they are creative. In the 1987-88 year mentioned above, over 24,000 employers with premium under $1,000 were able to interest insurers in providing them workers' compensation coverage voluntarily. In '91-'92, though the voluntary market had shrunk considerably, over 8,300 such employers were able to do so. Currently in Massachusetts, because of present rate adequacy, there are numerous programs available to small insureds. For example the July 14, 1995 issue of insurance publication The Standard announced a new workers' compensation program designed for that size employer. Endorsed by an agent's association, it is available only to employees with annual premium under $10,480, with no minimum premium.

With respect to Michigan, Klein states in the Journal of Insurance Regulation:

> "There has been particular concern that small employers would be especially vulnerable to this kind of problem [lack of insurance options] because they have fewer resources to survey the market and less bargaining power with insurers. However, Hunt, in a study of the Michigan workers' compensation market in 1983, found no substantial difference in the cost of insurance between small and large employers."[23]

A report from Texas showed similar results. A 1994 legislative report on workers' compensation stated:

> "...concern was raised that insurance carriers would only negotiate with large accounts... As of October 31, 1994, 327 modifiers have been negotiated. Forty-four (44%) percent of those negotiations were with insureds having less than $100,000 in premium. Although the negotiation of a modifier is not widely used, it appears that the negotiations are being made with insureds of all premium levels, not just large insureds."[24]

Texas did report higher prices in the voluntary market for employers with premiums below $5,000, however. Additionally, Illinois reported a preponderance of employers with premiums under $500 in their assigned risk pool, following a waive of depopulation.

There will no doubt be some effects for small employers. The better, safer and more creative ones should have some relief and options available to them. The remaining ones may pay some more than they currently do under competitive rating, but the dollar amounts will be small. They will still be paying no more than they should based on their size and risk factors. It will simply be that a previously existing subsidy will be removed for the overall health of this system.

Employers can help themselves by organizing association or trade groups in which a number of small insureds join together to increase their bargaining power. Pooling would allow them to make loss control activity cost effective and to amass a premium volume which will be attractive to insurers.

The vast majority of states have recognized that residual markets must pay their own way and that subsidies from the voluntary market are destructive of the system.

In Maine, the 1992 Blue Ribbon Commission report on workers' compensation recommended that "the residual market mechanism will become self-supporting," and this recommendation was adopted.

In Connecticut, a 1992 legislative report on workers' compensation stated the following:

> "Employers in the pool pay higher manual rates than do similar employers outside the pool, ... A new plan, approved by the Connecticut Insurance Department, impacts those employers in the assigned risk plan whose rating, based on loss experience, produces poorer results than average. The plan would impose an additional surcharge of up to 25% of premiums for those employers."[25]

The Missouri situation is summarized in a letter dated July 1995 to J. H. Albert from Kevin Lanahan at the Department of Insurance. He states:

> "Voluntary writers seem fairly optimistic that there will be no residual market assessment with the restructured assigned risk pool, or that any deficit they have will be small. We have seen them writing smaller accounts and accounts with higher mods than in the recent past. While it is still premature to draw many conclusions, it does seem that the combination of deregulated rates, a restructured assigned risk pool, and the entrance of an aggressive WC writer has resulted in lower rates and will depopulate the assigned risk pool."

Virtually all states which have adopted competitive rating have recognized that a residual market "rate differential" (rates higher than the average voluntary market rate) is essential. Rate differentials range in the various states up to as high as 25%. In Illinois, which has a very effective and well functioning competitive rating system, the differential on many classes is 20%, with the average differential over all classes about 12%.

A 1993 NAIC report indicated the need for a differential:

> "Administration and regulation of residual market mechanisms can have a substantial impact on overall market conditions in workers' compensation. Clearly, a very significant factor is the setting of residual market rates relative to voluntary market rates. As noted above, residual market rates effectively serve as a ceiling on voluntary market rates. Also, if residual market rates are inadequate, then it is necessary to cover the deficit through voluntary market assessments. The magnitude of the deficit (and implicitly the subsidy to residual market risks) and its distribution between insurers and voluntary market risks affects insurers' incentives to supply coverage and employers demand for that coverage... Further, residual market pricing may affect residual market risks incentives to control claims costs."[26]

Clearly, in an ideal model, a rate differential is required and the residual market should be self-sufficient. The current climate is ideal for instituting such self-sufficiency. Rates appear to be adequate, and probably no increase (or a very small increase) in the residual market rates at the present time would be necessary to achieve self-sufficiency. Since rates are adequate for pool risks, voluntary market risks may see rate reductions thus creating a differential. This differential will be necessary in the future because of the differences between loss experience of voluntary risks and pool risks.

SECTION 6.A.

Comparison of legislation filed as House 4047 to a representative sampling of competitive rating statutes in other states.

EXECUTIVE SUMMARY

This section compares House Bill 4047 with the rating laws of Michigan and Illinois, and also with the NAIC (National Association of Insurance Commissioners) Model Rating Law. Comparison is made in the key areas which could impact on the success of competitive rating.

Comparison of House Bill 4047 with NAIC Model Rating Law and Laws of Michigan and Illinois

	H4047	NAIC	Michigan	Illinois
1. Filing Method	File and Use - 30 days	File and Use - No waiting period	File and Use - 45 days	Use and File - File within 30 days after effective date
2. Bureau Advisory Rates - Loss Cost Plus...	Development, trend	Development, trend, loss adj. expense	Nil	Development, trend
3. Deviations From Advisory Loss Costs	Allowed - no justification required	Allowed - justification required, but used only if market declared non-competitive	Allowed - no justification required	Allowed - no justification required
4. Schedule Rating	Not addressed	Allowed - no stated maximum	Allowed - no stated max. in law. 25% max. allowed in practice	Allowed - no stated max. in law. 60% max. allowed in practice
5. Uniform Classification System	Not required	Required - subclassifications allowed	Not required	Not required
6. Uniform Experience Rating Plan	Not addressed	Required	Not required	Not required
7. Consumer Information	Not addressed	Required	Not addressed	Not addressed
8. Disapproval of Rates	All laws generally prohibit rates that are excessive, inadequate or unfairly discriminatory. They differ with respect to actual language and extent to which criteria change in a non-competitive market. See Section 6.B. for discussion.			
9. Non-Competitive Market	The laws vary as to the extent of action which can be undertaken by regulators in a non-competitive market in addition to simple disapproval of rates on an individual insurer basis. See Section 6.B. for discussion.			

SECTION 6.B.

Recommendations for Bill H4047.

NARRATIVE AND RECOMMENDATIONS

House Bill 4047 was compared in Section 6.A. to a model law proposed by the National Association of Insurance Commissioners (NAIC) and the laws of Michigan and Illinois. The NAIC is an organization of state insurance regulators. Their model bill reflects the beliefs and concerns of regulators. Michigan and Illinois are states with successful competitive rating laws which have each been in effect for over ten years. The provisions of their laws have been well tested.

H4047 should be modified to address the goals and concerns outlined in previous sections of this report. These recommendations are based partly on NAIC suggestions and on observations of those provisions which have worked well in other states.

Our recommendations are consistent with the principle that regulators should allow insurers extensive rate freedom to the extent that adequate protection for employers, employees and the system overall exists. Limited scrutiny should be applied to individual insurer rate filings as long as minimum conditions are met and the market remains competitive.

Important Note Regarding Comments in this Section:

Our comments and recommendations regarding H4047 provide insight into the issues which may affect the effectiveness of, or control over, a competitive rating law. Section 6.B. should be viewed as conceptual in nature. We do not intend to suggest actual language for a workers' compensation law. H4047 will have to be coordinated with the existing law, Chapter 152, Chapter 175A, and possibly other chapters. We defer to legal experts with respect to legal integrity and structure. Rather, comments in this section are intended to highlight the important issues.

1. FILING METHOD

The file and use system is the most common method found in competitive rating laws. Under this system, an insurer files rates with regulators and is free to use those rates after the specified waiting period, as long as the rates are not disapproved within that waiting period. The most common waiting period is thirty days. H4047 utilizes a file and use system with a thirty day waiting period. We recommend no change.

2. BUREAU ADVISORY RATES

In a competitive rating system, insurers are limited in the amount and types of rate making data which they are allowed to share. All competitive rating laws that we reviewed provide that insurers be allowed to share "loss costs" only and not be allowed to share general expense and profit information. Competitive rating laws vary with respect to the kinds of loss costs included in the information which insurers share, in other words, the "advisory rate." Michigan, for example, includes in the advisory rate only historical paid losses. Other states such as Illinois allow the advisory rate to include loss development (projection of ultimate cost of open claims) and trend (adjustment of historical claim values to current costs). The NAIC model law includes development, trend and loss adjustment expense, which reflects the actual expense involved in claims handling.

H4047 includes development and trend in the Bureau's advisory rate, but does not include loss adjustment expense. We recommend amending H4047 to include loss adjustment expense in the advisory rate for the benefit of small insurers that may have a limited data base, therefore hindering their ability to accurately calculate this component.

3. DEVIATIONS FROM ADVISORY LOSS COSTS

Deviations from advisory loss costs are allowed in many states, including Michigan and Illinois. Michigan and Illinois differ from the NAIC model by not requiring justification for the deviation. However, the information required by the NAIC law would only be used if the market were declared non-competitive.

H4047 does not require submission of justification for a deviation. There may be situations where the Commissioner would require information supporting a deviation, and H4047 should be amended to provide for this. For example, Section 6. of Chapter 175A, dealing with lines of insurance other than workers' compensation, provides authority to the Commissioner as follows:

> "The Commissioner may require such insurer to furnish the information upon which it supports such filing. Any filing may be supported by (1) the experience or judgment of the insurer or rating organization making the filing, (2) the experience of other insurers or rating organizations, or (3) any other factors which the insurer or rating organization deems relevant. A filing of any supporting information shall be open to public inspection after the filing becomes effective."

We recommend that language similar (in purpose) be included in H4047.

4. SCHEDULE RATING

Most states, including Michigan and Illinois, and the NAIC allow and/or recommend the use of schedule rating to adjust for individual differences among employers. Neither the NAIC model law nor the statutes in Michigan or Illinois set a limit on the amount of debit or credit which may be applied. However, regulators in practice have been allowing 25% in Michigan and 60% in Illinois. A very common maximum in other states is 25%.

H4047 does not address schedule rating. Schedule rating up to a 25% maximum should be included in the bill to allow an additional element of competition. In addition, the law should clarify that schedule rating plans must be included with each insurer's rate filing. Schedule rating plans may be patterned after existing plans, such as the national NCCI model, or may be developed by the insurers themselves.

5. UNIFORM CLASSIFICATION SYSTEM

Currently in Massachusetts all insurers use the same uniform classification system. All employers in the Commonwealth, regardless of their carrier, are subject to the same classification schedule. This is beneficial for employers, and helps to guarantee an accurate statistical database.

The laws of Michigan, Illinois and several other states do not require insurers to adhere to a uniform classification system, but rather allow insurers to establish their own. In practice, insurers have not done this in Michigan or Illinois. They have, however, established sub-classifications within the existing uniform classification system. The NAIC also recommends allowing sub-classifications.

H4047 does not require that insurers adhere to a uniform classification system, and therefore allows them to establish non-standard systems. We recommend that H4047 be amended to require all insurers to adhere to a uniform classification system, without sub-classifications. Insurers will still be able to adjust for poor classification fit via schedule credits or debits (schedule rating).

A uniform classification system eliminates confusion in the marketplace and preserves the integrity of the statistical database. (Classification data is the basis for future rate making and for the experience modification.)

6. UNIFORM EXPERIENCE RATING PLAN

The current experience rating plan adjusts individual employers' premium based on their past loss experience, and the experience modification multiplier is calculated by the Bureau and follows employers regardless of their workers' compensation carrier.

The experience rating plan helps to equitably distribute premium charges and acts as an incentive for safety. The uniform experience rating plan should continue to be maintained by the Bureau and should follow employers. H4047 does not address experience rating. It may need to be amended to indicate that all insurers continue to use the uniform experience rating plan.

7. CONSUMER INFORMATION

Although many state laws do not specifically address this, several have provided market rate information to employers as a practice.

The NAIC model law addresses consumer information as follows:

> "The Commissioner shall utilize, develop or cause to be developed a consumer information system(s) which will provide and disseminate price and other relevant information on a readily available basis to purchasers of...insurance for commercial risks... To the extent deemed necessary and appropriate by the Commissioner, insurers, advisory organizations, and other persons or organizations involved in conducting the business of insurance in this state, to which this section applies, shall cooperate in the development and utilization of a consumer information system(s)."

H4047 does not address consumer information. It should be amended to specifically indicate that insurers, either directly or through their rating bureau, shall provide consumer information in a format approved by the Commissioner to all employers in the state. The law itself may specify the amount and type of consumer information required, or it may be left to the discretion of the Commissioner. In any event, consumer information will be a major contributing factor to the successful operation of a competitive rating system. Consumer information should do the following: (i) outline the transition from administered to competitive pricing in workers' compensation rates; (ii) explain how premium is determined; (iii) describe how competition can affect that premium; (iv) explain how insurer service can ultimately affect employer cost through the experience rating system; and (v) describe the pro-active steps that employers can take in affecting their own experience.

Consumer information could be communicated to employers via several methods. A mandatory policy endorsement should be developed and attached to all policies, advising employers of the revised competitive rating law. When competition is first initiated, sending letters to policyholders and publishing advertisements in general business publications should be considered. At all times, employers should have easy access to rate information. One suggestion is to establish a classification/rate hot line number at the Bureau, similar to that in Missouri which is described in this report.

8 DISAPPROVAL OF RATES

All laws generally prohibit rates that are excessive, inadequate, or unfairly discriminatory. The laws differ with respect to actual language and the extent to which criteria changes in a non-competitive market.

H4047 contains the following language:

> "...the Commissioner may disapprove such classifications and rates for the voluntary market only if she determines after a hearing that such rates, if continued in use, would tend to impair or threaten the solvency of an insurer, are unfairly discriminatory, or would create a monopoly in the market, based upon relevant tests of workable competition pertaining to market structure, market performance, and market conduct..."

This language (a) does not address the matter of "excessive" rates and (b) it is very limited concerning creation of a monopoly.

(a) Excessive rates.

Many states and the NAIC model law indicate that in a *competitive* market no rate shall be considered excessive. However, the other states and the NAIC generally recognize that in a "non-competitive" market, some rates may be considered excessive. These laws prohibit excessive rates and define them. The Michigan law states, for example:

> "A rate shall not be held to be excessive unless the rate is unreasonably high for the insurance coverage provided and a reasonable degree of competition does not exist with respect to the classification, kind, or type of risks to which the rate is applicable."

This language should be considered when addressing excessive rates in the law.

(b) Monopoly.

H4047 states that rates can be disapproved if they "create a monopoly in the market." This is very narrow language. The possibility of a true monopoly existing is extremely remote; broader language may be more effective in this case. The Michigan law indicates that rates can be disapproved if:

> "...the rate is unreasonably low for the insurance coverage provided and the use of the rate has or will have the effect of destroying competition among insurers, creating a monopoly, or causing a kind of insurance to be unavailable to a significant number of applicants who are in good faith entitled to procure the insurance through ordinary methods."

We recommend that the provision of H4047 concerning "monopoly" be broadened in a manner similar to the Michigan language.

9 NON-COMPETITIVE MARKET

The previous section (8) concerns approval or disapproval of *individual insurer* rate filings. Whether the Commissioner should be granted broader powers in the event that a market is declared non-competitive is a separate question. Such broader powers could enable the regulator to enact wide-ranging emergency measures which might be faster and more effective than having to individually disapprove the filings of many insurers.

Michigan law provides for such broad powers with the following language:

> "If the Commissioner certifies and the legislature resolves...that a reasonable degree of competition does not exist with respect to the workers' compensation insurance market on a state-wide basis or any geographic areas, classifications, kinds or types of risk, or that insurance in unavailable to a segment of the market who are, in good faith, entitled to obtain insurance through ordinary means, the Commissioner shall create competition or availability where it does not exist... The plan shall only relate to those geographic areas, classifications, or kinds or types of risks where such competition has been certified not to

exist. The plan may include such methods designed to create competition or availability as the Commissioner considers necessary, and may provide for the Commissioner to do one or more of the following:

(a) Authorize, by order, joint underwriting activities in a manner specified in the Commissioner's order.

(b) Modify the rate approval process in a manner to increase competition or availability while at the same time providing for reasonably timely rate approvals, including prior approval or file and use processes.

(c) Order excess profits regulation...

(d) Establish and require workers' compensation insurance rates by order, which insurers must use as a condition of maintaining their certificate of authority. The order setting the rates shall take effect not less than 90 days nor more than 150 days after the order is issued."

The language from the Michigan law does not directly tie in with Massachusetts' situation, and it is presented as an example only. We believe that some elements of paragraphs (b) and (d) could be adapted to Massachusetts law. These sections concern modification of the rate approval process, and allowing the Commissioner to fix and establish rates.

This section of the Michigan law also requires consent of the legislature before action is authorized. Any provisions being considered for Massachusetts may want to provide that temporary emergency powers be given to the Commissioner to act without legislative approval.

Legislation should provide parameters for the definition of competitive versus non-competitive market. The following language is included in the NAIC model rating law:

> "A competitive market is presumed to exist unless the Commissioner...determines that a reasonably degree of competition does not exist in the market... In determining whether a reasonable degree of competition exists, the Commissioner shall consider relevant tests of workable competition pertaining to market structure, market performance and market conduct and the practical opportunities available to consumers in the market to acquire pricing and other consumer information and to compare and obtain insurance from competing insurers. Such tests may include, but are not limited to, the following: size and number of firms actively engaged in the market; market shares and changes in market shares of firms; ease of entry and exit from a given market; underwriting restrictions; whether profitability for companies generally in the market segment is unreasonably high; availability of consumer information concerning the product and sales outlets or other sales mechanisms; and efforts of insurers to provide consumer information. The determination of competition involves the interaction of the various tests, and the weight given to specific tests depends upon the particular situation and pattern of test results."

The likelihood of a Commissioner exercising powers to restore order to the marketplace are remote, but we believe such protection is necessary. We recommend that language providing power to the Commissioner, beyond approving or disapproving individual insurer filings, should be considered for inclusion in H4047.

10. <u>MISCELLANEOUS</u>

a) H4047 provides in two sections that a hearing shall be provided within ten days of the request of an aggrieved rating organization or insurer. Current Massachusetts workers' compensation law provides that a hearing will be provided within thirty days. We suggest that ten days is an unusually short period of time for the holding of a hearing, and that the Bill be amended to provide for thirty days.

b) H4047 contains the following language:

> "A reinsurance pool constituted by and comprised of all insurers writing workers' compensation insurance in the Commonwealth is hereby established."

We believe editing of this language is required, as it is our understanding that no reinsurance pool is intended to be "established" by this Bill, but rather that the existing reinsurance pool will continue to be utilized.

APPENDIX

Listing of Available Literature

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