

John Garamendi, Insurance Commissioner
California Department of Insurance



**STATE COMPENSATION
INSURANCE FUND'S ABILITY
TO REDUCE ITS RATES**

**REPORT TO THE LEGISLATURE AND GOVERNOR
AS REQUIRED BY SENATE BILL 228**

JULY 2004

Executive Summary

Senate Bill 228 directed the Department of Insurance ("the Department") to "review and analyze the financial condition, underwriting practices, and rate structure of the State Compensation Insurance Fund (State Fund)" and report to the Legislature and the Governor on State Fund's "potential of reducing rates."

The substantial reforms enacted in 2003 and 2004 were intended to reduce workers' compensation system costs and benefit California's employers. That is a goal we are committed to help achieve. However, in our efforts to reduce premiums we must not jeopardize the very institution that is so essential to employers in this state—the State Fund. Our twin goals must be to lower rates to the greatest extent possible and to preserve the solvency of State Fund.

Scope of current report

The following report primarily focuses on two areas that we can accurately report on at this time. They are State Fund's underwriting practices and rate structure. While these are important areas, they are far less significant in terms of rate relief than loss reserves and claims handling, which currently can not be adequately assessed.

It must be noted that any changes in underwriting practices and rate structure would primarily alter the *allocation* of the charged rate among policyholders, but not necessarily result in a decrease in overall rates to all policyholders or in costs to State Fund. Underwriting practices and rate structure raise issues that concern whether some policyholders pay more than they should, while others pay less. Therefore, to the extent such an inequity is found and a given group of employers should have their rates reduced, an equal amount of charges would have to be allocated to other employers resulting in a revenue neutral change.

If State Fund were to adopt rating plan recommendations contained in this report, it could potentially reduce rates for eligible policyholders by between 6.5% and 11.5%, depending on whether the accounts also qualify for group membership, were directly written, or are not able to take advantage of the premium discount factor.

Proper claims handling

Prior to May 25, 2003 when State Fund filed suit against the Department, it cooperated in an operational review by IBM Business Consulting Services of, among other areas, claims handling. That review was completed before any of the reforms were passed. However, even then IBM concluded that State Fund used an operating model that impaired its ability to address its high cost claims in a timely manner. After the reforms were passed, the Department attempted to bring in a team to conduct an operational review of State Fund's post-reform claims handling. State Fund refused, asserting among other things that the Legislature and Governor only directed the Department to review its "financial condition, underwriting practices and rate structure," not its ability to pass on the reform savings through proper handling of claims. This refusal by State Fund prevented any analysis of this most critical operational function in time for this July report. It is recommended that an operational review of State Fund, including claims handling, be ordered by the Legislature and Governor.

Adequacy of loss reserves

Determining the financial condition of the State Fund and therefore the extent of its ability to pass through the reform savings is a highly complex process. Workers' compensation benefits are often paid out over many years and reserves must be adequate to pay those claims. Projections of needed reserves would be difficult even if the system itself were static. But, as experts acknowledge, the very reforms that help reduce costs increase the difficulty of setting accurate loss reserves.

For year end 2002 the Department, as well as its consulting actuary and State Fund's independent auditor, PricewaterhouseCoopers, believed State Fund's loss reserves for prior years (through 12/31/02) were inadequate by approximately \$1 billion dollars. State Fund disagreed with that conclusion in public statements, but subsequently booked additional loss reserves over the course of 2003. Given the unprecedented scope and impact of the 2003 and 2004 reforms and the divergent points of view experts have taken with respect to this impact, the Department will conduct a further study of State Fund's loss reserves in order to carefully, prudently and thoroughly evaluate this issue. Therefore, within the next 45 days, the Department will supplement this report with its findings on the adequacy of State Fund's current loss reserves.

Additional Savings Possible

Additional rate reductions of as much as 5.9% are possible if State Fund fully implements the recommendations in the IBM report, redirects its investment portfolio, and reduces its maximum commissions. With respect to the redirection of investment, the Department believes that if the current investment and workers compensation deposit laws were amended to allow State Fund to invest as broadly as other domestic insurers its investment yield might modestly increase. Furthermore, if State Fund were to reduce its maximum commission rate below the current 5.5%, the concomitant expense savings would result in further rate reductions. These reductions would benefit **all** classes of policyholders.

Introduction

Senate Bill 228, passed by the Assembly and Senate on September 12, 2003 and approved by the Governor on September 30, 2003, directed the Department of Insurance to report to the Legislature and Governor by July 1, 2004, and each July 1st thereafter, on the State Compensation Insurance Fund's ("State Fund") ability to lower its rates. Specifically, Stats. 2003, ch. 639, § 52.5 of Senate Bill 228 states:

- (a) The legislature finds and declares all of the following:
 - (1) The State Compensation Insurance Fund is the workers' compensation insurer of last resort insuring most of the small employers in the state, and employers that cannot find insurance elsewhere.
 - (2) Today the State Compensation Insurance Fund covers over 50 percent of the market and its financial health is essential to the economic well-being of the state.
 - (3) Employers in this state need reasonably priced workers' compensation insurance.
- (b) It is the intent of the Legislature that the Insurance Commissioner review and analyze the financial condition, underwriting practices, and rate structure of the State Compensation Insurance Fund and report to the Legislature and the Governor on the potential of reducing rates by July 1, 2004, and every July 1 thereafter.

This intent language needs to be evaluated in light of a companion bill to SB 228, Assembly Bill 227, which did not become operative unless SB 228 was also signed into law. Insurance Code Section 11735.1 (b) of AB 227 stated that:

Insurers shall file rates to apply to policies incepting on or after January 1, 2004, that include the provision for projected savings determined by the Insurance Commissioner pursuant to subdivision (a), provided, however, that these rates shall comply with Section 11732.

This provision requires that insurers pass on the savings from the reform legislation to employers. The relevant provision that rates comply with Insurance Code Section 11732 requires that an insurer's rates be adequate to cover its losses and expenses. This latter requirement, which has a technical meaning in insurance ratemaking, means that the insurer's rates, *set for a period to occur in the future*, must be sufficient to cover what the *future* losses and expenses will be.

The requirement that reform savings be passed on to employers must be balanced against the overriding requirement that State Fund remain financially stable and able to meet its obligations to all beneficiaries and employers/policyholders. State Fund's financial stability has been of concern to the Department since early 2002, and, as of this date, the Department continues to evaluate its financial condition as of year-end 2003. The key to determining the financial condition of State Fund is making as accurate an analysis of the adequacy of its reported liability for loss reserves as is possible. Completing that analysis is made more complicated by the reform measures adopted in AB 227, SB 228, and the recently-enacted SB 899. Measuring the impact of those bills on the \$13+ billion pre-reform loss reserves of State Fund has proven to be a formidable task, and one that the Department wishes to accomplish in a most deliberate and comprehensive fashion, given the impact of an erroneous conclusion on State Fund, State Fund policyholders, and the economy of California.

Hence, this report will focus upon State Fund's underwriting practices and rate structure. The Department, within the next 45 days, will supplement this report and provide its final conclusions as to State Fund's loss reserves and the potential for State Fund to pass on reform savings in its premiums.

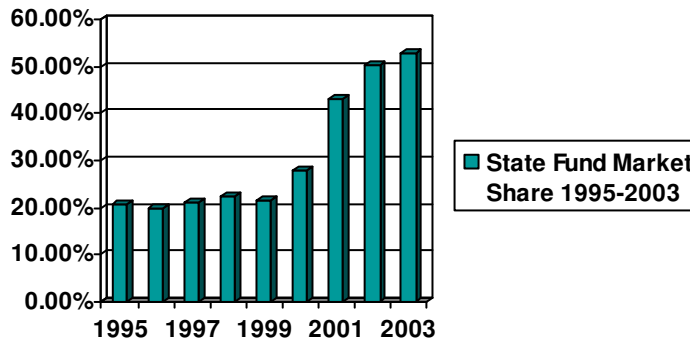
Background on State Fund's Changes Since Open Rating

As has been well documented, State Fund has undergone tremendous change since open rating began in 1995, and the nature of the business written by State Fund and its market share have changed dramatically.

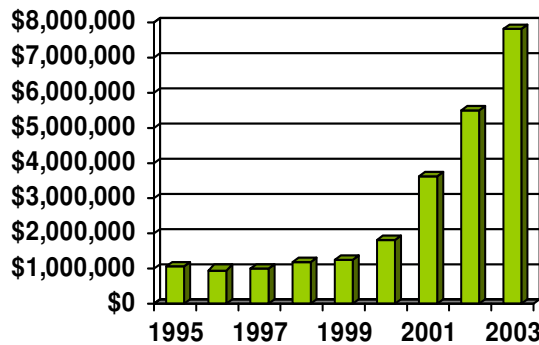
State Fund has evolved from an insurer that wrote primarily small employers to an insurer that has a significant amount of business from accounts with more than \$250,000 in premium. By 2002, 30% of State Fund's premium came from these large accounts, yet such accounts represented only 1% of its policyholders. The average account size for the remaining 99% of State Fund's policyholders was \$13,000. State Fund has transformed from being a sizeable insurer focusing on small employer business to a dominant writer of workers' compensation for employers of all size. It is, in fact, the largest provider of workers' compensation in the United States as measured by premiums written.

Market Share and Premium history

During 1995, the first year of open rating, State Fund's share was about 21% of the insured market, but has grown to 53% of the market for the year 2003. As shown in the graph below, its market share has grown at an unprecedented rate from 2000 through 2003.



State Fund's premium went from approximately \$1 billion in 1995, the first year of open rating, to \$1.2 billion in 1999, and to \$7.8 billion for 2003 (a five-year increase of 550%). Premium growth for the period from 1995 – 2003 is graphically illustrated below:

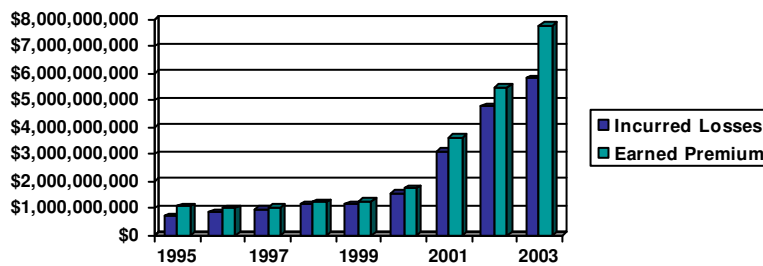
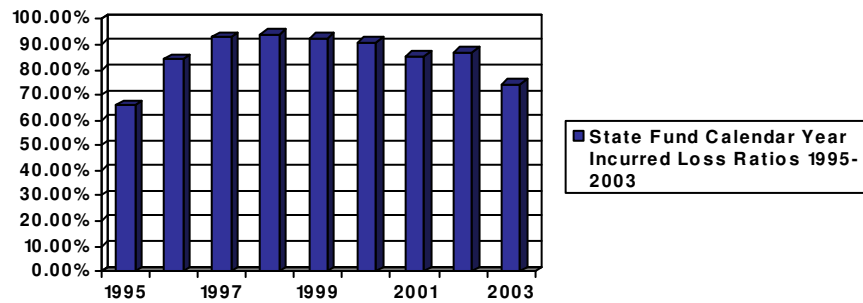


**State Fund Direct Written Premiums 1995-2003
(in thousands of \$)**

State Fund's most rapid growth began in 2000 following the liquidation of the Superior National group of seven insurers, and was fueled by subsequent liquidations of the Reliance Group, HIH Group, Credit General Insurance Company, and Frontier Pacific Insurance Company in 2001. In 2002, Paula Insurance Company, Alistar Insurance Company, and the National Auto Group were placed in liquidation and in 2003 the Legion Group, Fremont General, and Western Growers were placed in liquidation. All of these liquidations contributed toward a contracting private market and exacerbated the rapid business growth of the State Fund.

Loss History

State Fund's calendar year loss ratios reported in its annual financial statements (and not adjusted to reflect the CDI's examination findings) show significant increases shortly after open rating began in 1995. These loss ratios reflect a profile similar to the industry as a whole with peaks in 1998 and 1999. Loss ratios are a function of the ratio of incurred losses to earned premiums. For example, if an insurer charged \$100 million in premium and had \$90 million in losses its loss ratio would be 90%. Inadequate rates and excessive growth in claims costs will result in high loss ratios. Several factors have contributed to the State Fund's high loss ratios including price discounting between 1995 and 1999 and adverse loss severity and loss development¹ in 1999 and later years. State Fund's recent calendar year loss ratios have been negatively impacted by significant reserve charges related to prior accident years. For example, loss development in calendar year 2003 reflected adverse one-year development of \$192 million and adverse two-year development of \$795 million. Reserve re-evaluation of this magnitude is unusual and may be a function of consistent under-reserving practices (apparently due to traditional reserving procedures and methodologies not being adjusted in light of the dramatically accelerating loss costs)². Recent CHSWC studies have documented adverse loss severity and average annual medical inflation of 17% and over-utilization of medical visits, procedures, as well as the litigation impact on indemnity awards. The recent improvement in State Fund's historical loss ratio is attributable to significant rate and premium increases, *not* declining claims costs, as total claims costs continued to increase through the end of 2003.

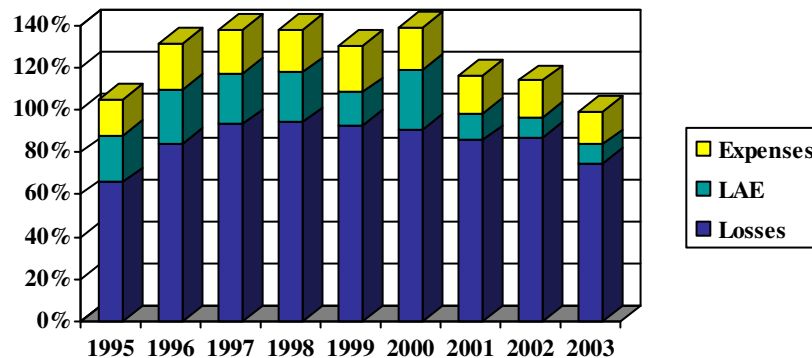


¹ Adverse loss development occurs when prior year estimates of loss reserves turn out to be inadequate and the reserves have to be increased in subsequent years. Reserves are the dollars that an insurer expects to pay over time for claims that have already occurred and are an insurer's largest liability.

² Please note that the State Fund has certainly not been the only workers' compensation insurer to be impacted by this recent, unique phenomenon.

Combined Ratio

In 1995 when open rating began, State Fund's combined ratio (which includes its loss ratio, loss adjustment expense (LAE) ratio, and underwriting expense ratio) was 104.65%. Therefore, for every dollar of premium collected by State Fund, approximately \$1.05 was paid out in losses, claims adjustment expenses, and underwriting expenses and commissions. However, considering that State Fund earns investment income for every premium dollar collected, and the losses are paid out over many years, it still can earn an operating gain and still break even with a combined ratio greater than 100%. However, by 2000, State Fund's combined ratio had climbed to approximately 140%, and was paying out \$1.40 in losses and expenses for every premium dollar collected, such that even after investment income, it was losing money for every dollar collected. This would soon cause a significant drain on surplus. Although substantial rate increases implemented in successive years beginning in 2000 would improve the combined ratio and bring it slightly below 100% by 2003, reserve inadequacies continue to siphon off operating profits and investment income as State Fund backfills prior year's deficits. By 2003 State Fund earned an underwriting profit³ for the first time since open rating began of approximately \$75 million and investment income of approximately \$535 million. This raised the question as to whether State Fund could begin reducing rates following the passage of cost containment reform legislation and if so, by how much.



Department's limited exam of State Fund's underwriting practices⁴

Scope and Method of Examination: The Department's Market Conduct Division conducted a regularly scheduled examination of State Fund's underwriting practices during the first quarter of 2004. A team of two examiners was on-site at State Fund's San Francisco office from February 2, 2004 to March 23, 2004, reviewing whether State Fund's rate application practices and underwriting practices comply with applicable sections of the California Insurance Code and the California Code of Regulations. This market conduct examination did not include an analysis of State Fund's rate level, rating plan structure, financial condition, profitability, or operational efficiency.

To conduct the examination, the examiners reviewed a sample of the policies issued, renewed, cancelled, or non-renewed during the period of October 1, 2003 through December 31, 2003 (the most recent complete quarter of business prior to the start of the examination). The examiners used State Fund's filed rating plan to verify that it was applying its filed rates in developing the premium for each policy⁵. Through the review of the policy sample, the examiners also sought to determine whether rating or

³ A positive underwriting return means that a profit was earned on the insurance operations alone before consideration of investment income.

⁴ State Fund refused to permit a fuller exam of its underwriting and claims handling practices by a team of experts that I had assembled.

⁵ Absent exemption from the Commissioner, California Insurance Code § 11735 requires Workers' Compensation insurers to file their rates and supplementary rate information with the Department no less than 30 days prior to using those rates.

underwriting rules established by State Fund, or administrative procedures adopted by State Fund to perform policy transactions, resulted in any unfairly discriminatory treatment of policyholders, or any other violations of the California Insurance Code.

After collecting the policy review data, the examiners identified in writing to State Fund certain areas of non-compliance, and obtained either commitments to correct the non-compliance or State Fund's reasons for why it believes its practices are not in violation of the law. The Market Conduct Division is in the process of compiling these findings into an examination report.

Important Findings: Through its market conduct examination, the Department has determined that State Fund's underwriting practices in at least two specific areas hinder the Company's ability to ensure that each employer is paying the lowest premium for which he or she is eligible, or to ensure that there is not disparate treatment of policyholders in terms of the premiums and deposits that they pay.

1) State Fund's underwriting procedures do not allow the Company to maximize employer participation in the Kaiser Alliance and Preferred Provider Network (PPN) program and the safety group programs.

As will be explained later in this report, participants in the Kaiser Alliance and PPN programs have a discount of 10% applied to their premium; safety group participants receive a 6% discount. State Fund's failure to communicate the availability of these programs to all policyholders and its failure to collect information to determine who is eligible for participation result in the application of rates that are unfairly discriminatory.

- Policyholders who were insured as new business by State Fund prior to the implementation of the Kaiser Alliance and PPN programs are not advised of the availability of the programs and the steps that they need to take in order to participate.
- If there is conflicting information on the new business application regarding an applicant's eligibility for the Kaiser Alliance or PPN programs, State Fund does not follow up with the applicant to clarify eligibility or to communicate the availability of the programs.
- For an applicant meeting all Kaiser Alliance or PPN criteria except the requirement to have an early return to work (ERTW) program, State Fund does not advise the applicant that the programs are available, and that the policyholder could participate in the discount program if it establishes an ERTW program within 90 days of the policy effective date.⁶
- New applicants that appear to meet group program eligibility requirements according to information provided on the application are not advised of the availability of the group programs unless they also indicate that they are already a member of the group or association. Employers who are eligible for and may be interested in these programs are prevented from participating as a result.⁷
- For renewals on direct written accounts under \$25,000, State Fund does not review eligibility for the group programs and communicate the group program option to the policyholder. This failure occurs because renewals for this type of account are automated and not handled by district underwriters, who State Fund stated were responsible for this function.
- The examination also detected inconsistencies in how group program eligibility is handled for direct written accounts \$25,000 and above, and brokered accounts. Although State Fund stated that district underwriters review the renewal and contact policyholders and/or the brokers to discuss group eligibility, the policy sample reviewed did not support this contention. More than

⁶ State Fund's established eligibility rules for participation in the Kaiser Alliance and the PPN Program allow the applicant up to 90 days to establish an early return to work program following policy inception.

⁷ California Insurance Code § 11656.6 provides the authority for issuing a worker's compensation policy to an organization or association of employers as a group, and lists the requirements that the group must meet.

one example was found of group discounts being discussed only after the insured or the broker had contacted State Fund to request information on how to lower their rates.

2) State Fund has adopted different procedures for handling direct written accounts with less than \$25,000 in annual premium (which can result in less accurate rating), than it uses for all other accounts (direct written accounts \$25,000 in premium and above, and all broker-represented accounts.)

State Fund's adoption of different handling procedures for large and small direct written accounts has resulted in small accounts not receiving the same level of disclosure regarding the future costs of their workers' compensation coverage and small accounts having these future charges calculated on the basis of less accurate information than is used for all other larger accounts.

- At renewal, a direct written account under \$25,000 in premium receives only an Annual Rating Endorsement (ARE), which contains information on the base rates that will be used on the renewal, and the interim billing factors that will apply. The ARE does not show the payroll upon which the premium will be based, or an estimate of the annual premium. These items are contained in a renewal quote, which is only provided if the insured specifically requests a quote. All other accounts automatically receive a quote in addition to the ARE. Direct accounts under \$25,000 are therefore not being given the same information regarding what to expect for their renewal as all other accounts receive.
- For accounts receiving renewal quotes, State Fund solicits payroll information for the upcoming year, or extrapolates a full year's payroll based on the payroll reports provided by the insured during the policy period prior to the renewal. This payroll is used to generate the estimated annual premium (EAP) for the upcoming year. For the direct written accounts under \$25,000 where no quote was requested by the insured, State Fund takes the payroll from the latest final billed policy term, increases it by 8%, and uses this figure to calculate the EAP. This is done through an automated system that State Fund calls the Automated Deposit Premium System (ADP). As a result, the payroll used to determine annual premium for direct written accounts under \$25,000 may not be as accurate as payroll used for all other accounts.
- The ADP system uses the current year's filed base rates to calculate the estimated annual premium for direct written accounts under \$25,000, but the system does not include in this calculation any updated discounts that the insured may not have been getting the previous year, but for which it now qualifies (or which are newly added to the Company's rating plan). As a result, these types of accounts may have estimated premiums and resulting deposits that are larger than they would have had were the updated discounts applied.
- The examination detected inconsistencies in how the ADP system calculates EAPs and resulting deposit amounts (although State Fund stated that the system is supposed to work as described in the two bullet points above). At least one 2003 renewal policy was issued with an EAP that "rolled over" from an automated quote that had been given in 1999. The policy sample also contained 2003 renewal policies that were issued using the 2002 policy term's EAP with no modification, rather than the expiring payroll plus 8%. State Fund did not identify the cause of the inconsistency.

State Fund's Response to the Department's Findings

State Fund has advised the Department's examiners that it is reviewing its procedures for offering the Kaiser Alliance and Preferred Provider Network programs, and is discussing aggressive education of underwriters and brokers to ensure that eligible employers are offered the medical cost containment programs when they apply as new business and at the time of renewal. However, State Fund has not provided any specific plan of action, and has demonstrated no improvement, to date, in its ability to maximize employer participation in the Kaiser Alliance and Preferred Provider Network programs.

State Fund has also advised the Department that it is working on procedural changes to improve consistency in the treatment of renewal policyholders. State Fund stated that it has developed a pilot system to solicit estimated renewal payroll information from all policyholders for use in developing estimated annual premiums and deposit amounts, and to provide a quote to all renewals. Based on the programming effort that is required, State Fund anticipates having the new procedure implemented by the end of 2005.

RATE STRUCTURE:

Comparison to Private Competitors

Compared to private insurers, the State Fund’s rate structure is unique in several respects. First, as a tax exempt non-profit organization, State Fund does not pay income tax, and in normal circumstances, is not expected to have a profit provision in its base rates, as it has no shareholders to whom it may distribute dividends or issue securities. Historically, State Fund did issue policyholder dividends from policyholder surplus, and until recently, did not pay broker commissions. This arrangement gives any “state fund” certain advantages over its private market competitors, insofar as it does not pay out as much in commission expense as most private insurers and it is tax exempt.

However, California’s State Fund also has an unusual rating system that charges very high base rates to the smallest policyholders, and then provides numerous, successive rating plan credits, in many cases to larger accounts, as many of the rating plans have premium eligibility requirements. Base rates are determined by multiplying the insurer’s “pure premium rate multiplier” (PPRM) by the advisory pure premium rates that it has adopted. State Fund has one of the highest PPRMs of all California insurers.

TOP 10 INSURER'S FILED PPRM'S EFFECTIVE 1/1/04 & 1/1/95

	2004	1995
STATE COMPENSATION INSURANCE FUND	2.154	1.653
EVEREST NATIONAL INSURANCE COMPANY	1.625	n/a
ZENITH INSURANCE COMPANY	1.381	1.249
AMERICAN HOME ASSURANCE COMPANY	1.672	1.210
ZURICH AMERICAN INSURANCE COMPANY	1.791	1.319
LIBERTY MUTUAL FIRE INSURANCE COMPANY	1.597	1.200
HARBOR SPECIALTY INSURANCE COMPANY	1.730	n/a
REPUBLIC INDEMNITY COMPANY OF CALIFORNIA	1.500	1.146
TRAVELERS INDEMNITY COMPANY OF ILLINOIS (THE)	1.716	1.231
FEDERAL INSURANCE COMPANY	1.462	1.318

TOP 10 INSURER'S FILED RATING PLAN CREDITS EFFECTIVE 1-1-95

	MAX SCHEDULE RATING CREDIT	MAX PREMIUM DISCOUNT	GROUP CREDIT	HMO / PPO / HCO CREDIT	MAXIMUM CUMULATIVE CREDIT
STATE COMPENSATION INSURANCE FUND	25	27.2	20	15	63%
CALIFORNIA COMPENSATION INSURANCE COMPANY	50	14.4			57%
GOLDEN EAGLE INSURANCE COMPANY	40				40%
FREMONT COMPENSATION INSURANCE COMPANY	30	6.9			35%
NATIONAL UNION FIRE INSURANCE COMPANY OF PITT.	40	14.15			48%
REPUBLIC INDEMNITY COMPANY OF AMERICA	50				50%
LIBERTY MUTUAL FIRE INSURANCE COMPANY	60	12.3			65%
ZENITH INSURANCE COMPANY	20	10			28%
UNICARE INSURANCE COMPANY	50				50%
SUPERIOR NATIONAL INSURANCE COMPANY	18				18%

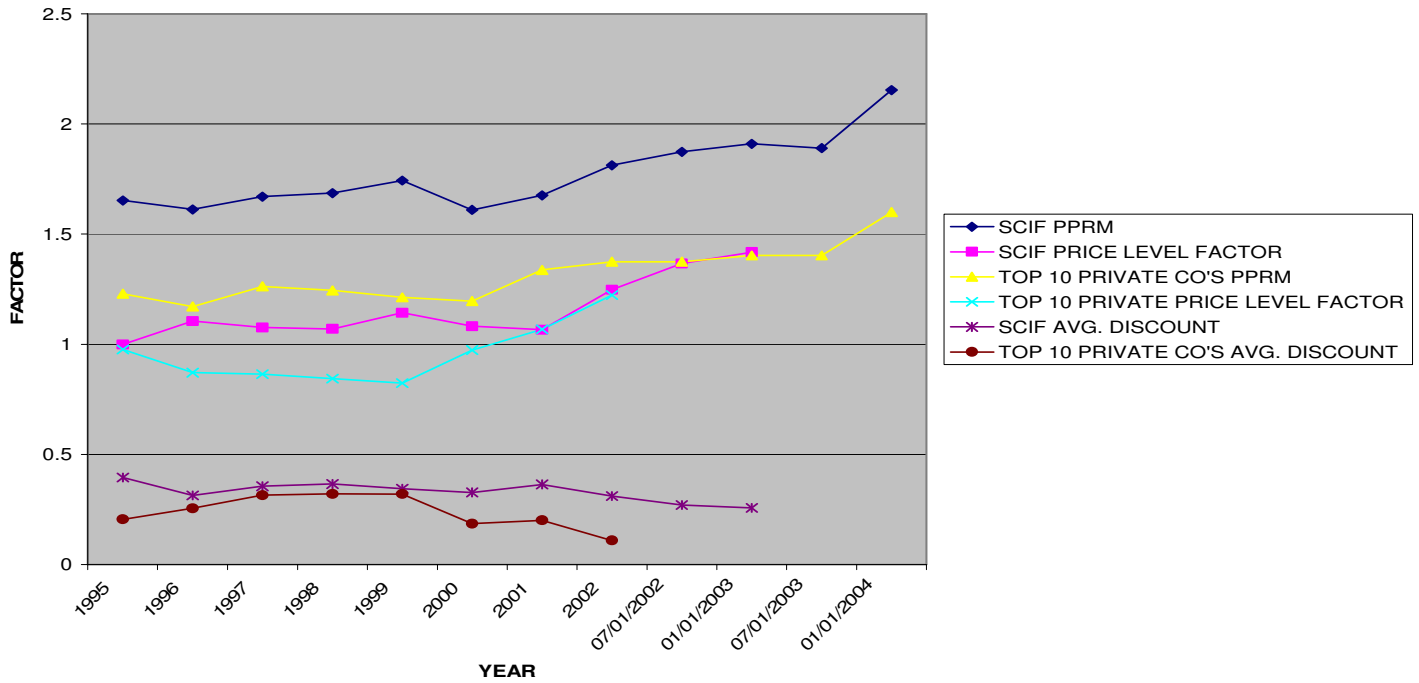
TOP 10 INSURER'S FILED RATING PLAN CREDITS EFFECTIVE 1-1-04					
	MAX SCHEDULE RATING CREDIT	MAX PREMIUM DISCOUNT	GROUP CREDIT	HMO / PPO / HCO CREDIT	MAXIMUM CUMULATIVE CREDIT
STATE COMPENSATION INSURANCE FUND	10	17.5	6	10	37%
EVEREST NATIONAL INSURANCE COMPANY	25			8	31%
ZENITH INSURANCE COMPANY	25	5			29%
AMERICAN HOME ASSURANCE COMPANY	25	14.4			36%
ZURICH AMERICAN INSURANCE COMPANY	25				25%
LIBERTY MUTUAL FIRE INSURANCE COMPANY	25	12.3			34%
HARBOR SPECIALTY INSURANCE COMPANY	25				25%
REPUBLIC INDEMNITY COMPANY OF CALIFORNIA	25		10		33%
TRAVELERS INDEMNITY COMPANY OF ILLINOIS (THE)	25	7			30%
FEDERAL INSURANCE COMPANY	25	12			34%

Actual Pricing History

Under the open rating laws of Insurance Code §11735, insurers are required to file with the Commissioner their base rates for each classification code (i.e., each job title), consisting of advisory pure premium rates or loss costs, plus the insurer's expense multiplier, which loads the loss costs for projected average underwriting expenses for each insurer. Insurers are also required to file their rating plans, which vary in scope and purpose, but allow for the charging of debits and credits based on individual account characteristics. The pervasive use of rating plan debits and credits can result in actual market rates or final net rates that vary significantly from insurers filed base rates. Stated differently, filed base rates may or may not be accurate indicators of actual market rates, depending on the degree of discounting or surcharging that is occurring in the market place. However, the Department receives a quarterly data call from the Workers' Compensation Insurance Rating Bureau (WCIRB) which provides actual pricing information for each insurer. Using the approved pure premium rates in effect each year as a benchmark, the State Fund's "Price Level Factor" (insurer net rates as a percentage of approved pure premium rates) was 1.11 in 1995. Therefore, the State Fund was only collecting enough premiums to pay for approved loss costs plus an additional 11% to cover its underwriting expenses and commissions, before investment income.⁸ The State Fund's price level factor dropped to 1.08 in 1997, increased to 1.14 in 1999, and dropped back to 1.07 in 2001, before increasing significantly to 1.29 in 2002 and 1.42 in 2003. The increased price level factor was the result of the rate increases filed by State Fund, and the revisions to its rating plans which sharply curtailed the size of credits offered. Also, State Fund severely restricted eligibility for rating plan credits by increasing the premium eligibility requirements beginning in 2002. These changes were made pursuant to a corrective action plan entered into with the Department in 2002. The following graph summarizes State Fund's historical filed PPRMs and actual price level factors, and those of the private industry. The difference between the base rate PPRM and the actual price level reflects the degree of discounting occurring by State Fund and the private market, at the bottom of the graph.

⁸ And this comparison assumes that the approved loss costs were adequate, and also that they were reflective of the State Funds loss costs.

SCIF & TOP 10 PRIVATE INSURERS FILED PPRM, PRICE LEVELS, AVG DISCOUNTS



The above chart shows that State Fund’s actual net rates charged in the market place, after application of all credits and debits, were *in the aggregate* consistently higher than those charged by the top 10 private insurers through the end of 2001. And, State Fund’s actual net rates were higher than the approved pure premium rates in effect at the time (i.e. above the 1.0 line), as compared to the top 10 private insurers whose final net rates were actually less than the pure premium rate through the end of 2000 (i.e. below the 1.0 line). After 2001, both the State Fund’s actual net rates and those of the private insurers exceeded the pure premium rate as rate adequacy improved, and the difference between the State Fund and the private insurers actual price level dissipated. However, this data is summarized in the aggregate and does not mean that in certain individual cases, State Fund never engaged in excessive discounting through the use of its multiple credit rating plans. State Fund certainly had the ability to underbid private market competitors and take on desirable large accounts by using its numerous rating plan discounts. More importantly, the above graph shows that while the top ten private insurers increased their actual net rates beginning in 1999 and each year thereafter, State Fund decreased its actual net rates throughout the period 1999 to 2001, increasing them for the first time in 2002.

DISTRIBUTION OF PREMIUM BY ACCOUNT SIZE

Estimated Annual Premium Strata (EAP)	1999		2000		2001		2002		2003	
<1,000	3.12%	42,982,715	1.52%	40,037,877	0.83%	37,254,704	0.51%	33,020,825	0.35%	28,681,795
1,000 to 2,500	6.35%	87,324,438	3.18%	83,813,371	1.91%	86,065,551	1.15%	74,624,364	0.81%	66,709,104
2,501 to 9,999	24.03%	330,573,602	14.10%	371,272,604	9.98%	448,738,849	7.60%	495,086,218	5.97%	492,152,600
10,000 to 19,999	17.27%	237,627,098	12.90%	339,796,661	10.66%	479,179,344	8.37%	545,536,230	6.96%	573,892,894
20,000 to 49,999	18.98%	261,215,718	17.65%	464,861,663	16.83%	756,763,805	15.62%	1,017,598,938	13.37%	1,103,233,374
50,000 to 99,999	12.42%	170,843,632	13.81%	363,704,769	14.65%	658,778,997	14.36%	935,855,080	13.42%	1,106,843,632
100,000 to 249,999	11.06%	152,116,284	17.64%	464,552,393	19.85%	892,592,040	20.90%	1,361,750,446	21.31%	1,757,630,183
250,000>	6.78%	93,239,411	19.21%	505,903,124	25.28%	1,136,810,470	31.51%	2,053,182,172	37.83%	3,120,555,024
	100.00%	1,375,922,898	100.00%	2,633,942,462	100.00%	4,496,183,760	100.00%	6,516,654,273	100.00%	8,249,698,606

The above data shows that the number of large policies above \$250,000 in annual premium has increased significantly from 206 in 1999 to 5,793 in 2003 while the number of small policies below \$2,500 in annual premium has declined from 139,494 in 1999 to 124,180 in 2003. Some of this shift is certainly a function of across the board rate increases which has resulted in dislocation and moved accounts up in the size of premium category.

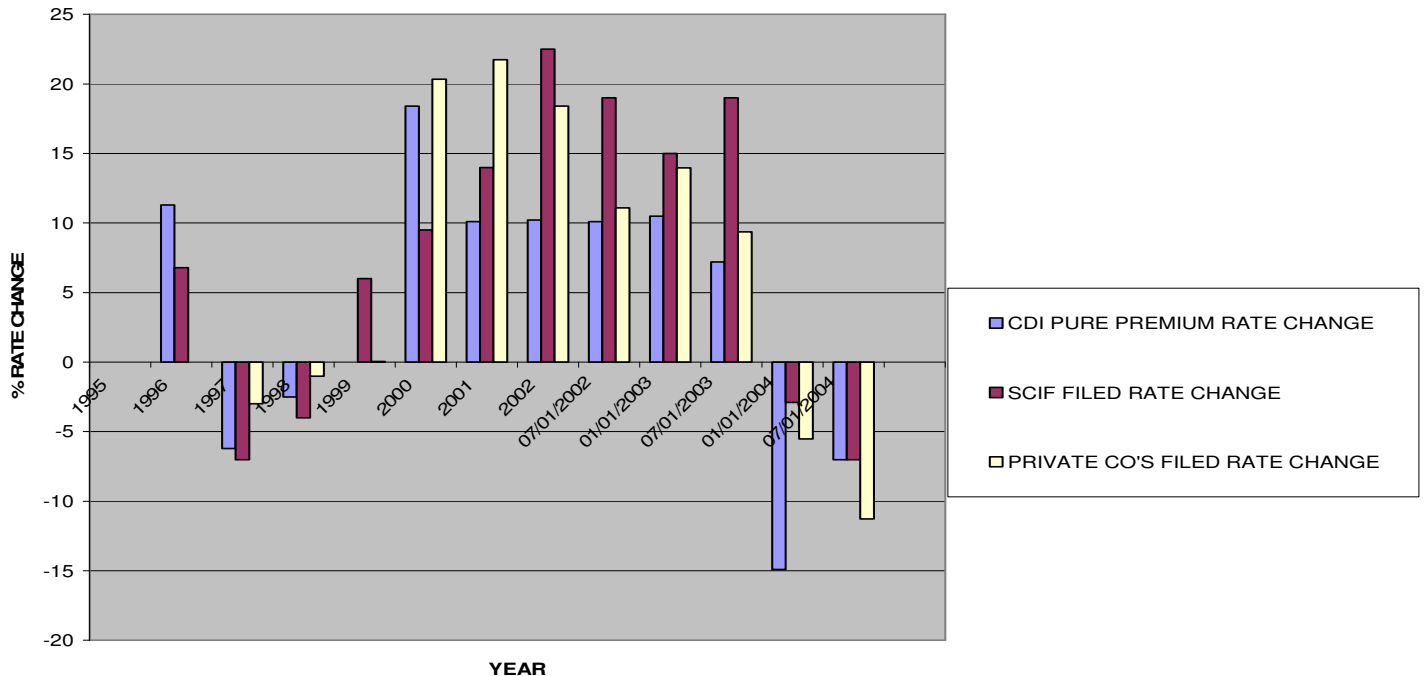
DISTRIBUTION OF POLICIES BY ACCOUNT SIZE

Estimated Annual Premium Strata (EAP)	1999		2000		2001		2002		2003	
	%	#of policies	%	#of policies	%	#of policies	%	#of policies	%	#of policies
<2501	60.22%	139,494	54.35%	134,866	45.74%	129,077	42.61%	125,369	42.94%	124,180
2,501 TO 9,999	26.99%	62,521	25.94%	64,378	27.33%	77,118	24.27%	71,410	19.62%	56,731
10,000 to 19,999	7.38%	17,094	9.78%	24,264	11.98%	33,799	13.05%	38,397	13.98%	40,435
20,000 to 49,999	3.78%	8,764	6.16%	15,279	8.72%	24,606	11.14%	32,775	12.05%	34,858
50,000 to 99,999	1.08%	2,500	2.11%	5,239	3.36%	9,468	4.55%	13,391	5.47%	15,815
100,000 to 249,999	0.45%	1,049	1.24%	3,080	2.08%	5,864	3.02%	8,891	3.94%	11,390
250,000+	0.09%	206	0.42%	1,049	0.80%	2,248	1.36%	4,014	2.00%	5,793
	100.00%	231,628	100.00%	248,155	100.00%	282,180	100.00%	294,247	100.00%	289,202

Summary of Rate Filing Changes

A graph summarizing the State Fund’s rate filing history as compared to that of the private insurers, along with the Commissioner-approved pure premium rates follows below. As is evident, for both the 1/1/04 and 7/1/04 rate filing, State Fund’s filed rate reductions have been less than the private insurers’ filed rate reductions.

SCIF versus INDUSTRY RATE CHANGES



Base Rates and Expense Components

As stated above, State Fund has the highest PPRMs and, by definition, the highest base rates of the top 10 insurers. Expense components determine the insurer's PPRM, which determines its base rates. State Fund's current expense provisions for the first \$2,500 premium layer are as follows:

Commission	5.50%
Other Acquisition & General expense	18.38%
Taxes, License, and Fees	3.15%
Profit & Contingency	10.50% *
LAE Differential	2.50%
TOTAL PROJECTED EXPENSES	40.03%

Investment Income	11.60% *
Uniform Class Deviation/Modification	25.00% *

Total Profit / Surplus Rebuild Provision 47.10% *

Because State Fund is technically a non-profit organization, it is unusual that it would file a profit provision. In normal times, a break even non-profit insurer would be expected to have a negative profit provision, that is to say it would expect to have an underwriting loss and break even after inclusion of investment income. State Fund's inclusion of a profit provision is a result of its recently inadequate surplus and need to rebuild capital.

Originally, State Fund did not utilize a Uniform Class Modification (UCM) factor and from 1995 to 2003 its UCM factor was 1.0 representing 0% deviation. This was increased to 1.15 in July 2003 and again to 1.25 in January 2004. The stated intent of the UCM was to account for differences in the Commissioner's approved pure premium rates and the WCIRB's proposed pure premium rates, and therefore account for any pure premium rate inadequacy. However, by 2004, there was no more pure premium rate inadequacy and there was actually some redundancy, especially following the passage of AB 227 and SB 228. State Fund has stated in correspondence with the Department that another function of the UCM is to assist it in rebuilding capital and surplus. When asked how long the UCM would remain in effect, State Fund indicated in December of 2003 that it anticipated that its capital and surplus would be restored within 2 years at which time it could remove the UCM. Based on data contained in the 2003 annual financial statement, State Fund realized a 40.30% return on equity, which is consistent with the profit and surplus rebuilding provisions marked above by asterisk (*).

A discussion of the individual rating plans and the impacts of rating plan discounts follows below.

Premium Discount

The purpose of the premium discount plan is to recognize the fact that insurer expenses associated with marketing and servicing larger accounts are comparatively lower when stated as a percentage of premium or rate, than those expenses associated with smaller accounts. Stated differently, because certain expenses have some fixed component rather than being purely variable with premium size, the ratio of those expenses to premiums is higher for smaller accounts than larger accounts. The WCIRB does not currently promulgate an advisory premium discount schedule, although the National Council on Compensation Insurance (NCCI) does in other states, and most insurers have filed one of the NCCI premium discount tables for use in California.

NCCI Premium Discount Plan:

Account Size	Premium Discount
\$1 to \$5,000	0%
\$5,001 to \$100,000	10.9%
\$100,001 to \$500,000	12.6%
Over \$500,000	14.4%

Previous State Fund Premium Discount Plan through 12/31/01:

Account Size	Premium Discount
\$1 to \$1,000	0%
\$1,001 to \$5,000	19%
Over \$5,000	23.6%

Current State Fund Premium Discount Plan effective 1/1/02:

Account Size	Premium Discount
\$1 to \$2,500	0%
Over \$2,500	17.5%

Clearly the State Fund's premium discount plan provides for much larger credits at a much lower premium eligibility level than private insurers plans which follow the NCCI table. If State Fund, however, retains its current expense gradation threshold at \$2,500, its current discount of 17.5% is not supported by its most recent evaluation and indication. In the January 1, 2004 filing, the indicated discount was 15.4% and the selected discount was 17.5%.

INDICATED (as of 1/1/04)		SELECTED (1/1/04)	
First \$2,500	0.0%	First \$2,500	0.0%
Above \$2,500	15.4%	Above \$2,500	17.5%

In that filing State Fund stated its commitment to revise the premium discount scheme in its next rate filing. This did not occur as the July 1, 2004 filing contained no premium discount analysis and the premium discount scheme remained unchanged.

Conclusion: State Fund, therefore, could reduce its premium discount percentage to its indicated 15.4% which would reduce rates by 2% for the smallest policyholders with premiums below \$2,500, through the off-balance adjustment. Larger accounts over \$2,500 would receive a corresponding 2% increase, making the change revenue neutral.

Merit Rating (Schedule Rating)

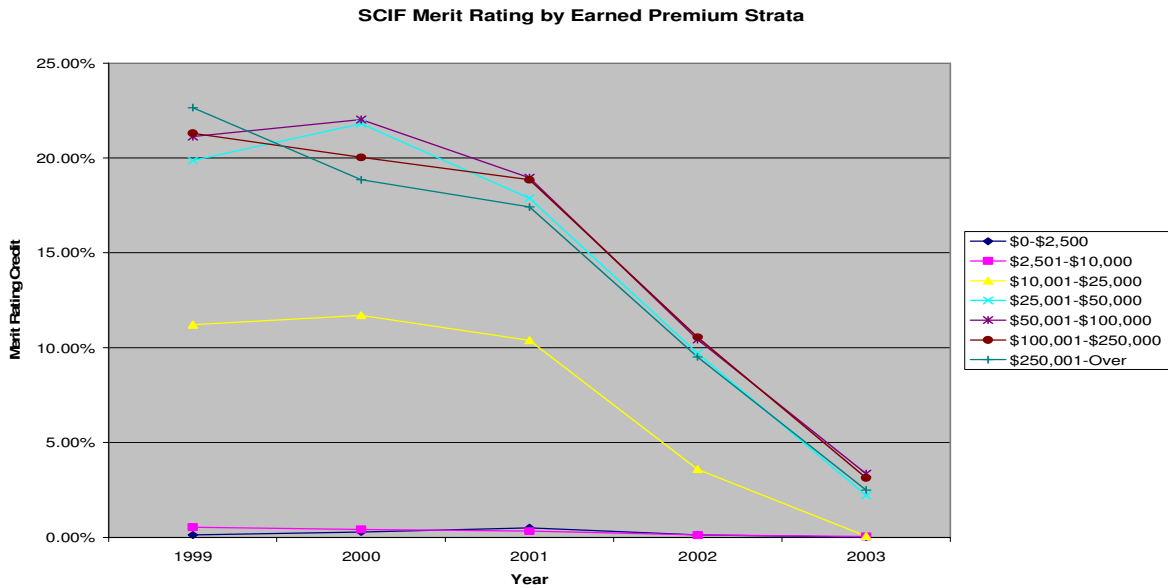
The purpose of a merit rating or schedule rating plan is to recognize a policyholder's business and safety practices that would tend to result in higher or lower claims costs. Subjective factors such as the extent to which equipment contains safety guards, having effective illness and injury prevention programs, access to emergency medical care, employee selection and training – are typically evaluated in the schedule rating plan. State Fund's merit rating plan has undergone significant changes since it entered into the corrective action plan with the Department. As originally submitted when open rating began in 1995, the merit rating plan had a \$100,000 premium eligibility requirement. As the industry embarked on its soft market pricing, it appears that State Fund responded by lowering the premium eligibility to \$50,000 and later to \$25,000 while still providing a 25% credit. Additional schedule rating credits up to 67% were available to large accounts over \$100,000 through the Individual Account Adjustment Program. The Individual Account Adjustment Program was eliminated in 2001 and the merit rating premium eligibility was increased to \$30,000 in 2002 and \$50,000 in 2003, and back to \$100,000 in 2004. In 2003, State

Fund reduced the maximum merit rating credit to 10% and indicated its intent to bring merit rating into revenue neutrality by providing an equal amount of debits and credits in the aggregate. This objective was made pursuant to the corrective action plan and began on July 1, 2003. In 2003, \$237,000,000 in net merit rating credits were provided, down sharply from \$624,000,000 in 2000.

The current merit rating plan contains the following elements.

CATEGORIES	RANGE
Classification Evaluation	+20%/-10%
Management Business Practices	+20%/-10%
Management Safety Practices	+20%/-10%

The present plan contains a maximum overall credit of 10% and a maximum overall debit of 20% although these maximums can be reached by any one of the three merit rating categories. The maximum debit of 20% exists as an incentive tool for policyholders with poor loss control practices.



Presently, the average merit rating credit is 2.5% and has not yet attained revenue neutrality. The segment of accounts containing premiums over \$100,000 that is currently eligible for merit rating has historically been a poor performing segment (only the smallest group of accounts below \$2,500 performed worse). Even as recently as 2002, the group of large accounts over \$100,000 was performing poorly, with only the smallest group of accounts below \$2,500 and the second smallest group of accounts between \$2,500 and \$10,000 performing worse. However, the largest accounts over \$250,000 have shown significant improvement from being the second worst performing group in 2000 to being the best performing group in 2002 and 2003. Also, it is recognized that pricing flexibility is most appropriate for large accounts over \$100,000 which tend to develop more credible and predictable loss data. The percentage of large accounts with premiums between \$100,000 and \$250,000 has grown from 11% in 1999 to 21% in 2003 and the percentage of very large accounts with premiums over \$250,000 has grown from 7% in 1999 to 38% in 2003. Therefore, in 2003, 59% of State Fund’s premiums represented large accounts over \$100,000. This is a sizable portion of State Fund’s book of business that deserves careful monitoring.

Conclusion: As the merit rating plan has become a large account rating tool and the group of large accounts over \$100,000 has shown significant improvement, no changes in the merit rating plan credit structure are recommended. However, State Fund should establish a special large account unit so as to monitor the individual case reserves and pricing for these large accounts, as any future adverse development in this segment will have significant ramifications for the State Fund's entire book of business.

Group Discount

The purpose of the group discount plan is to recognize both loss and expense efficiencies experienced by safety groups as a result of loss control coordination, marketing efficiencies, and analysis of more credible data found when data is consolidated for multiple employer members of a large safety group. Safety groups are authorized by California Insurance Code Section 11656.6 and are certified by the WCIRB as having homogenous payroll classifications. In 2000, State Fund provided over \$149,000,000 in group discount credits and that figure increased to \$259,000,000 in 2003. In 2000, the bulk of State Fund's group policies were in the premium range of \$10,000 to \$15,000. In 2003, the bulk of State Fund's group policies were in the premium range of \$50,000 to \$60,000 and the \$100,000 to \$150,000 range.

State Fund reduced the group credit to 6% in 2001 and it has remained at that level ever since. Recently, State Fund provided updated exhibits that indicate that an 8% or 9% group credit is now justified, due to favorable loss ratio results for group business.

INDICATED (based on 2000-2002 final audit data): 8% to 9%

SELECTED (unchanged since January 1, 2001): 6%

State Fund acknowledges recent indications of a group discount greater than 6% being supported. The Department's Rate Filing Bureau requested State Fund to consider increasing the group discount to 8% or 9% in its July 1, 2004 filing so as to provide some additional rate relief to safety group members, and to recognize their superior experience. However, State Fund declined indicating "its own stated bias is toward 'stability' in its rating plans (i.e., not changing rating plans for two to three years), and given that this greater discount indication is only a recent development, State Fund believes that a 'wait and see' position is appropriate in order to ascertain if the greater discount indication is sustained over time." The trend appears to show improving group experience over time.

Conclusion: State Fund should adopt its latest indication and increase the Group Discount by 3% so as to reward group members for their superior experience.

Commission Adjustment Plan

The purpose of the commission adjustment plan is to allow employers and brokers to negotiate lower commission rates than the standard 5.5% commission for brokered business. It is logical that large accounts with premiums over \$100,000 which generate commission of \$5,500 may be able to justify and negotiate a slightly lower commission to the extent that broker marketing expenses are fixed and not totally variable with premium size. It may cost a broker \$3,000 to service a \$50,000 account as well as a \$150,000 account. State Fund has reduced its maximum commission schedule in recent years as a result of the corrective action plan. On January 1, 2002, the maximum commission was 10%. This was reduced to 8% on January 1, 2003 and 5.5% on July 1, 2003. However, when one considers the 100% increase in State Fund rates since 2002, net commissions earned by brokers have actually increased despite the maximum variable commission reductions. In 2003, less than \$5,000,000 in variable

commission credits were provided, which is negligible considering the size of State Fund's book of business. In 2003, 22% of State Funds premium volume was written on a direct basis and 78% was brokered.

As previously noted, State Fund's rates include a charge for a 5.5% commission rate for all business. This is supposed to represent the fee that must be paid to the agent/broker. However, direct written business does not involve payment of a commission to an agent/broker so that charge, already included in the rate, should be backed out with the use of State Fund's commission adjustment plan which allows for a 6.5% discount at the zero commission level. During the recent field rating and underwriting examination, it was discovered that State Fund also includes a 5.5% commission charge for business written in-house on a direct basis. While the commission adjustment plan allows for a 6.5% discount at the zero commission level, directly written business is not receiving a 6.5% discount and in fact is receiving a 5.5% commission charge. The income generated by the direct business commission charge does not go toward compensating State Fund customer service and marketing employees who are salaried state employees. When questioned about this practice, State Fund provided some analysis that showed that it incurred similar servicing expenses for its brokered business as compared to its direct business. However, these types of servicing expenses are accounted for in the "general and other acquisition" expense provision of the rate filing. Therefore, State Fund may be double counting its general and other acquisition expense provisions, but only in the case of directly written business.

Conclusion: State Fund should adhere to its filed rating plan and provide a 6.5% credit to directly written accounts where no broker is employed in the transaction. This would reduce revenue by approximately 1.4%. However, State Fund should continue its strategy of reducing the maximum commission rate so as to reduce account retention and growth. By reducing the maximum commission expense another 2%, all accounts would receive a 2% rate reduction. Combined, the two changes would justify an overall net rate reduction of -0.6%.

Kaiser Alliance, Preferred Provider Network (PPN), Health Care Organization (HCO)

The purpose of the network rating plans is to provide an incentive for using network physicians so as to contain medical costs. In 1999, State Fund provided \$81 million in Kaiser and PPN credits to its network policyholders. This figure grew to \$663 million by 2003.

State Fund indicates that it is actively working on the implementation details of the medical network provisions of SB 899 and advises that it will be ready to implement the changes and account for the savings in its January 1, 2005 filing. Finally, State Fund states that it took into account the beneficial impacts of the network change on July 1 through December 31, 2004 policies in its selection of a 7% rate reduction, effective July 1, 2004.

Network Statistical Indication:

INDICATED (based on claims sampled from 1996 & 1997): 10%

SELECTED (unchanged since inception of programs): 10%

Conclusion: State Fund should develop an implementation work plan with appropriate targets and deadlines to ensure that network physicians are utilized as a routine business practice, with very limited exceptions.

Collective Bargaining Agreements (CBAs)

State Fund provides various “carve out” credits for collective bargaining agreements for specific industries where labor and management agree to use preferred providers for medical treatment, and alternative dispute resolution services. The data provided thus far indicates that the experience of the programs is poor, and loss ratios are higher than average and higher than the target loss ratios. However, the participation in such programs is small, and the data lacks credibility. The impact and performance of the programs is negligible when viewed in the aggregate.

INDICATED: No indication provided. Data not credible.

SELECTED:

5% discount for aerospace and timber industries (Labor Code 3201.7)

10% discount for all other groups (Labor Code 3201.5)

15% discount for programs sponsored by the Southern California Carpenters-Contractors Carve Out Trust and the Piping Industry Progress and Education (PIPE) Trust.

Conclusion: The Department has no recommendations related to the carve out programs.

Large Account Surcharge for Adverse Loss Experience

Effective July 1, 2003, State Fund implemented a 15% surcharge on policies generating \$100,000 to \$999,999 in standard premium when experience with State Fund for combined policy years 2000 and 2001 resulted in a loss ratio of 79% or greater. Any account under \$100,000 is not sufficiently credible to justify a surcharge and any account greater than \$999,999 is handled by retrospective rating. The 15% surcharge was judgmentally selected, designed to be substantive but not punitive. It should encourage larger accounts with the worst loss experience to look elsewhere for coverage or in the alternative improve their profitability. The loss ratio level at which it applies (79% or greater) was also a judgmental selection based on a cutoff ratio that would identify a significant but limited number of accounts for the surcharge. The performance of the large accounts over \$100,000 has improved from among the worst performers to among the best, in State Fund’s book of business.

Conclusion: The Department has no recommendations related to the large account surcharge program.

Premium Growth and Account Retention

In terms of the State Fund’s latest growth trends, the most recent monthly marketing statistical report shows that State Fund has lost \$227 million in premium renewals to private insurers, for the twelve months ending May 2004. However it has picked up 1,083 more renewal policies than it has lost in this same period. Half of the new business policy growth is in the Los Angeles area. Combining the two apparently inconsistent figures it appears that State Fund is losing larger accounts, thereby shedding premium volume, but picking up greater numbers of smaller sized accounts, thereby increasing policy counts. State Fund estimates that it will lose between \$200 million and \$250 million in premium volume in 2004 and seems to be in sight of this target. In view of the fact that State Fund grew to almost \$8 billion in size in 2003, premium reductions totaling \$250 million are small by comparison. As stated above, State Fund could realize significant premium reductions by further reducing its maximum commission rate by another 2% as it has done in the past.

Investment Income

State Fund is limited by statute to invest its policyholder surplus, loss reserves, and unearned premium reserves in conservative and liquid bonds authorized under the general funds investments sections of the Insurance Code. Because it has made investments beyond those statutory limitations, albeit generally safe and sound investments, State Fund's actual returns have exceeded returns available under the statutes. In 2003, when State Fund finally achieved an underwriting profit of \$75 million, its investment income of \$535 million dwarfed its underwriting results. If the current investment and the workers' compensation deposit laws were amended to allow State Fund to invest as broadly as other domestic insurers, its investment yield might modestly increase, providing more options for rate relief.

Conclusion: State Fund could fund a 1% rate reduction through a more diversified investment portfolio.

11735.1 and incorporation of reform savings provision.

California Insurance Code Section 11735.1 enacted with the passage of AB 227 requires all insurers to include in their rates a provision reflecting the reform savings resulting from AB 227, SB 228, and SB 899. On January 1, 2004, State Fund reduced its rates by -2.9%, citing the rate adequacy exception. In its July 1, 2004 rate filing, State Fund filed for an additional 7.1% rate reduction to reflect SB 899 savings. This figure compares to an average private industry rate reduction for the same two periods of -4.53% and -7.95% percent respectively. State Fund has used a cumulative loss trend reflecting the reform savings which totals 20% as compared to the WCIRB's estimate of 28%. State Fund states that it disagrees with the WCIRB's estimates of savings in the areas of apportionment, annual medical inflation, and medical utilization in arriving at a year to date loss trend provision less than the WCIRB's and the Commissioner's estimates.

IBM Business Consulting Services report

In 2003, the Department requested State Fund to hire a consultant to perform an operational review. In response to this request State Fund hired IBM Business Consulting Services to perform a 90 day review of State Fund's operations. The final confidential⁹ report from that review conservatively estimated State Fund could save \$294 million dollars a year by January 2005 from adopting its recommended improvements in operations.

It is important to put the IBM figure in perspective. Although State Fund wrote almost \$8 billion dollars in premium in 2003, its net underwriting income was only slightly over \$75 million, the remainder of its income coming from investments. Thus the IBM savings would represent four times the amount of underwriting income that State Fund reported in 2003. Any savings from such reforms could expedite the improvement of its surplus and position it to lower its rates more quickly. Based on its review for this report the Department has concluded that the State Fund has not adhered to the implementation timeline IBM identified for realizing savings from the recommended reforms and, therefore, will not realize the \$294 million of annual savings IBM estimated by 2005. This potential savings translates to a potential rate reduction of approximately 4%.

⁹ Insurance Code section 739.8 provides that absent permission from State Fund, or an enforcement action by the Commissioner, the report must remain confidential.

Conclusion

If State Fund adopted the above mentioned rating plan recommendations, it could potentially reduce rates for smaller, directly written and/or group policyholders by between 6.5% and 11.5% as follows: premium discount -2%; group discount -3%; variable commission -6.5%.

Furthermore, State Fund could reduce rates across the board for all policyholders by an additional 5.9% by: reducing the maximum commission rate, increasing the investment income yield (which would require legislation) and implementing the IBM recommendations.¹⁰

The rate reductions in the previous paragraph would be in addition to the total of the 9.7% in reductions that State Fund has filed during 2004. Of course, State Fund's choices are severely limited by the primary concern of boosting reserves and restoring depleted surplus levels.

¹⁰ Reduce commission 2% + Increased Investment Yield 1% + IBM savings 4.3% - Commission refunds for directly written business 1.4% = 5.9% net rate reduction.