



# The Florida Senate

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Committee on Banking and Insurance

Senator Rudy Garcia, Chair

## FLORIDA'S WORKERS' COMPENSATION INSURANCE RATING SYSTEM

### SUMMARY

Due to growing concerns regarding the availability and affordability of workers' compensation insurance in Florida, the Legislature substantially revised many aspects of the workers' compensation law in 2003. Prior to these reforms, Florida was ranked as having the second highest premiums of all of the states. In 2005, Florida is ranked as having the fifth highest rates.

Because of the 2003 legislation, rates for new and renewal policies were reduced by 14.0 percent, effective October 1, 2003. Subsequently, the overall average rates were reduced by 5.1 percent for 2005. Recently, the Office of Insurance Regulation recommended an overall 13.5 percent decrease in rates for 2006, denying the 7.2 percent reduction proposed by the National Council on Compensation Insurance (NCCI).

Prior to 1980, every state, excluding states with exclusive state funds, operated under a system under which a rating organization filed one uniform full rate for all carriers writing in that state. Since that time, 37 states have adopted a system under which a rating organization generally files advisory loss costs to cover benefit costs for the insurers and the insurers individually file their own expenses and profit factors, or "loss costs multipliers." Florida is one of eight states that continue to use an administered pricing or full rate system.

Some contend that availability and affordability issues continue to exist in the voluntary market particularly for small firms, new firms, and firms engaged in construction. If employers are unable to secure coverage in the voluntary market, they must purchase coverage from the Florida Workers' Compensation Joint Underwriting Association (JUA), the insurer of last resort. As expected, rates in the JUA are higher than rates in the voluntary market; however, premiums

in Florida's JUA are significantly higher than residual markets or JUAs in other states. Presently, the JUA has a deficit of approximately \$4.8 million attributable to losses incurred in former subplan D. Without additional legislative funding sources, the JUA may be required to levy a "below-the-line" assessment on policyholders in the voluntary market.

Although there are potential benefits to adopting a loss costs rating system, at this time, staff does not recommend changing to a loss costs rating law for the following reasons:

- Rates have experienced a cumulative decrease of approximately 30 percent in the last three years, assuming the decrease of 13.5 recommended by the Office of Insurance Regulation is enacted in 2006;
- The results of studies relating to workers' compensation rate regulation do not clearly demonstrate that a change in the rating law would result in lower rates;
- Recently, the OIR has stated that there is still no clear evidence that changing from an administered pricing system to a loss costs system rating law would benefit Florida consumers; and
- The 2003 Joint Select Committee on Workers' Compensation Rating Reform concluded that evidence presented to the committee did not demonstrate any obvious benefit or detriment attributable to changing from an administered pricing system to a loss costs system.

The Legislature should consider the following options to address funding, availability, and affordability issues relating to the JUA:

1. Authorize the JUA to use some of the estimated \$15 million surplus funds attributable to former plans A, B, and C to mitigate the estimated \$4.77 million deficit in subplan D and any deficits in Tiers One and Two that are a result of the capped

rates. The capped rates in Tiers One and Two will be eliminated by January 1, 2007.

2. Exclude former policyholders of plans B and C from any potential assessments, effective January 1, 2007, to prevent these former policyholders from incurring any potential liability in the event the JUA's estimated surplus in these plans adversely changes.
3. Consider extending the current expiration date of January 1, 2007, for accessing the \$15 million contingency reserve to allow the JUA to use any remaining funds beyond this deadline to fund subplan D deficits.
4. Consider extending or eliminating the January 1, 2007 expiration date for the below-the-line assessments for Tiers One and Two in order to keep these rates at a more reasonable level. As an alternative to extending the below-the-line assessment as a funding mechanism, the Legislature should consider providing funding from the Worker's Compensation Administrative Trust Fund through the current Legislative Budget Commission process to cover deficits attributable to capped rates in Tiers One and Two.
5. Require the JUA to obtain approval of its rates prior to using the rates, as is currently required of the voluntary market insurers, to ensure that the rates are not excessive, inadequate, or unfairly discriminatory, subject to statutory requirements regarding capped rates.

The Legislature should consider the following options to provide greater accountability and oversight of the JUA, a state-created entity, which will receive at least \$15 million in state funds by January 1, 2007:

1. Require the JUA to return any unused state funds allocated for funding subplan D deficits to the State of Florida.
2. Consider enacting legislation to assist the JUA in meeting criteria to qualify as a tax-exempt organization under s. 501(c) of the Internal Revenue Code, such as changing the board composition of the JUA so that the state appoints a majority of the board members.
3. Create public records and meeting exemptions for the JUA that are comparable to the exemptions provided to other residual markets. This type of exemption assists a residual market during the litigation of a claim since the release of such information could jeopardize or compromise ongoing or pending litigation.

## BACKGROUND

Prior to 1980, all states, excluding states with exclusive state funds, used the administered pricing system for establishing workers' compensation rates. The objective of an administered pricing system is to establish adequate, full rates. The components of a full rate consists of benefit costs, loss adjustment expenses, production expenses, taxes and assessments, general expenses, and a provision for profit and contingencies. Generally, a rating organization files the full workers' compensation rate for prior approval with the insurance regulator.

Since 1980, 37 states have moved to rating systems that rely more heavily on market competition by requiring or allowing each insurer to file its own loss costs multiplier that reflects the carrier's own benefit experience as well as their expense load (expense and profit components of a rate filing).<sup>1</sup>

Presently, the National Council of Compensation Insurance, Inc., ("NCCI") is the licensed advisory organization or ratemaking organization for 34 states. Twelve states use an independent local rating or advisory organization. Generally, the independent local rating or advisory organizations are funded by assessments on insurers. The NCCI provides data collection or ratemaking services as a vendor to independent rating or advisory organizations in Indiana, North Carolina, and Texas.

### Regulation of Workers' Compensation Insurance Rates in Florida

Workers' compensation rates are regulated by the Office of Insurance Regulation (OIR) pursuant to authority granted under part I of ch. 627, F.S. The OIR must approve or disapprove rates in the voluntary market prior to becoming effective.<sup>2</sup> In contrast, the Florida Workers' Compensation Joint Underwriting Association, the insurer of last resort, is not required to obtain prior approval before implementing its rates.<sup>3</sup> Generally, a "prior approval" system is viewed as the most restrictive form of state insurance regulation, other than a state promulgated rate. In comparison, the rating law in Florida for other lines of property and casualty insurance provides a "file and use" procedure

<sup>1</sup> In North Dakota, Ohio, Washington, West Virginia, and Wyoming coverage is provided exclusively through a state fund or employers are allowed to self-insure.

<sup>2</sup> Section 627.101, F.S.

<sup>3</sup> Section 627.311(5), F.S.

under which a rate filing must be made at least 90 days before it's used, subject to approval or disapproval by the OIR, but which is deemed approved if not disapproved within this time period. Property and casualty insurers are also given a "use and file" option that allows an insurer to make a rate filing within 30 days after a rate is used, subject to the authority of the OIR to disapprove the filing and order refunds of any amount that is determined to be excessive.<sup>4</sup>

In determining whether to approve or disapprove a workers' compensation rate filing, the OIR considers certain statutory standards and factors specified in sections 627.062 and 627.072, F.S.<sup>5</sup> The standard for approving insurance rates in Florida and most states is that the rate may not be excessive, inadequate, or unfairly discriminatory.<sup>6</sup> In making this determination for a workers' compensation rate, the OIR is also required to consider other factors.<sup>7</sup>

The insurance rate is the "unit charge by which the measure of exposure or the amount of insurance specified in a policy of insurance or coverage there under is multiplied to determine the premium."<sup>8</sup> A manual rate per \$100 of payroll is developed for each of the 600 classification codes that reflects the potential for loss associated with a group of employers engaged in the same type of business or industry. This rate is multiplied by the employer's payroll to determine the unadjusted premium. Then, the unadjusted premium is multiplied by the employer's experience modification factor to determine the adjusted premium. An experience rating compares an employer's actual losses and the losses that would be expected to occur for an average employer with a similar business.

The law and the rating plans approved by OIR allow for mechanisms for insurers to vary premiums. These pricing tools include retrospective rating plans that adjust the premium at the end of the policy period to reflect the actual loss experience of the employer; dividend plans that allow insurers to provide refunds to

participating policyholders; and premium credits for large deductible policies, approved safety programs, drug-free workplaces, and other standard credits. The law also permits insurers to file for approval of a rate deviation, by which the insurer proposes a uniform percentage increase or decrease to be applied to all rates charged or to rates for a particular class or classes of insurance.<sup>9</sup> Currently, only one carrier is authorized to deviate from the 2005 rates.

### Overview of a Loss Costs Regulatory System

Generally, loss costs are all of the components of a full rate, excluding expenses and profits. The loss costs represent the rate an insurer must charge in order to cover the losses associated with covering all claims for the year. Depending on the state, loss costs may or may not include all expenses associated with loss adjustment. In the majority of states where an advisory or rating organization makes a loss costs filing, an individual insurer may base their rates on their individual loss costs or the advisory loss costs modified by a loss costs multiplier. The loss costs multiplier is a factor that represents an individual insurer's profit and expense portion of the full workers' compensation rate.

Florida law requires every workers' compensation insurer to file with the OIR its rates and classifications that the insurer proposes to use.<sup>10</sup> However, the law allows an insurer to satisfy this obligation by becoming a member of a licensed rating organization, which makes such filings on its behalf.<sup>11</sup> All workers' compensation insurers in Florida have chosen to become members of the NCCI.

### Filing and Approval Requirements

Under a competitive rating system, such as a loss costs system, an insurer's rates are generally subject to file and use or use and file requirements, rather than prior approval of the rates. In some states, including California, Georgia, and Illinois, the loss costs filing is an advisory filing since an individual insurer is authorized to deviate from the filed loss costs.<sup>12</sup> In Georgia, individual insurers are required to develop their own premium rate based on their own experience. If the individual insurer does not have actuarially credible experience, the experience filed by the rating organization is also considered. The insurer is required

<sup>4</sup> Section 627.062(2)(a), F.S.

<sup>5</sup> Section 627.151, F.S.

<sup>6</sup> Sections 627.062(1) and 627.151, F.S.

<sup>7</sup> The past loss experience and prospective loss experience; the conflagration and catastrophe hazards; a reasonable margin for underwriting profits and contingencies; dividends, savings, or unabsorbed premium deposits allowed or returned by insurers; investment income on unearned premium reserves and loss reserves; past expenses and prospective expenses; and all other relevant factors. [s. 627.072, F.S.]

<sup>8</sup> Section 627.041(1), F.S.

<sup>9</sup> Section 627.211, F.S.

<sup>10</sup> Section 627.091(1), F.S.

<sup>11</sup> Section 627.091(4), F.S.

<sup>12</sup> In Indiana and Illinois, carriers have the option of using loss costs or administered pricing for rate filings.

to submit expense and experience to support the development of the loss costs multiplier.<sup>13</sup>

Georgia and Texas have enacted loss costs systems that maintain greater regulatory control over the market by requiring prior approval of the rate. In Texas, a filing is deemed approved if it is not disapproved within 30 days after filing. Georgia law provides that if the filing is not disapproved within 45 days after submission, the filing is deemed approved.<sup>14</sup> However, Georgia requires an examination of rate filings in certain circumstances.<sup>15</sup> If the filing results in an overall increase of at least 10 percent within a 12-month period, the regulator is required to examine the insurer to determine the accuracy of claim reserves. If the overall rate increase is less than 25 percent within a 12-month period, the regulator has the discretion to waive the examination requirement if there is sufficient information to evaluate the rate increase.<sup>16</sup>

However, some states, including California, Illinois, Michigan, and Oklahoma, generally do not require prior approval of the rates. In California, the advisory loss costs filing, submitted by the independent rating bureau, is subject to prior approval by the regulator; however, filings made by individual insurers are subject to the regulator's ability to disapprove rates subsequent to filing.<sup>17</sup> Carriers in Illinois, as well as Indiana, have the option of adopting the advisory full rates, advisory loss costs multiplier, or filing their own loss costs multiplier. In Illinois, each insurer is required to make an affirmative choice as to which rates are being adopted, along with the expense and profit modification factor, and file such notification within 30 days after the effective date of the rate.<sup>18</sup> The Compensation Advisory Organization of Michigan, an independent rating organization funded by insurers, compiles pure premium data pursuant to the statistical plans approved by the Office of Financial and Insurance Services for approval. Carriers are allowed to file loss costs multipliers and use them without prior approval. Oklahoma does not require prior approval if the increase is less than 15 percent from the prior year.

Some states, including Georgia, Illinois, and Michigan, evaluate whether rates are excessive in terms of the existence of a competitive market. In Illinois, a

competitive market is deemed to exist unless the regulator determines that a reasonable degree of competition does not exist in the market based on an ongoing monitoring of the degree of competition in the state.<sup>19</sup> If the regulator finds that a reasonable degree of competition does not exist, the regulator is authorized to require the insurers in that market to file supporting information in support of existing rates. In Michigan, the regulator is required to evaluate the competition in the market, on an annual basis, to determine whether prices exceed a level consistent with a fair rate of return on investment to cost-efficient insurers.<sup>20</sup>

### **2003 Joint Select Committee on Workers' Compensation Rating Reform**

In 2003, the Joint Select Committee on Workers' Compensation Rating Reform (committee), created by the Florida Legislature, was charged with studying the merits of a loss costs system and other options that would promote greater competition.<sup>21</sup> Evidence presented to the committee did not demonstrate any obvious benefit or detriment attributable to changing from an administered pricing system to a loss costs system. In the final committee report, the committee encouraged the Legislature to explore changing the rating law once significant reforms contained in SB 50-A were fully implemented. In response to the committee's recommendations, the 2004 Florida Legislature amended the workers' compensation rating laws by providing the following changes:

1. Revised the standards for approval and disapproval of deviations by removing the requirement that the OIR consider certain market conditions;
2. Allowed workers' compensation insurers to use rates in excess of their filed rates with the written consent of a policyholder for a period of 3 years, for employers the insurer takes out of the Florida Workers' Compensation Joint Underwriting Association without these policies being subject to the current maximum limitation of 10 percent of an insurer's commercial policies; and
3. Requires the Office of Insurance Regulation to submit an annual report to the Legislature that

<sup>13</sup> GA ADC 120-2-37-.05.

<sup>14</sup> GA ST section 33-9-21.

<sup>15</sup> GA ST section 33-9-21.

<sup>16</sup> Id.

<sup>17</sup> CA Code section 11734 and 11735.

<sup>18</sup> IL CS 215 section 5/457.

<sup>19</sup> IL CS 215 section 5/460.

<sup>20</sup> 1956 PA 218, MCL 500.2409.

<sup>21</sup> Chapter 2003-412, L.O.F.

evaluates competition in the workers' compensation insurance market.<sup>22</sup>

### **Florida Workers' Compensation Joint Underwriting Association (JUA)**

There are various types of residual market mechanisms, such as an assigned risk plan, a plan offered by a state competitive fund or joint underwriting association, or other mechanism. In an assigned risk plan, applicants who have been rejected by the voluntary market can be assigned to individual carriers in proportion to the carriers' market share in the state and the carrier may retain the risk of such coverage. Some states establish or use a reinsurance pool. The pool is a reinsurance agreement among participating insurers to share in the operating results arising out of the residual market assignments. Employers insured by the pool are assigned to one of the carriers administering claims on behalf of the pool. Carriers fund deficits of the pool through assessments based on each carrier's market share in the voluntary market.

The NCCI provides services for the residual market in 29 states. These services include serving as the plan administrator of the Workers' Compensation Insurance Plan, or assigned risk plan, and administering the National Workers' Compensation Reinsurance Pool, which is the largest workers' compensation reinsurance pool in the United States. The remaining states use competitive state funds, a joint underwriting association, or some other type of mechanism or combination.

Prior to the creation of the JUA in 1993, the Florida Workers' Compensation Insurance Plan (FWCIP) was the residual market, or insurer of last resort, for workers' compensation insurance coverage in Florida. The FWCIP, administered by the NCCI, provided workers' compensation and employer's liability insurance to employers who were required by law to maintain coverage and who were unable to purchase such insurance through the voluntary market. Deficits in the FWCIP were funded by assessments on carriers writing such coverage in the voluntary market based on their market share in the voluntary market.

In 1993, the Legislature eliminated the FWCIP and created the current JUA as a nonprofit, self-funding entity to act as a residual market mechanism.<sup>23</sup> A nine-member board governs the current JUA and is

composed of three members appointed by the Financial Services Commission, the consumer advocate for the Department of Financial Services, four members representing insurers, and one member representing agents.<sup>24</sup>

Employers in the JUA pay premiums in excess of those paid in the voluntary market. Historically, certain employers insured by the JUA receive assessable policies that are subject to an assessment if the JUA experiences a deficit. The JUA is authorized to establish and use its rates and rating plans and may revise them no more than two times per calendar year for any rating class. This filing method is known as "use and file." This method of rate regulation allows the JUA to file its rates and immediately begin using the new rates. The OIR has the authority to disapprove these rates. In contrast, the OIR must approve rate filings for workers' compensation insurers in the voluntary market before the rates become effective.<sup>25</sup>

### **2003 JUA Legislation**

During the last two years, the Legislature has addressed concerns regarding affordability and availability of workers' compensation insurance for small employers in the JUA, the insurer of last resort. In 2003, the Legislature established subplan D in the JUA to provide coverage for generally small employers (15 or fewer employees).<sup>26</sup> Although rates in this subplan were capped at 25 percent over the voluntary market rates, the policies were assessable meaning that these employers could be assessed for additional premiums to cover any deficits in the subplan. At the time, the JUA estimated that its premiums for subplan D should have been 2.57 times higher than the voluntary market premium to remain actuarially sound; hence, it projected subplan D would likely incur a deficit. As of December 31, 2003, the JUA reported a \$9.9 million deficit. In February 2004, there were approximately 2,500 policyholders in subplan D.

### **2004 JUA Legislation**

In 2004, the Legislature enacted changes to the JUA law to address the growing deficit in subplan D and provide affordable coverage for small employers that are unable to obtain coverage in the voluntary market.<sup>27</sup> The law provided a one-time appropriation of

<sup>24</sup> Id.

<sup>25</sup> Section 627.101(2), F.S.

<sup>26</sup> The law also provided coverage for certain charitable organizations that was capped at 10 percent over the voluntary market rates.

<sup>27</sup> Chapter 2004-266, L.O.F.

<sup>22</sup> The results of the 2004 report are summarized under the Findings section of this report.

<sup>23</sup> Section 627.311(5), F.S.

\$10 million from the Workers' Compensation Administrative Trust Fund (WCATF) in the Department of Financial Services to fund any deficit in the JUA. Additionally, the bill authorized the JUA to request periodic transfers, not to exceed a total of \$15 million, from the WCATF to cover any remaining subplan D deficits, subject to approval by the Legislative Budget Commission. The Governor subsequently vetoed the \$10 million appropriation to the JUA.

The law also restructured the JUA by eliminating plans A, B, C, and D and creating three tiers with eligibility based on an employer's loss experience, effective July 1, 2004.<sup>28</sup> Premiums in Tier One and Two are capped at 25 percent and 50 percent above the premiums of the voluntary market, respectively, until there is sufficient experience for the JUA to establish actuarially sound rates for the tiers, but no earlier than January 1, 2007. Employers in Tier Three will be charged actuarially sound rates and only these policies will be assessable meaning that policyholders could be assessed additional premiums to cover any deficits.

Any deficits in Tiers One or Two or any deficit remaining from any of the former subplans would be funded by an assessment on workers' compensation policies in the voluntary market for a period of one year. Policyholders in the voluntary market and nongovernmental self-insurance funds are subject to the assessment. These "below-the-line" assessments may not be levied after July 1, 2007. The JUA is authorized to request funding for any deficit in Tier Three in the event assessments on Tier Three policyholders are inadequate to fund such a deficit. Former subplan D policyholders are not subject to assessments for the funding of any deficits.

#### ***Applicability of the "Government-in-the-Sunshine Law"***

Florida's Government-in-the-Sunshine Law, commonly referred to as the Sunshine Law, provides a right of access to governmental records and proceedings at both

the state and local governmental levels. Historically, this law has been held to apply to private entities created by law or by public agencies, unless specifically exempted by law. Section 119.01, F.S., the public records laws, requires that records made or received in connection with the transaction of official business by an agency must be open for inspection in the absence of a statute exempting the record or making it confidential. The law defines the term, "agency," to include any authority, board, commission, or other separate unit of government, *created or established by law* and any other public or private agency, person, partnership, corporation, or business entity, acting on behalf of any public agency.<sup>29</sup> Section 286.011, F.S., relating to public meetings and records provides that all meetings of any board of any state agency or authority at which official acts are to be taken are open to the public unless exempted.

Citizens Property Insurance Corporation, the Florida Automobile Joint Underwriting Association, and the Florida Medical Malpractice Joint Underwriting Association, which operate as residual markets, have public record exemptions created in law. These exemptions include portions of meetings and claims and underwriting records related to ongoing litigation. This type of public records and meeting exemption assists residual markets during the litigation of a claim since the release of such information could jeopardize or compromise ongoing or pending litigation. Presently, the JUA does not have statutory exemptions from the Sunshine Law.

## **METHODOLOGY**

Committee staff reviewed laws, rules, and studies relating to rate regulation in Florida and other states. Staff interviewed insurers, representatives of employees and employers, regulators, and other stakeholders. Staff evaluated premium information, economic data, and trends regarding market conditions in order to compare Florida's rate regulation, level of competition in the marketplace, and affordability of coverage with other states.

<sup>28</sup> Tier One provides coverage for employers that have an experience-rating modification factor of less than 1.0 or, if nonrated, the employers must have a continuous three-year history of workers' compensation coverage and a good loss history. Tier Two provides coverage for new employers, employers with moderate experience (experience-rating modification factor equal to or greater than 1.0 but not greater than 1.10), and employers with good experience who do not have a continuous 3-year history of workers' compensation coverage. Tier Three provides coverage for all other employers.

<sup>29</sup> Section 119.011(2), F.S.

## FINDINGS

### The State of Florida's Workers' Compensation Insurance Market

Is the workers' compensation insurance market in Florida competitive? Would a loss costs system affect the affordability of coverage and the level of competition in the market?

According to the OIR, there are approximately 400 carriers authorized to write workers' compensation insurance in Florida and approximately 240 are actively writing.<sup>30</sup> The number of carriers has not fluctuated significantly in recent years. In 2005, the top five carriers include four national companies: Liberty, AIG, CNA, Hartford, and one domestic carrier, FCCI.

To evaluate market concentration and the degree of market competition, committee staff evaluated the Herfindahl-Hirshman Index (HHI) for Florida and other states in recent years. The HHI is a generally accepted economic measure of market concentration and the degree of competition.<sup>31</sup> The HHI takes into account the relative size and distribution of the firms in a market and approaches zero when a market consists of a large number of firms of relatively equal size. A market with an index of less than 1,000 is not considered concentrated and is more competitive than a market with an index of 1,000 or higher. In 1999, Florida's HHI was 933, ranking it as the 28<sup>th</sup> most competitive state by insurer group. According to the 2004 analysis conducted by NCCI, Florida had an HHI of 729, ranking it as the 14<sup>th</sup> most competitive state.

The residual market share as a percentage of the total premium is another measure used to evaluate availability of coverage in the voluntary market. The Florida residual market as a percentage of the total market has declined from 2 percent in 2003 to 1.7 percent in 2004. In 2004, the JUA issued 5,434 policies. As of August 31, 2005, the JUA had approximately 3,700 policies in force. In contrast, the residual market premium share as a percentage of the total premium market in 24 NCCI plan-administered states averaged 12.2 percent in 2004. This average

<sup>30</sup> Office of Insurance Regulation Memorandum to Senate Banking and Insurance Staff, dated September 15, 2005.

<sup>31</sup> The HHI is calculated by squaring the market share of each insurer competing in the market and then summing the resulting numbers.

reflects a range from 0.9 percent in Arizona to 23.6 percent in Delaware.<sup>32</sup>

### Independent Rankings of State Workers' Compensation Insurance Rates

According to the *Workers Compensation State Rankings – Manufacturing Industry Costs and Statutory Benefit Provisions*,<sup>33</sup> Florida has the fifth highest workers' compensation comparative costs out of the 45 states reviewed in 2005.<sup>34</sup> In contrast, Florida was ranked as having the third highest costs in 2004. California remains the highest cost state for the past five years.<sup>35</sup> Five of the eight states that use administered pricing systems were ranked among the 15 lowest states in comparative costs.<sup>36</sup>

In May 2005, the Oregon Department of Consumer and Business Services ranked Florida as having the third highest premiums in the United States.<sup>37</sup> Premiums were compiled for 50 classification codes in each state and weighted by the 1998-2000 Oregon payroll to generate an average manual rate for each state. The results of this study are somewhat dated, since this 2004 study reflects Florida rates that were in effect, as of October 1, 2003. Since the release of this report, the OIR has approved a 5.1 percent overall decrease for 2005, and has recommended a 13.5 decrease for 2006. At the request of Senate staff, the NCCI recently updated the Oregon study by adjusting by state for rate changes that occurred between the effective date underlying the 2004 index rate and August 1, 2005. This updated ranking indicates that Florida has dropped from its ranking as third highest in 2004 to the fifth highest, as of August 1, 2005.<sup>38</sup>

<sup>32</sup> The NCCI, *Residual Market Management Summary 2004* (2005).

<sup>33</sup> Actuarial and Technical Solutions, Inc., *Workers' Compensation State Ranking: Manufacturing Industry Costs and Statutory Benefit Provisions*, (2004).

<sup>34</sup> The five states with exclusive state funds were not included.

<sup>35</sup> The rates for approximately 60 manufacturing class codes for each state are weighted, using a countrywide distribution of payroll, to generate the comparative costs of each state.

<sup>36</sup> Arizona was ranked as having the lowest costs, followed by Massachusetts (9), Iowa (10), Idaho (12), Wisconsin (15), New Jersey (30), New York (32), and Florida (41).

<sup>37</sup> Oregon Department of Consumer and Business Services, *Oregon Workers' Compensation Premium Rate Ranking Calendar Year 2004* (2005).

<sup>38</sup> *NCCI Update to 2004 Oregon Workers' Compensation Premium Rate Ranking Summary*, NCCI (2005).

Senate staff reviewed data and studies from other states to evaluate the variation in loss costs multipliers used by carriers. In California, to calculate a carrier's manual base rate for a class code, the pure premium rate for a class code is multiplied by an insurer's rate multiplier. In 2004, the rate multiplier filed by individual carriers ranged from 1.015 to 2.402. The rate multiplier for the largest insurer in California, the State Compensation Insurance Fund, was 2.154. This manual rate is subject to further adjustments for experience modification factor, schedule rating credits or debits, etc. In Pennsylvania, the loss costs multipliers for carriers, effective July 1, 2005, ranged from 0.7240 to 2.5430. The Pennsylvania Compensation Rating Bureau, an independent rating organization funded by insurers, files the pure premiums or loss costs with the Pennsylvania Department of Insurance for approval.

What accounts for the variation in pricing? There are several possible explanations for the variations in prices. For example, variances in manual rates among carriers could be substantially offset by differences in schedule credits, experience rating, premium discounts, and other rating adjustments. Manual rate variances also may reflect that workers' compensation insurance is not a homogenous commodity. Carriers with higher rates may offer additional services that other carriers do not provide.

In 2004, the Pennsylvania Compensation Rating Bureau compared workers' compensation rates in Pennsylvania with rates in Delaware, Maryland, New Jersey, New York, Ohio, and West Virginia for various classification codes among these states without adjusting for the impact of special rating programs. Pennsylvania, Delaware, and Maryland have loss costs systems. New Jersey and New York use an administered pricing system and New York allows for the use of deviations. Ohio and West Virginia provide coverage through their exclusive state funds. For each of these states, a low and high rate was derived by selecting classification codes in manufacturing, contracting, and miscellaneous industry classifications. While the study could not determine the extent to which carriers with extreme values have written business in each of the classifications evaluated, the ranges of loss costs multipliers (LCM) or deviations shown do reflect the potential variation of prices in each state. The ranges of approved rates for classification are summarized below:

State	Low LCM/Deviation	High LCM/Deviation
Delaware	1.044	2.232
Maryland	0.750	2.608
New Jersey	Deviations not allowed.	
New York	0.825 (or 17.5 percent downward)	1.00 (or no deviation)
Pennsylvania	0.724	2.214

The report notes that the ranges of approved rates are attributable in part to differences in carrier pricing and to differences in the structure of approved classifications. The study also suggests that differences in rates among the states arise primarily due to differences in benefit designs and administrative procedures along with the interaction of economic, industrial, and social forces. The authors concluded their analysis by stating, "workers' compensation insurance costs are more where losses and insurer expenses are higher and less where losses and insurer expenses are lower. It is not generally the case that differences in insurance costs are attributable to differences in insurance carrier requirements for operating margins or profits."<sup>39</sup>

#### ***Office of Insurance Regulation's 2004 Workers' Compensation Annual Report***

Pursuant to s. 627.211(6), F.S. the OIR is required to submit an annual report to the Legislature evaluating competition in the workers' compensation market in Florida.<sup>40</sup> Overall, the report found that the workers' compensation market appears to be reasonably competitive. Specifically, the report provided the following findings:

1. The concentration of insurers suggests that the market contains a large number of independent firms. The market concentration is "not unduly concentrated."
2. None of the firms has enough of the market share to exercise any meaningful control over the price of coverage.
3. Based on entries and withdrawals, it would seem that the market is attractive for insurers.

The OIR report also concluded that given the number of actively writing insurers and the results of

<sup>39</sup> Pennsylvania Compensation Rating Bureau, *Comparison of Workers' Compensation Rates, Effective July 1, 2004, Seven Selected Northeastern States* (2004).

<sup>40</sup> Office of Insurance Regulation, *2004 Workers' Compensation Annual Report* (2005).

competitive analysis coverage should be generally available in the voluntary market. The report noted that the residual market, the JUA, is small, which suggests that the voluntary market is generally absorbing the vast majority of demand. The report noted that there appears to be some availability issues in the voluntary market groups, such as small firms, new firms, and construction firms. However, the report indicated that the use of professional employer organizations among small employers has helped with this availability issue. The report also contained concerns and recommendations regarding the JUA, which are discussed later in this report.

### **Possible Advantages and Disadvantages of an Administered Pricing System or a Loss Costs System**

#### ***Administered Pricing System***

Advocates of the current administered pricing system contend that the current workers' compensation insurance market is stable and that the 2003 reforms have resulted in significant reductions in premiums to employers, better loss ratios for carriers, and increased writings by large, national carriers. They also note that since the 2003 reforms, Florida will experience a cumulative, overall average decrease in rates of almost 30 percent, assuming the 13.5 decrease recommended by the OIR is implemented in 2006.

Advocates of the current pricing system also contend that the ability of carriers to use rate variation methods such as retrospective rating plans, deviations, safety credits, and drug-free workplace credits, allows for pricing competition in Florida. These carriers also note that dividends, one of the several pricing mechanisms currently employed by carriers, acts as a retroactive pricing mechanism, which rewards safety conscious employers. Many of the large carriers that have taken on an increased market share in Florida over the last couple of years are using dividends as a competitive pricing mechanism. They also contend that the use of rate variation mechanisms, as a competitive pricing mechanism, is preferable to switching to a loss costs system where predatory pricing, as well as under pricing, can create an unstable market and might lead to more insolvencies.

Opponents of the current pricing system contend that there is little incentive to compete since the rating system provides an average profit factor for every carrier. Some would argue that this might provide little incentive for inefficient companies to enhance their performance.

#### ***Loss Costs System***

Advocates for a loss costs system in Florida contend that such a system would provide greater competition in the market and promote efficiency among the insurers, ultimately resulting in increased availability and affordability of coverage. Proponents note that availability and affordability issues still exist in the voluntary market especially for small firms, new firms, and construction businesses. If employers cannot access coverage in the voluntary market, the employer is forced to get coverage in JUA, for which rates are consistently higher than residual markets or JUA's in other states. Proponents of a loss costs change also note that the majority of states have moved to a loss costs rating system. Such a system could be designed to protect employers from rates that are excessive or inadequate to pay claims.

Opponents of a loss costs system contend that a move to a loss costs system would place additional administrative costs on carriers to redesign their existing structures and processes in order to implement a new rating system. Carriers would have to hire more actuarial assistance to operate under this type of rating system.

#### ***The Office of Insurance Regulations' Comments Regarding the Implementation of a Loss Costs System***

In a recent memorandum to Senate committee staff, representatives of the Office of Insurance Regulation provided comments on regarding the implementation of a loss costs system in Florida.<sup>41</sup> The OIR provided the following observations:

1. The OIR noted that there are currently a number of price and non-price mechanisms used by carriers to compete in the market. However, the OIR noted that the biggest difference in the Florida market and other states is the amount of price competition in basic rates. The use of deviations in recent years is practically nonexistent.
2. Dividends, as a pricing mechanism, are used in the Florida market as a back-end incentive to encourage employers to develop and maintain safe work places. Carriers paid out approximately \$108 million in dividends to employers in 2004. The OIR noted that a typical loss costs system does not provide this type of incentive.

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<sup>41</sup> Memorandum from the Office of Insurance Regulation to Senate Banking and Insurance staff, dated September 15, 2005.

3. The OIR does not see any material disruptions in the market that would prevent consideration of adopting a loss costs filing system.
4. There is still no clear evidence that the implementation of a loss costs system would benefit Florida.
5. If a loss costs system is implemented, there is a potential that carriers may compete for good risks only, and may write such risks at low or potentially inadequate rates.
6. Under a loss costs system, there is no assurance that carriers will offer competitive rates, i.e., rates at or below the JUA rates, to high-risk employers. Therefore, a loss costs system may not provide a benefit for the high-risk employers that could ultimately end up in the JUA.

Although the OIR was not advocating a change in the rating law at this time, the OIR stated it "...would support a change to a loss costs system, assuming appropriate constraints are included to ensure regulatory oversight of the prices charged to Florida employers." A transition to a loss costs system would have a fiscal impact on the OIR since each insurer could be required to make an annual rate filing. All 400 companies writing in Florida could be required to make an annual filing to establish rates for their individual companies. The NCCI would continue to make an annual loss costs filing without the expense portion of the rate.

The OIR estimates that it would need to establish an additional four positions and upgrade the current information technology system to accommodate the new filing system. The OIR estimate includes two additional positions each in the Property and Casualty Review and in the Property and Casualty Financial Surveillance program areas. The additional positions in Property and Casualty Financial Surveillance would be used to ensure compliance with solvency requirements, ensure market stability, and protect the public from predatory pricing. The OIR estimates that the initial costs for these positions and technology upgrades would be approximately \$300,000 the first year.<sup>42</sup>

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<sup>42</sup> Memorandum from the Office of Insurance Regulation to Senate Banking and Insurance staff, dated September 15, 2005.

### Impact of the Type of Insurance Regulatory Structure

In recent years, studies have attempted to determine whether an open competition concept, such as a loss costs system, has resulted in lower costs and greater competition in the market. Thomason, Schmidle, and Burton evaluated how various regulatory systems affect employers' costs. The authors noted that, in general, such studies have generated mixed results.<sup>43</sup> Just as in any other programs it appears that, some states have fared better than others have. The authors noted that some studies have concluded that the level of deregulation is associated with lower prices, while other studies have found conflicting results.<sup>44</sup> The authors cited an earlier 1994 study by Schmidle that concluded that deregulation had no effect on the price of the insurance; however, there was some support for the hypothesis that deregulation increased insurance prices. These results suggest rate suppression existed in the administered pricing states prior to the enactment of open competition.<sup>45</sup>

However, the authors point to other research that suggests that rate regulation is associated with a reduction in availability and less competition in the market. The authors note, "The effect of rate regulation (or deregulation) depends on the interaction of the statutory framework, regulatory behavior, insurer behavior, and market conditions."<sup>46</sup> The authors concluded that:

A completely deregulated market is a more efficient delivery system and is, therefore preferable to either partial deregulation or administered pricing. The latter two alternatives seem to be associated with inefficiencies resulting

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<sup>43</sup> The authors suggest that some of the inconsistencies in results could be attributable to methodological problems, lack of agreement on the definition and measurement of regulatory environment, and other factors.

<sup>44</sup> Thomason, Schmidle, and Burton, *Workers' Compensation Benefits, Costs, and Safety Under Alternative Insurance Arrangements*. Kalamazoo, Michigan, W.E. Upjohn Institute for Employment Research (2001).

<sup>45</sup> Schmidle, Timothy P. "The Impact of Insurance Pricing on the Employers' Costs of Workers' Compensation Insurance." Ph.D. dissertation, Cornell University (1994).

<sup>46</sup> Thomason, Schmidle, and Burton, *Workers' Compensation Benefits, Costs, and Safety Under Alternative Insurance Arrangements*. Kalamazoo, Michigan, W.E. Upjohn Institute for Employment Research (2001).

from insurer uncertainty over their ability to respond to market changes.<sup>47</sup>

However, the study contained a few caveats regarding this conclusion regarding deregulation. For example, long-term data series involving deregulation are limited. Evidence suggests that comprehensive deregulation has led to a price war in some states. It is possible that the significant rate reductions found in those states are temporary; as the struggle for market share is resolved, prices may rise again. It is possible that while deregulation may improve system performance, relative to delivery efficiency, it could diminish performance relative to other objectives, such as increasing the availability of coverage and preventing insolvency.<sup>48</sup>

### **Florida Workers' Compensation Joint Underwriting Association**

Due to concerns regarding the accountability of the JUA, the Legislature directed the Auditor General to perform an operational audit of the JUA.<sup>49</sup> In 2004, the Auditor General released the audit report, which included findings and recommendations regarding the administration, rates, and funding of the JUA.<sup>50</sup> The Auditor General's contracted actuary concluded, among other findings, that: required reserves of the JUA should be significantly less than the JUA actuary's best estimate of required reserves and the JUA could have established a lower rate for Tier Three policies. Due to the statutory caps, the rates mandated for Tiers One and Two were found to be too low. The Auditor General recommended that the Legislature consider enacting legislation that expedites the requirement that rates for Tiers One and Two are determined on an actuarially sound basis. The report also recommended that the Legislature consider enacting legislation addressing the use of surplus funds attributable to other plans, such as former plan C, to fund subplan D deficits.

Through legislative action, the report noted that it might be possible to reduce the JUA's costs by making the JUA exempt from federal taxation. The report recommended that the Legislature consider enacting legislation to qualify the JUA as a tax-exempt

organization under s. 501(c) of the Internal Revenue Code. Currently, Citizens and the Florida Automobile Joint Underwriting Association qualify as tax-exempt organizations.

The audit noted that the JUA had not subjected most of its contractual services to a competitive selection process since 1995. Recently, the JUA completed such a competitive bidding process for the selection of its servicing provider. The report also provided recommendations to enhance monitoring the performance of service providers that the JUA is currently evaluating.

### ***Oversight and Regulation of the JUA***

The JUA, as a residual market mechanism, is exempt from many provisions of the Insurance Code that are applicable to insurers in the voluntary market, such as surplus and solvency requirements. However, the JUA and the other residual markets are subject to market conduct examinations pursuant to the OIR's authority under s. 624.3161, F.S., to determine whether the entity is complying with applicable provisions of the Insurance Code and the Workers' Compensation Law. In addition, the JUA's plan of operation and any changes to the plan are subject to the approval of the OIR pursuant to s. 627.311, F.S.

The Office of Insurance Regulation noted that the JUA premiums are consistently higher than residual markets or JUA's in other states. The rates in Tier Three policies are currently set at 170 percent above the voluntary market rate.<sup>51</sup> In contrast, the OIR noted that residual markets in 21 other states charge rates with an average differential of 35 percent above the voluntary market rate.<sup>52</sup>

In its *2004 Workers' Compensation Annual Report*, the OIR noted that the capped rates for Tiers One and Two expire on January 1, 2007, and then the rates are required to be actuarially sound. Since the ability to levy below-the-line assessments for Tiers One and Two expires on January 1, 2007, there will no funding mechanism for deficits in Tiers One and Two. The report notes that this will undoubtedly result in the use of very conservative actuarial assumptions to prevent deficits, which can only mean higher rates. The OIR recommends that the Legislature should extend or

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<sup>47</sup> Id.

<sup>48</sup> Id.

<sup>49</sup> Chapter 2004-266, L.O.F

<sup>50</sup> Auditor General, State of Florida, *Operational Audit of the Florida Workers' Compensation Joint Underwriting Association, Inc.*, (2004).

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<sup>51</sup> Preferred Insurance Capital Consultants, LLC, *Actuarial Review of the Florida Workers' Compensation Joint Underwriting Association*, November 22, 2004.

<sup>52</sup> Office of Insurance Regulation, *2004 Workers' Compensation Annual Report* (2005).

eliminate the January 1, 2007 expiration date of the below-the-line assessments for Tiers One and Two in order to keep these rates at a more reasonable level.

#### ***Funding Deficits in the JUA***

The JUA recognized an overall deficit of \$9,336,598 for calendar year 2004. The JUA annual filing provided the following breakout of the deficit by subplan and tier:

<b>Subplan/Tier</b>	<b>2005 Total Surplus/(Deficit)</b>
A, B, and C	\$17,506,004
D	(\$20,545,523)
1	(\$466,859)
2	(\$2,894,005)
3	(\$2,936,215)

On June 30, 2004, the JUA ceased writing policies in plans A, B, C, D when these plans were eliminated and Tiers One, Two, and Three were created, effective July 1, 2004. The JUA's plan to eliminate the deficit in subplan D contemplates the use of the remaining funds in the \$15 million contingency reserve of approximately \$7 million and the collection of a "below-the-line assessment" of \$4.77 million in order to extinguish the subplan D deficit by June 2007. As of August 2005, the JUA has received approximately \$7.9 million in funds transferred from the Workers' Compensation Administrative Trust Fund.<sup>53</sup> Without legislative action, the only available source of additional funding is the below-the-line assessment. Individual, self-insured employers and governmental self-insurance funds are not subject to the assessment. The JUA contemplates collecting the assessment in 12 equal installments, effective July 31, 2006.<sup>54</sup> To fund the deficit, an estimated assessment between 0.1 - 0.2 percent needs to be levied on every policy in the voluntary market.

The elimination of the deficit in Tier Three relies upon the deficit being eliminated by increasing rates. At the JUA's September 20, 2005 meeting, the board considered a recommendation to increase the average premium level of Tier Three by 2 percent, based upon the current voluntary market rate levels, effective January 1, 2007. The board of the JUA also discussed the option of eliminating deficits in Tiers One and Two by increasing the premiums in these tiers on January 1,

<sup>53</sup> The trust fund is projected to have a surplus balance of approximately \$260 million, as of June 30, 2005.

<sup>54</sup> Letter from Milliman Consultants and Actuaries to Laura Torrence, Executive Director of the JUA, dated September 7, 2005.

2007, when the rate caps are eliminated. The board also noted that the current law provides for a "below-the-line" assessment to fund such deficits. The JUA board reviewed analysis from their actuary that indicated a need for a premium level increase of 35.4% for Tier 1 and 32.3% for Tier 2 based upon current voluntary market rates.

The JUA believes that the rates in effect for former plans A, B, and C were actuarially sound and the loss reserves carried through 2004 makes a reasonable provision for all unpaid loss obligations of those subplans. The combined surplus balance in these former plans is approximately \$15 million. Plans B and C issued assessable policies. The JUA states that no policyholder assessments will be required for these plans.<sup>55</sup> Currently, the operation manual of the JUA prohibits the use of surplus funds related to other plans to fund subplan D deficits. However, the statutes do not clearly address this issue.

#### ***Applicability of Public Record and Meeting Laws on the JUA and other Residual Markets in Florida***

In recent years, representatives of the JUA have contended that the JUA is not statutorily subject to the "Government-in-the-Sunshine" provisions; however, the JUA "has agreed to conduct its meetings in the spirit of those requirements pursuant to regulatory requests."<sup>56</sup> The Office of the Attorney General has opined that joint underwriting associations, such as the former Florida Windstorm Underwriting Association and the Residential Property and Casualty Joint Underwriting Association are subject to Public Records Law. The Attorney General's Office has opined that residual markets are considered "agencies" as defined in chapter 119, F.S., and are accordingly, subject to the provisions of the Government-in-the-Sunshine Law, unless specifically exempted from the provisions.<sup>57</sup>

Recently, the Office of Insurance Regulation directed the JUA to amend its plan of operations to provide for meetings noticed in accordance with the Sunshine Laws and to comply promptly with all public record requests unless the information is exempt from the public record laws.<sup>58</sup> Presently, the JUA does not have

<sup>55</sup> 2004 Management's Discussion and Analysis, Florida Workers Compensation Joint Underwriting Association filed with the OIR April 1, 2005.

<sup>56</sup> Florida Workers' Compensation Joint Underwriting Association, Inc. Minutes of the Board of Governors Meeting, June 22, 2005.

<sup>57</sup> AGO 94-32 and AGO 95-32.

<sup>58</sup> Letter from Kevin M. McCarty, Commission of the OIR

a public records or meeting exemption for meetings or records related to litigation that have been created for other residual markets. This type of public records and meeting exemption assists residual markets during the litigation of a claim since the release of such information could jeopardize or compromise ongoing or pending litigation.

## RECOMMENDATIONS

Although there are potential benefits to adopting a loss costs rating system, at this time, staff does not recommend changing to a loss costs rating law for the following reasons:

- Rates have experienced a cumulative decrease of approximately 30 percent in the last three years, if the decrease of 13.5 recommended by the Office of Insurance Regulation is enacted in 2006;
- The results of studies relating to workers' compensation rate regulation do not clearly demonstrate that a change in the rating law would result in lower rates;
- Recently, the OIR has stated that there is still no clear evidence that changing from an administered pricing system to a loss costs system rating law would benefit Florida consumers; and
- The 2004 Joint Select Committee on Workers' Compensation Rating Reform concluded that evidence presented to the committee did not demonstrate any obvious benefit or detriment attributable to changing from an administered pricing system to a loss costs system;

The Legislature should consider the following options to address funding, availability, and affordability issues relating to the JUA:

1. Authorize the JUA to use some of the estimated \$15 million surplus funds attributable to former plans A, B, and C to mitigate the estimated \$4.77 million deficit in subplan D and any deficits in Tiers One and Two that are a result of the capped rates. The capped rates in Tiers One and Two will be eliminated by January 1, 2007.
2. Exclude former policyholders of subplans B and C from any potential assessments, effective January 1, 2007, to prevent these former policyholders from incurring any potential liability in the event

the JUA's estimated surplus in these plans adversely changes.

3. Consider extending the current expiration date of January 1, 2007, for accessing the \$15 million contingency reserve to allow the JUA to use any remaining funds beyond deadline to fund subplan D deficits.
4. Consider extending or eliminating the January 1, 2007 expiration date for the below-the-line assessments for Tiers One and Two in order to keep these rates at a more reasonable level. As an alternative to extending the below-the-line assessment, the Legislature should consider providing funding from the Workers' Compensation Administrative Trust Fund through the current Legislative Budget Commission process to cover deficits attributable to capped rates in Tiers One and Two.
5. Require the JUA to obtain approval of its rates prior to using the rates, as is currently required of the voluntary market insurers, to ensure that the rates are not excessive, inadequate, or unfairly discriminatory, subject to statutory requirements regarding capped rates.

The Legislature should consider the following options to provide greater accountability and oversight of the JUA, a state-created entity, which will receive at least \$15 million in state funds by January 1, 2007:

1. Require the JUA to return any unused state funds allocated for funding subplan D deficits to the State of Florida.
2. Consider enacting legislation to assist the JUA in meeting criteria to qualify as a tax-exempt organization under s. 501(c) of the Internal Revenue Code, such as changing the board composition of the JUA so that the state appoints a majority of the board members.
3. Create public records and meetings exemption for the JUA that are comparable to the exemptions provided to other JUAs. This type of exemption, which currently exists for many other residual markets, aids residual markets during the litigation of a claim since the release of such information could jeopardize or compromise ongoing or pending litigation.