Workers’ Compensation Insurance Rates: Their Determination and Regulation

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Chapter 8 (pp. 209-236) in:
Current Issues in Workers' Compensation
James Chelius, ed.
Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1986
DOI: 10.17848/9780880995443.ch8

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Workers’ Compensation
Insurance Rates
Their Determination and Regulation
A Regional Perspective

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One of the most discussed issues of the day is the high cost of workers’ compensation insurance. As of September 1, 1982, in the 45 states (including the District of Columbia) with private insurers, workers’ compensation standard earned premiums (a term to be defined later) averaged about $2.41 per $100 of payroll. The variation among states was great, however, ranging from $.74 in Indiana to $4.83 in Hawaii.¹ Comparable data are not available for the six states with exclusive state funds (Ohio, Nevada, North Dakota, Washington, West Virginia, and Wyoming). Because this session is directed mainly toward regional experience in Connecticut, New Jersey, and New York, the relative cost in those three states is of special interest. Connecticut ranked 16th highest with a $2.75 rate, New Jersey 22nd with a $2.48 rate, and New York 39th with a $1.55 rate.

Many factors account for the variation in these rates, including differences in the following: (1) the mix of payrolls according to industry and firm size; (2) injury and disease
frequency and severity rates; (3) statutory benefits including eligibility requirements; (4) administrative and court interpretations of these benefits; (5) medical expenses for the same treatment; (6) the effectiveness of loss control and claims handling services provided by employers, insurers, and state agencies; (7) insurer expense and profit loadings; and (8) the presence or absence of a competitive state fund.

This paper will concentrate on how the ways in which workers’ compensation insurance rates are determined and regulated vary among the states, with special attention to Connecticut, New Jersey, and New York.

**Workers’ Compensation Insurance Rate Determination**

Insured employers can be classified according to whether they are (1) class-rated, (2) experience rated, (3) schedule-rated, or (4) retrospectively-rated. This section will discuss first how insurers determine the insured’s premium, given a set of rates and rating plans. Second, it will describe in general terms how insurers determine the class rates printed in their rating manuals. In addition to these rating methods many insurers return a dividend that reduces the net cost. The dividend may vary among firms depending upon their size and individual loss experience. Because these methods tend to be the same in all jurisdictions, no special attention will be paid to regional practices in this section.

**Class Premiums**

Employers who are class-rated pay a rate per $100 of payroll that is based primarily on the industry or industries in which they are engaged. Separate rates have been developed for over 600 industries. However, the payroll assigned to certain employees such as clerical office employees, drivers (usually but not always), and outside
Workers' Compensation Rates

salespersons is assigned the same rate regardless of the employer's industry. For example, suppose a small abrasive paper manufacturer has a total payroll of $250,000-$200,000 for plant workers and $50,000 for clerical office employees. Further assume that the class rates per $100 of payroll are $2.50 for the plant workers and $.25 for the clerical employees. The class premium would be 2,000($2.50) - 500($.25) or $5,125.² Traditionally all workers' compensation insurers in the state charged the same class rates, but in an increasing number of states some price competition exists with respect to class rates.

For employers whose average class premium is under $2,500 (still $750 in some states), the class premium is the amount charged. Over half the insured employers are class-rated, but because they employ few workers, these class-rated firms pay less than 10 percent of the premiums received by insurers. All other employers are experience rated. An increasing number are both experience rated and schedule-rated. Employers whose premiums exceed $5,000 may be permitted to be retrospectively-rated in addition to being experience rated. Insurers, however, usually limit retrospective rating to firms paying premiums of at least $100,000. Employers whose experience premiums exceed $5,000 (still $1,000 in some states) receive a premium discount because the insurer's expenses (not loss payments) do not increase proportionately with the premium size. Retrospectively-rated employers receive this discount through the retrospective rating formula. Other eligible employers are rated under a separate premium discount plan.

Experience Rating

Under experience rating an employer's class premium is modified to reflect two factors.³ The first factor is how the employer's loss experience during a recent three-year period
compares with the amount the insurer would have expected to pay (given current rates except for changes in the workers' compensation law since the experience period) if the employer had been an average employer in the same industry with the same payroll. For example, if the employer's losses were half the insurer's expectation, this factor alone would suggest cutting the rate in half. If the losses were twice the insurer's expectation, this comparison would suggest a doubling of the rate. However, the adjustment also depends on how much credibility or confidence the insurer should assign to this employer's loss experience. The reasoning behind this factor is that chance alone may cause the experience of individual employers to fluctuate greatly from year to year. The smaller the payroll exposure for a given hazard class, the more important this chance factor becomes. For example, a very small employer may have no losses for 10 years followed by a substantial loss the next year. As the employer's payroll increases, his or her experience becomes more predictable because the future tends to resemble the past more and more closely. Of course, no matter how large the employer may be, the future may differ from the past because of such factors as law amendments, inflation, or changes in the work environment. In practice, insurers assign no credibility to the experience of employers with average class premiums of less than $2,500. Above that point the credibility increases gradually from 1 percent to 100 percent. Few employers have enough exposure for their experience to be considered 100 percent credible. If an employer had a credibility factor of 20 percent and experience period losses equal to half the insurer's expectations, instead of cutting the class premium in half the insurer would reduce the class premium (20 percent) (50 percent) or 10 percent. If the experience period losses had been twice the insurer's loss expectation, instead of doubling the premium the insurer would increase the class premium (20 percent) (100 percent) or 20 percent.
The net effect of experience rating is that the employer pays a rate that is in effect a weighted average of two rates. The first of these two rates is one based on his or her own loss experience during the experience period adjusted to reflect what these payments would have been under the current workers' compensation law. The second is the appropriate class rate. The first rate is weighted by the employer's credibility factor, the second by one minus that same factor. For example, if the credibility factor is 20 percent, the rate based on the employer's experience is .50, and the class rate is 1.00, the experience rate will be (20 percent) (.50) + (80 percent) (1.00) = .90. The higher the credibility factor the less the experience rate will depend upon the class rate.

**Schedule Rating**

In many states many insurers have in recent years introduced schedule rating plans. Under these plans insurers usually decrease the rate the employer would otherwise pay through credits based on a subjective evaluation of such factors as the employer's loss control program.

**Retrospective Rating**

Retrospective rating bases the employer's premium on the employer's loss experience during the policy period, subject to the condition that the premium cannot be less than a stated minimum nor higher than a stated maximum. Between the minimum and maximum limits the retrospective premium is equal to the losses the employer incurs during the policy period plus the expenses that are related to the losses incurred and a basic premium. The basic premium covers the expenses that do not vary with the losses incurred and a net insurance charge. The insurer imposes a net insurance charge because in the aggregate the insurer loses more dollars
(because of the maximum premium limitation) than it gains from those who pay the minimum premium. Retrospective rating permits quasi-self-insurance. In most cases the premium depends upon the employer’s own loss experience, but the insurer administers the program and the premium is bounded by the minimum and maximum premiums. Because the basic premium is a function of the experience premium, it is affected by any change in the class premium in the same manner as the experience premium. For the most part, however, an employer’s retrospective premium does not depend upon its class rates.

A version of retrospective rating that has become popular in many states in recent years is paid-loss retro. Instead of paying a deposit premium in advance, subject to later adjustments as more information on payrolls and losses becomes available, the insured pays the retrospective premium in annual installments. Each year’s installment is the benefits and expenses paid that year because of accidents that occurred during the policy period. The insured may prefer this approach because (1) the insured retains the use of the premium dollars longer and (2) the premium paid never depends upon the insurer’s estimate of future payments. However, the insurer may increase its charges because it loses some of the investment income it would otherwise make. A related practice that affects more insureds than paid-loss retro plans waives the requirement that employers with a premium of at least $2,500 pay in advance a full deposit premium.

**Dividends**

Many workers’ compensation insurers return dividends to their policyholders. These dividends may vary among firms depending upon their size and their individual loss experience.
**How Insurers Determine Their Class Rates**

In order to understand how insurers determine the class rates in the rating manual, one must know the elements of a class rate. A class rate includes allowances for (1) expected losses, (2) the expenses the insurer expects to incur in servicing the insured, and (3) a profit for the insurer or a margin for policyholder dividends.

The *expected loss allowance* is the amount the insurer expects to pay in benefits per $100 of payroll to all insured employees in the same industry during the period the rate is in effect. The principal reasons the insurer may change this allowance are that it expects changes in (1) the frequency and severity of job-related injuries or diseases, (2) the propensity of employees to claim benefits for their injuries or diseases, (3) the workers' compensation law, or (4) the cost of settling claims because of such economic factors as rising or falling wage levels or medical costs. The expected loss allowance, therefore, is based on expectations for the future that are subject to considerable error. In establishing these expectations, the insurer analyzes its experience in the recent past, modified to reflect changes that it expects to occur during the future because of law changes and trends in claim frequency and severity. Even if the law will remain the same and there are no changes in claim frequency or severity, the past experience may suggest that the current rates be increased or decreased. The current rates may be inadequate or excessive because the insurers or the regulators either underestimated or overestimated the insurer's needs when they established those rates, or because the rates have been in effect for some time and conditions have changed.

The *expense allowance* is expressed as a percent of the rate. Some of these expenses, such as commissions, are budgeted and paid as a percent of the rate. Others, such as general administrative expenses, are not budgeted, but on
the basis of past experience and future trends the insurer can determine what proportion of the rate it will use for this purpose.

The profit or profit and contingency allowance is also expressed as a percent of the rate. As will be explained later, the profit allowance in most states is 2.5 percent. Consequently if the insurer's expected loss and expense allowances exactly matched actual losses and expenses, the insurers would have earned an underwriting profit equal to 2.5 percent of the class premiums written. Because these expectations are almost never realized exactly, the actual underwriting profit rate may be more or less than 2.5 percent. Insurers argue that this 2.5 percent profit rate plus the investment income generated by writing workers' compensation insurance would produce a reasonable profit on net worth.

If the expense allowance were set at 32.5 percent of the rate and the profit allowance at 2.5 percent, the remainder of the rate, 65 percent, would be available to pay losses. If the dollar amount required to pay losses was determined to be $1.30 per $100 of payroll, the rate would be $1.30/.65 or $2.00.

Workers' Compensation Insurance Rate Regulation

Workers' compensation rates are regulated in a variety of ways. Except for Texas, where a state board makes the rates, states are commonly grouped into two general categories: (1) rating bureau—prior approval states and (2) open-competition states. In rating bureau—prior approval states, the largest category at the present time, rating bureaus are permitted to develop and file rates in behalf of their members and subscribers. Membership in the rating bureau may be compulsory or optional. Agreements to adhere to
these rates may or may not be permitted; where such agreements are permitted, members and subscribers may or may not be permitted to deviate from these rates. All of these states require the insurance commissioner to approve workers' compensation rates before they can be used.

Open-competition states may or may not permit rating bureaus, renamed data service organizations, to publish advisory rates. All, however, make membership in the organization optional, and prohibit agreements to adhere to these rates. All require insurers to file their rates with the state insurance department, but none have a prior approval requirement. Insurers, however, may be unable to use filed rates until after they have been on file for a designated period of time. The six open-competition states at present are Arkansas, Illinois, Kentucky, Michigan, Oregon, and Rhode Island. Georgia and Minnesota have also enacted open-competition laws that soon will become effective.

As this discussion indicates, a two-way classification of states (other than Texas) oversimplifies the situation. Within each of these two categories some significant differences exist. Table 1 shows for each of the 45 states in which private insurers operate (1) the role that rating bureaus are permitted to play in rate determinations and (2) whether the state insurance commissioner must approve proposed bureau or individual insurer rates before they go into effect.

Role of Rating Bureaus

As of early 1983, every state except Kentucky, Michigan, Oregon, and Texas permits rating bureaus either to develop advisory rates or make rate filings in behalf of their members. Kentucky, Michigan and Oregon permit rating bureaus to develop only advisory "pure" premiums (premiums without expense or profit loadings). In Texas the State Board of Insurance makes the rates. Only 10 of these
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SOURCE: Derived from information supplied by the American Insurance Association and the National Council on Compensation Insurance.

a. Unless above rates approved by the commissioner.

b. Effective January 1, 1984 Georgia will substitute an open competition rating law for its present approach. Bureaus will be permitted to publish advisory rates.

c. Effective July 1, 1983 Minnesota will enter a transition period that will lead to full open competition by January 1, 1986. After that date the bureau will not even be permitted to publish advisory pure premiums. It will be able to publish aggregated loss data, trend factors, and loss development factors. Prior approval will continue with respect to upward deviations from these pure premiums until July 1, 1986 when it will cease completely. (In late May 1983 Minnesota advanced the beginning of complete open competition to January 1, 1984.)

d. Advisory pure premiums only.
220 Workers' Compensation Rates

43 jurisdictions (Arizona, California, Idaho, Indiana, Minnesota, Montana, New Jersey, North Carolina, Pennsylvania, and Wisconsin) require all workers' compensation insurers to belong to a rating organization, but the practice in most other states is for most, if not all, insurers to become bureau members. Although bureau membership is not required in most states, all but 14 of the 43 states that permit bureau rate filings (Arkansas, Colorado, Connecticut, Georgia, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Montana, Rhode Island, and Virginia) permit bureaus to require adherence to the bureau rates. In these states that prohibit such adherence agreements, however, most insurers have until recently elected to use the bureau rates. Among the 29 states that permit agreements to adhere to bureau rates all but seven states (California, Massachusetts, Missouri, New Jersey, North Carolina, Pennsylvania, and Wisconsin) permit insurers either (1) to deviate from the bureau rates after securing the insurance commissioner's approval or (2) a much less common option, to charge lower rates without securing any prior approval. Such deviations seldom occurred in the past except for specialized classes for which some insurers may have developed some special expertise or associations. They have become more common in recent years through the filing of deviations from class rates or of scheduled rating plans. Only five states require all insurers to belong to a rating bureau, permit agreements to adhere to the bureau rates, and prohibit deviations from these rates.

In most states the National Council on Compensation Insurance is the rating organization. The exceptions are as follows:

Workers' Compensation Insurance Rating Bureau of California
Delaware Compensation Rating Bureau
Hawaii Insurance Rating Bureau
Indiana Compensation Rating Bureau (administered by the National Council on Compensation Insurance)
Workers’ Compensation Rating and Inspection Bureau of Massachusetts
Workers’ Compensation Rating and Inspection Association of Michigan
Workers’ Compensation Insurers’ Rating Association of Minnesota
New Jersey Compensation Rating and Inspection Bureau
New York Compensation Insurance Rating Board
North Carolina Rate Bureau
Pennsylvania Compensation Rating Bureau
Virginia Compensation Rating Bureau
Wisconsin Compensation Rating Bureau

The National Council provides many of these independent rating bureaus with statistical services.

All states with independent rating bureaus except Indiana, Minnesota, and Virginia permit these bureaus to require adherence to their rates. Of the seven states that prohibit deviations from agreements to adhere to bureau rates, all but Missouri are states with independent rating bureaus.

Georgia and Minnesota will soon become open-competition states. In Georgia insurers will be permitted to develop advisory rates. In Minnesota rating bureaus will at first be permitted to develop advisory pure premiums, but starting in 1986 (changed to 1984 in late May 1983) they can publish only actual loss costs plus loss development and trend information.

Connecticut, New Jersey, and New York are all rating bureau-prior approval states. However, Connecticut does not require insurers to belong to the bureau and forbids
agreements to adhere to the bureau rates. New Jersey requires insurers to belong to its independent bureau, permits agreements to adhere to the bureau rates, and prohibits deviations from those rates. New York does not require insurers to belong to its independent bureau, but it permits agreements to adhere to bureau rates. However, deviations from the bureau rates are permitted. Connecticut and New Jersey, but not New York, permit insurers to waive the advance payment of a full deposit premium.

Prior Approval Requirements

As table 1 shows, all states, except the six open-competition states, require insurers to file their proposed rates and wait until the state insurance commissioner approves them. Usually the commissioner must act within a stated period after the rates are filed. If he or she fails to act within that period, the insurer can use the rates.

In two open-competition states (Arkansas and Oregon) an insurer cannot use rates until they have been on file for a designated period. In the other states, insurers are permitted either to use the rates and then file them or to file their rates and use them immediately.

Georgia and Minnesota will soon become open-competition states. Georgia will not require prior approval; Minnesota will require approval only of upward deviations from the bureau advisory pure premiums until 1986 (changed to 1984 in late May 1983) after which time insurers will be able to use their rates immediately and file them later. Connecticut, New Jersey, and New York are all prior approval states.

Important Regulatory Issues

Three regulatory issues that have been the subject of intense debate in recent years are (1) open competition versus
the rating bureau-prior approval approach, (2) the effect of insurers' investment income on the profit loading in their rates, and (3) the excess profits approach as a supplement to either open competition or prior approval.

Open Competition Versus Rating Bureau-Prior Approval Approach

Traditionally workers' compensation insurance rates have been more restrictively regulated than other property and liability insurance rates. Although a few states have erased or reduced these differences, workers' compensation rates continue in most states to be more rigidly controlled. For example, 21 states are generally considered to be open-competition states with respect to property and liability insurance. Only six states (soon to be eight states) have open-competition workers' compensation laws. However, several other states have considered such legislation in recent years. The arguments advanced in the legislative debates on this issue are summarized in the next two sections.

Arguments Favoring Open-Competition Laws

Those who favor open-competition laws argue that the rating bureau-prior approval approach stifles or discourages price and service competition. In the early days of workers' compensation, this approach made sense because only a few states had insolvency funds that would protect employers and injured workers against insurers who became insolvent because of competitive pricing pressures or undercapitalization. Furthermore, few insurers had developed enough experience or expertise to establish their own prices. Today such guarantee funds exist in every state; insurers are now more highly capitalized and better managed, and many insurers, with the aid of data advisory organizations, can establish their own rates with confidence.
A prior approval requirement, in their opinion, is a misguided, inefficient use of regulatory resources. Insurers are subjected to costly delays, decisions that are influenced too often by political pressures instead of objective evaluations, and in some states expensive hearings. Regulators are required to make decisions that would frustrate Solomon and are better left to the marketplace. Consumers lose because insurance availability problems arise when insurers believe the approved rate structure is inadequate, and because for some insureds the approved price exceeds the competitive price.

Rating bureaus by definition set an average price that is too high for some insurers, too low for others. The expense allowances included in the rates are typically based on the average expense experience of nondividend paying stock insurers, which tend to have higher expenses than the other groups of insurers. Without rating bureaus or prior approval requirements, they argue, insurers will compete more vigorously for business. Both price competition and service competition will intensify, producing better services and lower prices. Much of the service competition will consist of improved loss control advice and assistance and more effective claims management, both of which will reduce claims costs. Price competition will cause the premiums to be lower on average and more responsive to the loss experience of groups of insureds with similar exposures and of individual insureds. Groups of similar insureds and individual insureds will in turn have more incentive to better their own performances in controlling losses and managing claims. Admittedly, some intense price and service competition does exist under the rating bureau-prior approval approach, but according to open-competition supporters, this competition benefits almost exclusively larger employers who might otherwise self-insure.
Open-competition laws will also force insurers to make more independent decisions regarding workers' compensation insurance instead of delegating so much of this decision-making to the rating organization. Currently, insurers tend to assign their most able employees to other lines involving more decisions. Open-competition laws will cause more of these employees to become concerned about workers' compensation problems; the result will be some innovative approaches.

Finally, open-competition advocates argue, in those states where open competition has been tried price competition has been intense, no serious insolvency problems have developed, insurer services have not suffered, and insurance has become more readily available through standard channels.

Arguments Against Open-Competition Laws

The opponents of open-competition laws argue with equal intensity that it would be a serious mistake for most states with rating bureau-prior approval laws to move to open competition. Workers' compensation insurance, they argue, is different. Workers' compensation insurance is social insurance. With a few exceptions, workers' compensation is the exclusive recourse of the employee against the employer. The benefits, prescribed by statute, are to be paid on a no-fault basis. Unless employers secure permission to self-insure their financial obligations under this statute, they must purchase workers’ compensation insurance. Consequently, the public is much more concerned about the solvency of workers’ compensation insurers and how they establish their prices than in the solvency and pricing practices of other insurers. Consequently the public is best served by (1) a pricing mechanism that permits a rating bureau to apply its expertise to the pooled experience of many insurers and promotes rate
stability and (2) prior approval which involves the regulator more actively in the pricing process.

These opponents deny that permitting rating bureaus to exist and requiring prior approval stifles price and service competition as much as the open-competition advocates claim. In the typical prior approval state, competition takes many forms. Insurers need not belong to the rating bureau; they may develop their own rates. The bureau is permitted to require members to adhere to its rates, but the members may secure insurance department approval to deviate from these rates. Schedule rating plans that permit such deviations on the basis of subjective evaluations have become much more commonplace. Dividends provide another avenue for price competition. Prior approval, they agree, could be a problem if rigidly and unfairly administered, but they believe this is not the case in most states. The trend is toward more flexibility and reliance on market forces. Furthermore, price competition is not the only kind of competition that is possible. Under prior approval, insurers have even more incentive to compete on the basis of services rendered.

The second line of thought pursued by the opponents of open competition is that this approach will itself produce some adverse effects. For many insureds, especially small employers, prices will rise in the short run and probably the long run. Price competition may become so intense that the solvency of many insurers and the viability of guarantee funds may be threatened. Small insurers especially will be adversely affected by the inability of the rating bureau to develop rates to which they can simply agree to adhere. Because smaller insurers may be less able to compete effectively under open competition, the market may soon be controlled by a few large insurers; this growing concentration would weaken the degree of effective competition. The proponents of open competition, they assert, have greatly
underestimated the quality of the insurer and rating organization personnel who are currently involved in workers' compensation insurance. The rating practices, loss control services, and claims management services match in quality those associated with any other line of insurance.

Probably the most serious concern of open-competition opponents is that the data base used to calculate workers' compensation rates will be less reliable. Unless all insurers use the same rate classes, or subclasses that can be combined into a uniform set of rate classes, their experience cannot be pooled to establish a credible yardstick for measuring the fairness of the class rates. Open-competition laws are likely to generate heterogeneous classifications that will substantially reduce the volume of experience that can be meaningfully pooled.

In any event, these opponents say, it is too early to evaluate experience under the open-competition laws in force. None of these laws has been in effect for more than a few years. Even if one leans toward the concept of open competition it is better to liberalize the administration of a prior approval state and to "wait and see."

Some opponents of open-competition laws simply deny that price competition in workers' compensation insurance is effective enough to justify such heavy reliance on the marketplace. These opponents are much more opposed to removal of the prior approval requirement than to prohibiting rating bureaus.

A Brief History: 1980-83

The trend toward open-competition workers' compensation laws was stimulated by the adoption in December 1980 by the National Association of Insurance Commissioners of a model open-competition rating law. This model bill, which was considered to be a regulatory alternative for those states
favoring the open-competition approach to rate regulation, dealt with most types of property and liability insurance, but one of its most controversial parts was the section on workers' compensation insurance rates. For two years rating organizations could publish advisory rates, but insurers would not be required to join the organization and would be prohibited from agreeing to adhere to the advisory rates. Insurers would have to file new rates before they used them, but these rates would not be subject to prior approval. After two years workers' compensation insurance rates would be treated like most other property and liability insurance rates. Rating organizations could develop only advisory pure premiums. Insurers could use new rates before filing them.

In December 1982, in response to some objections to the December 1980 model bill treatment of workers' compensation insurance rates, the NAIC adopted a separate and different model open-competition workers' compensation act. Under this bill, data service organizations can develop only advisory pure premium rates. A major provision requires insurers to report their loss experience under a uniform statistical plan approved by the state insurance commissioner.

During 1982 at least eight states debated vigorously but did not act on open-competition workers' compensation statutes. Fewer states have thus far seriously considered this possibility. This slowing down has been attributed primarily to the development of, and more liberal regulatory response to, scheduled rating plans and other deviations from bureau rates, but some observers believe the real cause is a "wait and see" attitude.4

*Investment Income and Insurance Rates*

Employers and others have expressed intense interest in recent years in whether workers' compensation insurers have
adequately recognized in their pricing the investment income they generate from writing workers' compensation insurance. This section will describe (1) why insurers generate investment income from writing workers' compensation insurance and (2) how this investment income is recognized in the profit loading in class rates.

How Insurers Generate Investment Income From Insurance Writings

Insurers generate some investment income from their writings in all lines of insurance because some time elapses between the dates when the insurer collects its premiums and the dates when it pays some of its expenses and most of its claims. For some lines of insurance, such as fire insurance and automobile physical damage insurance, the time lag is short and the investment income generated during this period on the monies held by the insurer is relatively small. For other lines of insurance such as automobile liability insurance and workers' compensation insurance, the time that elapses is long and the investment income generated by the insurer relatively large. For example, according to the most recent rate filing by the Workers' Compensation Insurers Rating Association of Minnesota, on the average only 22.5 percent of the total dollar claims is paid by the time the insured's policy expires, 58.5 percent five years after the policy period starts, 77.8 percent ten years later, and 92.9 percent 20 years later.5

The Profit Loading in Manual Rates

Insurers have for many years recognized investment income in their pricing of workers' compensation insurance. Whether they have adequately recognized such income and whether they should do so explicitly is the real issue. In most states insurers include a 2.5 percent profit loading in their class rates which, if their predictions are correct, will produce an underwriting profit equal to 2.5 percent of the
premiums earned. If an insurer’s workers’ compensation premiums are three times the net worth the insurer allocates toward writing workers’ compensation insurance, the 2.5 percent profit loading will produce a 7.5 percent underwriting profit on net worth. Therefore, the insurer’s total return on net worth because of its workers’ compensation writings would be 7.5 percent plus its investment income expressed as a percent of net worth.

The underwriting profit loading has not always been 2.5 percent. In 1915 the national underwriting profit loading was 0 percent. The loading was raised to 1.5 percent in 1917 but dropped again to 0 percent in 1920. Despite underwriting losses insurers did not try to increase this 0 percent profit loading again until 1934. According to C. A. Kulp, insurers did not seek a higher profit loading during this period because (1) workers’ compensation insurance was a favorite wedge or business-getter for more profitable lines and (2) workers’ compensation time lags provided substantial funds for investments. Other considerations were the threat of state funds and the social insurance characteristics of workers’ compensation. In the early thirties, however, investment income disappeared or turned into losses and underwriting experience worsened. In 1934 the National Association of Insurance Commissioners approved a profit loading of 0 percent to 5 percent, depending upon how the insurers’ cumulative losses in the state since 1933 compared with the portion of the premiums collected since 1933 that was supposed to cover these losses. If the cumulative loss payments equaled the cumulative loss allowances in the rates, the approved profit loading was to be 2.5 percent. If the cumulative payments exceeded the cumulative loss allowances, the profit loading could be more than 2.5 percent but not more than 5 percent. If the payments were less than the allowance, the loading could be less than 2.5 percent but not less than 0 percent. Because underwriting experience
improved markedly during the next few years, during the forties the loading under this rule soon became 0 percent for all but a few states.

In 1949 the National Council on Compensation Insurance included a 2.5 percent profit loading in its rates, which by 1957 had been approved in most states. One argument in favor of including a 2.5 percent profit loading in workers' compensation insurance rates was that in all other property and liability insurance lines the profit loading was at least 2.5 percent. In 1951, however, a subcommittee of the National Association of Insurance Commissioners had recommended that the loading be only 1.5 percent. The subcommittee argued that a 1.5 percent profit loading plus investment profits should provide a reasonable rate of return on net worth. The NAIC, however, approved a 2.5 percent profit loading.

In recent years a few states have required insurers to include a smaller profit loading than 2.5 percent because of the presence of investment income. For example, on April 21, 1981 then Minnesota Commissioner of Insurance Michael Markman issued an order disapproving the request of the Workers’ Compensation Insurers Rating Association of Minnesota for an average 28.6 percent increase in workers’ compensation rates. Instead he granted an average increase of 11.8 percent effective June 1, 1981. The principal reason why the Commissioner recommended a much lower increase than requested was because he disagreed with WCIRAM’s 2.5 percent profit loading in the proposed rates. He argued that if rates were increased 28.6 percent, the combined underwriting and investment profits of insurers would exceed 30 percent, which would be excessive. He based this finding on several assumptions, including a 14-year payment period for losses incurred during the policy year, net worth during those 14 years equal to one-third of the loss reserve established at the end of each year, and a 7 percent after-tax
investment return on assets corresponding in amount to the loss reserves and associated net worth. Commissioner Markman argued that the reasonable rate of return was 18 percent and that, under the assumptions noted above, insurers could attain this objective with a -10 percent profit loading in their rates. Depending on the assumptions used this approach may produce a profit loading above, below, or equal to 2.5 percent.

Only three other states have reduced the 2.5 percent profit loading to reflect investment income—Georgia to 2 percent, Massachusetts\(^9\) to -12 percent, and Oklahoma to 0 percent. The effect of investment income on total insurer profits has been cited in two or three other states as one of the reasons for reducing recently requested rate increases, but the profit loading was not explicitly reduced. In Connecticut, New Jersey, and New York the profit loading is 2.5 percent.

**Excess Profits Statutes**

Another approach to rate regulation that may supplement either a prior approval or an open-competition law is an excess profits statute. Six states (Florida, Georgia, Hawaii, Minnesota, New York, and South Carolina) have excess profits statutes applicable to automobile insurance.\(^{10}\) Only one state, Florida, has such a statute applicable to workers' compensation insurance.

Excess profits statutes require insurers to return to their policyholders profits in excess of a specified threshold. In theory the threshold is the long-run reasonable rate of return from all sources plus an allowance for short-run fluctuations around that reasonable rate of return.

The Florida statute requires workers' compensation insurers to return to their policyholders any underwriting profit that exceeds the profit loading in the rate by 5 percent.
Currently, therefore, the threshold is 2.5 percent plus 5 percent or 7.5 percent. Instead of applying the test to each year’s operations, however, the statute orders the state insurance department to test the average underwriting profit over the past three years. Investment income does not affect the allowance for short-run fluctuations, but the department is supposed to consider investment income in approving the basic profit loading.

Excess profits statutes first appeared on the scene during the early seventies when several states passed automobile no-fault statutes and a gasoline shortage existed. Both of these events were expected to reduce insurance costs, but opinions differed widely on the extent of those reductions. Excess profits statutes were passed to protect consumers against large insurer windfall profits. Florida’s workers’ compensation statute had a similar stimulus—the conversion of permanent partial disability benefits to a wage loss benefit. Insurance costs were expected to decrease because of this change with the possibility of large windfall profits for insurers.

Excess profits may make open-competition statutes more acceptable because insureds have some protection against excess insurer profits. For the same reasons regulators might be able to also administer prior approval statutes more flexibly. On the other hand, excess profits will occasionally require insurers to return profits to their policyholders even if their long-run rate of return is equal to or even less than the reasonable rate of return. Furthermore, determining the excess profit threshold is a difficult process involving several highly subjective assumptions.¹¹

None of the three regional states has an excess profits statute applicable to workers’ compensation insurance. New York, however, is one of only two states, the other being Florida, that has implemented such a statute applicable to automobile insurance.
Concluding Remarks

Workers’ compensation insurance rate determination and regulation vary widely among the states. A trend exists toward more reliance on competition through the passage of open-competition laws or, more commonly, through more flexible administration of rules permitting class rate deviations and schedule rating. A few prior approval states have reduced the 2.5 percent profit loading in the rates to reflect insurers’ investment income. Open-competition states expect competition to reduce insurers’ total profits. One state has an excess profits statute.

The three states represented here illustrate this diversity. All are rating bureau-prior approval states. All authorize a 2.5 percent underwriting profit loading. In Connecticut membership in the rating bureau is optional and rate adherence agreements are prohibited. New Jersey, on the other hand, forbids deviations from the rates developed by its rating bureau to which all insurers must belong. New York is much closer to Connecticut than to New Jersey in its rate regulation, but is somewhat less flexible. Both Connecticut and New York have seriously considered open-competition laws. New Jersey has not. New York is one of two states in the nation to implement an excess profits law applicable to automobile insurance.

Strong arguments exist pro and con for each of these approaches. The opportunity to experiment is supposed to be one of the advantages of state regulation as opposed to federal regulation. The laboratories testing ways of determining and regulating workers’ compensation insurance rates have probably never been more active.
NOTES


2. Employers whose class premium would otherwise be under some small amount, such as $500, have to pay an extra charge called an expense constant because the expense allowance in the rate does not produce enough dollars to cover the expenses incurred in servicing these very small insureds.

3. The rating formula used in practice is more complicated than the one described here. The results, however, are close to those described above.


6. No generally accepted method exists for determining what portion of an insurer's net worth is devoted to writing a single line of insurance. Indeed, some persons argue that an insurer's net worth cannot be apportioned among lines of insurance; each $1 of net worth is available if needed for all lines of insurance written.


8. For more details, see the original order and C. A. Williams, Jr., "Minnesota Employers' Workers' Compensation Costs: The Short-Run and the Long-Run," Risk Management and Insurance Issues, No. 1, School of Management, University of Minnesota, January 1982.

9. The Massachusetts -12 percent profit loading, which became effective January 1, 1983, is currently being contested before a court. Investment income was the major reason for a negative profit loading but no single formula was used to derive -12 percent.

10. For an analysis of these statutes see C. A. Williams, Jr., "Regulating Property and Liability Insurance Rates Through Excess Profits Statutes," The Journal of Risk and Insurance 50, 3 (September 1983).

11. For additional arguments for and against such statutes see Ibid.