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Research Report

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OREGON'S WORKERS' COMPENSATION INSURANCE MARKET

SUMMARY

Oregon's workers' comp insurance market has undergone profound changes over the past decade. Ten years ago workers' compensation insurance costs were some of the highest in the country and the solvency of the state's accident insurance fund was being seriously questioned. Now Oregon's costs are below the national average and the state's insurance fund reserve position has improved dramatically. The turnaround is due to a combination of state regulatory reforms and positive external trends such as strong job growth and low inflation.

The State Accident Insurance Fund (SAIF) Corporation has clearly benefited from these forces. SAIF's strong financial position has allowed it to pay substantial dividends to its customers in recent years. Private insurers, who compete with SAIF in the Oregon market, are raising concerns about the viability of competition in the market under the current policy environment. They argue that SAIF, due to its regulatory advantages, threatens to push the Oregon market toward monopoly.

This report summarizes testimony on conditions in Oregon's workers' comp insurance market received by the House Interim Revenue Committee. This testimony examined market conditions from four different perspectives. The perspectives are: state regulator, national market analyst, private insurer and the SAIF corporation. This report summarizes areas of agreement and disagreement in the testimony and briefly assesses policy risks to the state. It concludes with a set of policy questions for possible consideration by the 2001 Legislature.

CHARGE

In consultation with Speaker Snodgrass, House Interim Revenue Committee Chair Strobeck directed Legislative Revenue Office (LRO) to organize a committee hearing on the structure of Oregon's workers' compensation insurance market. The hearing took place on April 27, 2000.

At the hearing, Chair Strobeck directed LRO to produce a report summarizing the testimony and background material presented. The objective is to report findings on market trends and conditions. There should be a clear delineation between consensus findings and those that are in dispute. The report should conclude with a detailed listing of policy issues raised by committee members and the testimony. This list of policy issues is to serve as a starting point for the 2001 Legislative session.

At a subsequent Interim Revenue Committee meeting (June 22, 2000), the committee directed the Secretary of State's Office to contract for a detailed study investigating the competitiveness of Oregon's workers' compensation insurance market. Specifically, the study is to address the following question: Can an independent insurance company operating in Oregon's workers' compensation insurance market be profitable over the long-term? The full text of the approved motion can be found in Appendix A. The study is to be completed in time for the 2001 legislative session. It is designed to be more focused and detailed than this report. It can best be thought of as a follow-up to this report.

INDUSTRY OVERVIEW

From 1914 to 1965, the State Industrial Accident Commission was the only provider of workers' compensation insurance in Oregon. A new "three-way" system was created by the 1965 Legislature. The basic structure of this system remains in place today. Under this system, workers' compensation insurance is standardized and mandatory for nearly all employers. Employers have three ways to acquire their insurance. The first is through self-insurance. The second is by purchasing it from private providers. Finally, employers have the option of buying insurance from SAIF Corporation.

The State Accident Insurance Fund (SAIF) Corporation has undergone a number of changes since 1965. It was originally a state agency called the State Compensation Department. The name was changed to SAIF in 1969. It operated as a state government agency from 1966 to 1980. Under the original legislation, SAIF was exempt from state regulatory oversight. However, this was changed in 1972 when SAIF became subject to ratemaking and trade practice oversight.

In 1980, SAIF was converted to an independent public corporation. A Board of Directors appointed by the Governor now governs SAIF.

SAIF's mission is stated in ORS 656.752(2)(b):

> To make insurance available to as many Oregon employers as inexpensively as may be consistent with the overall integrity of the Industrial Accident Fund…

In 1998, there were 20 states (including Oregon), with a competitive state workers' compensation fund system. 24 states had no state insurer. The remaining six states, including Washington, operated a monopolistic state fund system.

SUMMARY OF PUBLIC HEARING

The hearing was arranged so that the committee could examine market trends and policy issues from four different perspectives.

- Government regulator
- National market analyst
- Current private sector operators
- State Accident Insurance Fund Corporation

Government Regulator Perspective

The Insurance Division of the Department of Consumer and Business Services is responsible for regulating Oregon's workers' compensation insurance industry.

Division officials briefed the committee on SAIF's statutory mission, structure and current condition. They also discussed current private insurer market trends. Finally, they addressed the overall health of Oregon's workers' compensation insurance industry. A report prepared by the division on the current condition (April 2000) of the industry can be found in Appendix B.

Key points raised in the testimony:

- SAIF's statutory mission is to ensure availability of workers' compensation insurance as inexpensively as possible. SAIF is not an insurer of last resort. Instead, Oregon's workers compensation insurers, including SAIF, participate in an assigned risk plan.

- Although SAIF competes directly with private insurers it has a number of unique characteristics. Among the most important are: exclusive right to insure state employees, exclusion from the Oregon Insurance Guaranty Association, favorable tax status and the ability to use more liberal discounting assumptions.

- SAIF also has significant constraints. Most importantly, SAIF is restricted to writing only workers' compensation insurance in Oregon. This keeps SAIF from competing for multi-line, multi-state accounts.

- SAIF has paid $656 million in policyholder dividends since 1990. SAIF's income is derived from investments, premiums and capital gains.

- SAIF's ability to pay out dividends has been enhanced by high investment earnings in the 1990's. An Oregon Supreme Court decision requiring the state to pay SAIF $240 million also contributed to the size of policyholder dividends.

- SAIF has used high investment earnings to exercise a pricing advantage over the private sector in the 1990's.

- SAIF has adopted "very conservative" reserve practices. SAIF's total reserve and surplus margin is estimated to be $319 million.

- SAIF's overall market share remained relatively constant between 1992 and 1998 (see Table). During this period, SAIF's largest private competitor—Liberty Northwest (LNW), experienced a decline in market share. The self-insured component remained relatively unchanged while the other private insurer component increased modestly.

OREGON WORKERS' COMP INSURANCE INDUSTRY MARKET SHARE

YEAR	SAIF	LNW	OTHER PRIVATE	TOTAL INS.	SELF INS.	TOTAL MARKET
1992	32.7%	19.3%	31.2%	83.3%	16.7%	100%
1993	34.7%	17.7%	30.4%	82.8%	17.2%	100%
1994	36.0%	19.0%	29.1%	84.1%	15.9%	100%
1995	33.3%	19.0%	31.3%	83.6%	16.4%	100%
1996	32.6%	17.9%	32.5%	83.0%	17.0%	100%
1997	31.3%	16.0%	35.7%	82.9%	17.1%	100%
1998	31.8%	16.2%	35.7%	83.8%	16.2%	100%

Source: Oregon Department of Business and Consumer Services

- Efforts on the part of private insurers to enter the Oregon market have recently leveled off.

The Insurance Division concluded by stating that external trends have been very positive for the industry over the past decade. These conditions are unlikely to be repeated in the coming decade. However, they observed that the industry remains relatively healthy. Their industry analysis concluded that: "Rates are not excessive and are still adequate to allow workers' compensation carriers to make a profit in Oregon".

National Market Analyst's Perspective

Dennis Pillsbury of Pillsbury Enterprises, Inc. provided the national market analyst's perspective. His testimony was based on an analysis of all 50 states using a rating system. This rating system, developed by IMR Corp., is designed to reflect relative future industry profitability in each state. The index consists of a series of indicators such as premium growth and losses. Mr. Pillsbury emphasized that the index is a measure of future industry health, not an indicator of current conditions. The IMR market analysis for Oregon can be found in Appendix C.

Before describing his assessment of the Oregon market, Mr. Pillsbury discussed the industry fundamentals he uses to evaluate trends. He described three industry components. These are:

- Income, consisting of premiums and investment earnings.
- Losses, consisting of medical bills and replacement wages for injured workers.
- Expense, defined to include loss control expenditures such as safety and back-to-work programs.

It is the third category that is most subject to management discretion. However, current decisions regarding loss control expenses has important implications for future profitability. Mr. Pillsbury argued that the industry, on a national level, is under-investing in this area. He sees this trend as particularly risky for future industry health.

Turning to the specifics of the Oregon market, Mr. Pillsbury cited a per employee premium decline over the past decade as an indication of the industry's strong performance. He pointed to the state's regulatory reforms in the late 1980's as the major driver behind this positive trend. However, he told the committee that this trend was coming to an end. He noted that losses were no longer declining while premium continued to fall. He said this was preventing adequate expenditures on future loss control.

According to the Marketdex indicators, Oregon's workers' compensation insurance market is one of the least attractive in the country in terms of relative industry profitability. The study gives Oregon an overall rating of "D" on an A through F scale. The two primary reasons for the low rating are:

- Premium growth is negative while employment growth remains positive.
- The six-year statewide average loss ratio exceeds 65%.

Mr. Pillsbury argued that a purely private market in Oregon's situation would self correct. Premium would begin rising to eventually restore profitability. However, in his view, this self-correcting process is being prevented by SAIF. In his written testimony, Mr. Pillsbury stated:

> " SAIF is writing business at a level that is certain to cause problems in the future. And in the short-term, these predatory practices are killing off any incentives employers might have to institute loss control and safer workplaces. In the long-term, they may be killing off the insurance industry in the state."

Mr. Pillsbury concluded his testimony by stating that Oregon's workers' compensation insurance market is approaching "crisis". He said the outcome will depend on external factors such as employment growth, health care inflation and investment earnings. If private insurers are forced to exit the Oregon market in large numbers, the risk of industry instability will increase in the event of an economic downturn.

Private Workers' Compensation Insurance Perspective

The committee heard the private insurance industry perspective from three trade associations representing the industry. These associations are the Alliance of American Insurers, the National Association of Independent Insurers and the American Insurance Association. Their testimony will be summarized jointly as the Associations.

The Associations reinforced the Pillsbury testimony. They expressed concern that Oregon's three-way system was in jeopardy if current trends continue. They pointed to SAIF's dividend policies as the primary risk to the system.

The Associations reviewed Oregon market share data with the committee. They pointed out that while the self-insured and SAIF market share had remained relatively stable, other private insurers have gained considerably at the expense of Liberty Northwest. They argued that these summary figures are misleading in terms of underlying market forces. This is because Oregon's market consists of two segments. Level one refers to insurance for multi-state companies. The level two segment of the market is companies that are based in Oregon. Level two companies tend to be smaller and are concentrated in the trade and service sectors.

The level one share of Oregon's market has grown over the past ten years. The Associations cited mergers as the primary cause. They explained that the growth of level one companies has increased the presence of insurance companies who provide insurance to their clients on a national basis. The level two share of the market has shrunk and this explains the drop in Liberty Northwest's market share during this period. In summary, the Associations argued that SAIF's share of the market for Oregon based companies has grown over the past ten years even though their share of the overall market has not.

The Associations told the committee that SAIF's policy of paying large dividends to customers was undermining competition in the industry. They gave examples of SAIF price quotes that when adjusted for dividend payments were below estimated costs. The Associations stated that the use of dividends to cut net price below cost was widespread and constituted below cost pricing.

According to the Associations, SAIF's ability to pay out such large dividends is directly linked to the "excessive" reserves they have accumulated over the past ten years. Data supplied by the Associations show SAIF's 1998 surplus at $493 million. This compares with premiums of $206 million. The ratio of surplus to premiums for SAIF in 1998 was 2.39. This compares with an average of 1.28 surplus to premium ratio for the 19 other states that operate in a competitive state fund system. The Associations also presented data that showed 1998 SAIF dividend payments of $202 million. This compares with an average of $61 million in dividend payments for the 19 other competitive fund states.

The Associations told the committee that there was concern at the national level regarding the market impact of competitive state funds. They presented a set of principles and recommended actions that had been produced at the Property & Casualty Insurance CEO Roundtable in January 2000.

The CEO's set down the following principles:

- Oppose expansion of state fund products.
- Support regulatory authority over state funds.
- Oppose inclusion of state funds into the guaranty fund system.
- Examine tax status of state funds.

The CEO's recommended actions:

1. Facilitate greater alignment of the industry's advocacy position regarding state workers' compensation fund issues.
2. Develop specific legislative or regulatory strategies on a state-by-state basis.
3. Undertake a legal analysis of the state fund's tax status.

The Associations closed with a series of research and policy questions for consideration in the 2001 legislative session. The key policy question raised by the Associations: is there a conflict between SAIF's statutory mission statement and state policy of maintaining a viable three-way workers' compensation market? In other words, does SAIF's status as a quasi-public entity with a different tax and regulatory structure create a market environment where the degree of competition will decline over time?

The SAIF Perspective

Representatives from SAIF Corporation told the committee that Oregon's workers' compensation market is healthy and viable for the long-term. They argued that SAIF's policies are consistent with its statutory mission. They also pointed out that SAIF's business practices have led to greater efficiency thereby putting pressure on private insurers to lower costs and improve services. Finally, SAIF officials described the higher risks inherent in being a single line insurer in a single state. From their viewpoint this justified SAIF's reserve position.

SAIF officials began their testimony by presenting evidence on market share trends in Oregon. They pointed out that private insurer's share of the market has risen relative to SAIF over the past 15 years. They interpreted the rising private insurer's market share as a sign of a competitive industry. They also presented evidence that showed SAIF's lost market share over the 1994-98 period was comparable to the lost share for Liberty Northwest.

To further support their position that the workers' compensation market remains competitive, SAIF officials presented other evidence. Among this evidence:

- An increase in the share of the market accounted for by the top five insurance groups after SAIF and Liberty Northwest over the 1994 to 1998 period.

- An increase in the number of private insurance companies underwriting workers' compensation insurance in Oregon between 1994 and 1998.

- In 1998 there were 41 insurance companies (including SAIF) that offered rates within 10 % of the floor established by the Insurance Division.

Next, SAIF officials discussed industry profitability in Oregon over the past ten years. They presented data showing that the ratio of losses to premiums earned in Oregon was 79.1 % compared to a national average of 76.7 % over the 1987 to 1996 period. SAIF officials went on to show that companies doing business in Oregon ranked 4th among 45 states in profits on insurance transactions and 6th among 45 states on return on net worth. Again SAIF officials argued that this was evidence of a healthy workers' compensation insurance industry in Oregon.

SAIF officials then presented financial data comparing SAIF with Liberty Northwest. SAIF officials argued that Liberty Northwest had been relatively profitable over the 1994-99 period. They also told the committee that Liberty Northwest distributes most company profits to stockholders rather than insurance customers. SAIF's situation is different. It has no shareholders and therefore distributes dividends to customers.

SAIF's competitive advantages and disadvantages were then discussed. The key advantages for SAIF relative to the private sector are its exemption from federal income taxes and the state corporate excise tax due to its public corporation status. SAIF also has greater flexibility regarding discounting of loss reserves. On the other hand, SAIF has disadvantages relative to private insurance companies. The major ones are its limitation to a single line of insurance, its inability to offer insurance in other states and its inability to select its own general counsel, auditor and investment advisors.

SAIF officials then turned to internal operations and briefed the committee on steps taken to control losses and improve efficiency. They pointed to favorable trends in time required to approve claims, injured workers time off before returning and claim frequency. They argued that SAIF's operational effectiveness has lowered overall industry costs for employers. They also gave estimates on the impact of SAIF's policies on Liberty Northwest's profits over the past 5 years. They estimated that company profits were $2.4 to $5 million less per year as a result of SAIF's presence in the market. Finally, the SAIF representatives argued that SAIF's policy of paying dividends to customers had more beneficial secondary economic effects than private for-profit insurers who tend to pay dividends to out-of-state shareholders.

The final issue addressed by SAIF officials was the corporation's reserving policies. They argued that SAIF's surplus was prudent given the size of liabilities. They emphasized the uncertainty surrounding estimates of long-term liabilities. They went through a series of variables that affect liabilities over time. The most significant variables are medical inflation and the duration and speed of medical payments. The amount of reserve and surplus necessary is also sensitive to the return on equity securities. They showed the committee that the size of the reserves has a wide range depending on the values assumed for these variables. SAIF officials closed by showing that SAIF's surplus to liability ratio was less than a number of large private insurers.

CONSENSUS FINDINGS

The purpose of this section is to set out facts that are not in dispute.

- The cost of workers' compensation insurance is an important state business climate factor. High costs compared to other states have a negative effect on a state's relative economic performance.

- Oregon's workers' compensation insurance industry benefited from a number of external factors in the 1990's. Among these favorable trends: lower costs due to legislated reforms, modest health care inflation, high investment earnings and strong employment growth.

- SAIF Corporation's overall share of the Oregon market remained relatively stable in the 1990's, increasing slightly in the first half of the decade and declining slightly in the second half.

- Liberty Northwest, the largest private workers' compensation insurer, lost market share in the 1990's. Other private insurers gained share during this period.

- SAIF's unique status as a quasi-public institution gives it certain advantages and disadvantages compared to private insurers. The most important of these advantages are: favorable federal and state tax status, ability to use more liberal discounting assumptions and exclusive right to insure state government employees. Disadvantages include inability to offer additional insurance products or to insure Oregon companies' workers in other states and inability to hire legal, audit and investment experts of its own choosing.

- SAIF's dividend distributions increased significantly in the mid to late 1990's. This has given SAIF a key competitive advantage by allowing it to offer lower priced insurance, net of dividend payments.

KEY DISPUTED ISSUES

- Current health of Oregon's three-way way insurance system. A national market analyst and the Associations testified that signs of deteriorating conditions in the industry are beginning to appear. SAIF and the Insurance Division testified that current conditions are competitive and profitable.

- Outlook for Oregon's three-way insurance system. The Associations made the case that the current system is not viable in the future because of SAIF's role. Specifically they told the committee that private insurance carriers would not be able to compete with SAIF for the level 2 (Oregon based) segment of the market under the current system. From SAIF's perspective, the three-way system is viable and their own presence in the market encourages competition and keeps prices low for employers.

- Profitability of private insurers. SAIF presented estimates they had developed of Liberty Northwest's profitability over the past year. These figures are disputed by Liberty Northwest.

- Reasons behind market share patterns over the past five years. The Associations testified that increases in the overall private carrier share of the market were due solely to growth in the level 1 (interstate) segment of the market. They also postulated that growth in this segment was primarily the result of increased merger activity in the overall economy. SAIF representatives disputed this analysis. From their perspective, an increase in the private carrier market share was a sign of healthy industry competition. They also testified that merger activity was only a minor factor influencing market trends.

- Adequacy of SAIF's reserves and surplus. The Associations told the committee that SAIF's current surplus is well above averages for other competitive state fund states and therefore is excessive. From the Association's perspective this gives SAIF a pricing advantage because this large surplus generates investment income which can then be used to pay dividends to customers. SAIF representatives portrayed their reserve and surplus policy as prudent in light of their narrow market and potential long-term liabilities. The Insurance Division referred to SAIF's reserve position as "very conservative."

RISKS TO THE STATE

It is clear that state policy decisions concerning regulation of the workers' compensation industry and SAIF's role within it have major implications for all current and potential insurance providers in Oregon. However, the broader policy question for the Legislature is the implications for the state's economic performance and the welfare of the general population.

The performance of Oregon's workers' compensation insurance industry over the next decade is dependent on state policy and a series of external factors. State policy makers should weigh the risks of maintaining current policy against the possible risks of restricting SAIF's status in some way.

The primary risk of maintaining current policy is that Oregon's market will become increasingly concentrated. This is particularly true for the Oregon based or level 2 segment of the market. This means that the market will become less diverse and potentially unstable. Instability would likely emerge when external factors turn negative.

A potential policy course is to change SAIF's status in some way. This could take many forms. At one extreme would be complete privatization. At the other end of the spectrum is a minor statutory change. A more restricted SAIF would likely lead to lower dividend payments for a given set of external factors. This could put upward pressure on net premium rates for employers. The risk is higher workers' compensation costs for Oregon businesses. Over the long-term, if policy restrictions turn out to be too severe, SAIF's financial integrity may be undermined. Oregon law does not provide for specific action if SAIF were to become financially impaired.

Whatever policy course is chosen, external factors are likely to dominate industry performance over the next decade. The most important external factors are:

- Rate of health care inflation. If medical care inflation accelerates, industry costs will rise.

- Job growth. If the rate of job growth declines or turns negative, premium growth will decline.

- Investment earnings. If the capital markets weaken or turn down, overall industry earnings growth will decline.

These factors were far more favorable than most industry analysts anticipated during the 1990's. Deterioration in any one of these factors has the potential to strongly affect industry profitability or in SAIF's case—surplus.

POLICY ISSUES FOR THE 2001 LEGISLATURE

There are a number of important policy issues which the 2001 and future legislatures may consider. These can be divided into broad policy issues and those that are narrower in scope.

Broad policy issues:

- Should SAIF be privatized as was done in Michigan?
- Should SAIF be made an insurer of last resort for workers' compensation insurance?
- Should SAIF's market advantages such as exclusive right to insure state agencies be curtailed?
- Should SAIF's market disadvantages such as the restriction to single line, single state insurance be reduced?
- What are the specific public benefits and costs resulting from SAIF's quasi-public status?
- Should SAIF's statutory mission statement be revised?

Specific policy issues:

- Should SAIF's dividend policies be limited?
- Should SAIF's surplus be reduced or redirected?

- Should SAIF be brought into the insurance guaranty fund?
- Should SAIF's investment policies be restricted?
- Should the state insurance regulatory code be applied more uniformly to SAIF?
- Should SAIF's tax status be changed?
- Is SAIF adequately managing its potential liabilities?

APPENDIX A

MOTION PASSED BY HOUSE INTERIM REVENUE COMMITTEE 6-22-2000

Direct the Secretary of State to commission a study on the competitiveness of Oregon's workers' compensation insurance market. This study should address the following question: Can an independent insurance company operating in Oregon's workers' compensation market be profitable over the long-term? All necessary steps should be taken to ensure the objectivity of the study.

This directive is contingent on approval of cost estimates and funding method by the Legislative Emergency Board.

APPENDIX B

REPORT PREPARED BY

INSURANCE DIVISION

OREGON DEPARTMENT OF CONSUMER AND BUSINESS SERVICES

APPENDIX C

REPORT PREPARED BY IMR INC.