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MINNESOTA
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COMMERCE

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February 27, 2002

Shirley Chase, Commissioner
Department of Labor and Industry
443 Lafayette Road
St. Paul MN 55155

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Dear Commissioner Chase:

Minnesota Statutes 79.55, Subdivision 10, state that the Commissioner of Commerce shall annually issue a report comparing the average rates charged by workers' compensation insurers in the state to the pure premium base rates filed by the MWCIA. The statutes go on to state that the Rate Oversight Commission, of which you are the chair, shall review the report. I've attached for your review a copy of the current report.

Sincerely,

James C. Bernstein
Commissioner of Commerce

JCB:RBA

1997 Minn. Laws Chap. 128
Sec. 2

Minn. Stat. 79.55 Subd. 10

Report on Workers Compensation Rates

as required by MN Stat 79.55, Subd. 10.

**February 2002
Minnesota Department of Commerce**

SUMMARY AND CONCLUSION

Minnesota Statute 79.55, Subdivision 10, states: "The commissioner shall issue a report by March 1 of each year, comparing the average rates charged by workers' compensation insurers in the state to the pure premium base rates filed by the association, as reviewed by the rate oversight commission." This is the sixth report required by that statute.

The pure premium base rates filed by the association (the MWCIA) increased by 1.4% on January 1, 2002. The pure premium base rates have decreased 34.2% on a cumulative basis since 1996, the period covered by these reports. The average rates charged by workers' compensation insurers in Minnesota increased by 4.3% between January 1, 2001, and January 1, 2002. Insurers' rates have decreased 35.0% on a cumulative basis since 1996. The Commissioner concludes that the market rates have reasonably reflected changes in pure premiums.

DISCUSSION AND ANALYSIS

Rate increases

Although average market rates are still 35% below their level of six years ago, they increased during 2001 for the second year in a row and will probably continue to increase during 2002. Insurers' results have deteriorated significantly since 1996. Losses are replacing profits, and the strong competition that drove prices down appears to have subsided. Law changes could exacerbate the situation. If the State takes back the assigned risk plan surplus that it transferred to the Special Compensation Fund (SCF), that will drive up the SCF assessment and require about a 4% rate increase, including an increase for the assigned risk plan itself. If the legislature changes the basis for the SCF assessment from losses to premiums, that will also drive up employers' costs. Insurers have already collected from their policyholders many millions of dollars for future SCF assessments (roughly 10% of about \$1.5 billion in reserves that insurers hold for Minnesota work comp claims). If the assessment base changes with no requirement that insurers reimburse the SCF for those past collections, then insurers will have to collect the same amount all over again from policyholders. This will be spread out over many years, so it may not be a large percentage of premium, but it is a large number of dollars.

Measurement of the Insurer Rate Level

The Commerce Department has rate filings from every insurer doing business in Minnesota. Insurers must file an explanation of any rate change, and the vast majority of them file a multiplier that they apply to the MWCIA loss costs to produce their rates. For this report, we compared the average multiplier filed as of January 1, 2001, to the average multiplier filed as of January 1, 2002. We

adjusted the average multipliers so that both were on the same level, namely the level of the 2002 MWCIA loss costs. The average multiplier on January 1, 2001, was 1.684. The average on January 1, 2002, was 1.756. That represents an increase of 4.3%.

Companies Compared

To calculate the average multipliers, this report uses the filed rates of the vast majority of the insurers writing workers' compensation in Minnesota. The calculations include 98.8% of the total market based on premiums written in 2000, the most recent year for which premiums are available. We exclude insurers who did not express their rates as the product of a multiplier and the MWCIA loss costs. In some cases the excluded insurers do not base their premiums on the MWCIA loss costs, but rather calculate their own loss costs, consequently they had no multiplier. In theory we could correct the data of the missing insurers and refine the estimated multipliers. Those few insurers' results would not materially change the estimates. We have percentage changes for the excluded insurers; their rates did not change. Inclusion of those companies would not change the overall 4.3% increase.

Shifts in Market Share

The insurance marketplace is constantly changing in Minnesota. New employers and insurers come into the market; old insurers and employers leave the market; existing employers change insurers. Even if no insurer ever changed its rates, this continuing flux could have a big effect on the average premiums that employers pay. Consider the extreme example where one insurer writes the entire market at a rate of \$2 in 2000, and a different insurer writes the entire market at a rate of \$1 in 2001. Premiums would drop by 50% even if neither company changed its rates. For this report we took this flux into account in order to accurately measure how the market is responding to changing underlying loss costs. We used 1999 market shares for averaging the old rates and 2000 market shares for averaging the new rates. The market shares for 2000 and 2001 would have been better, but 2001 premiums are not available until after March 1, 2002. Using a one-year lag introduces a possible error, but it is much better than ignoring the shifts in market share, which would introduce an even larger error. The error caused by the lag becomes immaterial over time, but the error caused by ignoring the shifts would compound over time and could become truly enormous.

Timing

Insurers do not all change their rates at the same time. Furthermore, a particular insurer does not necessarily change rates at the same time every year. As a result, one can never measure an annual change in multipliers with total precision. One needs to look at an analysis such as this one over a period of

years before reaching a firm conclusion. Insurers are currently in the midst of filings. At the end of another month or two, the average multiplier of 1.756 will probably have changed.

Schedule Rating

The multipliers estimated in this report do not present the entire rate picture. Insurers also give "schedule" credits or debits based on an employer's individual risk characteristics. For the majority of insurers, that can mean adjustments to rates of up to $\pm 40\%$. We do not now have a good way to measure the overall effect of schedule credits and debits. In the long run their use does not materially affect the cumulative changes in rates, but changes in credits can have a large impact in the short run. Insurers gave generous credits in recent years, and that drove down employers' premiums even more than the filed rate decreases would imply. As insurers' losses increase, insurers will probably give fewer credits, which will increase employers' premiums beyond the filed rate increases.

Other Credits

Schedule credits are not the only possible rate modifications. Some insurers, for example, give rate reductions to employers that participate in managed care programs. Most such programs are still relatively new, and their increased use may contribute to rates that are lower than otherwise indicated by this analysis. Insurers also give experience-rating modifications to many insureds, and at a time when experience is improving, the balance of such modifications becomes more favorable to insureds than in the past. The opposite occurs when experience is deteriorating. The same thing applies to policyholder dividends.

Assigned Risk Plan and Self-Insurance

Changes in the Assigned Risk Plan market share can have the same result as shifts in other companies' market shares. The Assigned Risk Plan lost market share for several years, which generally meant that its former customers found coverage at lower rates in the voluntary market. These reports have not included the effect of that price reduction. Even if the voluntary market rates had never changed, the movement from the Assigned Risk Plan would mean that the overall average rate for employers decreased. That movement has now turned around, and the assigned risk plan is growing again. As of the end of 2001, that growth had an insignificant effect on the overall average premium, but the impact will probably increase during the year 2002.

Movement of employers into or out of self-insurance can also affect the overall average price of workers' compensation. An employer will generally move out of self-insurance only when it is financially advantageous to do so, but that may mean a reduction in risk rather than a reduction in price. Even if it means a

reduction in price, it does not necessarily mean a greater reduction than the insured employers themselves are getting. Employers moving from self-insurance to insurance probably have less favorable price changes than the average voluntary market price change.

Here's an example showing how this can happen. Suppose that in 1999 there were only two insureds in the voluntary market, each paying \$50, and one self-insured, paying \$35. Then in 2000 the self-insured employer became insured and continued to pay \$35, the same price for insurance as for self-insurance. The other insureds continued to pay \$50, so no employer got a price change. The average market price in 2000 did change, though. In 1999 the market consisted of two employers with total premium of \$100, for an average price of \$50 per employer. In 2000 the market consisted of three employers with a total premium of \$135, for an average price of \$45. That represents a 10% decrease in average market price, even though no employer actually got a decrease. That is possible only because self-insured employers generally have better loss experience than the market average. Exactly the opposite happens when employers move into the voluntary market from the Assigned Risk Plan: they can cause the average market price to go up even when no employer actually gets an increase.

In recent years employers moved into the voluntary insurance market from both the Assigned Risk Plan and from self-insurance. Nearly three times more exposure moved from assigned risk than from self-insurance, so the dominating effect came from assigned risk. That put upward pressure on voluntary market loss costs but reduced prices for the average employer beyond the reduction in the voluntary market prices. With the voluntary market tightening, the flow is likely to reverse for both self-insurance and assigned risk, but the dominating factor should continue to be assigned risk.

Expenses

Insurance company expenses do not necessarily change at the same rate as underlying pure premiums. Some expenses, such as commissions and premium taxes, are closely linked with pure premiums; other expenses, such as the cost of the insurer's physical plant, are only loosely related to pure premiums. When pure premiums drop, insurers' expenses usually drop, too, but more slowly than the pure premiums. Insurers still have the same buildings to heat, the same envelopes to mail, etc. By the same token, when pure premiums increase, expenses do not normally increase as fast. Thus when pure premiums change, insurers' total costs tend to change more slowly, and so one normally expects rates to change more slowly, too. When looking into the reasonableness of rate changes, one may need to consider shifts in expenses as well as shifts in pure premiums. In this year of low inflation and a small pure premium increase, expenses are not likely to cause distortion.