JANUARY 2013

P&C PERSPECTIVES
Current Issues in Property and Casualty

Self-insured entities and the California workers' compensation reforms

The changes affect *you*

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Senate Bill 863 (SB 863), the workers' compensation reform act that passed the California legislature in 2012, was designed to increase permanent disability benefits for workers while reducing systemwide costs to employers. For many self-insured companies, the new law also contains provisions that will likely increase the cost of collateralizing their self-insured obligations with the state.

Early in December, the state Department of Industrial Relations (DIR) issued a set of emergency regulations governing the reporting and collateralization for 2012. The emergency regulations require every self-insurer to retain an independent actuary to prepare an actuarial estimate of its self-insured obligations as of December 31, 2012. The actuarial report is due May 1, 2013, and must include provisions for future claim payments as well as certain program costs. The new requirement applies to all private employers that are or were qualified workers' compensation self-insurers in California, even those that now have other insurance arrangements.

Prior standard

Self-insured employers must have a financial guarantee with which they securitize their unpaid self-insured workers' compensation liabilities (reserves). In the past, the required contribution was generally[1] 135% of case reserves for losses (medical and indemnity). Case reserves are determined by a third-party administrator (TPA) or the employer if they are self-administrated. Case reserves are based on the facts of individual reported claims at the time they are set. However, the facts often change as a claim matures and generally for workers' compensation, the final cost is higher than the original estimate.

What. **New actuarial report requirement and changes to the collateralization formula for self-insured workers' compensation employers in California.**

Why. **Emergency regulation related to California Senate Bill 863 (SB 863); the Department of Industrial Relations (DIR) will use the actuarial reports in setting collateral requirements.**

When. **Actuarial reports are due May 1, 2013, and must be based on data evaluated as of December 31, 2012.**

Where. **California self-insured workers' compensation exposure. For multistate employers, an analysisis required on the exposure specific to California.**

How. **Contact your workers' compensation actuary.**

[1] At the discretion of the Office of Self Insurance Plans, the requirement could be higher for individual employers.

Statewide aggregate Self-insurer's Annual Reports illustrate the extent to which total reserves exceed case reserves. Using 2001 as an example, the case reserves at the end of the year were $485 million. At the end of 2005, the case reserves on the remaining open claims were $435 million, despite more than $1.1 billion in payments being made during those four years. These percentages are likely understated because they assume no further development after five years, the point at which the DIR stops reporting the data on an individual-year basis.

Figure 1: Development on First-year Case Reserves ($ millions)

Report Year	(1) Case Reserves (End of Year 1)	(2) Case Reserves (End of Year 5)	(3) Payments (Years 2 to 5)	(4) Development % [(2)+(3)]/(1)
2001	$485	$435	$1,134	324%
2002	$527	$438	$1,136	299%
2003	$583	$445	$980	244%
2004	$487	$327	$999	211%
2005	$411	$333	$598	226%
2006	$409	$358	$624	240%
2007	$379	$377	$650	271%

Since 1984, more than 70 employers have defaulted on their California self-insured workers' compensation liabilities. Since the collateral is based on case reserves, many of these employers had insufficient deposits to cover their claims. Any shortfall is paid by the Self-Insurance Security Fund (SISF).

New standard

In place of the 135% of case reserves of standard, §15209 of the DIR's guidelines[2] require an actuarial study to identify the self-insurer's losses at the undiscounted "actuarial central estimate" level. This standard requires an estimate of all components of the unpaid liability, including:

- Case reserves. The estimated future payments established on individual open claims by claims adjusters.
- Incurred but not reported (IBNR) reserves. This is a provision for additional development (beyond the provision in case reserves) on known claims as well as for claims that will be reported after (but occur before) December 31, 2012.
- Allocated loss-adjustment expense (ALAE) reserves. This is a provision for expenses associated with specific claims, such as defense costs and medical cost containment.
- Unallocated loss-adjusted expense (ULAE) reserves. This is a provision for future claims handling expenses, and may include claims administration expenses, such as the cost of a third-party claims administrator.

The difference between the two collateralization standards can be significant. Often, IBNR is greater than the case reserves. When ALAE and ULAE are included in addition to indemnity and medical loss amounts, the actuarial estimate of the total reserve may be more than twice as high as the current standard.

Actuarial study

The requirement for an annual actuarial study applies to all qualified private self-insurers and self-insurance groups. The requirement does not apply to public entities, such as cities, counties, and other governmental entities. The actuarial study must include an analysis of all, and only, the California self-insured exposures of the self-insurer, even if California represents a relatively small portion of total operations. In addition, the actuarial report must be based on loss data and case reserved amounts as of December 31, 2012 (i.e., the same data underlying the private Self-insurer's Annual Report).

Employers and self-insurance groups that already commission actuarial reviews of their self-insured workers' compensation exposure may need to commission an additional report. The existing actuarial work may be used, in part, as the basis of the California analysis, but the California analysis will need to summarize the estimated loss and LAE reserves as of December 31, 2012, using actual paid losses and case reserves as of December 31, 2012, for California exposures only. The estimates in the California standalone report might differ from the actuarial estimates in other analyses prepared to assist companies with their financial reporting. For example, the California standalone report will need to include all reserve components listed in the prior section, but self-insured companies do not commonly establish reserves for ULAE costs. The standalone report must also present amounts net and gross of excess insurance in addition to other potential differences with existing actuarial estimates, such as the use of discounting and contingency margins.

Employers that have never had an actuarial study completed should begin to gather the data necessary to complete one. Typically, actuaries review an employer's claims listing (ideally available at a number of historical valuations) and payroll. It will also be necessary to have a summary of excess insurance policies, including carriers and limits, because the actuary must estimate claim liabilities net and gross of this coverage.

[2] State of California, Department of Industrial Relations, Office of the Director, "Administration of Self-Insurance Plans" (2012), §15209.

What next?

The DIR issued "emergency" regulations because, with the reporting for calendar year 2012 coming due so soon, there was not enough time for the standard 45-day comment period that applies to such regulatory changes. During the first half of 2013, the DIR will move toward replacing the emergency regulations with permanent ones. That process will include a 45-day comment period. The emergency regulations will remain applicable until the end of June, and the permanent regulations will be in effect during the second half of the year and into subsequent years.

In the meantime, employers must commission an actuarial study and file the results by May 1, 2013. As mentioned above, employers that have never had an actuarial study completed should begin to gather the data necessary to complete one, such as historical claim listings, payroll, and summaries of the insurance programs, all specific to California workers' compensation. Employers that commission annual or quarterly analyses should discuss the timing and scope of the new requirement with their actuaries.

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