IV. THE GUARANTEED AVAILABLE MARKET PROBLEM

A. THE FUNCTION OF THE STATE FUND

In order to evaluate the feasibility of privatizing the State Fund, we must begin with an understanding of the function which the State Fund plays in the workers compensation system. Also, we must evaluate whether, and the degree to which, the State of California has an obligation to ensure the availability of workers compensation insurance.

The State Fund has two functions:

(a) Provision of guaranteed insurance availability to any employer who is willing to comply with safety requirements and who is willing to pay for insurance.

(b) Provision of a competitive yardstick against which the performance of private carriers can be measured and balanced. Benchmarks include cost, comprehensiveness of service, and the fair treatment of injured workers. (Although the idea of a competitive yardstick was clearly one intent of State policymakers who established the Fund, privatization would obviously limit or eliminate that. Accordingly, the balance of the analysis therefore will focus on policy considerations related to guaranteed insurance availability and the state agency status of the State Fund.)

Guaranteed availability of coverage remains an important public policy objective.

Availability of coverage may be a condition precedent to the constitutionality of the workers compensation law. A concurring minority of Supreme Court Justices in the Western Indemnity case (Western Indemnity v. Pillsbury (1915) 170 Cal. 686) suggested that the guaranteed availability of insurance coverage was important to their support for the constitutionality of imposing a workers compensation liability on employers. (The workers compensation system is "no fault" and an employer is liable for on-the-job injuries even if they are due to the employee's own negligence.) However, the constitutionality of the workers compensation system absent guaranteed availability of insurance has not been tested directly because a guaranteed available market (the State Fund) was in place when the Western Indemnity decision was made. If the constitutionality of the workers compensation system is not dependent on the availability of coverage, one privatization option would be for the state to decide that it no longer accepts responsibility for guaranteeing an available market. In that event, the State Fund becomes a surplus entity, and may be disposed of via any one of several options discussed below.

Even if the state is not obligated to assure the availability of workers compensation insurance, the state has followed a consistent policy of promoting the availability of essential insurance coverages. In addition to workers compensation, the state has taken an active role in promoting availability of coverage for personal auto liability, homeowners, earthquake, health, and general liability.

Assuming the state does have a continuing interest in guaranteeing the availability of workers compensation insurance coverage, there are a number of alternative models for providing such guarantees. The next section examines the different models used throughout the country for providing such guaranteed insurance availability.

B. NATIONAL MODELS FOR GUARANTEEING WORKERS COMPENSATION INSURANCE AVAILABILITY

1. BACKGROUND

As mentioned earlier, private insurance companies historically have not written all applicants for insurance and not all employers can find coverage in the voluntary market. For example, private insurance companies have not provided an ample market for new employers, small employers, employers classified in certain hazard groupings, employers with Longshoreman and Harbor Workers exposure, mining risks, and weak or financially troubled employers. New employers and small employers are often seen as the vehicles for job creation and play a very important role in the overall health of a state's economy. In many states, these types of employers are likely to obtain coverage either from the state fund or from the assigned risk plan.

The size of the residual market is a function of the perceived adequacy of the rate level in a particular jurisdiction at any particular time. In a market where rates are viewed as adequate, the residual market is often less than 10% of the insured market. However, where rates have been consistently suppressed, residual markets have accounted for as much as 90% of the insured market. This is a simple matter of economics: if rates are adequate enough to cover the majority of risks, insurance companies will supply enough capacity to write coverage for most employers. When rates are perceived as inadequate, insurance companies will move their capital to other markets where they perceive they can earn a more adequate return on capital.

Regardless of the degree of rate adequacy, there are some risks which will find it either difficult or impossible to obtain coverage. Therefore, all 50 states have a mechanism in place to guarantee the availability of workers compensation insurance. There are two basic approaches: assigned risk plans and state funds (some states use both in combination).

Summary tables showing the mechanisms employed in each state are displayed on the following pages. As can be seen, more than half the states have developed some form of state fund or competitive mutual insurance company, eighteen of which serve as the assured, or residual, market in the jurisdiction.

The following chart summarizes these mechanisms graphically:

State Funds, Public Entities, and Assigned Risk Plans

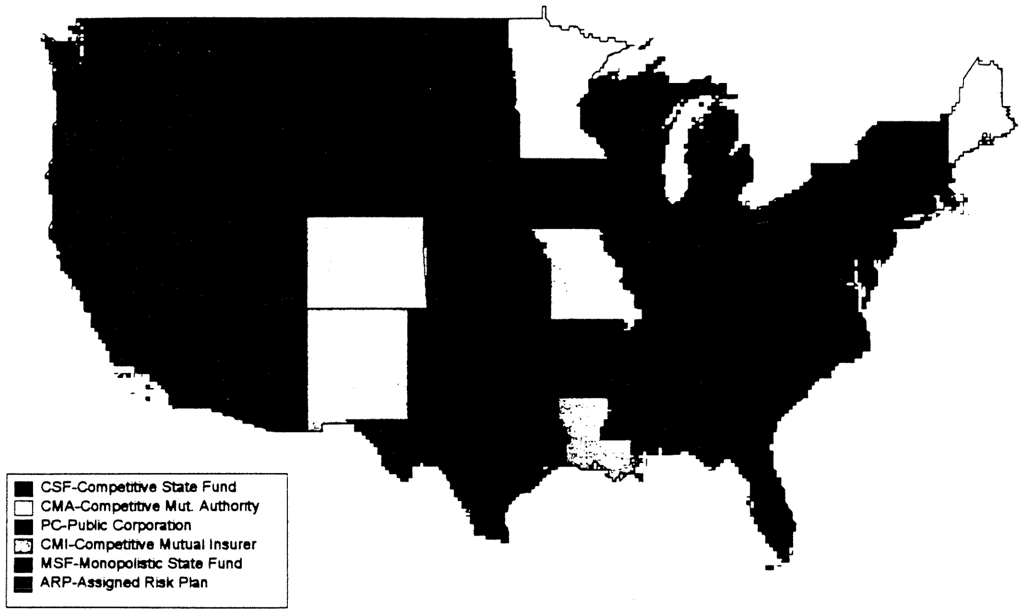

Table 1

STATE FUNDS, PUBLIC ENTITIES, AND ASSIGNED RISK PLANS - 1996 STATUS

State	State Fund or Publicly Created Entity	Assigned Risk Plan (Date Eliminated)	State Fund 1995 Earned Premium ($000's)	State Fund 1995 Policyholder Surplus ($000's)
Alabama		Yes		
Alaska		Yes		
Arizona	CSF	Yes	343,627	180,239
Arkansas		Yes		
California	CSF	No	1,072,672	1,594,255
Colorado	CMA	No	328,396	(68,521)
Connecticut		Yes		
Delaware		Yes		
DC		Yes		
Florida		Yes		
Georgia		Yes		
Hawaii	CMI	No (12/31/96)	NA	NA
Idaho	CSF	Yes	132,275	135,441
Illinois		Yes		
Indiana		Yes		
Iowa		Yes		
Kansas		Yes		
Kentucky	PC	No (9/1/95)	6,258	(5,512)
Louisiana	CMI	No (10/1/93)	212,531	70,892
Maine	CMI	No (1/1/93)	114,989	12,109
Maryland	CSF	No	126,921	149,962
Massachusetts		Yes		
Michigan		Yes		
Minnesota	CMI	Yes	51,482	26,372
Mississippi		Yes		
Missouri	CMI	Yes	30,511	(633)
Montana	CSF	No	152,839	69,597
Nebraska		Yes		
Nevada	CSF	No	451,243	(1,729,905)
New Hampshire		Yes		
New Jersey		Yes		
New Mexico	CMI	Yes	42,578	14,205
New York*	CSF	No	1,713,936	218,738
North Carolina		Yes		
North Dakota	MSF	No	120,890	(141,241)
Ohio	MSF	No	2,264,840	2,881,391
Oklahoma	CSF	No	315,837	36,549
Oregon	PC	Yes	250,560	429,928
Pennsylvania	CSF	Yes	315,330	249,764
Puerto Rico	MSF	No	381,956	32,969
Rhode Island	CMI	No (8/12/92)	102,916	46,244
South Carolina	CSF	Yes	41,108	0
South Dakota		Yes		
Tennessee		Yes		
Texas	PC	No (1/1/94)	574,774	540,924
Utah	PC	No	144,000	135,974
Vermont		Yes		
Virginia		Yes		
Washington	MSF	Yes**	907,832	631,080
West VA.	MSF	No	431,802	(1,910,199)
Wisconsin		Yes		
Wyoming	MSF	No	128,606	0
Total			10,760,709	3,600,622

Source: 1996 AASCIF Fact Book
CSF: Competitive State Fund
MSF: Exclusive or Monopolistic State Fund
CMI: Competitive Mutual Insurer
CMA: Competitive Mutual Authority
PC: Public Corporation
* New York is 1994 data
** for Longshoreman and Harborworkers only

2. PRIVATE INSURER POOLS

The typical workers compensation residual market mechanism, as administered by the National Council on Compensation Insurance in many states, operates as follows. A plan of operation is approved by the Insurance Commissioner, and all carriers in the state are required, as a condition of licensure, to participate in a reinsurance pool. Carriers participate in the pool in proportion to the amount of premium written in the state.

The administrator of the pool contracts with one or more insurers (or other service providers) as servicing carriers for the pool. Servicing carriers issue policies, audit and collect the premium, provide safety services and adjust claims. Servicing carriers receive a fee for their services which is a direct charge against the collected premium. Employers who are unable to obtain insurance after contacting at least two carriers can submit an application for insurance to a servicing carrier who is required to issue a policy at the rates approved by the Commissioner.

Residual market rates are set by the Insurance Commissioner. An operating result is calculated for the pool; and any operating loss of the pool is shared by all carriers in the state in proportion to their direct workers compensation premium written in the state. Under such an arrangement the responsibility for guaranteed availability is effectively transferred to the private carriers; although the state continues to supervise the residual market mechanism through the Insurance Commissioner.

3. STATE FUNDS OR OTHER PUBLICLY CREATED ORGANIZATIONS.

State funds are an alternative approach to handling the residual market problem. A key mission of state funds is to make workers compensation insurance available to employers regardless of their size, industry, or loss experience, on a non-profit basis. The majority, 21 funds, were established to operate in the market where private insurance companies are permitted to compete for business and are known as "competitive funds." Six state funds (plus Puerto Rico) were set up as "exclusive or monopolistic funds" and no private market exists in those states. The California state fund (State Fund) is a competitive fund.

While the concept of a state fund is generic, implementation has been somewhat unique in each jurisdiction. These differences in organization provide an important source of models for privatization. As presented in greater detail below, state funds have been created as (or converted to): state agencies, state authorities, and non-profit mutual insurance companies.

Various activities involving both restructuring of existing state funds, and formation of new entities, have taken place. For example, in Michigan, an existing competitive state fund was sold to the private sector, while in Utah, Oregon, and Colorado there were changes in the structure of existing funds. In addition, in nine states (Hawaii, Kentucky, Louisiana, Maine, Minnesota, Missouri, New Mexico, Rhode Island, and Texas), new mutual insurance companies or authorities were established, primarily to function as competitors with the private sector. Six of these new companies provide the assured market in the state.

Appendix C to this report presents a more detailed analysis of these individual state developments. A careful review of this appendix will indicate the wide variation in characteristics that exists across the various entities. In addition to differences in ownership and organizational structure, the funds also differ with respect to their role in the residual market, the status of their employees, and other aspects of their participation in the market. Moreover, the conditions that motivated the formation or change in status of these organizations varied from state to state as well.

There are many differences between these states and California that must be considered before proposing similar changes in California.

A table summarizing state fund structural changes is provided on the next page.

Table 2

SUMMARY OF STATE FUND STRUCTURE CHANGES

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
State	Effective Date	New Structure	Market of Last Resort	ARP Current	ARP Before	Employees Past	Employees Now	Salary Plan	Retirement Plan	Reasons for Change
Conversions from State Funds										
Colorado	1987	Authority	Y	N	N	Civil	Private	Private	State	Fund Condition
Oregon	1979	Public Corp.	N	Y	Y	Civil	Private	Private	State	Fund Condition
Utah	1988	Public Corp.	Y	N	N	Civil	Private	Private	State	Liability Concern
New Entities										
Hawaii	1997	Mutual	Y	N	Y	-	Private	Private	Private	Market Condition
Kentucky	1994	Public Corp.	Y	N	Y	-	Private	Private	State	Market Condition
Louisiana	1992	Mutual	Y	N	Y	-	Private	Private	Private	Market Condition
Maine	1993	Mutual	Y	N	Y	-	Private	Private	Private	Market Condition
Minnesota	1983	Mutual	N	Y	Y	-	Private	Private	Private	High WC Costs
Missouri	1994	Mutual	N	Private	Y	-	Private	Private	Private	Market Condition
New Mexico	1991	Mutual	N	Y	Y	-	Private	Private	Private	Market Condition
Rhode Island	1990	Mutual	Y	N	Y	-	Private	Private	Private	Market Condition
Texas	1993	Public Corp.	Y	N	Y	-	Private	Private	Private	Market Condition
Other Changes										
Michigan	1994	Sold	N	Y	Y	Civil	Private	Private	Private	Privatization

The experience restructuring state funds and assigned risk plans in these other jurisdictions has highlighted issues which are key to the successful implementation of residual market mechanisms. These include the following:

a. Financial Stability

There is recognition of the need for financial stability in residual market mechanisms. The traditional assigned risk pool focused on coverage availability for employers who could not buy insurance in the voluntary market, while transferring operating losses to other employers (those covered in the voluntary market), or to insurance companies. It was not focused on reducing costs. This resulted in substantial cross subsidization from the voluntary to the residual market; in fact, in a number of instances assigned risk operating losses reached levels where they began to significantly increase the cost of voluntary insurance, causing private insurance companies to withdraw from the market and creating significant political turmoil. In each of those states, the creation of an alternative mechanism (state fund, Mutual Authority, mutual insurance company, etc.) was part of the solution.

b. Market Competitiveness

There is also recognition of the need for a healthy, competitive workers compensation insurance marketplace. As it relates to workers compensation insurance, a competitive marketplace is one in which many companies compete for business with the freedom to use desired rates, dividend plans, and services, and has minimal residual market burden. A self-supporting competitive state fund (or its equivalent) can promote competition, and additionally benefits employers, because it writes their coverage voluntarily and always has a presence in the state, regardless of entry and exit of private insurance companies. A state fund's market share can vary widely depending on how much business the commercial insurance companies are willing to write in a state.

c. Guaranteed Available Market Flexibility

An assured market should operate efficiently and be free to respond to changes in the marketplace that are beyond its control. Insurers will enter and exit markets from time to time, and a state fund or assigned risk plan must have the flexibility to respond accordingly, by having the ability to either write more or fewer policies.

d. Rate Level Adequacy

Since high cost workers compensation coverage can be a disincentive to attracting or retaining employers within the state, the state may be interested in keeping workers compensation premiums at the lowest possible level. This creates a major conflict when premiums need to increase, and it can lead to intervention in the rate making process. If premiums do not fully reflect underlying costs, then employers are not totally accountable for their losses, and they invest less in workplace safety and loss prevention programs. Adequate rate levels are a key component to the success of any fund, pool, or insurance company.

e. Provision for Safety and Loss Control Programs

While employers should be responsible for providing a safe work place, an objective of any assured market should be to foster safety programs, loss prevention, claim management, managed care practices, and to reduce or eliminate fraud or abuse in the system. These programs will lower workers compensation losses and premium to employers and will be in the interest of workers.

f. Efficiency of Operations

The efficient residual market delivers high quality insurance coverages and services to employers at the optimum price and on a financially sound basis.