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The California Workers Compensation Market: Rough Waters Ahead!!!

By Michael Boldt

It is common knowledge among insurance professionals that insurance premiums continuously rise and fall over time in a loose pattern called "The Underwriting Cycle." There are three main factors that affect this cycle: Competition, Government Action, and Loss Control Efforts.

The first and most compelling factor is competition. There is a very basic principal involved. Businesses chase profit and flee from losses. Insurance carriers like to enter and compete for market share where and when other carriers are making large profits.

Once committed to a market, carriers will compete vigorously for market share to the point that the market becomes unprofitable. Unfortunately for insurance companies, there is a significant lag between when a market becomes unprofitable and the awareness that the market is unprofitable. In an unprofitable market some carriers go bankrupt, others leave the market or severely curtail their activities, and the remaining carriers dramatically increase premiums to gain profitability. High premiums and little competition create an extremely profitable market and the cycle begins anew.

Competition is not the only factor driving the high peaks and low valleys of the underwriting cycle. When premiums are high and most carriers are bankrupt or have left the market (this is known as a hard market), government begins to take action. A "Hard Market" also prompts intense loss control efforts on the part of the insurance consumer. When the legislative and loss control efforts take effect, premiums are still high. High premiums and low losses lead to large profits which prompt the government to pass legislation designed to make sure the "little guy" gets his fair share from the profiteering insurance companies. As premiums fall, loss control efforts become lax. Just as there is a reaction lag in the competition component of the "Underwriting Cycle," there is a lag in the government and loss control components.

In order to conceptualize the aforementioned lag, it is useful to compare premiums to loss ratio.

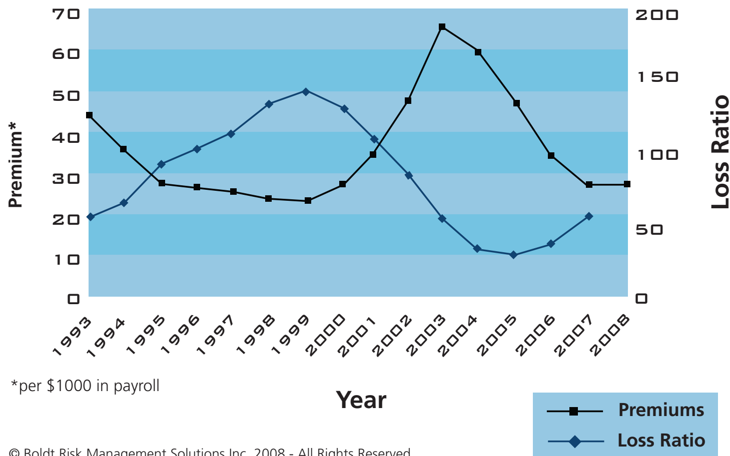
"Those who do not learn from history are doomed…" George Santayana

(Spanish born American Philosopher, Poet and Humanist. 1863-1952)

Loss Ratio to Premium Increase - Lag Analysis

California Workers Compensation

Patent Pending



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The loss ratio is very simply the percentage of premium dollar for a given year that went to pay losses. The loss ratio is a good indicator of insurance company profitability for a given time period. The California WCIRB produces a report several times a year that shows insurer experience. By taking the average premium per $1,000 of payroll in the state and comparing that rate to the loss ratio for a particular year, a sense of the "Underwriting Cycle" can be seen. This comparison shows how premiums continue to decrease or remain steady even during times of dramatic increases to the loss ratio.

In addition to the three factors mentioned above, there are some internal insurance company factors that likely cause the long reaction time. At the beginning of these periods of increased losses, carriers are in the throes of a highly aggressive competition for market share. Underwriting rigor is usually greatly relaxed during a soft market so there has been little consideration given for good and bad risks. Claims reserves are often inaccurate because of overly optimistic assumptions based on the previous era of loss reductions or in some cases due to insurance company management pressuring the claims administrator to keep low reserves as a service to the client (i.e. lower X-Mods). Years after the fact the actual loss chickens come home to roost, and loss ratios are retroactively increased.

By the time these internal and external factors are worked out, many carriers are gone. In the year 2000, twenty-seven Workers' Compensation Companies went bankrupt according to former California Insurance Commissioner, John Garamendi. Some industries, such as long term care providers, began to suffer the ill effects of a hardening market sooner than others.

Current trends and anecdotal evidence show ominous signs that the workers' compensation underwriting cycle is about to repeat the traumatic ride of the mid 1990s and early 2000s. The preliminary loss ratio for 2007 is nearly double what it was in 2005 and is likely to increase when actual losses shatter the rosy assumptions used to inadequately reserve for losses. The WCIRB has suggested a rate increase for the last two years. The California Insurance Commissioner has rejected those suggestions. Lastly, one newer carrier catering almost exclusively to long term care providers has asked for approval for a 24% rate increase from the Department of Insurance due to several unprofitable quarters, but has also requested approval for granting 50% credits to retain its customers and continue to grow its market share.

An educational effort is required at this point to help prudent employers weather the coming storm: Employers should be made aware of the negative consequences related to their carrier declaring bankruptcy. Warning signs of a weak insurance company should be highlighted. The effect of a hard market on captives and self insurance groups or self insured individual companies should be explained to those employers who are involved in such alternative programs. Finally, different approaches for riding out a hard market should be reviewed.

A good insurance broker is always a valuable asset. In times like these, it is not enough for a broker to provide tactical services such as application submission and quote acquisition. A thorough understanding of the insurance business and strategic vision are required to address the needs of prudent employers in today's marketplace.

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