California State Senate

SENATE COMMITTEE ON INSURANCE

RICHARD D. ROTH
CHAIR

STATE CAPITOL
ROOM 2195
SACRAMENTO, CA 95814
TEL (916) 651-4110
FAX (916) 266-9353

PRINCIPAL CONSULTANT
ERIN RYAN

CONSULTANT
HUGH SLAYDEN

COMMITTEE ASSISTANT
INEZ TAYLOR

Oversight Hearing

State of the State Compensation Insurance Fund

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State Capitol, Room 112
1:30 PM

The Senate Banking, Finance and Insurance Committee held two hearings—in 2007 and 2008—to investigate allegations of serious financial and operation improprieties at the State Compensation Insurance Fund (State Fund). Since that time, many organizational and operational changes have been made within State Fund (some through legislation), and there have also been significant changes in the workers' compensation insurance marketplace, leading to a dramatic drop in State Fund's workers' compensation insurance market share. The purpose of this hearing is to examine State Fund's response to the serious findings of the earlier reviews and to changing conditions in the workers' compensation insurance market, and to determine if State Fund is adequately managing its role as California's workers' compensation "insurer of last resort."

Background

The State Compensation Insurance Fund was created by statute in 1914 to act as a workers' compensation insurer for the state and to serve as the workers' comp insurer of last resort in the private market. It also serves as a Third Party Administrator (TPA) for self-insured public and private employers. The State of California is its largest TPA client. Although created by the Legislature, it is operated as a private non-profit enterprise, and is supposed to be "neither more nor less than self-supporting." The State of California is not liable for any obligations of State Fund. Its market share has fluctuated from a record high of 53% in 2000-2001 to a low of 10% in 2012. It has increased slightly since then, and State Fund remains one of the largest workers'

compensation insurers in the country and the largest in California, although some private insurers are closing in[1].

California's workers' comp market became chaotic in 1995, the first year of "open rating"[2]. When the minimum rating system was eliminated, insurers engaged in price-cutting to try and gain market share. Many large carriers underpriced their insurance policies, experienced high loss ratios, faced rising health costs and benefits increases and became insolvent between 2000 and 2003. The largest of these were Superior National and Fremont General. State Fund's market share went up dramatically as other insurers became insolvent or stopped writing workers' comp policies in California. Once the market stabilized, its market share began to normalize, and went down more than 25% from 2004 to 2005. In the mid 90's, State Fund's market share was about 20%.

State Fund's financial situation was also on a rollercoaster over this period. In addition to gaining market share when other insurers pulled out of the market, it also faced increasing costs and a high loss ratio. The Insurance Commissioner (IC) was ordered through legislation in 2003 to examine State Fund's finances. He testified in 2004 that he considered State Fund's reserves inadequate and would have taken action to take control of State Fund had it been a private insurer. Since that time, State Fund's financial condition improved—largely due to workers' comp reforms that reduced costs and also reduced State Fund's market share as other insurers returned to the California market. State Fund's business was also affected by the recent recession, leading to challenges in managing its overall expense and overhead structure.

In 2014, State Fund wrote 139,000 policies for $1.46 billion in annual premium, up from about $1 billion in 2013. At its peak in 2004, annual premium was almost $8 billion. Although 2014 premiums increased more than 24% over the prior year, underwriting losses, at $681 million, were also higher than expected and more than double the previous year. State Fund relies on investment income to cover the shortfall. State Fund had $656 million in net investment earnings in 2014 on almost $20 billion in assets, and a $75 million capital gain, allowing it to post net income of $33 million.

As part of its mandate to be "neither less nor more than self-supporting," State Fund is required to return excess income over legally required reserves or surplus to its policyholders, or provide a credit on the renewal premium of, employers insured with the fund and meeting specific criteria. During the rollercoaster period in the 2000s, State Fund issued no dividends. It again started returning excess income in the form of dividends in 2011 and each of the last four years[3], although such dividends declined significantly in 2014. On February 20, 2015, State Fund announced it would issue a $37

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[1] There are more than 200 workers' compensation insurers in California. The second largest insurer (after State Fund) is Travelers Property Casualty Company of America, which in 2013 had almost seven percent of the market.

[2] A workers' compensation insurance pricing system that permits each insurer to set its own rates. Open rating became effective in California on January 1, 1995.

[3] $50 million for 2011, $100 million for 2012, $100 million for 2013 and $37 million for 2014.

million dividend for the 2014 year (in the form of 2015 policy renewal discounts) as a result of higher than anticipated investment income. State Fund also recently filed for a significant premium increase for 2015, effective April 1, 2015. The overall increase is nine percent, although some premiums will increase by more than 20%, particularly in Los Angeles County and other areas of southern California.[4]

The State Fund Conundrum

As a non-profit quasi state entity, State Fund faces a mandate different from other insurers: to maintain enough market share to remain financially stable and provide quality services, but not to compete for increased market share or make a profit. State Fund is required to report its business quarterly to the Governor, including its resources and liabilities, and to use an outside auditor to annually audit its books and operations.

As the state's workers' compensation "insurer of last resort", State Fund insures more high-risk entities and therefore has a higher loss ratio than other California workers' compensation insurers, but it must maintain a portfolio that also includes lower-risk businesses to balance its risk. State Fund insures a greater proportion of higher hazard construction and agricultural employers than other workers' compensation insurers; in 2012 nearly one third of its entire book of business was construction employers. As a result, State Fund's indemnity claim frequency is also higher than other insurers. As noted above, the role of "insurer of last resort" has led to dramatic fluctuations in State Fund's market share.

State Fund also must manage significant organizational and operational issues not faced by other insurers. State Fund's workforce is part of the civil service, entitled to the same job protections as other state workers. Until 2009, it had only one exempt position—the president and CEO[5]. State Fund is not able to benefit from efficiencies of size and it's expense ratio of staff to premium is higher than other large workers' compensation insurers. In actuality, its overhead and expenses are more in line with small California insurers. The quick growth of State Fund's operation from 2000 to 2003 led to a dramatic increase in hiring and expansion, peaking at more than 9,000 employees in

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[4] According to the Workers Compensation Insurance Rating Bureau, in 2010 indemnity claim frequency increase was generally experienced across all California regions. Indemnity claims involve loss of work and temporary or permanent disability claims, versus medical only claims. Since that time, the increases have been concentrated in the Los Angeles area. Indemnity claim frequency increased an estimated 9% in the Los Angeles/Los Angeles Basin region from 2010 to 2013 while, similar to the pattern shown in many other states, the other California regions showed modest declines. (For example, indemnity claim frequency in the Bay Area declined by 7% over the same period.) The Los Angeles area also has experienced significantly higher numbers of cumulative injury claims and claims involving multiple body parts than other regions of California.

[5] AB 1874 (Coto 2008) granted State Fund six additional exempt positions, including a chief financial officer, chief operating officer, general counsel, chief information technology officer, chief investment officer, and chief risk officer. SB 1145 (Machado 2008) made State Fund subject to the Bagley-Keene open meeting law. In 2013, AB 1394 (Committee on Insurance) added a chief medical officer, chief actuarial officer, chief claims operations officer, and chief of internal affairs to the list of exempt positions.

2005. That number has now dropped to a little more than 4,000 through a difficult process for both employees and management of buyouts, retirements, closures of offices and hundreds of workers shifting to positions in other state agencies. Much of the reduction happened during the height of the recession.

There has also been a regulatory struggle between the Department of Insurance (CDI) and State Fund. State Fund long insisted it is not subject to the same scrutiny and regulation by the CDI as other insurers because it was legislatively created. Legislation in 2006 clarified that State Fund's finances may be examined by the IC just like any other carrier (and also made it subject to audit by the State Auditor), but the IC would have to consult with Governor and Legislature if problems requiring action were identified. At that point, the Governor--in consultation with the Legislature--could replace the president with a "recovery administrator". The recovery administrator would remain until the IC determined things were back on course.

Prior to 2008, the State Fund board had only five members who received no compensation. In the fall of 2006, two board members voluntarily resigned after conflict of interest concerns were raised--the board members were owners or had a financial interest in insurance brokers or associations receiving substantial payments under the Group Association Program. The board then hired an outside legal firm to conduct an internal examination and audit, and in March of 2007, the board fired several executives, including the President and an Executive Vice President, and made a referral for criminal investigation to the California Highway Patrol (CHP). In April of 2007 the CHP, CDI and the San Francisco District Attorney's office formed a task force to investigate allegations of potential misconduct by former State Fund employees. Ultimately the task force was closed and no criminal charges were ever brought.

At the same time, the CDI, as part of its regulatory authority, launched a full operational and financial audit of State Fund by an outside firm that provided a scathing review of an organization run amok, with poor business and accounting practices throughout the organization.[6] That audit found the State Fund board was too small and lacked sufficient resources and expertise to provide the degree of oversight for an insurer of State Fund's size and complexity. State Fund also lacked a functional management team, including a Chief Financial Officer, Chief Investment Officer, Chief Information Officer or Chief Operating Officer.

As a result of legislation in 2008, State Fund now has an 11-member board of directors, one of whom must come from labor; nine are appointed by the Governor. In addition, the Governor chooses the chairperson, which is a pleasure appointment. The Speaker of the Assembly appoints one member who represents organized labor, and the Senate Committee on Rules appoints one member[7]. The board also includes the Director of the Department of Industrial Relations as a non-voting "ex-officio" member. Board members

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[6] A summary of the CDI findings can be found at the end of this document

[7] Currently former State Senator Mike Machado, chairman of the Banking, Finance and Insurance Committee in 2007 and 2008

must sign financial conflict of interest statements, and are provided $50,650 in annual compensation to help attract and retain highly qualified candidates. In addition, board members now must have experience in positions involving workers' compensation, legal, investment, corporate governance, accounting or other skills relevant to an organization the size of State Fund.

Major Operational Changes Still Underway

The operational reviews of State Fund in 2007 and 2010 recommended more than 100 major findings and recommendations for reforms and improvements to State Fund's operations. As noted above, issues dealing with governance and management issues have largely been addressed, although turnover in its leadership positions remains a concern.

Starting in 2010, State Fund implemented a consolidation plan to reduce its real estate footprint statewide and to geographically restructure its operations to operate more efficiently. It sold its home office in San Francisco and relocated to leased space, transferring the majority of employees to other locations. It also closed several regional offices. Through its reduction in force, consolidation of offices and other steps, State Fund says it has reduced its fixed annual operating costs by more than $358 million since 2008.

In 2013, State Fund discontinued its problematic Group Association Program, whereby policyholders had the ability to join industry associations and receive a six percent discount on premiums, with the associations receiving a fee based on a percentage of premium generated[8]. Pursuant to their contracts, the group associations were paid an administrative fee for their services and were supposed to provide safety services to their members, thereby reducing the likelihood of injuries and claims. The operational review in 2007 found that State Fund had failed to provide adequate oversight of the Group Association Program. State Fund paid more than $520 million in group program administrative fees from 1997-2007 with more than half going to two associations affiliated with State Fund board members, but subsequent audits found no improvement in the loss ratios for those in the program.

In place of the Group program, State Fund implemented new tiered rate pricing. According to State Fund, this allows them to more closely match price to the actual risk of individual policyholders and incentivize safe employer practices. The plan is based on an analytic model that uses the organization's long history as the dominant underwriter of workers' compensation risks in California, and analyzes payroll, loss frequency and other objective data points, and sets three tiers:

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[8] The 2007 operational review found that the associations were motivated to increase their membership base (more premiums equated to more fees), not to increase safety services provided to members, which was their presumed function. Some group associations were paid millions of dollars for merely sending members quarterly newsletters, and in many instances, State Fund employees actually wrote the content for the newsletters.

- **Tier A** is for policyholders whose experience and other risk attributes reflect a low expectation for loss frequency and severity.
- **Tier B** pricing is designed to price those operations with moderate risk factors whose results reflect average safety and risk management.
- **Tier C** is for policyholders whose experience and other risk attributes reflect a much higher than average expectation for loss frequency and severity. State Fund is often one of the few, if not the only choice for this employer group.

State Fund in 2012 also changed its relationship with thousands of insurance brokers throughout the state, imposing minimum paid premium volume requirements of $100,000 for one of the last three years for them to qualify for direct broker access. State Fund selected two general insurance agencies to administer access for brokers who do not meet the minimum production requirement, in essence making these brokers work through a third party broker or wholesaler who, in some cases, could be considered a competitor for the broker's business, or at least reduce broker commissions. According to State Fund, this change was made because of its declining market share and workforce, and the operational cost of being the only insurer that accepted all brokers' business regardless of volume. For reference, State Fund had 4,694 authorized brokers in 2011. As a result of the new system, State Fund terminated the contracts of 3,328 brokers effective January 1, 2013, requiring them to go through one of the two third party brokers.

Another area receiving significant criticism in past reviews is State Fund's handling of information technology requirements. IT vendor contracts were general in nature and did not address key control procedures, contracts were extended for years beyond the original contract term, and some payments were not in compliance with contract terms. Information technology and critical infrastructure and data security remain challenges for the organization.

Key findings of the CDI 2007 Operational Review/Audit:

- The State Fund Board of Directors was too small and lacked sufficient resources and expertise to provide the degree of oversight for an insurer of State Fund's size and complexity.

- State Fund lacked a functional management team, including a Chief Financial Officer, Chief Investment Officer, Chief Information Officer or Chief Operating Officer. State Fund had only one exempt position, its president.

- State Fund had engaged in inappropriate business practices that allowed expenditures to be made to vendors outside of the Board approved budgetary process, allowing it to purchase goods and services that were neither known nor approved by the Board. Certain former State Fund executives created a virtual slush fund by having vendors pre-bill State Fund for services and then used those funds to obtain goods and services from third parties as directed by those former executives. Among the items reportedly purchased were wine, hundreds of iPods, and computers.

- State Fund failed to provide adequate oversight of its Group Association Program, whereby policyholders had the ability to join industry associations and receive a six percent discount on premiums, with the associations receiving a fee based on a percentage of premium generated. SCIF paid more than $520 million in group program administrative fees from 1997-2007, with more than half going to two associations affiliated with SCIF board members. State Fund incorrectly classified these fees as legal and accounting fees in its financial statements. No audits of these fees were ever performed. Questions about the group program led the Board to hire an external firm to perform an investigation.

- State Fund's information technology (IT) policies and procedures were fragmented and had had little oversight from senior management. State Fund was heavily reliant on more than 200 outside vendors and consultants, and since 2004 had paid IT vendors more than $321 million. At the same time, State Fund's data management and security was poor and disjointed.

- Payments made to certain IT vendors were not in compliance with contract terms, and in one case, a key data management vendor was paid more than $100 million through 2006 even though its primary contract expired in 1997. State Fund filed suit against that vendor in September 2007 for failure to deliver a new internet based insurance application and underwriting program, and for failure to turn over State Fund's customer data files.

- State Fund maintained a fleet of 2,000 vehicles for its 8,000 employees, but it had not performed an audit of fleet management since 2003. There was no audit of mileage or travel logs, each vehicle had an assigned gasoline card but management had made no effort to determine if usage was reasonable to the assigned tasks or used for unauthorized purchases, and there was no tracking mechanism to verify if vehicle maintenance was performed. Some employees reportedly would not travel off-site unless they received approval to take their own cars due to the poor condition of pool vehicles.

- There was no established procedure to ensure that company issued equipment, property or records were tracked or returned by employees following termination or resignation.

- State Fund had consolidated its medical bill payment function into three claims processing centers, but since the transition, late payment penalties had almost tripled, and reached $19.5 million in the first six months of 2007, with $4.7 million in July alone. This despite the fact that State Fund's market share had dropped dramatically. In December 2006, penalties were approximately $600,000. Apparently, budget cuts were made to these facilities contrary to the recommendation of the Board Chair and the Vice President who assumed management of these facilities. The audit reported that part of the problem may also have been a transition to new software that was understaffed and not as effective as planned.

- State Fund made material investments in securities that were not in compliance with those investments allowed by statute, and continued to invest in securities that were not allowable investments.

- Prior to March 2007, State Fund's internal auditors reported only to the General Counsel and did not attend Board meetings or interact with the Board. In essence, the auditors reported to those who were carrying out the questionable activities.