

Benefits & Implications of State Workers Compensation Fund Modernization and Privatization

State workers compensation funds currently face several challenges related to the overall workers compensation insurance market and their standing as quasi-government entities. They face competitive disadvantages that other workers compensation carriers do not experience and often have complex relationships with state legislatures. Many funds have decided to modernize in order to become more competitive and more efficient. Additionally, conditions have prompted many state workers compensation funds to explore privatization. Whether they decide to privatize or modernize, both options present state workers compensation funds with a variety of tax, regulatory, operational, and technological challenges.

Industry overview

Most states require employers operating in their respective states to maintain workers compensation insurance coverage for the employers' workers. As a result of negative market forces and other factors, certain employers are unable to obtain workers compensation insurance in the private market (particularly small employers, employers in high risk sectors, and employers with poor safety records).

To ensure that all employers are able to obtain workers compensation insurance, many states have established workers compensation funds to provide insurance coverage to businesses that are unable to obtain affordable coverage in the private market. These funds have the following characteristics:

- They are typically formed and operated as quasi-governmental bodies. In many cases, the formation of the fund occurs through enabling state legislation and the state may provide initial capital.
- Board members are usually appointed by one or more of the state government branches, and the fund may be subject to government oversight.
- As is the case for private sector workers, fund employees may not be subject to civil service laws.
- In nonexclusive states, funds compete with private insurers for policyholders and typically do not rely on government funding or appropriations for their ongoing operations and surplus support. Instead, they obtain funding from policyholder premiums.

Workers' compensation represented 18% of U.S. property/casualty industry commercial lines net written premiums in 2012, but has been the worst performing major commercial lines segment for several years. However, workers' compensation insurance market fundamentals have improved recently. Following a long period of declining premium rates, pricing has increased for two consecutive years and, according to Fitch Ratings, this trend should continue in the near term. The 2012 industry aggregate segment combined ratio improved to 110% from 117% in 2011, and for calendar year 2013 Fitch projects a 105% combined ratio.¹

Privatization – Key business considerations

In several states, disputes have arisen between the state and the fund over legal ownership of fund assets. Since these funds tend to be single-state, mono-line writers that fill the role of insurer-of-last-resort, economic and competitive forces can have a more adverse impact on their premium volume and loss ratios than their private sector competitors may experience. Moreover, many state governments are looking to limit or reduce their potential liability for the fund underwriting activities and address uncertainty about the fund's federal income tax status.

In reaction to these disputes, a number state workers compensation funds have taken steps to become private mutual insurance companies. Taking this step establishes certainty over the fund asset ownership and provides the fund with varying degrees of operational autonomy from state governments.

However, privatization comes with a number of significant business considerations:

Operational considerations

- Market performance will largely impact investment income.
- Having fewer employees – the mark of a weak employment market – has reduced demand for workers compensation insurance over the last five years.
- Competitors may aggressively try to expand marketshare at privatized entities expense, often by aggressively suppressing rates.
- If the recent trend of declining accident frequency and severity continues, then it likely will suppress rates and reduce industry profitability.
- Diversified risk profiles are a key to sustainable profitability.
- Diversified investment portfolios are a key tactic to minimize investment income risk.

Regulatory & Tax considerations:

- Evaluate potential challenges by taxing authorities for federal tax exemption.
- Mitigate potential adverse tax consequences as a result of a change in structure or operations.
- Evaluate future tax implications on pricing and capital requirements.

Technology considerations

- Select more cost effective information systems that can provide key competitive advantages in areas such as policy administration, billing, claims, imaging, forms/prints and agency and policyholder portals.

¹ Source: <http://finance.yahoo.com/news/fitch-workers-comp-insurance-rate-161300508.html>

Planning for the future

Given the overall workers compensation market environment and the specific challenges they face, funds need to address several key questions:

- How do they navigate an increasingly complex regulatory environment?
- What are the tax consequences and what options are available to mitigate any adverse tax costs, both with a privatization transaction and in future years?
- Given state budgets, could funds lose current preferential treatment by the states?
- Should state funds spend the money to modernize antiquated processes and outdated technology?
- Do funds have the appropriate surplus monitoring tools to safeguard the company's long-term solvency?
- Should they privatize?

Moreover, state funds that choose to privatize need to think strategically about which insurance products to offer their policyholders after they form a new entity:

- Offering products which complement their existing workers compensation offerings should provide continuity and room for growth for the carrier, agents, and policyholders.
- In many cases, newly privatized carriers also choose to expand into other states. They should consider market opportunity, the regulatory and tax environment, the cost of expansion, and their ability to financially sustain expansion.
- Many state funds are performing a thorough review of all major operations in the front, middle and back office. These operations include policy administration, billing, claims, the agent experience, and policyholder relationship.
- A more efficient carrier usually has lower costs and a more effective workforce, and typically offers agents and policyholders better service.

In order to achieve efficiencies and better service, many state workers compensation funds, whether they choose to privatize or remain with the state, are improving their technology:

- When modernization is warranted, they are moving aggressively to upgrade core systems, including policy administration, billing, claims, forms/print, and imaging, and are integrating core systems to financial systems and the rest of their legacy environment.
- The more fully functional and integrated vendor software that has become available in recent years allows for shorter implementation cycles and lower cost of ownership. Most of these newer solutions also are affordable for small and mid-size carriers.
- Enhanced technology environments are improving the agent and policyholder experience, as well as worker efficiency.

The path forward – How PwC can help

Business & technology operations (both existing and new entity)

- Assist in the development of appropriate long-term surplus and capital requirements plans during the transition toward privatization.
- Day-to-day risk management for private entities, in underwriting, reserving, operational, investment, etc. This includes quantification and comparison of risks relevant to the level of surplus available to the company, and providing management with a methodology for informing the strategic decisions (e.g., rate level changes, business expansion) that will protect the long-term solvency of the entity. This also includes support for conversations with internal and external stakeholders.
- Develop actuarial capabilities related to product pricing and monitoring, as well as overall reserving methodologies and governance. As companies decide to move into other states, this includes help with cross-state product pricing and the obtainment of an accurate understanding of new markets.
- Assist state funds that choose to privatize on which insurance products to offer policyholders after the formation of a new entity. This includes advice on market opportunity, the regulatory and tax environment, and the cost of expansion.
- Thorough review of all major front, middle and back office operations. This review encompasses policy administration, billing, claims, finance, the agent experience and the policyholder experience. We work with state funds and newly formed entities to improve their processes and upgrade workforce skill by focusing on improving the agent, policyholder and employee experience, lowering operational costs, increasing revenue, and improving profitability.
- Improve state workers compensation fund and private entity technology environments, including core systems transformation (policy administration, billing, claims, forms/print, imaging, agent portals and policyholder portals). PwC helps determine technology requirements based on business needs, review and select the most appropriate technology and plan, and estimate the transformation. We integrate core systems to financial systems and the rest of our client's legacy environment.

Tax & regulatory assistance upon formation of the new entity

- Assist with the preparation of federal and state income tax returns, tax provisions and related financial statement reporting.
- Identify and implement tax mitigation solutions, such as research and development tax credits. For example, state funds have received a lengthy questionnaire from the IRS reviewing entities that are exempt under IRC 501(c)(27)(B); PwC has helped carriers to review the questionnaire and guide them through the response.
- Assist with the development of new employee benefit plans and compensation strategies which complement their overall strategy.
- Assist with state and federal regulatory compliance matters.

Guidance throughout the privatization

- Assessment of tax implications of proposed privatization legislation and assistance with obtaining a determination from the IRS where tax-exempt status is to be maintained.
- Privatization transaction structuring that minimizes or eliminates adverse tax consequences to the new entity as well as their policyholders.
- Assistance with the obtainment of a Private Letter Ruling on the tax consequences of the privatization, and guidance for the new entity on the "Day 1" tax basis balance sheet and proper period to claim deductions for assumed liabilities.

For more information about how PwC can assist state workers compensation insurance fund privatization and modernization, please contact:

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