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NAIC Focusing On Large Deductible Workers' Compensation

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In the spring of 2015, the National Association of Insurance Commissioners' (NAIC) task force on workers' compensation began a period of renewed attention to, and scrutiny of, large deductible workers' compensation insurance policies. As of the NAIC's most recent summer 2016 national meeting in San Diego, the workers' compensation task force adopted a "2016 Workers' Compensation Large Deductible Study" which includes renewed recommendations for regulatory action aimed at more tightly controlling issuance of such policies and curtailing the damaging effects of both employer and insurer insolvencies, which can be exacerbated, if not caused outright, by large deductible coverage programs.

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"Large deductible" workers' compensation insurance policies are essentially a market solution for employers seeking to reduce their cost of coverage and who might otherwise prefer to self-insure their workers' compensation liabilities but are precluded from doing so by extraordinarily high financial qualification thresholds imposed by state law. Whereas an employer which qualifies to self-insure might still obtain excess coverage for liabilities on claims exceeding a certain attachment point, in order for the employer, rather than the excess insurance carrier, to be directly liable for the first dollar of a claim, the employer must (under most state laws) qualify to self-insure. In many ways, a large deductible workers' compensation policy closely resembles an excess policy, in that the carrier (at least in theory) is only liable to pay a claim once its cost has exceeded an insured employer's deductible obligation — analogous to an excess attachment point. Under the terms of a large deductible policy, and unlike the coverage afforded under an excess policy, the insurance carrier must assume direct liability to satisfy the first dollar of a covered employee's claim. This leaves the carrier in the position of having to recoup deductible obligations directly from the insured employer, and leaves the carrier exposed to significant credit risk.

The NAIC first took significant notice of the market trend toward large deductible workers' compensation policies in 2005, and the workers' compensation task force, together with the International Association of Industrial Accident Boards and Commissions formed a joint working group to produce the "2006 Workers' Compensation Large Deductible Study." This 2006 study identified several important insurance regulatory concerns raised by large deductibles, and adopted several recommendations. Specifically, the 2006 study confirmed the NAIC's position that the large deductible insurer must be liable for the first dollar of liability on an injured employer's claim, so that in the event of an employer's insolvency or cessation of business, the injured employee's interests are protected, regardless of the insurer's ability to recoup a deductible obligation from the employer. The 2006 study also took a firm stance against employers' attempts to self-administer claims below the deductible threshold and avoid timely notification of their insurer — a practice which severely hampers effective and accurate risk rating and underwriting. While this framework is clearly intended to protect covered employees first and foremost, it also cements significant credit risk into the system and makes large deductible coverage a solvency concern.

Between the NAIC's adoption of the 2006 study, and its call for a renewed study less than ten years later, a spate of small carrier insolvencies arising from large deductible workers' compensation programs occurred. While large national insurance carriers largely implemented strict underwriting controls and guidelines to secure full collateralization of insured employers' deductible obligations, many smaller carriers, especially those affiliated with or controlled by the owners of professional employment organizations (PEOs), did not implement such controls. PEOs add significant underwriting risk back into the pricing of large deductible coverage. A carrier offering large deductible coverage to a PEO must first consider whether the PEO has properly analyzed and anticipated claims volume that will be generated by each of its clients' business operations and properly contracted with clients to either price in, or allow for recoupment of, such claim costs. On top of that underwriting concern, the insurer must also consider the credit worthiness of the PEO itself.

Common ownership interests among PEOs, insurers and managing general agents adds a conflict of interest to the inherent underwriting and pricing challenges. Despite a recommendation in the 2006 study to curtail the formation of, or affiliation with, insurers and insurance managing general agencies by PEOs, such controls were not widely adopted by the states, and in the last decade several PEOs organized their own large deductible workers' compensation programs within their holding company systems, with less than scrupulous underwriting standards and collateralization. As a result of these arrangements and less-than-arms-length transactions, when the PEOs suffered claims, first the PEOs became insolvent, and shortly thereafter, so did their affiliated carriers.

Insurer insolvencies driven in significant part by issuance of large deductible workers' compensation policies are particularly problematic and costly to state insurance guaranty associations, and in turn, to member insurers and the insurance-buying public. Workers' compensation claims are long-tailed, often poorly documented and reported (especially when the liable employer is under common ownership as the insolvent carrier and/or third-party administrator), and guaranty associations are forced to fight to recover deductible obligations insolvent or uncooperative employers. In a minority of states, including New Jersey, statutory reforms have been implemented to ensure that deductible obligations recovered from an insured employer are used either to directly fund that employer's claim obligations to injured employees or to reimburse state guaranty associations, rather than fund the general estate of the insolvent insurer. As of 2016, only one state — Illinois — has passed legislation aimed at directly regulating collateralization of large deductible programs and limiting the size of deductibles.

The new 2016 study was commissioned after state insurance regulators began noticing a trend toward "super" large deductible workers' compensation programs — policies under which there is hardly any conceivable circumstance under which a single workers' compensation claim could exceed the insured employer's deductible obligation. Simultaneously, the National Conference of Insurance Guaranty Funds (NCIGF) has reported that five ongoing insurer insolvencies driven by large deductible programs have thus far cost guaranty association member insurers over $600 million. As a result, the 2016 study, currently in the form of an Aug. 2, 2016 draft, may eventually drive a renewed effort at the national (NAIC) level to more closely regulate large deductible programs.

The 2016 study recommends enacting legislation that would specifically define "large deductible coverage" and impose "size and financial strength requirements for insurers writing large deductible policies," "limitations on the risk employers may retain, relative to their financial capacity[,]" and "requirements for collateral." The 2016 study further recommends requiring insurers to conduct more thorough examinations of policyholders' creditworthiness, and that regulators be permitted to conduct "special examinations" of insurers writing such business and show signs of financial distress. As to guaranty association rights, the 2016 study recommends amendments to state guaranty association acts and, where necessary, workers' compensation laws to allow direct guaranty association recovery of deductible obligations from employers. Finally, the 2016 study recommends referring additional questions regarding the calculation of risk-based capital requirements for insurers writing large deductible programs to the NAIC's financial condition committee.

As of the summer 2016 NAIC national meeting, the 2016 study has been adopted by the NAIC workers' compensation task force, and the study, together with its recommendations, has been referred to the full property and casualty committee of the NAIC for consideration, debate and potentially adoption. While it is far from certain at this juncture as to what, if any, statutory and/or regulatory reforms the 2016 study will lead to, discussion and consideration of the 2016 study's recommendations will now begin at the full "letter committee" level of the NAIC. As such, insurers, employers, PEOs, third-party administrators, managing general agents, guaranty associations and receivers should carefully monitor forthcoming developments as meaningful regulatory changes in the market for large deductible workers' compensation coverage may be just over the horizon. Furthermore, as many of the stated concerns regarding large deductible coverage apply equally to other loss sensitive programs such as retrospectively-rated policies, interested persons should also be attuned to potential expansion of the focus generated by this 2016 study to include such programs.

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