Office of the Washington State Auditor
Pat McCarthy

State of Washington Workers' Compensation Funds

July 1, 2019, through June 30, 2020

December 31, 2020

This report summarizes the results of our audit of the Workers' Compensation Program financial statements. The report also summarizes an independent actuarial assessment of the loss reserves and effects of the Program's 2021 premium rate changes on the actuarial solvency of the Accident, Medical Aid and Pension Reserve funds.

We found that the financial statements for the fiscal year that ended June 30, 2020, were presented fairly. An independent actuarial firm reported that a reasonable provision had been made for unpaid and estimated claims payable liabilities. Considering the premium rates adopted for 2021, the firm reported a low probability the funds would become insolvent over the next five years.

We recommend the Department of Labor & Industries closely monitor the contingency reserves and adjust premium rates as needed to maintain the actuarial solvency of the Accident and Medical Aid funds.

Report Number: 1027538

Audit authority

The state's Workers' Compensation Program (Program), administered by the Department of Labor & Industries (Department), provides limited wage replacement and medical coverage to workers who experience job-related injuries and illness.

State law (RCW 51.44.115) requires the State Auditor's Office to annually audit and report on the financial statements of the program. The law also requires the Auditor's Office to contract with independent actuaries for actuarial assessments and opinions on three of the Program's funds: Accident, Medical Aid and Pension Reserve.

Results in brief

Our examination determined:

- The financial statements for the Program for the fiscal year that ended June 30, 2020, were fairly presented in accordance with generally accepted accounting principles.

The assessments and opinions of the independent actuaries are:

- Average combined 2021 premium rates for all funds (including the Supplemental Pension Reserve Fund) will remain unchanged from the prior year. Individually, average rates for the Accident Fund and Stay at Work Program will remain unchanged, while the Medical Aid Fund will decrease by 7.8 percent. The adopted rate changes for the Accident Fund and Medical Aid Fund (including the Stay at Work Program) result in rates that are reasonable to allow the funds to break even in 2021 on a combined basis.
- Considering the 2021 adopted rates and if the Department were to leave premium rates unchanged from 2022 through 2030, the actuarial firm calculated a 73.6 percent chance the contingency reserve will fall below zero (or become actuarially insolvent, as defined in the sidebar) in the combined Accident and Medical Aid funds over a 10-year period. Under this same scenario, the actuarial firm calculated a 10.7 percent chance the contingency reserve will fall below zero over a five-year period. The contingency reserve is the difference between a fund's total assets and its total liabilities.
- Considering the 2021 premium rates, and if the Department chooses to raise rates from 2022 through 2030 consistent with anticipated future wage inflation, the actuarial firm calculated that there is a 39.6 percent chance the contingency reserve will fall below zero in the combined Accident and Medical Aid funds over the 10-year period. Under this same scenario, the actuarial firm calculated a 7.5 percent chance the contingency reserve will fall below zero over a five-year period.

Actuarial insolvency is defined as liabilities in excess of the value of assets. It is important to note that insolvency is not necessarily a key indicator of the funds' ability to pay claims or have sufficient cash, or the Department's ability to liquidate invested assets to pay obligations over the next several years.

- Contingency reserves remained relatively unchanged during the fiscal year that ended June 30, 2020. The contingency reserves were above the Department's target levels on a combined basis. However, they were below levels benchmarked to workers' compensation funds in other states.

- To arrive at the Department's targeted contingency reserve-to-loss reserve ratio of 25 percent at the end of 10 years, the actuarial firm estimates a 4.7 percent annual increase for the Accident Fund and a 7.5 percent annual increase for the Medical Aid Fund would be needed each year from 2022 to 2030.

- The Department has made a reasonable provision in its financial statements for unpaid and estimated claims payable liabilities.

Recommendation

We recommend the Department closely monitor the contingency reserves and adjust premium rates as necessary to maintain the actuarial solvency of the Accident and Medical Aid funds.

About the Workers' Compensation funds

The Workers' Compensation Program Basic Plan consists of three funds:

- The Medical Aid Fund pays for medical care and related services, including some vocational rehabilitation and Stay at Work reimbursements.

- The Accident Fund pays non-medical claim costs such as wage replacement benefits, structured settlements, disability pensions and survivor benefits.

- The Pension Reserve Fund pays benefits to permanently disabled pensioners, including disabled employees of self-insured employers and survivors of fatally injured workers.

Four additional funds are not included in the scope of our actuarial review: Supplemental Pension, Second Injury, Self-Insured Employer Overpayment Reimbursement and the Industrial Insurance Rainy Day.

In 2011, the state significantly reformed the program. Legislation created a structured settlement option, a Stay at Work Program and a statewide medical provider network, and expanded the Centers of Occupational Health and Education, which treat injured workers. It also temporarily froze cost-of-living increases and made other changes designed to reduce the program's overall costs.

The Program bases the amount of its claims payable liabilities on estimates of the cost of claims reported but not resolved, and of unreported injuries that that will result in claims.

The Department's Director sets premium rates after considering information from the Workers' Compensation Advisory Committee, the Governor, the public, interest groups and the Department's actuaries. For calendar year 2020, the state's employers will pay an expected average hourly premium rate of $0.6401. Under state law, employers may require employees to pay a portion of the total premium.

The State Investment Board invests the money in these funds under policies and procedures designed to maximize return at a prudent level of risk. Eligible investments include U.S. equities, international equities, U.S. treasuries and government agencies, credit bonds, mortgage-backed securities, asset-backed securities, non-U.S. dollar bonds and real estate. Exhibit 1 shows investment allocation targets.

Exhibit 1 - Investment allocation targets

Fund	Fixed income	Equity	Real estate
Accident	80%	15%	5%
Medical Aid	75%	20%	5%
Pension Reserve	85%	10%	5%

Methodology

We selected the actuarial firm through competitive bidding by independent, qualified firms. The leader of the actuarial team is a member of the American Academy of Actuaries and a Fellow of the Casualty Actuarial Society and meets qualification standards for providing statements of actuarial opinion.

In addition to assessing loss reserves in three required funds, the firm also assessed the financial effect of the 2021 rate changes on these funds' actuarial solvency, considering the risks inherent with insurance and the effect of the actuarial assumptions, discount rates, reserving, retrospective rating program, refunds and individual employer rate classes, as well as the standard accounting principles used for insurance underwriting purposes.

Audit results

Financial statement opinion

We issued an unqualified opinion, concluding that the Program's financial statements for the fiscal year that ended June 30, 2020, were fairly presented in accordance with generally accepted accounting principles. You can see the financial statements at: **portal.sao.wa.gov/ReportSearch/Home/ViewReportFile?arn=1027347&isFinding=false&sp=false**

Actuarial opinion on loss reserves

The actuarial firm issued an opinion stating the reported loss and loss adjustment expense reserves are consistent with reserves computed in accordance with Standards of Practice issued by the Actuarial Standards Board. The firm concluded the reserves make a reasonable provision for all of the Program's unpaid loss and loss adjustment expense obligations.

Assessment of the 2021 rate level's financial effect

As shown in **Exhibit 2**, contingency reserves remained relatively unchanged during the fiscal year that ended June 30, 2020, and continued to exceed the Department's target levels on a combined basis. The contingency reserve is the difference between the fund's total assets and its total liabilities. It is important to maintain adequate reserves to cover unexpected losses as well as shortfalls in premium and investment income.

Exhibit 2 - Contingency reserve presented under statutory accounting principles

(Dollars in thousands)

Fiscal year ending	Accident Fund	Medical Aid Fund	Combined
June 30, 2011	$63,250	$716,119	$779,369
June 30, 2012 (restated)	$39,560	$550,579	$590,139
June 30, 2013	$202,841	$416,721	$619,562
June 30, 2014	$283,479	$666,042	$949,521
June 30, 2015 (restated)	$279,916	$941,644	$1,221,560
June 30, 2016	$489,517	$1,003,405	$1,492,922
June 30, 2017	$1,339,171	$1,632,593	$2,971,764
June 30, 2018	$1,286,621	$2,198,343	$3,484,964
June 30, 2019	$1,695,966	$2,258,310	$3,954,276
June 30, 2020	**$1,780,846**	**$2,214,087**	**$3,994,933**

The increase in contingency reserves from June 30, 2011, levels can be attributed to the following:

- Increased realized and unrealized gains from the sale of stocks and bonds
- Reforms enacted in 2011 designed to reduce the program's overall cost
- Lower levels of medical inflation and use
- Lower claim frequency and persistency than expected

Overall premium rates will remain unchanged in 2021. Unlike other states, Washington bases its premiums on hours worked rather than payroll costs. With wage inflation, other states' funds are likely to experience premium growth without rate increases. To experience similar premium growth in Washington, higher rates may be adopted to keep up with wage inflation. **Exhibit 3** shows expected average 2021 premium rates and changes from 2020.

Exhibit 3 - Rate changes from 2020 to 2021

Fund/Program	Hourly rate	Percent change
Accident Fund	$0.3235	0.0%
Medical Aid Fund	$0.1745	(7.8%)
Stay at Work Program	$0.0049	0.0%
Supplemental Pension Fund	$0.1370	12.0%
Total	**$0.6399**	**0.0%**

Future rate change scenarios

Considering the 2021 adopted rates, and if the Department were to leave premium rates unchanged from 2022 through 2030, the actuarial firm estimates the probability that the combined funds would become insolvent (contingency reserve less than zero) is low after two years but does increase significanty over time. **Exhibit 4** shows the firm's estimates.

Exhibit 4 - Probability of actuarial insolvency – No rate change

(Contingency reserve below zero)

Fund	Two years	Five years	10 years
Accident	0.3%	14.6%	51.7%
Medical Aid	0.6%	14.6%	85.6%
Combined	0.0%	10.7%	73.6%

Considering the 2021 adopted rates, and if the Department chooses to raise rates from 2022 through 2030 consistent with anticipated future wage inflation, the actuarial firm estimates a low probability that the rate changes will be insufficient to keep the combined funds solvent (contingency reserve greater than zero) after two years. However, over 10 years these rate changes likely will be insufficient to cover the historical and likely future effects of medical inflation. Annual wage inflation is estimated to be 3.0 percent in years 2022 through 2030. **Exhibit 5** shows the firm's estimates.

Exhibit 5 - Probability of actuarial insolvency – Wage inflation rate change

(Contingency reserve below zero)

Fund	Two years	Five years	10 years
Accident	0.3%	10.7%	24.6%
Medical Aid	0.5%	11.2%	65.6%
Combined	0.0%	7.5%	39.6%

The actuarial firm also calculated the projected rate changes that would be necessary to increase or decrease the contingency reserves to the Department's targeted contingency reserve-to-loss reserve ratio of 25 percent (see box at right) after 10 years. The reserve ratio for the combined funds, as of June 30, 2020, was 27.1 percent. To reach the 25 percent reserve ratio target, the actuarial firm estimates a 4.7 percent increase for the Accident Fund and a 7.5 percent increase for the Medical Aid Fund annually from 2022 to 2030 would be required. If the Department changes rates to take the contingency reserve ratio to 25 percent, the actuarial firm said, the chance of the contingency reserve falling below zero in the combined Accident and Medical Aid funds will be 5.1 percent after five years and 13.8 percent after 10 years.

Washington's reserves target ratio is lower than other states'

A survey of workers' compensation funds in other states, based on financial data filed as of December 31, 2013, found the average contingency reserve to loss reserve ratio was considerably higher than Washington's at 53 percent.

The actuarial firm stated the probability that the funds would not have sufficient cash and invested assets to pay benefits during the next 10 years is extremely low. However, it concluded that over the much longer term (20 to 30 years), it is possible that the funds would run out of cash and invested assets without appropriate rate actions. The firm based its conclusions on a number of assumptions regarding future conditions and events described in detail in its report.

The Pension Reserve Fund does not assess premiums. It is funded through contributions and transfers from the Accident Fund and self-insurers. Typically, the system fully funds each pension annuity when the liability is transferred to the Pension Reserve Fund. Because of the way the Pension Reserve Fund is financed, its solvency is guaranteed as long as the Accident Fund and the self-insurance program remain solvent.

The actuarial firm also calculated a range of reasonable rate changes that would be required for the funds to **break even in 2021. At the break-even level, the estimated revenues would equal the expected cost of claims and administrative expenses less investment returns that occur during the year.

Break even is defined as the point at which zero profits are expected to be generated in calendar year 2019 and the fund's contingency reserves remain unchanged.

Within this range, the firm's best estimate of the rate changes required to break even are a rate decrease of 1.4 percent for the Accident Fund, a rate increase of 1.9 percent for the Medical Aid Fund and a rate decrease of 0.1 percent for the Accident and Medical Aid funds (including the Stay at Work Program) combined.

The Department actually adopted no rate change for the Accident Fund, a 7.8 percent rate decrease for the Medical Aid Fund and a 2.9 percent rate decrease for the funds combined (including the Stay at Work Program and excluding the Supplemental Pension Fund). These rate changes were reasonable to allow the funds to break even in 2021.

About the State Auditor's Office

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

We work with our audit clients and citizens to achieve our vision of government that works for citizens, by helping governments work better, cost less, deliver higher value, and earn greater public trust.

In fulfilling our mission to hold state and local governments accountable for the use of public resources, we also hold ourselves accountable by continually improving our audit quality and operational efficiency and developing highly engaged and committed employees.

As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments as well as fraud, state whistleblower and citizen hotline investigations.

The results of our work are widely distributed through a variety of reports, which are available on our website and through our free, electronic subscription service.

We take our role as partners in accountability seriously, and provide training and technical assistance to governments, and have an extensive quality assurance program.

Stay connected at sao.wa.gov

- **Find your audit team**
- **Request public records**
- Search BARS manuals (**GAAP** and **cash**), and find **reporting templates**
- Learn about our **training workshops** and **on-demand videos**
- Discover **which governments serve you** — enter an address on our map
- Explore public financial data with the **Financial Intelligence Tool**

Other ways to stay in touch

- **Main telephone:** (564) 999-0950
- **Toll-free Citizen Hotline:** (866) 902-3900
- **Email:** **webmaster@sao.wa.gov**