

EXAM 6 – UNITED STATES, FALL 2012

11. (3 points)

Three models for government involvement in workers' compensation state funds are:

- Competitive state funds
- Partner with private insurers
- Exclusive state funds

Select the most economically efficient model. Fully justify the selection, including a comparison of the following three characteristics for each model: profitability, expense load and availability of coverage.

CONTINUED ON NEXT PAGE

11) Sample Answer

Answer 1

- Competitive state funds:
 - Profitability – in order to ensure affordability of WC insurance to the public, the government might need to lower its price to compete with private insurer. Hence, the government will not earn much profit in this model.
 - Expense load – lower for government as compared to private insurers. Government can save costs from marketing and commissions.
 - Availability – affordable WC insurance will be available to employers.
- Partner with private insurers:
 - Profitability – government is not likely to gain any profits. It will subsidize the private insurers so they can charge equitable rates while earning normal level of profit.
 - Expense load – will be the same for private insurers as they still need to market and pay commissions.
 - Availability – with assistance from government, it enhances the availability of WC insurance.
- Exclusive state funds:
 - Profitability – government will have lower rates in order to enhance affordability to all. Hence, profit load will not be the main concern of the government, hence likely to be lower.
 - Expense load – expense savings from marketing and commissions
 - Availability – it will always be available since it is provided by the government.
- Therefore the most economically efficient model is competitive state funds because:
 - Despite reduction in profitability, private insurers can still offer the coverage with some profit load with the competition from the government
 - Expense savings for the government competitive funds
 - Affordable insurance with great availability

Answer 2

- Exclusive state funds are the most economically efficient. They do not have to spend money on advertising or most other acquisition costs like private companies would if they had to compete w/private insurers. Partnerships with the insurers would still have the expense of the administration of the relationship w/private insurers. While in all three models the state fund wouldn't have to worry about earning a profit (or loading rates w/a profit load), if partnering w/private insurers or being in competition w/them they would have to worry about adverse selection hurting profitability since private companies might "cherry-pick" the low risk insured leaving the state fund with only poor/high-risk policies. An exclusive state fund would insure all policies including both the high and the low risk exposures.
- While all three models would help ensure availability of coverage, the exclusive state fund would be the most stable because with the other two models the availability can still be impacted by private insurers loosening or tightening underwriting or possibly deciding to exit the market.

Answer 3

- Competitive state funds – decrease expense load due to lack of commissions, availability in public and private sector, profitability may decline if private insurers marketing strategies attract all the lower risks therefore state fund may retain more of the high risks.
- Partner w/private insurers – likely increased expense load due to having to pay commission, admin or agent fees to insurers. Can also decrease profitability since shared and increased expenses, however, a more actuarially sound price can be charged due to no need to compete. Availability is achieved.
- Exclusive state funds – this would be the most economically efficient model. Decreased expenses due to no marketing commissions or agents fees. Greater profitability since adverse selection does not exist as in a competitive market and state can make available so availability is achieved.

Answer 4

- Profitability
 - Competitive fund – may have highest profitability since under competition, the rate can fully affect the risk.
 - Partner – may have lower profitability than “competitive fund” since private insurers normally accept good risk but not bad risk, while the rate can generally reflect the risk.
 - Exclusive state fund – may have the lowest profitability since it achieves social equity more than actuarial equity, so the rate cannot reflect the risk fully.
- Expense load
 - Exclusive state fund – may have lowest expense load since no commission and other acquisition expense is needed.
 - Partner – may have higher expense than exclusive state fund since it needs resources to coordinate with private insurer to obtain business
 - Competitive fund – may have highest expense load since it has to obtain business with competitive insurers.
- Availability of coverage
 - Exclusive state fund – have the broadest availability since everyone can only obtain insurance from it.
 - Partner – have narrower availability since private insurer normally would not share the insurance of good risk.
 - Competitive fund – have narrowest availability since only bad risk will obtain insurance from it as no private insurer is willing to offer coverage.
- The most economically efficient model will be “partner with private insurer” since:
 - While the profitability may be highest it allows competition of private insurer on good risk, while also allowed bad risk to obtain coverage.
 - While the expense is not the lowest it achieves social equity
 - While the availability of coverage is not the broadest, in terms of the whole society, most risks could obtain insurance.

Examiner’s Report

Common themes for candidates to consider:

- Ensure that you’re answering the entire question. The question asks that the candidate include a comparison for each model. For example, some candidates selected a model and

justified their selection but did not include a comparison for each model. They only included characteristics for their selection, not a comparison against the two models that they did not select.

- Directly answer the question. Some candidates described the circumstances under which each model may be put in place, rather than selecting the most economically efficient model and describing/comparing its characteristics.
- Fully justify. In making a comparison, the candidate needs to explain why something may be the case. For example, simply stating that the expense load for an Exclusive state fund is lower than that for a Competitive state fund does not explain why that may be true. A more complete response would be that the expense load for an Exclusive state fund may be lower than a Competitive state fund since the Exclusive may have lower acquisition expenses (less/no commission and marketing).
- Best government model. Some candidates elected to describe why the private market was more efficient than the government. While one could argue whether that is true or not, this is not what is being asked in the question. The question asked the student to select the most economically efficient model for the three different models for the government's involvement in a workers' compensation state fund, not to compare the efficiency of a government state fund to that of a private insurer or the private insurance market.