

## WORKERS COMPENSATION MARKET OUTLOOK—2009

AT OUR *ANNUAL ISSUES SYMPOSIUM* IN MAY 2008, NCCI DELIVERED A CAUTIOUSLY OPTIMISTIC OUTLOOK FOR THE WORKERS COMPENSATION INDUSTRY.

BUT LOOKING BACK AT ECONOMIC FORECASTS AND NUMBERS PRESENTED IN THE SPRING OF LAST YEAR CAN BE SOBERING—THE ENTIRE US ECONOMY HAS SINCE DESCENDED INTO THE WORST RECESSION SINCE WORLD WAR II.



By Stephen J. Klingel, CPCU  
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The numbers of layoffs and profit warnings from major national firms continues to grow almost daily. And our new President has warned the country that no quick economic fixes are in the offing.

In expressing cautious optimism for the line last spring, NCCI anticipated:

- A second straight year of underwriting profits for the line
- Generally lower bureau loss costs and rate filings across the country
- A continuing favorable claims frequency trend

However, we also called for a cautionary long-term outlook due to uncertainties that continued to face the business.

Among the uncertainties cited by NCCI:


- Medical increases placing upward pressure on costs
- Low investment yields putting pressure on insurers' ability to earn an adequate return on capital

- A fluid political landscape in many states and at the federal level that put additional pressure on regulation and reforms
- The current underwriting cycle moving past its cyclical peak

So how did the NCCI prognosis for workers compensation hold up, given the subsequent development of a severe recession?

While metrics that we offered such as premium volume, the loss ratio, and the dividend ratio did not materially change, final underwriting results were not as positive as previously anticipated. And, importantly, NCCI is seeing that early projections for full year 2008 results indicate continued weakening.

The 2007 (latest full year) preliminary estimates for workers compensation industry premium volume that NCCI delivered in May were right on target.



Final workers compensation industry premium results were \$37.6 billion for private carriers, representing a 2.9% decline in premium from 2006 for private carriers. And early projections of 2008 premiums for private carriers show a continued decline in premium levels—on the order of 10%.

The final 2007 calendar year combined ratio for the workers compensation industry was 100.7%. The components of the final 2007 combined ratio were:

- Loss ratio: 60.1%
- Loss adjustment expense ratio: 14.6%
- Underwriting expense ratio: 24.6%
- Dividend ratio: 1.5%

With the exception of the expense ratio, all of these metrics were as expected.

Looking forward to preliminary indications for 2008, NCCI is seeing additional pressure (from decreasing premium and increasing losses) on the loss ratio and a subsequent deterioration of roughly 3 percentage points.

As noted above, final 2007 underwriting results showed a slight underwriting loss rather than the modest underwriting gain that NCCI originally projected. The deterioration in the combined ratio—from the 99.0% preliminary estimate to a 100.7% final result—was due almost entirely to the underwriting expense component, which moved from a preliminary estimate of 23.0% to a final result of 24.6%. This final result in the underwriting expense ratio represents a 5-point increase over the 2006 underwriting expense ratio of 19.6%.

While the expense ratio increase seems particularly sharp, it's important to note that the expense ratio for 2006 was depressed due to an isolated large reinsurance transaction. (The expense ratio for 2005 was 22.3 points, with similar numbers for 2003 and 2004.) As such, a

two-year decline of 2.3 points seems in line with expectations.

Although 2007 private carrier volume is comparable to 2005, it is composed of more risks written at lower prices.

The final 2007 investment gain ratio (investment gain on insurance transactions as a ratio to earned premiums) was 12.7% versus a preliminary indication of 12%. This result was 2.7 percentage points higher than in 2006 and represents an increase from recent historical levels, which hovered between 10% and 11%.

The upward revision in the investment gain ratio for 2007 helped offset the underwriting result and provided a final pretax operating gain of 12%. That result was 1 percentage point less than the preliminary indication, but remains at or near NCCI's estimate of the industry's cost of capital for one more year. Here again, however, the economic conditions of the financial markets point toward weaker investment gains and greater pressure on underwriting results for 2008.

NCCI is tracking changing market conditions in light of a difficult economic environment. We will deliver more up-to-date market results at our **Annual Issues Symposium** this May.

In the meantime, in this **Issues Report**, NCCI Chief Economist Harry Shuford comments on the historic impact that recessions have had on workers compensation insurance in his article, "What Does Recession Mean for Workers Compensation?"

And Insurance Information Institute (I.I.I.) President Dr. Robert Hartwig offers his observations and reflections on the broader property/casualty market as well as specific workers compensation predictions for the months ahead in the article, "Financial Crisis and the Future

of Workers Compensation: 2009 and Beyond."

## 2008 RESIDUAL MARKET RESULTS

One positive market development that NCCI did witness in 2008 was a continued decline in the residual market population and stable operating results.

Through 2008, the number of employers applying for coverage in the residual markets managed by NCCI declined by 18%, and newly assigned market premium declined by 23%. This marks the fourth straight year of declining applications. Because of fewer applications for coverage, the residual market has declined as a percentage of the overall workers compensation market to about 5%—indicating a competitive workers compensation voluntary market.

In addition, 2007 residual market operating results remained stable. The operating losses are less than 1% of the voluntary workers compensation premium.

The majority of NCCI-managed residual market states are at or near a self-funded status. However, New Jersey, Georgia, Virginia, North Carolina, and Illinois continue to generate significant deficits. While NCCI is pleased with these overall results, we continue to work in those states with significant deficits in order to achieve a self-funded residual market in *all* states.

Finally, NCCI was very pleased to have been appointed as the West Virginia residual market plan administrator. The appropriate residual market rates, rules, and forms have been filed and approved in the state. And internal process and system changes were made at NCCI in order to provide residual market services in West Virginia beginning in 2009. The residual market is now fully functional in West Virginia.

## CLAIM FREQUENCY DECLINE CONTINUES

For several years, NCCI has reported on a continuing decline in claims frequency. Our research indicates that the long-term decline is likely a long-term phenomenon related to improved technology and competitive market forces working together to create ever safer workplaces over time.

Based on a preliminary analysis of the most recent complete data in NCCI states, the frequency of lost-time claims declined 2.5% in 2007. This is a significant tempering of the near 7% declines for the prior two years, and much closer to the historic average of a 3–4% decline per year.

In this time of financial distress and significant market changes, some have speculated that the economic slowdown could produce an increase in frequency as more workers lose their jobs. In fact, NCCI's research has shown that, for each of the last four recessions, frequency declines have continued and may have even accelerated somewhat.

NCCI will continue to analyze and closely monitor the frequency change to make sure that we detect and report on any changes in the recent pattern of claims frequency decline.

## MEDICAL COSTS REMAIN A SIGNIFICANT CONCERN

In the most recent complete data (2007), medical costs again grew faster than wages, though the increases seemed to have tempered a bit. In fact, medical costs comprise 59% of total losses in NCCI states, with many states in the 65%–70% range.

The increased interest in medical benefits and costs is creating demand for ever more data to analyze medical cost drivers, with many states seeking ways to control medical costs in their workers compensation systems.

To meet that demand, NCCI has developed a new data Call for detailed medical transactions. This Call will allow NCCI to continue to provide the highest quality evaluations of system reform proposals and legislation.

Since announcing work on the new Medical Data Call, NCCI has released a number of resources designed to assist data providers with their planning efforts. These include our MED circular series, **Medical Data Call Reporting Guidebook**, and Medical Call Web section. I encourage you to click Medical Data Call at [ncci.com](http://ncci.com) to view complete background, updates, and communications regarding this important industry effort.

## A CHANGING POLITICAL LANDSCAPE

In addition to the historic presidential election of 2008, NCCI has witnessed several years of political change in state legislatures across the country. And looking forward to the 2009 state legislative sessions, we anticipate another active year for workers compensation.

A series of state legislative initiatives are expected to drive the agenda in the coming months. These include proposed benefit increases and workers compensation task force recommendations on independent contractors and employee misclassification.

Peter Burton, NCCI's senior division executive for state relations, offers a detailed outlook on these and other anticipated state activities in his article, "2009 Legislative and Regulatory Outlook" in this edition of **Issues Report**.

In terms of anticipated federal activities, economic recovery and increased federal regulation of the financial industry appear to be first priorities. What those increased regulations will mean to the insurance industry—and workers compensation insurance in particular—re-

mains a matter of some debate. In the coming months, NCCI will continue to work with state and federal lawmakers to educate them on the implications and unintended consequences of any and all new proposals.

## WHAT'S AHEAD?

Looking back, the workers compensation insurance industry had a solid year of financial performance in 2007, with all major financial performance measures continuing to perform well. Calendar year underwriting results continued to show an underwriting gain for a second consecutive year, and accident year combined ratios, although increasing, remained at near record low levels. Finally, the bottom line financial results after investment income and federal income taxes were only at or near historical averages due to an environment of low interest rates and significant federal income taxes.

Positive trends we've observed from the past several months include:

- Frequency continues to decline
- Reserves appear adequate
- Residual markets are depopulating in most states
- The Federal Terrorism Risk Insurance Program was renewed for seven years

Among continuing areas of concern are:

- Economic recession
- Medical costs
- State and federal reform challenges
- Low investment returns
- Underwriting cycle

(In addition to the above trends, author Bill Thorness offers a broad review of emerging industry issues in his **Issues Report** article, "Vectors of Change: Charting Today's Complex Industry Concerns.")

In the months ahead, NCCI will continue to collaborate with all market stakeholders to meet the challenges that the cur-

rent difficult economy poses. We will ensure that rates and loss costs are adequate, provide unbiased quantification of the impacts of legislative reform proposals, and strive for self-funded residual markets.

In addition, we will continue to produce pertinent and timely research to help stakeholders understand current and emerging trends impacting workers compensation.

These objectives will help to maintain a healthy workers compensation insurance market that is able to deliver promised benefits to the injured worker quickly, fairly, and efficiently, and provide the proper incentives to create the safest possible workplaces.

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*Stephen J. Klingel, CPCU, was appointed president and chief executive officer of NCCI Holdings, Inc., in 2002. Before joining NCCI, Mr. Klingel was a leader with the St. Paul Companies for more than 25 years. Most recently, he served as senior vice president—commercial lines, responsible for managing \$1.1 billion in premium. Also at St. Paul, he served as regional president and president of personal insurance.*