Precarious Market Outlook Prevails

By Stephen J. Klingel, CPCU • President and CEO
NCCI Holdings, Inc.

In May of 2010, NCCI defined the state of the workers compensation market as "precarious." The uncertainty implied in that outlook was based on two factors: the lingering effects of a deep economic recession and concerns caused by significant changes in the regulatory environment.

It is now close to a year later and, given the latest numbers, we find little reason to change our opinion that the market remains in a precarious position, at least in the near term. However, as we continue to collect full-year 2010 data, we may adjust that outlook going forward—either positively or negatively.

In the following, we expand on the reasons for our continuing unease regarding market conditions and offer some context and examination of the forces shaping today's market.

Broad Property/Casualty Market Remains Stable

Our outlook for the workers compensation industry may seem incongruous given the much more positive condition of the broader property/casualty (P/C) insurance industry. In fact, for several months, industry headlines and financial reports have noted that the P/C insurance industry largely out-performed other sectors of the economy during the economic downturn.

Property/casualty insurers' net income after taxes was more than $16 billion in 2009, largely due to a lack of major disasters or catastrophes; this despite the fact that cumulative net written premium was down for the third consecutive year. And results for the period ending September 30, 2010 indicate a material increase in net income, largely due to realized capital gains. These latest results also indicate a marginal increase in net written premium over the same period from the prior year.

Added to this, the P/C combined ratio remains near 100. That combined ratio showed only a slight upward movement for the period ending September 30, 2010, resulting from favorable prior-year loss development and increased catastrophe-related losses. In December, the Insurance Information Institute noted in their annual outlook report on the market that the industry has recovered 100% of the capital lost during the fiscal crisis, and the financial strength and ratings of most insurers remain strong.[1]

In short, the overall P/C industry appears to have weathered the financial storm of the last 18 months remarkably well. It is financially stable and ready to meet the needs of its customers and the recovering economy.

But Workers Compensation Results Not as Favorable

Given the positive P/C environment, even some workers compensation insurers posted profits. But on further scrutiny, the workers compensation line has shown significant deterioration overall.

[1] "After the Crisis: The Future of the P/C Insurance Industry," Robert P. Hartwig, PhD, CPCU, president and economist, Insurance Information Institute, December 7, 2010.

As we first reported last year, after very minor underwriting losses in 2007 and 2008, the combined ratio for workers compensation (private carriers) shot up 9 points in 2009—the largest single year increase since the mid-1980s. In fact, the line was one of only two of the major lines (along with general liability) that had an increase in combined ratio for 2009.

Deteriorating underwriting results, combined with a record low interest rate environment, left the line in an only slightly-better-than-break-even position after investment income is considered. And once again, the calendar year net written premium declined precipitously in 2009 for both private carriers and the state funds.

The recessionary impact, particularly on manufacturing and contracting, along with price decreases, took its toll on industry premium. In all, industry net written premium declined 23% over two years!

Countrywide frequency declines persisted in 2009, continuing the long trend downward and becoming somewhat more negative as the recession deepened. Not surprisingly, workers compensation insurance prices also continued their declines in 2009 in most jurisdictions.

In addition to the decline in premium volume, an increased combined ratio, and falling prices, we have continued uncertainty regarding the national healthcare reform law.

To date, the only direct impact on workers compensation has been a change to the Federal Coal Mine Black Lung program that liberalized criteria for qualifying for claimant benefits and survivor benefits. However, the law offers a major reorganization of the healthcare industry. It will increase the number of people with insurance. It will also impose several new taxes and regulations on the healthcare system, which could have implications for workers compensation insurance. (With a new Republican majority in the House and a stronger minority in the Senate—who have promised to repeal or reform healthcare—the issue of potential impact remains uncertain as we enter 2011.)

Right now, NCCI is compiling and examining industry results and economic data from 2010, and we will report on those numbers at our May ***Annual Issues Symposium (AIS)*** in Orlando. Updates and new market research are also posted on **ncci.com** throughout the year.

The Economic Outlook

The workers compensation industry's underwriting performance is tied directly to the labor markets and indirectly to the financial markets. Given that, it is not surprising that the outlook for 2010 was not favorable, or that things appear to be only slightly more positive for 2011. During the recent recession, the collapse in private sector wages and salaries accounted for a material portion of the 23% decline in workers compensation written premium.

It is important to note that more than 40% of workers compensation premium is generated by manufacturing and contracting, even though only about 20% of the workers are employed in those industry groups. And the recession hit the manufacturing and construction sectors much harder than it hit other professions, causing a greater decline in premium. NCCI estimates that this industry group's impact caused a 4%–6% decline in workers compensation premium by itself.

Another impact that NCCI has previously reported on is the impact of the business cycle on smaller firms versus larger firms. Our research indicates that in recessions, smaller firms tend to have greater decreases than larger firms in employees and payroll. Small firms buy workers compensation policies that tend to be full coverage (i.e., no deductibles) and, therefore, generate more workers compensation premium per employee than larger firms.

Larger businesses tend to be self-insured or buy workers compensation policies with large deductibles. Therefore, drops in employment in smaller firms have a disproportionate impact on workers compensation premium. We estimate that this effect caused premium to drop an additional 4%–6% over the last two years.

The good news on this last point is that the converse also seems to be true. As the economy continues to expand, smaller firms will add more employees, proportionally, than larger firms—generating a bigger boost to workers compensation premium.

Another optimistic signal is that during the first half of 2010, employment and payrolls stabilized with some limited increases, especially in the high premium manufacturing sector. And there were preliminary signs that the fall in workers compensation premium may have slowed by the third quarter of 2010. However, employment in construction, the other high premium sector, continued to stagnate.

Unfortunately, the outlook for a strong recovery in the labor market during 2011 remains guarded. This continues to be a "jobless recovery." As such, the ongoing economic recovery is unlikely to generate a strong rebound in workers comp standard premium in the near future.

On the positive side, the period of rapid declines appears to be behind us. Our preliminary 2010 premium forecast (countrywide, private carrier) is indicating another premium decline, but not nearly of the same magnitude as in recent years.

This edition of ***Issues Report*** features two detailed analyses of the economy's impact on the workers compensation industry. Dr. Robert P. Hartwig, president and economist with the Insurance Information Institute, offers a review of the opportunities and challenges ahead in his article, "The Road to Recovery: The Workers Compensation Insurance Industry in the Aftermath of the Great Recession." And NCCI Chief Economist Harry Shuford details his forecast for the economy and the workers compensation industry in "Will There Be a Recovery in Workers Compensation in 2011?"

Significant Market Touchstones

A broad overview of workers compensation market conditions reveals a number of significant market indicators worth noting. These include:

Investment Returns

The investment gains associated with workers compensation insurance transactions increased a bit during 2009, to 11.8%. The ratio has been hovering between 10% and 12% for the last several years and is dramatically lower than it was from 1997–2000, when it was around 20%. (At that time, interest rates were higher and the stock market was booming.)

Combining the underwriting loss with the investment gains, the result is a pre-tax operating gain of 1.6%. This operating result is significantly below the industry's long-term cost of capital, and is the worst result since the 0.9% gain of 2003. Clearly, with investment returns at current levels, any significant underwriting loss will lead to an unsatisfactory bottom-line result.

This level of return underlines our conclusion that the market continues to reside in a "precarious" position.

Indemnity and Medical Average Claim Costs

NCCI estimates that the average workers compensation indemnity claim cost increased by 0.8% in 2009. This compares to an increase between 2% and 5% in prior recent years (which is generally in line with the wage growth in these years). As noted earlier, the poor economy has hit the manufacturing and contracting sectors particularly hard. These sectors also tend to have proportionately more of the larger claims than other sectors. The dramatic decline in manufacturing and contracting economic activity is the likely reason for the small indemnity increase.

In 2009, medical average claim costs per lost-time claim continued to increase, although the increases have tempered a bit for the last several years. NCCI estimates that the average medical claim costs per lost-time claim increased by 5.4%. For the most recent two accident years, the average medical claim costs per lost-time claim have increased by less than 5.5%—a far cry from the double-digit rates we were seeing just a few years ago.

NCCI research indicates that some of the reasons for the tempering of the medical cost increases include a flattening in the number of treatments per claim and a leveling of prescription drug prices in recent years. Both of these impacts are likely related to the continued focus on medical cost control on the part of public policy makers and carriers.

Claim Frequency Continues to Decline

Last May, NCCI reported that, based on our preliminary analysis of data in NCCI states, the frequency of lost-time claims per 100,000 workers declined an estimated 4% in 2009. With more complete data in hand, we're now reporting a full-year decrease of 5.5%.

Over the past few years, our research has shown that economic slowdowns put additional downward pressure on claim frequency. And workers compensation claim frequencies have declined in the last four economic downturns.

More recently, some market stakeholders have offered their experience that claims frequency may either not be declining, or may be declining at a slower pace. We will be awaiting and reporting on the countrywide 2010 data to see if, in fact, this recession is any different for most stakeholders.

Residual Markets Continue to Shrink

The workers compensation residual markets managed by NCCI continued to depopulate for the sixth year in a row. This decline in business is driven by several factors including the economic recession, competitive insurance markets, and NCCI's own depopulation efforts.

While the decline in residual market business continues, the rate of change slowed in 2010. As of the third quarter of 2010, residual market policies in force were down 11%, compared to a 20% decline for the same period in 2009.

Fortunately, the market has maintained stable operating results even during the decline in business by focusing on rate adequacy, effective rating plans, expense controls, and effective performance standards. As of the latest valuation, residual market losses have been held to 0.8% of voluntary premium. Essentially, the residual markets are self-funded in all but a few states where incurred losses and expenses are above written premium.

Federal Initiatives Continue to Create Uncertainty

The insurance industry (and likely every other American industry) continues to closely monitor developments at the federal level regarding new laws and proposed regulations or regulatory bodies.

Given the dramatic election results of 2010, some believe that we should expect fewer federal initiatives in 2011, while others point to significant new developments that bear watching.

Among the latter are the new leaders in the House of Representatives, the continued development of the Federal Insurance Office, and uncertainty about how the Office of Health and Human Services (HHS) will administer new rules and guidelines.

Other items of industry interest on the agenda for the President and Congress in 2011 include Medicare reporting requirements and review procedures; the continued development of financial regulatory reform; and Republicans' efforts to reform or repeal the national healthcare law.

These initiatives, and others, are discussed more fully in the article "Workers Comp and Congress: A Look at the Possible Ramifications of the 111th Congress and a View to the 112th" in this ***Issues Report***.

State Landscape Shifts

Just as at the federal level, the 2010 election season saw tremendous change in elected offices at the state level across the country. Republicans were the clear winners in terms of gaining elected office, with a net gain of six governorships and over 680 seats in state legislatures.

It remains to be seen what effect this will have on the workers compensation industry. We have already witnessed significant changes in the offices of insurance regulators, with more changes expected in 2011. Further, the high numbers of newly elected or appointed state officials, who are now in a position to make decisions about workers compensation rules and regulations, will require additional informational and educational assistance from all stakeholders, including NCCI.

In terms of legislation, the last two years have been relatively quiet for workers compensation insurance in most states, largely due to the attention required by an ailing economy.

Although a few states continued to examine privatization of state funds in 2010, only Arizona took action toward transitioning their state fund to a private market entity. In those states that did enact workers compensation legislation, changes were minimal and focused on increasing burial expenses, medical fee schedules, and continued study of the misclassification of employees as independent contractors. Looking forward to 2011, NCCI is anticipating a more active year, with new reforms proposed in states such as Illinois, Kansas, Maine, Montana, and Oklahoma.

A full review of 2010 state activities regarding workers compensation regulation—and a look forward to 2011 initiatives—can be found in the article "2011 Legislative and Regulatory Outlook" in this ***Issues Report***.

Precarious Outlook Remains Intact . . . for Now

Given the state of the market and the broader economy, we see little reason to change our view that the workers compensation market is in a "precarious" position. The line certainly continues to face significant challenges, ranging from poor results to growing medical costs. Those challenges include:

- Low investment returns and the resulting pressure on underwriting results
- Potential reform erosion at the state level
- Uncertain impacts from the Congressional majority shift
- Unknown scope of future federal actions in the regulatory arena
- Underwriting cycle

On the more optimistic side, some positive market indicators include:

- The industry's capital position
- Moderate claim severity increases
- The economy's continuing recovery
- Continuing residual market depopulation

NCCI's Continuing Priorities

As always, NCCI takes very seriously our obligation to understand and respond to the economic circumstances of our stakeholders. In the current environment, the best way NCCI can continue to support the industry is through the quality of our information, the insight of our research, and the flexibility and responsiveness of our services.

The workers compensation industry has worked through down cycles before, and we will surely work through this one as well. We join with other system stakeholders in hoping that the economy will continue to build steam and, eventually, grow more jobs in the months to come.

In the meantime, NCCI stands ready to provide the type of objective, dependable analysis and critical market services that industry stakeholders have come to expect from us for nearly 100 years.

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.