Workers Compensation Market Snapshot

by Stephen J. Klingel, CPCU
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During 2005, NCCI reported on many positive improvements in the workers compensation market … along with some serious issues facing our industry.

On the positive side, the 2004 workers compensation calendar year combined ratio dropped four points to 105%—the best performance in the line since 1997. And the accident year combined ratio dropped to 94%—a continuation of a downward progression that began nearly a decade ago.

Reforms adopted in California, Florida, and Tennessee also lent support to an improving environment in 2005, and encouraging results are starting to emerge in these and other reform-minded states.

Despite the positive trends, however, a number of significant issues remain on the market landscape. For example, medical costs continue to rise unabated. Federal actions on asbestos and regulatory reform have yet to be resolved (although a critical TRIA [Terrorism Risk Insurance Act of 2002] extension did pass). And while states continue to adopt individual reform efforts, the long-term results remain uncertain.

The following offers an overview of broad concerns affecting the workers compensation and property/casualty insurance markets as we enter 2006.

Workers Compensation Results

Late October results reported by A.M. Best support the 2004 NCCI preliminary estimates delivered at NCCI's ***Annual Issues Symposium (AIS)*** in May 2005. As noted above, NCCI estimated an industrywide 2004 calendar year combined ratio of 105 for private carriers. A.M. Best is currently reporting a 2004 combined ratio of 107, based on actual data reported. The two-point difference was almost completely due to a variance in the underwriting expense component.

Both NCCI and A.M. Best have projected a pretax operating gain ratio of 5%. NCCI's preliminary estimate of 10% for the investment gain ratio was two points less than A.M. Best's current result, thereby offsetting the difference in the combined ratio to achieve the 5% pretax operating gain result.

NCCI has also evaluated data reported through Third Quarter 2005. Based on this preliminary information, our analysis suggests a continued decline (improvement) in the combined ratio and a modest increase in premium volume over 2004 levels. Current projections are indicating a combined ratio of 101 for 2005, which would be a five-point improvement over 2004. Following the near 11.5% premium growth in 2004, private carrier premium volume for 2005 appears to have moderated from its previous level and is expected to grow 4% to nearly $36 billion for 2005.

The most current data available for the residual markets confirms the levels and performance reported at ***AIS*** for 2004, which showed an uptick in premium volume, market share, and the combined ratio ($1.5 billion, 13%, and 116, respectively). Through mid-2005, it appears that performance in the residual markets for 2005 is not likely to be materially different from 2004. (For more information concerning the residual markets, see the accompanying sidebar, "The Latest on Residual Market Activity.")

NCCI will continue to review new data and update projections as it becomes appropriate. Be sure to check the **Research and Outlook** section of **ncci.com** for updated results, research, and discussions of key factors affecting workers compensation.

Loss Cost Adequacy and Reform

Several states saw active loss cost adequacy and reform efforts during 2005, including:

South Carolina

In June, NCCI recommended a 33% average rate increase for the South Carolina workers compensation market. A few weeks later, the South Carolina Second Injury Fund reported that workers compensation insurers and self-insured employers would see assessments rise by 38%. In response, Governor Mark Sanford convened a special workers compensation panel to recommend cost-saving improvements for the market. The panel recommended changes in mid-December, such as dissolving the Second Injury Fund, restricting repetitive injury claims, and tightening disability definitions. The Governor's spokesperson said that the Governor will review the report's contents and is interested in "enacting some reform that will have some immediate impact on rates."

Florida

In 2003, Florida passed sweeping workers compensation reform legislation. As a result, the state saw consecutive rate reductions of 14% (2003), 5.2% (2005), and 13.5% (2006). NCCI filed for a 7.2% rate reduction in 2006. The combined total reduction is 29.5%.

Missouri

Workers compensation reform legislation modified the definition of an accident to include primarily events where work is the "prevailing" factor. Changes also gave greater emphasis to readily identifiable ailments while still allowing for repetitive-trauma claims. The bill reduces compensation benefits if an injured worker violated safety rules or used drugs or alcohol at the time an accident occurred, or if the worker is receiving unemployment compensation.

Texas

Texas recently adopted workers compensation reforms to allow employers and insurers to direct employees into new physician networks. The reforms also call for the adoption of treatment guidelines and allow participating doctors to independently negotiate their fees. Previously, a state commission set the fees paid to doctors treating injured workers. In addition to these reforms, the Texas Workers' Compensation Commission (TWCC) was abolished and has been replaced by a Division of Workers' Compensation.

Hawaii*

Due to a conflict between the governor and the legislature, Hawaiian lawmakers failed to pass a reform package requiring doctors who treat injured workers to adhere to evidence-based treatment guidelines established by the American College of Occupational and Environmental Medicine.

Nebraska

A new reform law allows insurers to "file and use" workers compensation rates, and increase or decrease rates by a wide margin. Legislative Bill 119 is intended to increase competition in the state's workers compensation and personal lines market. Under the legislation, the state adopts a "file and use" regulatory approval system for workers compensation rates, replacing a "prior approval" system. In addition, the measure allows insurers the option of increasing or decreasing filed workers compensation rates by up to 40%. Insurance regulators hope that the new pricing flexibility will encourage more insurers to write workers compensation coverage in the voluntary market.

Oklahoma

Like Nebraska, Oklahoma adopted a "file and use" system in their workers compensation market. Oklahoma Governor Brad Henry signed workers compensation reform legislation that is expected to save employers $108 million annually. The wide-ranging legislation allows self-insured employers and insurers to choose doctors for injured employees, discourages claimant attorney participation by restricting their fees, and eliminates "dueling doctor" scenarios in claim disputes by allowing workers compensation judges to appoint independent doctors to evaluate injured employees.

North Carolina

North Carolina expanded employers' ability to access employee medical records. H.B. 99 makes it harder for employees to collect benefits in cases where they are injured in accidents caused while they are impaired by drugs or alcohol.

Illinois

Illinois Governor Rod Blagojevich signed workers compensation reform legislation to fight fraud, increase benefits, and reduce business costs. The new law calls for establishing a state workers compensation fraud unit and strengthens fines for fraud. It also creates a work-stop order for employers who fail to obtain insurance. The law also calls for implementing a medical fee schedule indexed to the Consumer Price Index. Industry advocates disputed the Governor's projected savings from some of the reform initiatives.

Several states are also planning to initiate or complete workers compensation reforms and changes in 2006 legislative sessions. For more information on those efforts, please see the "2006 Legislative and Regulatory Outlook" article in this ***Issues Report.***

Medical Costs Continue to Rise

In its annual Health Care Cost Survey for 2006, Towers Perrin reported that US companies are facing an 8% increase in their healthcare costs. The survey covers more than 200 of the largest US employers. Towers Perrin called the rising healthcare costs a crisis, noting that "the health care crisis has clearly become a chronic and persistent challenge for employers and employees alike."

For 2006, employers expect average healthcare spending per employee to climb again, representing a 140% increase over the last 10 years. Compared with five years ago, Towers Perrin reports that the employee share of healthcare costs is up 64%, while the employer share is up 78%.

In our May discussion of workers compensation challenges, we reported that medical costs made up 57% of total losses in NCCI states. Workers compensation medical costs continued to grow at double-digit rates in 2004, rising 10.5% over 2003 levels. Without the benefit of continuing declines in claim frequency (reported below), rising medical costs would be putting significant additional pressure on workers compensation prices and results.

To help control rising medical costs, more and more states (as well as employers working directly with their insurers) are acting to control growth in employee healthcare costs—aggressively managing vendor selection and performance, and controlling prescription drug expenditures though generics, care management initiatives, and employee communication and engagement.

The issue of medical cost inflation continues to be tremendously important for both the industry and the country. As prices and costs continue to rise and such demographic factors as the aging of the Baby Boom Generation add pressure, a national solution that addresses healthcare costs in general seems all the more necessary.

* Updated

Claims Frequency Continues to Decline

The decline in claim frequency for workers compensation injuries continued into 2004 and 2005—good news for workers, employers, and their insurers. This decline continues to be the greatest for smaller claims.

While NCCI's 2005 review of claim frequency and severity shows that claims frequency declined, indemnity and medical severities continue to rise.

A higher rate of frequency decline for smaller claims than for larger claims has contributed to an increase in severity (average cost per claim). The latest NCCI research indicates that approximately 30% of the growth in severity in recent years, or about 2.5% out of the 8.4% average annual increase, can be attributed to this uneven claim frequency decline.

A key issue facing employers and workers compensation insurers is whether the large declines in claim frequency that began in the 1990s are likely to continue. Predicting a continuation of that declining trend is difficult because it has been such a widespread phenomenon. In fact, virtually every major employment category examined has experienced marked declines. Preliminary summary data for Accident Year 2004 reveals continued overall declines in claim frequency and overall increases in indemnity and medical severities.

NCCI's complete report on the continuing claims frequency results can be found by visiting **ncci.com.**

Property/Casualty Results Brighten

Turning from an examination of specific workers compensation issues to a discussion of the broader property/casualty (P/C) market, we were pleased to see two important industry rating firms report solid results in the P/C industry for the first part of 2005.

According to an October report by A.M. Best, the US P/C industry recorded an underwriting profit of nearly $13.2 billion during the first six months of 2005, a substantial gain from the record results reported during the comparable period of 2004. Strong operating results also drove the industry's surplus base up 5% to a new high.

The six-month 2005 combined ratio also improved by approximately 1.5 points to 93.0—an improvement realized by a 1.8-point decline in the loss and loss-adjustment expense ratio, which offset a 0.2-point increase in the expense-plus-policyholder dividend ratio.

Despite the positive results, Best has expressed concern with the reduction of year-over-year premium rates across most lines of business and sizes of accounts in 2005.

Standard & Poor's also reported increased P/C market pricing stabilization in October, due in part to insurers' recent hurricane losses.

S&P reported that recent catastrophes are helping to stabilize the P/C market since the softening price trend appears to be less strong than originally feared through the third quarter. However, uncertainty remains in the commercial and specialty sector, which is expected to see significant business interruption losses.

S&P projected that the onset of a hard market precipitated by large storms will offset questions about ability to raise capital, questions over modeling, and affordability of retrocession coverage for the rest of the year. Strong underwriting performance for 2006 and 2007 was also projected by the rating agency.

A more stable and profitable P/C market bodes well for the workers compensation market at large. A complete discussion and outlook for the P/C market can be found in "Property/Casualty Market Overview—Will Things Be Different After Katrina?" in this ***Issues Report.***

SMART Act

In early 2004, House Financial Committee Chairman Mike Oxley (R-OH) joined with Richard Baker (R-LA), chairman of the Committee's Capital Markets Subcommittee, to author the State Modernization and Regulatory Transparency Act (SMART). While insurance companies, legislators, and state insurance regulators differ over the proposed methods to accomplish this goal, many parties agree that now is the time to move forward.

If enacted, the proposed legislation would leave the current state-based insurance regulatory system in place. However, the plan would facilitate a major overhaul of the system by eliminating conflicting state laws and regulations.

Alternatively, other industry supporters are pushing for passage of an optional federal charter (OFC), which they say would not supplant state regulation. As 2005 came to an end, two senators announced plans to reintroduce an OFC bill in early 2006.

As with other federal measures such as TRIA and asbestos reform, the forecast for passage of a final SMART or OFC bill remains uncertain as of this writing. For a more complete discussion of SMART and OFC, with positions both in opposition and support, see "OFC/SMART Aimed at Kick-Starting Modernization of Rate Regulatory Process" in this ***Issues Report.***

Terrorism Risk Insurance Act of 2002

The importance of Congressional action with regard to extending TRIA is hard to overestimate. Because workers compensation insurers cannot exclude terrorist events from coverage, the expiration of TRIA might well have been accompanied by significant reductions in insurers' capacity to write coverage. And, lacking TRIA, another significant terrorism event might very well have overwhelmed state residual markets and guaranty funds for workers compensation insurance.

Thankfully, leaders in Congress and in the White House were aware of these hazards and acted before TRIA could expire (see the accompanying sidebar detailing elements of the 2005 TRIA Extension bill). As we enter the new year with a two-year extension, industry leaders must continue to work together and with federal and state officials to develop a long-term solution for how to handle terrorism risks in our industry.

Tort Reform

There was some good news on the tort reform front in 2005, with several successful reform measures adopted at both the state and national levels.

In Mississippi, the Tort Reform Act of 2004 limited pain-and-suffering awards and required medical malpractice lawsuits to be filed in the county where the procedure in question was performed, helping to eliminate so-called "forum shopping." As a result, the Medical Assurance Company of Mississippi announced recently that malpractice rates for the physicians it insures—about 70% of the physicians in the state—will decrease by 10% in 2006.

In August, North Carolina legislators adopted a measure making it harder for workers compensation claimants to collect benefits for accidents occurring while they are under the influence of alcohol or illegal drugs. Similarly, Arizona employer groups are pushing for a constitutional amendment allowing the restriction of workers compensation benefits for employees injured while intoxicated or drug-impaired.

Other states such as Missouri have recently moved to strengthen their existing laws. This year, Missouri allowed insurers to increase the percentage of workers compensation benefits they can withhold from 15% to 50% when injuries occur in violation of employers' alcohol or drug policies.

Beyond the state-based successes, in August, the Department of Justice reported that the number of tort trials concluded in US district courts fell by 79% between 1985 and 2003. The bureau found that 768 tort cases—primarily involving personal injury—were decided by trial in US district courts in 2003, the most recent year for which statistics are available, compared with 3,604 such cases in 1985—the peak year to date.

The bureau also noted that "the growing use of alternative dispute resolution is frequently cited as the primary contributor to the falling trial rate."

More recently, tort reform advocates pointed to action by the House of Representatives in favor of two civil justice reform bills as a signal that tort reform efforts are starting to see success. Those measures included the Personal Responsibility in Food Consumption Act and the Protection of Lawful Commerce in Arms Act.

Building on these legislative victories, in October, the House passed the Lawsuit Abuse Reduction Act (LARA), a bill designed to require federal judges to impose mandatory sanctions on attorneys who file frivolous lawsuits.

LARA is also designed to curb abusive forum-shopping, where attorneys seek out the most plaintiff-friendly jurisdiction in which to file a personal injury lawsuit. No legislation similar to LARA was introduced in the Senate this past session.

Despite the lack of coordinated action at the federal level, the success in Mississippi, noted above, shows that tort reform continues to be a necessary and important goal. We will be watching new developments in this arena with great interest during 2006.

Asbestos Reform

Asbestos litigation reform is another in a series of issues that have been present in the market for quite some time (e.g., TRIA, SMART Act) that moved closer to resolution in 2005.

At the state level, asbestos reforms have been adopted in Mississippi, Ohio, Texas, and Florida. Measures at the state level include targeting tactics such as mass filings by unimpaired claimants, forum shopping by lawyers in search of friendly courts, and doctors and screening companies submitting questionable medical evidence to prove cases.

On the federal front, leaders of the Senate Judiciary Committee have asked senators to prepare amendments in case legislation to create a $140 billion asbestos compensation fund is brought up for a vote this month. Senator Arlen Specter (R-PA) and Senator Patrick Leahy (D-VT) are coauthors of the bill to take asbestos injury claims out of the courts and pay them from a fund financed by asbestos defendant companies and insurers. The asbestos fund legislation was voted out of judiciary committee in May but has not been brought to the Senate floor.

In mid-November, Senate Majority Leader Bill Frist announced that the asbestos legislation would be one of the first issues before the Senate next year.

As action at both the state and federal level appears to be finally heating up, insurers, attorneys, auditors, and regulators are all taking note of the changes and hoping that more cost-effective and efficient solutions will be passed at both the state and federal levels.

What's Ahead?

While the most pressing issues in the workers compensation market have not dramatically changed, it's gratifying to see that some issues do seem headed for resolution in the weeks to come. As noted above, tort reform and asbestos litigation reform seem to be inevitable at some level, and insurers and employers are getting the message on safe workplaces as claims continue to fall.

At the same time, new issues are already drawing some market attention. The threat of a new bird flu pandemic (with the potential to hit a large number of farm and emergency service workers) has business and government leaders already planning ahead. Estimates of the potential economic cost of such a pandemic go as high as $600 billion.
In a related issue, the continued and relentless increases in medical and prescription drug costs in the face of an aging Baby Boom population (and new medical threats such as a flu pandemic) are very troublesome for both the workers compensation market and the nation.

A quieter 2006—in terms of reduced scandal, catastrophes, terrorism, etc.—would also be helpful. The 2005 environment left lawmakers with little time or interest in the incremental changes that often move our industry forward significantly. Hopefully, a calmer 2006 will result in more industry gains.

For our part, NCCI will continue to work with our industry partners to address developments with regard to TRIA, SMART, reform initiatives, medical expenses, and any and all other issues that stand to have a significant effect on the workers compensation market.

Stephen J. Klingel, CPCU, was appointed president and chief executive officer of NCCI Holdings, Inc., in September 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. A native of Eagan, MN, Mr. Klingel is a graduate of Beloit College, with degrees in economics and business.

The Latest on Residual Market Activity

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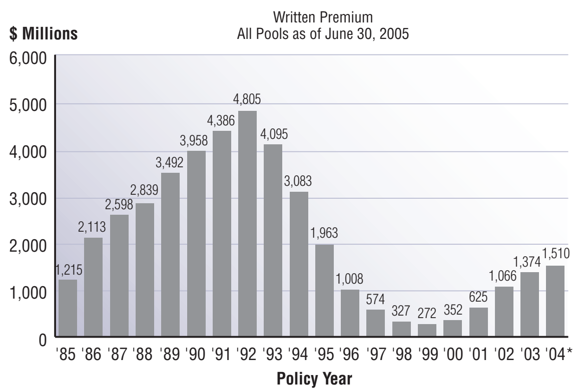
For the workers compensation residual markets serviced by NCCI, the latest 2005 statistics reflect a reduction in the growth of new business. In fact, the amount of new assigned premium dropped by 19% from the first half of 2004.

Of course, residual market application volume changes for new business are only part of the picture when comparing growth from year to year. NCCI's most recent projections for the latest written premium volume growth for both new and existing residual market accounts indicate that, for all pools serviced by NCCI, Policy Year 2004 written premium is expected to remain flat at approximately $1.5 billion as of Second Quarter 2005 (Exhibit 1).

Exhibit 1 **Written Premium#**

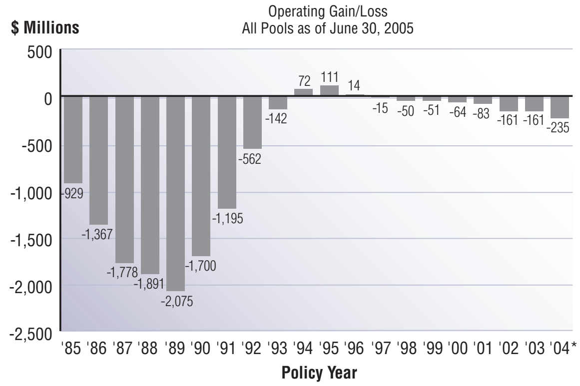
All Pools Serviced by NCCI as of December 31, 2004



\# Projected to ultimate
* 2004, incomplete policy year

Exhibit 2 **Operating Gain/Loss#**

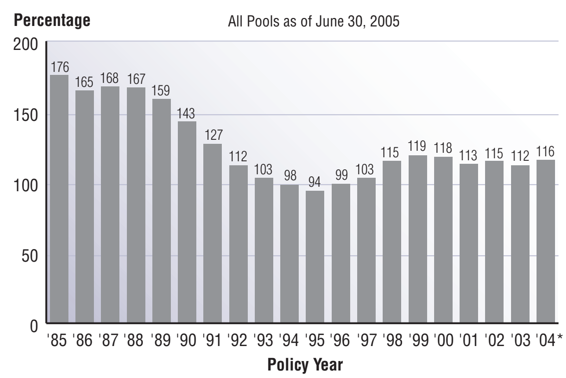
All Pools Serviced by NCCI as of December 31, 2004



Projected to ultimate
* 2004, incomplete policy year

Exhibit 3 **Combined Ratio#**

All Pools Serviced by NCCI as of June 30, 2005



Projected to ultimate
* 2004, incomplete policy year

NCCI's efforts to achieve self-funded residual markets continue to focus on residual market operating results. As of the Second Quarter 2005, the estimated operating loss is 1.1% of voluntary premium for Policy Year 2004 for those states where NCCI is the plan administrator. New Jersey and Massachusetts (which are independent states with prior rate approval laws), along with Georgia, Virginia, and Illinois, generate most of the workers compensation residual market operating losses (Exhibit 2).

While each state is different, these five states have a history of generating higher than average operating losses over the years. NCCI continues to work with all appropriate parties to address the deficits in these states. In all states, NCCI strives to develop the optimum amount of rates, programs, and incentives to achieve self-funded workers compensation residual markets. Accordingly, the combined ratio for all pools has remained relatively flat over the last few years (Exhibit 3).

Other key residual market demographics:

- For 2004, residual market total estimated annual premiums as a share of the total estimated annual premium is estimated to be 13%
- In 2004, Alaska, Kansas, New Hampshire, South Dakota, and Vermont had the highest residual market share of total premium
- In 2005, the average residual market policy size was $4,900
- Today, 80% of applications seeking coverage are submitted online

Significant market process improvements implemented recently by NCCI:

- Our online compliance reporting process has been improved, making it easier than ever to report policyholders not eligible for residual market coverage due to nonpayment of premium or other noncompliance issues. This has potential to further improve operating deficits.
- The Residual Market Take-Out Credit Program is now automated, which will improve the incentives for insurers to take business out of the residual market.
- A Quarterly Large Loss Call for servicing carriers to report claims over $250,000 has been implemented, allowing NCCI to better understand and account for large losses in the residual market loss reserves and ratemaking analysis.
- The servicing carrier self-audit process has been automated, allowing for easier online reporting and faster analysis of the self-audit to ensure compliance with service standards.

Finally, NCCI's service to residual market stakeholders, including policyholders, producers, regulators, and insurance companies, continues to receive high marks on our customer satisfaction surveys. NCCI remains committed to continuous process improvements in order to maintain our position as the preeminent provider of workers compensation residual market services.

Terrorism Risk Insurance Extension Act of 2005 Becomes Law

Workers compensation insurers were among many actively lobbying the federal government to grant an extension to the Terrorism Risk Insurance Act of 2002 (TRIA) last year. Because workers compensation insurers cannot exclude terrorist events from coverage, the expiration of TRIA might have resulted in some insurers being unable to write coverage. Another significant terrorism event might very well have devastated residual markets and guaranty funds for workers compensation insurance.

Thankfully, on December 17, Congress approved a bill that would extend TRIA another two years, and President Bush signed the bill on Thursday, December 22.

Let's take a brief look at how the extension was created.

On November 18, the Senate unanimously passed a TRIA extension bill that was much narrower in scope than what the House would eventually pass.

On December 7, the US House of Representatives also approved a bill that reauthorized TRIA through 2007. The bill raised the program's loss trigger from the current $5 million to $50 million in 2006 and $100 million in 2007. The House bill would have expanded the lines of coverage and subjected them to different deductibles before individual insurers would tap the backstop created by TRIA.

During the weekend of December 16, the House and Senate negotiated the provisions of a final bill, most of which were contained in the Senate's version. The bill is known as the Terrorism Risk Insurance Extension Act of 2005.

The bill continues the current program for two years and covers only certified foreign acts of terrorism. It also includes acts of war for purposes of workers compensation insurance coverage. Insurance companies would have to have losses of at least $50 million from a certified act occurring after March 31, 2006 as a trigger for reimbursement from the federal government and $100 million during 2007. Until the end of March 2006, the trigger amount is $5 million.

An individual insurer's deductible will be 17.5% of direct earned premium of the preceding year for 2006 and 20% of direct earned premium of the preceding year for 2007. The industry's total retention for 2006 will be the lesser of $25 billion and the aggregate amount for all insurers of insured losses during the year. For 2007, the industry's total retention will be the lesser of $27.5 billion and the aggregate amount of all insured losses during the program year. The federal government's cap on its liability remains at $100 billion.

With regard to the "make available" requirement, the bill would not change the current law; that is, insurers must make available coverage for certified acts of terrorism on the same terms and conditions as for other covered risks. There would not be any explicit coverage for nuclear, biological, chemical, and radiological incidents (otherwise known as NBCR). Workers compensation insurers will still have to cover acts of war even though those acts are usually excluded in their policies.

Lines of insurance **not** covered by the extension include commercial automobile, burglary and theft, surety, professional liability, and farm owners' multiple peril.

The Presidential Working Group on Financial Markets—in consultation with representatives of the NAIC, the insurance industry, the security industry, and policyholders—is required to do a study of the long-term availability and affordability of terrorism risk insurance, including group life and NBCR coverage. The report is due to Congress by September 30, 2006.

Not included in the Extension Act are elements of the House proposal that would be more favorable to the industry, including a smaller deductible for workers compensation insurance companies.

The Extension Act does not change any elements of the Terrorism Risk Insurance Program (TRIP), which means that the TRIP office continues to operate the program as they have been doing. It is likely that this office will have to write some additional regulations that address the changes in the Act.

As events and analysis of the TRIA extension continue to unfold, NCCI will monitor and report on those developments and their potential effects on the workers compensation insurance industry. Please continue to visit **ncci.com** for updates and information about this and other critical industry issues.