



Viewpoint



Managing Through Tough Times (and Not Just Living Through Them)

by Diane Brown and Lew Palca, Gen Re, Stamford

The theme of the May 2011 NCCI meeting in Orlando was “Managing the Waves of Change.” As interpreted by NCCI President Steve Klingel, this means “managing our way through a difficult environment.” Uncertainty in the economy still challenges Workers’ Compensation (WC) insurers. Although payrolls are starting to increase, much of the growth is coming from small businesses rather than large corporations. Consequently, the premium decline in WC overall continues, but at a slower rate. And certain industries, such as construction and, to a lesser degree, manufacturing, exhibit little sign of improvement.

A record 740 attendees were in Orlando to celebrate the 100th anniversary of the first Workers’ Compensation law in the United States. This historic milestone could not overcome NCCI’s 2011 WC market outlook—

“deteriorating,” on the heels of “precarious” in 2010 and “guarded” in 2009.

There are a few positive waves of change in the stormy seas, but overall we are facing another very difficult year.

2010 Highlights

- > 115% Combined Ratio on a calendar year basis for private carriers, up from 110% in 2009—compared to 136% for the NCCI affiliated State Funds
- > +2% Medical Inflation—lower than the CPI annual medical inflation rate of +3.4%
- > +3% rise in WC Claim Frequency—compared to -5.5% in 2009—more medical-only claims are becoming lost-time claims
- > Fourth straight year of WC Premium declines, falling to \$33.8B from \$34.6B in 2009
- > Average Bureau rate change of -1.1%, but +0.2% increase in 2011 for states approved through early April, 2011
- > Rate changes in voluntary NCCI market range from -12.4% in Alabama to +7.8% in Florida

We express our appreciation to NCCI for giving us permission to reproduce materials from their 2011 Annual Issues Symposium.

WC by the Numbers

Yet again, more bad than good news emerged from the NCCI annual conference. NCCI's characterization of the outlook as "deteriorating" says it all. As usual, we present the NCCI numbers with the caveat that all 2010 totals are preliminary.

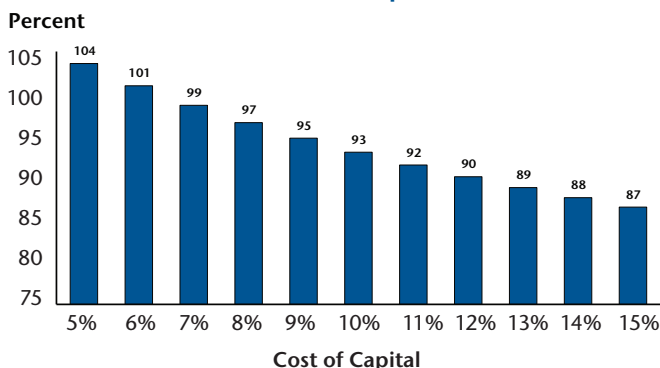
> **The WC combined ratios (private carriers) worsened to 115% (calendar year or CY) and 114% (accident year or AY).** For 2009 these combined ratios were 110% and 109% respectively. This is the fourth straight year of deterioration.

The NCCI-affiliated State Funds posted a 136% CY combined ratio, while the non-affiliated (with NCCI) State Funds, dominated by California, reported a combined ratio of 137%. Noteworthy is that this is the first year in some time that California data was not treated separately. The State Fund results were the same with or without California.

> **Given the drop in interest rates with the recent economic downturn, a company needs to write to a lower Combined Ratio (CR) to achieve adequate return for shareholders.** NCCI presented this graph to demonstrate how the return on capital varies with the combined ratio. (See Exhibit 1) If you need a return on capital (or cost of capital) of only 5%, you can write to a CR of 104. However, if your shareholders expect a return on capital of 15%, you will need to write to a very low CR of 87 to meet this goal.

Cost of Capital is the "ultimate bottom-line" for insurance and most industries. It is total income (investment income on the capital and reserves as well as the underwriting gain or loss) divided by the capital needed to support the business. Whatever the equation, achieving that 87% CR (or even 104% CR) is a stretch for most WC carriers.

Exhibit 1. Workers' Compensation Combined Ratio to Achieve Selected Cost of Capital



Assumptions: 3.8% Pre-Tax Investment Yield, 2.8% After-Tax Investment Yield, WC Reserve to Surplus Ratio = 2.07
Based on NCCI's 2011 Internal Rate of Return Model

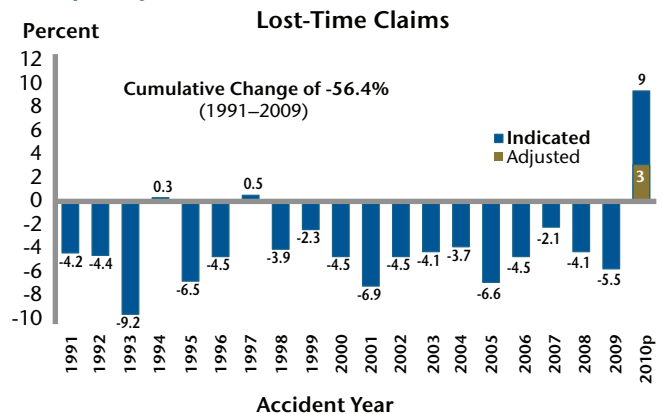
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> **The reported 2010 medical inflation rate of +2.0% was the lowest in recent history and, for the first time, below the CPI annual medical inflation rate of +3.4%.** With medical costs being some 60% of the WC "dollar" cost, this is an extraordinarily positive development, especially if this becomes a new "norm" in annual medical cost increases.

WC medical costs had been holding steady for the past two years at a +5.4% annual increase, and had been expected to start rising again. To illustrate the medical cost trends over the last 20 years, NCCI presented these average increases: 1991–1993 (+1.9%); 1994–2001 (+8.9%); 2002–2009 (+6.7%).

> **WC indemnity was up +3%, compared to -5.5% in 2009, and these lost-time claims are a major reason for the increase in claim frequency.** (See Exhibit 2) The +3.0% uptick was derived after the first calculation of +12.0% was reworked to account for premium audit adjustments for CYs 2008, 2009 and 2010. (See Exhibit 3)

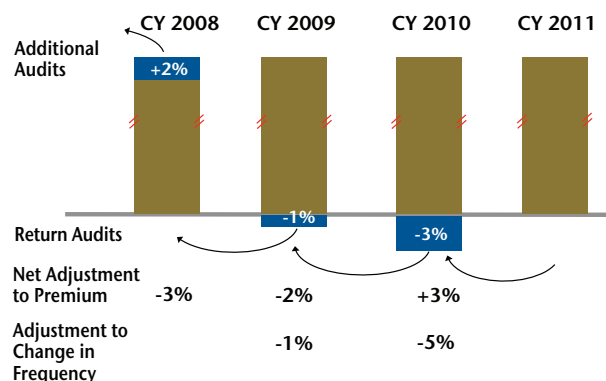
Exhibit 2. Workers' Compensation Lost Time Claim Frequency Increased in 2010



1991–2009: Based on data through 12/31/2009, developed to ultimate Based on the states where NCCI provides ratemaking services, including state funds; excludes high deductible policies. Frequency is the number of lost-time claims per \$1M wage-adjusted pure premium at current voluntary level.

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Exhibit 3. Impact of Premium Audits on Frequency



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NCCI observes a shift in the proportion of medical only and lost-time claims. The proportion of lost-time claims to the total is increasing. This is the first increase in annual WC claim frequency in 13 years. Severity relative to indemnity costs (the average indemnity costs per lost-time claim), actually declined by -3.0% in spite of wage recovery. Balancing the -3.0% indemnity cost decrease by the +2.0% increase in medical costs for 2010, the net loss cost change was essentially flat. **Another factor in the rise of frequency was employers' inability to return people to the workforce.** There simply weren't jobs to which people could return.

- > **The +2.0% increase in medical severity for those who focus on large losses may be somewhat hard to reconcile.** NCCI research shows that the increase in frequency is driven by lost-time claims where there are no medical payments. Companies can appreciate how this shift away from medical claims would put a damper on severity. When it comes to reality, however, companies paying large loss claims may find the idea of +2.0% medical severity hard to balance with the checks they write for catastrophic and “creeping catastrophic” injuries. That improving severity trend may not benefit all carriers to the same degree.
- > **WC premium volume declines have moderated, with 2010 net written WC premium at \$33.8B (\$29.9B private carriers and the balance from state funds).** This is four straight years of WC premium reduction. In 2009 the WC net written premium was \$34.6B. The Private Carrier Premium of \$29.9B has clawed back to its 2002 level (\$29.2B). On the impact of discounting WC premium, NCCI has quantified it at -9.2% in 2010 and -8.2% in 2009.
- > **Average approved WC Bureau Rate/Loss Cost Level changes for 2010 were essentially flat at -1.1%.** The cumulative rate change for years 2004–2010 was -26.2%, so flat is an improvement. NCCI shows a very modest +0.2% increase for 2011 (for states approved through 4/8/2011). Of the current NCCI Voluntary Market for Filed Rate/Loss Cost Changes, 22 are down and 14 are up with an overall range of -12.4% for Alabama to +7.8% for Florida, both approved. Goldman Sachs Research indicates WC policy renewal “pricing declines continue to moderate.”
- > **Investment returns for WC were +14% in 2010, up from +10.8% in 2009.** The average investment return was +14.6% for the period 1990–2009.
- > **There was a modest operating (pre-tax) loss for private insurers of -1.0% in 2010, down from +0.4% in 2009 and +8.8% in 2008.** Between 1990–2009, the annual operating gain averaged +6.3%.
- > **NCCI noted a deteriorating WC reserve position for the industry.** This is a “reality check” from the possible over-optimism of the last few years. The estimated reserve deficiency for private carriers in 2010 was \$10B, with \$5.5B of that total being ascribed to tabular discount. Reserve adjustments on “old” accident years added 3 percentage points to the estimated Loss and LAE ratio of 83% in 2010, up from 80% in 2009.
- > **Obesity drew attention from NCCI for its impact on the American worker and the overall Workers’ Compensation industry.** Studies find systematic differences in the outcomes for obese and non-obese claimants with comparable demographic characteristics. Obese workers are at greater risk for injuries that will ultimately result in permanent disabilities. In general, even when claims are of the same type, the medical treatments and costs, as well as duration, are greater for obese claimants. The principle cost drivers include physical therapy, complex surgery, medications and medical supplies.

III View of WC—Robert Hartwig

Robert Hartwig, CEO of the Insurance Information Institute (III), shared his insights on WC trends and the general insurance environment. Here are his observations on developments important to WC carriers:

- > Business services and healthcare employment is growing.
- > Construction and financial services premium is down, with California and Florida down in premium volume significantly, -60%.
- > Economic growth is most significant in the Mountain and Plains states, with North Dakota being the fastest-growing economy.
- > Since 2007, there has been no net growth in the establishment of private businesses, but there have been a record number of business bankruptcy filings.
- > While WC premiums are 15% of the total insurance industry premium, WC represents 26.6% of the “failed” written insurance industry premium.
- > Reserve releases mask deterioration, but this is starting to slow down.
- > There is overwhelming evidence that obesity is a major driver of the increase in healthcare costs, including those that are WC-related.

Major Legislative Development on Medical Severity—Montana

Montana has amended its WC Act to limit medical benefits to five years, except for Permanent Total or prosthesis claims. HB 334 was signed into law in April. The bill also provides an avenue for re-opening the claim, and makes other significant changes to the WC law. If this medical benefit limitation stands up to expected constitutional challenge, it would be the first such limitation we can recall since states adopted the 1972 NCCI recommendations for unlimited medical benefits. We usually do not drill into state-specific legislative issues in our NCCI review, but this change warranted mention.

The Big Picture—NCCI Perspectives	
Negatives	Positives
> Frequency increases	> Severity flat
> Underwriting results deteriorated	> Overall loss cost impact of frequency and severity minimal
> Underwriting cycle	> Industry’s capital position
> Uncertain impact of healthcare reform	> Premium decline slowed materially
> Unknown scope of future federal actions	

Looking Ahead

Consider the 20- to 40-year tail associated with WC losses, Claims Management is a critical differentiator for companies

writing this line. Getting an early handle on soft tissue injuries can produce enormous cost savings, and we hope that our May 2011 **“Emerging Issues in Workers’ Compensation”** publication on chronic pain management has been helpful in this endeavor. The focus on soft tissue injuries will continue simply due to the potential costs and benefits.

Another interesting dynamic to watch in 2011 and beyond is the extent to which Multiline carriers will be able to leverage commercial lines tools in the WC market. Monoline WC companies have held some advantage over Multiline writers in that they could cancel poor performing accounts without risk of losing the more profitable commercial package business. In the next few years the advantage may shift to Multiline companies that employ their Commercial Auto predictive analytics to help them with WC pricing. Motor vehicle accidents are a major contributor to WC catastrophic injuries. Understanding your insureds’ vehicles and fleets can help you see the entire “workplace,” improve loss control and experience, and hone pricing.

Guarded, precarious, deteriorating...with such NCCI outlooks for past years, how can we be optimistic? Some companies may

have put off making difficult expense and account decisions, thinking that the market would turn and improve. It hasn’t. The economic recovery has been slow and uneven. It still comes down to basics. In good and bad times, the insurers exercising underwriting and expense discipline over the long haul will produce better results. ■

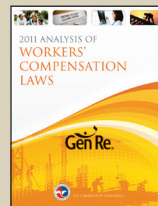
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About the NCCI and Workers’ Compensation

National Council on Compensation Insurance (NCCI) manages the nation’s largest database of workers’ compensation insurance information. NCCI analyzes industry trends, prepares workers’ compensation insurance rate recommendations, determines the cost of proposed legislation, and provides a variety of services and tools to maintain a healthy workers’ compensation system.

Workers’ Compensation Law Resource



The 2011 edition of *Analysis of Workers’ Compensation Laws*, a publication of the U.S. Chamber of Commerce, will be available soon. If you would like more information, contact your Gen Re representative.

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