Workers’ Compensation Market Overview

Third Quarter 2014

ACCIDENT FUND HOLDINGS, INC.
Workers’ compensation was the most significantly impacted segment of any property-casualty sector by the 2009 Great Recession. As a result, workers’ compensation experienced a drop of almost 30% in total market premiums between 2005 and 2010, coupled with a 15-point-plus increase in the combined ratio.

During the recession, the labor market significantly decreased. Unemployment peaked at 10.1% in October 2009 with underemployment at 17.5% — the highest rate since 1983. Claims costs continued to rise, manual rates fell, competition increased, and interest rates/market returns fell dramatically. Because workers’ compensation premiums are directly linked to employment levels and wages, this led to one of the most challenging operating environments the workers’ compensation industry has ever seen.

Today’s Environment

While 2013 showed positive improvement from the 2009 recession (namely rate increases, modest premium growth and improved underwriting results), the workers’ compensation environment still faces challenges that will likely continue for the next few years. Richard Kerr, CEO of MarketScout, noted, “Workers’ compensation is and always has been a tough class of business with an extremely long tail. In the last six months, several major workers’ compensation insurers have exited the market. Many others have dramatically cut back their writings. We expect workers’ compensation insurers to hold steady with small rate increases continuing.”

Earning acceptable operating returns in an environment where sustained low interest rates, uncertainty in employment and spiraling medical-claim costs exist cannot be achieved with combined ratios above 100. Carriers are refocusing their efforts on underwriting discipline with a return to profitability as the greatest near-term challenge. These efforts are visible in 2013 results.
Net Written Premiums
As a result of high unemployment, the recession and soft pricing pressures, premiums plummeted for five straight years resulting in a 29% decrease between 2005 and 2010. In 2011, a turnaround began as private carrier premiums finally increased and ended at $32.3 billion, but restoration of lost premiums have yet to fully recover.

Net written premium for private carriers increased in 2013 to $37 billion—an amount only exceeded during the hard market of 2005-2007 and the highest peak since the Great Recession. The growth rate for 2013 was 5.4% – lower than that of 2011 and 2012 but still a healthy mark. Written premium for private carriers has grown 24% in the past four years but is still shy of the 2006 high.

Combined Ratio
The workers’ compensation combined ratio for private carriers showed strong improvement for 2013, falling to 101—which is a seven-point drop from 2012 and a 14-point drop from 2011. This was driven largely by a calendar year loss ratio of 61%, 4.2 points of improvement from 2012.

While the improvement was positive, the workers’ compensation industry was still at an underwriting loss and the industry is paying more in claims than it is earning in premium. In today’s historically low interest rate environment, it is critically important to earn an underwriting profit; the seven-point combined ratio improvement from 2012 exemplifies carriers’ efforts to obtain one.
Investment Yields

The U.S. Treasury security yields have seen a long downward trend. Since 1990, rates have decreased by more than 70% for 10-year and 2-year yields with current 10-year interest rates below 3%. Since roughly 80% of P/C bond/cash investments are in 10-year or shorter durations, most P/C insurer portfolios will have low-yielding bonds for years to come. Due to low interest rates, investment income is running below the 2007 pre-crisis peak.

Realized investment gains (the gain resulting from selling an asset at a price higher than the original purchase price) were the highest in 2013 since the post-crisis era at $58.8 billion. This was a large factor in the sharp rise of the operating gain ratio.

Insurance companies generate income through two main focuses; underwriting and investments. As noted earlier, the underwriting side generated a 101 combined ratio which is a 1 point loss. The investment side generated 15 points of investment gain, leading to a total of 14% for 2013, the highest since 2006 (16.7%) and well above the long-term average of 5.3%.

While 14% is a great mark, if the industry had its bond portfolio completely invested at the today’s money rates, the 2013 operating gain would be 5-6 points lower. This is further emphasizes the extreme importance of underwriting results in today’s workers’ compensation market.

Rates

In 2013, direct written premium rose 7.3% in NCCI states, driven largely by carrier estimated payrolls and less carrier discounting. As the industry moves toward a combined ratio under 100, the rate environment continues to soften with approved filings increasing 0.6% through April 2014, compared to 2.2% in 2013. A recent survey of independent agents conducted by Goldman Sachs indicates that price increases for workers’ compensation are moderating.
Employment
The U.S. economy lost more than eight million jobs during the Great Recession, with unemployment reaching levels above 10%, placing strong constrains on overall economic growth. 2013 saw growth in overall employment as it continues to near prerecession levels, with unemployment rates highest for younger workers as a large number of people continue to exit the labor force.

Indemnity Claim Frequency
Workers’ compensation indemnity claims frequency dropped 2% in 2013 – the third consecutive year of decrease. Indemnity claim frequency has declined 58.3% since 1991 at an average annual rate of 3.9%. Since the approval of the experience rating adjustment in 1998 (which provides incentive for return-to-work programs by discounting medical only claims by 70%), lost-time claims have improved in all but one year.
Terrorism Coverage

Since the Sept. 11, 2001 terrorist attacks, workers’ compensation insurers have been taking a closer look at their catastrophic exposures – both natural and manmade. A report by Risk Management Solutions indicates that if the San Francisco earthquake of 1906 were to happen today, it could cause approximately 78,000 injuries, 5,000 deaths and more than $7 billion in workers’ compensation losses.

Claims for terrorism could cost a workers’ compensation insurer anywhere from $300,000 to $1 million per employee, depending on the state. As a result, firms located in major metropolitan areas with a high concentration of employees in a single building or near a city landmark are now considered high risk. All but the largest of insurers are limiting coverage as insurers are faced with the possibility of a large death loss costing millions of dollars and the threat of insolvency as a result.

The Terrorism Risk Insurance Act (TRIA) provides a federal insurance backstop to terrorist attacks; however, this expires at the end of 2014. Due to the uncertainty surrounding the renewal of TRIA, insurers must prepare for its expiration.

Conclusions

On the positive side, 2013 showed many signs of improvement: Industry underwriting results were strong due to a low number of catastrophes; investment income was surprisingly robust; capital positioning improved and employment growth accelerated. Still, significant challenges remain for the workers’ compensation industry. These include:

- Uncertainty surrounding renewal of TRIA
- Historically low interest rates
- Impact of the Affordable Care Act
- Lagging employment in construction & manufacturing