



Critical Issues Facing Workers Compensation

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As we near the mid-point of 2003, our nation, our economy, and our public security continue to be threatened—both by fallout from having troops on the ground in Iraq and by what some feel is an ever-increasing threat of international terrorism. These threats, along with the already difficult economic conditions facing the workers compensation market, contribute to a series of significant challenges for the industry in 2003.

From terrorism to rising medical costs to growth in the residual market, industry stakeholders are dealing with a wide range of critical issues. In this piece, we review several of the most crucial topics facing the workers compensation industry today. Analysis of the economic factors influencing our industry and the specific financial results of our line are examined separately in this publication.

Terrorism—Continuing the Search for Answers

The ongoing threat of terrorism remains the highest profile issue facing the workers compensation market—with the potential of endangering its very future. Throughout most of last year, insurers fought for passage of the Terrorism Risk Insurance Act of 2002 (TRIA). Although President

Bush signed the measure into law last November, a number of TRIA-related questions remain unanswered.

The first difficulty is with TRIA itself. TRIA is a short-term measure, currently scheduled to expire in 2005. During this period, TRIA allows companies to build adequate capacity to handle terrorism risk. At the end of three years, the Act will expire—leaving insurers without the much-needed federal backstop in the event of another

- Guaranty fund assessments for insolvencies caused by terrorism losses
- Increasing insurer retentions
- Responsibility for all loss adjustment expenses

The persistence of this imposing array of economic threats to the workers compensation insurance system—even under TRIA—naturally begs the decisive question: What will be needed to stabilize and preserve the workers compensation safety net for our nation's workers, especially if TRIA expires in 2005?

NCCI is contributing to the search for solutions to this dilemma in several ways:

1. Efforts by rating organizations and insurers to determine appropriate premium charges for terrorism exposure are still in their early stages. Nevertheless, as current world events remind us, the fight against terrorism will likely be a long-term struggle. NCCI will be exploring ways to refine methodologies for the most accurate rate forecasting possible.

Working within the framework of TRIA, we have filed rates or loss costs in all NCCI jurisdictions. Before making these filings, we reviewed our working assumptions with the National Association of Insurance Commissioners and individual state regulators. NCCI also worked closely with independent state workers compensation bureaus to share data, assist in modeling efforts, and create a common method for handling terrorism premiums on workers compensation policies.

2. We have accepted an invitation to advise the U.S. Treasury Department, along with other experts, on ways to determine whether TRIA is achieving its stated goals. Such assessments are needed to supply background and support for the report on TRIA's effects, which the Treasury Department will provide to Congress by mid-2005.
3. To satisfy TRIA's provisions of ensuring consistency across all insurance lines, NCCI will confer with industry stakeholders to develop prospective data reporting guidelines.
4. NCCI will continue to maintain frequent, open, and active communications on terrorism-related matters with our affiliates, the NAIC, individual insurance regulators, trade associations, and independent rating bureaus. (The accompanying "Terrorism Resources" sidebar



Terrorism, the highest profile issue, will be a long-term struggle.

devastating terrorist attack. For this reason, many in the industry hope Congress will elect to extend TRIA in some form.

The essence of the problem is this: Enacting TRIA did not return insurers to pre-September 11 conditions. Phasing it out will again expose those insurers to potentially catastrophic financial loss. While TRIA represents an important legislative safeguard for insurers, there are significant limitations for workers compensation writers:

- The protection ends in three years
- TRIA is designed to provide coverage on an all-lines basis
- Coverage under the program is confined to terrorist attacks of foreign origin
- Company retentions may be higher than the risk tolerance of individual companies, thus representing a serious economic threat if such losses are sustained

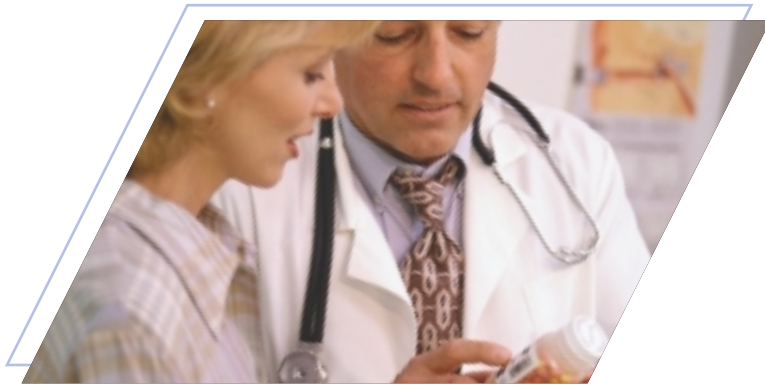
The bottom line is, even with TRIA in place, insurers continue to have significant vulnerability to a host of financial exposures, including:

- The challenge of acquiring adequate terrorism reinsurance terms at affordable prices
- Ongoing exposure to domestic terrorism

identifies many of the tools and information at ncci.com.) Clearly, addressing this threat will take time and new thinking by all market participants.

Market Scan—Critical Issues for the Industry

While terrorism remains the highest profile issue in the market, other concerns also continue to affect results. The following offers an overview of some of the current critical issues as identified by NCCI experts and other industry leaders.



As prescription drug prices skyrocket, double-digit medical cost increases are likely to continue in the coming years.

Medical Costs Continue to Rise

The issue of rising medical costs is certainly not new. The following passage is from our 1932 **Annual Report**.

“For a long time it has been recognized that the medical portion of the losses in workmen’s compensation insurance has been increasing at a faster rate than the indemnity cost... The inclusion of an ever increasing amount to cover medical and hospital losses in our rates will obviously have little justification unless very definite efforts are made to curb this increase or unless it can be demonstrated that there is no practical solution to the problem.”

More than 70 years later, we are still struggling to identify a “practical solution to the problem.”

Today, virtually every industry in America is battling against increasing medical costs. Correspondingly, average workers compensation medical claim costs are also increasing at double-digit rates (12.0% in 2002; 10.7% in 2001), a trend that is not expected to slow down in the near future.

With medical costs currently making up more than 50% of the total average workers compensation claim, this double-digit level of medical inflation adds significant expense to the system. Additionally, savings associated with managed care and other initiatives have already been realized nationwide, making the situation even more distressing.

Unfortunately, few solutions to the current medical cost crisis have been identified. Some issues further complicate the system—medical records privacy and the threat of diluting the exclusive remedy protection of the workers compensation system by controlling available providers.

Apart from medical fees, insurers are also watching prescription drug prices skyrocket. Current NCCI research shows that workers compensation insurers pay roughly 75% more than group health insurers for the same drugs. That cost needs to be brought more in line with average wholesale prices. In response to what many feel are excessive drug costs, some employers and workers compensation insurers have turned to prescription benefit managers to help control costs.

NCCI continues to study the issues of medical costs and prescription drug cost inflation in the workers compensation system, and we will report our findings in the weeks to come.

(NCCI’s 2003 **Issues Report** provides additional information on this subject in “Economic Prospects and Their Implications for Workers Compensation”.)

Reserve Deficiencies

Several independent research and investment firms have counseled that reserve deficiencies will continue to be an industry issue. Already, a number of major insurers have made headlines by identifying reserve issues.

Causes cited by property/casualty insurers that have identified reserve issues include:

- Covering outstanding asbestos claims
- Workers compensation coverage
- Directors’ and officers’ liability coverage
- Lingering claims from the September 11 terrorist attacks

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Terrorism Risk Insurance Act Key Features

On November 26, 2002, President Bush signed into law the Terrorism Risk Insurance Act of 2002 (TRIA). TRIA establishes a federal reinsurance program, under the Secretary of the Treasury, to serve as a federal backstop for property/casualty insurers in the event of future terrorist attacks. The law is in place for three years and terminates on December 31, 2005.

The following is a summary of TRIA's key provisions:

- **Certification of an Act of Foreign Terrorism**—A certified event occurs when the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General, determines that the event meets the definition of an act of foreign terrorism. Losses from the act must exceed \$5 million.
- **Act of Foreign Terrorism Defined**—An “act of terrorism” is defined as an act that (1) is violent or dangerous to life, property, or infrastructure, (2) causes damage in the United States or to certain air carriers or vessels or United States missions abroad, and (3) is committed on behalf of foreign individuals or interests to coerce the United States civilian population or government.

Losses resulting from an act of war are also covered in the case of workers compensation.
- **Mandatory Terrorism Insurance Availability**—Through the end of 2004, insurers must offer terrorism coverage in all commercial property and casualty policies. Except in the case of workers compensation, policyholders may decline the coverage. The Secretary of the Treasury has the discretion to extend the coverage requirement through the end of 2005.
- **Federal Backstop of Terrorism Losses**—After an insurer has satisfied its deductible, the federal government will pay the insurer 90% of its insured losses that exceed the deductible amount, while the insurer must pay the remaining 10% of losses.
- **Insurer Deductible**—The deductible for 2003 is 7% of 2002 direct earned premium. It rises next year to 10% of 2003 direct earned premium and increases again in 2005 to 15% of 2004 direct earned premium.
- **Annual Cap on Liability**—TRIA contains a \$100 billion per year cap. The law indicates that Congress may take other actions in this area and would determine the procedures to apply to losses in excess of this amount.
- **Recoupment of Federal Payments**—Recoupment is achieved through surcharges on policyholders of up to 3% of annual premium. In order to mitigate the impact on taxpayers, the federal government must recoup all amounts it pays under the Industry Marketplace Retention amounts discussed below. The Secretary of the Treasury has the discretion to recoup additional amounts.
- **Insurance Marketplace Retention**—Recoupment of federal assistance is not required if the aggregate payments made by all insurers for losses under the Act (consisting of amounts paid by insurers toward their deductibles and the 10% share of losses above their deductibles) exceed \$10 billion in 2003, \$12.5 billion in 2004, or \$15 billion in 2005.
- **Required Disclosure of Terrorism Premium Charge and Federal Backstop**—Insurers must provide clear and conspicuous disclosure to policyholders of the premium charged for terrorism losses covered by the law and the federal share of compensation for insured losses. Now that the law has been in place for more than 90 days, the disclosure must be provided “on a separate line item in the policy, at the time of offer, purchase, and renewal of the policy.”
- **No Prior Approval or Waiting Period for Terrorism Rates and Forms**—Through the end of 2003, insurers may use terrorism rates and forms without being subject to a waiting period or obtaining prior state regulatory approval. States may subsequently disapprove a rate that is inadequate, excessive, or unfairly discriminatory, and subsequently review policy forms.
- **No Federal Coverage of Punitive Damages**—Federal assistance will not be provided for insurer losses resulting from punitive damage awards. At the same time, the law does not require insurers to provide insurance coverage of punitive damages. The employers liability part of the workers compensation insurance policy already excludes coverage of punitive damages, and punitive damages are not available in workers compensation claims.
- **Exclusive Federal Jurisdiction over Terrorism Claims**—Claims for damages or injuries resulting from a certified act of terrorism must be pursued in federal rather than state courts.

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Last year, NCCI estimated that 2001 workers compensation reserves were deficient by \$21 billion—up from \$20 billion at Year-End 2000. While 2002 saw a reduction in the level of deficiency (down to \$18 billion) we are continuing to monitor the issue.

Carrier Financial Deterioration/Downgrades

Reserve deficiencies, poor investment returns, and high claim costs were all significant factors behind a host of insurer downgrades over the past few months. These downgrades added to insurer financial woes by making their debt more expensive—further frustrating attempts to return to sustainable growth. (Please see “Divining the Rating Process,” our **Issues Report** interview with S&P Director of Financial Services Matt Coyle on page 30.)

Corporate scandals, such as the Enron bankruptcy, also affected the industry by challenging the credibility of auditing and accounting firms that evaluate insurers. This had the positive effect of causing state and federal authorities to encourage tighter reporting standards across all industries and to require more conservative reserve positions by insurers. (Simultaneously, there was a negative effect on consumer and investor confidence.)

Market watchers such as Standard & Poor’s have predicted more downgrades in the near future as insurers at all levels struggle to implement new strategies in the face of difficult financial conditions.

If the downgrades lead to more insolvencies, this would impact the profitability of remaining insurers and cause more problems for the already stressed guaranty funds. It would also create missing data problems for advisory organizations, which negatively impacts the ratemaking and experience rating process.

A Changing Regulatory Environment

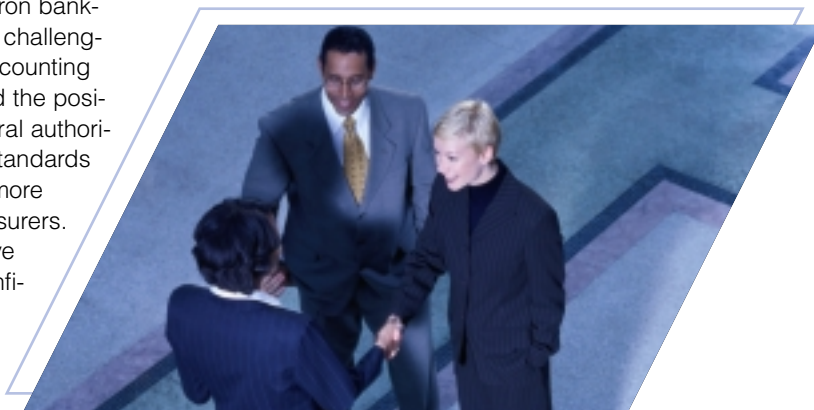
Few can recall a year in which more changes in leadership were seen at all levels of state government. The November 2002 elections produced 24 new governors. By the end of the first quarter, 16 new insurance commissioners were either elected or appointed by these governors. Of these 16 changes, 11

new commissioners (or new acting commissioners) are in NCCI jurisdictions.

As a result of these changes, market participants are bracing for new challenges in terms of education and resisting attempts to roll back reforms, especially those states in which the political party in power has changed.

Legislative issues that have been raised during the first part of 2003 include:

- Increased benefits
- Definition of physician
- Choice of physician
- Compensability standards
- Financial raids on workers compensation state funds (as in Montana and Arizona)



The November 2002 elections produced one of the largest turnover rates in political history, posing new educational and information-sharing challenges for the industry.

(Please see “2003 State Legislative Outlook” on page 34 of this **Issues Report**.)

Because of this significant change in the legislative and regulatory environment, NCCI has embarked on a renewed educational effort to assist new commissioners and legislators in understanding the workers compensation system. The program includes information on NCCI’s mission, the state of the workers compensation market, and a variety of other material designed to help new regulators understand their marketplaces and discharge their regulatory duties.

Residual Market Growth

With conditions reminiscent of the last hard market in the early 1990s, NCCI-administered

residual market pools face the largest total premium volume since 1995—\$1.2 billion. That's twice the previous year's volume. Additionally, the estimated ultimate operating loss for the pools is projected to be \$176 million for 2002. Although today's operating loss is nowhere near the level of the mid-1990s, we must still manage this issue in the future.

Complete coverage of workers compensation economics—including information on the residual market—can be found in the accompanying “State of the Line” article, a supplement to the 2003 **Issues Report**.

Accordingly, NCCI continues to work toward self-funded workers compensation residual markets in NCCI-administered jurisdictions. Aggressively pursuing self-supporting rates, rating plans, and loss prevention programs is an essential component of that effort. In addition, NCCI continues to develop and implement high-quality residual market services, aided by automation of many processes. (Please see sidebar “Improving Residual Market Administration” sidebar on page 13 of this **Issues Report**.)

HIPAA Privacy Legislation

Medical privacy provisions of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) took effect on April 14, 2003. These provisions require covered entities such as health plans, health insurers, and health care providers to inform patients of their privacy rights and the privacy practices of the entity.

While insurance advocates were unsuccessful in attempts to gain exemptions from the HIPAA requirements for workers compensation participants, the final rule addressed these concerns in its preamble. The Department of Health and Human Services (HHS) has vowed to actively monitor the effects of HIPAA on workers compensation. At this still early date, insurers and employers are adopting a “wait-and-see” approach.

The potential for difficulty lies with entities that treat covered functions (such as health care) as well as noncovered functions (such as workers compensation). The HHS regulations are meant to apply only to the covered functions.

However, some fear that problems could arise from health care providers refusing to provide medical information to workers compensation

NCCI's Terrorism Resources

As part of our ongoing mandate to provide industry information and education regarding the Terrorism Risk Insurance Act of 2002 (TRIA), NCCI has collected considerable terrorism information resources at ncci.com.

Visit our Web site and click **Terrorism Resources** to learn more about how TRIA is being implemented—and how it affects you and your business.

NCCI provides e-mail notifications of the latest terrorism updates. Under Questions, click **e-mail notification** and check off Terrorism Resources under News & Events. You will be automatically notified when new terrorism-related information is posted to ncci.com. There are also tools for asking NCCI questions about TRIA and for contacting our residual market and account services experts.

Terrorism Articles on ncci.com:

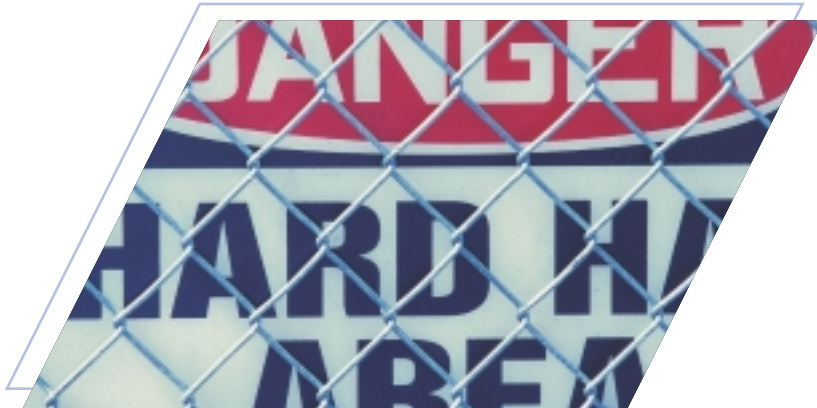
- American Academy of Actuaries Weighs in on TRIA With Report to National Association of Insurance Commissioners
- Treasury Department Regulation Clarifies Definitions in Terrorism Risk Insurance Act
- NCCI Releases Filings for Terrorism Risk Insurance Act
- Implementing the Terrorism Risk Insurance Act of 2002
- What NCCI's Terrorism Modeling Demonstrates
- NCCI Responds to New Terrorism Insurance Act
- NCCI Applauds Passage of Terrorism Insurance Bill
- Terrorism Risk Insurance Act (TRIA) FAQs

TRIA Resource Library at ncci.com:

- Item Filing B-1383—Catastrophe Provision—Certified Terrorism Losses
- Endorsement WC 00 04 20—Terrorism Risk Insurance Act Endorsement
- Status of Filing for NCCI States
- Data Reporting Requirements
- State-Specific Model Bulletins
- Treasury Department Interim Guidance
- NCCI Filing Overview
- NAIC Model Bulletin
- State Premium Algorithm Exhibits
- Key Provisions to the Act
- Policyholder Disclosure Notices
- Industry-Related Sites

insurers. Others may develop a blanket rule to seek patient authorization in all cases.

As such, there may be an educational need to address the various rules for workers compensation and other health care providers. There is



Improved construction techniques, workplace safety programs, and advances in ergonomic design helped to reduce claim frequency in the last decade.

also a continuing concern about imposing a federal information disclosure standard on state-based workers compensation systems.

Claim Frequency

For the better part of a decade, declines in claim frequency have had a positive effect on the workers compensation system in helping to keep loss costs down.

During 2002, NCCI's study of claim frequency showed general downward movement. Using the most recent data available, our study showed an overall frequency decline in each year over the past decade—with a cumulative 27% decline over the most recent five-year period.

The reasons behind this decline have been numerous—a continued emphasis on workplace safety, the increased use of robotics and modular design, improved construction techniques, and advances in ergonomic design.

Today, however, there are some indications that the rate of claim frequency decreases may be leveling off—a condition that could cause concern for workers compensation insurers in the months to come. (For more information on claims frequency, please see "Economic Prospects and Their Implications for Workers Compensation" on page 42 of this **Issues Report**).

State Regulation/Federal Chartering

Recent years have seen a growing trend for the federal government to become involved in state-based workers compensation insurance systems. Recent examples include HIPAA privacy regulations, ergonomics rules proposed by the Clinton administration, and even some TRIA provisions.

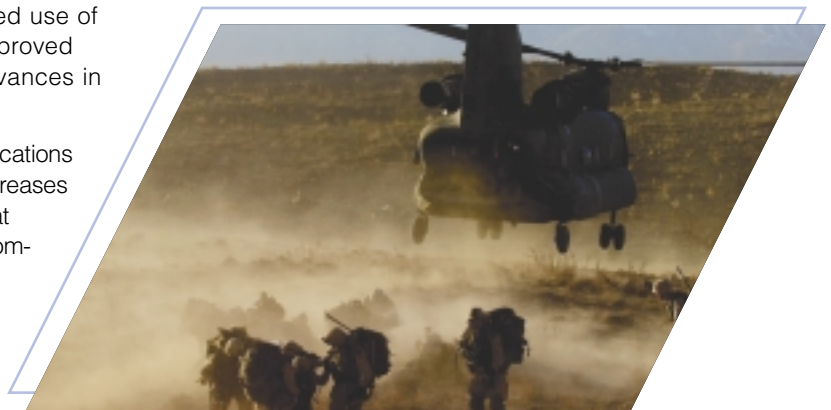
These activities—and federal chartering initiatives proposed by Congress—have raised the issue that traditional state control over workers compensation rules and systems may be compromised by federal involvement.

Some of the specific issues raised with regard to increased federal involvement in workers compensation tend to revolve around items such as increased regulatory and administrative costs, rules overlap, decreased understanding of how workers compensation interacts with other elements of insurance (e.g., records privacy), and increased bureaucracy.

Certainly, erosion of state regulatory jurisdiction continues to be an important issue with the National Association of Insurance Commissioners (NAIC). This year, the association created a new coalition, the "Alliance for Sound State Uniform Regulatory Efficiency" (ASSURE) to deal with what it views as a continuing trend toward federal action.

According to an NAIC statement, the coalition's mission is "to improve and defend state insurance regulation by supporting greater efficiency and uniformity in regulatory practices ... as well as promoting streamlined national standards that recognize a unique and evolving state-based marketplace."

The regulatory tension of state versus federal control will be an issue throughout 2003, and insurers and regulators will be paying close attention to new initiatives in the months to come.



The ongoing threat of terrorism is only one of several challenges that will impact the workers compensation industry in 2003 and beyond.

Conclusion—Looking Ahead

The above list of crucial issues is only a sampling of items expected to impact the workers compensation industry in 2003 and beyond.

In the face of the remarkable—and in many cases unprecedented—challenges facing the workers compensation market, NCCI remains committed to working with our industry partners to provide comprehensive analyses of critical issues. If we as an industry, and NCCI as an industry leader, are to continue to succeed, we must learn how to better cooperate and partner with each other.

For our part, NCCI will leverage considerable technical and data collection resources to identify solutions and report on industry trends that affect our customers and industry partners.

NCCI will also continue to focus on our core, traditional services. Our commitment to delivering excellence in rate adequacy, managing the residual market, and providing market forms and procedures, among our other core services, becomes even more critical during a difficult market.

Finally, by demonstrating accurate and unbiased information in our public interactions, NCCI will continue to add value on behalf of our industry partners by ensuring that our market information is viewed as both highly objective and accurate.

With U.S. military activities continuing in the Middle East and ongoing threats of terrorism at home and around the world, workers compensation system participants will need to remain aware of changing conditions for the foreseeable future. As the industry's leading information provider, NCCI will also remain vigilant and proactive when it comes to issues that impact the workers compensation market in 2003. ■

Stephen J. Klingel is president and chief executive officer of NCCI Holdings, Inc.. A highly accomplished insurance executive, Mr. Klingel has more than 25 years of leadership experience in the property/ casualty business. During his career, Mr. Klingel has built a respected reputation for implementing creative and effective programs in strategic direction, change leadership, customer insight, and for developing and motivating organizational talent. Mr. Klingel was a senior vice president with The St. Paul Companies prior to joining NCCI.

Improving Residual Market Administration

With conditions reminiscent of the last hard market in the early 1990s, the residual market pools administered by NCCI face the largest total amount (\$1.2 billion) of written premium since 1995.

As NCCI continues to work toward self-funded workers compensation residual markets in jurisdictions where we act as administrator, we have also introduced high-quality residual market processing services—including our Residual Market Application Processing System (**RMAPS®** Online Application Service) and our pilot Voluntary Coverage Assistance Program (**VCAPSM** Service). A brief description of each program follows:

Residual Market Application Processing System (RMAPS® Online Application Service)

RMAPS® Online Application Service is NCCI's user-friendly, Internet-based tool that helps producers and applicants quickly obtain premium estimates and assigned risk workers compensation insurance coverage in NCCI-administered states.

Benefits of **RMAPS®** Online Application Service include:

- Fast residual market premium estimates
- An online workers compensation application, resulting in improved customer service
- Promptly secured coverage effective dates
- Acceptance of credit cards and electronic check payments

The recently enhanced **RMAPS®** Online Application Service is working effectively to reduce paperwork, bureaucracy, and system costs.

For more information on NCCI's **RMAPS®** Online Application Service, please visit ncci.com.

Voluntary Coverage Assistance Program (VCAPSM Service)

NCCI's new **VCAPSM** Service is part of our strategic vision for depopulating the residual market. By providing an additional mechanism for producers and employers to find voluntary workers compensation coverage, **VCAPSM** Service serves as a "last chance" effort to prevent migration of employers into the residual market.

Working within the framework of the **RMAPS®** Online Application Service, **VCAPSM** Service can identify applicants that may be eligible for voluntary coverage by comparing application information to preselected criteria established by voluntary carriers. If applicants match, producers will then receive notifications of potential interest from voluntary carriers.

Voluntary carriers will be given the option to either extend or decline an offer of voluntary coverage to applicants, and producers will be required to accept any "reasonable" offer of coverage made via the **VCAPSM** Service.

This June, NCCI's **VCAPSM** Service pilot program will begin in Alabama, Connecticut, Illinois, and Vermont. We expect that the program will be in full operation for all NCCI Plan-administered states in 2004.

As the pilot program proceeds and more states are added, updated **VCAPSM** Service information will be posted on ncci.com.

In the residual markets that NCCI administers, we will continue to leverage available technologies and our own tools to add efficiencies and new solutions for controlling costs and improving service.