What’s Up With the Residual Markets?

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The second half of 2011 marked a turning point in the direction of the workers compensation residual markets managed by NCCI. After shrinking for six straight years, the number of new applications and the amount of new premium bound in the residual markets started to grow in the third quarter of 2011.

By the end of 2011, the total written premium for all pools serviced by NCCI grew to nearly $500 million. This resulted in a slight increase in the market share of the residual market business from 4.6% to 5% at the end of 2011.

Starting in January 2012, NCCI saw a significant increase in the number and size of accounts seeking workers compensation coverage in the residual markets. In the first half of 2012, the number of new applications for coverage increased 13%, and the amount of newly bound premium increased 89% from the same period in 2011. The combined new and renewal premium covered in NCCI-administered states has increased by 41% over that time. And the growth is continuing in early 2013.

This significant residual market growth is coming from all states managed by NCCI and does not significantly differ by state or region of the country. As of this date, NCCI estimates that residual market written premium in reinsurance pools serviced by NCCI will reach $806 million when all 2012 data is reported. We have not seen this rate of growth since 2001–2002.

Beyond the overall growth in 2012, it is also interesting that the highest percentage of growth is coming from accounts over $100,000 in premium. These accounts have a significant impact since the average workers compensation residual market account is only $4,100 in estimated annual premium. While NCCI and its servicing carriers can properly service these large accounts, it has been a decade since we have seen this many large accounts applying for residual market coverage.

The fallout from a struggling national economy no doubt plays a role in the increase in large accounts seeking coverage in the residual market. Continued high unemployment, tightened credit markets, low investment returns and interest
rates, and the resulting firmer underwriting standards are all, to some degree, driving voluntary market decisions. To deal with the increased volume and size of business, NCCI and the servicing carriers that write the business have been increasing staff appropriately.

The following graphs provide a historical frame of reference to better understand the key metrics for analyzing the residual markets.

**Written Premium**

The residual market written premium for all reinsurance pools serviced by NCCI varies considerably over the long term and clearly shows the cyclical nature of workers compensation insurance. (See Exhibit 1.)

In 1992, for instance, during a period of significant turmoil and change in state workers compensation systems, residual market premium grew to $4.8 billion. Premium then dropped considerably due to a series of state workers compensation reforms, which included the establishment of some state mutual funds that began to act as markets of last resort. The result was that premium dropped to $300 million in 1998, a historically low level.

Since that time, we have witnessed more moderate cycles of residual market growth and depopulation leading up to renewed growth in 2011 and 2012 as described earlier. As the result of this residual market premium growth, the residual market share is expected at this time to increase from 5% in 2011, as shown in Exhibit 2, to about 6% in 2012—the highest level since 2007.

**A Focus on Operating Results**

While many workers compensation insurance stakeholders are focused on the rapid growth of the residual markets in 2012, NCCI is concentrating its attention on the operating results of this business and the impact this new growth may have on those results.

The latest available statistics, reported as of June 30, 2012, show that residual market results have remained fairly stable over the last few years (Exhibit 3). However, the 2012 results can be volatile until a full year of data is received. In fact, the incomplete policy year data for 2012 shows that the projected residual market combined ratio is expected to decrease to 113. The improved combined ratio is primarily due to increased premium and stable expenses that are driving the expense ratio down.
The combined ratio exhibit and following underwriting results (Exhibit 4) provide a broad historical context for analyzing the recent residual market combined ratios and operating results. The exhibits show the unsustainable combined ratios and losses that forced major changes to workers compensation laws in the early 1990s.

These reforms were very effective in balancing and stabilizing the systems, and returning the combined ratios and operating results to manageable levels. There have been relatively small fluctuations in operating results for the past 15 years.

Stable and self-sufficient residual market operating results are the most important factors in managing residual markets and maintaining a competitive workers compensation insurance system. NCCI has been working with insurance regulators to adjust assigned risk rates, rating plans, and rules as needed to maintain self-sufficient residual markets.

One of the most interesting aspects of residual market growth last year was the increase in the number of large accounts seeking residual market coverage.

Exhibit 5 shows that accounts over $100,000 in estimated annual premium have accounted for 150% of residual market growth through September 2012. This is remarkable since the average size of an account serviced in the workers compensation residual market was approximately $4,100 in 2012.

Conclusion

The rise and fall of workers compensation residual markets is neither new nor unusual. The size of residual markets varies, like any other market, based on the cumulative actions of insurance agents, underwriters, and policyholders as they each seek optimal coverage and pricing for their workers compensation insurance needs.

Factors such as expected loss ratios, investment returns, market stability, and economic conditions all play a part in these individual transactions. Successfully managing workers compensation residual markets requires the administrator to effectively and efficiently service the residual market accounts and to maintain self-sufficient residual markets as conditions constantly change.

Despite the rapid growth in 2012, the workers compensation residual markets operated effectively and efficiently, and the residual market share and operating results remained manageable. As 2013 unfolds, NCCI, state insurance regulators, and other stakeholders need to remain vigilant to ensure that the residual markets continue to operate effectively and do not impede the voluntary markets.

Jim Nau is responsible for the administration of the workers compensation residual market reinsurance pools and assigned risk plans approved in NCCI states. He is a frequent author and speaker on workers compensation issues and is an active member and past president of the CPCU Society.