



NCCI Holdings, Inc.

Gauging the Economy

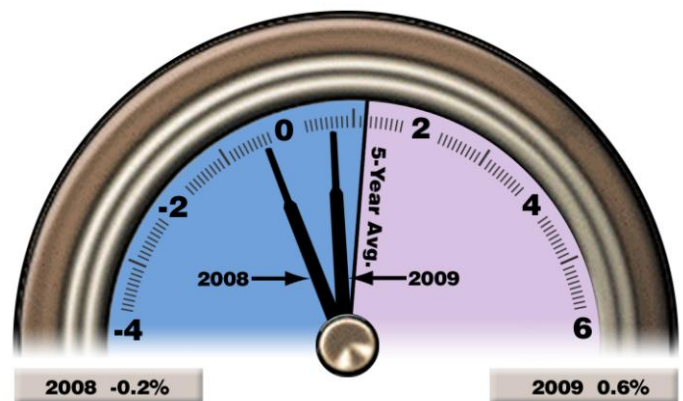
Summer • 2008

Gauging Current Conditions: The Economic Outlook and Its Impact on Workers Compensation

The gauges below reflect the consensus economic outlook for 2008 and for 2009 for key factors that typically impact workers compensation. Each gauge also provides some context for the outlook, relative to a historical average of the previous five years.

Deteriorating Outlook for Employment in 2008 Suggests Downward Pressure on Both Exposure and Claim Frequency

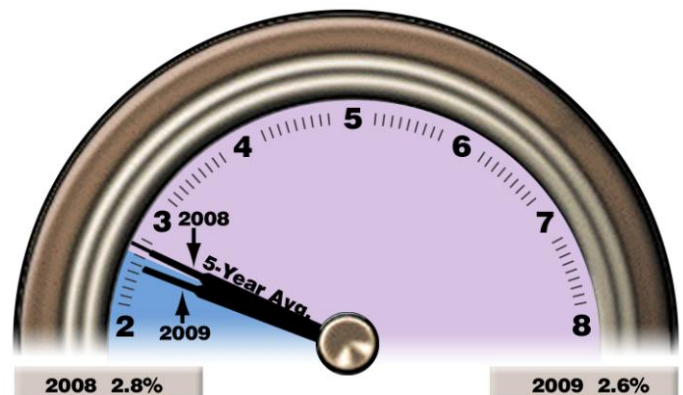
Employment is expected to decline during 2008, reflecting an increasingly negative outlook for the economy. Consumer expectations and demand have weakened markedly, the housing debacle is showing no signs of improvement, and higher energy prices are taking a major toll. So far, the decline in jobs has been relatively mild (in comparison to past recession periods), and Moody's Economy.com's forecast calls for some improvement in 2009. However, the company also indicates that the risks are large and mostly on the downside. The bleak job situation suggests deteriorating prospects for exposure as well as some downward pressure on claim frequency (because the more tenured/experienced workers tend to be the last workers laid off).



Weakening Private Sector Employment

Slowing Wage Gains May Constrain Increases in Indemnity Severity

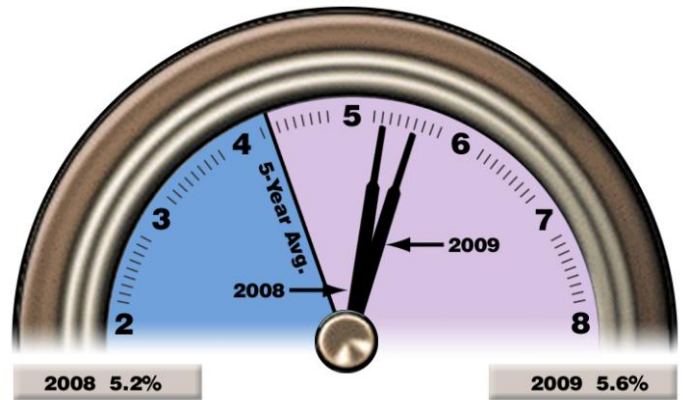
Wage gains are expected to moderate in both 2008 and 2009 as the weakening economy brings with it a slackening in labor demand and rising unemployment rates (which are expected to top 6% by year's end, according to Moody's Economy.com). The moderation in wage increases suggests a slowing in the rate of growth of indemnity severity, since changes in indemnity benefits are tied to wage movements in most states.



Moderating Average Weekly Wage Gains

Accelerating Medical Care Price Increases Suggest Further Upward Pressure on Medical Severity

The Medical Care component of the Consumer Price Index is forecast to accelerate to 5.2% in 2008 and 5.6% in 2009, from 4.4% in 2007. That rise partly reflects a flow-through of increasing prices for all goods and services. The step-up in medical care inflation will place further upward pressure on medical severity, which is also being impacted by substantial increases in utilization (reflecting both the quantity and mix of medical care goods and services).



Accelerating Medical Care Price Inflation

Financial Markets Pose Major Challenges for P&C Portfolio Managers

Short-term interest rates are not expected to decline below current levels, even in the face of further economic weakness, because of the Federal Reserve's concerns about a ratcheting up of inflationary expectations. Indeed, once the economy begins to stabilize—most likely in early 2009—Moody's Economy.com believes that the Fed will begin to boost short-term rates to demonstrate its inflation-fighting resolve. Stock prices, meanwhile, have shown marked volatility in recent months and are in bear-market territory as of this writing. All of this suggests challenging times ahead for P&C portfolio managers. (The "gauge" shows the rate of the seven-year Treasury note because the average maturity of Treasury securities held by P&C carriers is roughly seven years.)



Rising Interest Rates

Behind the Gauges

Factors Affecting Frequency and Severity

The following set of charts focuses on factors affecting claim frequency, indemnity, and medical severity, and their implications for the P&C industry.

Employment

- Private-sector employment is forecast to decline throughout 2008 (it reached a peak in November 2007), with a gradual upturn beginning in the first quarter of 2009. Some 780,000 jobs are expected to be lost, a decline that is substantially less than the average 1.7 million job losses seen during the 1990–91 and 2001 recessions.
- The loss in jobs will reduce workers compensation exposure, especially in more cyclically sensitive industries such as manufacturing and construction (see next chart). Claim frequency, meanwhile, may come under downward pressure, because those laid off tend to be the least skilled or experienced.

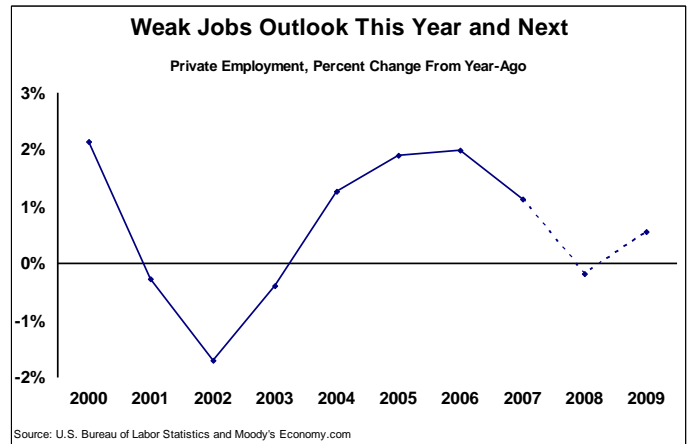


Exhibit 1

Manufacturing and Construction

- Construction employment is expected to decline roughly 5% this year and show virtually no growth in 2009. Much of the job loss reflects the weakness in housing, where housing starts (including both single-family and multifamily structures) have plummeted, down nearly 30% so far this year (through May) vs. the same period in 2007.
- Manufacturing jobs, which have been under downward pressure throughout this decade, are forecast to post accelerating declines this year, in part the consequence of the marked fall-off in demand for autos and other big-ticket durables. The one bright spot in the manufacturing sector has been strong export demand, buoyed in part by the weakening of the dollar, which, in real terms, was down 8% against a market-basket of major currencies (as of June, vs. a year ago).

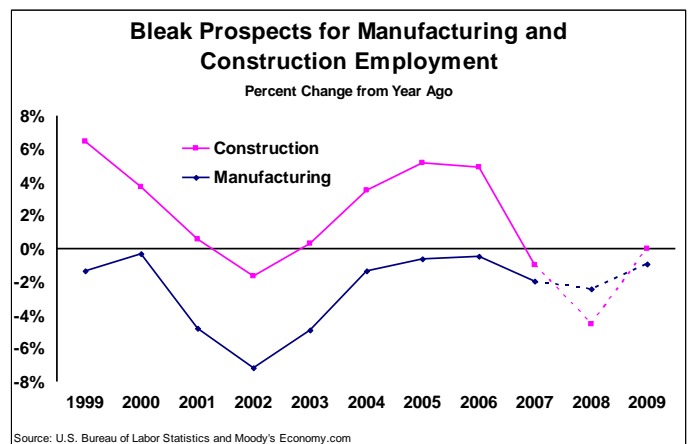


Exhibit 2

Regional Prospects

- Job declines for 2008 are expected in the Northeast and Central states, which are dominated by old-line (and more hazardous) manufacturing, higher business costs, and weak demographic trends. The sub-prime meltdown and its aftershocks are having an especially pronounced impact on financial market employment in the Northeast, while the marked weakness in auto sales is affecting auto and auto-related employment in the Central states.
- Job prospects for 2008 are somewhat better in the South and West regions, although the expected increase in the West is markedly less than in 2007. These regions tend to have stronger population growth and lower business costs. The South, in particular, benefits from a number of large defense-related industries. In the West, weakness in housing is taking a major toll, largely offsetting the positive impact of strong export demand for the region's high tech products.

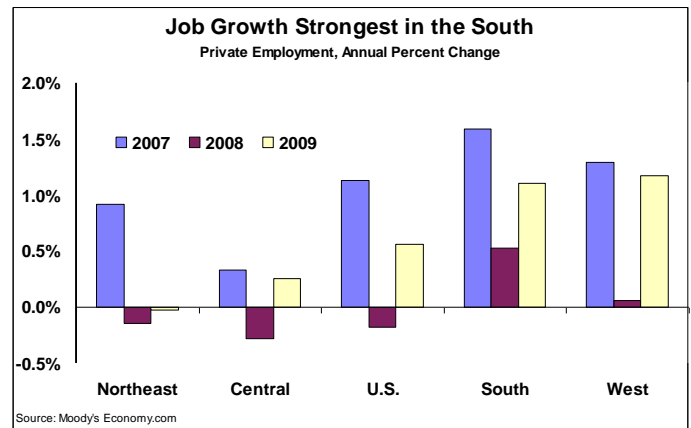


Exhibit 3

Wages

- Nationally, wage increases are expected to slow relative to earlier gains, reflecting the weakening economy and increased slack in labor markets (see next chart). The experience of the 1970s, when sharply higher oil prices flowed through to wages via cost-of-living adjustments (COLAs) in union contracts, is unlikely to be repeated in the current period. Such COLAs are less common in union contracts, and the number of workers covered by such contracts is far fewer now than earlier. Moreover, the competitive environment facing firms is far tougher now, limiting the extent to which wage increases can be passed on via higher prices.
- Indemnity payments in most states are increased annually based on increases in the state's average weekly wage (although, in some states, such increases are implemented on a periodic basis).

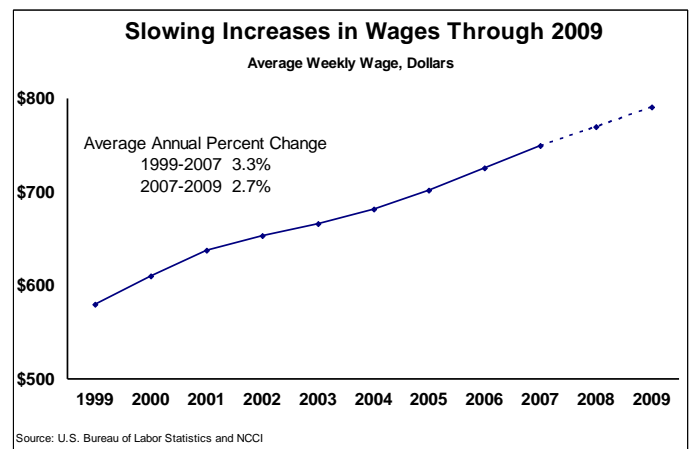


Exhibit 4

Unemployment Rate

- One factor helping to restrain wage gains is the rise in the unemployment rate. That rate was 6.1% in August, 1.4 percentage points higher than a year-ago. Forecasts are for the unemployment rate to increase further, to 6.5% by the second quarter of 2009, and to stay at about that rate through most of the year, even as economic growth begins to accelerate.
- That lagged relationship reflects the following: In slack economic times, many persons “drop out” of the job market and are not counted by the Labor Department as being unemployed. As the economy shows signs of improvement, such “discouraged” persons flock back into the job market. However, they generally do so at a far faster rate than companies increase their hiring (since firms are reluctant to add head count until they are sure that conditions have improved). The result is that the unemployment rate edges higher or stays high until job growth picks up in earnest.

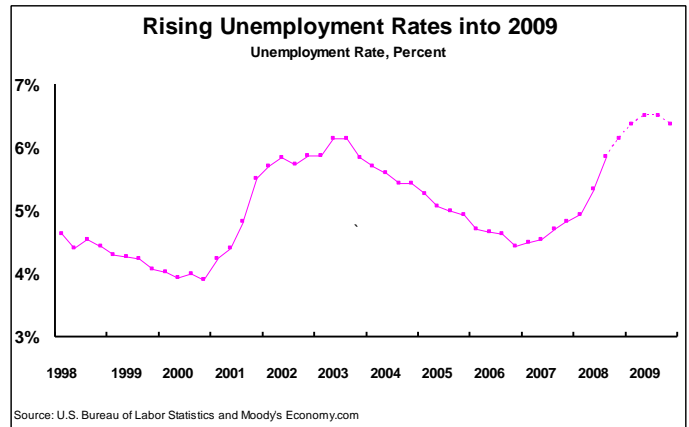


Exhibit 5

Medical Care Inflation

- Medical care price inflation, a rough proxy for medical price increases in workers compensation, is expected to continue to accelerate into 2009, in part reflecting the substantial oil-fueled increase in overall inflation in 2008. (Moody's Economy.com's forecast assumes oil prices will decline later this year and in 2009. That decline will have an immediate impact on the “All Items” CPI, with a lagged effect on the Medical Care component.)
- Increases in medical severity largely reflect two factors—increases in the price of medical services and, more importantly, increases in the utilization of those services (that is, changes in both the quantity of services used and the mix of services). A detailed study discussing the impact of changes in utilization on medical severity is available in the Research section of ncci.com.

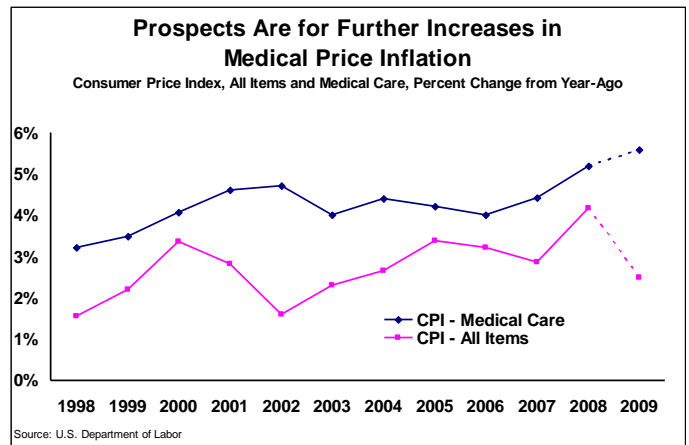


Exhibit 6

IMPLICATIONS

Media reports – and some politicians – have been focusing on a recent Census Bureau statistic that nearly 47 million Americans lack health insurance. A close look at the data suggests that the numbers of uninsured may be exaggerated, implying that the existing healthcare system may be more in need of selective reforms than a major overhaul. For workers compensation, expanding the availability of health insurance may have consequences that are not readily apparent.

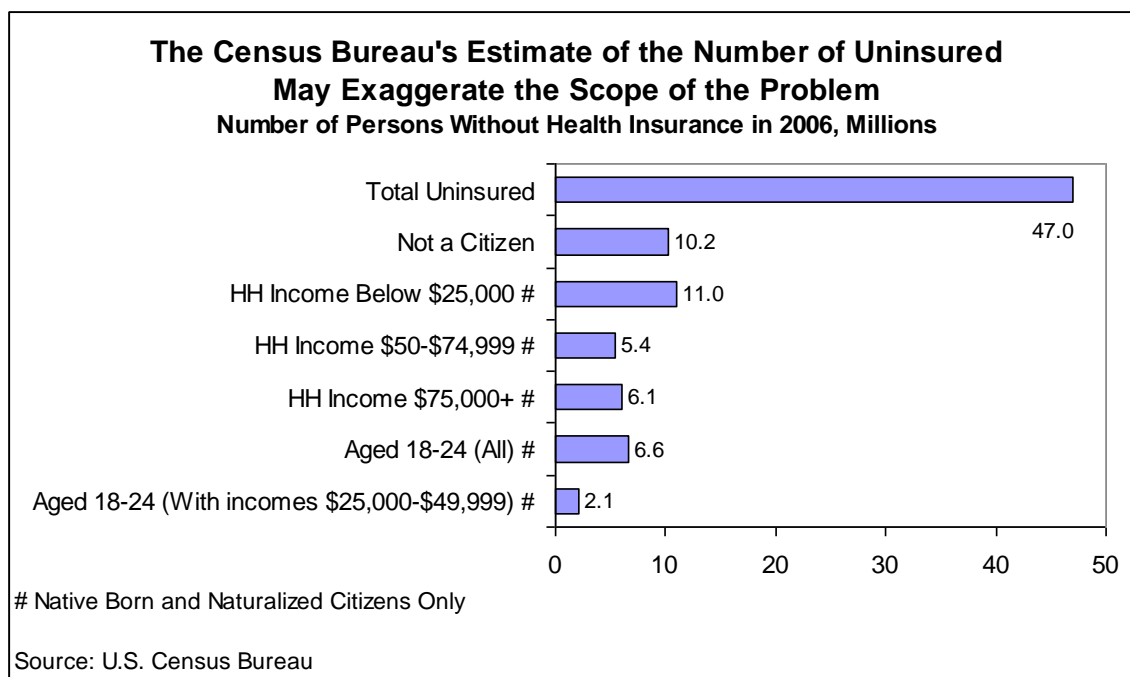
This edition of *Implications* takes a close look at one aspect of the healthcare debate that has been occupying a great deal of media and political attention – the reported 47 million persons that do not have health insurance. Its key take-aways:

- Examining the make up of the number of uninsured reported in an often-cited Census Bureau analysis provides insights that suggest that the current healthcare system, while not perfect, may not be in need of wholesale “reform.”
- The high cost of insurance is the major reason for lack of coverage.
- Recent research indicates that workers compensation is not a substitute for general health insurance; thus implementation of major reform even including universal health care is unlikely to have a material impact on the role of the workers compensation system.

How Many Persons Do Not Have Health Insurance?

A central issue in the ongoing debate on the need for healthcare reform concerns the number of uninsured. Those calling for a major reforms the system often cite the Census Bureau’s top-line estimate of some 47 million uninsured (as of 2006), representing nearly 16% of the population.ⁱ The reality of the situation is that Census data may overstate the number of persons without access to medical insurance. Reasons why are highlighted in Exhibit 1.ⁱⁱ

Exhibit 1



- More than 20% of the 47 million uninsured, fully 10 million, are not citizens. Such persons – many of whom may be in the United States illegally – would most likely not be covered in any national health insurance program.
- Eleven million, almost a third of the 36 million uninsured US citizens, have household incomes below \$25,000 and presumably would qualify for Medicaid and other the state-run programs for the needy. The fact that they apparently were not enrolled in these programs when the Census' survey was conducted does not necessarily mean that they do not have access to health insurance.
- Nearly 13 million of the uninsured (excluding non-citizens) have household incomes of \$50,000 and above, with more than 6 million of those with incomes of \$75,000 or greater. At these income levels, being uninsured may reflect factors other than affordability; for example, pre-existing costly medical conditions.
- Some 6.6 million of the uninsured (excluding non-citizens) are between 18 and 24, an age of generally good health, and likely could secure insurance. A portion of these younger persons may opt-out of obtaining health insurance because they feel it is simply not needed at their stage in life – regardless of their level of income. Note that roughly 1.8 million of the 6.6 million aged 18-24 have incomes below \$25,000 and 2.7 million have incomes above \$50,000 -- these counts are included in the income-related counts described immediately above. Not included in any other category are the 2.1 million aged 18-24 with household income of between \$25,000 and \$49,999. (Please see footnote 5 for additional information on the relationship between age and health insurance.)

This suggests that, while currently there are millions of persons who are not covered by health insurance, limited access is only one of several contributing factors. From a policy perspective, this analysis argues for a cautious approach in making large system changes to benefit what is most-likely a much smaller portion of the *eligible* population than suggested by the raw Census data.

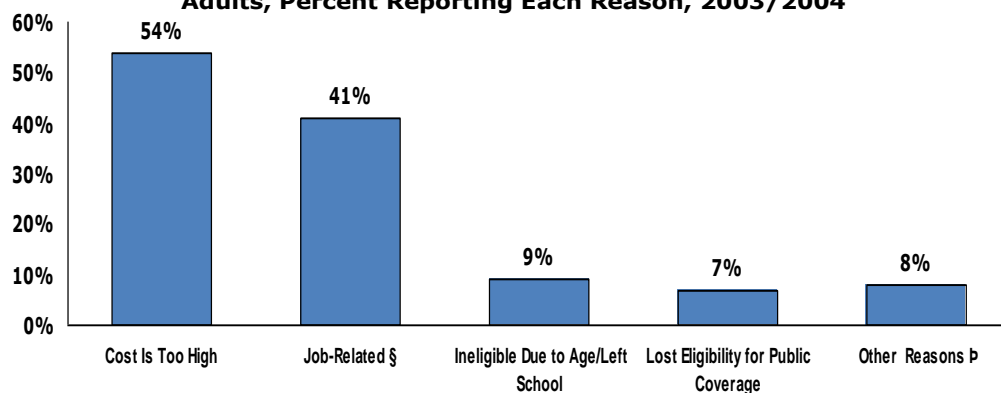
Why Do Persons Lack Health Insurance

High cost is the most cited reason given as to lack of health insurance coverage (see Exhibit 2, based on an Urban Institute analysisⁱⁱⁱ of data from the National Health Interview Survey (NHIS).^{iv})

Exhibit 2

High Cost is The Chief Reason for Not Having Health Insurance

Reasons for Absence of Insurance Among Uninsured, Non-Elderly Adults, Percent Reporting Each Reason, 2003/2004



Notes: Reasons are not mutually exclusive; nonelderly adults are age 19–64;

§ Job-related reasons include lost job or changed employers, self-employed, employer doesn't offer/not eligible for ESI

¶ Other reasons include moved, got married or divorced, insurance company refused coverage, and other unspecified reasons

Source: Urban Institute analysis of 2003 and 2004; National Health Interview Survey (NHIS)

- The most prevalent reason given by non-elderly adults is that the cost is too high. The percentage indicating this reason was lowest for younger workers (44%) and highest for older workers (61%) (not shown).^v Interestingly there were no significant differences between respondents below the poverty level and those 300% or more above it.
- Job-related factors were the second-most prevalent reason, at 41%. Such factors include “lost job or changed employers,” “self employed”, and “employer doesn’t offer/not eligible for employer-sponsored insurance (ESI).” The Urban Institute noted in its commentary that: “To the extent that job-related issues are an indirect reporting of cost (in that the individual does not have access to ESI coverage and can only purchase coverage in the nongroup market) health insurance costs were a factor for the majority of the uninsured adults (79 percent).”
- The third most common reason cited by adults was ineligibility due to age or change in student status. This was especially important for persons aged 19-24 who are likely to be affected by age/student limitations on a parent’s ESI policy.

The Urban Institute also tracked the NHIS results over time, finding that the share of persons reporting high costs as the reason for being uninsured rose nearly 8 percentage points between 1999 and 2004.

Implications for Workers Compensation

The two candidates are deeply divided as to how to make health care more affordable – the Democrats through government-supplied coverage and the Republicans through market-based solutions (e.g., by encouraging market competition, providing for an increased range of coverage options, etc.).^{vi} So far, the various proposals do not appear to significantly affect the basic structure of the workers compensation system. In large part that is because there is already universal coverage under workers compensation for employees in all but the smallest firms. Moreover, even in countries with universal health care coverage, such as Canada, the workers compensation system largely parallels that of the U.S. – that is, a separate regulated insurance-based system with the costs funded by employers.

While the basic structure of the workers compensation system may stay largely the same under either party’s health insurance program, recent research suggests that claim frequency may be adversely affected to the extent that health insurance becomes increasingly available to persons already covered under workers compensation.

This conclusion may be surprising to some, since the conventional wisdom holds just the opposite. That is, an increase in the availability of health insurance *reduces* claim frequency. The logic underlying the conventional wisdom is that workers without health insurance who need medical treatment and cannot afford to obtain it may be incented to file a false claim in order to secure such treatment. Thus, providing workers with health insurance would reduce claim frequency by reducing the incentive to file false claims.

Recent research from the Rand Institute for Civil Justice casts doubt on this conclusion. The study showed that injured workers in firms that offer health insurance are 21 percentage points more likely to file a workers compensation claim than injured workers in companies that do not offer health insurance (60% vs. 39%). The study’s authors opine that “...workplaces offering health insurance may be offering more information and/or encouraging injured workers to seek benefits... [and] employers who chose to offer health insurance may have unobserved characteristics that also make them less likely to discourage workers compensation filing.” They also indicate that concerns about the use of workers compensation to cover non-occupational illnesses and injuries are “probably overstated.”^{vii}

The conclusions in the RAND study are reinforced by other research that showed a lack of evidence of a “Monday Morning” effect in workers compensation claims – that is, the fraudulent filing of workers compensation claims on a Monday for strains and sprains incurred over the weekend in non-work-related activities. That latter research found that workers with a low probability of medical coverage are no more likely to report a Monday injury than are other workers. In addition, employers were seen to be no more likely to challenge the Monday injury claim of workers regardless of the medical insurance coverage rates of such workers.^{viii}

More broadly, with high cost cited as the main reason for not having health insurance, “reform” legislation will likely include measures to reduce the costs of the healthcare system. Such measures are likely to filter through to workers compensation. That has certainly been the case in terms of the Resource Based Relative Value Scale (RVRBS), which was adopted as the basis for payment by Medicare in 1992. That system is now widely used as a basis of workers compensation fee schedules. Indeed, according to a 2006 WCRI study, “more than half of the 42 states [in their analysis] base their workers compensation fee schedule on the RBRVS system, at least in part.”^{ix}

Other cost-containment measures now widely used within workers compensation, such as utilization reviews and treatment guidelines, were rooted in the managed care systems that became prevalent during the early 1990's. It seems likely that newer cost control programs such as pay for performance and pay per claim, that are being discussed for health care, likely will also begin to appear in workers compensation in the future.

Conclusion

The debate on healthcare is still in its early stages, and it will be up to the next Administration and Congress to reach agreement on any reform legislation. If history is a guide, workers compensation will likely follow and be affected by group health initiatives. NCCI will naturally be monitoring developments with an eye toward their implications for our industry.

Martin H. Wolf, Ph.D., July 21, 2008

ENDNOTES

ⁱ For example, the 47 million figure is cited in the opening sections Senator Clinton's healthcare plan ("The American Health Choices Plan: Ensuring Quality, Affordable Health Care for All Americans."). A similar (45 million) figure is cited in Senator Obama's website dealing with his healthcare initiative.

ⁱⁱ US Census Bureau, "Income, Poverty, and Health Insurance Coverage in the United States: 2006," Issued August 2007. The data shown in Exhibit 1 is based on Table 6 of the Census report. Note that the categories shown are not mutually exclusive.

This section of the analysis benefits from a November 4, 2007 *New York Times* op-ed article by N. Gregory Mankiw, currently a professor at Harvard and formerly Chairman of the President's Council of Economic Advisors under President Bush.

ⁱⁱⁱ John A. Graves and Sharon K. Long, "Why do People Lack Health Insurance?" in *Health Policy Online*, No. 14, published by The Urban Institute.

^{iv} This annual survey is undertaken by the National Center for Health Statistics of the CDC (Centers for Disease Control and Prevention).

^v The lower percentage for younger workers may reflect the belief on the part of such workers that health insurance is something they do not need at this stage of their life (on the dubious premise that their youth and general good health makes health insurance an unnecessary expense). In that regard, recent NCCI research showed a substantial difference in emergency room use between younger (aged 20-34) and older (aged 45-64) workers, possibly related to (1) Census Bureau data (for 2005) that showed that 31% of persons aged 18-24 and 26% of persons aged 25-34 were uninsured, as opposed to just 15% for persons aged 45-64, and (2) uninsured adults are almost four times as likely as insured adults to lack a personal doctor or health care provider. The complete NCCI study, "Younger Vs. Older Workers Going to the Emergency Room: Explaining Differences in Utilization and Price," is available on ncci.com (INSERT LINK).

^{vi} For a discussion of the alternative views of the candidates on health care reform, see "The Real Health Reform Debate We Need to Have," PowerPoint presentation by Drew Altman, President and CEO of The Henry J. Kaiser Family Foundation, at the National Academy of Social Insurance 20th Annual Conference, January 31, 2008. Available on the NASI website at www.nasi.org.

^{vii} Darius Lakdawalla, Robert T. Reville and Seth Seabury, "How Does Health Insurance Affect Workers' Compensation Filing?," RAND Institute for Civil Justice, Working Paper No. WR-205-1-ICJ, April 2005, pp. 3-5, 25, 27.

^{viii} David Card and Brian P. McCall, "Is Workers' Compensation Covering Uninsured Medical Costs? Evidence from the Monday Effect," *Industrial and Labor Relations Review*, Vol. 49, No. 4, (July 1996).

^{ix} Stacey M. Eccleston and Te-Chun Liu, "Benchmarks for Designing Workers' Compensation Medical Fee Schedules: 2006," Workers Compensation Research Institute, November, 2006, p.5.

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