NCCI Holdings, Inc.

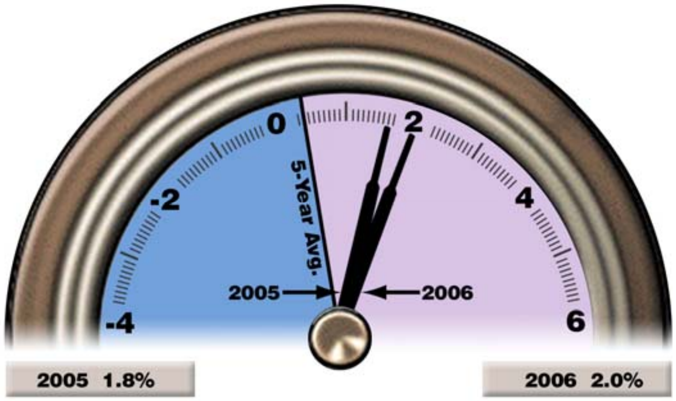
Gauging the Economy

Vol. 4 • 2005

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

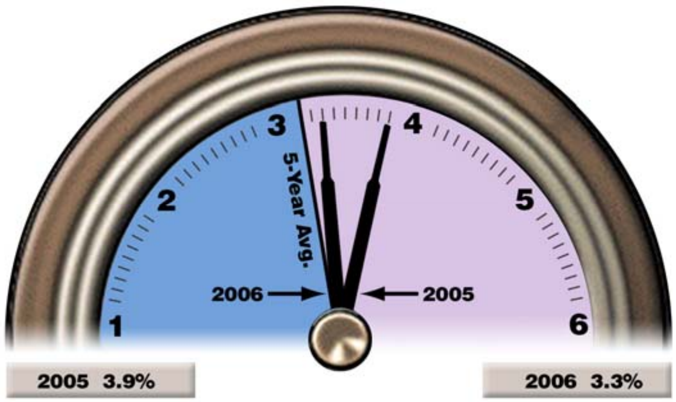
The gauges below indicate the economic outlook for the current year and 2006 for factors that typically impact workers compensation. Each gauge also provides some context for the outlook, relative to a historical average of the previous five years.

Improved Job Growth May Slow the Pace of Prospective Frequency Declines
Job growth is expected to remain upbeat this year and next, consistent with the ongoing economic expansion. In general, increases in employment are accompanied by a rise in the number of new or less well-trained employees. That suggests some slowing in the decline in claim frequency (a decline that has been under way since the early 1990s).



Private Sector Employment Growth Much Improved

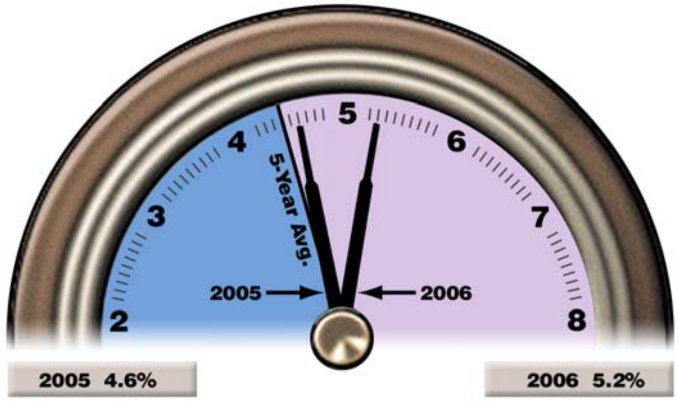
Continued Wage Gains Will Likely Push Up Indemnity Severity
Wage gains are expected to average nearly 4% this year and 3.5% in 2006, as workers share in the fruits of the expansion as well as ongoing gains in productivity. Since indemnity benefits are tied to wage growth in most states, the rise in wages suggests further increases in indemnity severity.



Average Weekly Wages on the Rise

Accelerating Price Increases for Medical Care Imply Further Increases in Medical Severity

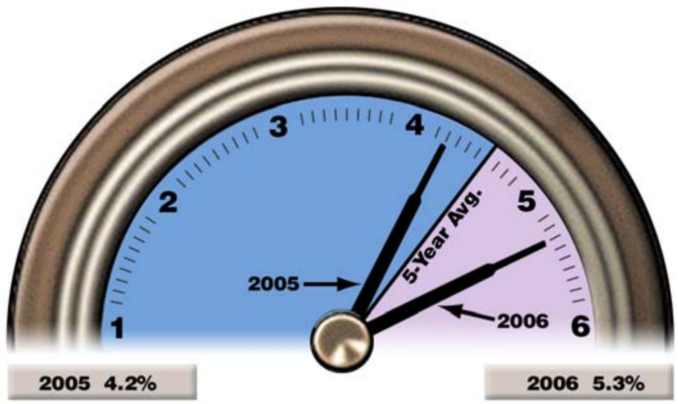
Medical care price inflation shows no sign of abating, with increases in the medical care component of the CPI expected to average 5.2% in 2006 versus 4.6% this year. Those increases are likely to be reflected in additional upward pressure on medical severity.



Medical Care Price Increases Continuing

Firming Interest Rates in 2006 Suggest Better News on Investment Income

After being little changed through much of 2005, longer term yields moved higher toward year's end. Long-term rates are expected to continue to rise in 2006, consistent with the economy's increasing credit needs and the likelihood of further short-term rate increases by the Federal Reserve. As long as corporate earnings reports remain upbeat, the rise in long-term rates is unlikely to dampen the stock market, and hence, carriers' ability to achieve realized capital gains. Of course, higher yields will also provide a boost to fixed-income returns on newly invested funds. (The average maturity of Treasury securities held by P&C carriers is roughly seven years.)

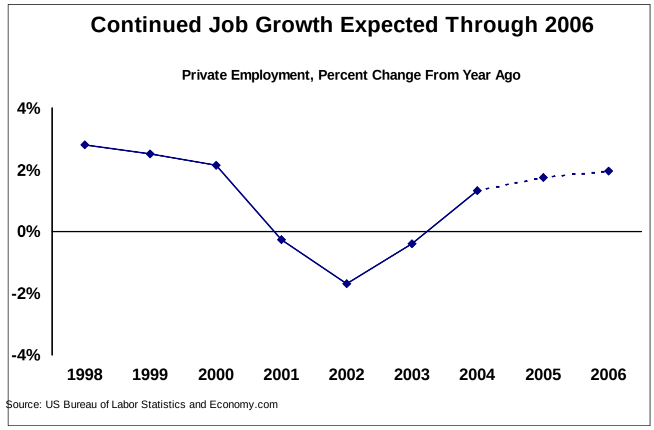


Behind the Gauges: Labor Market Conditions

Claim Frequency

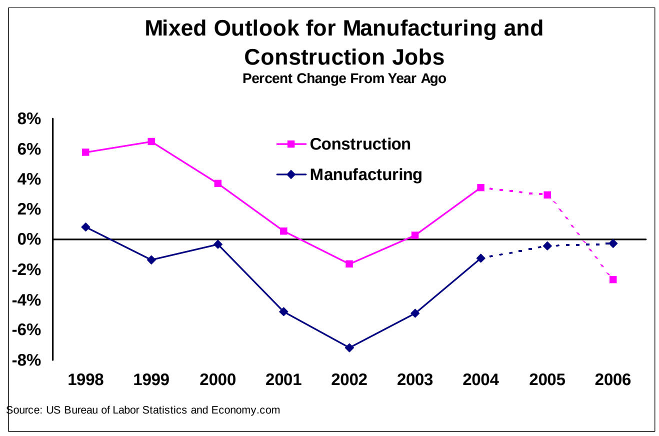
Employment Growth

- Private sector job gains are expected to average 1.8% this year and 2.0% in 2006, a marked improvement from that seen earlier in this expansion. Indeed, some 200,000 jobs are expected to be added each month, on average, in 2006. This compares with an average 170,000 monthly gain in 2005.
- In general, increases in employment tend to reduce the skill level of the workforce, which suggests a slower rate of frequency decline going forward.



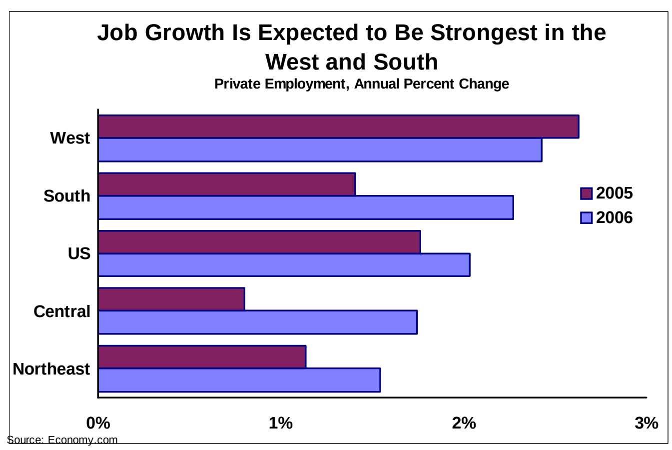
Manufacturing and Construction

- These more hazardous sectors are expected to follow a mixed pattern in 2005 and 2006.
- As US-based production comes under continued competition from lower cost producers abroad, manufacturing jobs are likely to weaken further.
- Construction employment, meanwhile, is on track to increase nearly 4% in 2005, reflecting a generally strong housing market and rebuilding related to the slew of hurricanes that decimated many southern states. However, prospects for continued increases in mortgage interest rates suggest reduced home building, with a resulting decline in construction jobs in 2006.



Regional Prospects

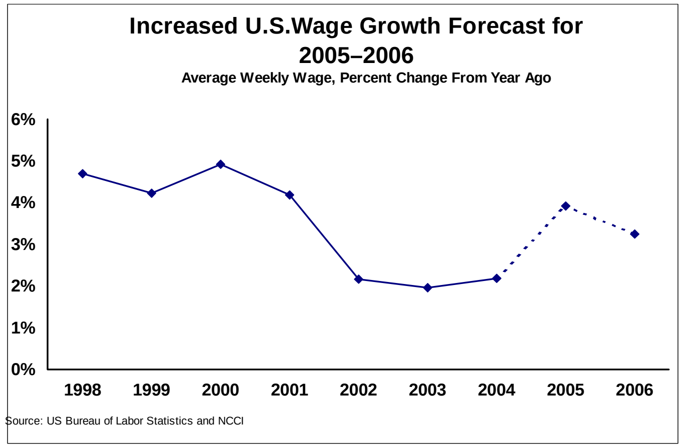
- Employment prospects are strongest in the West and weakest in the Northeast. Gains in the West are in no small part related to the markedly stronger population growth there, along with substantially lower business costs. Weakness in the Northeast, and in the Central states as well, reflects the presence of old-line (and often less safe) manufacturing facilities in those areas.
- The outlook for job growth in the South partly reflects the effects of Hurricane Katrina. That storm caused a sharp drop in employment in a number of southern states, which has depressed job growth for 2005 as a whole. The accompanying article on the ensuing implications focuses on the impact Katrina had on employment in the region and the implications for key workers compensation indicators.



Indemnity Severity

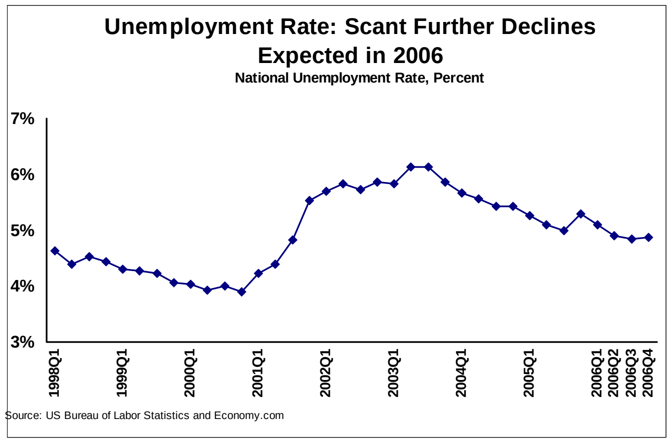
Wage Increases

- The key factor affecting the change in indemnity payments in many states is the increase in state average weekly wages.
- The pace of wage gains is expected to increase substantially in 2005 and 2006 versus 2004, reflecting the strengthening economy and ongoing increases in productivity. This suggests continued upward pressure on indemnity severity this year and next.



Unemployment Rate

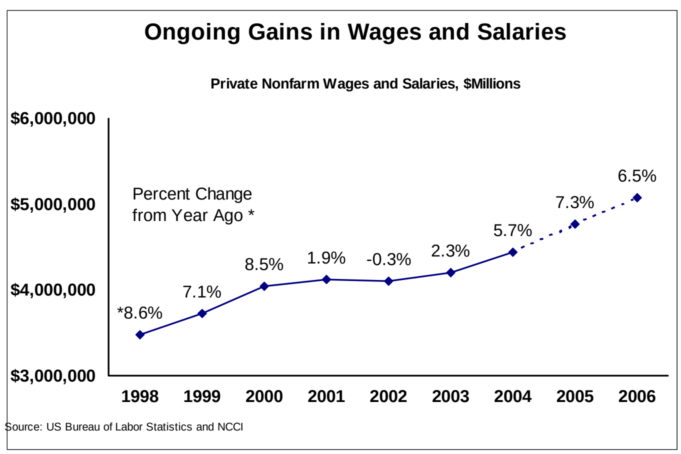
- One factor helping to boost wage gains is the continued lowering in the unemployment rate. Nationally, the rate stood at 5.0% in the third quarter, down from a high of 6.1% in the third quarter of 2003.
- Although down substantially, the unemployment rate is not expected to decline to the 4% range seen prior to the 2001 recession.
- The forecasted up-tick in the unemployment rate in the fourth quarter of this year is attributable to the temporary effects of Hurricane Katrina.



Premium Growth

Wages and Salaries

- After languishing in 2001 through 2003, growth in wages and salaries moved up substantially in 2004, with further gains expected in 2005 and 2006.
- Since workers compensation premiums are based on payrolls, prospective increases in wages and salaries suggest premiums will also be moving higher.



Implications

Mother Nature Strikes Back

Workers Compensation is likely to take a temporary premium hit from Hurricane Katrina. Frequency and severity impacts are less certain, but are likely to be mild, based on past experience.

The 2005 hurricane season has finally ended—and none too soon for the residents of Florida and the Gulf Coast states, who have been battered by a record number of storms. These storms, particularly Hurricane Katrina, resulted in enormous destruction of wealth and physical capital, and indeed, Hurricane Katrina has replaced Hurricane Andrew as the nation's most costly natural disaster (see Exhibit 1).

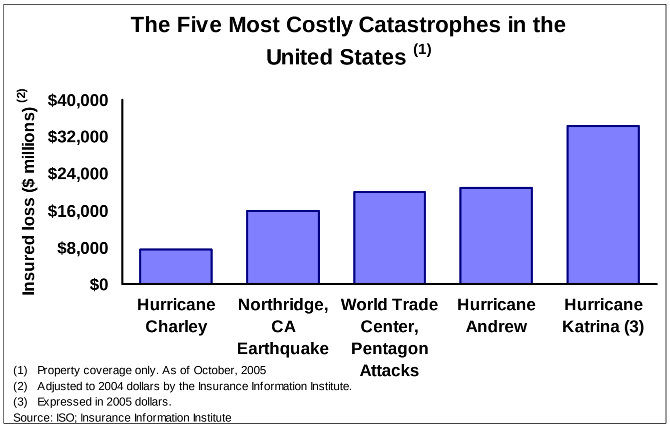


Exhibit 1

Although the initial effects of Hurricane Katrina will depress economic growth from what might have otherwise been the case, the rebuilding process that is now under way will provide a much needed boost to the economies of the affected areas—and to the national economy as well. Indeed, Economy.com indicates that its post-Katrina forecast of national employment growth will be substantially higher in the second half of 2006 and in the first half of 2007 than its pre-Katrina forecast (see Exhibit 2). As has been the case in prior recoveries from natural disasters, the ensuing rebuilding leaves the infrastructure and the overall economy in the affected areas far stronger than was previously the case.

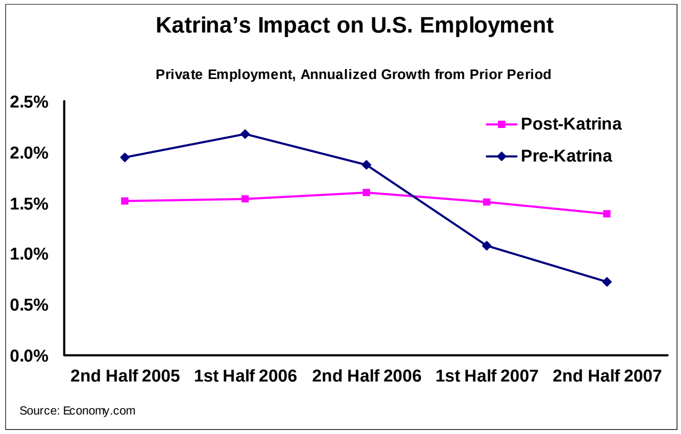


Exhibit 2

Most discussions relating to the implications of Hurricane Katrina on the insurance industry have focused on the extent of the property damage in affected areas and issues relating to flood insurance and related coverages. However, there are also a number of important implications for workers compensation insurance in terms of exposure, premium, and frequency and severity. The balance of this article focuses on those implications.

Exposure

Louisiana and Mississippi were the two states most affected by Hurricane Katrina. Private sector employment in Louisiana plunged 235,000 in the first reporting period following the storm (i.e., in the September employment report, released in early October), with virtually all the job losses coming from New Orleans (216,000). On a percentage basis, New Orleans suffered an initial drop in employment of 42%. Some 49,000 jobs were initially lost in Mississippi, with about half in the Gulfport-Biloxi metropolitan area. As of October's job report (released in early November), only 6,500 jobs were regained in Louisiana, although jobs in New Orleans rose 14,000 (nearly 5%). Jobs in Mississippi as a whole rose 8,000 in October, even as employment in the Biloxi area declined an additional 1,000.[1]

Exhibits 3 and 4 provide the percentage distribution of job losses by industry through October (vs. August) for Louisiana (Exhibit 3) and Mississippi (Exhibit 4). Also shown is an estimate of the total wages lost during that period. The estimate is developed by multiplying the reported decline in the number of persons on payrolls between August and October by the US Labor Department's estimates of average monthly wages in the counties and parishes most likely to be affected by Hurricane Katrina.

[1] The US Bureau of Labor Statistics included in its data an "adjustment" factor to incorporate potential distortions due to firms not being able to report because of temporary plant shutdowns, lost or destroyed records, etc.

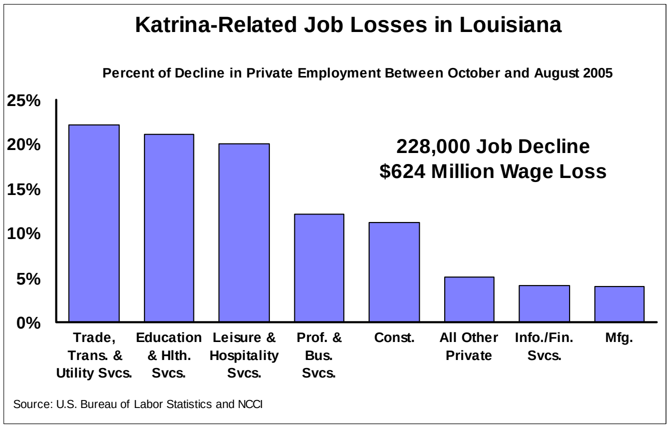


Exhibit 3

As shown in Exhibit 3, the 228,000 decline in reported private payroll is concentrated in the trade/ transportation/utility, education/health care and leisure/hospitality sectors. The overall job loss in Louisiana through October implies a loss in wages of $624 million.

For Mississippi, the 41,000 decline in private employment is concentrated in the trade/transportation/utility and leisure/hospitality sectors. The implied wage loss is $97 million across all sectors. Since many companies continued to pay their workers while business was disrupted by Katrina, these estimates are best viewed as very rough indicator of the potential decline in the wages.

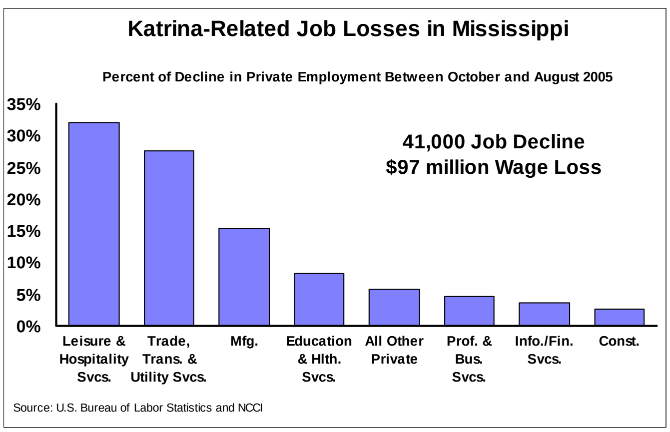


Exhibit 4

Wage losses seem likely to moderate in the months ahead. For example, there are already signs of a pickup in employment in Mississippi's manufacturing industries, and repair work on New Orleans' critical port facilities and its gaming facilities is proceeding at a fast pace (although damage to Harrah's casino may keep that facility closed next year). Some gaming workers are reportedly finding work in other facilities, suggesting that the net job loss may be less than that implied by looking solely at state-specific data. Also encouraging in this regard is that workers in major retail chains that were damaged in the storm, such as Wal-Mart, are finding jobs in other company locations.

One indication of the possible speed of recovery can be inferred from what occurred in the Miami metropolitan area following Hurricane Andrew, which devastated southern Florida in August 1992. Within four to six months, all of the most-affected industries (leisure and hospitality, retail trade, and education and health services) had regained their hurricane-related job losses. At the same time, construction employment surged, increasing 7% in September (vs. August), 11% in October, and 3% in November (all on a seasonally adjusted basis).

It is still too soon to know how quickly employment in the storm-affected areas will return to "normal" levels. In this regard, a recent Labor Department analysis of the near 900,000 evacuees from Katrina indicated an unemployment rate of nearly 28% for those who have not returned to their prestorm residence and 12.5% for those who have returned home.[2] Interestingly, the unemployment rate for New Orleans (from where most evacuees originated) was 16% in October, suggesting that many of those returning to their prestorm residences may be doing so because a job was waiting for them.

Premium

Since workers compensation premium is based on the wages of covered workers, the loss in wages implies a decline in premium payments to insurers. A rough calculation of the amount of lost premium can be obtained by first multiplying total wage losses by the share of WC business written by private carriers (and state funds) and then multiplying the resultant product by the premium-to-payroll ratio in the state (based on recent historical averages).

For Louisiana, that calculation, including the State fund, suggests a potential premium loss of $8.9 million through October. For Mississippi, the potential premium loss is roughly $0.7 million.

To be sure, where companies cease operations or lay off employees, there will be an unambiguous reduction in premium because of the associated decline in payrolls. Many small businesses may fall into this category. But for larger companies, the loss in jobs may be temporary, and as discussed below, there may be far less of an impact on premium than the "worst case" calculation above.

[2] A total of 886,000 persons were evacuated, according to the Labor Department's analysis. Of those, 442,000 returned to their prestorm residence as of November, while 443,000 were in a different residence. Some 46% of those returning home were employed versus 41.6% for those still in a remote location.

- For example, where companies have suspended operations but continue to compensate their workers, the premium impact depends on whether the compensation is in the form of a grant (which may be considered a "perk" that is excluded from payroll) or in the form of hourly wage or salary, which is counted toward premium.[3]
- Where a company continues to compensate their "nonworking" employees via wage or salary payments (while operations are interrupted or suspended), carriers may consider a change in the governing classification to a classification such as "office and clerical" (Code 8810) or "clerical telecommuter" (Code 8871). This could affect premium to the extent that premium was formerly based on more hazardous job classifications. Once normal business operations resume, however, appropriate classifications should apply.[4]
- One potential risk for insurers is that employees involved in hurricane cleanup prior to a business resuming normal operations may be engaged in more hazardous activities than their "business as usual" job classification entails. Insureds and their carriers may want to discuss such issues based on individual company circumstances. If properly reported, this could well lead to a temporary rise in premium. Premium may also be affected by President Bush's decision to suspend application of the federal law governing workers' pay on federal contracts in the Hurricane Katrina-damaged areas. This action will likely reduce payrolls in some cases. Indemnity severity might also be reduced to the extent that wage rates are reduced.

Frequency and Severity

As with exposure and premium, the frequency and severity implications of Hurricanes Katrina and Rita are likely to be localized and transitory in nature.

In terms of frequency impacts, frequency may initially decline to the extent that workers who are unable to work are kept on payrolls. However, where companies may be unable to reopen, there may be a temporary jump in frequency as workers attempt to gain benefits by filing possibly fraudulent claims. Frequency may also jump if workers engage in more hazardous-than-normal activities related to storm cleanup or if they work prolonged hours, resulting in increased fatigue and a heightened risk of accidents.

To see what impact hurricanes have had on claim frequency in the past, NCCI examined contractor injury rates in Florida before and after four major hurricanes in 2004 (Hurricanes Charley, Frances, Ivan, and Jeanne), all of which occurred between August 13 and September 25, 2004). We looked at the ratio of claims in counties in the hurricanes' paths to claims in all other counties in Florida for each of the six quarters before those storms and in the third and fourth quarter of 2004. The results of that analysis, shown in Exhibit 5, are that there appears to be no discernable impact on frequency, with the ratio essentially the same in prestorm and poststorm periods.

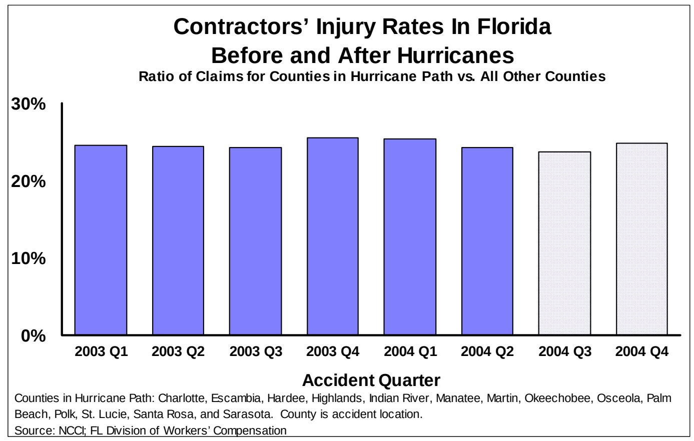


Exhibit 5

In terms of severity, there may be some initial upward pressure on indemnity severity from the aforementioned "plant closing" effect as well as from possibly more severe (and longer-to-heal) injuries associated with cleanup activity. For example, toxic substances deposited by storm and flood damage also pose an immediate and longer term risk to workers. (The suspension of wage restrictions on federal contracts may, as noted, work in the opposite direction.)

Since these various impacts will be occurring over a possible extended time period, it is too soon to make judgments as to the effects on indemnity and severity. However, as with frequency, history suggests that the impacts may not be substantial. In that regard, NCCI examined the pattern of indemnity and medical severity payments for the "top-ten" contractor class codes, evaluated at 5th report, prior to and after Hurricane Andrew. On a percent-change-from-year-ago basis (concluded from seasonal patterns in the data), there was only a limited indication of any impacts from the storm.

[3] Full details on this option are provided in NCCI's ***Basic Manual for Workers Compensation and Employers Liability Insurance***, Rule 2-B-2-1.

[4] See Rule 1-F-1 in the Basic Manual.

Key Conclusions

History suggests that the economy will quickly recover from the effects of Hurricane Katrina—although it will take far longer for the societal costs to be absorbed. For workers compensation, the following effects are expected:

- Some declines in exposure, but with a quick turnaround in most cases. Construction employment is likely to boom, based on past experience.
- A short-lived decline in premium, except for severely impacted industries such as gaming. Any premium decline in the affected areas are likely to be moderated because many larger companies continue to pay workers prior to resuming normal business operations and because workers are able to obtain employment elsewhere (reducing the net loss in premium to the workers compensation system as a whole).
- Prior experience also suggests little in the way of increases (or decreases) in either frequency or severity, although reliable information in that regard will not be available until normal reporting processes have had time to generate sufficiently mature information.

[3] Full details on this option are provided in NCCI’s ***Basic Manual for Workers Compensation and Employers Liability Insurance***, Rule 2-B-2-1.

[4] See Rule 1-F-1 in the Basic Manual.