Mega-Trends Influencing the Workers Compensation Insurance Industry

62nd Annual Workers Compensation Educational Conference
Orlando, FL

August 13, 2007
IT’S EASY TO FEEL GOOD ABOUT WORKERS COMP TODAY

Once Disastrous Line, Now Makes Healthy Profit
Workers Comp Combined Ratios, 1994-2006p

Workers Comp Calendar Year – Private Carriers

Percent

WC insurers lopped 25 points off the combined ratio in just 5 years

p Preliminary AY figure.
Accident Year data is evaluated as of 12/31/2006 and developed to ultimate
Source: Calendar Years 1994-2005, A.M. Best Aggregates & Averages; Calendar Year 2006p and Accident Years 1994-2006p based on NCCI Annual Statement Analysis.
Includes dividends to policyholders
As recently as 2001, insurers were paying out nearly $1.16 for every dollar they earned in premiums.

2006 produced the best underwriting result since the 91.2 combined ratio in 1949.

2007/8 deterioration due primarily to falling rates, but results still strong assuming normal CAT activity.

2005 figure benefited from heavy use of reinsurance which lowered net losses.

Workers Comp
Profitability Is Improving

WC profitability is on the rise, but is it sustainable?

Pre-Tax Operating Gain Ratio (%)

Source: NCCI
P/C Net Income After Taxes
1991-2007F ($ Millions)*

- 2001 ROE = -1.2%
- 2002 ROE = 2.2%
- 2003 ROE = 8.9%
- 2004 ROE = 9.4%
- 2005 ROE = 9.4%
- 2006 ROAS\(^1\) = 14.0%
- 2007F ROAS = 12.9%**

Insurer profits peaked in 2006/7. “Normal” CAT year, average investment gain imply flattening

*ROE figures are GAAP; \(^1\)Return on avg. surplus. 2007F figure is annualized actual Q1 net income of $15.813B **Actual first quarter 2007 result.
Sources: A.M. Best, ISO, Insurance Information Inst.
WHY YOU SHOULD FEEL GOOD ABOUT WHAT YOU DO

Saving Lives, Increasing Productivity and Much More

It’s Not Just About the Money
Did You Know That When You Prevent a Workplace Injury You…

• Keeping Workers Comp Costs Down is Just the Beginning
• You Help Companies Remain Productive¹
  ➢ **Permanently Disabling Injuries** → 565 Lost Future Work Days on Avg.
  ➢ **Fatal Injuries** → 5,850 Lost Future Work Days on Average
• You Increase/Preserve Worker Incomes
  ➢ Seriously Injured Workers Have Lower Lifetime Earnings, on Average
  ➢ Reduced Likelihood of Filing Bankruptcy
  ➢ Less Likely to Need Public Assistance
• You Maintain/Improve the Quality of Worker’s Home Life
  ➢ Higher Incidence of Divorce, Substance Abuse, Depression Among Seriously Injured

**ALL REASONS TO BE PROUD OF WHAT YOU DO!!**

¹ US Census Bureau: http://www.census.gov/compendia/statab/tables/07s0639.xls
Workers Comp Lost-Time Claim Frequency Down More than 50% Since 1991

Cumulative Change of –52.1% since 1991 means that lost work time claims have been cut by more than half

Percent Change

Lost-Time Claims

Accident Year

2006p: Preliminary based on data valued as of 12/31/2006
1991-2005: Based on data through 12/31/2005, developed to ultimate
Based on the states where NCCI provides ratemaking services
Excludes the effects of deductible policies
Source: NCCI
Number of Fatal Work Injuries is Continues to Fall, 1992 – 2006

Workers comp insurers & the entire workplace safety community have contributed to the 14% decline in workplace fatalities since 1994

Fatality rates are down 26.4% since 1994—nearly double the 14% decline in the number of on the job fatalities.

Lives Saved Due to Reduction in Fatal Work Injury Rate, 1995–2006

Reduction in Occupational Deaths Due to Fall in Fatality Rate from 5.3 per 100,000 Workers in 1994 to 3.9 in 2006

Workers comp insurers are a major force in saving worker lives

Nearly 2,000 work lives are saved annually due to improved workplace safety!

Source: Insurance Information Institute from BLS data.
Cumulative Lives Saved Due to Reduction in Fatal Work Injury Rate

Cumulative Lives Saved Due to Fall in Fatality Rate from 5.3 per 100,000 Workers in 1994 to 3.9 in 2006

Since 1995, nearly 15,000 worker lives have been saved due to improved workplace safety!

Source: Insurance Information Institute from BLS data.
There has been a 52% decrease in work-related homicides since 1994. Vehicular deaths are #1 killer.

BUT ALAS, THERE ARE MANY CONCERNS

Operational, Demographic & Regulatory
THE SHRINKING PREMIUM BASE

Competition, Leakage Conspire to Shrink WC
Total Workers Compensation
Premium Declined in 2006

Net Written Premium

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>State Funds ($ B)</th>
<th>Private Carriers ($ B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
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<tr>
<td>2005</td>
<td>47.2</td>
<td>46.0</td>
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1996–2006p State Funds: AZ, CA, CO, HI, ID, KY, LA, MO, MT, NM, OR, RI, TX, UT Annual Statements
State Funds available for 1996 and subsequent
Workers Comp rates (red line) along with most major commercial coverages is renewing down about 10% during 2007.
Alternative Risk Transfer Market
Saps Traditional WC Carriers

$ Billions

- Workers Comp, 43%
- Automobile, 12%
- Liability (excl. Auto), 35%
- Property, 10%

Workers Comp account for the largest share of the alternative market, particularly captives.

Source: MarketStance.
Workers Compensation: Large Deductible Market Share

Employers have become very accustomed to accepting a greater share of risk and claim frequency has decreased.

Strength of Recent Hard Markets by NWP Growth*

Note: Shaded areas denote hard market periods.
Source: A.M. Best, Insurance Information Institute

*2007-10 figures are III forecasts/estimates. 2005 growth of 0.4% equates to 1.8% after adjustment for a special one-time transaction between one company and its foreign parent. 2006-2008 figures from III Groundhog Survey.
Growth in Net Written Premium, 2000-2008F

P/C insurers will experience their slowest growth rates since the late 1990s…but underwriting results are expected to remain healthy.

*2007 figure based 2007:Q1 result of 0.8%.
Source: A.M. Best; Forecasts from the Insurance Information Institute.
MEDICAL CLAIM COST INFLATION

The Problem That Will Never Go Away
WC Medical Severity Rising Far Faster than Medical CPI

WC medical severity rose more than twice as fast as the medical CPI (8.8% vs. 4.0%) from 1995 through 2006.

Workers Comp Medical Claims Continue to Climb

Medical Claim Cost ($000s)

Annual Change 1991–1996: +4.1%
Annual Change 1997–2005: +9.5%

Cumulative Change = +200%
(1993-2006p)

2006p: Preliminary based on data valued as of 12/31/2006
1991-2005: Based on data through 12/31/2005, developed to ultimate
Based on the states where NCCI provides ratemaking services; Excludes the effects of deductible policies
Med Costs Share of Total Costs is Increasing Steadily

Source: NCCI (based on states where NCCI provides ratemaking services).
WC Med Cost Will Equal 70% of Total by 2016 if Trends Hold

2016 Estimate

Source: Insurance Information Institute.

WC med costs could equal 70% of system costs by 2016. This means that claims severity will accelerate relative today and claims management will become progressively more difficult and complex.
INDEMNITY CLAIM COST INFLATION

The Problem That Can Sometimes Be Tamed
**Workers Comp Indemnity Claims Costs Have Accelerated, 1993-2006p**

Indemnity Claim Cost (000s)

Lost-Time Claims

Annual Change 1991–1996: +1.2%
Annual Change 1997–2005: +6.6%

Cumulative Change = +108.5% (1993-2006p)

2005p: Preliminary based on data valued as of 12/31/2006
1991-2005: Based on data through 12/31/2005, developed to ultimate
Based on the states where NCCI provides ratemaking services
Excludes the effects of deductible policies
Source: NCCI
WC Indemnity Severity vs. Wage Inflation

WC indemnity severity is once again outpacing wage inflation

Source: NCCI
THE AGEING WORKFORCE

Working Longer, But Not Stronger
The median age of US workers as the Baby Boomer begin to retire is about 41 years. Immigration will hold this number down and may even lower the figure.

Fatal Work Injuries per 100,000 Workers (2006)

Fatality rates for workers 65 and older are **triple** that of workers age 35-44. The workplace of the future will have to be completely redesigned to accommodate the surge in older workers.
THE OBESITY EPIDEMIC

Major Cost Driver that WC Has Yet to Address
The most obese workers file twice as many WC claims and 13 times more lost workdays than healthy weight workers.

Obesity is costing workers comp insurers and employers billions.

Med claims costs are 6.8 times higher for the most obese workers and indemnity costs are 11 times higher.

REGULATORY NIGHTMARES

WC’s Low Profile Won’t Last Forever
Regulatory Concerns

- Political Populism is On the Rise
- Eventually WC Trends Will Turn Adverse
- New Congress and Populist Governors, Attorneys General and Insurance Commissioners Will Take Great Interest in WC Which Impacts All Employers and Their Workers

FLORIDA SCENARIO
- Governor would react to rising workers comp rates the same way he reacted to rising property rates
- Rates would be actively suppressed
- Proposal to create “competitive” state fund that would also subsume residual market
- Would be unlikely to charge actuarially sound rates or set proper reserves
- Residual market would explode with deficits financed by voluntary mkt.
- State fund would grow rapidly and market would become progressively more socialized, possibly substantially so while real problems go unaddressed/
- SOUND FAMILIAR???
Regulatory Concerns (cont’d)

• McCarran-Ferguson
  ➢ Narrowing could be harmful to WC rating bureaus and smaller insurers who rely most heavily on advisory loss cost information

• Health Care Reform Déjà Vu—1992
  ➢ Health Care reform will be a major theme in 2008 elections as in 1992
  ➢ Back in 1992, it was proposed that workers comp would be rolled into the general health care system
  ➢ This could happen again
  ➢ Insurers back then fretted about the “Medical Indemnity Disconnect”

• Terrorism
  ➢ Extension virtually assured, but will likely be December
  ➢ House has proposed 15-year extension; Senate and Administration will want something much shorter
  ➢ NBCR requirement on property side will have negative impact on insurers to assume workers comp exposure (Senate may excise this)
### Insured Loss Estimates:
**Large NBCR Terrorist Attack ($ Bill)**

<table>
<thead>
<tr>
<th>Type of Coverage</th>
<th>New York</th>
<th>Washington</th>
<th>San Francisco</th>
<th>Des Moines</th>
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<tbody>
<tr>
<td>Group Life</td>
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<td>$22.5</td>
<td>$21.5</td>
<td>$3.4</td>
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<tr>
<td>General Liability</td>
<td>14.4</td>
<td>2.9</td>
<td>3.2</td>
<td>0.4</td>
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<tr>
<td>Workers Comp</td>
<td>483.7</td>
<td>126.7</td>
<td>87.5</td>
<td>31.4</td>
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<tr>
<td>Residential Prop.</td>
<td>38.7</td>
<td>12.7</td>
<td>22.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Commercial Prop.</td>
<td>158.3</td>
<td>31.5</td>
<td>35.5</td>
<td>4.1</td>
</tr>
<tr>
<td>Auto</td>
<td>1.0</td>
<td>0.6</td>
<td>0.8</td>
<td>0.4</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$778.1</strong></td>
<td><strong>$196.8</strong></td>
<td><strong>$171.2</strong></td>
<td><strong>$42.3</strong></td>
</tr>
</tbody>
</table>

Source: American Academy of Actuaries, Response to President’s Working Group, Appendix II, April 26, 2006.
Summary

- Workers Compensation Markets Will Continue to Perform Well but Operating Results and Profitability Will Begin to Erode
- Competition in WC Markets More Intense Than Anytime in Last 15 Years
- WC Market Participants Have Provided One of the Most Valuable Services in the Industry—Saving Lives & Families
- Should be Proud of Achievements at Time When Insurers are Being Attacked by Politicians in Some States and in Washington
- BUT…Threats Abound
- Pressure is Building in a Number of Area
  - Pricing, Leakage to Alternative Markets
  - Medical Costs, Long-Run Regulatory Environment a Problem
- Disciplined Underwriting, Cost Management Key to Long-Run Success
Insurance Information Institute On-Line

WWW.III.ORG

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