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Making Sense of Workers Compensation Market Swings

J. Bruce Cochrane

Practically every business has cycles, and the workers compensation market is no exception to this rule. Unfortunately, aside from those who make their livings in this market, very few "users" are in a position to identify the workers compensation cycles, to adjust to them, or, more importantly, to take advantage of the opportunities they afford. Often, the changes in the cycle are so subtle that even the trained observer is unprepared. One thing is certain: The workers compensation market cycle does exist, and significant opportunities await those who can react to and take advantage of its changes.

Rate Adequacy: Perception Is Reality

Capital capacity, the cost of money, and underwriting profits are all

associated with workers compensation cycles, but the perceptions of rate adequacy and market stability arguably have the greatest impact on the cycle. While actual rate adequacy can be documented on an insurer's bottom line, the long-tail nature of workers compensation forces insurers to take a longer term view of rate adequacy for this line than for any other line of insurance. It can take several years for the losses from any given year to settle out sufficiently to make a final profitability determination for that year. While actuaries can make reasonable estimates of the eventual outcomes of a given year's experience, actuarial calculations are not an exact science. As Yogi Berra has been immortalized for saying, "It ain't over 'til it's over."

Stability (predictability) is a relative measure that is influenced by recent institutional memory. Insurers that have been conditioned by an overadequate rate environment become alarmed when rates get closer to being simply adequate. The irony is that institutions that place capital into risk-bearing environments try, as much as possible, to take all risk out of the equation. While timidity toward risk and the fear of making a mistake can often paralyze sound underwriting judgment, without at least some degree of predictability, underwriting would soon erode into gambling. No serious businessperson would leave his or her business to pure chance.

Market Decisions Driven by Profit Potential

An insurer's decision to devote capital to a given line of insurance in a given state inevitably boils down to its prospects of making a reasonable profit. The fundamentals of profit are typically a combination of rate, risk selection, and ability to manage the risk once it has been selected. Striking a balance among these elements is crucial to profit stability. When any one element is out of balance, the others must pick up the slack to ensure profitability.

Insurers that are exceptional risk selectors and managers of risk can usually make a profit regardless of the rate. These insurers are the "overachievers" of the workers compensation industry. By minimizing the frequency and severity of work-related injuries, these overachievers create savings for themselves and their insured employers. *Under*achieving insurers can turn a profit only when rates are higher than adequate because they are not as effective at risk selection and risk management as *over*achievers. Insurance buyers are better served by overachieving insurers because injuries will be prevented and those that do occur will be minimized as a result of the risk management process.

The Survivors: Deep Pockets and Overachievers

When rates are considered overadequate, practically any insurer with any workers compensation experience can participate in the market and make a profit, so there are plenty of insurers from whom employers can choose during these periods. As rates drop, either from competition or regulatory fiat, the less-than-effective insurers (underachievers) begin to pull out of the race because they are the first to see their profits erode. The more rates drop, the more insurers get out of the game, until the cycle reaches its bottom — commonly referred to as the trough.

At this point in the cycle, there are generally only two types of insurers remaining in the market: the large, deep-pocket insurers who can make up workers compensation losses in other lines or in other states, and the overachieving insurers. Overachievers that specialize in workers compensation have only one way to turn a profit — their losses and expenses must be less than the premium collected. This is a pretty simple equation, but one that is a direct reflection on the insurer's ability to manage this line of insurance.

Upfront rate discounts are a typical means insurers utilize to attract accounts, but the employer's own experience modification has a greater impact on the amount of ultimate premium paid than any typical rate deviation. Rate deviations provide instant gratification, but the effects are short-term; the effects of loss experience are more long-lasting. Every loss incurred by an employer follows that employer for up to three years, having a direct impact on premium regardless of the insurer for any given policy year. Employers literally have their premium destinies in their own hands, but they generally cannot achieve the lowest loss costs — and, therefore, the lowest premium — alone. An employer usually needs to partner with an insurer to proactively prevent injuries and minimize the impact of those that do occur. The impact of a poorly managed injury can haunt an employer and directly affect its bottom line for years. It stands to reason that the best way for an employer to minimize premiums over time is to choose the workers compensation insurer wisely. Selection should be based not on upfront premium credits or deviations, but on the insurer's ability to manage the employer's risk.

The Massachusetts Experience: A Study in Market Cycles

Workers compensation cycles can be clear and unmistakable or they can be subtle. The ability to discern when a change is in the air is a matter of degree. The more stable the workers compensation environment, the more difficult it is to predict changes in the cycle. Conversely, the more volatile

the environment, the easier it is to observe and even predict a cycle change because the swings can be rather abrupt.

A great example of this principle can be seen by studying the events in the Massachusetts marketplace between 1985 and 2000. The workers compensation system had not been adjusted since 1913, the year the workers compensation law was first enacted in the Commonwealth. Profound societal and technological changes occurring over eight decades finally caught up with the archaic workers compensation system in the early 1980s. The result was paralysis. The system was rendered incapable of responding to changes in the environment. Costs began to escalate wildly, running out of control. Rates could not keep pace with costs, so they became woefully inadequate, forcing most insurers out of the market and the majority of employers into the residual market, also known as the market of last resort.

Workers compensation ratemaking is retrospective in nature, using actual costs and exposures two and three years in arrears from the dates when rates are actually promulgated. As market forces soared out of control in Massachusetts during the 1980s, it became increasingly more impossible for the ratemaking system to predict the skyrocketing trend in cost escalation. Between 1986 and 1991, rates more than doubled, yet there remained no end in sight to this insidious parallel upward spiral of costs and rates. This condition got so bad that an economic crisis ensued. Major employers actively investigated the option of leaving Massachusetts and relocating in states with lower employment costs. Thousands of jobs were at risk.

Reform Sparks a Turnaround

Fortunately, politicians finally woke up. Spurred on by the specter of total system implosion, they enacted sweeping legislative reforms that swiftly turned the system around. But despite resolution of the problems, the system did not return to normalcy for another several years. The same forces that could not keep up with cost escalation on the upward slope of this dramatic cycle could not keep up with the lightning pace of cost reductions put in motion by the reforms. Costs plummeted so quickly that rate overadequacy was as pronounced and prolonged on the downward slope of the cycle as the inadequacy was on the prereform upward slope.

Just prior to reform, no insurers that were subject to steep residual market assessments remained in the market. Immediately following reform, an interesting herd psychology kept most insurers on the sidelines until the improved environment could be validated. However, once the herd was reasonably assured the storm had passed, an unprecedented number of

insurers entered the Massachusetts marketplace. All market participants flourished for a time as rates far exceeded costs.

Exhibit 1 displays the disparities between the actual rates charged during this period and what they theoretically should have been (see "hindsight" rates) to match the actual costs to the system during these years. This volatile period graphically demonstrates the swings in the workers compensation market cycle. Most market cycle swings are more subtle.

During the 10 years following the 1991 reform, rates in Massachusetts were reduced by more than 60 percent. Today, rates remain more than 15 percent lower than they were in 1986, an incredible testament to the effectiveness of the reforms and the unresponsiveness of the ratemaking system.

As the descent from rate overadequacy inexorably led to the trough of rate inadequacy, one by one, insurers have been retreating from active involvement in the Massachusetts market. In today's market, there remains only the predictable combination of survivors: deep-pocket insurers that can afford to weather market fluctuations and the overachiever insurers that have succeeded by excelling in risk selection and risk management.

Choosing Insurers to Minimize Market Fluctuations

As discussed above, management of employers' experience modifications has an enormous impact on their workers compensation premiums over time.

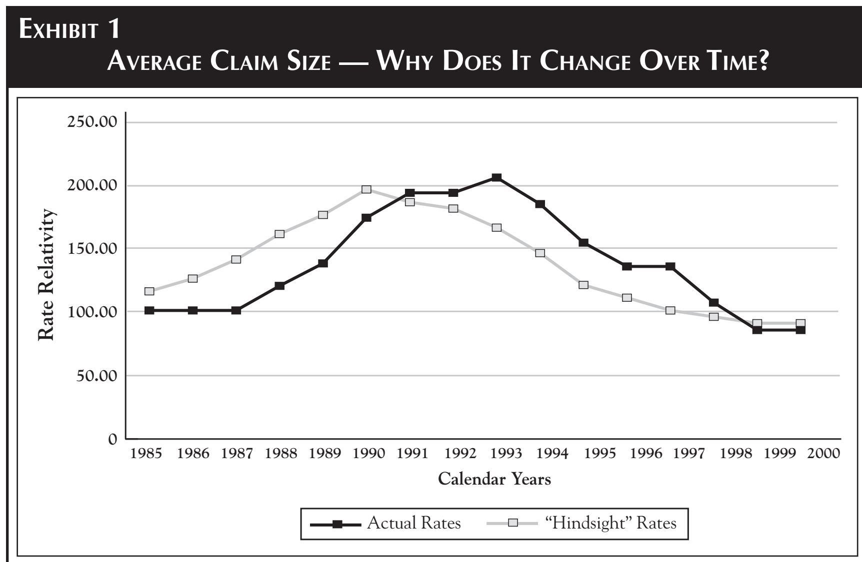

Exhibit 1
Average Claim Size — Why Does It Change Over Time?

For this reason, many employers choose their workers compensation insurers with the purpose of forging long-term relationships to bring consistency and continuity to the management of their workers compensation risk.

To the employer, market subtleties are generally academic. The shift from a buyer's market to a seller's market remains a mysterious process. Few understand insurance dynamics thoroughly enough to recognize that a cheap-pricing feast generally portends a famine. The rapid transition from being courted to being spurned seems capricious, with insurers entering and exiting the market via a revolving door. The employer desperately seeks some predictability in availability, in pricing, and in service.

To minimize market fluctuations and the frustrations and expense of being buffeted around by market forces, employers need to choose their workers compensation insurers wisely. Here are some criteria that should guide selection:

- *Stability in the market*: Look for insurers who have consistently been a presence in your market. Insurers who are present even in the tough times usually have been able to weather the storm due to their ability to overachieve when rates are low.

- *Profitability*: Insurers with consistent profitability have a proven track record for selecting and managing risk through good and bad times. Profitability means the insurer has been able to perform better than its peers.

- *Reputation for managing workers compensation risk*: Ask others in your industry how their exposures were managed by their insurer. The best recommendations come from those who have experienced firsthand an insurer's ability to manage risk.

- *Reputation for responsiveness*: Service providers who are responsive to their customers demonstrate an affinity with their customers' needs. Workers compensation is a time-sensitive and behavioral discipline. Timely and proactive responses to the needs of people are a clear measure of the insurer's attention to detail and understanding of the nuances of the workers compensation exposure.

- *Feet on the ground — local presence*: Insurers who outsource vital services to third parties tend to lose control of the workers compensation variables. Likewise, insurers who try to "centralize" key workers

compensation services territorially lose touch with local peculiarities that can spell the difference between getting by in handling an injury and making a real difference.

Workers compensation is not a commodity. While the minimization of premium may be the end goal for most employers, the most effective and long-lasting means to that end is to find an insurer that can be an effective steward of the employer's workers compensation experience. Over time, the employer's own experience has many times more impact on premium determination than any temporal upfront credit. The above selection criteria should assist an employer in making informed and wise insurer choices.

Summary

Workers compensation market cycles provide buyers with a roadmap to making sound insurer choices. The natural shakeout in insurers following a decline in rates weeds out the weak players. This is an opportune time to discern the overachievers among the remaining players; it is these insurers who are best equipped to help employers manage their workers compensation risk over the long haul, through up cycles, down cycles, and in between.

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