Session No. 533

What's Driving Your Insurance Costs for the Next Five Years

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Introduction

With the passage of the Occupational Safety and Health Act (OSHAct) and the consequent establishment of the Occupational Safety and Health Administration (OSHA) in 1971 many corporations shifted their safety programs' emphasis to specifically address regulatory and compliance issues from traditional accident prevention efforts. Even prior to OSHA few corporate safety programs concerned themselves with worker's compensation and cost issues. Recently, however, safety, health and environmental programs have taken a more practical business focus to demonstrate the numerous ways they contribute to the bottom line and enhance the organization's success (Arnold K., Duchscherer D. &, NyBlom S., 2004). As risk management increasingly becomes a top board agenda item for companies in the current financial crisis, we must further position ourselves to capitalize on this momentum by understanding what is driving our current and future cost of risk. Unfortunately the safety management profession is frequently perceived by many finance executives as a necessary evil and a corporate overhead. (Harrison N., 2006) As a profession we have started to improve our command and usage of the language of the boardroom, the language of economic return.

In fact, more business cases portray the value of effective pre- and post-incident risk control in formal objective studies. Knight and Pretty's study of corporate responses to catastrophes depicted quicker stock value recovery after a catastrophe when effective responses were deployed. (Knight, R., Pretty, D., 1995) A Goldman Sachs JBWere Research Report of Australia markets in 2007 also offers an associated value to business when effective safety management systems are established. This study claims, among other observations, that corporations with an effective safety management system in place outperform the market by 38%. (The West Australian, 2007) These and other respected studies move us away from an era when the benefits of safety and risk control were based on anecdotal examples and fuzzy math concepts to position us to further demonstrate our overall value to business organizations.

To identify what will impact your cost of risk, let's start by examining how insurance carriers operate. The basic function of insurance is the orderly transfer of risk from the organizational client to the insurance carrier utilizing feasible alternative risk management techniques. (Head, G. and Horn, S., 1997) There are numerous internal and external factors affecting the cost of risk to the organizational client but the underwriters evaluation combined with the current investment climate are the most dominate. The insurance carrier's underwriters will evaluate the risks they are assuming and determine the value of transferring that risk and the fees they will charge the

organizational client. Keep in mind that insurance carriers derive revenue primarily in two ways: first through the underwriting process i.e. the process by which insurers select the risks to insure and determine the premium to charge for accepting those risks, and second, by investing the premiums as soon as they are collected and earning interest on the float until claims are paid out.

Ernst & Young, as well as many other economists, asserts in a market outlook report for 2009 that profit margins will be squeezed even more by further asset write downs, falling investment income and increasing loss ratios due to lower rates and higher losses. The challenge of what is likely to become the longest recession since the Great Depression, the tremendous turmoil in the global financial markets and one of the costliest years for catastrophes have combined to start a cycle of price firming that has historically led to a hard market. Robert Hartwig, president of the Insurance Information Institute suggested "…. that compared to banks, insurers are operating normally."(Hartwig, S., 2009) That does not mean there are no changes to expect in the insurance markets, and understanding why the insurance industry is "operating normally" is fundamental to our capitalizing on the situation and will position us to advise and support our management and clients through the current difficulties. In this paper we have applied a modified SWOT analysis (Strengths, Weaknesses, Opportunities and, Threats) to examine, attempt to identify, and explain the potential risk drivers we can anticipate having an impact on our property and casualty insurance costs in the next five years.

Strengths

Whereas at one point it was good enough just to have insurance in place, it has never been more pertinent to ensure that the safety, insurance and risk management strategies and processes are as streamlined and efficient as possible. When the market hardens, as it appears to be doing now, even finding coverage can be a challenge as insurance carriers raise rates and become more restrictive in their underwriting practices. Consequently the organizations that best demonstrate control of their workers' compensation costs by developing strategies and practices to manage their exposure to work related injury costs will enjoy a competitive advantage. And while many companies are good at this, many more are missing the opportunity to gain new savings by painting the picture of their "state of risk." Safety professionals have long maintained that our efforts have a major impact on workers' compensation losses and actual costs. (ASSE. 2002 and Abrams, A., 2001-2002) However, after the establishment of the Occupational Safety and Health Administration (OSHA) in 1971, we became less involved in workers' compensation and cost issues and specifically focused on regulatory and compliance issues. We now need to shift that focus to painting the picture of how well our efforts are at managing risks, both current and anticipated.

Let's look at how we prepare for a catastrophe and disaster recovery. The Knight and Pretty study suggested that market forces have an initial negative reaction resulting in an immediate drop in an organization's stock price following a catastrophic event. They maintain that although the cash flow impact i.e. how much of the risk was anticipated and transferred, is not known with certainty at the time of the catastrophe, the stock market will form a collective opinion and adjust value accordingly. Usually this effect will have an initial negative impact on shareholder value, cushioned somewhat by the extent to which the aforementioned insurance recoveries reduce the cash outflows associated with the catastrophe. After this brief initial drop, the market begins to evaluate the organizational response to the event to determine what the catastrophe reveals about the organization's management skills not previously reflected in shareholder value. The study further proposes this re-evaluation of management is likely to result in a market re-assessment of

the firm's future cash flows in terms of both magnitude and confidence with potentially large implications for shareholder value.

Management, including safety and risk control, is placed in the spotlight and has an opportunity to demonstrate its skill or otherwise in the extreme situation. If the benefits of what is revealed about management outweigh the net financial loss of the catastrophe the combined effect could be favorable. However, if the management reevaluation is judged unfavorable, the effects are negative, since this will amplify the negative impact of the financial loss. To corroborate this theory the study examined the stock performance of organizations experiencing a catastrophe. The study concluded that those organizations identified as implementing effective responses outperformed the market by 7% one year post catastrophe. On the opposite hand, organizations with an ineffective response to a catastrophe ultimately underperformed the market by 15% one year post event according to the Knight and Pretty data. (Knight, 1995). Both outcomes demonstrate the significant impact our work has on our organization's shareholder value.

Short of a catastrophic event, how can we demonstrate the impact we have on our organization? One of the best ways to demonstrate how well we are doing in controlling our organization's risk is to prepare a "statement of risk." This document can then be used during the renewal process to differentiate your risk control success to the potential carrier's underwriters even as they apply more restrictive criteria in this economic downturn. What kind of factors should be included in your statement of risk? In most organizations, at least half of the total cost of serious workplace injuries stem from three leading causes: Overexertion, Falls and Bodily Reaction i.e. Injuries from bending, climbing, slipping or tripping without falling (Liberty Mutual Research Institute for Safety 2008). Benchmark your organization's data against the Bureau of Labor Statistics (BLS) data and other like organizations in your North American Industrial Classification System (NACIS) sector. Favorable loss frequency rates translates to a favorable impact on experience modification, and therefore on the cost of insurance in either hard or soft markets.

Next, include how you got to this favorable position relative to your frequency. Summarize the major components of your safety and health program, especially the elements where you excel. How has your program addressed the big three issues listed above as well as your own leading loss drivers? Include examples such as comprehensive safety and health programs; an audit/assessment to ensure continued compliance and improvements; awards and other recognition that demonstrate success i.e. acceptance in the OSHA Voluntary Protection Program (VPP) or state awards. When the OSHA Permit Required Confined Space (PRCS) Standard was issued a few years ago I worked with a New Hampshire based client to develop and implement a compliance program for all of their North American manufacturing plants. (Occupational Safety and Health Administration 1998) We incorporated into the program, all of the standard's requirements including identification and classification of confined spaces; conducting a hazard/risk assessment; developing and implementing specific procedures to control the risks and; trained all of the employees involved with confined space entry. Shortly after we completed the project, an OSHA compliance officer arrived at the largest facility to conduct a compliance inspection. The facility's efforts were rewarded with no citations for the newly issued standard and the compliance officer was so impressed by the comprehensive permit that he took a copy to the Area Office in Concord NH. The OSHA Area Office used that comprehensive PRCS permit as a model for the state's other employers. Obviously this recognition was a key strength of the client's risk control program and warranted differentiation from other organizations faced with

similar risks. Focus on the potential risks that you anticipate impacting your organization and how you will control them (more on this in the opportunity & threat sections).

But don't stop just at the pre-loss side of the risk control equation. How does your post-loss risk control stack up? A study by the Hartford of claims data from 2001-02 indicated that long claim reporting lag times i.e. the time between notification to the organization and the reporting of the claim to the carrier or TPA, results in an increase in claim costs. The longer the lag time the greater the claim cost. Does your organization demonstrate effective administrative controls with 90% or more of your claims reported to your carrier or third party administrator (TPA) within 3 days of notification to your organization? If you answered yes, you have another positive arrow in your quiver. If not, well you have something else to work on.

Continue examining the post-loss risk control by looking at how well your organization manages the medical care of the injured, ensuring they are treated promptly and effectively ultimately impacting costs? Medical care costs are increasing much faster than inflation resulting in medical costs making up a larger portion of our total losses according to a report by the National Council on Compensation Insurance Inc. (NCCI). The NCCI data indicates that from the 1980s to present, medical costs have risen from 40% of our total losses to more than 60%. (Hartwig, 2009) If your ratio of medical costs to indemnity is better than this 60/40 split, you need to document your success. To achieve a favorable split an organization must manage these costs by developing clear protocols for interaction with injured employees, inclusive of treatment plans that embrace modified duty prescribed by occupational physicians with full knowledge of your workplace exposures. Crawford & Company in an article titled "Evaluating the Practicality of Return-to-Work (RTW) Programs," reported the savings formula at 54% of current Workers' Compensation costs. Their savings formula indicated that the return on investment (ROI) was nine dollars for every dollar spent by the organization in implementing an RTW program. (Batterson, L., Fyfe, B., Weigand, D., ASSE 2009) Remember the actual savings and ROI will vary dependent on the level of successful implementation of a formal medical management and RTW program organization-wide.

Use each of these elements to explain how you and your organizations are doing, then benchmark your loss cost data to demonstrate further success with post loss risk control i.e. severity, much like you documented frequency control with BLS industry data for frequency.

Weaknesses

Whereas we can demonstrate successes as strengths with objective data collected from our carriers, TPAs, and reliable statistical organizations like NCCI and BLS, we can damage our creditability by using nonobjective data to attempt to validate our value to the organization. Values we as safety professionals associate with accident prevention have historically often been vague and/or not tied to the business objectives of the organization. Consequently by not communicating our value in clear financial terms, we will not be given the respect and status within the organization we deserve. For instance we, as a profession, have steadfastly held onto the belief that controlling incident frequency will have a parallel reduction in incident severity graphically displayed in the accident pyramid (aka the accident triangles or specific ratios e.g. 300-29-1 ratios), despite objective data from many reliable sources that contradict this principle (Manuele, F., 2008). As we strive to be accepted by the business community, business leaders look at unsupported data objectively, then rightly question the validity of the data, ultimately diluting the creditability of the bearer.

Frequently our attempts to quantify accident costs also have focused on discussing the concept of “direct costs” (including such items as medical costs, workers’ compensation and, property damage) and “indirect costs” (including peripheral “costs” such as pain and suffering, the injured employees lost wages, increased paperwork and, loss of production by employees discussing the accident). Again a fuzzy math concept is offered in an attempt to quantify accident costs often asserted as a ratio of indirect to direct costs of 4:1 although this ratio could also be reported as high as 8:1, 10:1 or even 50:1 by some organizations depending on the creativity of the staff producing the ratio. We commonly illustrate this relationship by various pictorials such as icebergs with direct cost graphics above the surface and the hidden indirect costs below the surface (see figure 1). Like the accident pyramid, this outdated depiction uses numerous indirect costs that are subjective in nature and/or are not a cost borne by the business organization. Thus by inflating the indirect costs with subjective or non-applicable charges, we again risk the very creditability we are trying to establish and maintain with senior management within the organization. While management is very interested in the total cost of risk, the metrics must be in quantifiable financial terms to be meaningful. As a side benefit, if we demonstrate metrics in quantifiable financial terms, as previously discussed in the strength section, we can also have a beneficial impact in the renewal process with underwriters.

Exhibit 1. The Accident Cost Iceberg.
Source: The Army & Air Force Exchange Service – Europe.
Model: Bird/Germain. Photograph: Don Carrol.

Opportunities

Pastor Raymond Lindquist claimed, “Courage is the power to let go of the familiar.” Correctly identifying opportunity and responding appropriately can demonstrate our past successes will continue to result in improved results. We can all remember the dire consequences predicted as a result of emerging risks such as Y2K, SARS, Mad Cow Disease and Avian Influenza. No doubt some overreacted and implemented unnecessary and/or overly costly risk control measures, the fact is that most of us evaluated the risk/opportunity properly and implemented appropriate controls. I say this for no other reason than the dire predictions of catastrophic events from each of these emerging risks did not materialize to the extent predicted at least in part to the implementation of a successful mitigation strategy. So what are the next risks/opportunities that will call for evaluation and implementation of appropriate controls?

Workplace Violence

The National Institute of Mental Health estimates that 26.2 percent of Americans ages 18 and older - close to 60 million people - suffer from an identifiable mental disorder. And while mass murder at work and elsewhere remains a rare event, worker-against-worker violence and on-the-job homicide happens all too often. It is estimated that 85% of all workplace assaults and 55% of all workplace murders happen in service industry worksites or retail trades, sectors that are growing. Physical assaults are common in health care and social service-type agencies as well as in traditional at risk occupations that handle money or engage in person-to-person contact with the public (Jones, C., WORKPLACE VIOLENCE Health & Safety Best Practices: A Prevention Strategy 2007).

At no time since World War II have we faced as large a group of returning war veterans taking their place at their previous jobs as now and in the next few years. What will be the effect of returning veterans and the ramifications on their reintroduction into the workforce on workplace violence? An indicator may be recent research by the New York Times (Sontag, D., and Alvarez, L., Across America, Deadly Echoes of Foreign Battles, New York Times Series January 2008) that studied homicides involving all active-duty military personnel and new veterans for the six years before and after the present wartime period began with the invasion of Afghanistan in 2001. Their data revealed an 89 percent increase during the present wartime period, to 349 cases from 184, about three-quarters of which involved Iraq and Afghanistan war veterans. The increase occurred even though there have been fewer troops stationed in the United States in the last six years and the American homicide rate has been, on average, lower during this same period. Since October 2001, over 1.64 million troops have been deployed to military conflicts. The pace of these deployments in the current conflicts, Operation Enduring Freedom (OEF, Afghanistan) and Operation Iraqi Freedom (OIF, Iraq) have been the highest in the history of the all volunteer force. Approximately 30% to 40% of the deployed troops are National Guard or Reservists, meaning in excess of 200,000 people have been or will be returning to the workforce in the near future.

In addition, many troops have faced multiple deployments increasing the likelihood of exhibiting post-traumatic stress disorder (PTSD) symptoms with each deployment. Symptoms of PTSD are 54% more likely to be observed in second deployments and 125% higher in third or fourth deployments according to the Brookings Institution, Iraq Index Archive, updated August 18, 2008. (Hartwig 2009). Pentagon records show the number of troops diagnosed with PTSD jumped by roughly 50 percent in 2007, the most violent year so far in the conflicts in Iraq and Afghanistan. Defense Department officials said nearly 40,000 troops have been diagnosed with PTSD since 2003, though military officials including Army Surgeon General Eric Schoomaker, believe many more are likely keeping their illness a secret due in part to the perceived stigma attached by the military. General Schoomaker acknowledges, "I don't think right now we ... have good numbers." (AP May 2007) Granted many veterans rebound successfully from their war experiences and many actually flourish as a result of them, veterans groups have deplored the attention paid to the minority of soldiers who fail to readjust to civilian life dating back to World War I. But as recently as 2006, an article in the Veterans of Foreign Wars magazine referred with disdain to the pervasive “wacko-vet myth,” which, veterans contend, makes it difficult for them to find jobs.

What may help: Workplace violence prevention efforts that focus on recognition of symptoms and referral to programs that focus on PTSD and acclimation of returning veterans to the workforce.

Climate Change

Climate change has already started and is very probably contributing to increasingly frequent weather extremes and ensuing natural catastrophes in the US and throughout the world. These, in turn, generate greater and greater losses because the concentration of values in exposed areas, like regions on the coast, is also increasing throughout the world. There was a record number of 10 Significant Natural Catastrophes in the United States in 2008 ranging from California wildfires (California has averaged $480 million in Wildfire losses per year since 1990), Midwestern floods (affected states: Iowa, Illinois, Indiana, Minnesota, Missouri, Wisconsin, and Michigan), Thunderstorms (losses in 2008 broke the previous record by over $1.5 billion), recent ice storms across the eastern US and six tropical cyclones that made landfall in the US. All told, insured losses in the United States in 2008 were above $30 billion - one of the top five annual totals in U.S. history and many in the insurance industry are predicting that "mega losses are unavoidable" (Hartwig 2009).

What may help: Better building codes especially for potential storm surge areas; improved storm modeling to ensure adequate advanced emergency responses to limit impact and; binding rules on CO_2 emissions, so that climate change is curbed and future generations do not have to live with weather scenarios that are difficult to control.

People Stuff: Age + Obesity + Ethnicity

Stockholders, employees and executives have all felt the current global credit crunch, as 2008 ended dismally for most of the world's companies. Consequently, many older Americans close to retirement saw their 401-k and other savings disappear in the blink of an eye. As a result, workers will be working longer than they had planned even a few months ago. In January 2008, 18% of the workforce had changed their retirement plans in the past year (Hartwig 2009) with 14.2 % postponing retirement. A December 2008 survey of American Institute of Certified Public Accountants (AICPA) Financial Planners reported a jump to 35% of the AICPA member clients who had postponed retirement and 70% had changed retirement plans. (AICPA Study 2009) On one hand, this is good because older members of the workforce tend to have fewer injuries unfortunately they take longer to recover when they do experience an injury and older workers fatality rate (workers 65 and older) is triple that of workers comprising the median US workforce age of 41. (Hartwig 2009) Another challenge is that we lost over 2.5 million jobs in 2008 according to the US BLS, the largest number since 1945. Unemployment is projected to rise to 8% by mid year 2009. Those older workers who remain working may be doing more physically demanding jobs consequently increasing their exposure to injury. The workplace of the future will have to be completely redesigned to accommodate the surge in older workers.

Obesity rates exceed 20% of the population in every state but Colorado (the Centers for Disease Control or CDC defines obesity as a Body Mass Index of 30 or higher) according to the CDC. This is a concern for businesses as new preliminary research suggests that workers comp claims involving obese claimants are more costly than those involving healthier individuals. The ASSE reported that a recent NCCI newsletter indicated preliminary findings from a study that it will release in 2009 show that workers comp medical claims open for a year cost three times more when claimants are obese. This data also appears to be emerging in recent studies by

Østbye; Dement and; Krause at the Duke University Medical Center. Obesity issues often have been pushed onto employer's health care plans or wellness programs but progressive organizations are incorporating an injured employee's obesity into case planning and actively identifying resources to help injured employees address the problem, especially when it affects return-to-work outcomes.

Ethnicity

We have heard at this event and at previous PDCs about the need to reach non-English speaking workers. Although efforts are already underway, the fastest growing ethnic group, Latino workers, still experiences the highest rate of fatal injuries on the job, 25% more than whites, 61% more than blacks and more than double the rate for Asians according to the CDC. The CDC also reports that Latino workers experience the highest rate of non-fatal injuries on the job as well; 46% more than whites, 34% more than blacks and 150% the rate for Asians. Although some of this data is due to the unskilled, higher risk jobs many Latinos fill, we must do a better job protecting these workers.

Medical Costs

BLS data indicates on the job injuries and illnesses are decreasing over the last two decades resulting in lower costs but the average annual increase in WC medical severity from 1995 through 2007 was more than twice the medical CPI rate (8.2% vs. 4.0%). (Hartwig 2009) The NCCI data tracks the rise from 46% of total WC costs in 1987 to a projected 59% share in 2007 in NCCI states. This trend will more than offset the gains made in pre loss efforts unless we stem the cost increase as previously discussed in the **STRENGTHS** section.

Threats

It would have been easy to list each item in the **OPPORTUNITY** section in this section but I am “the glass is half full” kind of guy. Consequently, as I see it there are two major threats preventing us from successfully impacting how we are going to influence our insurance costs now and five years into the future. First, if we continue to do exactly what we have done in the past we probably won’t even obtain the same results. The combination of new technology and the fast pace of the global marketplace dictate that we must continually adapt to a brave new world just to maintain the status quo. And if all you are doing is maintaining the status quo – that will not be enough. Think back five or ten years and name one thing that has not changed. The future will continue to change only at a faster rate.

The second major threat is to look at the challenges only as threats. With each challenge comes the opportunity to develop or implement solutions that have an even wider impact on our organizations. Whether we wait for those changes to happen to us or prepare to meet them head on probably says a lot about what our success will be in controlling our insurance costs in the next five years.

Summary

During the next five years, 83% of companies will face a crisis that will negatively impact the profitability of a company (Barton, 2007) and could lead to higher insurance costs. Leaders must deal with the strategic challenges they face, the political risks and opportunities they encounter, the errors they make, the pitfalls they need to avoid, and the paths away from crisis they may pursue. Safety, health and environmental programs play a vital role in managing risks and

reducing a corporation's financial losses, especially when insurance markets are “hard” and premium rates are at a high level. The necessity for sound management is even more significant with the advent of a 24-hour news cycle and an increasingly internet-savvy audience with ever-changing technology at its fingertips. We need to do a much better job portraying how we impact our organization’s risks and finances, while adding value to the organization that can be used to leverage advantages with the carriers, especially during the renewal process.

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