State-Run Workers' Compensation Funds

Funds run by individual states control a significant portion of the workers' compensation business.

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Recently Retired President & CEO, Kentucky Employers' Mutual

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I'm Lee McDonald with the A.M. Best Company. Welcome to today's webinar, State of the U.S. State-Run Workers' Compensation Funds.

We have a full program and a strong lineup of panelists. Before we proceed, I'd like to mention that A.M. Best is a rating agency. It's possible that we will mention ratings and rating issues in today's discussion. I'd just like to give you a brief excerpt from our web page and our advisory: "A Best's financial strength rating is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. It's based on a comprehensive qualitative and quantitative evaluation of a company's balance sheet strength, operating performance and business profile."

That was from our full disclaimer of warranties which is found at www.ambest.com/terms.

My colleague, Jim Fowler, will introduce the questions [from viewers] at appropriate moments in our discussion.

Now we'd like to meet our panel, whose opinions expressed today, of course, are their own. Our first person to introduce is Tom Phelan. He's currently president of AASCIF, which is the national association of the American Association of State Compensation Insurance Funds, which happens to be meeting [July 14 - 17 2013] in Austin, Texas. He is president and CEO of the Injured Workers Insurance Fund in Maryland, which is on its way this fall to a new name of Chesapeake Employers Insurance Company.

PHELAN: Thank you. I look forward to a very lively discussion on a lot of the topics involving the workers' comp industry in general and state funds in particular.

MCDONALD: Thank you, Tom. And Roger Fries recently retired as president and CEO of Kentucky Employers Mutual Insurance, which is known popularly as KEMI. Roger is still very involved with KEMI and many other insurance organizations, including AASCIF, the WCRI, PCI, NAMIC and even more.

FRIES: Lee, thank you very much for having me here.

MCDONALD: And on our panel in the studio we have Jim Fowler. He's a manager with our Business Development Group and as I mentioned, he'll assist with the questions that you send us. And, one of the people who were very instrumental in the report that we'll be discussing is W. Dolson Smith. He's a member of A.M. Best's analytical rating team. He's a CFA, has been with A.M. Best for 22 years and has an even longer career in financial services. He's covered many of the highest profile insurance organizations and he has a broad background in property/casualty and life.

Dolson, why don't we start out and just kind of set the ground here. We're talking about state funds; there are quite a few of them. How do you define the group that we'll be talking about today?

SMITH: In our report, we refer to the term, state funds. We use this for the 20 U.S. competitive state funds, workers' compensation funds that are shown in Exhibit 2. There are 20 of them. These state funds serve the general workers' compensation markets, the voluntary or private markets, but important to our definition of state funds is that they are the market of last resort. They

provide residual market business.

MCDONALD: OK. And as a unit, I know you've done a lot of aggregating. What portion of the market do they account for?

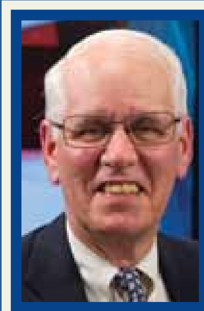
SMITH: The total U.S. workers' compensation writings, they account for 17% of that total. The state funds, I want to point out, don't include the monopolistic state funds in North Dakota, Ohio, Puerto Rico, Washington and Wyoming. They are of great significance generally in their states. Seven of these state funds account for more than 50% of the market share in their respective states. All but one of the 20 state funds are number one in their state in terms of premiums written. So they have greater significance in the individual states in which they operate.

MCDONALD: And, Tom, as president of AASCIF, obviously of your own fund, what are you seeing as far as how state funds are operating broadly in the United States? Does their position in the market seem to be changing much at all, in general?

PHELAN: As Dolson indicated, currently today we have 17% in the aggregate. I think you will notice there were times when the state funds served multiple purposes within the state in which they operate. Some which he identified are purely monopolistic state funds. Most are competitive state funds and I think if you look back over a history of time as the private sector has come and gone in the marketplace, state funds' share of the marketplace has ebbed and flowed pretty significantly over time. In the last hard market, I would say that the state funds had probably about $10 to $12 billion of total business in a marketplace that maybe had $36 billion in total to make that as much as 33% to 36% of the whole marketplace was controlled by state funds. In the most recent soft market, a lot of the state funds, myself included, have seen our share of the marketplace drop substantially, but I think that truly goes to what our core mission is, which is to be a marketplace to insure that there's a viable market out there for companies that need it.

MCDONALD: And, Roger, I'm going to quote you, and I think a quote that you gave one time is 'if you've seen one state fund, you've seen one state fund.' But when you look at them in aggregate, what are you seeing these days versus what it might have been a couple of years ago?

FRIES: I'll go back, Lee, even a few more years. If you look back at the changing of state funds and how many belonged to trade associations, how many are rated by ratings agencies such as Best. They do nothing but workers' compensation. Most of them are the lead writers as far as premium in their states. They play a role in economic development, more today than they ever did before. I think they've increased their IT investment. I think they're a leader in that area, so it's really much, much different than when it started 17 or 18 years ago. In those 18 years, I've seen a tremendous change. Again, I would say most of those that were created in the '90s probably resemble carriers — our friends at Liberty, Travelers, Hartford, AIG and so on — all good writers of workers' compensation. State funds have moved into that mentality of being a writer, a carrier. Not something that is just over there for — if you can't find coverage somewhere you can always go to the state fund.



> "If you don't make it on the investment income side, you have to make it on the underwriting side. What will have to happen, the combined ratios won't be able to be as high as they have been and still offset the underwriting losses generated by net investment income."
>
> —W. Dolson Smith
> A.M. Best Co.

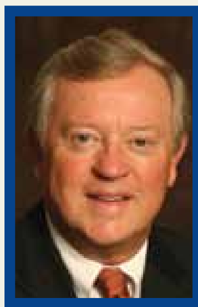
MCDONALD: Dolson, let's take it to the present here and one of the more notable things about the report is that we're seeing some growth and you point out that it's two years in a row of premium growth. What does that say about today's market?

SMITH: The premium growth for the state funds was 7.1% in 2011 and 13.5% in 2012. These are the first increases in premiums for the state funds since 2005. I think these increases reflect several things, most importantly, some hardening of the market. Some improved economic activity throughout these states will improve most of them, and the likelihood that there's increased demand for the residual market business provided by state funds. Regarding the hardening of the market, if you look at Exhibit 4, you can see that the premium rates, after many years of declining, started to turn positive in the second quarter of 2011. Those rate increases since then – eight quarters since then – they've been trending higher and they're close to 8% or 9%. We don't regard this hardening as a full-fledged hardening of the markets. There's a lot more to go in terms of getting back to where the industry was several years ago. However, we think the rate increases we're seeing will continue at least for the near term and it's encouraging. [The premium increases] also, as I mentioned, reflect improved demand for residual market business from the state funds. So I would say that overall it's encouraging, what we see with these percentage increases in premiums. However they're from a fairly low base and they're going to have to continue for a while to result in a very hard market.

MCDONALD: Tom, how about your market and anecdotally what you're seeing elsewhere. Are you seeing positive premium growth?

PHELAN: Yes, I would say a lot of the very same things that Dolson just commented upon are very, very similar things we're seeing here in Maryland

because of our location [close] to Washington and the higher income levels of a lot of the people that work and live in the Maryland area. It was not as impacted as other places were around the country, but we were nonetheless impacted by it. And what we're seeing right now is that the economy is starting to firm up a little bit and things are starting to get a little bit better. We're able to get some price increases. We're able to see things that weren't happening a couple of years ago. We're starting to see a growth in the general economy and I totally agree with Dolson. I don't think we're anywhere near what I would define as a "hard" market but I think if you look at market cycles in miniscule, not in the aggregate for a moment, you'll notice that they incrementally change over time. They don't radically make moves in one direction or the other. It's kind of an incremental change that happens and I think absolutely, as Dolson has mentioned, that we've noticed, from probably about late 2011 into 2012 and absolutely in 2013, we are seeing the firming of the market and we are seeing this incremental change month over month that I think is leading toward a harder market.



"Underwriting in general is getting some common sense to it. Underwriting is being a little more selective. That, by itself, may show a little hardening."

—Roger J. Fries
Kentucky Employers' Mutual

MCDONALD: Roger, your take. Hard market? Headed that way? Status quo? What do you see?

FRIES: Lee, I think that probably underwriting in general is getting some common sense to it. Underwriting is being a little more selective. That, by itself, may show a little hardening. That's part of the problem of the soft market and how long it lasted and so on. Some of the states with group funds do a great job and then other states have big problems. We recently had a group fund go under in Kentucky, our second one in about 10 years. And when you continue to have organizations that continue to lack discipline in their underwriting pricing, you're going to continue to have difficult times, for Dolson or NCCI or anybody else, to really stand up and tell you where this market's going. Things we can say are payrolls are up somewhat, but I think selective underwriting is getting better. There's a little better discipline, there's a little better control of losses, better medical cost containment program in some of the states, so that's going to bring some cost factors down. But, overall, Kentucky itself never went crazy on one side and had an economy change as much as maybe some other parts of the country and so hasn't had much of a getting back to normal.

MCDONALD: Dolson, one of the things you highlight in the report is – obviously this hasn't taken place or may never take place – but there's some questioning as far as tax status. If that was to occur, what might the impact be and could you explain what the questions are?

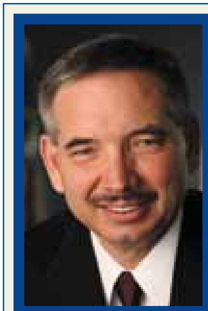
DOLSON: This issue has been talked about in the industry for several years but there was a lot more evidence of IRS interest in examining the state funds and other state sponsored groups that provide workers' compensation insurance that are tax exempt. This has just taken place in the last year. The IRS exempt organization, they sent out a letter last fall to these state-sponsored groups, a compliance questionnaire, just a lot of questions asked, trying to get at whether the state funds met the tax codes for tax exemption. And so that has made this more of an issue in the last year. How state funds would be affected? They have benefited competitively from tax exemption. They can charge lower rates, they can take advantage in a number of ways — pay higher commissions, pay higher policyholder dividends. Just being tax exempt saves you a good deal of money. It helps the bottom line. So that's one area that would be impacted. Their business strategies might change. Their operations might change. You have investments at the state funds that are largely in taxable securities, yielding higher than a lot of taxed companies that are investing in municipals with lower yields. So there would be some impact in that regard in terms of operations of the companies.

MCDONALD: Tom, has AASCIF taken any positions or started any activities with regard to the tax status?

PHELAN: Not really. We talk about this at our meetings. We talk about issues facing us all globally. One of the neat things about AASCIF — because we really don't compete with each other — we have an opportunity to talk about tax issues. We have a chance to talk about the economy. We have a chance to talk about a lot of things that are driving a lot of our businesses and it's a very collegial atmosphere, because as I say we really don't compete with each other. I do want to talk to a couple of things Dolson said and I do agree with Dolson that we were asked to fill out a questionnaire in December about our tax status and what drives our tax status. Most of us are exempt under the IRS code, section 501C27. It's important to understand the IRS enforces the tax code but the IRS doesn't write the tax code. Congress decides who is and who isn't going to be taxed and at what rates they're going to be taxed. So it's OK that the IRS asks us questions and things but the IRS doesn't have the authority, in effect, to overturn the tax status of state funds. I think that's important to understand, that yes, they're gathering information. But is it imminent that something is going to happen? I don't think it's imminent. I know there are a lot

of people looking at a lot of different things right now, so I just wanted to clarify that.

Dolson does also make the point that we may have some type of advantage because we don't pay federal taxes. It's also a disadvantage because most of us are the residual markets' mechanisms in our state. So that if the private carriers want to lay off the risk for the state, they can lay that risk off to us and we have to basically take that risk. So there's the yin and the yang, there's the give and the take, there's the back and forth. With regard to the impact it would possibly have on any one of the state funds, we currently are doing modeling in Iowa to determine what, if any, impact it would have on us. As Dolson indicates, one of the things we would probably do is shift a lot of our investments into tax deferred instruments, which would probably pay a lower yield, but would they have a substantial bottom line impact on the organization? I'm not sure it's as substantial as some people may have led you to believe it is.



"We have an aging workforce. I think it's a workforce that's more conservative because of the age of the workforce … [and] more intelligent because a lot of people who have been downsized and put out of work have a skill set that they are putting into another workforce."

—Thomas J. Phelan
Chsapeake Employers' Insurance Co.

MCDONALD: Roger, anything to add to that?

FRIES: I think Tom covered about everything. Some of the funds have the responsibility of last resort and some don't. I'm not using that as a negative. And many are government-appointed boards. And while they're not state agencies (actually all the state funds originally got their birth rights from the state legislature) that's how they were created. So there are a lot of ties there. … I still think from a taxing standpoint, several of the people who think state funds should be taxed, probably if they had the responsibility of market of last resort, would gladly keep paying taxes even if they are paying taxes. I'm not sure all of them are. But short of that, I think that's still up in the air. It's something that we all concern ourselves with a little bit. But at the same time, again, you've seen one state fund, you've seen one state fund. Several have moved on to maybe other states that they're writing in. It's not the original look of a state fund that you would see back in the '50s and '60s and '70s. Some people believe that's a difference and it's understandable. But there have been some very successful [ones]. I think John Wenner's group in Maine is a perfect example. They've done a fantastic job, not only in Maine but they've done some very good things elsewhere. If that's going to help economic development of these areas that they're going into and they provide coverage, personally I'd support it 100%.

MCDONALD: Dolson, getting back to some of the financial results, you talked about premium growth. But you also took a bigger look in the report. You talked about cycles. One of the things I thought was interesting is you said it appears a cycle may have ended somewhere around 2010 or early 2011, depending on how you look at it. What was that cycle and if we're in another cycle, is it too early to tell or what are you seeing?

SMITH: We talked about the premium increases for the state funds, which pretty much mirror the broader workers' compensation fund composite in 2011 and 2012. But we also talked about the rate increases that have occurred. Tom and Roger have said that there seems to be some hardening occurring and improvement and we would agree with that. The fact is that, the state funds and the broader workers' compensation market did have improved combined ratio in 2011. It declined to 125.5 from 134.9. Granted, there's still a lot to go but that was of some encouragement. In addition, the group's accident year combined ratio declined to 124.5 from 128.1. So, while we don't think we're in a full-fledged hard market there are encouraging signs occurring in terms of underwriting. We view the P/C industry, in terms of the industry as a whole, we see improved rate environment: generally moderate increases in loss costs and the industry in an adequate capital position. Some concerns though include the sluggish improvement in the economy [and] the low interest rate environment. We haven't talked about investment income declining but that's certainly of concern and the potential for adverse loss reserve development. We haven't seen that in the aggregate occurring, we see it at a lot of companies. There is that potential adverse reserve development in the workers' comp industry and lastly, uncertainties about health care reform, which we have to experience and become more familiar with before we can fully comment on the impact there.

MCDONALD: Tom, you touched on this a little bit before but if you'd go a little bit deeper … I know Maryland has shown some differences from other parts of the United States, but have you seen cycles there and are we in any kind of a fresh cycle at this point?

PHELAN: Absolutely, we do follow a lot of the very similar cycles as the rest of the country does follow. As I stated earlier, we're a little bit more immune to it because of the proximity to Washington and the amount of federal jobs and federal money that comes into this state and is used by people where you have their house and construction work and that sort of thing. I would actually agree with Dolson. I think his point earlier about seeing a cycle bottom maybe around the second quarter of 2011, probably drives exactly to the comment he made

about just seeing the combined ratios improving in 2012. As we all know, the ratios were driven by the losses and the expenses divided by the premium. If you can control your losses and your expenses and your premiums go up, your numbers are going to improve. I think we're starting to see that this is all coming home to roost and a lot of people, as Roger had indicated, were just making underwriting decisions which made no sense to a lot of other people. Looking at them independently, recognizing that you can only cut pricing so thin and after you cut it too thin, you start to bleed. And I think that we're in a period now where you're starting to see people take some rate increases and I think you're going to see an improvement of that combined ratio and that accident year ratio for a couple of periods going forward now.

MCDONALD: Roger, where are you as far as whether we're in cycles at this point?

FRIES: I totally agree with both Dolson and Tom. I won't repeat anything they said, but I think there are some ingredients that are in play now that maybe weren't before the downturn, and we're finding that more employers, more risk managers, are understanding what we try to teach keenly with our employers and that is they control their own destiny much more than they really maybe thought they had over the years. We sit down and work with them and explain to them, here's what an experience modification is. Here's how you got here. Here's what you need to improve and we want you to get better, we want your price to go down, we want to help you. I'm finding more — I think it's because of some of the technology tools that are out there, some of the younger people coming into the business are citing the fact that they do understand, when it comes to workers' comp and that's a key thing in this whole discussion, that whether a state fund or whether it's a carrier or it's a group fund or it's individual insurance, it's still a work comp statute in the state that we're talking about and everybody is selling a promise and they have to be there with that promise. So what we try to go out and do, is to explain to people this work comp policy is a promise we'll be here. But why this is going on, here's what you need to control your own destiny. And I think that's because of the economic downturns that a lot of businesses have learned. They have to roll up their sleeves and get back to controlling their own destiny much more than they have in the past.

FOWLER: We've referenced a couple of times about improving rates and premium growth. A question comes in from the audience: Does the increase in part-time employment affect work/comp results? I think we could maybe ask Tom and Roger both to comment. We'll start with Roger.

FRIES: Briefly, no question, nationally. We all know this from our families and friends and so on, part-time workers are probably more prominent in the overall payrolls submitted by a company in a month than they have been in a long, long time, if not ever. Some people in the part-timing world understand safety, understand common sense and understand that when you come to work, you do your job whether it's part time or full time and in this case, part time. But you train well, you listen well and I think we were seeing the frequency of severity, for instance, where frequency was up quite a bit, severity was down and then in the next quarter it changes somewhat. I think we're seeing a pretty good workforce. This part-time employment is much better off than any other part-time employment time we've ever had in the past.

MCDONALD: Tom, same question.

PHELAN: I would agree with Roger. There's no question that part-time employment is going to drive up the insured payrolls and it's going to help the premium flow because hopefully you're classifying the employees in the appropriate job that they're in and you're getting the right amount of exposure for the risk you're underwriting. As Roger says, the one thing you've got to be careful about is when you've got people working several part-time jobs, those people may tend to be more tired than an average person working one full-time job. Those people are maybe taking short cuts in their job that they wouldn't ordinarily take if they were full time and understood more of the risks involved with that job. And so you've got to be careful that the actual, ultimate loss that you experience as an insurance company doesn't exceed the premium you're getting from it. Additionally, as Roger said earlier, you've got to make sure that you're funding your own loss control area appropriately because part of your mission is to make sure you're actually helping make sure people are safe out there in the workforce. So one of the things we did here IWIF during this entire downturn in the economy, we didn't have any layoffs of our staff. We continue to fund all of our underwriting folks, our claims folks, our loss control folks, we funded those positions because we believe that the best accident is the one that never happens and as Roger said earlier, safety really needs to be the paramount thing you're trying to drive home. Any account with the right safety initiative can be a good account, even if it was bad before.

MCDONALD: Thank you. That was a good question. Dolson, a few minutes ago you mentioned some of the combined ratios and the fact they'd improved in recent years, but whenever you're looking at workers' comp you're always seeing triple digit combined — 120s, 130s. How do they get to that level and where do they ultimately need to be? Is that exactly where they should be? What do you see? They always look so high to me.

SMITH: Looking at the composites, the state fund composite and our board of workers' compensation composite, the industry has been profitable the last several years, even with these very high combined ratios. The workers' comp industry and those who are

familiar with it, generally workers' compensation companies and state funds, generate a lot of investment income. The investment ratio which is a ratio of net investment income to premiums earned is about 31% for the state funds. It's about 21% for the broader workers' compensation market. That same ratio is about 12% or 13% for commercial lines companies. So the workers' comp industry is able to write at higher combined ratios. In fact, they never dipped below 100 in the peak of their profitability back around 2005. So the industry is currently writing the state funds around 115. They are able to write that with the amount and the investment income and with that very high investment ratio they are able to generate profits and they have generated pre-tax profits the last several years even with very high combined ratios.

MCDONALD: Tom, do you have any opinion as to whether ratios are probably where they're going to remain or is there any need for those to change?

PHELAN: I think, where I sit, when I discuss things with my board of directors, I say we basically run two businesses here. We run an investment business and we run an insurance business. And depending on which side of the aisle is basically driving results at that point in time, can determine which side you're basically getting in and out of at what time. As Dolson indicated, if you look at my company in particular, if you look at IWIS in particular, during the last hard market in the period he just cited — 2005/2006 — we wrote $320 million of business and that was actually when I became CEO, back in 2007. We started noticing the market was shifting, the dynamics were shifting, we took the position, like Roger said earlier, where we are very much as competitive as everybody else is and we're very much in a mode of — we want to underwrite this. We don't just want to place business on our books. And our business actually shrank from $320 million down to $160 million. Our basic work comp business got cut in half. And as Dolson said, we relied more on our investment income at that period in time to carry things. We're in a challenging time right now. Everybody is, because investment yields are so low. That's what I think is partially driving this hardening market you're starting to see now. I think now people are coming to the realization that even though work comp claims take a long time to pay out, if your earnings were zero on it or 1%, 100 basis points on it, you have to have more discipline on the front end and I think that's what you're starting to see. It's happening. A lot of carriers are starting to push pricing more.

MCDONALD: Roger, any thoughts in that area?

FRIES: I don't think there will be a big change in 2013 combines when we get all done with this year. I don't think they'll be retreating but I don't think there'll be major improvements of any kind. From operations, again, you've seen one state fund, you've seen one state fund. Mostly it's around a 90/10, 85/15, maybe, fixed over equities. A pretty conservative book. In today's world that conservative book isn't going to be mapping out a lot of income but again it remains steady, remains solvent, remains healthy and concentrate of what they do day in and day out. There's only one line most all of the state funds are interested in and that's workers' compensation. You get pretty good in that area, you invest in following a track of what you believe you're going to need to continue your mission and you stay with it. I know that's one thing when we first started KEMI 13 years ago, we focused on it and I think it's worked out quite well, thank you.

MCDONALD: Dolson, let's jump to a point that Tom brought up and Roger just echoed, which is where the funds are deriving their investment income. Rates are low. And every webinar report we do, whether it's medical or whatever, it's a big challenge. So where are these funds getting their returns?

SMITH: The state funds are about 84% invested in bonds. Their average maturity is about 7.1 years. The net investment income for the industry and for the state funds, it's been declining for the last four years and it's likely going to continue to decline as funds are reinvested at lower yields than they currently pay. So that's where they're generating less investment income. I will say the last three years, there have been realized and unrealized gains on common stocks. The industry has a common stock leverage of about 27% and with the improving capital markets, realized and unrealized gains have been better the last three years, and year to date in 2013, they're going to be a factor in terms of surplus growth and net income growth, not so much operating income but surplus growth and net income growth will be a factor.

MCDONALD: Let me ask one more question that will bring in Tom and Roger on the same issue, which is, let's assume rates don't improve for a number of years. Now what?

SMITH: If you don't make it on the investment income side, you have to make it on the underwriting side. What will have to happen, the combined ratios won't be able to be as high as they have been and still offset the underwriting losses generated by net investment income. So combined ratios are going to have to come down, underwriting is going to have to accrue.

MCDONALD: Tom, what do you think? We've talked a little bit about the returns. Where are those returns coming from these days and how sustainable is that?

PHELAN: Well, as Dolson indicated, I can attest to the fact that we absolutely have seen a drop in our investment income. Again, when I took over as CEO in 2007, that was our high water mark year, if you will. We had investible assets of about $1.4 billion and we had investment income of $75 million. Our asset base has grown by almost 50%. Our asset base is approaching $2 billion

now and yet our income from our investments dropped by a third. It dropped from $75 million to $50 million. I can tell you going forward we have been using the $50 million number in our forecast and we believe the $50 million number is pretty sustainable. But to the point Dolson made, we absolutely have seen a tightening of the underwriting guidelines and as Roger pointed out earlier, Dolson made the comment that the state funds on average are 84% and bonds about 16% in equities. IWIS is about those same numbers; IWIS is about 80/20, 80/15 and five in cash — along those lines. We do not plan to deviate much from our core numbers. As Roger said earlier, one of the ways you get yourself in a lot of trouble is when you try to go out and be all things to all people and you try to change what you're doing and you don't fully understand what you're doing to yourself. We've looked at some other opportunities but we've been putting a toe in the water very cautiously. We're not jumping full steam into the pool all at once. We're looking at very measured amounts, very controlled amounts, very minimal amounts because we don't want to wake up and find ourselves in a bad way.

MCDONALD: Roger?

FRIES: Concerns I would have sound very similar to the property and personal lines people, with what the future there may hold. I've got a place down in Naples, a condo, and you know the market down there for insuring and so forth is challenging. I think what gets desperate in the workers' comp area is when companies aren't performing over several years mostly because of bad reserve practices for underwriting, watching out that people get desperate and they try to do a little bit more gambling in their investment field. Again, getting out of a discipline, staying away from what your goals are, making sure you're more conservative on that side because conservatism is, whether you like it or not, really what brings security to what we do day to day. But there could be some carriers, there could be some group funds, there are some excellent ones, especially group funds, but when you see their book out of desperation going towards a 50/50 equity fixed line ratio, you kind of look at it and say, I'd rather have them give 'Norm' and 'Cliff the mailman' a shot at it than some of the mentality that goes into the investment when companies get desperate because of mistakes they've made over a number of years. That's what I would look for.

MCDONALD: Thank you. We'll take your comments and your questions and they are good questions. We've got quite a few. Jim?

FOWLER: Yes, as we've referenced the economy a couple of times, the question reads: Are decreasing frequency rates a result of safety practices or something else like the economy and smaller workforces? And part two of that: As the economy rebounds do you expect the frequency rates to increase?

MCDONALD: Roger, maybe we'll pick it up with you. Are you seeing any changes in frequency?

FRIES: I think again it goes back and forth a little bit, but no. I would say there are not any dramatic changes. If anything, it's for the more positive. Again, smaller workforce? Yes. You have a lot of people that are doing different jobs than they did 10 years ago, with a very good education. I know several employers that have maybe not been so quick to hire back people as they had in the past, maybe doing more overtime, keeping the same employees, not overworking them but with the idea that the training is there, the safety is there and it's maybe better to keep this thing going, especially until we find out what may be going on in health care, the Affordable Care Act, coming up here. More employers may be not growing as fast, really working on training those existing employees. And when they do hire new employees, whether it's the trades or retail or whatever, I'm seeing a lot more educated in the previous type of work. They know what safety means when you have the discussion with them, is what I'm saying. They're pretty intelligent people. There are more of those available today on the market than there have been in the past and these are all good things to lessen losses in workers' compensation.

MCDONALD: And, Tom, what are you seeing in terms of frequency, as long as we've got you, anything different as far as severity as well?

PHELAN: We have seen, like Roger has said, if you look at our core numbers we've had pretty much a downward sloping curve of frequency, going down on us every year. Now the last couple of years we've noticed, Lee, that the drop in frequency has been very minimal. We're having some pretty good drops year over year and in the last couple of years it might be a 1% or maybe a 2 ½% drop. Of course we've been having 7% and 8% drops for a period of time. I'm not sure if the thing's run out of the steam on the frequency side or not. I do agree with everything Roger said. I think we have an aging workforce. I think it's a workforce that's more conservative because of the age of the workforce. I think the workforce is more intelligent because a lot of people who have been downsized and put out of work have a skill set that they are putting into another workforce.

We have seen frequency stay on a downward trend virtually uninterrupted for the past eight to 10 years. With regard to severity, we actually saw a significant drop in severity when this whole recession hit and I chalk it up to this: Our company has a tendency to write a lot of construction work. At one point in time, probably 35% of our premium income came in from construction. And, obviously, one of the first areas, the hardest hit, is construction. An economist told me a long time ago, if you really want to see which way the economy's going, look at what the construction business is doing. That's the thing that really fuels a lot of the other economic growth in a state and in

an economy. We all know what happened in construction. So we actually saw a pretty significant drop in our severity, which I chalk up to the fact that a lot of the higher paid, higher-risk jobs were either disappearing or other people were willing to undercut us pricewise at that time because they wanted to grow their book of business. Now we've seen a leveling off of severity. I'm hoping we don't see a growth in it, but we have seen a leveling off of it.

MCDONALD: Thank you. Dolson, just to return to one of the other points you make in the report, a lot of the results are driven by the largest states and you point out in a few different places, that California doesn't always consistently reflect the results of the other states. What do you see there?

SMITH: There are three large states in our composite — New York, Texas and California. California used to be a lot more of a factor in our composite than it is currently. In California, you had reforms in years 2002 to 2004 which allowed for the charging of lower rates. A lot of competition came into the California market in the 2005-2010 era and this provided a lot of capacity, a lot of competition and the California state fund. Its writings declined about 88% from 2004 through 2012, including double digit rate declines in 2011 and 2012 — the only state fund in our list of 20 that had such large double digit declines in '11 and '12. It was a factor that was contrary to other workers' compensation funds. So, that is somewhat the case in California. Things are hardening there but a lot has to be seen on how recent reforms are going to work out. I'm referring to SP863. We'll see what happens there. The reforms there are designed to curb medical cost increases, but again, the results remain to be seen.

MCDONALD: Dolson, just jumping back quickly, there was a point that you made, operating income, in your report. Can we talk about some of the changes there that you've seen?

SMITH: Well, operating income due to the somewhat improved underwriting largely. Again, investment income has declined but operating income for the state funds was positive, as it has been in recent years, in 2012. And actually the pre-tax operating equated to 5% of premiums earned. So it may continue to improve. Net income was more substantial due to realized gains last year.

MCDONALD: Roger, are you with us? I'll give you the honor of the last question here. Regarding AASCIF, what do you see there?

FRIES: I think probably — and one of the better features of this organization and others, talking about IT improvements, what's out there. There are such a great amount of products out there to help the bottom line … and the final results. How do you keep rates down? How do you keep costs down? How do you, as Dolson says, get those combined ratios down to something more attractive? It isn't just the investment side. There are several things. And there are so many great vendors (I hate to use the word) selling products that can make workers' compensation easier to manage and give you a better chance to succeed. The medical area is medical review, pharmacy, which has skyrocketed and now getting somewhat controlled. Many products out there, many companies that offer these management reports, those things I won't say are as important as the investment side, but those things help add up to a successful year, to a successful operation in workers' compensation. And it's a joy meeting all those people and seeing what technology has done to allow all of us to make workers' compensation a better program. Because, you keep in mind, that here's a program that 80% of the time a claim comes in, somebody goes back to work, they're off a week or two, sprained ankle or whatever, 80% of the time the claims are taken care of and the people go back to work. What happens to the other 20%? Well, 50% of those usually get resolved just by communications back and forth. So you're left with 10% of an overall program that probably ends up in litigation. But when you're doing roughly 90% of a product and people are satisfied with the results, that's not bad. Now, if you can get these other technologies to help drive the cost down and improve things, and I'm not just talking about companies that sit back and just rely on the medical schedule in their state. That's just like saying, is that the best you can do? You're watching HDTV on a black and white TV with rabbit ears. There are so many better things out there that help you control your costs and that's what helps that bottom line and that's what probably will be in a lot of discussion in Austin.

MCDONALD: Tom, we'll give you the honor of the final question. Actually, Tom, same question Roger just addressed which is can you tell us about the topics that you think are going to dominate this coming week's AASCIF event. When you get together with all your other funds, what's on your mind?

PHELAN: Obviously some of the very same things you, Lee, and Dolson and some of our listeners have been raising. If there are any questions about what we're seeing, with the low economic growth and the recovery today … is it a full blown recovery? Is it a partial recovery? What's going on there? I think there's going to be a lot of discussion about medical inflation and medical breakthroughs. I know we face a lot of the medical issues because I know when Dolson talked earlier about the low yield. There are two sides to this whole equation. One is you can't get the yield you're looking to get. One of the ways of dealing with it is what are you doing to actually deal with your medical inflation issues that you're facing as an organization. Another topic that I know is very, very much a concern to a lot of people is this whole opioid problem that's going on. These drugs were originally developed in the '70s, '80s and '90s to be used as end-stage cancer treatment drugs. They somehow found their way into the work comp environment as a "pain management environment" and have

become totally mainstream, and I think a lot of people are now recognizing that these drugs are very, very dangerous. I think the CDC came out the other day and said that more people died from prescription overdoses this past year than from any type of illegal drug that's out there. So absolutely this is going to be an issue. I think dealing with the aging workforce from both aspects of what does that mean with regard to severity of claims, what does it mean with regard to frequency claims. But what does it also mean to the state funds in general. A lot of us are facing the issue where we have an aging workforce internally and what are we doing to grow our new talent to replace our workers as they ultimately retire. So I think there's going to be a lot of different topics that all have a lot of relevance to this industry.

MCDONALD: OK. We look forward to that.

FOWLER: One other question that had come in, and it relates right here to a topic that will likely be prominent at AASCIF as well. The question reads: What effect will the Affordable Care Act have on the workers' comp sector? I suspect we'll hear about that, but could I ask Tom and Roger both to respond?

PHELAN: I'll jump in first on this. You know, it's interesting that the state that had something very similar to the Affordable Care Act was Massachusetts. And we've heard radically conflicting stories about this. I heard one story that basically said it was going to be a real significant savings for the work comp industry because the preliminary indications were that it had driven down costs in Massachusetts. About six to eight months later, I heard a story come out that was totally wrong because there was going to be such a shortage of physicians, and there was going to be such a strain on the entire system … that it was going to push prices up. I think the jury's out. I think a lot of people are speculating on this but I'm not sure anybody is really ready or has really any hard-core quantifiable, tangible data they can pinpoint to say what this thing's going to do one way or the other.

FRIES: I'll go back to 24-hour coverages and certain others everybody got so excited about. I have my concerns and my concerns are more in the availability area, the specialties, how those areas are going to be treated by the act and how much they're either going to jump into workers' comp or stay out of workers' comp. I've read a lot about people predicting different things. I'd rather look at it as it's an exciting time of an unknown. I'd stay fixed on what you're doing today, the way it is. And I would prepare with a lot of organization and a lot of workers' comp state funds and others that hire a lot of medical people in advance … they have them on staff right now. I think the workers' comp community in general – state funds and carriers across the board in TPAs — will do a pretty good job. There is an unknown but I'd rather see everybody look at it as more of an exciting time with an exciting future and not be so upset with what is not for sure to be known in the next few years.

MCDONALD: Thank you. Dolson, I don't believe it was addressed in the report. I know you cover workers' comp. Has that become part of the conversation yet?

SMITH: Well, certainly as I mentioned, we knew it as a concern. It's an unknown and my personal thought and concern is about rising medical costs and how soon this will happen or would happen is an unknown. But it is a concern of mine, personally.

MCDONALD: Well, thank you. Thank you, Tom. Thank you, Roger. Thank you, Dolson and thank you, Jim. Thank you all for joining us today. I'm Lee McDonald with the A.M. Best Company.

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