WOR COMP MARKET UPDATE

DON’T GO TO SLEEP ON THE WORKERS’ COMP MARKET

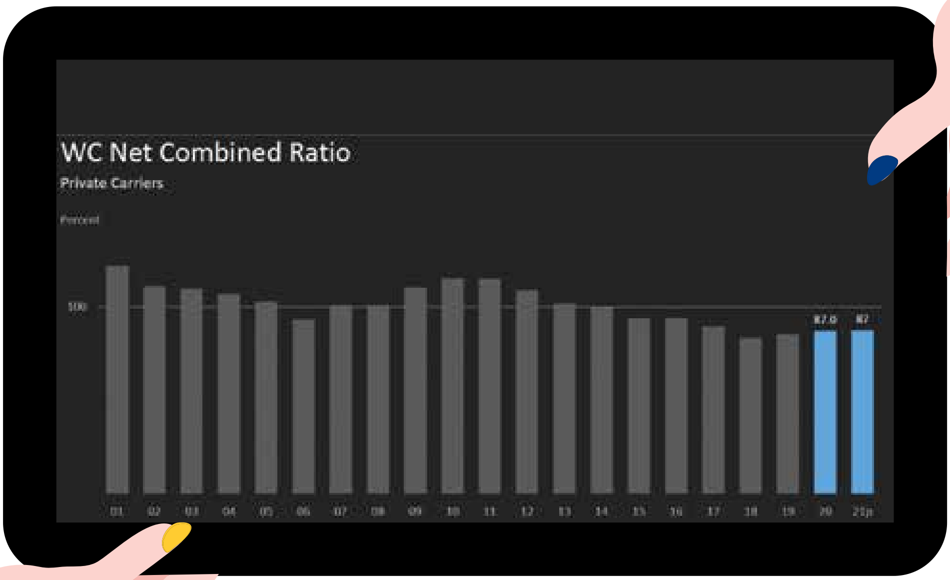
BY ANDY ATSAVES

History is a great teacher. 10 years ago NAPEO’s PEO Capitol Summit agenda was almost entirely workers’ compensation market and regulatory issues. The dearth of coverage options and threats to PEOs’ ability to own/sponsor workers’ compensation programs as a co-employer were very real. In 2012, I penned a *PEO Insider* ® article about workers’ compensation conditions described by the National Council on Compensation Insurance (NCCI) as “precarious and deteriorating,” with combined ratios around 115%. In 2015, we revisited the topic as industry results had improved significantly as a result of rate increases and regulatory reforms in many states. At that time, NCCI reported the best results in nearly 10 years with 2013 and 2014 combined ratios of 102% and 98%, respectively.

A combined ratio is a metric of underlying profitability of a line of insurance comprising the ratio of incurred losses and expenses divided by earned premiums. Quite simply, a combined ratio of less than 100% indicates an underwriting gain, or profit; alternatively, a combined ratio greater than 100% indicates an underwriting loss. Just as the economy and stock market are prone to cycles, so too are insurance lines. By way of example, when the wind blows hard in Florida in consecutive years, we can expect increases in underlying premium rates in property insurance and contraction of available insurance capacity. Likewise, PEOs have no doubt experienced upward bias in pricing in cyber liability and employment practices liability (EPLI) coverage over the past several years, given a very challenging claim environment.

STATE OF THE MARKET

In May 2022, NCCI issued their Annual State of the Line report which hit on key workers’ compensation metrics and trends impacting the industry. There can be no underestimating the positive results. With an 87% combined ratio, 2021 marked the eighth consecutive year



of record underwriting gains. Figure 1 above, from NCCI, illustrates the unprecedented run of positive results.

For perspective, NCCI compared the workers' compensation line of insurance to other property and casualty lines. In figure 2 below we can observe the significantly better performance of workers' compensation to various other lines. One line of note that's likely

P&C Industry Net Combined Ratio

Private Carriers

Line of Business	2020 (%)	2021p (%)
Personal Auto	93	101
Homeowners	107	104
Other Liability (Incl. Product Liability)	105	97
Commercial Auto	102	99
Commercial Multi-Peril	110	106
Fire & Allied Lines (Incl. Earthquake)	103	99
Workers Compensation	87	87
All Other Lines	98	92
Total P&C Industry	99	99

hitting all of us is personal auto. With significantly fewer commuters during the pandemic, and therefore less accidents, 2020 had a 93% combined ratio. In 2021 we began to see more drivers on the road, more accidents and a deterioration of underwriting results driving (pun intended) the personal auto combined ratio to 101%. As if rising gas prices weren't enough, we can all expect upward pressure on our car insurance!

In 10 years, we have moved from a workers' compensation market described as "precarious and deteriorating" to one NCCI describes as "strong and healthy" in 2022. The economy has been strong, with low unemployment and wage pressures offsetting multiple years of rate decreases, such that net written workers' compensation premiums increased in 2021, but only 1% driven by an 11% increase in wages. Thankfully, the dire predictions of COVID-19 claims' impact on the workers' compensation system did not emerge. Plus, while certain insurance carriers are underperforming in workers' compensation, NCCI reports the system as a whole is adequately reserved to pay future claims. However, since 2000 approximately 20 insurance companies have participated in the PEO space and exited, and at least 10 have gone out of business and/or are in receivership.

With that broad context as a background, what could possibly go wrong given the current market?

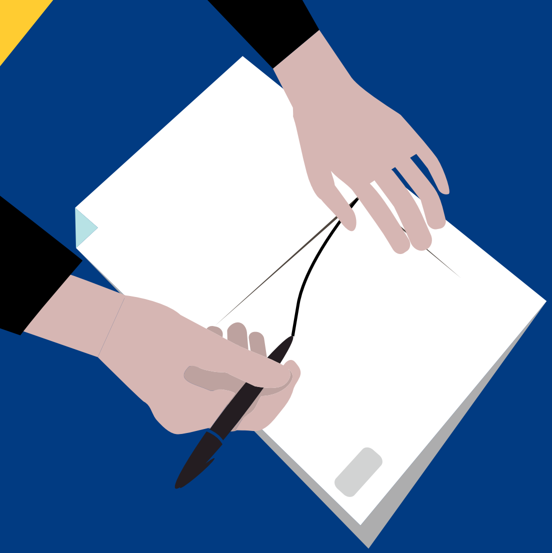
THE EXPERTS' TAKE

Over the summer, I interviewed key industry leaders, PEO risk managers and executive-level practitioners, insurance company executives with deep experience in the PEO space, PEO-centric insurance brokers, and investment banking specialists to understand what keeps them awake at night when they think about workers' compensation trends.

The question is simple:

Workers' compensation is essential to all PEOs and the line of business has had an unprecedented run of good success. What keeps you awake at night regarding workers' compensation, and how are you managing to those concerns?

Their insights are valuable in understanding how PEOs can navigate the best of times, and position themselves for possible turns in the market in years to come.



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Here are a few takeaways:

- While maybe not top of mind, PEOs, carriers and specialty insurance brokers tend to believe we are in the latter stages of the soft market cycle.
- PEOs are well served to be mindful of these market trends, and particularly on selection and pricing of new (and existing) client companies.
- Industry consolidation trends may also constrain available insuring capacity.
- Workers' compensation is almost universally viewed as a critical product offered through the PEO, and as such it has to be managed with aplomb so as to deliver best in class responsiveness to client companies.

Let's begin with views from Head of Large Casualty Brian Winters and VP of Underwriting and PEO Portfolio Manager Robert Morris of Zurich Insurance, one of the nation's largest writers of workers' compensation and a major player in the PEO space (disclosure: my company, Artex Risk Solutions, provides program administration support to Zurich). The good news is that both noted Zurich's bullishness in workers' compensation across an array of industries, including the PEO space. However, both shared concerns on current market conditions and implications in the coming years that all risk managers should consider, in their opinion.

While NCCI notes historic lows from a claims frequency standpoint, Winters and Morris believe the past two pandemic-centric years are not a realistic baseline for future conditions. Rather, Zurich expects frequency levels to increase from pandemic lows through 2023 and taper off in 2024 to the pre-pandemic levels (still at long term lows). Additionally, both sounded a cautionary tone regarding inflationary impacts to severity losses on both indemnity (through wage inflation) and medical (through medical cost inflation) well above what would naturally be expected, and importantly, not contemplated in today's soft market rate environment.

They noted that prescribed indemnity payment limitations at the state level and negotiated medical rates and fee schedules may ease inflationary pressures near term, but longer term there's a general belief the current rate environment will not be sufficient to support the historically low combined ratios shown above. In fact, Zurich believes these trends will lead to incrementally increased combined ratios around 96% by 2024. Volatility in loss costs without underlying rate support has historically driven insuring capacity correction, which in turn drives cost upwards. While this article is focused on workers' compensation, most PEOs with cyber or EPLI policies are seeing the impact of loss rate volatility, which ultimately shrinks available insuring capacity causing spikes in rates. To be sure, neither Winters nor Morris are predicting such acute challenges in workers' compensation, but they are voicing concern over the confluence of increasing frequency, higher severity claims and higher inflation on all claims costs given the current rate environment.

PEO insurance agent and former PEO risk manager Dave Carothers of Praxiom Risk Management believes PEOs may be shifting their focus to distressed lines of insurance, such as cyber and EPLI, and may be losing sight

of workers' compensation. "In general, PEOs are currently enjoying favorable workers' compensation rates, and climbing hard uphill on these other lines. Because workers compensation is a "product" that can be resold to clients, this is no time for PEOs to lose focus on protecting workers' compensation as one of the long-term foundation blocks of their business," he told me.

In fact, Carothers sees storm clouds on the horizon in the coming years as the soft market cycle wanes. He noted the historic challenges many workers' compensation carriers have had writing PEOs. Just as the Zurich underwriters noted inevitable volatility in the latter stages of a market cycle, Carothers voiced concerns over availability and sustainability of highly qualified markets in the PEO space, in part because of the significant structural consolidation in the PEO industry over the past few years shrinking the number of insurable entities.

Troy Reynolds of the Arthur J. Gallagher Cos. (AJG), and also a PEO insurance specialist, shared similar concerns about a shrinking total addressable market as a result of consolidation and the "attractiveness factor" in enticing blue-chip quality insurance carriers to the space. He also pointed out that though frequency has been down over the past several years, severity losses (the dollar value of a lost time claim) are increasing and he and his colleagues at AJG are guiding their clients to be just that much more discerning in their new client selection and pricing process to account for these trends. As claim values increase with inflationary pressure and rates remain low, Reynolds notes there will be an inflection point for PEOs that drives insurance costs higher, most likely in experience modification factor increases first, then followed by rate changes (in years to come).

Senior Vice President of Risk Management Wade Latham of CoAdvantage shared concerns in three distinct buckets, the first and most concerning is the overall workers' compensation insuring capacity to the space, and the negative impact to the PEO industry if a major insurer pulls out. He reflected on the chaos that hit the PEO industry when CNA summarily exited the PEO space years ago. Though not a proponent of a multiple carrier footprint at CoAdvantage, Latham notes he has observed a number of PEOs that leverage a syndicated coverage footprint amongst several carriers. In contrast with that paradigm, he is a strong proponent of creating a national carrier partnership with the ability to handle a PEO's unique administrative needs.

As with others, he is very concerned about continuous rate decreases (often enhanced by political goals) and tends to believe the "great statistical results can't continue forever and we will see a change." He's guiding his sales colleagues that ultra-low market conditions may mean saying no to otherwise viable client companies, simply because the client is obtaining open market pricing at below loss projections (in states where allowed, they may still write the client who stays on its own policy).

Finally, Latham voiced concerns over the intersection of macro-economic trends and late cycle workers' compensation trends. He notes the good news that wage inflation has offset continual rate decreases, but cautions a significant and sustained economic downturn in the current low rate environment will present even greater challenges for PEOs.

Interestingly, Steve Politis, CEO of Alcott HR and NAPEO Board member, echoed the "politicization" of workers' compensation (and health benefit rates), and strongly believes those influences lead to protracting the soft market cycle.

Bill Maness, CEO of Syndeo and NAPEO Board member, noted his biggest concerns are centered on technology dependence and the potential for tech failure and its negative consequences on his company and the broader PEO industry. Interestingly, Maness spoke of workers' compensation as a critical product offering that must perfectly

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transcend from the carrier through Syndeo to his client companies.
His concern was centered more on the insurance industry's ability to keep up from a technology standpoint, particularly with claims data/handling for his PEO and injured workers. Maness believes the industry is better suited to go through an inevitable turn in the workers' compensation cycle than years gone by and he is every bit, if not more focused, on how a new client fits into his PEO and the workers' compensation impact on Syndeo.

Director of Risk Mark Rodefeld of Paychex offered a unique perspective that is concerning to him. He noted the profound trends in severity losses, and particularly on larger catastrophic losses, that are substantially higher today then when the soft market cycle began. Specifically, he points out that with medical technology advancements and burgeoning inflation the same loss is exponentially more expensive today than the same loss 8 years ago, yet rates have been trending downward. To that end, Rodefeld believes that much as the Federal Reserve was slow reacting to "transitory inflation trends" with interest rate increases, workers' compensation rate making bureaus are likely behind in correcting course with rate filings.

Regardless of the market cycle, and perhaps more acute given current trends, Rodefeld notes it is critical for PEO risk management teams to have a balanced, disciplined approach to client selection and pricing, a key component of which is on-going collaboration with the PEO's sales team to target specific industries with best performing characteristics. He put in succinctly, "this isn't the time in the market cycle to be taking a risk, just hoping a prospective client company will perform."

Mark Perlberg is a Managing Director at Nautic Partners (also a former NAPEO Board Chair and former PEO CEO). He picked up on the theme of PEOs getting lulled into a state of complacency after an 8 year run of rate decreases. "A relatively benign period is not etched in stone, and nowhere is it ordained that a PEO won't find itself upside down simply riding rates down," he said.

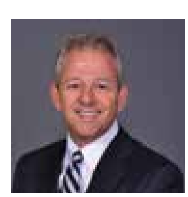
Perlberg contends PEOs must drive a value proposition that's not largely based on workers' compensation savings, especially at this stage in the market cycle, and that it is absolutely critical PEOs are focused on capturing a proper premium for each company (instead of buying business with unsustainable underpriced workers' compensation).

Perlberg firmly believes the influx of institutional capital will continue to drive PEO industry consolidation, and it's likely some PEO's workers' compensation programs may potentially overstate the true long-term contribution to EBITDA over the past several years for two reasons: 1) an artificially low frequency rate due to the pandemic, and 2) building books of business that were driven in large part by underpriced workers' compensation in a soft environment. He strongly stressed the importance of an effective, disciplined due diligence on workers' compensation in the M&A process. As he noted, "it's hard enough managing your own PEO's book of business, and buying another's that is, for example, not properly priced and/or insured by a blue chip insurer may lead to material mistakes in valuation."

Common themes are clearly emerging, regardless of which angle one looks through the PEO workers' compensation prism. Lying awake ruminating over an impending crash of the workers' compensation market certainly wasn't the predominant theme; rather, in this writer's opinion it's a lot more like Metallica's Enter Sandman: "Sleep with one eye open!"

1 NCCI Annual Issues Report (May 2022): **https://www.ncci.com/Articles/Pages/Insights-AISHighlightsReport.aspx**.

2 NCCI data on medical inflation relative to CPI: **https://www.ncci.com/Articles/Pages/Insights-AIS2022-Medical-Dilemma.aspx**



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