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In 2012, I wrote about PEOs and the workers’ compensation industry being at an inflection point. At that time, both the workers’ comp and the broader property and casualty insurance (P&C) market were in the midst of a cyclical firming, and the National Council on Compensation Insurance (NCCI) described market conditions for workers’ comp as “precarious” and “deteriorating,” with combined ratios in the 115 percent range—the worst in nearly a decade. By way of background, the combined ratio is a general measure of an insurance company’s underwriting profitability, and is the ratio of incurred losses and expenses divided by earned premiums. A combined ratio less than 100 percent indicates the insurance company is making an underwriting profit; conversely, a combined ratio greater than 100 percent indicates an underwriting loss.

Clearly, in 2012 we were in a challenging period for workers’ compensation. After approximately four years of rate increases in nearly every state, the NCCI is now reporting the best results in nearly 10 years, with 2013 and 2014 year-end combined ratios at 102 and 98 percent, respectively.

Despite improved industry-wide workers’ compensation results, the PEO industry continues to face structural challenges and increasing regulatory interest in the workers’ comp area. In this article, I will examine broader emerging trends, how they can affect PEOs, and steps PEOs can take to navigate the current and future environment.

Market Conditions

For PEOs, the focus is almost always on the workers’ compensation line of business, yet it is important to understand macro P&C trends and how they influence market conditions. In 2012, insurance markets were adversely influenced by significant catastrophic losses, both in the U.S. and globally, led by Superstorm Sandy. According to global reinsurance giant Swiss Re, total economic losses from all disaster events in 2014 were $110 billion, down from $138 billion in 2013, and importantly, well below the 10-year average of approximately $200 billion. Of these total economic losses, $101 billion were due to natural catastrophes, with cyclones in Asia Pacific causing the most damage. It is important to note that all losses are not insured losses. When natural and man-made disasters produce significant insurable losses, this puts considerable pressure on available insurance capital. Swiss Re indicates global insured losses amounted to $35 billion in 2014, down from $44 billion in 2013, and well below the 10-year average of $64 billion. Contrast those global statistics to 2012, when Superstorm Sandy produced approximately $25.85 billion in insured losses alone (third largest ever behind hurricanes Katrina and Andrew), and U.S. catastrophe losses eclipsed $77 billion, according to Swiss Re.

Severe spring hail storms in the spring of 2015 produced insured losses of $2.9 billion, and back-to-back harsh winters in the U.S. produced cumulative estimated losses of $2.4 billion, in excess of two times the prior 10 years’ average. A major hurricane, Category 3 or greater, has not made landfall in the United States since Wilma in 2005, so PEO operators along the Gulf coast and Atlantic seaboard have been able to breathe a sigh of relief (September is historically an active month). New Jersey and New York PEOs would argue with the definitions, because the National Hurricane Center actually dropped the “hurricane” moniker hours before landfall and dubbed Sandy a “Superstorm.” While the aforementioned catastrophic losses are eye-popping, over the past several years we have been below norms and have been generally absorbed by the P&C industry, with industry return on equity reaching nearly 11 percent in the first quarter of 2015, and 2014 year-end combined ratios of approximately 97 percent, according to the Insurance Information Institute.

Insurance markets, particularly workers’ compensation, are notoriously cyclical. As noted, the workers’ comp line of business went through a significant “hardening” between 2011 and 2014. Through April 2015, and with improved workers’ compensation results, NCCI has actually filed rate decreases in 30 states, ranging from -10.9 percent in Texas to -.2 percent in Idaho. Even though there appears to be a downward bias, seven NCCI states actually had rate increases, ranging from .9 percent...
in Colorado to 6.8 percent in the District of Columbia, and non-NCCI state Delaware recently announced a 15.1 percent increase.

Major non-NCCI states California and New York continue to have challenging workers' compensation environments. In California, the Workers' Compensation Insurance Rating Bureau (WCIRB) projects a 104 percent combined ratio for 2014—the seventh consecutive year over 100 percent—and a recent study spoke directly to the extraordinary loss development patterns in the Golden State, where they cite their own and NCCI data indicating that 61 percent of the ultimate California accident year medical payments are paid more than 36 months after the beginning of the year of injury.

To put that in perspective, on a countrywide basis, an average of 33 percent of medical payments are made after three years, and in a best-case state, Indiana typically has 93 percent of medical losses paid at 36 months. Prolonged medical payment patterns contributed to far longer-than-industry-average closure on indemnity claims in California, where it takes nearly 10.7 years on average before 95 percent of all indemnity claims are settled. In contrast, Colorado closes 95 percent of its indemnity claims in 3.5 years. The California WCIRB has suggested decreases at the July 1 and forthcoming January 1 rate filings, but many carriers have eschewed the decreases given these results.

Meantime, the Empire State has shown improvement, yet AM Best indicated an unadjusted (for New York State Insurance Fund statewide remittance of $2.2 billion in reserves and liability to the New York State Workers' Compensation Board) workers' compensation combined ratio of 103.7 percent in 2013. While significantly down from earlier years and a projected 102 percent for 2014, the New York Compensation Insurance Rating Board (CRIB) approved a 5.9 percent increase as of October 1, 2015.

**Interest Rates**

A macro review of workers' compensation and the broader insurance markets would be incomplete without commentary on the interest rate environment, which continues to deliver feeble returns. In years gone by, PEOs' workers' compensation carriers could enhance return on equity and adjust pricing at the customer level based on the interest they earned on funds held. A 10-year Treasury note issued in mid-2005 is just maturing, with a yield of 4.4 percent. On August 24, 2015, the day of the Dow Jones Industrial’s largest ever intraday swing (at one point down 1,000 points), a newly issued 10-year Treasury note yielded 1.97 percent! Though the Fed's quantitative easing program ended in 2014, rates are at historic lows and unquestionably influence pricing of insurance.

According to the Insurance Information Institute, nearly 80 percent of P&C bonds and cash investments are in 10-year or shorter duration notes. As bonds mature and are swapped at significantly lower yields, it's likely that will influence insurance costs, particularly in a declining rate environment. As well, even if the Fed moves to tighten rates, it's not likely it will have a material impact on workers' compensation (or any other line) insurance in the near to intermediate term. It has taken several years post the Great Recession of 2008 of renewing 10-year notes at investment yields, in some cases less than half the previous 10-year note yield, for insurance companies to absorb the full hit of these reduced investment yields. It will likely take an equal amount of time for increased income yields, if and when that day arrives, to begin having a measurable impact on insurers' profitability. In the interim, PEO insurance buyers can expect continued underwriting/pricing discipline as a result.

**Structural Changes in the PEO Space**

In 2012, I referred to the PEO workers' compensation market as approaching a structural inflection point. As contemplated, there have been several significant structural changes in the PEO space. Most recently, the industry has been dealing with regulator interest around how large-deductible insurance policies are secured by a policyholder to an issuing carrier, in large part due to the failures of a number of insurance companies in recent years writing large-deductible workers' compensation policies to PEOs. Here is a snapshot of the structural changes to the PEO marketplace since 2012:

- Liberty Mutual, a leading A-rated P&C carrier, announced it was not writing any new PEO or temporary services companies, and subsequently non-renewed all of their insureds in the employment outsourcing space. In the ensuing years, Liberty has strategically pared its workers' compensation writings, and has sold a workers' compensation-specific subsidiary, Summit Southeast (includes Bridgefield).
- Executives of Providence Property and Casualty Insurance, a defunct carrier (taken over by the state of Oklahoma) that issued large-deductible workers' compensation policies to PEOs, pleaded guilty to fraud charges, among them defrauding insurance regulators.
- Due to material insolvency issues, in 2013 the Delaware Chancery Court took similar action on Ullico Casualty, a less-than-A-rated insurance carrier that wrote large-deductible policies for PEOs.
- The Delaware Chancery Court took Dallas National Insurance Co., an unrated insurance company and writer of
PEO and temporary staffing large-deductible policies, into receivership in 2014 due to solvency issues.

- Tower Insurance Group, a multi-line P&C carrier that was adversely impacted by Superstorm Sandy and with a significant presence in the PEO workers’ compensation space, was downgraded by AM Best due to concern over the carrier’s ability to “continue as a going concern.” Tower ultimately merged into ACP Re, a unit of AmTrust Financial Service’s subsidiary, Maiden Holdings, Ltd.

- Most recently, Lumbermen’s Underwriting Alliance (LUA) was downgraded by AM Best to E (under regulatory supervision), and ultimately taken into receivership by the Missouri Department of Insurance. While LUA was involved in various lines of insurance, it had a significant workers’ compensation portfolio in the PEO industry, and according to AM Best was under-collateralized and/or inappropriately collateralized on a large PEO that declared bankruptcy as a result of a $95 million federal tax debt.

These structural changes have a variety of impacts on the PEO industry. Although workers’ compensation capacity remains limited to the PEO industry, carriers serving the industry absorbed most displaced PEOs. Beyond coverage disruption/uncertainty, which in and of itself is material, considering the importance of workers’ compensation to a PEO’s livelihood, there have been regulatory responses to the failure of under- and/or inappropriately collateralized insurers writing large-deductible policies to the PEO industry.

As NAPEO has noted to members through its NAPEO E-Source newsletter, the National Association of Insurance Commissioners (NAIC) and International Association of Industrial Accident Boards and Commissions (IAIABC) have a working group that is holding conference calls and a series of meetings to address issues surrounding large-deductible workers’ compensation policies, with a particular focus on the solvency of workers’ compensation carriers issuing those policies; the study also looks at PEOs in the large-deductible workers’ compensation space.

In fact, on August 20, 2015, the state of Illinois passed SB 1805, which sets specific parameters around an insurance carrier’s financial profile to limit the issuing of large-deductible workers’ compensation policies.
Acceptable forms of security to insurer by policyholder in Illinois are:

- A surety bond issued by an AM Best A-V rated insurer/issuer (note: As a practical matter, surety bonds are typically not acceptable to carriers, as they are not readily convertible).
- An irrevocable letter of credit issued by a financial institution with offices physically located within Illinois.
- Cash or securities held in trust by a third party or by the insurer and subject to a trust agreement for the express purpose of securing the policyholder’s obligation under a large-deductible agreement. No commingling of other policyholder assets is allowed.

Beyond matters of large-deductible securitization, insurance departments across the country are increasingly focused on PEO workers’ compensation policy construction, proof of coverage filings, and risk classification matters. Specific areas of emerging interest include, but are not limited to:

- Timely, accurate data elements used in constructing and tracking multiple coordinated policies (MCPs);
- Timely, accurate filing of proof of coverage filings—many states are vigorously focused in this area of concern and are issuing fines; and
- Many states are focusing on proper use of standard exception class codes, such as 8810 and 8742.

The former items are generally specific to PEOs, while the latter extends well beyond the PEO space and is indicative of broader scrutiny regulators are placing on workers’ compensation insurers and insureds.

The very good news is that the P&C industry workers’ compensation market conditions are generally stable, and though rates have drafted downward, there will continue to be a pricing offset while we are in a low interest rate environment. The emerging regulatory/legislative issues are manageable, particularly with open, transparent dialogue between NAPEO, PEO members, and their legislators.

The emerging regulatory/legislative issues include:

- Understanding what their carrier’s financial condition is. Is your carrier stable? What is its financial strength rating (FSR)? Does it have staying power to absorb a downturn in the workers’ compensation market? Regrettably, if the past is any precursor to the future, there’s a high correlation between un/under rated insurance carriers writing PEO workers’ compensation and failures.
- Planning and pricing with discipline. As market conditions stabilize, PEOs that are bearing risk in their programs will best position themselves to realize a profit with disciplined pricing and client selection decisions reinforced by continuous monitoring of these decisions to validate the effectiveness (or modify accordingly). Yes, you can be profitable in the tough states too!
- Vigorous management of claims. Though not the subject of this article, it stands to reason that PEOs that actively manage their claims have materially better results than the industry as a whole. Whether on a loss-sensitive or guaranteed-cost platform, failure to actively engage in workers’ compensation claims management will ultimately have an adverse impact on the long-term cost of coverage (particularly versus a given PEO’s peer group).
- Investing in a systematic process of managing risk and taking a total cost of risk approach. Certainly, the Certification Institute (www.certificationinstitute.org) provides an ideal infrastructure to managing the entire spectrum of workers’ compensation risk.

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