

Risk M A N A G E M E N T

Outside of Insurance

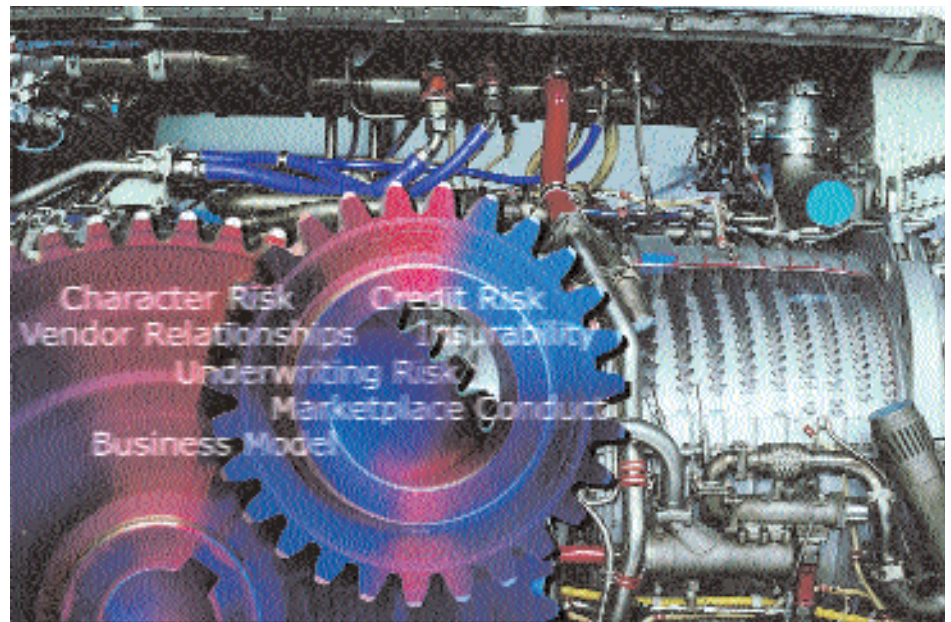
Paul Hughes

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Our PEO workers' compensation program recently procured excess of loss reinsurance coverage for the next 12 months with a nationally recognized A-rated reinsurer. We came ready with vast amounts of data supporting the program's success and the underlying underwriting performance metrics of the book. As what seems to be the case in any meeting with the reinsurance community involving PEOs though, our interviews with this group lead us towards an overall conversation of the purpose of a professional employer organization, and how one can separate the bad from the good outside of the underwriting data.

Their focus was on our agency's expertise in underwriting and evaluating what many perceive to be a difficult class of business and an area many carriers have had negative experiences with in recent history. Like most company people, these gentlemen live in actuarial principles that allow, with a high degree of probability, the prediction of ultimate expected losses for a given risk. The underlying data of a PEO's insurance program is the part of a PEO the insurance companies do

understand, although they sometimes have difficulty keeping up with the non-static nature of a PEO's book of business in terms of growth and mix of business. As usual, I broke down all of the benefits a PEO provides to a business, especially a small to medium-sized firm that lacks the appropriate resources to keep up with all



of the employment responsibilities state and federal governments require. To quote Peter Drucker in his recent *Harvard Business Journal* article: "In a traditional workforce, the worker serves the system; in a knowledge workplace, the system

must serve the worker."

This quote explains how PEOs allow businesses to focus on their core competencies while the PEO manages the non-operating aspects of the business. A knowledge economy produces a non-traditional work setting where set workplaces and times are not practical, and each worker and specialty must be treated in a unique way. Web-centric HR platforms, payroll deducted benefits, and 24-hour consultation allow a business flexibility in designing the workplace of its employees. My underwriting friends nodded approvingly, but arms were still crossed, and

there was still fear in their eyes.

I continued that it is my humble opinion that in evaluating the insurability of a PEO, underwriting risk is a distant third in terms of importance behind the evaluation of character risk and credit risk. The

risk the insurance community has been trained to assess is the easiest, in my opinion, and one that every major carrier that has ever underwritten a PEO knows very well. Why then did many of them fail in underwriting PEOs? Foremost, character risk is the number-one variable in the PEO equation. PEOs are made up of small businesses for the most part that on their own would be very attractive to most insurance carriers. What is it about the PEO wrapper that makes insurance executives cringe? The insurance industry has found that one of its foremost concepts in pricing risk — predictability — is significantly challenged by the PEO model. Each carrier has a chief actuary whose very job is to predict outcomes at different levels of confidence to ensure the carrier is protected. Unlike most every other industry type, a PEO can change its risk characteristics with one signature on a stock purchase deal of another PEO or the addition of a large client company whose risk profile is outside of that previously underwritten. Character risk in my opinion is: “The likelihood of an individual and/or entity to act in a manner that would seek to maximize its own profitability through acts of misrepresentation, fraud, or deceit.”

I have worked with accounts in the past that retained risk management departments better than those of many insurance carriers, yet due to the character and past actions of the ownership group, were uninsurable. There is no good business with bad people, no matter how much premium is at stake. What the account looks like on paper (underwriting risk) is a great marker to evaluate predictability, but if the ownership group itself is not predictable in how they operate a PEO, all of the actuarial training in the world will not allow an underwriter to properly predict the loss outcomes of a PEO. To assess this character risk, I first call my friends in the industry. We are

particularly concerned with how a PEO conducts itself in the marketplace, its vendor relationships and their tenure, as well as insight into that PEO’s business model and its success. I pay particular attention to what the PEO offers outside of insurance and how it is distributed and sold. Those PEOs that do nothing more than resell insurance are evaluated closely due to the fact that their profitability is so closely tied to insurance, which therefore increases the likelihood of a fraudulent act involving insurance. The assessments I get from my clients and associates typically are most valuable in our evaluation. Next, we pull full background checks on all officers of the PEO. Flags such as criminal convictions, bankruptcies, tax evasion, and any suits involving an insurance carrier are reviewed in great detail. Some things can be explained, and it is always good policy to address any blemishes up front with the underwriter prior to the background check being done.

Credit risk comes in a close second in underwriting importance. Simply stated, if a PEO is not capable of meeting its payment obligations to the insurance carriers, there is little hope the carrier can be profitable regardless of the book’s performance. This risk is partially identified in the background checks if there are bankruptcies and excessive liens listed. The rest needs to be evaluated within the financial statements and underlying operating ratios of the PEO. To start, anything less than audited financial statements serve no purpose in the evaluation, and without them, the submission is dead on arrival. Questions we consider when looking at each PEO include:

- What percentage of operating profits come from insurance?
- Can the PEO meet its burn rate without a workers’ compensation contribution to profit? and
- What is the net worth of the PEO versus its expected short-term liabilities?

In trying to compare the underlying ratios of a PEO against those of its peers, it becomes readily apparent there is not much financial data. The NAPEO Financial Ratios Survey is very helpful, but does not provide marketplace-specific data we feel is important in assessing peer versus peer. We have thus produced a quarterly financial report card for each of our PEOs that allows us to analyze their operating ratios versus those of the book as a whole and the NAPEO national results. Besides helping to alert us if there appears to be deterioration of financial performance for a current client, it allows us to analyze a prospect’s metrics in detail against a relevant peer group. For our current clients, it allows us to point out positive and negative trends in performance, and possibly suggest ways profitability could be improved.

While this process may seem excessive to some, it is the same exact process that reinsurers and primary insurance carriers take in evaluating both managing general agents and retail agents. The licensing requirements and barriers of entry to be a PEO are very different state by state, and therefore carriers have been enlightened to the need of a certification-like process before the underwriting data is ever analyzed. While it may seem like common sense, the most important thing in procuring workers’ compensation coverage for a PEO’s ownership group is being a responsible corporate citizen. In an industry that has been painted with a broad-brush stereotype too many times, anything less than total integrity in past and present business dealings will provide the quickest exit to the prospective client.

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