AMERICAN ACADEMY of ACTUARIES

September 18, 2000

Mr. Bob Card
Senior Regulatory Specialist
National Association of Insurance Commissioners
2301 McGee Street
Kansas City, Missouri 64108-2604

**RE: NAIC 1991 EMPLOYEE LEASING MODEL REGULATION**

Dear Mr. Card:

As Professional Employer Organizations (PEOs) have grown and become more common in both the voluntary and residual workers compensation markets, questions continue to arise regarding statistical reporting requirements and experience rating rules for employers insured under PEO arrangements. The NAIC created model regulations in 1991 that addressed the handling of PEO policies. Since then, a number of states have implemented their own rules, not always consistent with the model regulation. The IAIABC/NAIC Joint Working Group asked the American Academy of Actuaries Workers Compensation Working Group (the Working Group) to review the NAIC's 1991 model regulation and provide comments on it from an actuarial perspective. Below are our comments.

There are widely divergent and strongly held opinions within the actuarial community, as well as the insurance industry at large, concerning the respective merits of insuring employee leasing arrangements under a "multiple coordinated policies basis" and a "master policy basis." Similarly, there are differing views as to whether one or the other approach ought to be mandated.

PEOs lease employees to clients. A key and especially controversial question is whether the individual clients of PEOs should have a common experience modification based on the experience of all the clients of the PEO, a separate experience modifications based on each individual client's experience (including both leased and non-leased employees), or a combination of both approaches. Given that individual clients may move into and out of arrangements with one or more PEOs, a question arises regarding the data that should be used to determine a former client's experience modification if that client ceases to lease employees from a particular PEO. The preferred approach in these circumstances will dictate whether premium, payroll, and loss information must be reported separately by client or can be collected only for the PEO and all its clients collectively.

The use of multiple coordinated policies or a single master policy is not the issue. The key question is how statistical data is captured and then utilized in estimating losses through the experience rating plan. Multiple coordinated policies require issuance of, and statistical reporting for, separate policies for each client. This approach is administratively more expensive, but it allows the separate tracking of individual client information across multiple leasing arrangements and for both leased and non-leased employees in combination. However, this approach fails to recognize the collective credibility of the PEO's experience and the potential impact of risk management efforts by the PEO administrator.

If a master policy is used, individual clients are identified by endorsement to the master policy and a single experience modifier is computed reflecting the historical experience of the PEO, but not necessarily the historical experience of its current clients. Unless additional statistical reporting requirements are implemented to track experience of individual clients separately, the information reported to statistical agents/rating bureaus on unit statistical reports under the master policy approach will contain only the combined experience of all clients and will not allow identification or use of individual client data once the employer leaves the PEO. This may hurt an employer's chances of receiving a voluntary market quote (if it chooses to leave the PEO) because of the lack of historical experience. Experience modifiers computed for employers leaving PEO would be computed based on the experience of its non-leased (usually less hazardous) employees, and would not necessarily reflect the expected future experience of the employers entire operations.

The purpose of experience rating is to adjust an employer's expected losses based on published advisory loss costs to better reflect the actual loss experience for individual employers within a classification(s). Normally, there are only limited circumstances under which changes in ownership allow an employer's historical experience to be ignored when determining a subsequent experience modification. In determining the expected losses for an individual client of a PEO, a key question is whether one expects that individual client's experience to be determined by risk management activities of the PEO administrator, the client's risk manager (if any), or both. In the context of this discussion, the "master policy" approach suggests that the PEO controls employees and applies safety initiatives for its separate clients, while the "multiple coordinated policy" approach suggests that individual clients still have the most influential direction and control of their employees, leased or non-leased.

Which type of policy is appropriate will likely vary depending on the PEO and depending on the specific arrangement that exists between the PEO and its clients. To date, the Working Group is not aware of any studies testing whether one or the other of the approaches commonly considered (i.e., multiple coordinated policies or a single master policy) produces more accurate predictability of experience. The multiple coordinated approach should develop more equitable premiums for individual clients, but may less accurately predict losses for the PEO as a whole. On the other hand, most PEOs provide coverage for small employers, whose actual experience has limited credibility.

The model regulation requires that a multiple coordinated policy approach be used in the residual market, but allows discretion to use either a multiple coordinated policy or a master policy approach in the voluntary market. The Working Group perceives rules that vary depending on whether a risk is insured in the residual or voluntary market as being fundamentally inconsistent. The data reporting needs outlined above apply whether an employer is insured in the voluntary or residual market.. It is entirely possible that an employer might have some of its employees insured simultaneously in both markets.

Regardless of the merits of these alternative approaches to experience rating, the system envisioned in the model regulation clearly does require maintenance of separate and distinct types of records including a variety of duplicate information such as business identifiers, classification codes, etc. Under the model regulation, insurers and the rating organizations must be able to accomplish accurate and timely transitions from a "master policy" approach to a "multiple coordinated policy" approach or even individual policies.

This need would arise whenever a client insured through a PEO arrangement moves to another PEO or ceases to lease its employees.
Since the specific timing and occurrence of these circumstances could not be foreseen years in advance, appropriate records would have to be retained to apply either the master policy or multiple coordinated policy approach for any client) and/or PEOon a prospective basis. A potential improvement to the Model Regulation would be to more explicitly address the necessary additional volume and separate types of required data that needs to be tracked for clients of a PEO.

The model regulation's requirement that the insurer be responsible for collecting and maintaining records sufficient to support calculation of individual experience modifications for businesses insured under a master policy approach is an important provision. By virtue of this requirement, the possibility of default by the lessor of employees (by either failure or design) on the obligation to organize, support and submit data is minimized. A system that awaited the need for data before securing such records would be subject to delays, imprecision and potential abuse. However, in order for the data in question to be truly responsive to potential needs of all parties, the data collected and maintained by insurers would best be submitted to and retained by the authorized rating organization(s) in each jurisdiction. Otherwise, a process of notification, request and presentation of data will necessarily intervene whenever a change in insurance arrangements requires an adjustment to experience rating procedures.

Keeping separate sets of individual client records for employee leasing arrangements insured under a master policy approach could become expensive depending upon the volume of business involved and each particular insurer's available data system. Presumably, making the master policy approach optional addresses this problem, since additional record keeping is not imposed on any insurer which does not essentially accept this burden as part of the bargain when they enter into a master policy.

The model regulation tries to balance flexibility and the desire to streamline processes with the need to track individual client loss experience in dealing with PEO arrangements. From a public policy perspective, workers compensation cost allocation mechanisms should be both equitable and efficient. Within these constraints, consistency in approach is desirable both across states and between markets. In refining the model regulation, consideration should be given to how one wants the experience rating plan to work, including circumstances in which clients enter arrangements with a PEO and when such clients move to another PEO or go back to employing their own employees outside an employee leasing arrangement. The ideal from an actuarial perspective is to collect data in such a manner as to be able to determine experience modifications on either a client or a PEO basis as fits the circumstances. We recognize that this may not be practical due to expense and/or political considerations.

If you have any questions, please feel free to contact me through Greg Vass, Casualty Policy Analyst at the American Academy of Actuaries at (202) 223-8196 or vass@actuary.org.

Sincerely,

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insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.