STRATEGIES FOR SELF-INSURERS MANAGING WORKERS' COMP AND LIABILITY RISK DURING AN ACQUISITION

Written By Carly Rowland, FCAS, MAAA

Mergers and acquisitions (M&As) are on the rise, particularly over the past year. In 2021, global M&A volumes reached $5.9 trillion—a record high with a 64% increase from 2020.[1]

Businesses and organizations are driven to future-proof by current economic and social landscape transformations. Despite inflation, rising interest rates, and the expected slowdown of global economic growth and investment of 2022, the environment is still considered favorable, and dealmakers are continuing to move forward with M&A transactions.[2]

Acquiring new business, however, comes with challenges chief risk officers (CROs) and other risk management professionals should consider, especially when adding newly acquired business to existing self-insured or large deductible insurance programs.

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SLPC 29427 01/22 (exp. 01/24)

UNDERSTAND THE RISK PROFILE OF THE ACQUISITION

Risk management of self-insureds or large deductible programs should first consider the acquisition's risk profile.

To start, is the acquisition a stock or asset sale? A stock sale involves buying the entire entity, which includes unpaid claim liabilities arising from claims prior to the transaction date.

An asset sale allows for more flexibility in structure than a stock sale and typically does not include unpaid claim liabilities arising from claims prior to the transaction date. Depending on the magnitude of prior liabilities, this distinction may hold high importance for the unpaid claim liability booked on financial statements.

Having a thorough understanding of the acquisition's risk profile compared to the purchasing company's risk profile is important. Is the exposure to risk similar regarding both the nature and severity of claims?

Perhaps a sales and distribution company with equal weights of clerical and warehouse workers acquires a business mostly comprised of warehouse workers. A business with a higher percentage of warehouse workers and a smaller percentage of clerical workers will have a significantly higher workers' compensation cost per payroll. Or perhaps a restaurant franchise purchases a delivery business. The delivery business has a significantly lower general liability cost per revenue compared to restaurants serving patrons, which have greater exposure to slip and fall claims.

Additionally, what is risk management expected to look like on a go-forward basis for the acquired business? Risk management may continue under separate administration and stay consistent with the reserving and claim handling strategies used prior to the transaction.

It is more common, however, for the new business to be managed under the acquiring business's risk management team and transition to those reserving and claim handling strategies. Understanding the historical and potential future risk profile of the acquired company and its risk management strategies is valuable for not only self-insureds and program managers, but also for actuaries when estimating future losses. The same question and concept can be applied to third-party administrators (TPAs), or any other vendor involved in the program.

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UNDERSTAND ACQUIRED EXPOSURES: ACTUARIAL APPROACH WITH LITTLE TO NO HISTORICAL DATA AVAILABLE

For self-insureds or large deductible programs, an actuarial analysis is an important first step in understanding the potential current and future liability costs of the acquired business and is part of due diligence.

However, the availability of historical data, along with the risk profile, will determine an actuary's approach. Options are much more limited if historical loss and exposure information is not available. Without the ability to analyze the acquisition's historical cost per exposure, some approaches include:

1. Bring the acquired risk into the existing self-insured or large deductible insurance program assuming a similar cost per exposure.
2. Start with the existing program's cost per exposure and adjust based on any relevant knowledge related to the acquired business's risk profile or historical loss experience.
3. Base the initial cost per exposure on industry data. For example, workers' compensation losses can be estimated by weighing the new business's payroll distribution by state and class code with industry loss costs published by the National Council on Compensation Insurance (NCCI).

A combination of these approaches may also be used. Regardless of which approach is utilized, all approaches should be monitored over time and estimated losses should be adjusted appropriately as future loss experience is observed. Because these approaches involve a certain level of discretion, as all actuarial estimates do, risk management should have discussions with its actuary to provide as much detail about the acquired business's risk profile and historical loss experience as available.

Risk management may also wish to discuss its desired level of conservatism, also referred to as "risk appetite." Perhaps risk management believes that the new business has a lower cost per exposure, but they prefer to take a more conservative approach and therefore the new business is priced at a similar cost as the existing business.

This may provide some reasonable extra "cushion" built into the loss estimates. Or perhaps risk management would like to be more aggressive and apply some credit to the expected more favorable loss experience. It is important to mention that not all acquisitions will have a material impact on a program's combined cost per exposure, regardless of the availability of historical data. Thus, sometimes the more simplistic approach may be the best.

ACQUISITION ANALYSIS IN ACTION

Take a hypothetical transaction of a large national retailer acquiring a smaller regional retailer. Let's assume the asset sale occurs on January 1, 2022 and includes workers' compensation exposure. The regional retailer's program size is 25% of the national retailer's program size and is expected to have a 50% lower cost per $100 payroll based on its risk profile and location.

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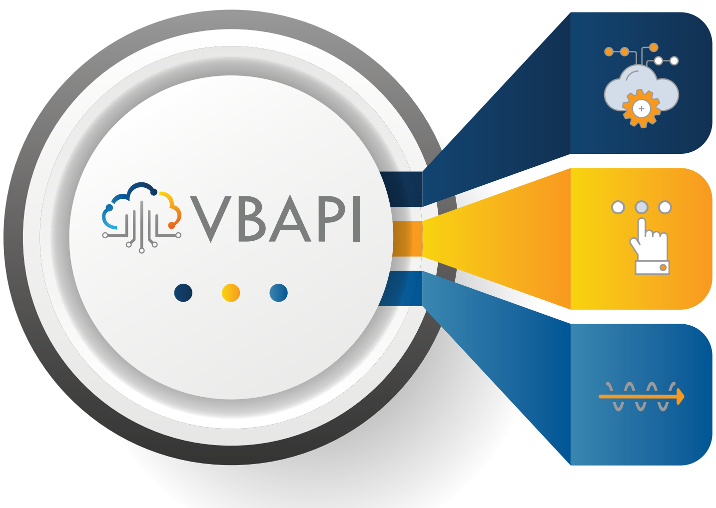

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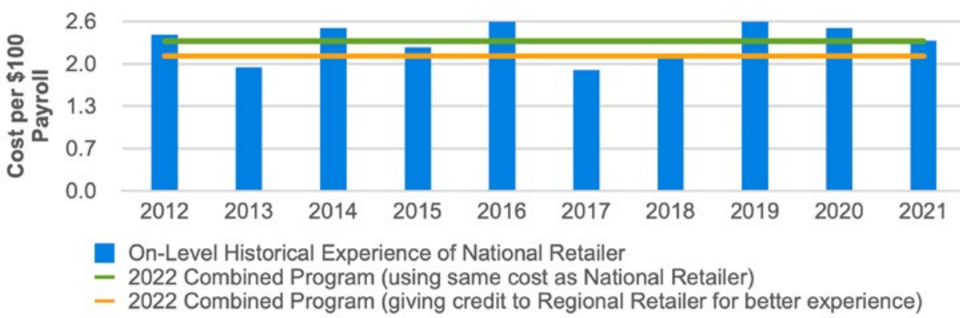
Figure 1 shows the estimated cost per $100 payroll for accident year 2022 two ways: adding the regional retailer to the program at the same cost as the national retailer (green line), as well as adjusting for the assumed 50% more favorable loss experience (orange line). The blue bars represent the national retailer's historical experience put on level with 2022 dollars. The larger the program size of the regional retailer compared to the national retailer, the lower the orange bar would move. The difference between the two lines could have a significant impact on the budget for the 2022 accident year depending on the amount of payroll involved.

Figure 1: Workers' Compensation Cost per $100 Payroll



UNDERSTAND ACQUIRED EXPOSURES: ACTUARIAL ANALYSIS WITH HISTORICAL DATA AVAILABLE

If there is enough historical loss and exposure data available to be credible (assuming the size of the acquisition compared to the existing company is material), then an actuary can complete a full analysis and estimate a cost per exposure for the acquired business.

The results could show a significantly higher or lower cost per exposure than the existing program, or the acquired business could in fact have similar loss experience as the existing program. Some factors that may impact results include risk profiles or mix of business, retentions, state jurisdictions, and historical risk management strategies.

Based on the initial study's results, risk management can discuss subsequent analysis approaches with its actuary. Approaches may include continuing to analyze the new business separately or combining the new and existing business's exposures.

If the initial results show a cost per exposure that is similar to the existing program, it is reasonable to roll the acquired exposures into a single analysis with the existing exposures.

If results show a significantly different cost per exposure, but risk management would still prefer one combined analysis, a mix of business adjustment based on the results of the initial study could be used until the new business is fully integrated into the overall program's loss experience.

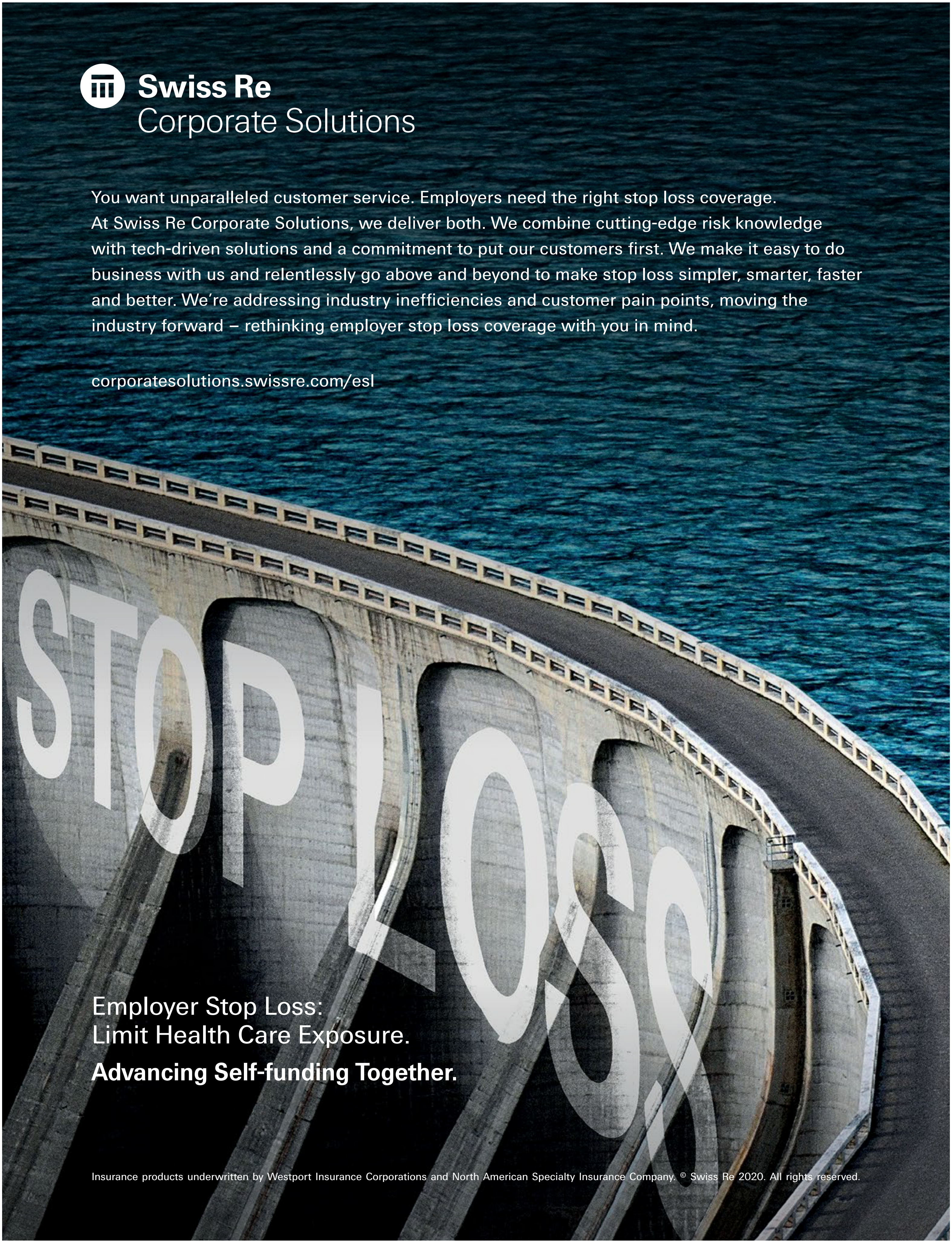
When choosing an actuarial analysis approach, self-insureds and program managers should consider whether estimated unpaid claim liabilities and projected losses need to be recorded separately between the acquired business and existing business.

Of course, separate analyses provide separate results. However, separate results can also be estimated for a combined analysis with the use of allocations. Allocations are a handy tool when analyses are completed for a program as a whole, but the program also needs results broken down into separate units or divisions. An allocation can provide actuarial support for charging losses back to the acquired and existing business based on actual losses and exposures (assuming the data is available and credible).

INTEGRATING ADDITIONAL EXPOSURES

Does the acquired business have additional types of exposures of credible size not covered by the existing program's self-insured or large deductible insurance program? Or perhaps, once the existing company combines a type of exposure with the same type of exposure from the acquired business, it is more cost-effective to change coverage structure.

For example, the existing company has a small fleet of vehicles and commercially insures the exposure with guaranteed cost coverage. However, the acquired business has a much larger fleet. Self-insuring or moving to a large deductible insurance structure may be more cost-effective than paying the premiums under the current guaranteed cost coverage for the new larger combined fleet.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An actuary can perform a feasibility study by projecting estimated losses under various retention layers. The projections can then be compared to quoted insurance premiums for similar layers to aid risk management in decision making. This can be done for combined exposures of existing and acquired business as well as for new exposure types that did not exist previously for the purchasing company (as long as historical data is available).

CONCLUSION

CROs and other risk management professionals face a number of critical decisions when adding acquired exposures to an existing self-insured or large deductible program. The availability of historical loss experience and exposures plays a major role in how to approach an actuarial analysis.

Risk appetite, size of the acquired business, risk management strategies, and the use of results could also have material impacts on the program's risk management decisions and approach. Overall, self-insurers and program managers should have detailed conversations with their actuary about the new business's risk profile and historical loss experience.

These conversations can lead to a more thorough understanding of the new business's risk profile for the actuary and aid in the analysis to ensure adequate estimated losses arising from the additional exposures. Additional confidence in estimates may be gained from independence and full transparency, as well as a fresh set of eyes provided by a detailed actuarial analysis. ■

Carly Rowland FCAS, MAAA is a consulting actuary in the Chicago casualty practice of Milliman. Carly's area of expertise is property and casualty insurance, including loss reserving and ratemaking.

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Carly's clients include Fortune 500 corporations, healthcare institutions, privately held companies, public entities and commercial insurers.

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