ROLL THE HARD SIX

EXPOSING THE SECRETS

OF THE WORKERS' COMP SYSTEM'S "HOUSE" ADVANTAGE

The atmosphere of a casino floor engages all five senses. The taste of success. A fused scent of perfume and cigars. The pinging sounds of rolling slot machines interrupted by short squeals of joy and excited laughter. The sting of high fives eased by the touch of six-sided dice. The sight of dealers pushing large stacks of chips to winning players dressed to the nines and standing four rows deep.

BY SCOTT T. BRADLEY

Popular for the excitement and lower "house" advantage, craps is a game of chance rather than skill. If you've ever seen the unmatched energy of what's called a "hot table," you'd likely agree that it's the most exciting of all the casino games. And if you've experienced it, you've probably walked away from the table with swag in your step and a "go-to" story whenever someone mentions Las Vegas or Atlantic City.

This all ties in to a recent conversation with the CFO of a large construction company about controlling workers' comp costs, specifically the Experience Modification Rating (EMR). The EMR applies to workers' comp premiums and reflects a company's loss experience in comparison with the average experience expected for its classification and size.

He described his feeling that the whole workers' comp "system" was stacked against him and any effort to control the outcome was in fact "a crapshoot." I was completely taken aback by this comment.

Does the "House" Always Win?

The first truth in gambling is that "The house always wins." But when it comes to controlling the EMR, and ultimately workers' comp costs in general, is there really a "house" advantage? Does the house always win or is there an opportunity to stack the chips to your advantage?

For the uneducated player, the house always wins. As professional gambler Nick Dandolos once said, "the house doesn't beat the player. It just gives him the opportunity to beat himself." Similarly, by not understanding how the EMR system works, every organization is vulnerable to losing big and beating itself through rising EMRs that result in higher premiums.

For the construction industry, the stakes are even higher, as many projects and jobs set eligibility ceilings on the EMR (typically between 1.0-1.25), disqualifying all companies that exceed the maximum permissible factor. (See "How Low Can You Go?" on page 34.) The potential costs of these missed opportunities could range from the tens of thousands, to hundreds of thousands, and possibly even millions of dollars.

But there are tricks and techniques that CFMs can learn to flip the odds of winning to their favor. Though there are slight differences from state to state, workers' comp benefits are statutory and a fixed commodity. Although the benefits do not change in relation to the price your company pays for them, the costs can range drastically.

Imagine the competitive advantage for a contractor with a .75 EMR vs. a contractor with a 1.25 EMR; all other things equal, that's a 50% lower cost of labor. At a time when margins are tighter than ever, the payoff can be huge and even more impactful in bidding situations.

By understanding how the system works, and the six secrets that create the house edge, companies can hit the proverbial "jackpot" when it comes to reducing workers' comp costs: beating the house while gaining a distinct advantage over the competition.

The Six Secrets of the "House" Advantage Exposed

While understanding these six secrets is quite easy, applying them to your business can be challenging and requires someone internally to champion the effort. Many insurance brokers offer help in this area as part of their services. Best in Class organizations deploy a combined effort by engaging internal resources, their brokers, and their insurance carriers.

SECRET #1: **NOT ALL BETS ARE EQUAL**

The first secret to beating the house is to understand that the dollars from every claim are split into two categories on the EMR: primary and excess. The dollar amount at which the balance of the claim goes into the excess category is known as the Split Point.

For the 35 state insurance departments that have designated the National Council of Compensation Insurance (NCCI) as the licensed rating and statistical organization for workers' comp (see Exhibit 1 at right), the 2015 Split Point is $15,000 plus two years of inflation adjustment.[1] This is up from $5,000 in 2012.

So, the first $15,000 of every claim goes into the primary category on the EMR. The balance of every claim gets placed into the excess category. For example, if you had a $50,000 claim, the first $15,000 goes into primary and the remaining $35,000 goes into excess.

Why is this important? While the full amount in the primary is counted against you for the penalty, the amount in the excess column is mitigated by a weighting factor based on the class code and state, which creates the *ratable excess* amount. The ratable excess and primary are added together to form the total penalty of the claim.

Using the previous $50,000 claim example and a .10 Weight Factor for simplicity, the actual penalty of that claim is $18,500 (see Exhibit 2 at right).

Since the impact of larger claims is reduced, not every claim carries the same risk/reward. So, to which claims do you need to pay the most attention? Counterintuitively it's the smaller claims that are more punitive, which leads us to Secret #2…

SECRET #2: **THE SMALL BETS ADD UP**

The first time I played blackjack in Las Vegas I sat in the last seat at a table with $5 minimum and $500 maximum bets. I played the $5 minimum the first two hands and won both. Emboldened by my "hot streak," I placed a $500 bet on the next hand. Surprisingly, I won! That's right; in just three hands of blackjack I doubled my money.

After winning the big one, I was convinced that I could just make small bets the rest of my trip and still come out a winner, or at least break even. So at $5 and $10 at a time, my winnings wasted away. By the time I boarded my flight home, Las Vegas taught me another valuable lesson: the small bets add up.

The same is true with the workers' comp experience rating system. All too often a company with a high EMR states, "we had a really large claim that is killing us." But 99% of the time, the exact opposite is true. The system has been specifically designed to penalize more for frequency than severity. The idea is that the greater the frequency, the higher probability of a severe claim.

HOW LOW CAN YOU GO?

While an EMR of 1.0 is considered an industry average, the minimum EMR for an individual organization varies by company and can be much lower. CFMs must know their company's potential minimum EMR in order to set a more competitive baseline than the industry average. The construction market is teeming with strong competition and talent; a company that sets "average" as their benchmark will find itself below that mark, noncompetitive, and unable to acquire much work.

As Thomas DePauw, Vice President and CFO of Harris Companies, states, "Plain and simple, a 1.0 mentality will lead to failure." By understanding your company's minimum EMR potential and executing on a comprehensive risk management plan to control it, a CFM can take his or her organization from good to great.

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Continuing with our example, let's say Company A had one $50,000 claim while Company B had four claims ($5,000 each) totaling $20,000. As we discovered earlier, the penalty for Company A's $50,000 claim is $18,500, since a majority of the claim falls into the Excess category and is mitigated. However, for Company B, since all four of their claims fall under the Split Point for an individual claim, their total penalty is $20,000; that's 8.1% greater than Company A.

When's the last time you looked at the small claims on your loss reports? Many CFMs don't pay close attention to these and get caught focusing on the claims with "higher stakes." In reality though, you'll play a lot more small hands than big ones. And racking up small wins is usually a better strategy than winning big once and taking frequent losses.

SECRET #3: **ROLL THE HARD SIX**

"Roll the hard six" is another popular term originating from the game of craps. It's a high-risk/high-reward gamble achieved by rolling threes on a pair of six-sided dice. Rolling a hard six has a probability of about 3% (with a seven to one payout) compared to the 14% probability (with a seven to six payout) of rolling a six by any other combination.

In workers' comp, the injury code "6" refers to medical-only and the reward for rolling a six can be even greater.

There are two fundamental categories of workers' comp claims: medical-only and indemnity. To qualify as a medical-only claim, the claimant must be back to work by a certain number of days from the date of injury (usually five or seven depending on the state).

What the house doesn't want you to know is that there are currently 37 states and the District of Columbia approved for an experience rating adjustment (ERA) for medical-only claims.[2]

In states where ERA is approved, the penalties for medical-only claims are reduced by 70% when calculating EMR. In our example, if Company B were able to keep all four of its claims medical-only, then the penalty would have been $6,000 in lieu of $20,000. This could account for several points on the EMR.

A few years ago, the CFO of a large framing contractor revealed the company had a 1.49 EMR. Not surprisingly, the contractor felt the system was "rigged" against similarly sized companies. When EMR and loss runs were examined, 17 small indemnity claims were discovered over a period of three years that were Temporary Partial injuries (injury code "5") – all of which could very easily have been medical-only with a more aggressive Return to Work program.

A quick analysis revealed that if the contractor had been able to "roll the hard six" on all 17 of those claims, then its EMR

EXHIBIT 1: **NCCI STATE MAP**

Source: *www.ncci.com/nccimain/AboutNCCI/StateMap/Pages/default.aspx*

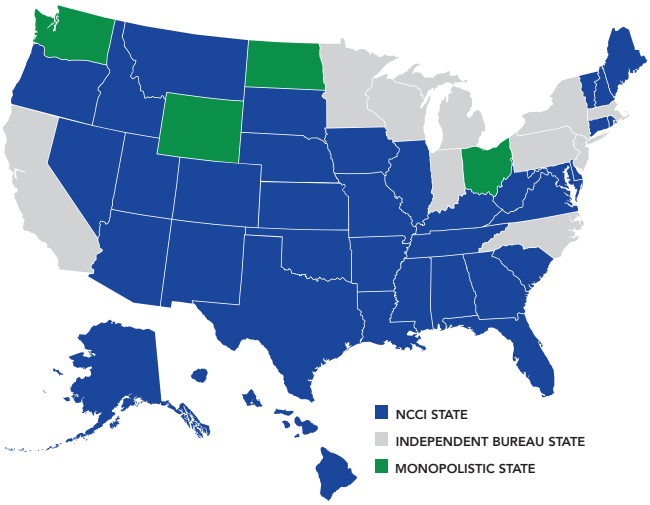
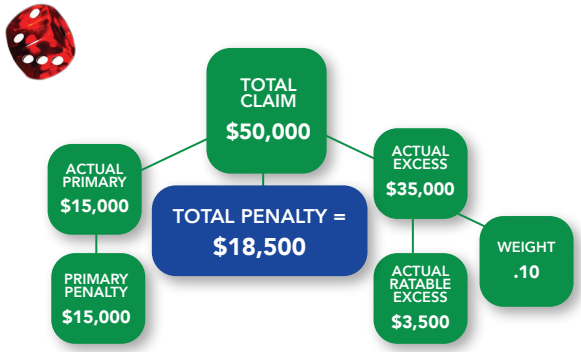


EXHIBIT 2: **CLAIM PENALTY**



would have been a 1.07. With a manual premium of roughly $300,000 a year, that's 42% or $126,000 in potential savings simply by getting injured employees back to work in a timelier manner.

Rolling a hard six in craps is high-risk/high-reward play. In managing workers' comp costs, it's the single greatest way to beat the house.

SECRET #4: DON'T LEAVE "NOTHING" BEHIND

If gambling is the sure way to get nothing from something, the opposite is true with EMR. Another secret that tilts the odds in the house's favor is its means of accumulating something from nothing. Its conduit? Open claims.

The experience rating formula calculates the penalty of a claim off the incurred amount, not the amount paid. For claims that are still open, this includes the amount the insurance company reserves for future payment. All insurance companies have different reserving practices; some are more conservative while others are more aggressive. Regardless, a contractor is penalized and ultimately pays premium for an insurance company's projection of what a claim might cost down the line.

This is problematic since many different factors could lead to a claim being over-reserved. Take for instance a workers' comp claim in which the treating physician has a choice between rehabilitation and surgery. A conservative claims adjuster may initially reserve the claim at $75,000 to account for the surgery. However, if the rehab is successful, the actual paid amount may be far less. In this situation, the unnecessary reserves add to the penalty of the claim, increasing the EMR and ultimately the insurance premium.

The best way to protect your company is to incorporate frequent open claim reviews with your insurance company's claims adjusters to confirm adequate reserves have been set. If reserves cannot be substantiated, then they need to

be reduced to an appropriate level. Don't leave "nothing" behind from which the house could create something.

SECRET #5: **GO "ALL-IN"**

In gambling, going "all-in" is to bet all your chips. At its foundational level, the EMR is a comparison of actual claims to expected claims based on individual class codes and payroll amounts. The more payroll your company has, the higher its expected claims are projected to be and the lower its EMR.

Often times though, not all payroll is reported to the rating bureau(s). The two most common situations are missing payroll from audits and OCIPs. Every company has a unit stat date (18 months from policy inception) by which all reported claims and payroll must be reported to the rating bureau. If there are extenuating circumstances that push the workers' comp audit past the unit stat date, then there is a chance that this payroll could not be reported in time to be included in the EMR calculation.

More common is when a company participates in an OCIP. It is the responsibility of the carrier on the OCIP to report the payrolls of all participating contractors to the rating bureau. Mistakes are common with second and third-tier subcontractors.

Recently, a temporary staffing firm that specializes in staffing electrical contractors was staring at a 1.62 EMR because only $1.5 million of its $11.5 million in payroll had been reported. The other $10 million in payroll was from two large OCIPs they participated in as a second-tier subcontractor that the carrier didn't report.

On the EMR, their claims reflected the size of an $11.5 million electrical contractor, but the reported payroll indicated a much smaller company with smaller expected losses. Once the correct payroll was reported, the EMR fell below 1.0.

When it comes to payroll, take away the "house" advantage by going "all-in."

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ROLLING A HARD SIX in craps is high-risk/high-reward play. In managing workers' comp costs, it's the SINGLE GREATEST way to BEAT THE HOUSE.

SECRET #6: KNOW THE STAKES

Perhaps the most important secret the house hopes to keep is that managing the EMR is a game of extremely high stakes. Every claim is a new roll of the dice where the payoff can be enormous or the loss devastating. Small fortunes can be made, either from nothing or from larger fortunes.

Let's again consider the framing contractor with the 1.49 EMR and a potential $126,000 of savings in 17 small indemnity claims if it had "rolled the hard six" and kept them medical-only. This is where the stakes are raised.

Every claim stays on the EMR for three years. Three. Entire. Years. So, for the framing contractor, the real cost of those 17 claims was not $126,000, but rather $378,000 ($126,000 multiplied by three years). If the contractor had a process in place to return those injured employees back to work within the allotted time period (in this case it was seven days), then the contractor would have saved $378,000 in workers' comp premiums over a three-year span.

Taking it a step further, let's conservatively say it operated at a 6% profit margin. An additional $6.3 million in revenue would be needed over that same time period to make up for the increased costs. Stretch that out over a decade and we're talking about $21 million in revenue at stake.

What could your organization do with an additional $21 million? Don't let the house fool you into thinking small bets don't matter. The stakes are much, much higher than you're led to believe.

A "Hot Boardroom Table"

While the house can't beat you, the secrets we just exposed give it an advantage by creating the opportunity for you to beat yourself. It's a game, not a crapshoot. One you have to play; one of exceedingly high stakes.

This is a game that engages all five senses: The taste of success; the scent of celebratory cigars; pinging sounds of growing bank accounts muffled from shouts of joy and excited laughter over decreased expenses; the sting of high fives from your executive team eased by the feeling of newfound cold hard cash; and the sight of employees walking through the front doors getting back to work and "hard sixes" being rolled after every claim. Experience that feeling and energy of a "hot boardroom table."

Here's to swag in your step and a "go-to" story whenever someone mentions workers' comp. Don't beat yourself; beat the house. ■

Endnotes

1. For the purposes of this article we are using NCCI guidelines. If you have employees in an Independent Bureau State(s) shown in Exhibit 1, check with that individual insurance department for the Split Point for that state.
2. ERA-approved states: AK, AL, AR, AZ, CT, FL, GA, HI, IA, ID, IL, IN, KS, KY, LA, MD, ME, MI, MO, MN, MS, MT, NC, NE, NH, NM, NV, OK, RI, SC, SD, TN, UT, VA, VT, WI, WV, and Washington, D.C. States that have not approved ERA: CA, CO, DE, MA, NJ, NY, ND, OR, OH, PA, WA, WY, and TX.

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