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WHY SELF-INSURE

A properly structured self-insurance program can provide a long-term, predictable and affordable alternative to traditional insurance plans as well as other risk-bearing programs. Employers that self-insure their workers' compensation exposures typically achieve savings through reductions in fixed costs and surcharges, improvement in claims experience, increased control over supporting vendors and retention of investment income on funds held in reserve. Further, qualified self-insurance plans generally require the least amount of collateral investment of any type of risk-bearing program.

UP-FRONT SAVINGS:

<u>Administrative Costs</u>

As much as 40% of the premium charged in a traditional workers' compensation policy is used to cover the insurance carrier's administrative costs. Administrative costs for other risk-bearing alternatives such as deductible and captive programs are slightly less but often comprise about 35% of the total program cost. Company overhead, policy issuance, claims handling, loss control services and profit margins are just a handful of the items that make up these costs. By contrast, the combined administrative and expense load in a self-insured program is usually 15% to 20% of the total cost of the program.

<u>Taxes and Assessments</u>

In most states, policyholders are required to pay taxes, fees, surcharges and/or assessments on the insurance coverages they purchase. These taxes and fees are collected by the insurance company along with the premiums and remitted to the state. Likewise, state fund or assigned risk programs in many states allow the insuring carrier to levy additional surcharges upon the policyholder. These surcharges are charged in addition to any taxes and fees levied by the state. In some states, taxes and surcharges can well exceed 10% of the total policy premium.

Qualified self-insurers are generally exempt from premium taxes and surcharges required for most other insurance policyholders. Instead, most states utilize an alternative assessment formula for their self-insurers. These formulas are often based on the self-insured employer's payroll or actual loss history and usually result in a much lower cost than would be required under a comparable traditional insurance policy.

LONG TERM SAVINGS:

<u>Claims Costs</u>

Claims represent the single largest cost component in any insurance program. Claims in a traditional insurance policy are typically handled by the insurance carrier's staff of claims adjusters. Insurance carriers adjust and adjudicate claims based on their book of business. The goal is to achieve a favorable result on the carrier's entire book of business; which may or may not be in the best interest of an individual policyholder. Further, the policyholder often has little or no input into the claims process and adjuster caseloads.

Under a self-insurance plan, the employer chooses their own third party claims administrator (TPA) to handle their claims. The employer participates in the claims adjudication process and contractually sets the desired adjuster caseloads. Self-insured employers also gain the ability to choose other important service providers such as PPO networks, nurse case management, bill review and legal counsel.

Unlike a traditional insurance plan, the claims in a self-insured plan are handled solely to the benefit of the employer. A well-designed program with a quality claims TPA will: (1) ensure that injured employees receive prompt and appropriate care, (2) achieve the maximum medical cost savings, and (3) return injured employees to work in the most reasonable timeframe possible. This approach not only reduces workers' compensation costs, but the costs associated with covering for the injured employee's absence such as overtime, temporary staffing costs and lost productivity.

Many employers realize an immediate improvement in claims costs shortly after instituting a self-insurance plan. Over time, a properly-managed self-insurance plan can reduce claims costs even further, thus reducing the overall cost of the program.

<u>Safety and Loss Control</u>

The single largest cost driver in any insurance plan is the cost of claims. The most effective way to control and reduce the cost of any workers' compensation program is to prevent claims from happening and reduce the cost of claims post-injury. Traditional insurance carriers sometimes provide safety and loss control services to their policyholders however, these services tend to be limited in scope and are often "one size fits all" programs.

A well-structured self-insurance program includes a sound safety program, a return-to-work plan and loss prevention procedures tailored to the unique needs and exposures of the employer's operations. Designated loss control vendors evaluate the employer's current safety program for potential improvements, meet with management and staff to enhance safety protocols, establish regular safety meetings, conduct on-site inspections, evaluate current safety equipment and training, conduct post-accident investigations and review losses to determine where to focus future safety efforts.

<u>Investment Income</u>

Administrative expenses associated with a self-insurance program are paid up-front to the supporting vendors, but only a fraction of ultimate claim costs is actually paid in the year those claims are incurred. This leaves a substantial reserve balance to pay the future liabilities of these claims. This fund balance is held in reserve to satisfy future claim payments until all claims are ultimately closed. When insurance carriers collect premiums from policyholders, they utilize a portion of the premium to cover their administrative costs as well as the claim costs as they come due. The balance of these retained funds is invested and used to offset operating expenses, pay future claims and generate additional profits for the carrier.

Under a self-insurance plan, the employer retains reserve funds held for future claims payments. For lines of insurance such as workers' compensation, these funds are often held

for many years giving the employer an opportunity to generate investment income that can be used to offset claims costs and reduce the overall cost of the program in future years.

ADDITIONAL BENEFITS:

Control of Service Providers

Traditional insurance policies provide a one-stop-shop for the policyholder. Program administration, claims handling, PPO network access, bill review services, ancillary cost containment, safety and loss control services (if any) and legal defense counsel are all included with the policy. Each of these services is either provided by the carrier or by outside vendors chosen by the carrier without approval or input from the policyholder. Policyholders do not have the ability to pick and choose individual services or vendors within a traditional policy structure.

Traditional carriers manage their services and vendors based on the needs of their collective book of business. While this strategy generally works to optimize the carrier's overall results, individual policyholders may not receive the greatest benefit or the best possible services for their individual needs under this structure. Maintaining multiple PPO networks, dozens of claims handling services and hundreds of individualized safety programs would not only be administratively cumbersome but ultimately cost-prohibitive for the carrier. If an employer has secured a favorable premium on a traditional policy but is unhappy with the claims service or, if the claims and ancillary services are excellent but the premium is prohibitive, the employer cannot pick and choose. The policyholder must pay the higher premium, accept the service as provided or search for a carrier that offers an acceptable combination of the two. Unfortunately, none of these options is easy to accommodate for most policyholders.

Self-insurance plans however, allow the employer to pick and choose each vendor individually. If the self-insurer is unhappy with the terms of the excess insurance, third party administrator (claims handler), the discounts afforded under the PPO network or any other service or provider, the self-insurer may replace the vendor or service without disrupting the rest of the vendors or the overall program.

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Collateral

In most risk-bearing plans, the insured entity pays the fixed expense component of the program up front. Claims costs are funded incrementally over time until all claims are fully paid and closed. If an employer participating in a retrospectively-rated insurance policy (retro), deductible or captive program is unable to make required claims payments, the issuing carrier is responsible for covering all claims costs. To offset credit risk and potential policyholder insolvency, these programs generally require the insured entity to post collateral with the issuing carrier to secure future claims payments.

A letter of credit (LOC) is the most common form of collateral for insurance programs but cash and sometimes trust agreements may be used in certain instances as well. When an LOC is used as collateral, the lending institution often requires the employer to maintain a cash deposit equal to the amount of the LOC in a dedicated account with the lending institution. The lending institution will also charge a fee for issuing the LOC. Fees generally range from 1-3% of the LOC amount.

In future years when these insurance programs renew, carriers will usually require additional collateral from the insured entity in recognition of the growing claims exposures and therefore inherent credit risk. This increase in collateral from year to year is known as "stacking." Depending on the size of the program, cumulative stacked collateral requirements can reach hundreds of thousands, millions and even tens of millions of dollars over time. The collateral requirement may level off at some point when the anticipated future claims are offset by claims closed from prior policy years however, carriers will continue to retain collateral until all claims are finally closed. Over time, collateral posted to these programs can prevent the employer from moving to an otherwise more favorable insurance program, impact the employer's credit rating, impede the employer's ability to fund its operations and limit their ability to secure loans and other forms of credit.

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Self-insurance programs have a distinct advantage on collateral in three key areas:

1. Collateral in a self-insurance program is posted with the state and follows the employer for as long as the employer is a qualified self-insurer. Therefore, a self-insured employer may move from one excess carrier to another without posting additional collateral.

2. In most states, the collateral amount set at the inception of the self-insurance program does not change or stack over time. Further, some states do not require any collateral at all from their qualified self-insurers.

3. In certain states, collateral requirements may be reduced in future years as the employer's financial status and/or loss experience improves.

A properly-structured self-insured workers' compensation plan can provide a long-term solution for the right employer. To find out if self-insurance may be a viable option for your company or your client, please contact Bay Oaks Group.