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The Truth Behind Self-Insurance Expenses

When it comes to individual and group self-insurance of all types, the main lure is saving money. Self-insured workers' compensation and health insurance are the most popular, with the majority of states having regulations allowing their formation. Third-party administrators (TPA's) and even regulators in some of these states perpetuate the belief that money will be saved on lower administrative expenses and/or better experience (less claims).

You might be expecting me to throw TPA's or regulators under the bus right about now, but they are not the secret we are talking about. Most TPA's and regulators have their hearts and expertise in the right place. They truly believe self-insuring is a better option and sometimes it is. Furthermore, most regulations require some level of feasibility study showing that a self-insured program will work before they allow its formation. But before you attempt to form or become a self-insured, let's examine what actually makes up the expenses and why they can be lower, but aren't guaranteed to be lower.

Lower Administrative Expenses

Insurance premiums consist of two pieces: claims expenses, which are the actual dollars used to pay a claim, and the expenses directly attributed to that particular claim. For a workers' compensation claim they might include independent medical exams or surveillance on an injured worker suspected of committing fraud. The other half of the premium is the underwriting expenses. This is the operational overhead of the insurance company and includes things like building expense, reinsurance and the salaries for the underwriters, claims adjusters, loss control, administrative and executives that do all the work for the insurance company.

The theory is that a self-insured, even if they have to pay a TPA to do all the insurance "stuff," will have lower underwriting (operating) expenses than the big insurance company. The problem is the TPA has the same types of expenses as an insurance company. Even if the self-insured decides to "self-administer," they have to hire people and buy or build systems to handle billing and claims, just like an insurance company or TPA. The self-

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insured also has to pay the same types of outside expenses an insurance company does. Regulatory fees/taxes, excess insurance (improperly called reinsurance), actuarial rate studies and some form of collateral are typically satisfied by a bond or letter of credit. The collateral mirrors an insurance company's surplus requirements.

The other theory or "marketing sizzle" that is often used is that self-insurance excludes the profit layer that insurance companies build into their pricing. That theory as a marketing concept gets shot down when you look at the facts. According to NCCI, the combined ratio (profit) statistics for private carriers, only two of the last 21 years (1990 to 2010) were profitable. The year 1995 had a ratio of 97, meaning they made three cents on every dollar of premium charged— 2006 was 93. If you do a simple average for the 21 years, you get 109. This means the industry has lost an average of 9 percent a year for the last 21 years. Oh, and your TPA is absolutely making a profit.

Many will argue that self-insuring is actually more expensive just based on the lack of economy of scale alone. On the other end of the spectrum, a large group that shares these expenses or a large individual self-insured that already has its own building, risk management team and tons of cash, does have the potential to save money.

It is not my intent to debate the possibility that operating costs for a self-insurance plan can be less expensive. Every individual and group self-insured is different, and a proper third party feasibility study can help predict profitability. But when it comes to a blanket statement, let's call operational expenses between standard insurance and self-insurance a draw.

Lower Claims Expenses

This area is completely different and where things get interesting. I will ruin the build up and get right to the point. If an insured company believes they can get their employees to get hurt less or make smaller and less frequent claim, then they can absolutely lower their claims expense. However, this is easier said than actually accomplished.

Many regulators actually focus on this area as the main place to save money by self-insuring. The self-insured workers' compensation group regulation in Georgia and Hawaii, for instance, requires all members to be part of one association. The theory is that the members are all in the same club and the group will pressure individual members with poor claims history to institute a better safety program or return-to- work program.

This is a fantastic theory and does work for smaller associations, but most large associations have little influence over their members. They don't have the resources or wherewithal to identify the perpetrators of high rates anyway. That being said, it works if an association can pull it off and herd the cats (members) to all care about their safety and losses.

Adverse Loss Experience

We discussed the potential to lower your claims from what might "normally" be expected or historically have occurred. But those not in the industry need to understand that claims can spike above what is expected. Self-insurance means what it says: you are responsible for those expenses whatever they may be.

If losses are above what is expected in a self-insured group, the members can be assessed the difference. Groups are typically joint and severally liable with one another. This means all members are responsible for an assessment, even if it was largely caused by a small sub-group.

There are protective "caps" that can limit the damage, but the potential still exists.

So Is There a Benefit?

The entire purpose of this article is realistic expectations. That is the truth behind self-insurance expenses. If a company chooses to self-insure, they are choosing to retain their risk of loss. This is inherently, risky and not for everyone. There is no guarantee that it will cost less in the long run. A business should not go into it assuming they will save money without any extra effort on their part.

Instead, they should go into it knowing they are now responsible for their own destiny. They should take extra measures to ensure they do fare better than being insured by a standard insurance company. These companies should make sure management is involved in safety and wellness from the top down. They should pay attention to their losses. If they are a member of a self-insured group, they need to be responsible for themselves and other members. Businesses should question and have their TPA reviewed (the good ones like it). Additionally, they should take the time to understand their state's self-insurance regulations or hire a third-party to explain it.

If they do all this, they might just see the real benefit of self-insurance, consistent and predictable insurance costs.

About The Author

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