LONG-TERM DISABILITY PROGRAM—SELF-INSURED VS. FULLY INSURED

Barry J. Goldberg and William M. Mon

Due to the economic environment of the past several years, has your company considered moving its long-term disability income benefit from a self-insured arrangement to a fully insured arrangement? Or maybe your company is considering the reverse, moving from a fully insured arrangement to a self-insured arrangement, when the LTD premium renewal arrived with a significant increase? If so, you should consider the issues associated with such moves addressed in this article.

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SELF-INSURED VS. FULLY INSURED

The three major issues to consider when deciding whether to self-insure or fully insure the LTD program are:

- ***Exposure Risk*** - who is ultimately responsible for paying the costs of disability coverage;
- ***Administration*** - who decides on how the plan terms are implemented; and
- ***Funding*** - determines how benefits are paid for.

The following discusses each of these issues from both a full-insurance and self-insurance perspective.

Exposure Risk

The risks associated with LTD benefits are primarily: (1) the number of employees becoming disabled is different from what is expected; (2) levels of benefit are different than expected; and (3) disabled employees on disability are staying out longer than expected. Not only do these risks cause direct benefit costs, but also the indirect costs of paying someone else to do the work (these costs, which can be significant, are out of the scope of this article).

With an LTD plan involving assets (fully insured or self-insured), assets performance is also a risk. Insurance carriers with fully insured plans must remain solvent, therefore assets losses will indirectly affect the renewal pricings. Self-insured plans must also have enough assets to pay benefits; while solvency is not typically a concern, the employer is still obligated to pay all benefits due by the plan.

Full-insurance perspective: The rate structure of an insured program provides cost predictability. While losses from the year just past are considered in setting rates for the coming year, carriers would not typically attempt to recoup all of them in one year. Although a plan sponsor could walk away from a large loss and seek a better going-forward rate from another insurer, any prospective insurer would review that plan sponsor's recent claims experience. Thus, for most large employers, the cost

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of an insured program should, over time, closely track actual experience, plus premium taxes, carrier risk, and profit charges, as well as additional margin.

Self-insurance perspective: Full insurance premiums include taxes, risk, and profit charges which usually amount to about 5 percent of premium. These are eliminated under self-insurance. Also, the assumptions used to set self-insured reserves evaluate claims experience and set rates excluding margins for conservatism with respect to: (a) the time value of money (interest rate); (b) the incidence of disability; and (c) the duration of disability. These margins generally add up to about 5 to 15 percent of the insured premium. Therefore, eliminating these above-mentioned items could result in self-insured costs about 10 to 20 percent lower than the costs of full insurance.

Administration

Full-insurance perspective: A fully insured program provides ease of administration and "one-stop shopping" for other services. The carrier will typically handle all claims, administrative and actuarial/pricing responsibilities, and the company is generally removed from administrative decisions.

Self-insurance perspective: Under a self-funded program, the employer has primary responsibility for determining disability and defending against legal actions, although an administrator can still be used to assist the employer in these areas. If the company desires to reduce the involvement of its staff, it can implement procedures which allow the carrier to administer the plan as if it were fully insured. Here, the company retains the ability to override any decisions made by the carrier but must be conscious of setting a precedent or straying from past practices. The administrator could also intervene while the employee is on Short-Term Disability to reduce exposure to the LTD program.

Funding

Full-insurance perspective: There is limited flexibility in the funding of LTD costs under a fully insured arrangement. The fully insured arrangement requires the full and immediate funding of the estimated cost (premiums).

Self-insurance perspective: For self-insured programs, there are no minimum funding requirements because claim costs can be funded as benefits become due. (However, FAS 112 rules mandate that unfunded obligations be recognized on the Company's books.) To address this issue and the issue of benefit security, reserves for future benefits for incurred claims may be funded through a VEBA trust. In general, employer contributions would be tax-deductible and the trust earnings would accumulate tax-free.

FINANCIAL ANALYSIS

When analyzing the financial impact of switching from one arrangement to another, it is important to not only recognize the long-term benefits under a mature basis, but also the financial impact of the transition itself. Following are two scenarios dealing with the transition from each of the arrangements to the other. You will notice that the transition period is longer and has a greater cash-flow impact when moving to a fully insured arrangement rather than to a self-insured arrangement.

Self-Insured to Fully Insured

If one assumes a self-insured premium of $2,668,000 per year, we estimate that a fully insured program will cost about $267,000 to $534,000 per year *more* than the self-insured program. Furthermore, the transition to a fully insured arrangement will give rise to higher cash outlays in the five to six years immediately after the transition. These higher payments are the fully insured premium *plus* the cost of disability benefits incurred under the self-insured program prior to the transition.

There are two transition options that the company would need to consider when moving from a self-insured to a fully insured arrangement. They will have the following impact on cash flow:

Transition Option 1(a): The company retains the liability, and the associated risks, for current disableds on a self-insured basis. Under this option, benefit payments for these disableds continue until all have recovered, retired, or died.

Transition Option 2(a): The company transfers the liability, and the associated risks, for current disableds to an insured arrangement. Under this option, the company pays the carrier a single sum payment equal to the liability plus margin, taxes, risk, and profit charges. Since employees were disabled prior to the agreement, the margin for conservatism could be set higher than the 5 to 15 percent mentioned earlier.

Exhibit 1 (next page) illustrates the cash-flow differences between the current self-insured arrangement and Transition Option 1(a) above (i.e., the company retains the liability for current disableds on a self-insured basis). As Exhibit 1 indicates, the cash flow of the fully insured arrangement requires higher cash payments than the self-insured arrangement, even after benefits for the current disableds cease.

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EXHIBIT 1

Self-Insured to Fully Insured LTD Programs Under Transition Option 1(a)

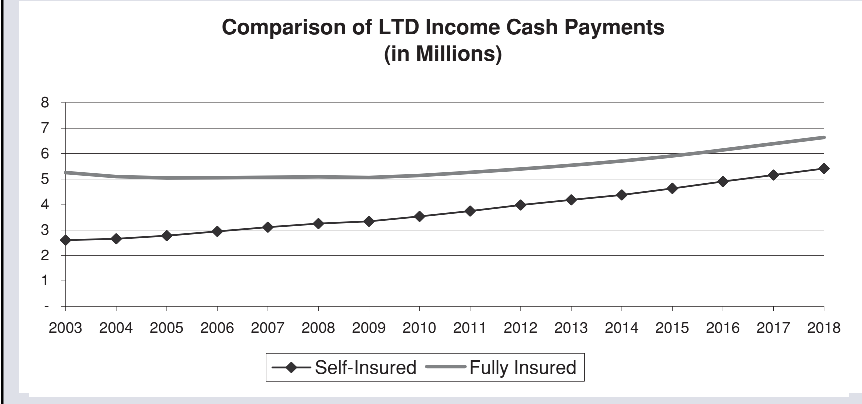
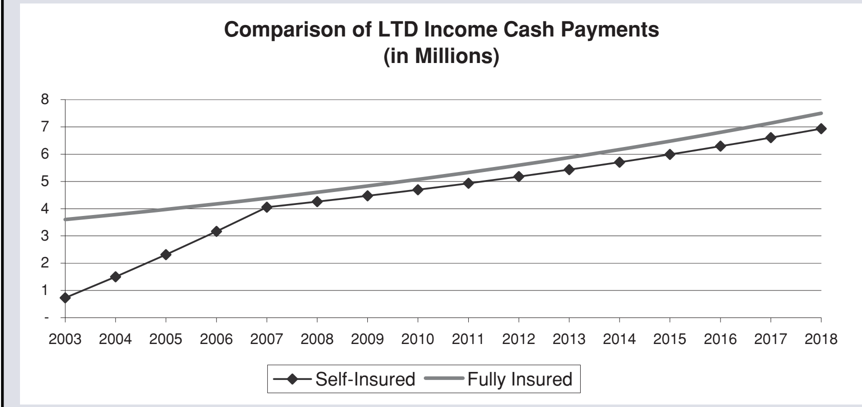


EXHIBIT 2

Fully Insured to Self-Insured LTD Programs Under Transition Option 1(b)



If the company selects Transition Option 2(a) (i.e., transfers the liability for current disableds to an insured arrangement), we expect the company to pay a large initial payment of about $17 million in addition to the first year's premium. This $17 million is the total cost of the benefits expected to be paid to the current disableds, plus the additional charges mentioned above.

Fully Insured to Self-Insured

If one assumes a fully insured premium of $3,400,000 per year, we estimate that a self-insured program will cost about $314,000 to $627,000 per year less than a fully insured program.

There are two transition options that the company would need to consider when moving from a fully insured to a self-insured arrangement. They will have the following impact on cash flow:

Transition Option 1(b): The company chooses to fund the benefit through a tax-favored VEBA. Under this option, a contribution method could be chosen so that either the total amount of the expected term cost or a percentage of that term cost would be contributed into a 501(c)(9) trust each year.

Transition Option 2(b): The company chooses a pay-as-you-go method of paying the benefit. Under this option, no benefit payments will be paid in the first six months of the plan due to the six-month elimination period. After this, however, benefit payments will quickly increase over four years until the plan reaches a mature level in five years.

Exhibit 2 (left) illustrates the cash flow differences between the current fully insured arrangement and Transition Option 1(b) above (i.e., the company chooses to prefund the benefit through a VEBA). In this illustration, self-insured benefits are funded through spreading each year's premium equivalent over five years. As the graph indicates, the cash flow of the fully insured arrangement requires higher cash payments than the self-insured arrangement.

If Transition Option 2(b) is selected (i.e., the company funds the benefit on a pay-as-you-go basis), we expect that the projected cashflow stream would be below the self-insured line in Exhibit 2. Also, the participant's benefit would not be as secure and the company would not get the tax benefits associated with funding a VEBA, although the company would receive a tax deduction for benefits paid.

While the financial analysis indicates that self-insurance will produce lower costs in the long-term, marketplace conditions may generate advantageous fully insured rates in the short-run. Ultimately, the insurer would increase the rates according to the company's experience.

VOLATILITY

The graphs provided show smooth lines into the future representing "expected" cash flows. However, the actual cash flow and liability for disability benefits can vary significantly from year to year depending on the size of the covered population. This volatility is greater in self-insured arrangements than in fully insured arrangements

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and there is greater volatility for smaller groups than larger groups.

This increased volatility for smaller groups makes it more risky to provide LTD benefits on a self-insured basis. Therefore, a fully insured arrangement may be a more viable option for smaller groups. However, in order to recognize this volatility, insurers build higher risk charges into the premiums for smaller groups than larger groups. Depending on the industry, an employer with fewer than 1,000 covered lives should give careful consideration before self-insuring its LTD income plan and should only do so if they can handle significant cash-flow and liability fluctuation.

Under the fully insured arrangement for smaller employers, the premium is based on a larger book of business and may be adjusted for the size and industry of the employer. This pooling technique helps smooth the costs to the small employers and gives the insurer a basis for the premiums. As such, the premiums do not solely reflect the individual experience of each employer (i.e., some pay more than their experience and others pay less). Therefore, the above graph is not indicative of the cash payments for smaller employers individually, but is indicative of the larger pool of smaller employers.

Over the long term, there should be no appreciable difference between the premiums paid under a fully insured arrangement and a self-insured arrangement other than the additional margin, premium taxes, and risk and profit charges associated with a fully insured arrangement.

ACCOUNTING ISSUES

Under a self-insured arrangement, unfunded obligations are recognized on the company's books. Under a fully insured arrangement, the company recognizes premiums paid to the insurance company under FAS 112. If a company moved to a fully insured arrangement and the liability for current claimants were transferred to the insurer, these additional premiums would be recognized under FAS 112.

If your company also accounts for the health and life insurance benefits of the disabled population under FAS 112, that accounting would continue unchanged under either funding arrangement.

SUMMARY

When evaluating whether the LTD income benefit should be self-insured or fully insured, the company needs to evaluate the major differences:

Exposure Risk:

- *Full-insurance perspective* - stable and predictable plan costs
- *Self-insurance perspective* - roughly 20 percent lower plan costs

Administration:

- *Full-insurance perspective* - limited company involvement in the administration of the plan
- *Self-insurance perspective* - flexibility in the administration

Funding:

- *Full-insurance perspective* - limited flexibility in funding options
- *Self-insurance perspective* - flexibility in the funding options

A health and welfare actuary should be able to provide the analysis needed to help your company make the important decision whether to fully insure or self-insure your company's LTD program.

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