

The workers compensation self-insurance decision:

Workers compensation is well suited for self-insurance, but a careful analysis must still be performed to determine if it is the right fit

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Alternate methods to finance workers compensation exposures become more attractive when the traditional insurance market hardens. Workers compensation in particular lends itself to self-insurance due to several aspects inherent in its nature.

- \* There is a statutory cap on loss wage benefits paid that brings an element of certainty to the severity of losses to be expected.

- \* The payment of large claims is spread over time providing cash-flow advantages to the self-insuring employer.

- \* Typically, workers compensation loss patterns are high volume, low severity, which translates to fairly predictable loss forecasting analysis.

Though workers compensation is well suited for self-insurance, a careful analysis must be performed to determine if this type of program is the right fit for the organization. The decision to self-insure cannot be made in isolation by a risk manager or any other individual. It requires careful consideration of a host of factors, including management's commitment to the program, the financial condition of the organization, the cost and availability of internal and external support systems, and the particular characteristics of the exposure. Unless all of these elements are included in the decision-making process and self-insurance is undertaken with knowledge of the risks and resources it entails, the program's chances of success are small.

#### Management Perspectives

Any evaluation of the feasibility of a workers compensation self-insurance program must begin with a review of management's perspectives regarding appetite for risk and commitment to this type of program. When moving to a self-insurance program, the organization trades known risk for unknown risk. Management must evidence the risk tolerance necessary for a long-term commitment to self-insurance. Self-insurance should never be used solely as a band-aid to bridge market conditions. Management must also be willing to adopt a hands-on proactive role in claim prevention and management, since the money being spent has a direct and immediate correlation to the organization's financial bottom line.

#### Financial Feasibility

A second component that must be analyzed in making the decision to self-insure is the financial condition of the organization and the financial resources that will be needed to fund the program at startup and in the future. Obviously, an organization with strong cash flow or with substantial cash reserves is in a better position to be self-insured than one without. Financial strength is especially important since self-insurance exposes the

organization to larger fluctuations in earnings than it experiences under most insurance programs.

Due to the nature of self-insurance, most states have minimum net worth requirements for employers to be eligible to self-insure. Organizations contemplating self-insurance should check state financial eligibility requirements first since they might be immediately disqualified by them and then would not expend other further resources or energy checking the feasibility of self-insuring.

### Infrastructure Capabilities

Since cost savings in workers compensation self-insurance programs are derived from two sources—lower medical and indemnity payments to the employee and lower expenses associated with administering the program—an evaluation needs to be made of the organization's internal resources to determine what components of the program (if any) must be outsourced. Self-insurers must provide for themselves a wide range of professional services that insurers previously provided.

- \* Medical knowledge will be needed to evaluate and process claims, and to negotiate services with providers.

- \* Legal judgment will be required to assess the merits and potential cost of litigated claims.

- \* Actuarial assistance will be necessary to forecast future loss projections for the organization.

- \* Safety and loss control programs overseen by engineers or other appropriate professionals will also be a vital component in a self-insurance program.

An employer can either develop an in-house infrastructure of personnel to perform these functions, purchase the services from outside sources, or a combination of the two. For example, third-party administrators (TPAs) will contract to provide most of the services insurance companies traditionally perform. In fact, insurance companies make up the largest segment of third-party administrators.

TPAs assume no underwriting risk, collect no insurance premiums, and have no ownership in loss reserves. They are paid a fee to perform in specific administrative and professional capacities. Ultimately, what the organization must attempt to do is to identify and utilize internal resources to the extent they can do so economically and outsource that which is not cost effective to handle internally.

### Operation and Exposure Audit

Another crucial step in the self-insurance feasibility process is for the organization to review and assess its operations and exposures. The states where the organization operates can play a key role in determining whether self-insurance is a viable alternative to workers compensation insurance. Figure 1 provides state-specific information regarding which states allow self-insurance and what types are allowed.

The more states an organization operates in; the greater the administrative costs associated with the self-insurance program since the organization must file its plan for approval in each state where it hopes to operate as a self-insurer. Additionally, state requirements for self-insurance vary and should be carefully reviewed so that the administrative burden for self-insurance does not become overwhelming or cost prohibitive. When an organization has some of its operations in states that do not allow

self-insurance, arrangements must be made to handle these states separately through workers compensation insurance. This can also increase the administrative workload. Further, organizations considering self-insurance must consider how acceptable self-insurance will be to their customers, business partners, and stockholders. The instability of expenses under a self-insurance program might not be viewed favorably. Often, contracts contain provisions specifying that the subordinate party maintain minimum amounts of workers compensation insurance from an insurer that satisfies certain criteria, such as state licensing and minimum financial ratings. Self-insureds do not maintain conventional insurance; hence such requirements cannot be satisfied. However, if the subordinate party is financially secure and is able to demonstrate a successful record of effective self-insured administration, additional negotiation and explanation can overcome contractual requirements for conventional insurance.

#### Summary

There is no hard-and-fast rule that dictates when workers compensation self-insurance should be considered. But, when an organization reaches the point where exploring alternatives to workers compensation insurance makes sense, then it becomes essential for an organization to fully evaluate the factors that affect that decision. These include but are not limited to management's attitude toward risk, the organization's financial strength and objectives, the internal risk management capabilities of the organization, and the nature of the organization's operations and loss exposures. p

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