

# Risk Management

## Basic Risk Theory

### In General

Risk theory and practices are significant to self-funding, because they assist the employer in assessing the extent to which self-funding may or may not be appropriate. The writer acknowledges the controversial nature of some aspect of risk theory and practices and intends to limit any material on risk theory and practices to noncontroversial areas.

*Risk*, by one generally accepted definition, is the chance of harm or loss. Risk management generally seeks to reduce the adverse effects of harm or loss at the lowest possible cost by identifying, measuring and controlling the underlying risks.

In the risk-management process, there are usually five steps. In Step 1, the risk is identified; in Step 2, the risk is measured; in Step 3, the tools of risk management (elimination or reduction, assumption, insurance and self-funding) are considered. In Step 4, the plan is executed; in Step 5, the plan is monitored and periodically reviewed.

### Risk Identification and Measurement

Risks may be classified as property (e.g., protection of a homeowner against the loss of a house because of a fire), liability (e.g., protection of a motorist against damages resulting from such motorist's negligence) or personal (e.g., reimbursement of an employee's hospital expenses).

### Tools of Risk Management

**In General.** There are at least four generally accepted tools of risk management. They are (1) elimination or reduction, (2) assumption, (3) insurance and (4) self-funding. These tools are discussed only as they may be applicable to personal risks; risk management tools such as avoidance, which might use a hold-harmless provision or noninsurance transfer, are not normally found with personal risks and therefore are not discussed.

**Elimination or Reduction.** The elimination or reduction of the risk is basic to any risk management program. Such programs are designed to increase productivity and reduce operational costs. Several important federal laws contain personal risk elimination or reduction programs that impact on welfare plans. There are also many private organizations involved in similar elimination and reduction programs. The trend is for

employers to take an increasingly active role in the elimination or reduction of personal risks involving employees.

**Assumption.** A risk is assumed by an employer when a loss resulting therefrom is recognized as a normal business expense without any risk recognition or funding considerations. It is often uneconomical to either insure or self-fund a risk which the employer may, or should, recognize as a general operating expense.

**Insurance.** Insurance is the most common method of dealing with risks that may result in substantial losses. For a premium, the risk is merely transferred from the employer to the insurer. An insurable risk traditionally has certain characteristics. Losses must be reasonably predictable. The peril must be random and fortuitous. Future conditions and past conditions upon which experience is based must be reasonably similar. The law of large numbers must be permitted to work. There must be an economic loss for which there is a legal insurable interest.

**Self-Funding.** Self-funding usually involves the establishment of a special reserve fund that is kept separate and invested so that funds will be available for payment of losses. That is, self-funding is the same as a risk assumption except that risk recognition and funding are considerations. In risk theory, self-funding is active whereas risk assumption is passive.

## **Risk Management and the Employer**

The management of risk in the corporate structure is a relatively recent practice. Essential to the success of any such program is the risk manager. A recent survey showed that corporate risk managers have substantial authority, either full or shared, in these numerous significant functions.

- Risk determination and evaluation
- Insurance selection
- Claims handling
- Insurance accounting
- Loss prevention
- Self-funding administration
- Benefit design of welfare packages
- Group insurance administration
- Pension administration.

The American Management Association has identified five attitudes that may endanger a risk management plan:

- Assignment of the insurance responsibility to an unqualified person because it is a minor or fringe expense.

- Reluctance to change past practices
- Fragmented or decentralized risk management functions
- Lack of written and well-defined risk guidelines
- Lack of top management support.

## **Risk Manager Looks At Self-Funding**

### **Overview**

The risk manager will apply the basic tools of risk management in determining whether a health care plan should be self-funded.

### **Candidates for Self-Funding**

The appendix describes two employers, each with certain characteristics that might or might not suggest self-funding. In this idealized comparison, Employer A might be a good candidate for self-funding; Employer B might be a poor candidate. There are several applications of risk theory to the comparison. Employer B may not be a candidate for full self-funding, but may elect to assume none of the plan administrative responsibilities, having such services provided by the insurer or a third party under an administrative services agreement. Employer B may not be a candidate for full self-funding, but may adopt a program of risk elimination or reduction. Employer A may be a candidate for full self-funding, but should not consider self-funding without some risk elimination or reduction program

### **Making Self-Funding Work**

The key factors in making a self-funded health care plan successful are these:

- Plan design
- Appropriate stop-loss coverage
- Good participant communication
- Reliable TPA.

**Plan Design.** Self-funders usually utilize plan design to encourage cost containment (e.g., copayment reductions if second opinions are not obtained), to avoid certain state-mandated benefits (e.g., reduced mental and other limitations) and to take advantage of overinsurance protection (e.g., subrogation).

**Stop-Loss Coverage.** Excess or stop-loss insurance assumes payments beyond a maximum dollar figure predetermined by the company. This protects against the potential

catastrophic loss. In fact, rarely will a self-funded health plan go without some level of stop-loss coverage and most of those are large companies. Stop-loss insurance has become so readily available in recent months that even small firms should have no trouble obtaining coverage.

**Communication.** A self-funded plan, particularly one with cost-containment provisions, needs to be properly communicated in order to be effective. Communications are particularly crucial where there is a union contract involved and during the period of transition from a fully insured to a self-funded arrangement.

**Third-Party Administration.** While large companies with a well-staffed personnel department may have the facilities and know-how to design and administer a cost-effective health plan, most small and medium-size companies will take advantage of the proliferation of third-party administrators (TPAs). A TPA essentially does the job of an insurance company – screening, processing, auditing claims – without the overhead or the prepaid premiums. The TPA may be paid a consulting fee for helping to design the plan and also be paid an administrative fee, based on the number or dollar volume of claims handled

## **Analysis of Relevant Factors**

Each of the relevant factors considered by the risk manager is briefly reviewed. Most of the answers to the risk manager's questions should be found in the feasibility study (more often referred to as the proposal). Properly done, the study should permit the risk manager to address all of the relevant factors and place some sort of a reasonable cost on such factors. The risk manager will wish to examine a number of relevant factors before the decision to self-fund is made:

1. The risks
  - What are they?
  - How extensive? That is, how frequent?
  - What is their nature? That is, what is their severity?
2. Available coverage
  - Is there any coverage available in the marketplace?
3. Maximum loss
  - What is employer's cap?
  - Are upside claims of high amount?
4. Management attitude
  - Is company well managed?
  - Any unions?
  - Is employer obligated to any insurer for credit?
5. Predictability
  - Is the likelihood predictable – stable?

- What is longevity of group?
- What is outside influence (e.g., economic changes)?
- 6. Employer's financial condition
  - Can employer handle the claim?
  - Are its assets liquid? What are the cash considerations?
  - Is employer looking to self-funding for the correct reasons?
- 7. Reserves
  - Are they adequate?
  - What about extraordinary losses?
- 8. Administration
  - Audits
  - Reporting requests
  - Claims problems
  - Legal fees
  - TPA
  - Start-up costs/fees
  - Bonding.
- 9. Risk
  - What cost-containment programs are needed?
  - Is it better to assume than to contain?
- 10. Transfer problems
  - What are transfer problems?
  - What can *fall between the cracks*?
- 11. Taxes
  - Any surprises with state/federal taxes?
- 12. Employee relations
  - Any possible negatives?
- 13. Smaller employer
  - What special considerations are needed?
- 14. Acquisitions and mergers
  - Will being self-funded or fully insured be a factor in effecting mergers?
- 15. Funding
  - What funding methods should be used?
  - If trustee, qualified or nonqualified?

## **The Risks**

Of the main risks – hospital, medical, surgical, dental, vision, short-term disability, long-term disability, death and dismemberment – all may be excellent candidates for self-funding. With long-term disability and death and dismemberment benefits, the frequency is low and the severity is high.

## **Maximum Loss**

The stop-loss coverage fixes the maximum loss to the employer.

**Selection of Specific Loss Amount.** While there is no magic formula, there are some practical rules of thumb that are useful in setting the specific attachment point.

- Rule 1 – 1-3% of working capital
- Rule 2 – 1% of surplus plus 1% average annual earning
- Rule 3 – 1% of revenues
- Rule 4 - \$150 times the number of plan participants.

Perceptions of what is an acceptable risk will vary widely by persons and group.

## **Management Attitudes**

Selecting a funding method is analogous to a family choosing to rent or own a home. Fully insured plans are rented: self-funded plans are owned. Home ownership brings financial, tax and control advantages not found with renting; however, the homeowner must assume responsibilities (e.g., care of yard) and also take some risks (e.g., fire and depreciation), nearly all of which may be protected by insurance.

Nonetheless, many employers choose to rent their plans, believing the responsibilities and risks are beyond their capabilities. This conservative attitude is substantial and must be honored; employers that reason they are in the *widget business* and want no part of being in the insurance business are not candidates for self-funding. Employers electing to pay more to enjoy total freedom from plan/risk worry or responsibility are numerous. Many employers feel or know intuitively that they are unable to assume even the smallest amount of responsibility that attaches to a self-funded plan.

## **Employers' Financial Condition**

Two types of employers are absolutely not candidates for self-funding:

- Those for whom bankruptcy is a real possibility
- Those that are uncomfortable with the unlikely, but possible, upside cost with to a self-funded plan.

Further, an employer that is overly concerned with the monthly ups and downs that go with the typical self-funded plan may not be a good candidate. The reader should note that many stop-loss carriers provide a monthly benefit leveling device to protect the employer from one month's claims being excessive in relation to the average monthly payout.

Regrettably, some employers do elect to self-funding for the wrong reasons. They want to capture the reserves, run the plan at minimum costs and hope that the upside doesn't

happen. These are poor self-funding candidates, being similar to the gambler who has it all on the table with nothing in reserve in case of a bad swing of fortune.

## **Reserves**

Most self-funders do not reserve for claims unpaid, whether or not reported. The reason is that they have become self-funders so that they need not reserve. Self-funding and advance funding are opposites with many employers. There are, however, many employers that do establish reserves, usually within the guides of a 501 (c)(9) trust. The reasons usually offered for such reserving are these:

- To measure and monitor the financial integrity of the program.
- To provide a basis to periodically test the financial advantages of continuing self-insurance.
- To obtain accurate and current distribution of loss costs by operating division.
- To provide cash flow forecasts.

## **Administration**

The risk manager is greatly concerned with the plan's administration, which is absolutely critical to the success of the plan. The administration may be with the employer (many larger employers do administer their own plans); with a TPA (most self-funded plans are so administered); or an insurer (by means of an ASO arrangement).

Most employers avoid self-administration because of the intensity of the skills required and also because they want a third-party scapegoat. ASO arrangements are often attractive but fail to give the plan the on-site closeness and entrepreneurial dimension that many self-funders desire; also self-funders wish to be removed from the insurer, not to be connected by contract. TPAs are, for the most part, reliable and excellent administrators; yet employers are well advised to carefully select those with a prior track record of solid administration, as there are those who fail to meet high standards.

Of considerable concern to the employer is the expense of administration. Typically, employers are led to self-funding because they can transfer administrative problems from their staff to the TPA or the ASO/insurer. There are many administrative needs that may be required. In a typical TPA-administered plan:

- The TPA will perform the recordkeeping, insurance, benefit administration and compliance duties according to the supervisory agreement.
- Often the TPA will have an actuarial dimension, which is helpful where COBRA premiums, benefit comparisons, contribution levels, and reserve attestations are required.
- Often the TPA will provide its own utilization reviews (precertification, concurrent, retrospective reviews).

- Where plan problems are of a legal nature, the employer's regular counsel is consulted.
- Where the plan is funded by a SO1(c)(9) trust, the employer's attorney (or accountant) will handle the filing/qualification unless the audit will be done, along with the Form 990, by the employer's accountant.

The employer should be comforted to have its plan supervised by a TPA that is subject to the typical TPA statute. A full-service TPA is all the employer needs to properly install and administer a self-funded plan. Other professionals (risk managers, brokers, actuaries, attorneys, accountants, medical support services) may be brought into the administration as needed.

## **Risk Avoidance**

Cost containment in self-funded plans is a must. For the employer to be an assumer and not be a container goes against basic risk theory.

## **Transfer Problems**

With fully insured plans, the transfer problems are erased because such plans are written on an incurred basis and nearly always provide for disability extension. Self-funded plans, being outside insurance law, may be and are commonly found to be, written on a paid basis without any extension whatever. Transfer in these circumstances may be done but must be carefully handled to avoid gaps, lost coverage and surprises.

## **Taxes**

Premium taxes have not been assessed against self-funded plans. Recent court cases and the recently enacted Texas TPA law suggest that premium taxes against self-funded plans might be attempted (albeit unsuccessfully) by the states.

## **Employee Relations**

Employee negatives may arise in these ways:

- Employees may resent having the strong backing of the XYZ Insurance Company replaced by the weak backing of the employer. This will be the case where they know, or sense, that the employer is become a self-funder for the wrong reason or at their expense.
- Employee may resent cost-containment programs usually associated with self-funded plans where they have been used to the *everything is paid* policies of the previous plan.

- Usually employees will readily and gladly accept containment where such programs are aimed at avoiding abuses

## **Smaller Employer**

Many myths have developed around the smaller employer and self-funding. These myths may be eliminated when the facts are presented.

*Myth 1. Only large employers can afford to self-fund.* The facts are that plans with as few as 50 participants can comfortably self-fund with predictable cost savings.

*Myth 2. Self-funding fails when bad claims experience occurs.* The facts are that self-funding works in the long run – through the fat years as well as the lean years.

*Myth 3. Self-funded plans cannot provide runoff protection.*

*Myth 4. Self-funding fails when a shocker hits.* The facts are that the specific deductible amount protects the plan against such shocker claims.

*Myth 5. It is difficult to find a new insurer when you leave a self-funded plan.* The facts are that excess loss plans have disabled lives extension coverage whenever there is a transfer of coverage from a self-funded to a fully insured plan.

*Myth 6. Most self-funded plans are serviced by financially unsound TPAs.* The facts are that TPAs are highly regulated by state TPA laws and in the majority of instances do a professional job of plan administration.

## Appendix

# CHARACTERISTICS THAT SUGGEST SELF-FUNDING

	<u>Employer A</u>	<u>Employer B</u>
Size of employer	Large	Small
Risk management staff	Yes	No
Self-funded workers' compensation	Yes	No
Centralized workforce	Yes	No
Risk reduction programs with property and liability coverages	Yes	No
Average size of benefit payments	Small	Large
Number of benefit payments	Large	Small
Multistate employer with mandated benefit requirements	Yes	No
Negotiated benefits	Yes	No
Employer-sponsored health care programs	Yes	No
Employer cash-flow problems	No	Yes

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Availability of effective TPAs	Yes	No
Availability of reasonable stop-loss coverage	Yes	No