The Secrets of Alternative Risk:
Why Self-Insurance May Be Your Best Bet

Self-Insurance vs. High Deductible Policies

WHY SELF-INSURANCE MAY BE YOUR BEST BET:

Self-Insured Employers obtain significant benefits over employers who cover their workers' compensation obligations with either a high deductible or a guaranteed cost policy. These benefits include considerable cost savings, better cash flow, reduced capital outlay, improved credit, and a stronger balance sheet. And most importantly, self-insured employers design and control every aspect of their workers' compensation program to meet the needs of their employees and their business.

The results? Stellar outcomes for their employees and the company. The good news is that it has never been quicker or easier to become self-insured. An employer who applies to be self-insured today can be readily approved within 30 days.

Let's examine the business case for self-insurance versus high deductible policies in terms of the benefits:

- **Considerable cost savings,**
- **better cash flow,**
- **reduced capital outlay,**
- **stronger credit position,**
- **stronger balance sheet, and**
- **perhaps most importantly, the ability to design and control every aspect of the workers' compensation program to meet the needs of employees and objectives of the business.**

DEFINITIONS:

A traditional workers' compensation policy, also known as a guaranteed-cost policy covers all liability in exchange for a fixed annual premium amount. The insurance carrier includes all its known and possible exposure and costs in the yearly premium along with dollars to cover administration, overhead, marketing, and profit. The Workers' Compensation Insurance Rating Bureau (WCIRB) 2018 Workers' Compensation Losses and Expenses report showed that 37% of insurance premium dollars go to the insurance carrier's overhead, administration, commissions and shareholder profits. Self-insured employers do not pay any of these costs. Guaranteed-cost policies are the most expensive type of workers' compensation coverage.

Alternative risk programs describe workers' compensation programs other than guaranteed-cost policies. The two alternative risk programs we discuss in this paper are self-insurance and high deductible policies.

Self-Insurance

A self-insured workers' compensation plan is one in which the employer assumes the financial risk for providing workers comp benefits to its employees. Instead of paying a fixed premium to an insurance carrier, the self-insured employer pays the cost of each claim out of pocket, as they are incurred. Companies that wish to be self-insured in California must apply and be granted a Certificate of Consent to Self-Insure by the State of California. Since being self-insured means there is no insurance company involved, the employer makes all decisions concerning their program, including the selection of third-party administrators and vendors they contract with, and how they prioritize resources to meet their employee's needs and company's objectives.

Self-insurance provides the employer with the highest degree of flexibility and control, and the greatest opportunity for cost savings.

High Deductible Policies

A high deductible policy is sometimes called a fronted policy, a large-deductible plan, or a high dollar deductible. Sometimes high deductible policies are incorrectly referred to as self-insurance; however, only companies granted a Certificate of Consent to Self-Insure from the State of California meet the legal definition of self-insured in California.

A high deductible policy functions in many ways like a traditional guaranteed-cost policy; with a significant difference, the employer is responsible for paying the first dollar and all costs of every claim up to the deductible amount, which usually is the first $100,000 to $1,000,000 or more per claim.

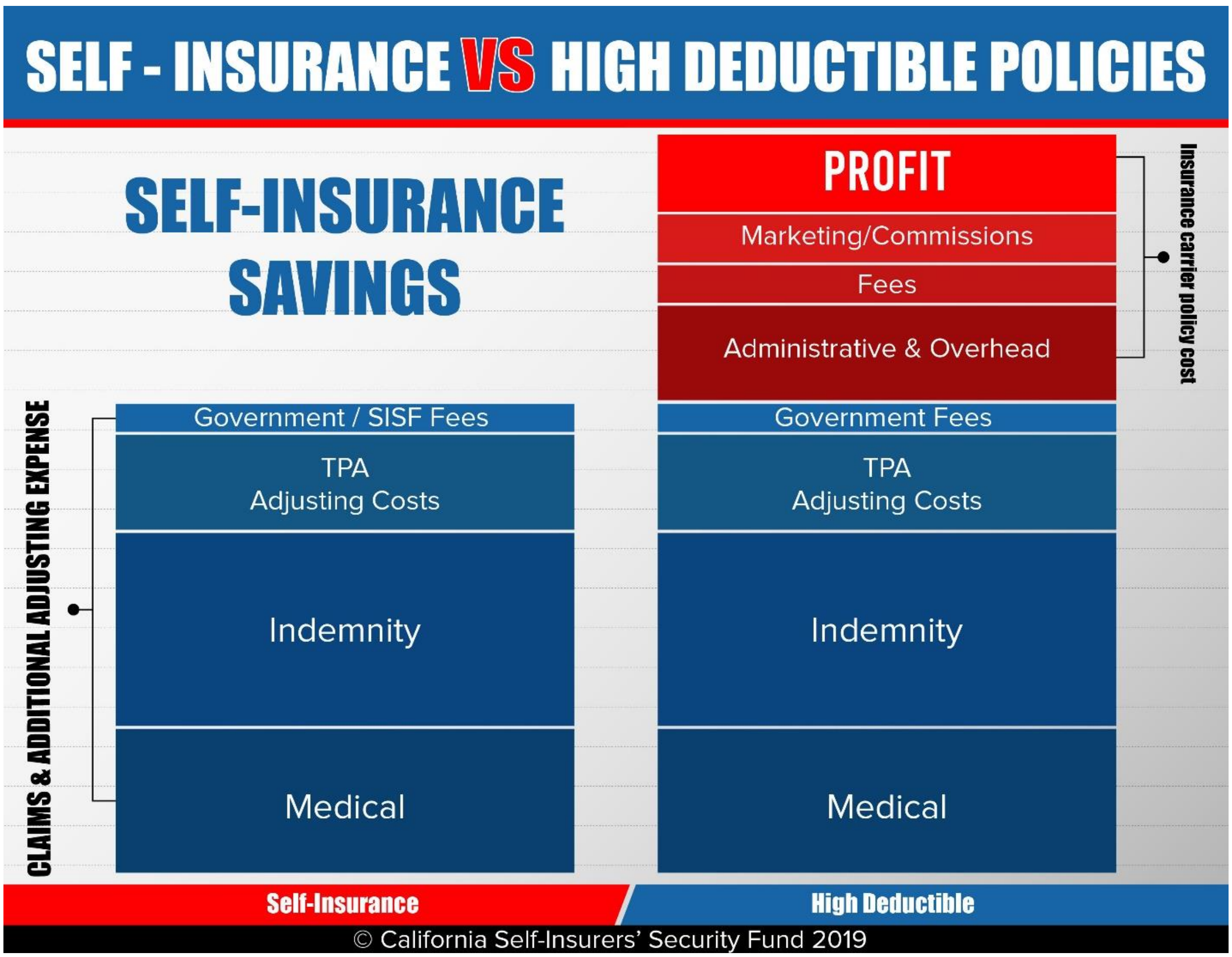
Like a guaranteed-cost policy, the premium charged for a high deductible policy covers not only the cost of the employer's claims but also the carrier's administrative and overhead costs, fees, sales commissions, and profits for their shareholders. As mentioned previously, the WCIRB found that in 2018 these costs were 37¢ of every insurance premium dollar.

In addition to the premium, the carrier will require the employer to post a substantial collateral security deposit. This collateral deposit will be an amount representing a portion of the employer's total claims liabilities for all years. This collateral deposit is regularly reviewed and adjusted (usually upwards) to protect the carrier in the event the employer defaults or becomes insolvent. Employers typically post the collateral in the form of an irrevocable letter of credit (ILOC). The ILOC impacts the employer by restricting their borrowing capacity and is reflected as a contingent liability on the company's balance sheet.

On a final note, as a result of several high deductible insurance carriers becoming insolvent in recent years, the California Insurance Commissioner enacted new regulations in 2019 to increase oversight of high deductible policies and impose more stringent collateral requirements. This action is intended to avoid further insurer insolvencies, which negatively impact insured employers and their injured workers, and to protect the stability of the high deductible marketplace. The Commissioner noted increased oversight was necessary, stating, “The NAIC whitepaper documented four prominent examples where the collateral was diverted [by the carrier] for purposes other than the payment of high deductible claims.” (California Department of Insurance, 2018).

WHERE THE COST SAVINGS COME FROM:

This chart demonstrates the cost differences between self-insurance and high deductible policies.



Specifically, the chart details the areas self-insured employers experience savings versus employers in high deductible policies. The additional costs of a high deductible policy flow from the added insurance carrier administrative and overhead costs, policy fees, sales commissions, and shareholder profits.

LOWER COST

Paying a lower cost just makes sense.

Self-Insurance

Self-insured employers retain the risk exposure and pay only the ***actual*** direct expenses of their workers' compensation programs. These expenses include claims liabilities, costs to adjust the claims, actuarial costs, and an annual assessment to both the Office of Self Insurance Plans (OSIP) and the California Self-Insurers' Security Fund (CASISF). Self-insured employers receive significant savings by not paying the insurance carriers' administrative and overhead costs, fees, sales commissions, or profits to their shareholders.

High Deductible Policies

Under a high deductible policy, the employer pays claims liabilities and costs to adjust claims. Additionally, the employer also pays charges for the insurance carriers' administrative and overhead costs, fees, sales commissions, actuarial costs, and profits to the carrier's shareholders.

BETTER CASH FLOW

The lifeblood of every business is cash flow. Arguably protecting and conserving a business's cash flow might be the difference between success and failure. Cash is what keeps the lights on, the employees working, and the phones ringing.

Self-Insurance

Self-insurance allows a company to pay worker's compensation costs on an actual real-time basis; this means dollars do not flow from the business until a workers' compensation expense is incurred and paid.

High Deductible Policies

With a high deductible policy, the employer pays a sizeable initial premium, posts collateral at the onset of the policy, and pre-funds claims. Typically, premium payments are scheduled throughout the policy term.

REDUCED CAPITAL OUTLAY

Business capital enables a business to invest in property, plant, and equipment allowing the company to grow and profit. Every business has a finite amount of capital that must be conserved and used prudently.

Self-Insurance

Self-insured employers participate in the innovative Alternative Security Program (ASP) administered by CASISF. This first-in-the-nation program provides a financial backstop to replace security deposits required to collateralize self-insured workers' compensation liabilities. The ASP frees the self-insured employer's capital to remain in the business for profit-generating activities. The ASP fee is comparable to the cost paid for a letter of credit under a high deductible policy. The ASP does <u>not</u> require underlying capital and does <u>not</u> impact the company's cash flow, borrowing capacity, or balance sheet.

High Deductible Policies

Conversely, a high deductible program requires posting a large collateral deposit in the form of cash or, more typically, an irrevocable letter-of-credit (ILOC). To obtain an ILOC, financial institutions require the employer to provide underlying cash collateral for a portion of the ILOC value. This collateral requirement negatively impacts a company's capital position and encumbers that capital indefinitely.

Additionally, a financial institution issuing the ILOC typically requires numerous restrictive financial covenants. These covenants may restrict taking on more debt or selling assets; and may set forth requirements to meet ongoing financial ratios such as cash-flow to debt, profitability, current, and solvency. The covenants must be met and maintained by the business for the duration of the ILOC.

STRONGER BALANCE SHEET

A balance sheet is a snapshot in time of a company's financial health showing the assets, liabilities, and net worth of the business. Therefore, protecting a company's balance sheet is paramount for the health of the business and the benefit of the owners.

Self-Insurance

Self-insured employers enjoy having their collateral covered by the Alternative Security Program (ASP). The ASP frees the employer from the obligation to tie-up working capital and credit to cover these deposits. **The ASP is available exclusively to self-insured employers and has NO impact on the employer's balance sheet, credit, or borrowing capacity.**

High Deductible Policies

Under a high deductible policy, the employer will experience a restriction on the portion of their liquid assets that collateralize the ILOC. The ILOC will appear as a contingent liability on the company's balance sheet impacting creditworthiness and borrowing decisions.

STRONGER CREDIT POSITION

A business's credit position directly impacts its ability to obtain funds to invest in the business, fund payroll, operations, and growth. Additionally, stronger credit directly results in a lower cost of borrowing. The ability to borrow money at favorable rates makes a business more competitive in the marketplace.

Self-Insurance

Self-Insurance frees the business's cash-flow, capital, borrowing capacity and strengthens their balance sheet and the business's overall creditworthiness.

High Deductible Policies

A high deductible program can have the exact opposite effect because it impacts cash-flow and capital, reduces borrowing capacity, and weakens the balance sheet. Over time as collateral requirements increase, this will place additional pressure on all these metrics resulting in negative impacts on the business.

BETTER CONTROL

A significant complaint voiced by many employers about workers' compensation is the treatment of their employees, the handling of costs, closure of claims, and lack of transparency and oversight into the process. These issues result in unsatisfactory outcomes for the employer and its employees.

Reasons to Self-Insure

'Many employers are dissatisfied with the value proposition of how their injured employees are treated vs. the cost of insurance and lack of control.' (McMurray, 2016)

Self-Insurance

A key hallmark of self-insurance is the high degree of flexibility and control it affords the employer company to implement a completely customized program. Many employers choose to create a program that exceeds the minimum regulatory standard of compliance and better meets their employees' needs and the business' objectives. Employers may select and engage vendors with specific expertise in their industry and alignment with their company values. The employer can choose to target resources for program areas that they determine are likely to provide the best ROI. An adequately tailored and customized program will result in improved employee outcomes, quicker return-to-work, reduced litigation, and lower overall claims costs.

With self-insurance, you are in the driver's seat and have complete control over all aspects of your program. You control your destiny.

High Deductible Policies

With high deductible policies, the insurance carrier exerts control, makes the decisions and manages claims adjusting, and issues payments funded by the employer. Larger employers may have the ability to take back some control by negotiating these terms; however, the insurance carrier must agree.

For additional fees, the carrier may bundle additional services such as a return-to-work program, loss prevention, safety programs, training, or other services as agreed. In a bundled contract, the carrier is responsible for all claims adjusting and services, and the employer has less control over how claims are processed, services delivered, and the claims experience the injured worker receives.

In an unbundled contract, the employer and carrier must negotiate every aspect of which party provides which services. The employer may choose to hire a third-party administrator (TPA) approved by the carrier to adjust claims and provide other services in house.

Why Self-Insurance May be Your Best Bet

- ✓ **Eliminate administrative, overhead, sales commissions and profits charged by insurance companies.**
- ✓ **Greater control and awareness over their employee safety resulting in few accidents – Lower cost**
- ✓ **Managing the TPA and service providers provides greater cost control and eliminates unnecessary costs for non-essential services.**
- ✓ **CASISF supports the continuous improvement and best practices of all its members through holding annual meetings, weekly social media communications, and speaking at industry conferences.**
- ✓ **No need to post large amounts of capital for collateral under CASISF's Alternative Security Program (ASP)**

THINGS TO CONSIDER

Self-insurance offers tremendous benefits, including lower cost, greater control, better outcomes, and peace of mind; however, it may not be the right fit for every company. It's essential to examine and understand the cost, benefits, and risks of being self-insured.

It's important to note that the annual assessment charged by CASISF may change in the future and could be impacted in the event of sizeable defaults by other self-insured employers. While CASISF maintains capital reserves to mitigate against such an event, there are no guarantees that current assessment levels will be maintained in the future.

Under both high deductible and self-insured programs, the economy and credit risks are factors that can significantly affect costs, performance, and outcomes of alternative risk programs.

With a high deductible policy, a bad economy may affect the access to and availability of insurance carriers and markets.

CONCLUSION

In summary, self-insured employers enjoy considerable cost savings, and better cash flow. The Alternative Security Program (ASP) available exclusively to self-insured employers avoids the need to post collateral, thereby reducing capital outlays with no impacts to creditworthiness or their balance sheet. Most importantly, self-insured employers can design and control every aspect of their workers' compensation program to meet the needs of employees and objectives of the business.

The bottom line is that self-insured employers experience lower costs, greater control, improved outcomes, and peace of mind.

FEATURES AND BENEFITS OF ALTERNATIVE RISK PROGRAMS

	Self-Insurance	High Deductible
Meets legal mandate to provide workers' comp benefits	✓	✓
Employer company retains risk	✓	✓
Savings by eliminating carrier's overhead, costs & profits	✓	
Collateral posted by Alternative Security Program (ASP)	✓	
No impact on working capital, balance sheet or borrowing capacity	✓	
Maximum flexibility to customize the claims process	✓	Maybe*
Maximum control and oversight over the claims process	✓	Maybe*
The lowest cost option	✓	

*Possible as negotiated with the insurance carrier and subject to carrier's approval.

NEXT STEPS: If you would like to discuss becoming self-insured with a self-insurance expert, call the California Self-Insurers' Security Fund at (510) 879-6035. We are California Workers' Comp Experts with a singular focus on self-insurance.

About the Fund: The California Self-Insurers' Security Fund (CASISF) has been proudly serving its members for 35 years since its founding on July 6, 1984. We are a member-driven non-profit organization with leadership by a volunteer Board of Trustees representing members serving members. The Security Fund is a key partner supporting California self-insured workers' compensation programs.

About the Author: Jon Wroten, MBA, CPP is the managing director of California Risk Advisors LLC and the former Chief of the Office of Self-Insurance Plans (OSIP) for the State of California, where he oversaw and was chief regulator of the nation's largest self-insurance marketplace. He also was a senior vice president at Sedgwick CMS, the nation's largest third-party administrator, where he was responsible for national regulatory compliance and quality. Jon taught business, insurance, and risk management as an adjunct professor at Sierra College for more than fifteen years.

References

California Department of Insurance. (2018, June 29). *Proposed Regulations.* Retrieved September 8, 2019, from California Department of Insurance: https://legaldocs.insurance.ca.gov/CyberDOCS/Libraries/DOCS_WEB/Common/viewdocdsp.asp?doc=316062&lib=DOCS_WEB&version=320839&mimetype=APPLICATION%2FPDF&file=.pdf&rendition=html&MSOESPq330994WA=x.mht

McMurray, S. (2016, April 25). *Take Control of Your Costs.* Retrieved September 8, 2019, from www.risk&insurance.com: https://riskandinsurance.com/why-would-you-self-insure/

National Association of Insurance Commissioners. (2016). *NAIC 2016 Workers' Compensation Large Deductible Study.* Washington DC. Retrieved November 5, 2019, from https://www.naic.org/prod_serv/WCD-OP-16.pdf

Workers' Compensation Insurance Rating Bureau of California. (June 28, 2019). *2018 California Worker's Compensation Losses and Expenses.* Oakland, California: WCIRB. Retrieved November 5, 2019, from https://www.wcirb.com/sites/default/files/documents/2018_ca_wc_losses_and_expenses_report-complete.pdf