

# Is Self-Funding Health Insurance Worth the Risk?

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With the cost of health insurance exploding, many employers are turning from traditional, fully funded plans to self-funded, also known as self-insured, plans to control expenses and give employees competitive health care coverage. According to the Employee Benefit Research Institute, 55 percent of American workers and their dependents were covered by some form of self-funded plan in 2007, up from 45 percent in 1999.

In a fully funded plan, the employer pays a fixed premium to an insurance company. The carrier assumes all financial risk, administers the plan, establishes reserve capital levels and manages other decisions concerning benefits and coverage.

In a self-funded plan, the employer essentially becomes an insurance company itself and assumes responsibility for funding and administering its benefit plan. This often generates substantial cost savings, but also exposes the company to increased risk since it is now responsible for directly paying claims and administrative costs.

## How Self-Funding Works

A self-funded employer will typically establish a trust account from which to pay claims, although larger employers may do so from operating capital. Enough money is placed in this reserve fund to pay for predicted levels of claims based upon employee demographics plus a claims history. The reserve generally holds at least two months of estimated claims payments.

To protect against unpredictable or catastrophic claims, a self-funded employer will usually purchase stop-loss insurance. A specific stop-loss policy reimburses the employer for claims incurred by any single employee above

a certain dollar limit; an aggregate stop-loss policy reimburses the employer for total employee claims above a stipulated annual threshold. Employers often purchase both specific and aggregate stop-loss coverage. Many experts advise buying a 12/15 policy, which pays claims incurred in a 12-month period over 15 months, permitting time for claims to be processed after the year ends.

Larger organizations may administer their self-funded plans in-house, but many employers use a third-party administrator (TPA) or administrative services only (ASO) organization to manage their plans. The TPA or ASO will process and pay bills submitted by doctors, hospitals and other providers; prepare and distribute plan documents and member identification cards; answer employee questions; vet employee and dependent eligibility; collect premiums; review and pay claims; and send the employer regular status reports. Before selecting a TPA or an ASO, employers should examine the company's annual Type II SAS 70 report to determine that it is processing and paying claims according to sound accounting practices.

## Self-Funding Advantages

**Control Over Plan Design** – Rather than purchasing a standard plan from an insurance carrier, the employer can design a plan to address employees' specific needs. This can save money by eliminating unnecessary features bundled with a carrier's plan, while adding additional features the workforce wants.

**Exemption from State Mandates** – While regulated under federal law, self-funded plans are exempt from state insurance laws, which typically mandate coverage for treatments that may or may not be suitable for a given employee population. Self-funded plans are also exempt from state premium

taxes, which are generally 2 or 3 percent of the premium.

**Direct Cost Savings** – Despite paying for TPA or ASO services and for stop-loss coverage, a self-funded employer will often realize immediate cost reductions by avoiding an insurance carrier's fees and overhead, which can top 20 percent of the premiums paid.

**Cash Flow and Investment Income** – Self-funding lets an employer improve cash flow control because claims are paid when due, rather than on an ongoing basis in the form of insurance carrier premiums. The employer controls how the reserve fund is invested, thereby maximizing interest income. The employer, rather than an insurer, also retains any excess reserve capital at year's end.

## Other Considerations

Self-funding generally works best for companies with at least 500 employees. For small firms, even with stop-loss coverage, unexpectedly high claims can exhaust a plan's reserve fund, forcing an employer to dangerously dip into operating capital. Also, numerous claims could cause the employer to lose affordable stop-loss insurance.

Before considering self-funding insurance, employers should talk to their insurance advisor, attorney and CPA to determine whether it is the right strategy given their employee population and business model. 🧩

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