Business Owners Should Match Promised Cost Savings Against Unanticipated Risk

By Adam Friedlander

Business owners generally look for the most cost-effective programs in the purchase of products and services. To survive in the competitive marketplace and to earn profits, sound choices are essential; that's just common sense. But another basic premise is that the focus has to be on pursuits where the rewards exceed the risks.

In the area of mandatory workers' compensation insurance, two of the choices are insurance company backed policies, on the one hand, or the self-insured trust.

It is vitally important for insurance brokers advising clients on the alternatives, to keep uppermost in their minds the risk characteristics of the trust system where, despite assurances to the contrary, the rewards of lower costs are challenged by the very real, high risk potentials.

For example, under the self-insured trust vehicle, there is the threat of under-funding, so that insufficient dollars are available to pay claims and the promise of reinsurance protection may prove illusory. Under such a scenario, trust members may find that self-insurance makes them jointly and severally liable for unpaid claims and the obligations of the trust itself. That is actually what befell self-insured workers' compensation trusts that operated in Florida.

Actual Example

An actual example of the muddled math involved in the purported savings advantages of the self-insured trust, is demonstrated by the experience of one disillusioned member, Jane A. Halbritter, president of Stonehedge Nursing Home of New York. Her institution had been a participant in a self-insured trust from 1992 to 1995. Here is the description of her experience as she presented it.

"As part of our trust agreement, we were required to post a $120,000 security deposit, the balance of which is not refundable until 27 months after the final claim is paid. We were quoted a very attractive rate, which, frankly, induced us to join... Within a year, the rate quickly escalated over 124 percent. Little did we know, the worst was yet to come. Two years after leaving the trust we were told we owed them an exit balance of $147,475... even more shocking was a letter we received six months later stating our exit balance was now $481,857. It's anyone's guess what the final cost will be. But one thing is for sure - the final cost will far exceed what we would have paid had we stayed with the State Insurance Fund. Perhaps even more troubling is the fact that we also discovered that it is virtually impossible to be released from our joint and several liability clause. Even though I had an attorney review the Trust Agreement, we never grasped the nature of that responsibility."

Two Types Of Reinsurance

To limit the amount of financial damage to members due to bad claims experience, most self-insured trusts purchase two types of reinsurance. But reinsurance, typically, has a very high deductible, and consequently leaves members vulnerable to assessments to fund the deductible in the event claims exceed expectations, before the reinsurance is even triggered. This situation can result from large claims, a high frequency of small or moderate-sized claims, or both.

Some self-insured trusts, to cover large claims, purchase specific excess reinsurance, where the deductible is usually $250,000. In the case of a $400,000 claim, the trust's portion of liability is the first $250,000, and the specific reinsurance pays the $150,000 above the deductible.

To limit the liability for the combined total of all small claims, plus the trust's portion of large claims, some trusts purchase "aggregate excess" reinsurance. The deductible can be 75 percent of written premium. If a trust has $1,000,000 in premium, then the reinsurance limits the liability of the trust to $750,000. For example, if the total claims were $2,000,000 in a policy year, then the self-insured trust may pay the first $750,000 and the aggregate excess reinsurance is called upon to pay $1,250,000.

The problem that arises is that the money required to pay the deductible may have already been spent. If so, a Pandora's Box, in the form of the assessment of members to pay claims and other obligations of the trust, can possibly be opened.

Historically, trusts' operating expenses, including New York State assessments, usually consume 35 percent of premiums. Dividends, that are an essential selling point of the trust, can deplete another 35 percent, leaving only 30 percent of premiums to cover claims. If the premium is $1,000,000, only $300,000 is left to pay claims. If dividends were greater than 35 percent, then even less remains to pay claims.

These eventualities leave members with an unfunded liability of up to $450,000, or 45 percent of premium, which is the difference between the $750,000 reinsurance deductible and the remaining $300,000. Members could then be assessed for their pro-rata share of the $450,000 shortfall.

In workers' compensation, as everyone in businesses is aware, premiums are paid immediately. On the other hand, claims take several years to develop their ultimate costs. These delayed payouts create an illusion of profit. Aggressive trust promotions, eager to attract and retain members, might repeatedly distribute these illusory profits in the form of dividends. Years later, serious and even unmanageable deficiency in funds sets off alarm bells that wake members to the nightmare of assessments. A 45 percent shortfall compounded for 5 years, for example, leaves an unfunded liability of 225 percent of annual premiums, despite being "fully reinsured".

To avoid the specter of insolvency, a trust may face because of the contrived arithmetic, money must be found to pay for claims and obligations. When accumulated net premiums prove inadequate, the trust may have to use new premiums as the source of funds. "Taking from Peter to pay Paul" is not a viable solution. If new members' premiums are used to pay for claims that occurred prior to their membership, then less remains to fund new claims. The resulting transfer of old liabilities to new members immediately increases their burden of liability.

A counterthrust may be to stop or sharply reduce dividends since that money can help fund the shortfall. As a result, net cost is increased. Members may conclude that assuming the high risks of self-insurance is hardly justified. Consequently, trusts would suffer a shrinking revenue stream but face a growing claims liability.

The least desirable option is to assess members for their pro-rata share of liability. According to the New York Workers' Compensation Law, self-insured trust members must be jointly and severally liable which can require members to make security deposits, file an acceptable surety bond or provide an irrevocable letter of credit. That's because each member of a trust is liable for all unpaid claims incurred during their membership, even after termination

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from the trust. In addition, all self-insured trusts and their members will be assessed for the insolvency of any other trust in New York, a disturbing fact that further expands the liability of a trust's members.

In addition, the insolvency of any members of a trust, increases the remaining members' burden of liability. That means that the financially strongest members are the most vulnerable, paying their pro-rata share of the assessment and picking up the tab for competitors who are unable to pay their share.

Market conditions might undermine the ability of some reinsurers of workers' compensation self-insured trusts to meet their obligations, a situation unthinkable to most members. Based upon recent studies of the National Council on Compensation Insurance, the 1999 accident year combined ratio (claims plus expenses) is projected to be 134.6% of premium. They project a workers' compensation reserve deficiency of $16.9 billion nationally.

Unable to withstand the substantial losses, some insurers and reinsurers are raising rates or refusing to offer coverage.

It's ironic that members of trusts, having expertise unrelated to insurance, "bet the farm" by assuming potentially unlimited risk with unknown partners. Unlike Florida, where trusts formed due to market limitations, New York has many low cost alternatives that are fully insured and not burdened by joint and several liability. As an example, safety groups, insured by the New York State Insurance Fund, guarantee that members will never pay more than their discounted premium and New York State Assessment, regardless of claims experience. Safety groups have a long history of providing substantial discounts and dividends, with no strings attached.

As mentioned above, to survive in the marketplace, business owners need complete focus on pursuits where the rewards exceed the risk. That is not the case with self-insured workers' compensation trusts. The risk of paying many multiples of the annual premium is not justified by the projected savings. The distractions from more worthwhile business pursuits could prove to be the highest cost of all.

Some trusts try to minimize the obvious risks of "self-insurance". Some advertise their invested assets, which may be financial strength. But, without listing the corresponding liabilities, the adequacy of those advertised assets is unknown. In addition, some members have a misunderstanding that reinsurance renders joint and several liability harmless and irrelevant. As we have seen, that can prove to be a very costly misunderstanding of the self-insured process.

It is important for brokers to be exceedingly careful when advising their clients in regard to participation in a self-insured workers' compensation trust. Insurance brokers risk jeopardizing the very relationship with clients they seek to nurture.