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Small Businesses Blaze a New Trail with Self-Funding

Reform and rising costs make small and midsized companies consider a new way to pay for employee health care

A UBA Member-Provided Publication Designed To Help Employers Make Informed Benefit Choices

UBA WisdomStream

As details of the recent health care reform legislation trickle down from Washington, employers are starting to wade through the flood of legal and financial consequences this law could have on their current and future employee benefit offerings.

The Patient Protection and Affordable Care Act (PPACA) — laden with a number of new requirements, an employer mandate and unknown future costs — is prompting many employers to take a hard look at what they're doing — and what they're paying — for employee benefits. While cost-sharing and cost-shifting are common strategies, some small and midsize employers are taking an even bigger plunge into an alternative method of funding that once was feasible only for big companies: self-funded health care plans.

In a self-funded plan, the employer — not the insurance company — assumes the risk and cost fluctuations associated with their health care plan. Plan costs can fluctuate by month (or even by week), depending on the medical claims submitted by the company's employees.

By contrast, a fully insured (or group) plan relies on the insurance carrier to assume the risk and administration.

"There has been a trend over the past decade of small to midsize employers moving toward self-funding, but we are seeing this now more than ever," said Robert Calise, Principal at Cornerstone Group of West Warwick, R.I., a Member Firm of United Benefit Advisors (UBA), a member-owned alliance of the nation's premier independent benefit advisory firms. "Since health care reform, smaller companies under 200 employees have shown an increased interest in self-funding, which offers more control over the dynamics of the plan," he said.

Several recent studies highlight this trend. The 2010 UBA Employer Opinion Survey found that 17.5 percent of respondents currently have a self-funded plan, while 12 percent said they would like to implement that funding strategy someday. A separate 2010 study by the Kaiser Family Foundation found that 16 percent of companies with three to 199 employees were partially or fully self-funded, compared with 12 percent in 2008.

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More Flexibility, Fewer Reform Headaches

While terms like "assuming all risk and cost" and "costs can fluctuate" may seem a bit jarring to some employers, the advantages of self-funding over fully insured coverage can be significant, according to Cathy Jackson, vice president at Atlanta-based Arista Consulting Group, a UBA Member Firm.

"Self-funding has always been the way to go for large groups because of the potential to save money," Jackson said. "With fully insured plans, you're subject to whatever the standard plans are from the insurers. With self-funding, you can decide your copay, your deductible — there's just more flexibility. It's always been that way."

With health care reform upending the benefits landscape, employers have even more incentive to explore self-funding options because this type of funding offers some relief from compliance issues and the possible new costs associated with reform.

In 2014, PPACA will require fully insured plans with fewer than 100 lives to adhere to "community rating" rules, which means the cost of insurance will not be based on health factors, according to the Congressional Research Service (CRS). Rates will vary only by age, tobacco use, self-only or family coverage, and region, the CRS reported in a June 2010 paper.

"Community rating will further disadvantage an employer that has a healthy workforce in that some of the demographic features that are inherent in fully insured contracts will not count," Jackson said. "Self-insured contracts allow the employer to pay health care costs based on the claims of their company. A self-insured contract would help to avoid [community rating] for healthy employers."

Jeff Hadden, a partner of Indianapolis-based LHD Benefits, a UBA Member Firm, said the community rating and other reform-related changes could have a major impact on future costs for employers in fully insured plans.

Self-Funding by the Numbers

Percentage of employers who are completely self-funded*	
By Size	
Number of Employees	Percentage
Under 25	0.3%
25 — 49	1.2%
50 — 99	4.2%
100 — 199	12.4%
200 — 499	33.7%
500 — 999	45.6%
1,000 +	71.9%
All Employers	9.6%
By Region	
Northeast	6.7%
Southeast	8.4%
North Central	12.8%
Central	12.4%
West	6.8%
Top Industries	
Government/ Education/Utilities	20.7%
Wholesale/Retail	11.6%
Manufacturing	11.3%
Finance/Insurance/Real Estate	9.2%
Health Care/ Social Assistance	8.7%

*2010 UBA Health Plan Survey

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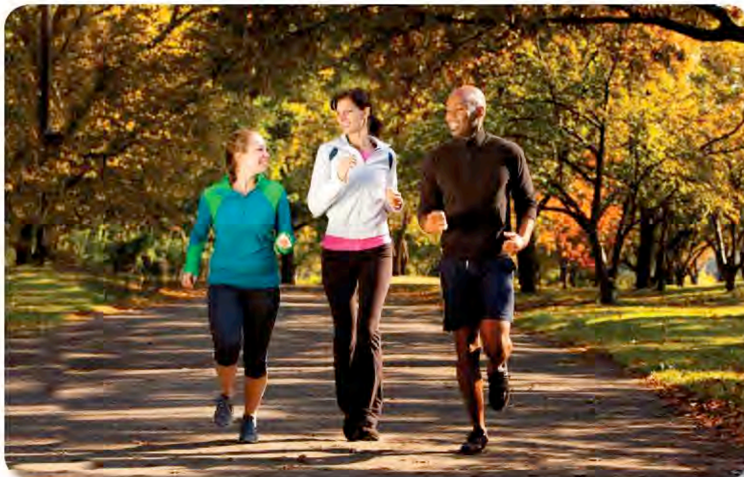
"You have to worry about the community rating," Hadden said. "Even in a very healthy group it may be difficult to capture savings. If groups are self-funded with appropriate levels of protection in place, they have more control over their costs and don't have to be driven by the community rate."

Working With Wellness

Apart from avoiding some reform headaches, self-funded employers also have the opportunity to create more effective wellness programs, which in turn can help lower health costs even more, according to Cornerstone's Calise.

"Wellness programs in a self-funding plan can help to reduce rates, where they may not have as much impact in a community pool. In a self-funded plan, the impact of a wellness plan has greater impact in attempting to reduce claims and control costs, versus a fully insured plan where community rate blending doesn't allow the company to see the true value of their wellness effort," Calise said.

The increased control and flexibility offered by a self-funded plan are major factors in wellness success, Arista's Jackson added.



Pros and Cons of Self-funding

Provided by LHD Benefits:

PROS:

- **Greater flexibility:** In a fully insured plan, the insurance company makes most of the decisions regarding plan design. With self-insurance, the employer bears the risk. Therefore, the employer designs the benefit program and pays the carrier (or third-party administrator) to administer the claims.
- **Avoid state-mandated benefits:** Group plans are governed by states, but self-funded plans are not. Instead, they are subject to ERISA, a federal law. As such, self-funded plans are not obligated to comply with state-mandated benefits that can boost administrative and claim costs.
- **Avoid/reduce premium taxes:** Employers with fully insured plans pay taxes on the full premium. Those with a self-funded plan pay premium tax on only the administration fee and stop loss insurance (if secured by the employer). The administration fee is related to a company's size and is usually 6 percent to 15 percent of total premium -- which means taxes are significantly lower under a self-funded arrangement.

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"For wellness programs, it's hard to show return on investment," Jackson said. "Employers spend money on it, and they want to know if they're going to get their money back. When you're small and your costs are pooled [in a fully insured plan], wellness isn't going to have an impact unless everyone's doing wellness. In self-funding, you can have a lot more control and success with wellness.

"Also, self-insured contracts allow more flexibility in plan design, thus participation in wellness programs can be encouraged with higher deductibles or out-of-pocket costs for health care services for those not participating," Jackson said.

This wellness edge likely will prompt more companies that are concerned about their workforce's health to seriously consider self-funding, Hadden said.

"Self-funded plans will become more common and provide more control," Hadden said. "The sickest groups will remain fully-funded and rely on community rates and mandated medical loss ratios. Self-funded [plans] rely on a healthy group, so wellness programs are in their best interest."

Success With Stop Loss

Once a company has made the decision to move to a self-funded plan, it must decide how much risk it can stomach and how much protection it needs. Stop loss insurance provides a cap on how much a company must pay on claims. Companies can purchase specific stop loss insurance (which covers large, individual claims) and/or aggregate stop loss insurance (which covers a company's total claims under the specific stop loss insurance for a given period).

Many stop loss insurance carriers have started to react to the shift by targeting small and midsize employers with self-funding programs and are offering lower levels of stop loss coverage for employers with as few as 25 employees, Hadden noted.

Employers need to take a hard look at stop loss because it protects their plan and their cash flow, Jackson said.

Pros and Cons of Self-funding

CONS:

- **Fluctuation in claims:** An employer with a self-funded plan is responsible for funding medical claims incurred by those covered by the plan. This can vary from month to month (and even week to week), so employers must be prepared to cover the costs of these claims on a regular basis.
- **More risk:** A self-funded employer assumes the risk for all claims and is responsible for paying them. While some claims can be estimated, there's no guarantee of what a self-funded plan will cost. It all depends on the amount and size of claims. Luckily, employers can purchase stop loss insurance, which places a cap on their liability and provides some stability to the plan.
- **More responsibility:** Under a fully insured plan, the insurance company is the fiduciary. But in a self-funded arrangement, the employer is the fiduciary and is responsible for decisions made about the plan. Being a fiduciary involves much more responsibility, administrative work and risk. Many employers can lessen their workload and hire a third-party administrator (TPA) to process claims and run the plan. However, hiring a TPA doesn't lessen an employer's fiduciary duty to the plan.

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"For a small group, [stop loss insurance] is very critical," Jackson said. "A premature baby can cost $800,000 if you don't have limits on your liability to fund that claim. If you don't have limits, your cash load could be hugely different from when you were just paying a static [fully insured] bill. I'd say for a group up to 1,000, it's vital to have coverage for specific and aggregate claims."

While that $800,000 claim might be uncommon, employers must carefully analyze their situation and ensure they have enough coverage to cope with surprises.

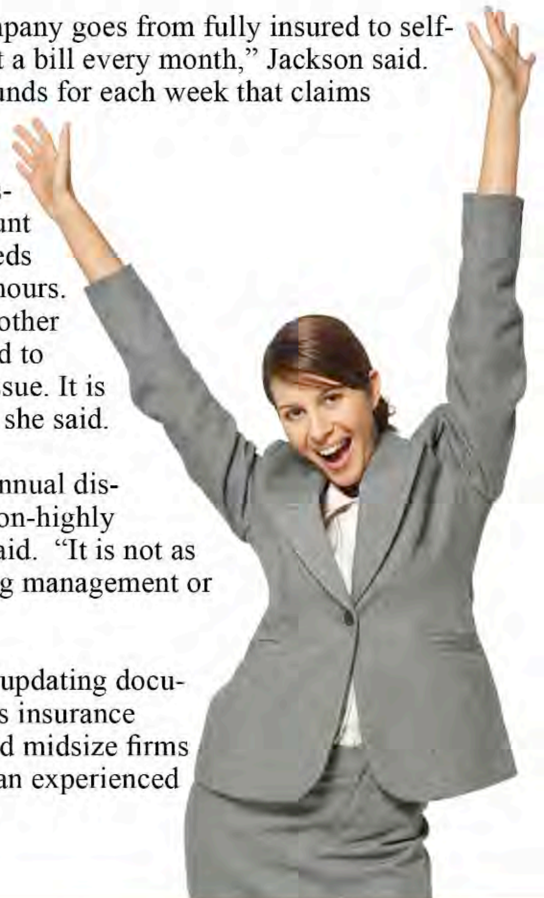
"With specific stop loss, you want to be able to afford that one large claim. The rule of thumb is 10 percent of your claims. So for a company with 50 employees that has claims of $400,000 or less, I'd say 10 percent, or $40,000, is adequate. You might have some employers who don't want to cover that much. It depends on their situation, and whether they know if a big claim is likely."

Getting The Right Help

While switching to self-funding can create more flexibility and control of cost, employers should be aware of a few changes they will see.

> The advantages of self-funding over fully insured coverage can be significant.

"What happens when a company goes from fully insured to self-funded is they don't just get a bill every month," Jackson said. "They have to wire claim funds for each week that claims are processed by the third-party administrator. The client receives a claim register report advising the amount of claims to be paid and needs to respond within 48 to 72 hours. Their monthly bill is much less, as it only covers stop loss and other administration fees. So for any group moving from fully insured to self-funded, they need to be aware of this potential cash-flow issue. It is important to educate the client on how to manage the process," she said.



Also, a self-funded contract requires the employer to conduct annual discrimination testing in regard to benefits and contributions for non-highly compensated versus highly compensated employees, Jackson said. "It is not as easy to create classes of employees for the purpose of rewarding management or highly paid individuals under these contracts," she said.

Developing processes for reconciling bills and funding claims, updating documents for changes in legislation and choosing the right stop loss insurance coverage can be challenging for employers, especially small and midsize firms that don't have much experience in self-funding. That's where an experienced benefit adviser can help, Jackson said.

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“Stop loss is so important, and employers need someone who can look at all the particulars, to understand the liability and to know what protections are in place. A thorough review of these contracts is very important,” Jackson said.

“Advisors also help to calculate reserves, develop financial projections, negotiate rates and fees, and use benchmarking tools to create a plan design that fits the objectives of the client,” she added.

Getting the right help from the start can help employers — even smaller ones — make a smooth transition to a funding strategy that will allow them to create a flexible and cost-effective health care plan, which can be leveraged to recruit top talent and retain employees, Calise said.

“There are a lot of moving pieces to consider [in self-funding], such as wellness programs, stop loss coverage and other risk factors, and employers should seek the advice of an advisor or benefit consultant,” Calise said. “There can be a lot of pitfalls if not administered properly.”

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