Self-Insurance

for Group Benefits Programs

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1. Nature of Self-Insurance

Self-insurance is basically a process whereby the plan sponsor assumes the financial responsibility for the payment of benefits to plan participants and their dependants.

Legal Considerations

Provincial statutes tend to define insurance as “the undertaking, by one person, to indemnify another person against loss or liability for loss in respect of a certain risk or peril to which the object of the insurance may be exposed, or to pay a sum of money or other thing of value upon the happening of a certain event, and includes life insurance” (*Insurance Act, Ontario, Section 1*).

These statutes also mention that no person shall engage in an act constituting the business of insurance in the province without a proper licence (e.g., *Insurance Act, Ontario, Section 40(2)*). An exception is generally made for trade unions that, under the authority of their incorporating Act or charter, have an assurance or benefit fund for the benefit of their own members exclusively.

The Quebec Insurance Act is slightly different as it includes in its definition of an “insurer” anyone who undertakes to pay insurance benefits or mutual benefits, excluding any professional syndicate authorized to do so. On the other hand, as the Quebec law does not define “insurance”, we can either rely on the traditional definition of insurance, whereby to have insurance, you need both the indemnity process and a premium, or consider Section 2389 of the Quebec Civil Code, stipulating that “A contract of insurance is a contract whereby the insurer undertakes, for a premium or assessment, to make a payment to the client or a third person if a risk covered by the insurance occurs”.

Recent Legal Developments

Federally Regulated Employees

In 2012, the Federal government passed legislation requiring long-term disability plans covering federally regulated employees to be insured by a licensed insurer. This legislation took effect on July 1, 2014. Federally regulated employees mainly include employees working for employers such as banks, marine shipping, air transportation, interprovincial and international transportation by rail, road or pipeline, radio and television broadcasting, telecommunications (phone, cable, etc.), federal Crown corporations.

This legislation deals with disabilities beginning on or after July 1, 2014 only.

Ontario

The 2014 Ontario budget was passed on July 24, 2014, amending the Insurance Act by adding Section 115.1.

Under this section, that will become effective at a future date not yet determined (as of February 2016), "Except as provided in the regulations, no person shall provide long-term disability benefits in Ontario unless the benefits are payable under a contract of insurance undertaken by a licensed insurer". However, a pension plan will be allowed to provide disability benefits. By "long term disability", the legislator means benefits payable to an individual for a period of not less than 52 weeks or until recovery, retirement or death, whichever period is shorter.

Alberta

Former employees of Nortel Networks are currently (2015-2016) lobbying to convince the Alberta government to pass legislation requiring companies incorporated in Alberta that offer long-term disability benefits to their employees to have these benefits insured with a licensed insurer.

Who Can Self-Insure?

Based on the legal considerations presented above, there seems to be a consensus that employers can self-insure their group insurance programs (except LTD for federally regulated employers and eventually Ontario employers regarding employees in Ontario) as long as they do not require their employees to pay any premium. In this situation, one can say that the employer, among its employee benefits package, provides either for the reimbursement of medical/dental expenses or pays some form of salary continuance to a disabled employee or pays a death benefit upon the death of an employee.

If the employer requires the employees to pay a premium toward a self-insured plan, the situation becomes similar to a "real" insurance program (by contrast with a "benefit" program). It is not clear whether such a situation would be considered as doing insurance without a proper license.

A trade union can presumably self-insure as long as it has an assurance or benefit fund and has no members in Quebec, unless it is a professional syndicate.

In line with these considerations, self-insured plans are found mostly among employer-pay-all plans (especially Health Care Spending Accounts), and mostly for health, dental and short-term disability benefits.

2. Forms of Self-Insurance

Self-insurance comes under two different forms: “pure” self-insurance and partial self-insurance.

Pure Self-insurance

With pure self-insurance, the plan sponsor bears the full risk related to self-insurance. For each self-insured benefit, the risk is two-fold:

- The claims frequency can be higher than expected
- Claims can be larger than expected

To illustrate this latter point, let us take a look at the order of magnitude of the maximum amount at risk for an employee earning $50,000/year and covered under a typical group insurance plan:

- Life insurance (assuming 2 x salary): $100,000
- Acc. Death / Dismemberment (assuming 2 x salary): $100,000
- Short-term disability (15 weeks at 75% of salary): $10,817
- Health: up to $100,000 or more (only for prescription drugs, according to data from the Société de compensation en assurance-médicaments du Québec; this figure is expected to increase with the development of new expensive drugs), though it is rather improbable to have a certificate claiming more than $25,000
- Dental: up to the maximum provided in the plan documents (typically a few thousand dollars)
- Long-term disability (40 years at 2/3 of salary, indexed at a rate equal to the discount rate, for the sake of simplicity): $1,333,333

As can be seen from the above example, certain benefits can be expected to be subject to wide fluctuations in their claims experience.

Partial Self-insurance

To alleviate the impact of potentially devastating claims fluctuations, it is possible to supplement a self-insured plan with an insured mechanism such as a Large Amount Pooling arrangement or an Aggregate Stop-loss.

Large Amount Pooling

With large amount pooling arrangement, the plan sponsor contracts with an insurer that, in exchange for an appropriate premium, will take responsibility for the portion of each claim that exceeds a predetermined threshold in a given year. This approach is found mostly with plans covering health care expenses, where the threshold is often a specified dollar amount per type of certificate (single vs family vs other).

A large amount pooling arrangement allows the plan sponsor to take advantage of the pooling capacity of the insurer and protects the sponsor against unexpected large individual claims. However, it does not protect the plan sponsor from the risk of a higher frequency of claims nor does it protect the sponsor against the risk of a systematic increase in the severity of claims, as only portions of very large claims are to be pooled.

Aggregate Stop-Loss

With an aggregate stop-loss arrangement, the plan sponsor contracts with an insurer that, in exchange for an appropriate premium, will take responsibility for all claims, in a year, that exceed a predetermined aggregate threshold. To account for possible fluctuations in the size of the group or in the amounts covered during a year, the threshold is frequently set as a percentage (anything from 80% to 125%) of the expected claims or of the expected cost. Expected claims are, in turn, determined by applying unit factors to a basis such as the number of certificates covered (for health & dental; with different factors being used for single vs family or other coverage) or the total amount of “insurance” equivalent, for death and disability benefits.

A self-insured plan supplemented by a stop-loss is often referred to as a “Minimum Premium Plan”.

By stabilizing the overall cost of a partially self-insured plan, an aggregate stop-loss addresses both the risk of higher frequency of claims and the risk of higher severity of claims.

3. Administration

Totally self-insured plans and the self-insured portion of partially self-insured plans require a framework for administering the self-insured benefits. This is usually done through an “Administration Services Only” (ASO) arrangement.

Administration Services Only Arrangement

An ASO arrangement is an arrangement whereby the sponsor of an employee benefit plan contracts with an outside provider (typically a life insurance company or a third party administrator (TPA)) to purchase services related to the administration of the plan. Typically, these services are centered around claims adjudication and may also include the maintenance of data regarding the participants and their dependants, beneficiary records, billing to the plan sponsor, fund advances, etc.

These arrangements are found with both totally and partially self-insured plans.

To avoid legal issues, plan documents must state clearly that the plan is self-insured and that the administrator is not acting as an insurer.

4. Reasons for Self-Insuring a Group Benefits Plan

Reasons for self-insuring a group plan are various and range from cost advantages to convenience.

Cost Savings

Tax Savings

For a certain period, in the late 1980s and early 1990s, self-insured plan had a tremendous tax advantage as they were not subject to sales tax nor premium taxes in Quebec and Ontario. This tax advantage has now been long gone, except for provinces other than Quebec, Ontario and Newfoundland, where a self-insured plan is still exempt from the provincial premium tax (typically 2% to 3% of premiums).

In Manitoba, the retail sales tax does not apply to ASO disability claims and fees (nor does it apply to health care claims and fees) even though it applies to premiums for group short-term and long-term disability insurance. This constitutes a significant incentive for self-insuring these benefits.

Savings on the Insurer’s Risk Charge

As there is no risk on the self-insured portion of the group plan, there is presumably no need for a risk charge. Since this charge typically varies between 0.5% and 2%, this would be a further savings for the plan sponsor.

However, this reasoning may be too simplistic. If we assume that, for example, on health insurance, claims will fluctuate between 80% and 120% of the expected, then, if you self-insure only the first 80% of the expected claims, would you really expect to save the risk charge on this portion of premium equivalent? Probably not, because the insurer's risk just doesn't change. If the insurer faces the same risk of fluctuation, but collects only the portion of the premium that corresponds to claims over 80% of average, the insurer will simply need to spread the same dollar risk charge over a smaller premium.

Savings on the Insurer's Profit Charge

As there is no risk for an insurer on a totally self-insured group plan, there is no MCCSR requirement, and no resulting minimum profit charge. As a result, the plan sponsor may make a savings that corresponds to approximately 1% of claims.

For a partially self-insured group plan, the underlying risk for the insurer is not much different than for a traditionally insured plan and the MCCSR formula allows a credit only for an arrangement where the plan sponsor has a legal obligation to repay the insurer for an eventual deficit (such as a "Hold Harmless Agreement"). As a result, assets are required to support the MCCSR attributable to the plan and the insurer must invest these assets in safe, low-income financial instruments, and charge the opportunity cost of this capital to its client through the profit charge. In this situation, there are no savings for the plan sponsor.

Investment Savings

Under a self-insured plan, reserves are held and invested by the plan sponsor. The plan sponsor saves the investment expenses that would have been charged by the insurer if the plan had been conventionally insured. He also has the opportunity to invest the reserves in assets that produce a better return than the investments made by the insurer that are typically safe, low-income, investments such as bonds or bank deposits.

Source of Capital

The reserves of a self-insured plan can even be invested in the sponsor's business and achieve a return equivalent to this business's internal rate of return. Moreover, by investing the plan reserves in its business, the plan sponsor may avoid borrowing money at a higher interest rate than the rate that he may pay on the reserves.

On the other hand, when the employer is in difficult financial situation, such as Nortel Networks in the early 2000s, investing the reserves in the plans sponsor's business may not be the best option.

Administration Advantages

Choosing an Administrator

Under a conventionally insured plan, the plan administrator is often the insurer itself. In this situation, the plan sponsor may end up with an insurer who has a high administration cost if this insurer has the lowest premium rates. Only large groups can use a Third Party Administrator while being conventionally insured. On the other hand, under a self-insured plan, the sponsor can select the plan administrator among a number of insurers or third party administrators. The criteria for selecting the administrator are its efficiency, the quality of its systems and the cost of handling claims, along with the general administration cost, regardless of the underlying claim cost. It is thus theoretically possible to have a better administrator with a self-insured plan.

Flexibility in Claims handling

Under a self-insured plan, as the plan sponsor is the ultimate payer of claims, he may direct the administrator to pay claims that an insurer would have rejected. This may happen, for example, with problem employees that the employer may want to put away from its business by putting them on short-term disability income. Another example is with unusual medical or dental claims submitted by an executive where the employer may want to reimburse more than the usual and customary amount, as long as the claim is for a service considered eligible for a Private Health Services Plan under the Income Tax Act.

5. Potential Problems with Self-insurance

Self-insurance provides the plan sponsor with some savings and leeway in the design, funding and administration of a group benefits plan. However, there are significant counterparts to these savings and leeway, making self-insurance less appropriate in various situations.

Disadvantages Related to the Lack of Insurance Protection

Risk of insolvency

By contrast with insurance contracts, where an insurer guarantees that benefits will always be paid to anyone who became entitled when the group policy was in force, the promise to pay benefits under a self-insured plan is enforceable only to the extent that the sponsor is able to pay. Also, if an insurer becomes insolvent, Assuris will guarantee that a major portion of any benefits owed to plan participants will be paid. On the other hand, no self-insured plan can benefit from the protection of Assuris.

Even though a plan sponsor may be solvent when a self-insured plan is established, there is no guarantee that it will remain solvent forever, as disabled employees of Massey Combines, Eaton's and Nortel Networks have learned the hard way.

In these three instances, the Long Term Disability was self-insured and not funded. As a result, when Massey Combines went bankrupt in 1988, more than 350 disabled employees lost their LTD benefits. Then, in 1999, when Eaton's went broke, 160 more disabled persons lost their LTD benefits. Finally, at Nortel Networks, a further 400 disabled employees received their final LTD benefit payment in December 2010. In this last case, an agreement provided that the disabled employees would recover approximately one-third of the amounts owed to them. This proportion would have reached something close to 50% if the Supreme Court had agreed to hear an appeal to redirect to disabled employees money currently set aside for retirees' death benefits. The Supreme Court declined to hear this appeal.

This situation is due to the fact that when an employer goes bankrupt, claims by employees for money promised under a self-insured plan are not considered as priority claims but rather as ordinary claims, just like anyone else who is being owed money by the bankrupt entity.

According to the Canadian Life and Health Insurance Association, uninsured plans provided 1.1 million people with LTD protection in 2008 and these plans paid income replacement benefits to 23,000 disabled employees.

Cost fluctuations

With a totally self-insured plan, there is no claims fluctuation reserve or rate stabilization fund. As a result, the sponsor pays the full cost of benefits each year. If there are significant experience fluctuations, the cost will fluctuate accordingly. On the other hand, with an insured plan, the cost supported by the sponsor is limited to the amount of premiums agreed upon at the beginning of the plan year.

Limited Pre-Funding

There is currently no tax advantage related to pre-funding self-insured benefits. The only tax relief available comes from using a Health & Welfare trust. However, this relief is rather limited if the trust is used to pre-fund LTD benefits as it is allowed to deduct benefits and administration expenses from the interest earned. In the accumulation phase of a LTD plan, tax relief would be minimal.

Legal Issues

If the plan sponsor requires the employees to contribute toward the cost of a self-insured program, there is a risk that the plan sponsor might be considered as doing insurance without being licensed to do so. However, the author of this study note is not aware of any legal decision rendered by a Court on this particular issue.

Taxation of the First $10,000 of Self-Insured Death Benefits

While the tax savings associated with a self-insured plan concerns the premium tax in provinces other than Quebec, Ontario and Newfoundland, certain employers are trying to escape all taxes on the first $10,000 of life insurance per person, by self-insuring this amount. By doing so, they take advantage of the $10,000 income tax exemption on death benefits paid by the employer as provided for in Section 248(1) of the Income Tax Act. As a result, no income tax applies to this self-insured amount.

Sales Tax on Claims or Premiums

Now, the fact that no income tax applies to the first $10,000 of self-insured death benefit does not necessarily mean that sales taxes or premium taxes do not apply.

In Ontario, the 8% retail sales tax is payable on the "premiums" of a benefits plan. Such premiums are defined as including "any amount paid by the planholder by reason of the occurrence of a risk, less any amounts paid to the planholder by members in order to receive benefits under the plan".

In Quebec, the 9% insurance tax applies to any amount of benefit paid upon the occurrence of a risk and that could otherwise be obtained by taking out a contract of insurance, whether the benefits are partly insured or not. The Quebec government makes a distinction in the application of the 9% tax on the first $10,000 of self-insured death benefit:

- If there is a formal plan promising a self-insured death benefit, then the 9% tax applies;
- If there is no formal plan and no promise to pay, and if the employer makes the decision to pay $10,000 on a case-by-case basis, then the 9% tax would not apply.

Premium Tax

In Ontario, Section 74.2 of the Corporations Tax Act applies the 2% premium tax on benefits and administration fees of any unfunded self-insured plan which gives protection against risk to an individual that could otherwise be obtained by taking out a contract of insurance, whether the benefits are partly insured or not, and under which the payment

of benefits is made directly to or for the benefit of a member of the plan, upon the occurrence of a risk. Quebec has a similar provision on both its 3% premium tax and its 0.48% compensatory tax. As a result, self-insuring the first $10,000 of life insurance does not prevent the premium tax from applying, at least in these provinces.

Taxation of Expenses under a Pure Self-Insured Plan

While the only sales taxes that apply to conventionally insured group insurance plans are the Ontario 8% Retail Sales Tax, the Quebec 9% Insurance tax and Manitoba 7% Retail Sales Tax, administration expenses under a pure self-insured plans are subject to the 5% GST in Manitoba, Saskatchewan, Alberta, British Columbia and the Territories, to the HST (15% in the Atlantic Provinces, 13% in Ontario) and to the Quebec 9.95% Provincial Sales Tax. As a result, a pure self-insured plan is charged 5% more (6% in Quebec) on its administration expenses than a conventionally insured plan.

Reserve Issues

Existence and Level of Reserves

As there is no obligation to pre-fund a self-insured plan and no tax advantage of doing so, there is typically no money set aside for funding reserves for claims incurred but not reported (IBNR) or claims in course of settlement (Short-term or Long-term disability). Should the plan may become insolvent, there may be no money left to pay IBNRs.

Even if reserves are set up, they may be claimed by other creditors and not be available to pay the benefits for which they were set up.

Accounting Issues

Under Chapter 3462 of the CPA (Chartered Professional Accountants) manual, an employer must determine a liability for post-employment benefits. This includes self-insured disability benefits and Health and dental benefits for disabled employees and survivors. This requirement does not apply to benefits provided to active employees in the current reporting period or within 12 months thereafter.

As a result, with a self-insured plan, the plan sponsor needs an actuary to at least determine the liability for benefits payable to disabled and to retired employees. Even though there is no obligation to calculate other reserves, such as health and dental IBNR, the underlying liability still exists since, should the plan terminate, the sponsor would still be liable for IBNRs.

Administration Issues

Litigation

As the third party administrator (an insurer or a specialized TPA) is paying benefits in the name of the plan sponsor, any disappointment on the part of a claimant under a self-insured plan is directed to the plan sponsor. Accordingly, any lawsuit related to the non-payment of benefits will be directed against the plan sponsor.

Confidentiality

Participants may also be uncomfortable with the fact that a self-insured plan sponsor may have access to personal and confidential information that would be kept confidential by the insurer if the plan were insured.

Expertise of Third Party Administrator

Insurers typically have a huge volume of business. As a result, their claims-paying personnel tend to be well-trained, with efficient claims administration systems. The cost of developing/maintaining these systems is spread over the insurer's client base. It may be difficult, for smaller, non-insurers, third party administrators to match the level of efficiency of an insurance company.

Disability Management Services

With their large volume of business, insurers have more experts in disability management than most non-insurer third party administrators. Disability management may also look more objective when it is done by someone (an insurer) who is independent from the plan sponsor.

6. Ethics

In the wake of the Nortel, Eaton and Massey cases, where disabled employees lost a significant part of their LTD benefits, any actuary contemplating self-insurance of LTD benefits must be extremely cautious.

Rule # 1 of our Rules of Professional Conduct specifies that "A member shall act honestly, with integrity and competence, and in a manner to fulfil the profession's responsibility to the public and to uphold the reputation of the actuarial profession". One can question to what extent recommending self-insurance for LTD is fulfilling our responsibility to the

public when the employer goes bankrupt and disabled employees lose a significant portion of their LTD benefit.

Actuaries should not hesitate to communicate with the Committee on Professional Conduct of the Canadian Institute of Actuaries if they have any doubt regarding the ethical aspect of their work.