



BENEFITS PERSPECTIVES

Current Issues in Employee Benefits

Short-term disability: To be or not to be (self-funded)?

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While slightly less dramatic than the question posited by the great bard William Shakespeare, the decision of whether or not to insure one's short-term disability (STD) plan is nonetheless a weighty one. When considering a switch from an insured plan to a self-funded plan, or vice versa, there is no single all-purpose solution. What is right for a particular employer depends on a slew of considerations, including the employer's size, risk appetite, historical STD experience, desired plan design, cost considerations, and available resources.

Employer size

STD plans typically pay a portion of lost income when an employee is disabled due to illness or injury. Usually STD covers the period of time between when sick leave/paid time off runs out and when long-term disability (LTD) benefits begin. Compared with life insurance or LTD insurance, STD is a high-frequency and low-severity benefit (i.e., there are many claims with relatively low benefit amounts, similar to most medical claims). This means that even smaller employers can quickly develop meaningful historical experience. Insurers generally consider STD claims experience to be fully credible at roughly 500 to 1,000 lives (varying by insurer and by benefit waiting period). This means that for a group with 500 or more employees, the insurance company will estimate the group's future claims based primarily on that group's past paid claims. This does not mean that future claims will be exactly equal to past claims; it means only that past claims are stable enough to be a useful predictor of future claims.

Due in part to this stability in claims experience over time, larger employers tend to be more likely to self-fund their STD benefits than smaller employers. For an employer with, say, 50 lives, STD claim payments could swing dramatically from year to year, making budgeting for these costs difficult. An employer with 5,000 lives, on the other hand, may expect claim payments to remain fairly stable from year to year.

Risk tolerance

Another consideration is the employer's tolerance for risk. Even with a large and fully credible group, STD claims experience will change from year to year due to random volatility (as well as for other reasons, such as a particularly nasty flu season). With an insured plan, on the other hand, the premium to be paid is determined in advance, so the employer knows exactly what it will pay for STD coverage. The annual volatility risk is borne by the insurance company (although longer-term experience trends will ultimately be reflected in the premium rates charged by the insurer).

When choosing to self-fund, an employer should monitor its STD plan experience over time. Periodic experience studies help the employer understand how its plan is performing and make adjustments as needed. Such modifications may include revising the rates charged to employees or groups for the coverage, adjusting the liability calculations for claims that have been incurred but not yet fully paid, and reevaluating plan design and claim management practices. These types of studies may require the help of actuarial and financial resources. With an insured plan, the insurance company handles these functions.

A survey of state government websites shows that even larger employers sometimes opt to insure their STD benefits. Table 1 on page 2 shows the proportion of state governments in each size group that have insured STD plans versus self-funded plans. Data is included for 15 states where STD coverage is provided to all employees and where the STD funding status was readily determined from the state's website. Although state governments are larger than many other employers, the general pattern of insured plans among smaller employee groups and self-funded plans in larger groups is reflective of patterns in other industries as well.

TABLE 1: FUNDED STATUS OF 15 STATE STD PLANS

NUMBER OF STATE FULL-TIME EMPLOYEES	INSURED	SELF-FUNDED
Under 40,000	60%	40%
40,000 to 59,999	40%	60%
60,000 or more	0%	100%

Plan design

Employers that decide to self-fund their STD benefits have more freedom to determine the details of their plan design. STD insurers do offer a range of choices, including, for example, common plan design elements such as benefit percentage, benefit period, benefit waiting period, definition of disability (24-hour coverage versus off-job-only coverage), and minimum and maximum benefit amounts. They also allow for the addition of supplemental benefits such as:

- Retroactive benefits, which pay benefits to cover the benefit waiting period (provided the insured remains disabled through the end of the waiting period);
- First-day hospitalization coverage, which waives the benefit waiting period when the employee is hospitalized; and
- Survivor benefits, which pay a multiple of the employee's monthly benefit to a surviving spouse if the employee dies while disabled.

When designing a plan for its employees, an employer should consider how the STD program interacts with other leave programs. Ideally, STD benefits should coordinate seamlessly with sick pay, vacation/paid-time-off (PTO) time, salary continuation, leave under the Family and Medical Leave Act (FMLA), and LTD benefits to provide the best protection for employees who find themselves unable to work due to illness or injury. A well-designed STD plan can ensure that all employees have adequate protection throughout the course of their disability. Approaches such as extended sick-pay plans can leave many employees with gaps in coverage, while prolonged salary continuation can reduce the incentive to return to work. Coordination of STD benefits with other types of leave may require creative benefit design solutions. An insurer may customize the plan design for a very large employer, but would be less likely to do so for a smaller one. With a self-funded plan, the employer has the freedom to determine the plan design that is best for its employees and for its business.

Some employers may opt for a voluntary STD benefit program. In that case, employee communication becomes an important piece of the puzzle. If employees do not understand the benefits being offered to them or don't know how to enroll, participation in the plan could be very low. Low participation, in turn, leads to higher average costs per plan participant as the result of adverse selection, a situation in which employees with a high expectation of receiving STD benefits (due to poor health or a planned pregnancy,

for example) are more likely to enroll in the plan than employees who perceive themselves as less likely to receive benefits. With an insured plan, the insurance company can help to provide materials and support for educating and enrolling employees in the plan. With a self-funded plan, the employer may wish to enlist the help of outside resources with expertise in the area of employee communications or enrollment methods.

Cost considerations

Often the most compelling reason for an employer to opt for a self-funded STD plan is to reduce costs. In exchange for taking on additional risk on behalf of the employer, the insurance company will expect to collect a profit, typically in the range of 5% to 10% of premium. There are also more subtle cost considerations at play. In addition to the profit margin, insurers often must pay commissions to agents and brokers to sell the coverage. This cost could be as high as 15% for very small plans, and would grade down to 1% or less as group size increases. Insurers are also required to pay a premium tax to the state, which is roughly 2% of the total premium. These extra costs are added into the quoted premium and ultimately paid by the employer. Self-funded plans do not have these particular additional expenses.

Table 2 illustrates the general differences in expenses (not including benefit payments) for insured versus self-funded STD plans. This cost comparison is for a hypothetical plan for a group with about 10,000 lives and considers only the particular expenses illustrated; any employer considering such a change should develop a similar comparison based on the characteristics of the employer's own organization and expected or other related expenses.

TABLE 2: ILLUSTRATIVE EXPENSE DIFFERENCES FOR INSURED VS. SELF-FUNDED STD PLANS

EXPENSE CATEGORY	FULLY INSURED	SELF-FUNDED
Broker Commissions	1%	0%
Premium Tax	2%	0%
Profit	7%	3% (risk margin)
Claim Administration	14%	15%
Other (e.g., eligibility determination)	1%	2%
Total Expenses	25%	20%

In this example, opting for a self-funded plan over an insured plan would be expected to save the employer roughly 5% of total plan costs in decreased expenses.

Employers may also gain some cash-flow benefits from self-funding. While insurance premiums generally need to be paid at the beginning of the coverage period, STD benefits for a self-funded plan are not paid out until each claim is actually incurred. Employers with a self-funded plan would also be able to collect interest on assets set aside to cover the future cost of existing and new claims.

On the other hand, insurance companies are experienced at STD claim management, specifically in getting employees back to work as soon as possible and thereby minimizing cost. They use a variety of techniques, including medical bill reviews, reviews of medical treatment plans, rehabilitation programs, workplace modification and case management, along with fraud investigations. Employers may not have the same level of expertise in claim management and may therefore be expected to have higher benefit costs when managing claims in-house. In fact, this difference could actually be so large that a smaller employer could see total STD plan costs *decrease* when moving from a self-funded, self-administered STD plan to a fully insured plan.

Additionally, if the employer does not have the infrastructure to support STD claim management, it can be costly to hire and train the necessary staff. Best practices in STD claim management might draw on resources such as nurses and rehabilitation specialists who can evaluate medical information and provide direct assistance in developing return-to-work plans. For a smaller employer, the financial and opportunity costs of administering the STD plan in-house could be prohibitive. It can also be difficult for an employer to make objective decisions regarding its own employees, particularly in smaller firms in which "everyone knows everyone." Fortunately, there is no shortage of organizations that are willing and able to manage the administration of an employer's self-funded STD plan.

In a nutshell

There are many factors to consider when determining whether an insured plan or a self-funded plan is better for a particular employer. Generally speaking, the larger the employer, the more likely self-funding is a viable option for STD benefits, but that doesn't mean that a smaller employer can't benefit from self-funding or that a very large employer shouldn't opt for an insured plan. Before a decision is made, each employer should carefully consider its risk appetite, historical claims experience, and available resources, as well as its desired plan design and expected expenses. This decision may also need to be reconsidered as any of these factors change over time. With a well thought-out decision and close monitoring of its STD program, a savvy employer need not suffer the slings and arrows of outrageous fortune.



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