INFORMATION MEMO

Self-Insuring Workers’ Compensation

Find out how the League of Minnesota Cities Insurance Trust (LMCIT) can help cities with workers’ compensation premiums over $250,000 evaluate whether self-insuring is worth considering. Understand loss development, the special compensation fund, projecting next year’s losses and accounting issues.

I. LMCIT assistance in self-insurance analysis

Cities with workers’ compensation premium costs over $250,000 may wonder if self-insuring is the right option. Sometimes consultants, agents, and third-party administrators push the idea very aggressively.

In the right circumstance, self-insuring can be an effective way for a city to handle its workers’ compensation exposure. For this reason, LMCIT is more than willing to work with a city that is interested in self-insuring by providing:

- Actuarial loss data to help the city evaluate its loss exposure and the economic feasibility of self-insuring.
- Aggregate excess coverage to protect the city against the risk that total losses will exceed budgeted amounts.
- Excess coverage with a lower attachment point than that available from the Workers’ Compensation Reinsurance Association (WCRA), to help control the year-to-year volatility of loss costs.

The decision to self-insure shouldn’t be made lightly. Self-insuring has long-term consequences and carries significant risk. A permanently disabling injury could require the city to make weekly benefit payments for many years. For example, LMCIT presently makes payments on an injury that occurred in 1980. Because liabilities for workers’ compensation injuries can affect the city’s finances for many years in the future, it is very important to understand and evaluate carefully the nature and the potential extent of the risks the city is retaining when it decides to self-insure.

A key question, of course, is which approach is the most economical way for the city to address its workers’ compensation exposure. Unfortunately, simply comparing a "projected" cost of self-insurance with the annual premium doesn’t necessarily give a complete picture.
II. Loss development

Member cities receive a loss run from LMCIT which shows the total current estimated cost of each incurred claim for each year. The incurred cost of each claim includes both the amounts already paid on that claim and the "reserve," which is the amount estimated to still be paid on that claim. Each claim is periodically reviewed, and the reserve estimates are revised if necessary.

The figures shown on the claim run represent the adjuster’s best current estimate of the total ultimate cost of that claim. But until the claim is closed, the figures are estimates. The actual ultimate cost will almost always be different; sometimes lower, sometimes higher. Sometimes too, a claim closes but later reopens, which means the final cost of that claim is going to be more than what was previously projected. And sometimes injuries simply aren’t reported until some considerable time after they occur.

It is extremely important to understand the concept of loss development when considering self-insurance. In practical terms, it means that even though the loss run shows the best current estimate of the total ultimate cost of the city’s claims for a given year, the actual ultimate cost will almost certainly turn out to be different. On the average, the real ultimate cost will turn out to be more than whatever the current estimate is.

By studying the patterns of how these incurred loss estimates have historically grown over time, LMCIT’s actuaries can estimate how much its current estimates are likely to increase in the future. LMCIT’s premium rates consider this projected loss development, and are designed to fund that cost. Because of this, when a city compares its reported claims with its premiums for a relatively recent year, the premiums may very well be substantially higher than the reported claims. If a city only looks at its current reserves, it can appear that self-insuring might be much cheaper. However, it’s likely that the final total claim costs for that year will almost certainly be different from what shows on the loss run, and chances are it will be higher.

A common way to evaluate self-insurance as an option is to look at how much it would have cost the city in past years based on the actual reported claims for those years. However, it’s important to keep loss development in mind and to factor it into all calculations. One way to do this is by applying projected development factors which LMCIT’s actuaries have calculated for LMCIT’s overall claims to the city’s claims.
For an individual city’s claims, though, these kinds of estimates have a very wide margin of error. LMCIT can be reasonably confident that by time all claims are closed, the ultimate total indemnity costs on LMCIT’s indemnity claims in recent years will probably be about 30 percent more than current total paid costs plus case reserves. Applying that same development factor to an individual city’s 10 or 12 indemnity claims for a recent year is one way for the city to determine a plausible estimate of its ultimate claim costs for that year; but, the city needs to recognize that final costs on those claims may vary widely in either direction from that projection.

Consider, for example, a back injury which now looks like a minor strain. If it turns out later to be a more serious problem requiring surgery, a $5,000 claim might suddenly be a $50,000 claim.

In summary, three key points to keep in mind are:

- The ultimate cost of the city’s claims for any given year is likely to be different than the current best estimate of the cost of those claims.
- For an individual city, the variation in ultimate costs can be substantial as a percentage of the total.
- The variation can be in either direction, but it’s more likely the ultimate cost will be greater rather than less.

### III. Special compensation fund

Anyone who pays workers’ compensation benefits to employees is also responsible for paying assessments to the state Special Compensation Fund (SCF). For self-insurers, those assessments are based on the amounts paid as indemnity benefits to injured employees. The rate is adjusted periodically.

Indemnity benefits typically are about 30 percent of total workers’ compensation claim costs. Thus, a quick rule of thumb is that SCF assessments will on the average add about 10 percent to claim costs. Of course, an individual claim may vary from that average. If an employee with dependents is killed on the job, the claim may be almost entirely indemnity benefits with very little medical cost.

SCF costs are not considered part of the claim for purposes of the excess coverage provided by the WCRA. Thus, even if the city buys WCRA coverage at the lowest retention option, a single claim could easily cost the city more than that amount.

It’s also important to remember that SCF costs are subject to development as well, since they’re based on indemnity payments. If a city’s indemnity claims turn out to be more than its current estimates, the city’s SCF assessment costs will grow along with the claims.
IV. Employer’s liability

The workers’ compensation statute precludes most tort claims against an employer for injuries to an employee, but there are a few ways such claims can occur. For example, if an employee is injured while operating a piece of equipment, the employee may collect workers’ compensation benefits from the city and decide to sue the equipment manufacturer for injuries that may have been caused by poor product design. The manufacturer in turn sues the employee’s supervisor for negligent supervision.

WCRA does not cover the city’s potential tort liability for injuries to an employee. Therefore, the city must self-insure this exposure, or find a provider that will write a supplemental policy for this risk. LMCIT can provide coverage to cities that self-insure.

V. Projecting next year’s losses

To project the cost of a self-insured approach, the city must estimate what the cost of next year’s claims will be. One common approach is to base the estimate on what the city’s actual losses in the past three to five years or so have been. While this technique is a reasonable approach, it can produce misleading results if a couple points are overlooked. It’s important to keep in mind the limitations of this or any other method of projecting probable losses in a future year.

In using past loss data to project future losses, it’s again important to keep loss development in mind. Remember, the goal is to project the ultimate cost of loss for that future year. If a city is trying to do so based on annual loss figures for past years, this means the city needs to use the projected ultimate costs for prior years (i.e., the total current incurred plus an adjustment for projected loss development as described above). Using only the raw numbers shown on the loss run is to ignore the possibility of future loss development which in turn would result in understating the likely ultimate cost of a self-insurance program.

Inflation is also a factor, especially when projecting medical costs. For the past couple years, LMCIT’s average medical cost per claim has increased about 8 percent per year, and there’s no sign medical inflation will ease in the near future. Since indemnity benefits are based on wages, the indemnity benefit trend should roughly track the city’s salary increases. The key point is that an injury now will likely cost more than that same a couple years ago.
It’s important not to confuse the trend in claims from year-to-year with the development of claims in any one year. In other words, when using past loss history to project future losses, the city needs to remember to make two adjustments to those past loss figures. First, apply a development factor to get a reasonable estimate of the likely ultimate cost of each of those past years’ claims. Second, apply a trend factor to reflect the year-to-year increase in the average cost of a claim.

**VI. Uncertainty of loss projections**

A sound technique for projecting city’s losses is to start with past loss history and apply appropriate development and trend factors to develop a projection of next year’s losses. It’s important, though, to be aware of the limitations inherent in that technique because it can only produce a projection, not a prediction. This kind of technique will show what next year’s losses would be if next year were like past years, but next year may or may not be like past years. The larger the numbers involved, the more likely it is that next year will resemble past years.

For a group the size of LMCIT, loss projections based on past experience can be reasonably certain. For an individual city, projections are less certain, and actual losses can vary a great deal in either direction from the best projection possible.

Sometimes standard statistical techniques are used to project the likelihood of losses, and such techniques can be useful in developing funding targets for a self-insurance plan. But, those techniques need to be applied properly. For example, to apply standard deviation techniques to calculate the likelihood that losses will be less than a specific amount, one needs to consider the shape of the severity curve (i.e., how frequently losses of a specific severity actually occur). Workers’ compensation loss severities don’t follow a "normal" or "bell curve" distribution.

It’s also important to be careful about the conclusions drawn from these calculations. If the calculation says there’s a 98 percent likelihood that losses will be less than “x” dollars, it’s tempting to conclude it’s not worth funding for because there is little chance of costs being higher. For most cities, though, adding even one WCRA retention level claim in a year would put the total cost well over any projected levels. Remember, if the city’s premium is $250,000, it doesn’t have enough to cover even one loss up to the lowest available WCRA retention, let alone the rest of the city’s losses plus expenses, SCF assessments, and reinsurance costs.
Most often, if a city looks at its last five years or so, there won’t be a catastrophically large loss (i.e., a loss that exceeds the minimum WCRA retention). If those five years don’t contain a catastrophic loss, basing next year’s projection solely on those five years’ experience is equivalent to assuming a big loss won’t occur next year either. Simply assuming it won’t happen isn’t a sound way to plan for the possibility of a large loss. Projecting losses and planning funding based solely on past experience can turn out to be nothing more than a complicated way of assuming nothing bad will happen next year, rather than planning for that possibility.

**VII. City’s loss history**

The city’s annual premium volume is one important factor to look at in evaluating whether individual self-insurance is feasible, but premium volume alone won’t determine whether self-insurance makes sense. If a city’s premiums are high because its experience modification is high, the city may not be a good candidate to self-insure on its own.

The experience modification formula LMCIT uses to determine premiums is designed to respond more to the frequency of claims than to the severity. Several small losses will affect the experience modification much more than one large loss. A high modification means the city has had more claims than the average city with the same payrolls. It’s also means the city may have to improve safety practices. Unless safety is improved, it’s likely the city will continue to experience a lot of injuries. A city that self-insures but also has a high modification is assuming the high risk of injuries rather than transferring it elsewhere. It makes sense to reduce that risk as much as possible before assuming it.

**VIII. Accounting issues**

Governmental Accounting Standards Board (GASB) standards require cities that self-insure to show on their financial statements the accrued liability for outstanding claims relating to a self-insurance operation. The liability can, at the city’s option, be discounted to its present value. GASB does not require the liability be funded, but it’s probably wise for a city to fund those liabilities, since they would otherwise appear on the financial statements as long-term debt. That in turn could affect bond ratings, for example.

A city that self-insures will therefore have to show the total accrued liability, including estimated development and Incurred But Not Reported (IBNR) on its financial statements to meet GASB standards. Cities going into a self-insured program need to ensure the liability for future claims development is accurately estimated and accrued on the city’s financial statements.