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Risk Management

Keys to Self Funding Your Health Plan

Insurance involves the transfer of risk from one entity to another. Without a true risk transfer no insurance exists. A federal appeals court judge once stated in one of his legal opinions regarding whether or not a transaction involved the business of insurance, "All insurance involves risk but all that involves risk is not insurance." It seems that many, in their efforts to market the latest of health care plans are willing to confuse purchasers into believing otherwise.

> *"All insurance involves risk but all that involves risk is not insurance."*

All business transactions involve risk. It is the existence of risk that creates opportunity. The avoidance of risk requires the forfeiture of opportunity. The solid business enterprise wisely manages risk. It does not imprudently avoid risk.

Basic Principles of Risk

The basic principles of risk management state that there are three conditions that should exist in an insurable risk.

1. The risk or occurrence that one is insuring should be unpredictable.
2. The loss resulting from the occurrence is very substantial and unbudgetable.
3. The loss cannot be prevented through control procedures.

Health care benefits do not fulfill any of these conditions. The occurrence of loss in a health care plan takes place when a covered service is rendered. However, coverage under health care plans has become so broad that most losses are reasonably expected. Only large claims are unexpected or unpredictable.

Predictable Risk

> *Risk* **Risk creates opportunity.**
> **Solid business enterprises wisely manages risk.**

The occurrence of claims under the large claim amount is quite predictable. An actuarial rule of thumb states that a risk is credible, that is the past is an excellent predictor of the future, at 2,400 life/months when large claims are pooled. The non-pooled claims of 200 employee lives for 12 months or 100 employee lives for 24 months equal 2,400 life/months of experience.

Historically, insurance companies and Blue Cross plans have experience rated groups of 50 or more lives. A purchaser's renewal was based on their most recent 1, 2, or 3 years of claims history.

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Variation Cannot Be Budgeted For

The second principle of risk management states that the unpredictable risk, if it should occur, should be of such magnitude that its occurrence would result in a loss that is so substantial that it cannot be budgeted for.

Based on the actuarial principle stated above, this is not the case. The random variation is quite small, no more than 15% on a smaller group and quickly reducing to 5% on a group of 200 employee lives.

Health plan purveyors handle this variation in their renewal calculation with an item called 'margin factor'. When they calculate the total cost, they add an extra 5 to 10% to the charge for 'margin'. They are not taking any risk for this variation but rather are passing it directly and immediately to the plan sponsor. The plan sponsor is budgeting and funding for the unpredictable risk of random variation. That same budgeting and funding technique can be applied to a self funded benefit arrangement without the plan sponsor permanently relinquishing the use of the funds.

Large Claims

The other risk is the risk of the large claim. This risk truly involves a risk that is unpredictable, not budgetable, and arguably, not preventable. In an insured plan this is accomplished through 'pooling'. Plan expense calculations will contain a 'pooling charge' and the contract will contain a 'pooling point'. If a 'shock loss' claim occurs, the expense will be charged to the large claim pool and will not be counted against the historical experience of the plan for renewal rating purposes. In exchange for this pooling, some portion of the premium paid is also not counted for renewal rating purposes in determining loss ratios. Some health plan purveyors will carry deficits in the pooling account forward and attempt to recoup such deficits in future renewals. Others handle these deficits on a true pooling basis and do not carry them forward.

The same impact is achieved in self funded arrangements with 'specific excess loss coverage'. Plan sponsors are reimbursed for claims in excess of a predetermined amount. This amount should correspond to the amount determined to be a large claim. There is a premium payable for this coverage. Deficits in this account are not carried forward.

Under any arrangement the plan sponsor is funding the budget for variation in claims. Since all plan sponsors are funding such amounts, one has to conclude that the variation in claims is a budgetable risk. The variation due to large claims is handled through a true insurance or risk transfer mechanism. The payment of periodic premiums in exchange for an effective transfer of risk is used to budget for this occurrence.

Recommended Pooling Levels

Based on $1,000,000 Expected Claims
Based on underwriting guidelines from Excess Loss Carrier

Low End Recommendation: **$55,000**
High End Recommendation: **$110,000**

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Cannot Be Controlled or Prevented

There does exist substantial evidence that occurrences of the events that are reimbursable under a health care plan are controllable and preventable. They are controllable through two sources.

"The existence of unmanageable risk in a health plan exists more in perception than it does in reality."

The first is through effective utilization management which has the effect of controlling the number of occurrences that are reimbursable, by reducing the number of clearly unnecessary services further. Service provider knowledge of the existence of the review process further causes a reduction in the number of services that may be of questionable value. Occurrences are also controllable through effective efforts to change the behavior of end users of services by exposing them to alternative but equally effective treatment choices. If less costly services are sought by end users to begin with, the occurrence of loss will automatically reduce. Disease management, education or patient empowerment and benefit plan design changes can impact end user behavior.

The occurrence of loss can also be prevented. This is accomplished again through changes in end user behavior. The focus in prevention is to modify behavior of the end user which will likely result in the occurrence of a loss. For example, height/weight ratio is generally considered to be an excellent predictor of the general state of health of an individual. As the degree of obesity increases, the state of one's health predictably decreases. Weight loss programs among overweight populations will increase that population's state of health and prevent occurrences of loss within that population. Further, effective management and treatment compliance of persons with chronic diseases can reduce future costs associated with those diseases. Programs that detect the existence of chronic diseases such as diabetes or hypertension are being combined with specific educational and compliance monitoring efforts related to those diseases to reduce the long term impact of those diseases. That reduction prevents losses resulting from use of services related to those diseases.

No Risk-No Risk Transfer

Purveyors of health care plans will often tout the wisdom of relieving a plan sponsor's health plan risk. However, that wisdom is questionable if the risk which is purportedly removed never existed in the first place. The existence of unmanageable risk in a health plan exists more in perception than it does in reality. One needs to analyze the factors of a health plan that make up its risk and understand if the mechanisms in place actually remove the risk or simply shift the risk back to the purchaser in a different form.