Issues To Consider in Self-Funding Long-Term Disability Insurance

Many employers consider self-funding their long-term disability plan as a way to save costs and improve cash flow. The reasons employers most often give for self-funding include:

- improvement of cash flow by the ability to control and use funds normally provided to the insurance company for reserves;
- not having to pay state premium taxes, as self-funded benefit payments and ASO administrative fees are not subject to state premium tax;
- elimination of the insurance carrier’s risk charge.

However, whenever an employer thinks about self-funding its long-term disability plan, there are serious implications to consider. The employer must evaluate whether it is financially advantageous to assume the risk function and weigh the advantages against any adverse economic, tax, legal or employee relations consequences.

Implications of Self-Funding

- **Loss of Third Party Guarantee for Employees**
  
  If an employer self-funds their long-term disability plan, it is responsible for the entire long-term disability liability and the insureds could lose the advantage of having a third party to guarantee benefit payments for covered disabilities. Under an insured program, financial oversight by state insurance regulators helps protect the policyholder and its insureds by requiring that insurers are solvent and have sufficient reserves to handle claim payments.

- **Volatility in Claims**
  
  Volatility due to fluctuations in claim incidence and severity are common in long-term disability coverage. Because there is no risk pooling on a single case, there is no protection against fluctuations which is provided by an insurance company's pool of customers. Because of this, the employer faces the difficulty of budgeting for fluctuations in benefit payments. In addition, the employer also assumes the risk that the overall claims liability could be larger than anticipated.

- **Economic Cycles**
  
  Long-term disability claim costs are often directly tied to the state of the general economy, as well as the economic state of the employer's industry. Long-term disability plans characteristically have both higher incidence and longer duration of claims in periods of high unemployment and downsizing. Poor economic conditions and an alternative income source may curtail an employee's desire to work, especially if there is no job to return to. Often, claim costs will increase at the very time the company's profit structure is suffering—when the employer can least afford additional expenditures.

- **Employee Relations**
  
  Under a self-funded arrangement, the employer maintains the financial liability to pay benefits, and as a result any claim suit is against the employer. This means that the employer is responsible financially and otherwise, for defending the suit. In contrast, suits under an insured plan are generally against the insurance company. The implication of this is that a suit could be viewed as employer versus employee rather than claimant versus contract. This kind of situation could undermine the relationship developed between the employer and its employees.
**Accounting Regulations**

Financial Accounting Standard Board (FASB) #112 requires that employers recognize a liability for self-funded long-term disability benefits. An employer who self-funds may have some cash flow benefits, however, FASB 112 forces the employer to recognize the liability on its balance sheet, which keeps the cash flow from dropping to the bottom line. By contrast, premiums paid for an insured plan are generally fully deductible by the employer.

**Tax Risks**

With trusts, there is a tax risk when maintaining reserves for self-funded benefits. Contributions are limited to paid claims plus a reasonable reserve for incurred claims. The current tax laws do not indicate what is considered reasonable, and there is presently no safe harbor. There are also substantial penalties for making excess contributions to the trust. The IRS will not permit a tax deduction for excessive amounts, any fund earnings attributable to the excessive amount would be taxable, and contributions to the fund in future years could be restricted.

If employers do not set up a trust to pre-fund benefits and pay benefits from current revenues, they still need to recognize a liability on their balance sheet for the value of the accrued benefits. FASB 112 requires that the value of accrued pre-retirement employee benefits (such as disability benefits) be recognized as a liability and this can only be avoided by making disability benefits forfeitable. However, since long-term disability benefits usually vest upon disability (this is required for insured benefits in all states), such a change would require disclosure to employees, who will likely find it unacceptable.

**Benefits of Insuring With A Carrier**

Any employer considering self-funding long-term disability benefits must weigh advantages against the cost of additional management, administrative and financial resources required, the loss of insuring long-term obligations with a strong and financially regulated insurance company, and potential adverse employee reaction to benefits disputes.

Long-term disability is an excellent candidate for insurance because the premium expenditure for a fully insured plan is stable and budgetable. Any one company choosing to self-fund its long-term disability coverage for its employees incurs increased risk due to the potential fluctuations inherent within any single long-term disability risk. The risks are increased when money is used to establish a separate trust for funding any portion of this volatile coverage.

In addition, under the FASB 112 change, self-funded programs must recognize open claims liabilities either on the books of the client company or under the accounting of a trust, if one exists. This change requires that such companies now post these reserves as liabilities on their balance sheets. This standard was prompted by the merger activity seen in the past decade. Many companies did not recognize these liabilities during merger proceedings, which left them with self-funded pensions, medical and disability programs in unbalanced positions. This accounting standard was established to protect against these situations and for this reason alone, many self-funded customers have explored insured options.