Report of the University Senate Ad hoc Committee on the Health Insurance Reserve

(March 15, 2010)

The committee was created to investigate the Health Insurance Reserve and the issue of cost shifting. The members of the committee are Alex Lebedinsky (Chair) Nevil Speer, Indudeep Chhachhi, Mac McKerral, Tony Glisson (Advisory), Jim Cummings (Advisory).

Background. For the past ten years, WKU's health insurance has operated as a self-insured plan. Under self-insurance, an employer collects insurance premiums from its employees and covers all insurance claims. Typically, a third party (in our case, Anthem Blue Cross/Blue Shield) administers the claims (i.e. negotiates the rates charged by health-care providers, files all necessary paperwork, etc.), and the employer' decides which insurance plans to have and what premiums to charge, and collects those premiums and pays the insurance administrator for all medical claims. As a result, the employer saves on the profit margin it would have to pay to an insurance provider if the insurance were purchased from an insurance company. But at the same time, the employer assumes all of the insurance risk. Consequently, the employer has to engage in risk-management activities to cover any unexpectedly high insurance claims. One such risk-management measure is maintaining a health insurance reserve.

An insurance reserve serves a dual purpose: to cover (1) unusually high insurance claims and (2) "runoff" claims. While the first function of the reserve is obvious, the second one deserves additional explanation. A runoff claim is a claim incurred after the insurance plan ceases to exist. As an example, consider the following hypothetical situation: Suppose the state of Kentucky creates a mandatory statewide insurance system for all higher educational institutions. The system starts January 1, 2011, and all insurance premiums are collected by the state. Because insurance claims can take up to three months to settle, the claims against the self-insurance plan that no longer exists can continue to arrive throughout the first quarter of 2011. Because no new premiums are being collected by the self-insurance plan, the claims have to be settled out of the insurance reserve.

Given the two functions of the insurance reserve, it should be possible to determine how much money should be in the insurance reserve yet there are no clearly established estimates on what the size of the Health Insurance Reserve should be. To determine how much is needed to cover runoff claims, we need to know the average amount of time it takes to process claims: If claims take three months to process on average, then you need about 25% of the annual total amount of claims. On the other hand, the amount needed to cover the high claims is much harder to estimate because it depends on the probability of rare but large claims.

Findings of the committee. The committee established the following about WKU's Health Insurance Reserve:

- In May 2005, the Health Insurance Reserve was moved to the WKU Foundation.

- From May 2005 until July 2009, the Health Insurance Reserve was invested in the same fashion as the rest of the WKU Foundation. The Foundation's investment policy is to invest 15% to 35% in fixed income (bonds, CDs); 30% to 65% equity (stocks); 0% to 40% alternative investments (e.g. real estate); 0 % to 10% in cash and reserves.

- Based on the report filed for the November 2009 meeting of the University Senate,

    - there were three major contributions to the Health Insurance Reserve that were made from 2005 to 2007:
      $401,167.68; $2,893,922.69; and $1,000,000.00.

    - between July 2005 and September 2007, the Health Insurance Reserve had an unrealized **gain** of $364,926.09.

    - between October 2007 and September 2008, the Health Insurance Reserve had an unrealized **loss** of $1,168,054.04.

- This committee finds that it is not clear who has and who should have the authority over the Health Insurance Reserve. In short, some of the members of the Benefits Committee did not know that the Health Insurance Reserve asset allocation had been changed – a year after the change had been made. We base this conclusion on the statements of the members of the Benefits Committee and statements and decisions made by WKU administration:

  At the **November 2009** meeting of the University Senate, Alex Lebedinsky asked about losses incurred by the Health Insurance Reserve. Senator Shadoan, a member of the benefits committee, said that the Health Insurance Reserve is invested in the same fashion as the rest of WKU foundation, which had incurred losses. Regent Minter, another member of the Benefits Committee, said, "The money should remain where it is until it breaks even; as long as it remains there, the loss that has occurred over the past year will not be realized. Once it breaks even, we should decide whether we want to make any changes."

  However, as early as **August 2009,** the WKU Foundation had already changed the asset allocation of the Health Insurance Reserve to a more conservative profile. That decision was made by Chief Financial Officer Jim Cummings and Vice President of Finance and Administration Ann Mead in consultation with Executive Director of the WKU Foundation Tom Hiles and Chief Financial Officer of the WKU Foundation Paula Jarboe in a meeting on **October 8, 2008**.

  Mr. Cummings said that the Benefits Committee **had been told** that the investment strategy of the Health Insurance Reserve had been evaluated and that a change to a more conservative investment strategy was under way.

- The committee finds that there are no guidelines that clearly state in what kind of assets Health Insurance Reserve should be invested. Current asset allocation is approximately 77% in cash and fixed income and 23% in equity. A chart describing current asset allocation has been provided by WKU foundation is attached to the report. The committee was not told why this particular asset allocation should be appropriate for a health insurance reserve. Currently, the investment committee of the WKU Foundation decides in which assets the Health Insurance Reserve should be invested. A representative of the WKU Foundation did state that, because Health Insurance Reserve has its own asset allocation, the Foundation can invest it in any fashion (e.g. 100% in fixed income) to meet the risk requirements of the Health Insurance Reserve.

- The committee finds that there are no clear benchmarks on what should be the size of the Health Insurance Reserve. Given the dual purpose of the Health Insurance Reserve, at the minimum the reserve should cover runoff claims. Given the annual volume of health insurance claims paid by WKU's health insurance plan ($11.78 million in 2009 and $10.5 million in 2008), the Health Insurance Reserve should be capable of meeting those obligations. However, if the Health Insurance Reserve is used as a risk management tool, the size of the reserve should be determined by the risk profile of the insurance plan participants. To the committee's best knowledge, **there are no estimates of how much we need to have in the Health Insurance Reserve to cover fluctuations in medical claims**.

  The committee recognizes that such estimate might be hard to obtain due to the relatively small size of WKU's insurance pool. The Benefits Committee employs two consulting companies that provide advice on Health Insurance: Anthem and Neace Lukens. These companies provide the Benefits Committee with estimates of what should be the health insurance premiums for the plans offered by WKU to cover **average** expected claims in a given year. These consultants do not provide an estimate on the likely **range** of values the total claims could be in any given year. According to Claus Ernst, a long-time member of the Benefits Committee, it is not possible to estimate a meaningful such a range: A few large medical claims in any given year can induce large fluctuations in the total amount of paid by WKU's plan. Because it is impossible to predict when such one-time fluctuations occur, conventional actuarial methods are rendered useless.

- The committee finds that there is at least a misunderstanding between the Benefits Committee and the administration of WKU regarding the process of withdrawing money from the Health Insurance Reserve: Mr. Cummings stated that it would be his responsibility to withdraw money from the reserve while Mrs. Minter indicated that any decision to withdraw funds from the reserve has to be made by a committee vote.

Conclusions and Recommendations of the Committee.

- The committee fully supports the decision to change the asset allocation of the Health Insurance Reserve to asset preservation, but we also think the Health Insurance Reserve should have adhered to that principle from the start. Therefore, **we recommend that there should be a clearly articulated investment strategy for the Health Insurance Reserve.** The investment strategy should be directly linked to the purpose of the reserve.

- Because presently there are no clearly established estimates on what the size of the Health Insurance Reserve should be, **we recommend that there should be a clearly stated target for the size of the Health Insurance Reserve.** Such a target is necessary to implement a meaningful investment strategy for it will establish how much of the Health Insurance Reserve should be shielded entirely from any financial risks.

- **We recommend that there should be a clearly stated set of rules under which the money can be withdrawn from the Health Insurance Reserve**. Such rules are instrumental to transparency of governance. For an example of such rules, see exhibit 1 (Utah Valley University Policies and Procedures).

- We applaud the hard work performed by the members of the Benefits Committee in overseeing WKU's health insurance and other benefits. The efforts of the members who bring their expertise to the committee are to be commended. However, we strongly urge the Benefits Committee to make a greater effort in attracting individuals with expertise in finance, accounting and actuarial science. Having greater number of such individuals on the Benefits Committee will enhance its ability to understand the complexities of issues at hand.

  We also recommend a review of the composition of the Benefits Committee to make sure that the members of the university community (faculty and staff) have sufficient representation.

  Finally, in our opinion, it also important to establish a greater rotation of the membership of the Benefits Committee so that it is more consistent with the term limits of other decision-making bodies such as the University Senate.

Attachments:

Exhibit 1. Utah Valley University Policies and Procedures
Exhibit 2. Health Insurance Quasi-Endowment Allocations at 12/31/09
Exhibit 3. Western KY University Foundation WKU Health Insurance Quasi Endowed Fund Income Statement
Exhibit 4. Membership of the WKU Foundation Investment Committee
Exhibit 5. Membership of the WKU Benefits Committee