

## Insurance Trust vs Prefunded Insurance

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## Stanford University



- ◆ Stanford is self insured for Workers' Compensation claims of \$250K or less.
- ◆ Historically, SU used a "Prefunded" method of covering those claims.
  - Annual payments to an insurance carrier who would then administer those claims.
  - Any additional payments, or credits, would be made in future years, as needed.
  - Expense as incurred.



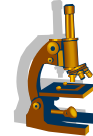
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## In fiscal 2005 Stanford was given the option of an Insurance Trust



## Major Differences



- ◆ **Insurance Trust Option**
  - Annually, set-aside collateral (for that premium year) against projected losses(1).
  - Interest is earned on collateral & paid to University.
  - Actuarial estimates are accrued annually. Collateral account is recorded as a prepaid asset.
  - Claims are paid by University as they are submitted (through the Insurance Co.).
  - Involves both a bank and Insurance carrier.
  - Collateral requirement may be reduced as Insurance carrier permits.
  - Insurance carrier is beneficiary of collateral.
- ◆ **Prefunded Option**
  - Annually, pay insurance carrier for “collateral” against projected losses (“Loss Fund Deposits”).
  - Payment to Insurance company does not earn interest to University (Insurance Co. benefits).
  - Annual Payments to the “Loss Fund Deposit” is expensed.
  - Claims are paid out of Loss Fund Deposit account.
  - Only involves Insurance carrier.
  - Insurance carrier eventually returns unused funds.

(1) Collateral may be substituted with a Letter of Credit; however this may impact debt ratios.

# Assumptions



- ◆ Analysis covered a five year period, with a five year tail for reduction of fund balances and collateral over claim payout horizon.
- ◆ Stanford contributes money to the Insurance Trust or Loss Fund Deposit ("Prefunded fund") annually, at the beginning of the premium year.
- ◆ PV Cash Flow is over 10 years
- ◆ Claims are paid out monthly, separate from the posted collateral.
- ◆ After a full year's worth of claims have been paid, the Insurer may allow a reduction of the Trust balance or the Loss Fund Deposit.
- ◆ Collateral is assumed to be drawn down over a five-year term at year end, so that money contributed in year 5 will not be fully withdrawn until the end of year 10.
- ◆ Stanford earns interest on the funds held in Trust.
- ◆ The ending balance is discounted to calculate a PV of Cash Flow.
- ◆ The difference in PV of the cash flows is the cost or benefit of using the Trust.

# Pros & Cons

	<u>Pro</u>	<u>Con</u>	<u>Same*</u>
◆ Additional up front cash/collateral required	PF	Trust	
◆ Administrative difficulty			Trust/PF
◆ Investment returns	Trust	PF	
◆ Cost less	Trust	PF	
◆ Cash/Collateral may be substituted with LC	Trust	PF	
◆ Meet regulatory requirements			Trust/PF



\* No major difference

## Results

The increased benefit of using the Trust was 5% of the PV of the Prefunded option.

Major contributors to PV calculation difference (in SU case):

- ◆ Interest Earned (only in Trust)
- ◆ Deductible Premium (higher in Trust)
- ◆ Loss Fund Deposit & Cash deposited in Trust as collateral offset each other.
- ◆ Gross cash flow nets to zero for collateral fund deposits and collateral funds returned over a 10 year claim payout horizon.
- ◆ The higher upfront costs incurred with the Trust option are more than offset by the interest earned on SU collateral.

