An Alternative Funding Plan Approach in a Post-Obamacare Market

November 5, 2013

Outlining a post-ACA marketplace solution for fully insured administrators and marketing organizations, niche carriers, and their reinsurers.

The Existential Threat Posed by the Affordable Care Act

Small group fully insured programs have been successfully sold and administered at TPAs around the country for decades. These programs have generally been insured by niche carriers and substantially reinsured by larger quota share reinsurers. They are targeted toward employers of sizes under fifty or one hundred, and typically use a full medical underwriting approach. The TPAs usually perform all functions connected with the administration of the program, including marketing, sales, underwriting, contracts, billing, and claims administration.

These programs have been successful because their distribution systems produce, and then maintain on the books, good risks from the marketplace, risks that deserve lower rates than what the large companies are offering. The key drivers for this underwriting profitability is new business underwriting, renewal underwriting, and distribution management. Under new ACA rules, this marketplace strategy is effectively eliminated, and, as a result, these TPA programs will largely cease to exist.

Since these vital distribution systems have become purposely devalued by the ACA, TPAs search for ways to transform their businesses, to use their valuable distribution assets effectively.

An ERISA-based, fully medically underwritten, self-funded approach allows TPA's to use assets effectively, delivering underwriting profits to their risk-takers using existing infrastructure and distribution assets.

The Case for Small Group Self-Funding

The ACA sanctioned small group market mandates that adjusted community rating be used by insurance companies for employer groups under fifty employees starting in 2014, and under 100 starting in 2016. In this market, employers with favorable demographics and health status will pay more in order to subsidize employers with unfavorable demographics and health status, which will pay less, since the rules are designed to level premium rates within the fully insured marketplace.

This mandate that employers pay a premium that is not based on the risk profile that they present creates an opportunity. Employers with favorable risk characteristics will seek lower cost alternatives if they are available, while employers with unfavorable characteristics will generally be happy with the premium rates available in the market.

Since, under ERISA, any employer can opt to self-fund the medical plan it offers its employees, employers with favorable risk characteristics will see the cost advantage of self-funding under ERISA.

Comparison of ACA Sanctioned Plans and ERISA Sanctioned Self-Funding

Issue	ACA Sanctioned Plans	ERISA Sanctioned Self-Funding
Premiums	Adjusted community rates	No rate restrictions
Medical Underwriting	No	Yes
Renewability	Yes	Rarely (some states)
MLR/Rebates	Yes	None
Risk Adjustors	Yes	None
ACA Filings	Yes, full AHP filings	No, stop-loss policy filing only
Health Insurance Tax	Yes	No
State Premium Tax	On the full cost	On the premium portion only
PCORI Fee	Yes	Yes
Reinsurance Program Fee	Yes	Yes
COBRA/Continuation	Yes	Yes
Form 5500 Filing	No	Yes
“Metal” Plans	Only	Any plan of benefits can be created
State Stop Loss Regulation	None	Minimum attachment points by state

The Natural Advantage over Traditional Stop Loss Distribution

Stop loss insurance for employers is typically produced and managed using a centralized home office and/or one or more third party managing general underwriters, with underwriting and rating processes likewise centralized. These entities generally see the national collection of TPAs as their natural market. Most of these TPAs are primarily involved in servicing large self-funded employers, with relatively few having expertise in the fully insured arena.

Two key observations can be made:

- Self-funded TPAs consider their clients to be the employers.
- Fully insured TPAs consider their clients to be their carrier and reinsurer.

TPAs develop fundamental and institutional biases that permeate every aspect of their infrastructures, including the behavior and priorities of owners and employees. Where TPAs engage in both fully insured programs and self-funded employer business, they will generally separate employees and departments so as to properly keep their resources aligned with their clients’ needs.

The self-funded TPAs will properly see that their employer clients enjoy every advantage when "choosing" a stop loss carrier. It will rarely consider the profitability of the carriers and reinsurers.

In contrast, the fully insured TPAs have a built-in institutional bias to favor their carrier and their reinsurer. For years, they have medically underwritten small employer cases and produced rate quotes. They have looked after a distribution system that has been primarily focused on producing profitable small group underwriting gains.

Carriers and reinsurers will want to get involved with fully insured TPAs with their new alternative self-funding products because they offer the best chance of consistent underwriting gains.

Features of Alternative Self-Funding Plans for the Post-ACA market

Three Components of Employer Payment
- Premium – For the risk that the insurance company assumes.
- Claims Funding – For the risk that the employer assumes.
- Administration Costs – For services and taxes.

Full Medical Underwriting
- Individual medical questions asked at the time of initial rating.
- Can lead to larger premium and funding ("loading") for higher risk employers.
- Can lead to smaller premium and funding ("discounting") for lower risk employers.
- Normal financial and participation underwriting applies.

Full Claims Funding for the Risk the Employer Assumes
- Funding is expressed as monthly tier composite rates or age rates.
- Funding dollars vary as the monthly enrollment shifts.
- Employer will never have to pay more than the scheduled funding rates.

No Guarantee of Renewability
- Insurer has no obligation to offer renewal terms, since the policy is a stop-loss policy.
- In the 2014 "reformed" market, the employer faces no consequential barriers when securing fully insured coverage from the open market.

No Restrictions on Premium Rates or Premium Increases
- Under a stop-loss policy, the underwriting decision by the carrier can provide for any load or discount.
- Premium rate restrictions from the fully insured market do not apply.
- Premium can be raised or lowered at the discretion of the insurance company.

A Regular Stop-Loss Policy is Issued
- The policy benefit is a contingent aggregate stop-loss payment, the kind normally available with most stop-loss policies.
- The benefits provided by the premium payments inure to the employer, not the employees.
- The attachment point is the aggregation of, and is equal to, the claims funding.

Normal Insurance Policy Risks and Mitigations
- If an employer with an aggregate accommodation terminates then the carrier has no chance to earn back the accommodation.

- An employer could pay the premium but not fund the claims account, if it is allowed to do so, thereby resulting in the carrier paying a claim when it is obligated by law to do so.
- An employer must make the full twelve monthly premium payments or the stop loss benefit is forfeited.
- The traditional 10% composition change rule still applies.
- Continuation/COBRA applies.
- TPAs are assigned the ability to make claims decisions.
- Pre-ex provisions apply to plan years beginning prior to 2014.

Features of AST's Approach to Alternative Stop Loss Products

The Contract is an Aggregate Only Contract

- Can use a normal specific and aggregate stop loss policy.
- Policy has an unlimited loss reimbursement.
- Policies are twelve months.

Benefit Plans are Constrained to Standard Plans

- Employer choice is limited to a relatively small number of plan choices.
- Reduces anti-selection for the insurance plan.
- This is unlike the normal partially self-funded marketplace.
- The same plans can be sold in multiple states since state mandates do not apply.

Aggregate Attachment Point is Less Than Expected Claims

- Creates a higher probability of an aggregate claim than traditional stop-loss.
- Probability can ranges from 50% to 75%.
- Aggregate attachment points can range from 20% to 80% or more of expected claims.

Aggregate Accommodations will be Frequent

- The vast majority of cases will need at least one aggregate accommodation.
- Recaptured as funding balances recover.
- Or can be recaptured at the end of the contract.

A Full Incurred Contract

- No 12/12 contracts since renewals would be large increases.
- The preferred contract is 12/18 as it allows for a timely disposition of the funding account.
- The projected funding account balance can be applied to the renewal year's financial workup, if settled early.
- If not, then the amount can be refunded to the employer.

Monthly Payments from the Employer Satisfies Premium Last

- Employer's funds apply to claims funding first.
- Employer's funds apply to administration next.
- Employer's funds apply to premium lastly.
- Allows for management of the inherent credit risk.

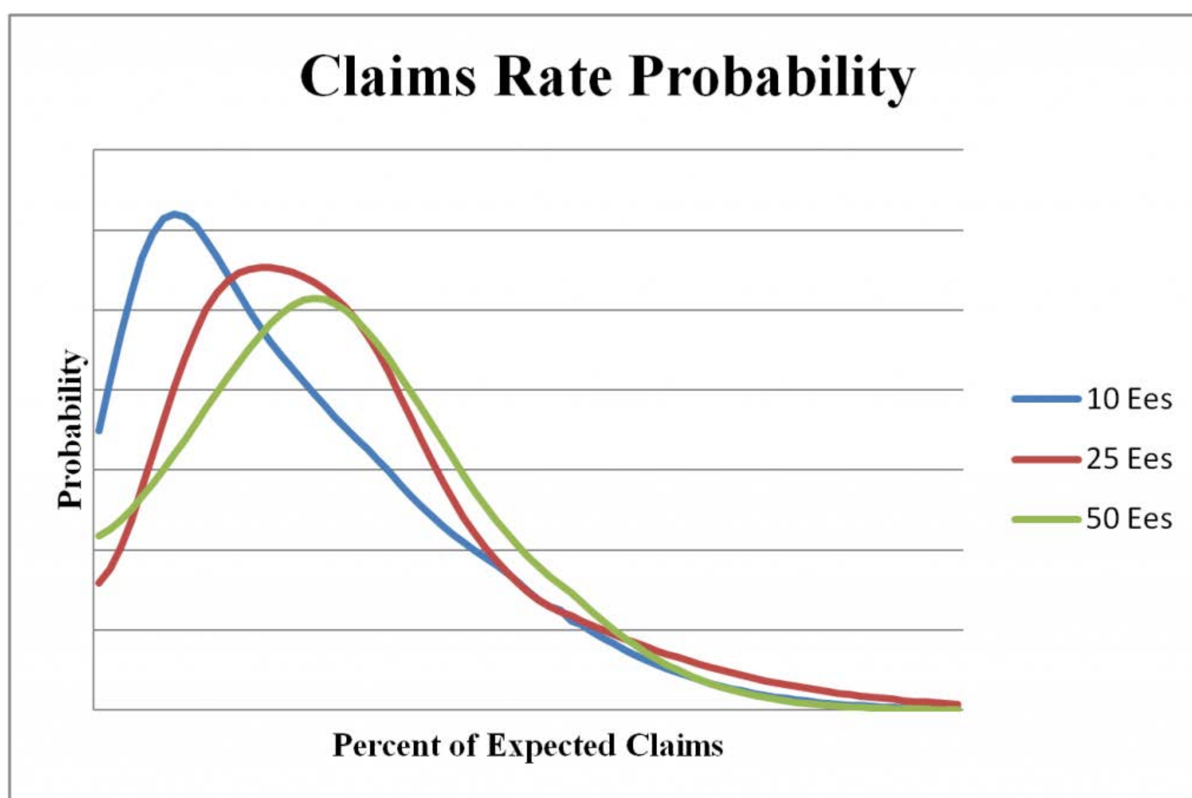
Appropriate Risk Transfer

- The uncertainty of a contingent surplus amount comprises the risk for the employer.
- The uncertainty must be material.

AST's Actuarial Considerations in Pricing Alternative Stop Loss

Concept of Outcome Probabilities

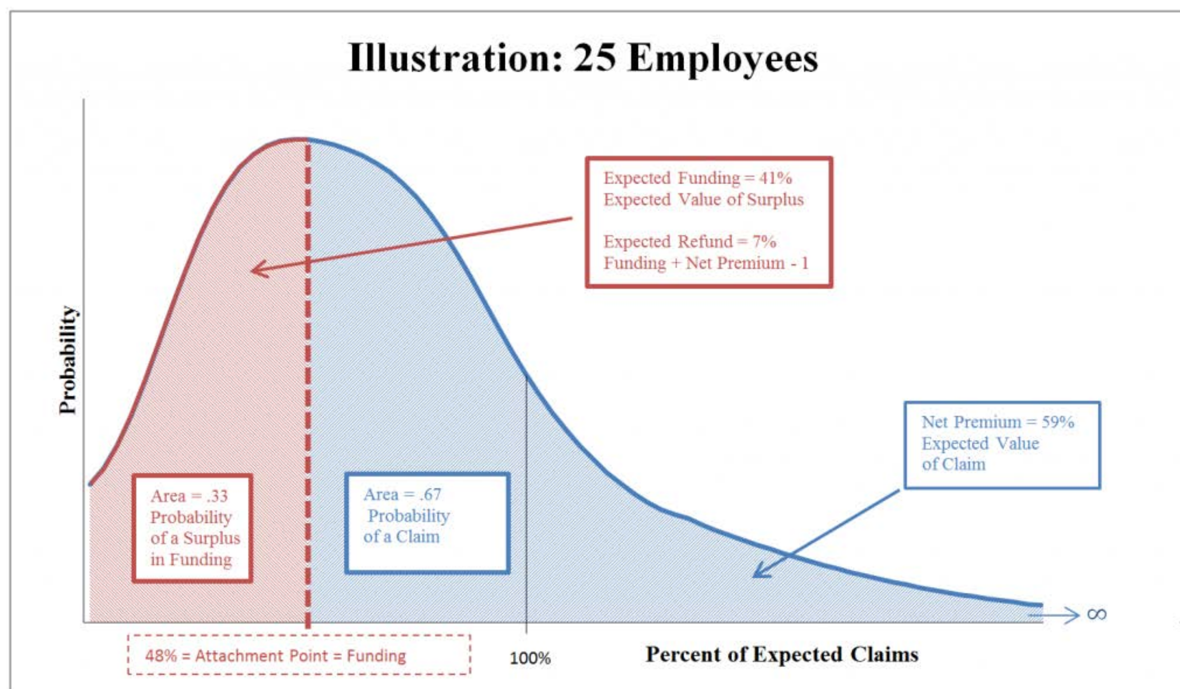
- Diagram shows sample probability density functions for three differently sized employers.
- The expected value of each curve is 100%, or the expected claims for the case.
- As the employer size increases, the distribution of outcomes gets less dispersed.
- Outcome probabilities vary by employer size, with first year outcomes more scattered than renewal years, and cases with underwriting loads generally being more predictable than standard cases.
- AST analyzed tens of thousands of employer-years at various sizes, duration years, and underwriting loads. AST has distilled the shapes of these probability density functions using a two-dimensional Whittaker-Henderson graduation routine.



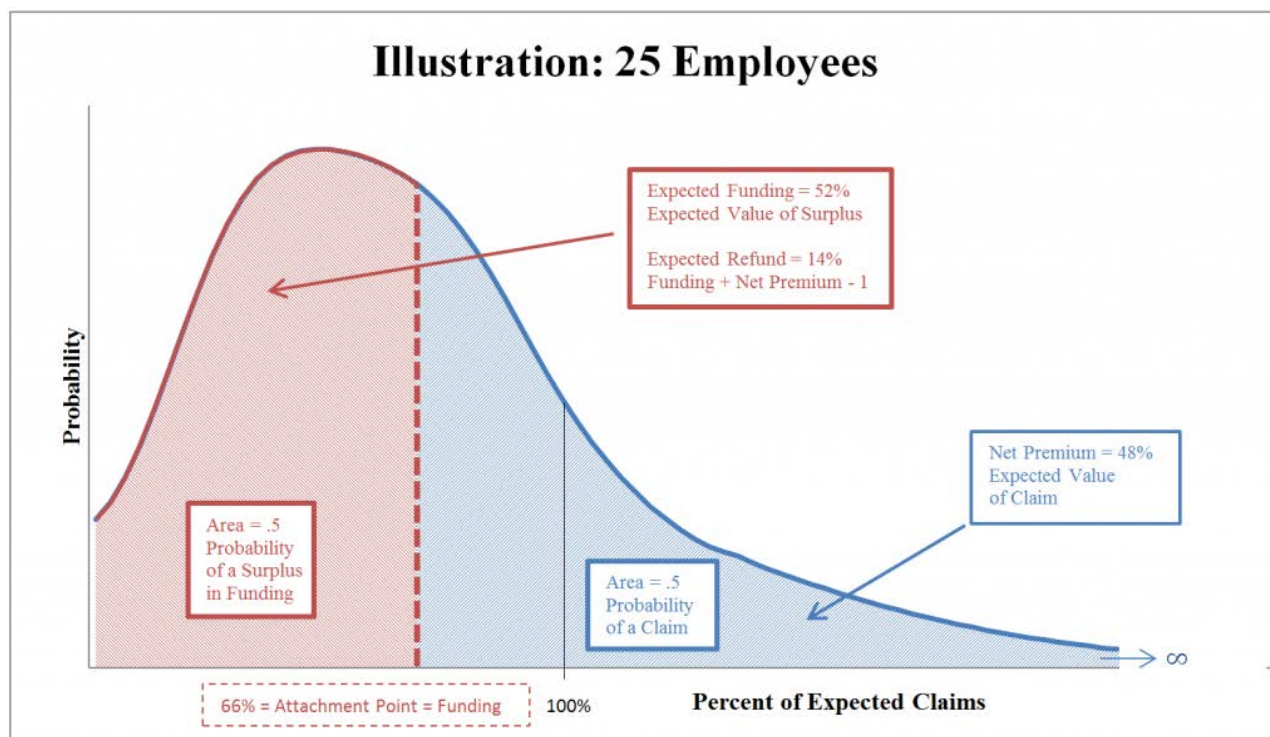
Pricing Objectives

- Profitability objective is the same dollar of profit that the employer would generate if the premium was fully insured premium. AST sets this objective as 8% of the full expected claims, making the profit margin on premium in the neighborhood of double, depending on the employer size of the portfolio.
- The claim probability objective must also be specified. This objective quantifies how likely an aggregate claim will result. AST allows this to be set at anywhere from 50% to 75%. Higher probability creates a higher premium and a lower attachment point, perhaps too low to achieve proper risk transfer. Lower probability creates a lower premium and a higher attachment point, perhaps so high that full funding creates too much pre-funding, making the arrangement too expensive.
- Note that the attachment point neatly divides the distribution in two.

- Note that the probability of a surplus and the probability of an aggregate claim are complements, i.e., they add to one. There will either be an aggregate claim for a case or there will be a surplus.



- Note that the net premium for the stop loss contract plus the aggregate attachment point is greater than one. The amount in excess of 100% is the expected surplus in the funding account.
- When the claim probability objective is moved to 50%, the pricing metrics change.
  - The net premium reduces from 59% to 48%.
  - The funding increases from 48% to 66%.
  - The expected surplus increases from 7% to 14%.
- The cost to the employer is higher under the 50% assumption since the expected surplus must be pre-funded.
- The net premium will be grossed up for profit margin and insurer expense, so the employer will do a little better when the premium is lower, but this is more than offset by the funding requirement.
- The funding requirement adds more cost as the group size increases, eventually making the arrangement too expensive at around 75 to 100 lives.



Underwriting and Rating Process is Routine

- Determine the medical load factor as if the case was fully insured, taking into account that small group rating restrictions do not apply, obviating the need for minimum and maximum loads.
- Apply the load to expected claims derived from the fully insured manual. These claims are either stated as composite rates or a single rate for each employee.
- Determine the attachment point factor from a table taking into account the group size, duration year, and underwriting load. Keep in mind that this attachment point is also the funding level.
- Multiply the attachment factor and the expected claims rates to get funding rates.
- Determine the stop loss net premium factor from the table taking the same attributes into account.
- Multiply the net premium factor and the expected claims rates to get the stop loss net premium.
- The expected surplus is the net premium plus the funding less the expected claims. This can be expressed as rates as well.
- Gross up net premium for expenses and profit.
- Determine third party fees.

Jurisdictional Considerations

- The majority of states will allow an aggregate attachment point at any claims level when the aggregate coverage is purchased without specific stop loss coverage. *Between 28 and 34 states allow attachment points at any level when sold without specific stop loss.*
- When specific stop loss is combined with aggregate stop loss then the attachment point is a bit more regulated. 25 states allow attachment points at any level.

- In states where the aggregate attachment point is regulated at dollar amount minimums, it may not be possible to construct arrangements that meet the requirements.
- In states where aggregate attachment points are regulated by positive corridor percentages, it is possible to construct an equivalent total net premium under a specific and aggregate contract, with equivalent expected funding levels. This approach may also not be possible for the smallest employers.
- Some regulatory authorities are considering more restrictive rules in order to protect the ACA-sanctioned market from a bifurcation brought on by the exit of employers with favorable risk characteristics. The issue is hotly debated.
- Some markets are not accustomed to medical underwriting questions.

Future Market Dynamics

- *2014 shapes up to be a terrific, once-in-a-generation opportunity to bring on high premium stop loss cases in the small group market.*
- Small employers, the ones with favorable risk characteristics, will be receiving larger than average rate increases in 2014. They will be eager to explore lower costs through self-funding, where they will not be required to subsidize the less than favorable risk characteristic cases.
- The end of 2014 will be interesting since many fully insured carriers are holding rates for their best cases until late in 2014.
- Fully insured TPAs, and their risk taking business partners, will enjoy the advantages that come with sound small group distribution and an institutional bias towards the risk taker, in contrast with their larger top down distributed stop loss carriers.
- 2015 promises to be a year of focus on employers getting in full compliance with the ACA's provisions since the employer mandate takes effect. There will be less energy devoted to the small group market as this focus moves to the fifty plus market.
- By 2016, the alternative small group market will have matured somewhat. A new underwriting approach will likely be necessary so as to continue to identify the best cases. AST is developing a normalized and parameterized individual continuance table approach, as an adjunct to the traditional dollar or debit based approaches.
- Also in 2016, community rating will expand to employers of up to 100 employees, creating a whole new market for alternative self-funding.

Example of a 25 Employee Contract with a 66% Chance of a Stop-Loss Claim

	Annualized	Factor Based On	
	Amount	Premium	Claims
Fully Insured			
Expected Claims	75,000	.75	1.00
Expenses	19,000	**.19**	.25
Profit	6,000	**.06**	.08
Premium (Assume $333 PEPM)	**100,000**	1.00	1.33
Direct Billed Fees (Assume $20 PEPM)	**6,000**	.06	.08
Total Cost	106,000	1.06	1.41

Alternative Stop-Loss			
Expected Claims = FI Expected Claims	75,000	1.37	1.00
Attachment Point + Funding (Factor From Table)	36,000	.66	**.48**
Net Premium (Factor From Table)	44,250	.81	**.59**
Expected Surplus = Funding + NP – Expected Claims	5,250	.10	.07
Expenses	4,370	**.08**	.06
Profit = Fully Insured Profit	6,000	.11	.08
Premium = NP + Expenses + Profit	54,620	1.00	.73
Direct Billed Fees (Assume $67 PEPM)	**20,000**	.37	.27
Total Outlay = Premium + Funding + Direct Billed Fees	110,620	2.03	1.47
Expected Total Cost = Total Outlay – Expected Surplus	105,370	1.93	1.40

Note that the total cost is roughly expected to be the same under both arrangements. This is expected since the profit, expense costs, and claims costs are assumed to be the same, just arranged in a different manner. The case is expected to front the expected refund, which is the material difference in the outlays for the two approaches.
In 2014, when cases with favorable characteristics are faced with big rate levels, the expected claims for the alternative stop-loss arrangement will be much lower, making the total outlay much lower than anything in the fully insured marketplace.

<u>Example of a 60 Employee Contract with a 66% Chance of a Stop-Loss Claim</u>

	Annualized	Factor Based On	
	Amount	Premium	Claims
Fully Insured			
Expected Claims	180,000	.75	1.00
Expenses	45,600	**.19**	.25
Profit	14,400	**.06**	.08
Premium (Assume $333 PEPM)	**240,000**	1.00	1.33
Direct Billed Fees (Assume $20 PEPM)	**14,400**	.06	.08
Total Cost	254,400	1.06	1.41
Alternative Stop-Loss			
Expected Claims = FI Expected Claims	180,000	1.67	1.00
Attachment Point + Funding (Factor From Table)	111,600	1.04	**.62**
Net Premium (Factor From Table)	84,600	.79	**.47**
Expected Surplus = Funding + NP – Expected Claims	16,200	.15	.09
Expenses	8,609	**.08**	.05
Profit = Fully Insured Profit	14,400	.13	.08
Premium = NP + Expenses + Profit	107,609	1.00	.60

Direct Billed Fees (Assume $67 PEPM)	**48,000**	.45	.27
Total Outlay = Premium + Funding + Direct Billed Fees	267,209	2.48	1.48
Expected Total Cost = Total Outlay – Expected Surplus	251,009	2.33	1.39

When comparing the 60 employee case with the 25 employee case, note:

- The attachment point factor is higher.
- The net premium factor is lower.
- The pre-funded expected surplus is higher, creating higher outlay.
- As the employer size goes up, the need to pre-fund higher expected surpluses goes up. These outlays make the arrangement too difficult at employer sizes higher than 75 to 100.