Excess Medical Reinsurance Treaty Considerations
By Daniel Wolak

Excess Reinsurance is a coverage purchased by insurance carriers to limit loss in a year from any one claim. This article addresses the issues when purchasing medical excess reinsurance on a medical portfolio. The most important consideration in the reinsurance purchasing decision is determining the risk objectives of the organization. The proper risk analysis by the carrier or in conjunction with its reinsurer will address the following questions**:** What is predictable risk versus unpredictable risk?

- Is coverage purchased just for the rare catastrophic claim or for more frequent types of large claims?
- What is the appropriate reinsurance deductible for the health carrier and how is it stated?
- How is the maximum reinsurance benefit stated?
- Is coverage purchased for losses occurring during a 12-month calendar period or for policies/risks that attach during a 12-month period?
- How do any special deductibles impact the reinsurance layer?
- Does the carrier want risk fully transferred on a non-participating basis or does the carrier want to retain a portion of the risk through a participating or other type of basis?
- Are lower deductibles desired for certain type of claims (such as premature infant claims)?
- How are costs for claims management shared?

- How is the reinsurer involved with claim disputes with the carrier's policyholders?

Medical excess normally covers all claim charges from an individual that exceed an annual excess deductible. The reinsurer's liability mirrors the claim liability of the carrier. In other words, the liability of the reinsurer shall begin and end with the liability of the company. This contrasts with HMO excess reinsurance which may not cover all claims on an individual, just those that fall within the limits of coverage as stated in the reinsurance treaty. Because of this, the reinsurer will be very interested in how the carrier and its third party administrators manage large claims and the networks that they utilize. A poorly managed claim can result in a large claim liability for the reinsurer. The following discusses the considerations in designing a reinsurance agreement.

Reinsurance Design Considerations

1. *Predictable risk versus unpredictable risk.* Predictable risk arises from claims that can be expected to occur each year within a range of deviation. Unpredictable risk, which usually is not fully considered, refers to claims that may arise once every five, ten, or more years. Examples of unpredictable risk include a medical claim that exceeds $2 million or more during a year, catastrophic claims from a multiple premature birth, a jumbo claim from a procedure which borderlines on being experimental but is deemed as covered under a program, claims from a catastrophic event, or claims arising from extra contractual damages.

2. *Working layer coverage versus catastrophic coverage.* A working layer is defined as an excess deductible level for which the carrier, with relative certainty, will have at least several claims exceed that deductible each year. Claims in a working layer can have some volatility, but the volatility as a percent of premium is usually in a smaller range. By purchasing reinsurance at a working layer, the carrier has more predictable experience for a product than he would if just purchasing coverage for claims at a catastrophic level. However, the downside is that the carrier is paying more in reinsurance premiums and possibly dollar margins to the reinsurer for this lower deductible layer.

   A catastrophic coverage layer is one where the carrier expects, at most, to have just a few excess claims a year, and in some years will have no claims that exceed the deductible. The cost of such coverage is much less than at a working layer, and the reinsurance recovery received when a claim exceeds that high layer is reduced by the high deductible. Therefore, the cost to the carrier is less when purchasing reinsurance for a catastrophic level, but it is important to note that the potential recovery is less as well.

3. *Reinsurance deductible*. A reinsurance excess deductible is established based on a review of carrier goals and risk tolerance. The setting of the deductible is a blend of quantitative risk features and qualitative risk tolerance. In many cases, a lower reinsurance deductible may be desired from a subjective risk tolerance level, though quantitatively a higher level could be purchased. Defining the deductible

is also important when purchasing excess medical reinsurance to cover claims arising from an employer stop loss program. One approach is to purchase an excess deductible that includes claims paid both by the plan up to the specific deductible and the carrier above the specific deductible. The other option is to include only claims paid by the carrier in excess of the specific deductible.

4. *Reinsurance maximum.* The maximum benefit reinsured can be different than that covered under the medical plan. Frequently, the medical plan provides a lifetime benefit. The reinsurance treaty will provide a maximum benefit that is the lesser of an annual maximum or the insured's available lifetime maximum.

5. *Loss occurring or risk attaching*. The deductible can be determined on a calendar year basis for losses occurring during a period or for risks that attach during a year. The decision depends on the type of risks covered. For insured medical, where an incurred date for each claim is clearly established, the medical excess coverage can be on a 12-month loss occurring period, such as a calendar year. A risk attaching coverage period is used frequently for group coverage. During the 12-month agreement period for the reinsurance, each underlying group is covered beginning on their next anniversary date or the effective date for a 12-month period.
6. *Impact of special deductibles.* Special deductibles arise in several ways.
    a. For employer stop loss, a higher specific deductible may be set on an individual as a way to underwrite known or projected claims in lieu of

higher premiums. This practice is called *lasering*. The excess medical treaty should define how the excess medical reinsurance deductible is impacted by lasering. One such approach is to have the reinsurance deductible increase by the same dollar amount that the laser exceeds the employer group's specific deducible.

b. Another option under an employer stop loss policy is offering an aggregating specific deductible. An aggregating specific deductible requires the employer's plan to not only pay claims up to the specific deductible on each person, but also to self insure claims in excess of the specific deductible until the aggregating specific deductible is met. Following is an example of such a situation:

    i. Carrier sells stop loss policy with a $200,000 specific deductible.

    ii. Stop loss policy has aggregating specific of $500,000.

    iii. Carrier purchases excess medical reinsurance for claims $500,000 (on a first dollar basis).

    iv. If one person has a $650,000 claim, the self insured plan is responsible for the first $200,000 as part of the specific deductible. In addition, $450,000 of claims in excess of the deductible satisfy a portion of the $500,000 aggregating specific deductible. In such a case, assuming no other claims from that employer group, neither the stop loss carrier nor the reinsurer would have a claim liability.

    v. If this example was changed so that one person has a $650,000 claim and two people each has $300,000 in claims, the stop loss

carrier would have a $150,000 claim. The reimbursement under the excess medical reinsurance could be handled one of several ways. The reinsurance could be designed to:

- Pay the $150,000 since this is the amount in excess of the $500,000 deductible and is not in excess of the carrier's liability
- Have no claim liability for this particular example.
- Pay a percent of claims determined by dividing the excess claim liability ($150,000) by the amount of claims exceeding the $200,000 deductible (i.e., $150,000 divided by $650,000).

7. *Risk transfer options.* A carrier can decide whether a non-participating or a participating arrangement is desired.
    a. A non-participating arrangement is desired when the carrier wants to lock in the cost and not have future earnings positively or negatively impacted by the excess reinsurance experience. With a non-participating arrangement, the carrier does not share in gains from good claims experience in a year directly; rather positive claims experience would be recognized potentially in current and future renewal premiums. From an accounting side, a non-participating arrangement is easier since future experience refunds need not be accounted for as an asset. For a participating arrangement, there is a risk of prematurely accounting for a

refund, which increases reported earnings in a quarter. Subsequently, this releases the accrued refund asset when a large claim is reported, thereby creating a charge to earnings.

b. A participating arrangement is selected by a carrier that desires to reduce its cost when its experience is favorable. Participation can arise in several forms.

    - Profit commission: A traditional way is that a percent of the experience gain is paid back to the carrier, after providing for the reinsurer's risk margin and expenses.
    - Swing rate: In such a case, the carrier pays a "minimum premium rate" until claims exceed a defined percent of that rate. At this point, the premium rate swings up proportionately to claims, but does not exceed a ceiling "maximum rate." A swing rate allows the carrier to have reinsurance costs that are proportional to normal claims fluctuations, but also locks in the cost in case of an unusually high claim level.
    - Aggregating specific deductible: Another common way for a carrier to have a participating arrangement is to have a second deductible—that being an aggregating specific deductible—for claims in excess of the deductible. The reinsurance does not begin to pay until excess claims exceed this second deductible. The coverage frequently is non-

participating once claims exceed the aggregating specific deductible and become the liability of the reinsurer.

8. *Lower deductibles for defined conditions*. In some cases, a lower excess deductible is offered by the reinsurer or requested by the carrier for certain conditions, e.g., an organ transplant where a network is established with preferred pricing. Another example may be a benefit which has a lower maximum limit.

9. *Claim management expenses.* Many times on large medical claims, a third party auditor or vendor will be utilized to review the hospital charges and to further negotiate a reduction on charges. The manner in which these expenses are shared needs to be defined in the reinsurance agreement. Following are several approaches:
    a. Claim management expenses are shared proportionately based on the amount of the billed claim.
    b. Claim management expenses are covered in the same manner as any other claim cost. Therefore, if the final claim exceeds the excess layer, the reinsurer pays all of the claim management expenses. If the final claim is reduced to below the excess deductible, the carrier pays the claim management expenses in combination with the underlying claim up to, but not exceeding, the excess deductible.

10. *Contested claim*. The carrier should notify the reinsurer of its intention to contest or compromise a claim that might exceed the excess deductible. If the reinsurer chooses not to participate in a contested claim, it shall pay its full amount of reinsurance liability on such claim and shall thereby be relieved of all future liability with respect to such contested claim. If the reinsurer joins the carrier in a contest or compromise, the reinsurer shall participate in the same proportion that the amount at risk reinsured with the reinsurer bears to the total amount at risk to the carrier on the claim and shall share in the reduction in liability in the same proportion.

Carrier Decision Process

In selecting excess deductible and reinsurance options, the reinsurance decision maker may consider the following:

- Frequency and severity of claims at various deductible levels. What has been the carrier's recent experience with excess claims?
- Risk profile of carrier's membership.
- Risk tolerance and budget considerations. How will management respond to a claim reported in a quarter which is in excess of $500,000? $1 million? $2 million or more?
- Carrier size and coverage type. Is the standard insured maximum benefit $1 million or is it $5 million?

- Underwriting margin and results. If program is marginally profitable, one large claim may result in a loss for the year. If program is very profitable, may want to retain risk rather then pay potential reinsurance margins to reinsurer.
- Carrier's financial strength and parental support.
- Capital requirement of product. Excess products such as employer stop loss require more capital than first dollar products.
- Relative size of medical block within a company to other insurance products.
- Reinsurer's expertise and market knowledge.

Renewal Process

Most agreements are one year in duration and must be amended each year as part of the renewal activity. Unlike underlying carrier policies, the reinsurance treaty does not provide for a 30-day notice of rate change. To change rates, the treaty must be changed by mutually agreeing to amend the current terms. To change the treaty, notice must be provided 90 days in advance by either party. One way to provide a shorter notice of rate change and to allow for proper time to evaluate experience is for the reinsurer each year to send to the carrier a preliminary notice of termination more than 90 days prior to the treaty anniversary. The reinsurer will then prepare renewal terms and normally present to the carrier 30 to 45 days prior to anniversary. If the offer is accepted, the reinsurer will send a treaty amendment to the carrier that reflects the renewal terms and rates.

Conclusion

The design of an Excess Medical Reinsurance agreement between an insurer and reinsurer is based on a number of different factors and options. This paper has focused

on the aspects which are important considerations in the design of the coverage and the financial aspects.

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