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EMPLOYEE BENEFIT DESIGN FOR SMALL GROUPS

Moderator: ALAN M. THALER. Panelists: HOWARD J. BOLNICK, CHRISTOPHER H. WAIN

MR. ALAN M. THALER: It is my intention as moderator to have the two panelists, Mr. Christopher H. Wain, FSA, and Mr. Howard J. Bolnick, FSA, present their comments first. Mr. Wain will direct his discussion to pension plans for small employers offered by insurance companies. Mr. Bolnick's presentation will be in the nature of an overview of actuarial considerations pertaining to MET group insurance.

The emphasis of Mr. Wain's remarks will be from the insurance company point of view.

MR. CHRISTOPHER H. WAIN: My comments today are from the standpoint of a life insurance company agency system providing retirement income benefits for a small employer.

The insurance company undertaking this job starts out with a split personality. On the other hand, its leading agents will tend to be selling pension plans as an adjunct to the estate and other insurance needs of the decision maker of an employer. Naturally, saving of income tax looms large in the thinking about such a plan. Yet, on the other hand, the insurer has to recognize that unless most employers will ultimately have pension plans, the private pension systems may ultimately be supplanted by a public program.

Fortunately, the problems of this split outlook are not incompatible. In order to be able to serve the needs of the sophisticated buyer, the insurer has to have a thorough knowledge of the pension business. Furthermore, even for the sophisticated agent and employer, the administrative responsibilities of ERISA can rarely be carried out efficiently by either of them. Therefore, as a matter of sound marketing strategy as well as of sound business, the insurer has got to see that there is some way that the plans it sells can be administered. This administration can be through a consultant, through an exceptional general agent, through a trust company or other professional administrator, or by the insurer itself. It can be argued that for many types of plans the insurer is functionally in a position to provide lower cost administration than a third party because it can take advantage of policy records it must maintain anyway. In any event, the administrative service and the know-how that are necessary for the sophisticated sales can also be applied to the unsophisticated ones--including those that start out emphasizing tax savings and wind up providing genuine pension benefits. Over a period of time these may turn into the great bulk of the cases.

As implied previously, insurers will often need to provide administrative services for plans. In general, a separate fee must be charged for these services. The range of types of plans that can be offered is very great. No single fee can be fair to the simple, efficiently run plan, and also adequate for the complex one. Therefore, such fees can not be built into the premiums or any standard dividend scale for individual policy plans. Conceivably a group contract could be offered with a sufficient loading so that the dividend could be varied by the amount of work required. That loading could look rather uncompetitive. The distinct dividend treatment introduces a substantial degree of further complexity of insurance company operations for small employer plans, often using individual policies.

A major service furnished by insurance companies is the use of prototype plans. These are plans of various types that have been approved by the Internal Revenue Service as to text. The language of these plans permits a number of choices such as whether the plans should be integrated with Social Security or not, the level of contributions or benefits desired, and whether employee contributions are to be permitted. These plans are expensive to develop and get approved; substantial usage is necessary if they are to pay for themselves. But the standardization they provide in provisions of little market significance, and the savings that they should permit in legal and consulting services in the establishment of the plan, make them an essential part of the pension program of most insurance companies.

In funding these plans, recognition has to be made that there are at least two basic types of plans from a record-keeping standpoint -- those that are on an individual account basis, and all others. In the individual account plans, where an individual policy is used to measure the responsibilities of the employer to the employee, the old retirement income type policy could be used, flexible or fixed payment annuities can be used, and whole life policies with a flexible annuity or deposit rider can be used. In the "all other" category of plans, all of these policies along with some type of group contract that does not maintain accounts for each individual can be used.

The individual employer buying a pension plan, perhaps at the urging of his agent, expects that he is paying the insurer a lot of money. When he is doing that, he expects special service--even though the money is not large from the standpoint of the insurer. Even more important, margins available for expenses in this money are very slim. Furthermore, in order to be able to serve the employer, the insurance company incurs a substantial special overhead expense in -- if it is possible -- understanding ERISA and developing prototypes and administrative services. It tends to face a substantial fixed expense that is largely independent of the volume of sales. This may cause some companies to specialize in limited small employer pension plans or to conclude that the field is not worth the trouble.

Whether companies will withdraw from the pension field or not probably depends on the work of the next Congress and the actions of the administration. The Senate Labor Committee in introducing the Williams-Javits bill has evidenced an interest in simplifying the job of operating pension plans. I am sure that the sponsors and their staff associates do not consider this bill perfect. It, of course, did not pass during the Congress just closed--but that was expected. An improved version will probably be introduced in the next Congress. If it or some other bill succeeds in making ERISA workable, partly by making providers of plans confident of their status and partly by bringing administrative responsibilities for plans to a reasonable level, the outlook for the private pension system can be favorable. The simplified pension plan proposal that was a part of the tax reduction bill passed by the last Congress can help all concerned be encouraged about the future pension business.

MR. THALER: Mr. Bolnick will present a broad outline of MET type group insurance.

MR. HOWARD J. BOLNICK: If we step back and take a broad overview of the marketplace for life, medical expense, and disability insurance sold by the insurance industry, we can clearly see three different markets. First, there are the products "retailed" directly to individuals and their families. These products fall under the individual life and health regulatory environment. Second, and at the other extreme, are the products that are "wholesaled" to the public through large employer/employee, union, and multiple-employer groups. These products are the traditional large group products that resulted in the creation of a distinct group life and health regulatory environment. Third, and last, is the hybrid animal with which we are concerned--the products sold to small groups. I call the small group product a hybrid because the distribution of the product can follow either a "retail" distribution system or a "wholesale" distribution system depending on the marketing plans of the distributor while the product itself falls under the group life and health regulatory environment.

To clarify my distinction between "retail" and "wholesale" distribution of small group products, let us take a look at some examples. To describe a "retail" distribution system, we can use as an example products distributed through general agents and brokers to the participating employers. The success of this system depends on the creation of a distribution pyramid to reach the prospects. The company recruits general agents. The G.A.'s, in turn, recruit brokers whose job it is to solicit prospects. Each broker may submit only two or three cases, but if there are a large number of brokers under contract, it is feasible to create adequate sales volume.

Small group products can also be distributed via a "wholesale" approach. As an example of this distribution approach we can cite mail order solicitation of small employers through an endorsement received from a trade or professional association. The success of this system depends on reaching a large number of prospects. If the number of prospects is large enough, even a modest "close-ratio" can create adequate sales volume.

Now, to successfully develop, underwrite, and market a product in each of the three markets, individual, large or true group, and small group requires consideration by the insurer of a broad range of issues. The issues can include marketing, administration, underwriting, product design, rating, or legal considerations. But, an insurer's response to these issues will quite likely be different for each different market. For example, the administration system used for individual products will not work efficiently for true group or small group products. Billing runs, reserve runs, and premium calculation routines are obvious points of difference between individual and small group or true group.

More importantly, though, true group or small group administration systems will not necessarily be efficient for other than the market for which the system was originally designed. For instance, small group rates per employee or per family are usually changed each time that the composition of the group changes while true group rates per unit are usually changed only upon renewal. Statistics needed to monitor a block of small group business are much different than those needed to monitor true group. And, underwriting small group is a separate "art" which is entirely different than either individual or true group underwriting. To me these differences, and there are many more differences that we have not yet discussed, simply mean that success in the small group market requires special consideration by management. A block of small group business probably will not be successful if viewed merely as an extension of true group down to smaller risks, or alternatively, as a conglomeration of individuals. Small group needs its own point of view.

The reason for mentioning these differences and possible pitfalls is to help point interested insurers in the right direction. On the positive side, for an insurer who wishes to participate in the small group market, and especially in the small group medical expense market which accounts for the majority of welfare benefit plan premium dollars, there are some distinct advantages over either the individual market or the true group market. We believe that the three most significant advantages are as follows:

1. Size of the market and ease of the sale - A recent study by a major management consulting firm estimated that 20 million people can be reached through their employers where the employer has 2 to 25 employees. This market is of substantial size. And, in reviewing small group programs, it has been our experience that reaching this market in volume is not as difficult as selling individual or true group products. This is true whether the product is "retailed" or "wholesaled."

2. Product design and rating flexibility - Small group products fall under the group regulatory environment. Group regulations do not control either rating or renewability of the product with the firm edicts that can be found in individual regulations. Group rates are generally one year term rates that are changeable at the insurer's option. Group renewability, too, is at the option of the insurer. By using a multiple employer trust as an intervening trust between the participating employer and the insurer, small group products can be designed to allow the insurer a great degree of control over the plan benefits, underwriting, product design, and rating.

3. Profit margins - In our opinion, a suitable profit margin on a small group program can be attained. We all have heard numerous stories of the large losses resulting from poorly managed small group programs. The names of Old Republic, Old Security, and Loyal Protective readily come to mind. What we rarely hear about, though, are the successes of those insurers who run well conceived and well managed small group medical expense programs. When the additional margins from the ancillary products such as group life, AD&D, and weekly income is added to the medical expense coverage margin, the resulting potential margin for the entire small group package is worthy of an insurer's attention.

Thus, the size of the market and the relative ease with which sales can be made, the retention of control by the insurer over the program, and the relatively attractive potential profit margin are good reasons for management to be interested in small group life, medical expense, and disability insurance.

A small group program can be attractive. But there are, admittedly, a number of difficult issues to be addressed before its profitability can be expected to reach full potential. Let's briefly discuss what I believe are the major issues from somewhat different perspectives: that of the insurer's management, that of the insurer's in-house actuary or consultant, and that of the participating employer.

MANAGEMENT

The insurer's management is obviously responsible for making a large number of decisions in designing and implementing a small group program. There are, though, three issues which we believe are of utmost importance:

1. Whether or not to use a multiple employer trust as a vehicle for marketing the program.
2. Whether or not to use a third party administrator to administer and/or distribute the product.
3. How best to control the quality of the business.

We will look at each of these questions.

MULTIPLE EMPLOYER TRUSTS

Many insurers have found that the use of a multiple employer trust, or MET, greatly simplifies the product design, rating, administration, and distribution of a small group product. A MET is simply a trust formed for the purpose of having a group insurance contract issued to it. Employers can join the trust and participate in the group insurance plan. The trust, then, is an intervening vehicle between the insurer and the participating employers.

Most states allow insurers to issue a group insurance contract to the trustees of a fund established by two or more employers in the same industry. There is generally no provision that these employers have any reason for banding together other than for the purchase of insurance. Thus, it is quite easy to legally form a multiple employer trust.

The ACLI recently reviewed the Model Group Life Insurance Definition and Standard Provision Act and recommended to the NAIC that the jurisdiction by the state of contract issue principle remain untouched. The NAIC had formed a new subcommittee to review the Model Group Life and Model Group Health Acts and the ACLI's recommendations. I understand that this subcommittee is once again trying to tackle the intricate issue of the state of issue principle. The subcommittee is exploring the possibility of requiring the certificates issued to a resident of a state confirm to that state's regulations regardless of the state of issue or the group contract. I expect the industry to react strongly against this "trial balloon" and ultimately to defeat any dilution of the state of issue principle.

THIRD PARTY ADMINISTRATORS

We have briefly noted that the administration of a small group product differs from the administration of either an individual product or of a true group product. These differences can extend to almost all areas.

1. Sales Administration may differ since, as we have discussed, the method chosen to distribute a small group product may not fit into an insurer's existing distribution system.
2. Underwriting will differ since small groups are most often underwritten on a combination of limited information on the

employer and on his employees rather than information on individual policies, or, rather than information on the employer's past insured claim experience as true group policies.

3. Claims Administration differs due to the common need to administer a pre-existing condition exclusion.

4. Management Information needed to support rating and reserving differs significantly from either individual or true group.

This list can be expanded to include differences in billing, cash flow, commissions, etc. I hope that is it becoming obvious that an efficient small group system must be structured differently than either individual or true group.

Given all of these, and many more differences, some of which are significant and some of which are quite subtle, many insurers have found it difficult and costly to efficiently administer a small group product using administrative and distribution systems designed for individual or true group programs. Third party administrators offer an alternative to patching existing systems or developing new systems from scratch. A good third party administrator has already taken the time and money to develop and implement administration and distribution systems that can efficiently and effectively administer a small group program. These systems are made available to the insurer at a very competitive price.

Immediate cost effective access to a new market, then, is the reason for insurers to be interested in third party administrators. The disadvantage of this approach, though, is a possible loss of control over the small group program. In the past, some insurers have turned over total control of the business to the administrator. The insurer merely sat back and waited for the profits to "come rolling in." Of course, the profits usually did not materialize. The administrators were able to sell business, but in many instances, they did not carefully scrutinize its quality nor did they keep rates current. Profits turned to losses.

Despite these "horror stories," good administrators working with knowledgeable insurers have helped to operate sound programs throughout the past years. The insurers have played a key role in these instances by maintaining close contact with the administrators and exercising careful control over all phases of the administrator's program. With proper control and proper motivation, an insurer can find using third party administrators to be a mutually profitable venture.

QUALITY CONTROL

Whether or not management chooses to use a MET or third party administrator, the problem of controlling the quality of the business still remains. Without adequate controls, it is likely that a poor quality of business will find its way into the insurer's pool. In designing an effective underwriting program, it is important to consider approaches to underwriting that differ from those used to select individual or true group risks. We believe that a sound small group underwriting program should take into consideration that there is only a limited amount of data that can reasonably be made available to underwrite small group business. The underwriter can afford to request only a limited amount of data on individual medical histories. And, historical claim experience on small group is rarely, if ever, available from prior insurers. These limitations make it very difficult to select a uniformly superior block of business. Small group underwriting cannot reasonably be expected to select superior risks. The primary emphasis, then, should be directed toward not underwriting poor risks, and, if possible, "weeding-out" poor risks from the insurer's existing business.

The difference between underwriting to select superior risks and underwriting to avoid poor risks may be subtle, but there can be substantial differences in actual practice. Participation requirements, excluded industries, and pre-existing condition exclusions are examples of underwriting tools which fit into the category of avoiding poor risks. There are a number of items that an insurer should consider in addition to these standard underwriting practices. An insurer should recognize that the closer someone is to the risk, the better the chances that he or she "knows" whether or not it is a good risk. That is, certainly the employer "knows" whether or not his risk is good or bad. A quality agent quite often "knows" whether or not a risk is good or bad. And, if applicable, a third party administrator can observe the general quality of the block of business. Even with such initial underwriting incentive programs, it is easy for "bad" risks to slip through the initial underwriting controls. To keep a block of small group business profitable, it is useful to have a renewal underwriting program. One note of caution, state regulations sometime limit the insurer's range of renewal options even for a MET sited in another jurisdiction.

We believe, then, that initial underwriting incentives and renewal underwriting controls are the keys to innovative underwriting of small group programs.

We have spend a great deal of time discussing the major issues from management's point of view. This is appropriate since these are the most important of all the major issues. We should, though, discuss briefly a few issues from the points of view of the actuary or consultant and the employer.

THE IN-HOUSE ACTUARY OR CONSULTANT

The major issues that concern the actuary are involved with risk control and rating. The two most important issues are:

1. To ascertain whether or not management has an adequate understanding of the nature of the risk and whether they have developed meaningful controls over the business.
2. How the actuary prices a medical expense product for which there exists no experience data.

A brief comment on each issue is in order.

Control

The actuary, whether in-house or a consultant, should carefully follow management's deliberations on the control procedures. Where possible, factual data should be presented to supplement the more theoretical discussions on, for example, the effect of a pre-existing condition exclusion on experience, the effect of various types of underwriting (guaranteed issue, short form non-medical,etc.) on experience, and the effect of various renewal underwriting programs on experience.

Rating

The initial rates needed to profitably write a small group program depend, in large part, on the quality of the block of business. This quality is, of course, unknown when the actuary is called upon to produce a rate structure. It is, therefore, very difficult to rate a new program. General population data, or data from other small group programs serve only as useful guidelines. Given this difficulty, the actuary seems to have two major responsibilities in pricing a new program. First, to inform management of the risks inherent in a rate structure based on data not directly related to the new program. And, second, to work with the administrator to design and to implement an experience reporting system which will eventually allow the block of business to be rated based on its own claims experience.

In addition to the problems inherent in producing an adequate initial rating structure, the actuary has a significant problem to face in devising an equitable rating structure. Since each participating employer can elect whether or not to join the program and whether or not to continue participating in the program, the rate for each employer must be equitable. It is simply not sufficient for the program to receive enough premium income from all employers combined. For example, if the actuary underrates the area factor for Chicago, the program may attract a disproportionate number of employers from Chicago. The poor experience from these participating employers, if not properly identified, may cause the actuary to increase rates for the entire program. Increased rates may, in turn, cause participating employers from, say, Springfield to leave the program for a lower cost plan. An inequitable rate structure, then, can cause good risks to be replaced by poor risks. Our example used area factors to demonstrate this point. But, beside area factors, the age curve, the relation of employee to dependent rates, and rate differentials by plan benefit differences can also cause the same problem.

The problems inherent in initially developing an adequate rate structure and in keeping the structure equitable for each participating employer require great care on the part of the actuary.

THE EMPLOYER

In buying a small group product, the employer may have considerations other than price and benefits in mind. The employer may have been aware of the bankruptcies of certain self-funded and third party administered METs. This may mean that he will be far more interested in financial viability and the indemnity of the insurer.

Another increasingly common consideration, especially for employers with 25 or more employees, is whether to fully insure, partially self-insure, or even fully self-insure (with stop-loss coverage) their welfare benefit plans. High deductible medical expense plans with the employer filling in the first $1,000 or $2,500 of benefits are becoming increasingly available. So, too, is specific and aggregate stop-loss insurance. Many agents have been able to develop attractive, and in some cases, meaningful sales presentations which are proving effective in selling self-insurance with stop-loss coverage. This trend to more risk bearing by the employer is one that an insurer will want to consider when designing a small group program.

CONCLUSION

Small group life, health, and disability insurance can be an attractive and profitable venture for an insurer. There are, though, myriad practical issues to be addressed. While these issues are far from insurmountable, there is one overriding consideration to keep in mind. The small group programs are not merely a conglomeration of individual risks or an extension of the lower limit of a true group program. It is our belief, then, that a successful program requires management to develop a fresh, small group point of view.

MR. THALER: I think you will all agree that Howard Bolnick has touched on many important facets of the MET group insurance business and that Chris Wain has given a very comprehensive summary of the current status of small pension business as viewed by insurance companies. Howard gave you a little of his background. I might say that my own is such that I was with a large insurance company for many years. In recent years I have been practicing as an independent consultant and seeing things from a different point of view. However, I have not completely lost my tendency to identify with insurance companies.

Let me address the subject of pensions first. I find that I am very often in sympathy with the need for an insured type of pension plan. Small employers come to us looking for actuarial help in connection with their pension plans. We often find that a plan is unsatisfactory in a number of ways. One problem sometimes is the confusion that arises from a pension plan document that has been drafted by an attorney who has had little practical experience with pension plan administration and design. Thus, we start with a document that is confusing; and, particularly in the case of a defined benefit plan, the plan drafter may have had only a limited understanding of the financial consequences of the plan design. Further, he may have created future fiduciary problems for the plan sponsor by a failure to anticipate administrative questions that will need to be resolved by reference to the plan document. Also, the plan sponsor may face the expense question of employing an attorney, an actuary, an accountant, and a plan administrator. By the time you add up the fees of all of these outside persons, a large portion of savings from tax deferment is lost thus defeating the plan sponsor's objective in adopting the pension plan. This is a serious problem. From my point of view, it is important that the small pension business survive. The employer must be able to afford a pension plan and I think affordability is one area where the insurance industry can be and is often of great help. There is no question in my mind but that the investment performance of the insurance business offers a great deal of dependability that the small employer cannot provide in attempting to manage his own pension fund. As a consultant, I encourage consideration of both the investment and mortality guarantees offered by the insurers. But, nevertheless, some employers want to control their own funds, and we do get involved in those kind of situations and try to service them as efficiently as possible. I think whether you be a consultant or an actuary with an insurance company there is a great deal yet to be done in improving the efficiency of the small pension business. We have many insurance brokers and general agents who come to us and say their insurance company cannot handle a particular kind of pension plan. We find that regional Internal Revenue offices do not always go along with prototypes approved by the national IRS office. In other words, if an insurance company has a prototype approved, it does not mean that the IRS' Los Agenles office, say, is not going to take exception to some provisions. ERISA is still in its infancy and there is a great deal more to be accomplished toward standardization and improved efficiency. I know that there are some actuaries who have been working hard at standardizing both administrative and actuarial programs. Also there are available services that give the agent in the field the ability to use a computer terminal to determine an optimum plan design while in his client's office. I mention these areas of progress as stimulants to the discussion which I hope will follow these few comments.

Let me turn for a moment to this matter of MET group insurance to which Howard Bolnick has addressed himself. I do not want to repeat what he said but I would like to present a different viewpoint on some of the things he said. Howard talked about this MET business as attractive and profitable. Now, we really do not disagree on this. I think it can be attractive and profitable, but I am sure for many of you in the audience these are not the words that would first come to mind in connection with this kind of business. As Howard pointed out, there have been some very unhappy circumstances in the last couple of years which have given anything but that impression. As a result, I think that the MET business has been abandoned by some insurers and avoided by others for fear of the risk. The facts are that whether you call it MET business or by its more generic name group medical expense insurance for small employers, this business has been around for a long time and it has been and continues to be marketed profitably by some insurance companies. So, I would like to add a word of encouragement to insurers reassessing this marketplace. In our contracts with both large and small insurance companies, we find that where there was genuine concern a year or two ago, there is now serious consideration of this business again. This business serves an important social need and there is no question but that the marketplace is a big one. Further, there is an important tie between Chris Wain's topic and Howard Bolnick's. Many agents and brokers view the ease with which they can sell medical expense plans as a door opener for the sale of other important insurance products such as business insurance and small pension plans. The small employer, as a matter of fact, has little alternative these days but to buy a plan of life and medical expense insurance for his employees. Thus, medical expense insurance is a relatively easy sale and there is a big market. Once that sale is made, the agent or broker has a contact which opens up a proprietor or officer of that small company to him for the useful by-product sale.

But the important question is how do you underwrite this business and not lose money in the process? I would place at the top of the list the need for a management information system that an insurer must have in its own offices, or it had better look carefully for a third-party administrator with such capabilities. If you are an insurer, it is essential that you remain fully in control of how that business is being administered. The need to understand how well your financial, marketing and conservation results are projected to emerge a year from now is information that you should have monthly in the aggregate and in much greater detail, say quarterly or semi-annually.

In the past few years, some insurance companies have failed to recognize that there is a basic difference between this MET product and regular group insurance. Larger groups are sold on the basis of averages but averages cannot be relied upon in this business. Each employer constitutes a unit of potential anti-selection and an employer usually knows much about the health of his employees and his own family. I for one do not recommend that an insurer forego use of individual health underwriting. There are many METs that in effect disregard the health of the insured individuals except for the protection of a pre-existing condition provision. I cannot personally encorse this point of view. Failure to use individual underwriting procedures will result in significantly higher loss ratios and a possible need for severe rerating practices. I think individual underwriting can be modified to some extent to take account of the total size of the group being underwritten but to overlook it completely is a much more hazardous undertaking. Further, as long as some METs are sold without individual underwriting, this fact will help insurers who do get health statements. To some extent the brokers and employers who are concerned about particular individuals qualifying for coverage will tend to select those plans which do not have these requirements.

The other thing I would like to mention is the trend that has taken place in the last few years toward more careful area rating by zip code address of employer. This method of rating not only reflects the differences in the cost of medical care, but it also reflects the difference in the quality of business that an insurer is getting in a particular area. I had a very interesting remark made to me just the other day by an agent who is active in this field and whose company rates the business by zip code. He said, "You know, I encouraged a potential policyholder to stay with his present carrier because I know that the owner had diabetes and that at least one of his employees was seriously ill." He said that if his company accepted that kind of business it would adversely affect the rating of business in his agency next year. Unfortunately, that is not always the attitude of agents who are marketing this business, but I think it is a healthy sign to see this kind of identification by an agent with his company's need for sound underwriting.