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Insurers Giving Away The Store With Aggregating Specific Pricing

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Today, many employers are requesting quotes for aggregating specific provisions to their individual medical stop loss contracts as a means to reduce the premium outlay. While this will reduce the premium, brokers, TPAs and underwriters alike have been placing too high a value on this provision.

(Employers who self-fund their employee medical plans often arrange for stop loss reinsurance with an insurer for strictly financial reasons. It does not impact the employee's medical benefits. This article focuses on how the employer is attempting to reduce their stop loss reinsurance premium.)

Consider a specific contract with a $50,000 individual deductible and a request for a $50,000 aggregating deductible. This implies that the insurer only pays the excess of the total specific claims for the groups over $50,000. Frequently, the employer (as well as the broker and the TPA) expect that such a provision will decrease the premium by close to $50,000. The theory is that since the insurer will be paying $50,000 less in claims, the premium should be reduced by $50,000. Many underwriters agree and reduce the premium by the full amount.

However, without getting too technical, it is very easy to illustrate why this discount is overstated.

Consider an insurer who writes 10 policies for which the insurer collects $100,000 each for a total of $1 million in premium. Assume the insurer priced for a 70% permissible loss ratio, ($700,000 in claims), and expenses, commissions and profit of 30% or $300,000.

A typical expected claim distribution among the 10 policies may be as follows:

Policy #	Expected Claim
1	0
2	0
3	0
4	$10,000
5	$20,000
6	$30,000
7	$40,000
8	$50,000
9	$150,000
10	$400,000

As mentioned above, the total is an expected $700,000 in claims.

What happens if an aggregating specific deductible of $50,000 is added to all ten policies and the underwriter gives discounts of 100% of the $50,000?

First, the insurer now collects only $500,000 in premium rather than $1 million. Assuming the 70% permissible loss ratio is still valid, there is only $350,000 for which to pay claims. This assumption, however, is doubtful, as the provision does not alleviate any fixed expenses in the original premium, such as underwriting the case or reviewing the individual claims. It actually adds administrative expense as the insurer's specific claims unit must now aggregate the specific claims to determine what they should pay.

'Lasering is the practice of setting a higher deductible for one or more individuals in the group based on the known medical conditions prior to the start of the coverage period.'

Second, the aggregating specific provision only reduces the insurer's claims by $250,000 ($150,000 from policies 4 through 8; $50,000 on policies 9 and 10). This means there will be $450,000 in claims. Hence, the insurer has collected $350,000 of the $500,000 in premium to pay $450,000 in claims. In other words, they under priced the claim portion of the premium by $100,000. That's 20% of the $500,000 in premium collected, which will cause their loss ratio to be 90% instead of 70%.

Apparently, many in the industry have forgotten the actuary who drowned in a river that averaged two feet deep. Although the average depth was two feet, some spots were actually much deeper. While the premium reflects our "expected claim amount" statistically speaking, the "expected claim amount" is not meant to serve as a prediction of what the actual claim amount will be. (Just like the depth of the river!) Rather, the "expected claim amount" of a particular policy is only its contribution to the insured pool. Actual claims will vary considerably from the average.

Aggregating specific is also used as an alternative to lasering. Lasering is the practice of setting a higher deductible for one or more individuals in the group based on the known medical conditions prior to the start of the coverage period. (Note that this does not impact the employee's medical benefits – it only impacts the agreement between the reinsurer and the employer.) In this case, the pricing

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