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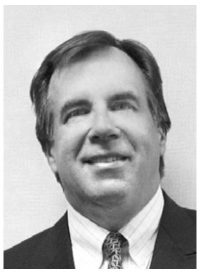
Stop Loss Myths Debunked

by John Ahrens



John Ahrens, FSA, MAAA, is consulting actuary at Hause Actuarial Solutions in Overland Park, Kan. He can be reached at *johna@hauseactuarial.com*.

Having been involved with medical stop loss for 30 years, I'm surprised at the number of myths that have persisted over three decades. In this article I will share some opinions and observations derived from my experiences as a major reinsurer of stop loss in the early 80's and as a rapidly growing stop loss MGU (managing general underwriter) in the 90's.

Starting as a Reinsurer

As a reinsurer in 1981, I provided the specific stop loss rates to MGUs and they determined the aggregate attachments. The stop loss market was growing very fast, so distribution channels and TPA relationships were more important to success than sophisticated rating approaches. On the other hand, I had an MGU on the HMO excess side, R.W. Morey, whose pioneering rate and contract approach on provider excess shaped that industry. Bob Morey kept his approach entirely proprietary and that business segment enjoyed tremendous financial success based primarily on his rating skills and sales efforts. His success motivated me to consider a new approach to rating stop loss.

Beginning Small and Evolving to a Large MGU

I was hired in 1993 to be MGU for a Blues owned TPA whose small life insurer affiliate took all the risk. After gaining over 40 percent market share and excellent profit margins due to a new experience rating technique in one market, I formed a national MGU in 1995 with a partner and traditional underwriters and used issuing companies taking 10 percent of the risk with 90 percent quota share reinsurance arranged by intermediaries.

By mid 1997 the traditional underwriting approach was not producing adequate results, so traditional underwriters were replaced with my experience rating approach on all groups and I reviewed every case. My firm, AFS, grew rapidly although much of the growth was in the riskier under 100 employee market. By late 1999 the stop loss rating cycle was very difficult for MGUs and the lack of profits discouraged reinsurers. In 2000, without a strong reinsurance relationship or a risk-taking carrier, I was forced to liquidate my large, 80 person MGU. Although the hardening of the market in 2000 was celebrated by the survivors, stop loss has continued to be characterized by rating cycles and continued disruptions to participants.

TPA Market vs. ASO Carriers

ASO carriers with proprietary networks have made steep inroads in to the TPA market. Stop loss has become harder to find for groups with fewer than 100 employees which should be a key market for TPAs who are having trouble retaining large groups. Even now, it seems significant changes have not taken place regarding stop loss rating approaches. Pooling provided by a carrier as part of their ASO services has a captive audience and thus faces fewer obstacles to profits as compared to MGUs in the TPA stop loss market. However, they still face "rate" competition in the form of consultants to the employer deciding on the level of stop loss or possibly going without. Small and mid-size MGUs are being squeezed by large carriers that take all the risk in the TPA market with their own underwriting departments and by large MGUs that have been bought or merged with insurers.

Having seen stop loss from many angles, I offer my opinions. It seems that little has changed with regard to common "myths" and lack of change is not necessarily a positive thing, since stop loss is a line of business where few risk takers have consistently made money. I hope to provide insight for those relatively new to the marketplace, and possibly provoke some spirited discussion and stimulate action for seasoned veterans of the "stop loss wars."

MYTH 1: Only Buy Stop Loss from Insurers Rated A or Higher

Myth Promulgators

E&O Carriers, Employers

The Reality

- Many employers are unaware or confused about the roles played by TPAs, MGUs, issuing companies and reinsurers so think a high rating provides security.
- Many agents are required to use A and higher-rated insurers by their E&O insurer.
- The employer usually follows the stop loss recommendation of the TPA/broker without independent verification.
- For the TPA, the most important criterion is often their relationship with the MGU underwriters and executives and TPAs follow them to other firms.
- Most employers and TPAs expect to get a reasonable renewal from the stop loss insurer.
- Highly-rated insurers are often reluctant to get in to a line of business that executives know little about.
- Stop loss is a one-year contract with no guaranteed renewals, so insurer insolvency is a very low risk compared to the relatively high likelihood of the issuing carrier or reinsurer leaving the market, often with very little warning.

Resulting Problems

- B+ insurers and some A- that are interested in writing stop loss and even taking substantial risk have to get a highly rated front company, at significant cost.
- Employers and TPAs are constantly at risk that the current stop loss MGU or carrier will not be there to provide a renewal quote.
- Many TPAs have to trust the MGU and are not equipped to make informed decisions about the MGUs future.
- If an MGU or reinsurer treats a client poorly, usually only the affected client and TPA know about the issue. Sometimes, the highest rated entity (often the reinsurer) is the one most likely to cause slow or only partial claim reimbursement, since they have significantly more legal resources and may play hardball to limit losses.

A Solution—Transparency and Education

Employers and TPAs/brokers need to know much more about key players at the MGU, issuing insurers and even reinsurers. E&O carriers need to be educated on the real sources of lawsuit risks in stop loss—and there are many, but have nothing to do with the issuing company's rating.

Commentary

Greater disclosure by MGUs and risk takers in an ongoing, published format with negative implications for those not participating would be a first step. Ultimately, a subscription-based service with informed commentary and opinion would be very helpful in gaining real insights for decision making by employers and could reduce the number of lawsuits.

CONTINUED ON **PAGE 40**

Many employers are unaware or confused about the roles played by TPAs, MGUs, issuing companies and reinsurers so think a high rating provides security.

MTYH 2: Reinsurers Are Key Partners

Myth Promulgators

Intermediaries, Issuing Insurer Executives, Reinsurers

The Reality

- A few reinsurers efficiently provide specialized services like transplant centers, network discount analysis and administrative functions by spreading the cost over a large client base.
- Although the stop loss claims tail is relatively short, reinsurers tend to move off MGU based programs quickly and also leave stop loss entirely.
- Reinsurers may abuse the spirit behind a 90 day termination clause by always providing provisional termination notice.
- Key persons often move from one reinsurer to another, so personal history and reputation is important.

Resulting Problems

- Accident and health is often considered a minor line for reinsurers, so senior management is often unfamiliar with the product, and likely to get out of the market without much concern for staff or clients.
- Most reinsurers only have a contractual relationship with the issuing company and not the MGU who does the rating.
- Typical reinsurance contracts are only for a treaty year, and are renewed without even a single month's completed contract year for the contract period.
- Issuing carriers prefer to reduce their risk exposure by taking a sizeable fronting fee but minimal risk.

A Solution—Issuing Carriers Need to Take the Majority of Risk

Issuing carriers should be prepared to take up to 50 percent of the risk, and even go for periods of time without any quota share reinsurance, otherwise their MGU market could disappear. MGUs, especially large ones, need to affiliate with insurers that can take sizeable risks and have a longer term risk horizon.

Commentary

It is risky to rely on a reinsurer that has not been in the stop loss market through an underwriting cycle (five to six years). Make sure the lead reinsurer contact is knowledgeable in stop loss, and become familiar with the decision-makers. Reinsurers or issuing companies taking a large portion of the risk should retain the right to review and approve final underwriting on every case. With that right, they should be willing to commit to a longer-term risk horizon (at least two years) and a six-month termination notice requirement.

MYTH 3: The Relationship of Quoted Rates to Manual is the Key to Profitability

Myth Promulgators

Unsophisticated Reinsurers, Actuarial Consultants, Stop Loss Auditing Firms

The Reality

- The most important factor in rating is determining the true underlying claim cost.
- Manual rates can be manipulated by underwriters, especially on industry factors and network assumptions.
- Providers of manual rates are often secretive as to their sources of data.
- Many firms fail to tie manual rates back to their experience before implementing them.
- Reinsurers and MGUs often combine several rate manuals for their own unique blend.
- Surveys of manual rates don't seem to reflect real quotes and in-force rates.
- Reinsurers may forbid quoting below a figure such as 85 percent of approved manual rates.

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Table 1: Analysis of Stop Loss Block Based on Manual and Experience Rated Rates

						Current Year Results (In 1,000s)					Three Year Results (In 1,000s)		
						Gross Premiums				Claims	Gross Premiums		Claims
Industry		Ees	Adult Units	Spec Level	EAF	EAF Renewal Trended	Manual Renewal Trended	Actual Renewal Trended	Current Premium	Current Yr. Actual Claims	EAF Est. Adj. Premium	Renewal Est. Adj. Premium	Total Claims
Clinic	(a)	285	458	60	1.70	$658.8	$387.5	$279.6	$271.2	$479.0	$1,527.0	$648.1	$809.3
VoTec Clg.	(b)	56	78	25	1.45	$131.7	$90.8	$72.3	$82.2	$150.4	$320.6	$176.0	$183.9
Mfg-Pckg	(c)	263	495	75	2.21	$566.9	$256.5	$184.1	$267.5	$327.2	$1,732.6	$562.6	$1,199.7
Mfg-Svcs	(d)*	335	749	75	0.80	$264.2	$330.3	$223.9	$236.6	$78.3	$814.7	$630.2	$459.7
Retail	(e)*	44	76	30	1.35	$129.3	$95.8	$122.1	$143.9	$29.9	$530.4	$501.0	$322.8
Hospital	(f)*	743	1,323	150	1.45	$637.1	$439.4	$173.6	$245.7	$557.3	$1,738.9	$474.0	$1,284.2
Mfg-Svcs	(g)	199	327	60	0.55	$124.0	$225.5	$128.4	$137.8	$61.5	$531.3	$515.0	$62.5
Bank	(h)	331	586	75	1.22	$475.6	$389.8	$185.4	$222.1	$422.3	$1,185.6	$462.3	$1,025.9
School	(i)	1,208	2,332	150	1.20	$814.4	$678.7	$495.2	$388.8	$859.2	$2,479.9	$1,423.4	$2,170.2
Retail	(j)	1,400	2,590	175	0.55	$322.3	$586.0	$242.2	$383.9	$0.0	$774.6	$582.0	$1,311.0
Total		4,864				$4,124.4	$3,480.3	$2,106.8	$2,379.9	$2,965.1	$11,635.7	$5,974.6	$8,829.2
Average		486.4				$412.4	$348.0	$210.7	$238.0	$296.5			
All Groups													
Est. Net Premium Avail for Claims & Profit						$2,929.2	$2,471.8	$1,496.3	$1,690.3		$8,264.0	$4,243.3	
Net Incurred Loss Ratio						101%	120%	198%	175%	$2,965.1	107%	208%	$8,829.2
*EAF Competitive Groups (d,e,g)													
Est. Net Premium Avail for Claims & Profit						$367.6		$336.9	$368.2		$1,332.7	$1,169.2	
Net Incurred Loss Ratio						46%		50%	46%	$169.7	63%	72%	$845.0
Remaining Groups													
Est. Net Premium Avail for Claims & Profit						$2,561.7		$1,159.4	$1,322.1		$6,931.3	$3,074.1	
Net Incurred Loss Ratio						109%		241%	211%	$2,795.4	115%	260%	$7,984.2

Resulting Problems

- Manual rates will usually be too high or too low for actual groups. If they are too low, writing the business will generate losses that could lead to higher rates and a death spiral. If they are too high, you may be letting your competitors pick off the better risks.

- Manual rates are usually not provided in a format that helps in analyzing the underlying risk—they do not provide an expected number of claims.
- Underwriters often are skeptical of manual rates and have difficulty selling significantly higher rates, especially if a group has good experience or no ongoing claims.

A Solution—
Re-Rate Based on Experience Analysis

The best way to maintain profitability is to independently re-rate a large proportion of business shortly after or just before it is written. Never quote without reviewing experience and modify the manual rate based on experience.

Commentary

Table 1 summarizes results of an analysis of actual groups that renewed in 2007 for a respected TPA. "EAF" stands for Experience Adjustment Factor and represents the ratio of the "true" rate deemed appropriate for a risk based on experience rating to the manual rate, which reflects demographics, area, industry and network. Under "Current Year Results," gross premiums for the renewal period are trended back to the midpoint of the current year on four bases: EAF, manual, sold renewal and actual premiums for the year. The fifth column shows the actual claims for that year. I also show the EAF based premium trended back for three years and the actual renewal rates sold trended back and compare them to total stop loss claims for the three years.

The EAF approach would have been competitive on three of the 10 groups and the loss ratios for the current year and the past three years on those three groups was very good. What is alarming is the reality of actual stop loss pricing where, despite losses in the current year and over three years, the renewal premiums overall actually decreased. The actual renewal rates sold

CONTINUED ON **PAGE 42**

in 2007, if trended back for the last three years, would have generated a 208 percent net loss ratio (claims divided by gross premium less expenses). Also, note that for two of the three EAF rated groups that are competitive, (d and g) the EAF is below what would often be allowed by reinsurers relative to manual.

MYTH 4: Competition Keeps Compensation to TPAs / Brokers and MGUs Reasonable

Myth Promulgators

Reinsurers, Employers

The Reality

- Almost all compensation is expressed as a flat percentage of premiums.
- MGUs compete for TPAs with TPAs focused on getting the highest percentage commission possible.
- A significant amount of underwriting effort is spent providing quotes on prospects with poor close ratios.
- Renewals are relatively easy to keep because of the last look process, except during aggressive pricing portions of the underwriting/ rating cycle.
- Reinsurers will try to improve loss ratios by reducing allowed compensation to MGUs and possibly TPA/brokers but it seldom lasts.

Resulting Problems

- Stop loss commissions to TPAs often exceed administration fees for smaller groups.

Table 2: Typical Expense Levels and an Alternate Approach

		Typical Levels		Alternative Approach		
Payee	Based On	High	Low	%	Fixed	Fixed Payout Based On
Risk Charge	Expected Claims	15.0%	10.0%	8.0%	$3,000	Add in to Claims
Lead Reinsurer & Int.	Net Premiums	3.0%	1.5%	2.0%	$0	Load in Net Premiums
Issuing Carrier-Pr. Tax	Gross Premiums	2.5%	2.5%	2.5%		Actual State Tax and Assessments
Issuing Carrier-Other	Gross Premiums	5.0%	3.5%	2.0%	$1,000	For Audit and Compliance Costs
MGU	Gross Premiums	12.0%	8.0%	5.0%	$4,000	$4,000 at Policy Issue
TPA/Broker	Gross Premiums	15.0%	10.0%	5.0%	$6,000	$3,000 at Issue, $3,000 at Renewal
		34.5%	24.0%	14.5%	$11,000	
Total Load Factor to Expected Claims*		1.810	1.469	*1.289*	*Incremental Factor,*	
					see below for total based on premium size	

Alternative Approach Average Non-Risk Takers Fees at Different Gross Premium Levels

		$ 60,000	$ 120,000	$ 200,000	$ 300,000
Issuing Carrier-Premium Tax		2.5%	2.5%	2.5%	2.5%
Issuing Carrier-Other		3.7%	2.8%	2.5%	2.3%
MGU		11.7%	8.3%	7.0%	6.3%
TPA/Broker		15.0%	10.0%	8.0%	7.0%
	Non-Risk Takers Expense	32.8%	23.7%	20.0%	18.2%
Total Load Factor to Expected Claims*		1.775	1.493	1.404	1.363

Comparison of Alternative Approach to Typical Fee Levels

Gross Premium	$ 60,000	$ 120,000	$ 200,000	$ 300,000
Net Premium to Risk Takers	39,510	89,804	156,863	240,686
Expected Claims	33,805	80,374	142,466	220,080
Premium at High Fees	61,189	145,479	257,866	398,350
Premium at Low Fees	49,674	118,102	209,340	323,387
Ratio of High Fees to Alternate	1.02	1.21	1.29	1.33
Ratio of Low Fees to Alternate	0.83	0.98	1.05	1.08

*Includes reinsurance and risk charge

- The level of fees adds dramatically to the cost of the self-funded plan for employers with less than 500 employees, and especially under 200 employees.
- Employers are generally unaware of the total compensation paid and how much of the premium is available for claims and the risk takers' profits.
- Smart employers should try to minimize premiums with specific corridors, which are also difficult to rate.
- TPA stop loss business has significantly higher expenses than carrier ASO business.

A Solution – Move to a Graded Fee Schedule, Possibly Using a Fixed Fee Plus Lower Percentage

Graded compensation arrangements based on a group's premium would better align the interests of all parties and improve competitiveness. TPAs and brokers must be held more accountable for cost levels on their blocks of business. Underwriting must become more efficient, perhaps MGUs should even charge for new business quotes.

Commentary

Many actual expenses per group in stop loss are relatively constant. As a result, a fixed-cost component works well to get more compensation on low premium groups and then a lower percentage keeps premium levels more competitive for groups with high premiums. In addition, the fixed fee component could be paid to encourage certain behavior that is desired. Profit commissions are complicated and generally discounted by affected parties so not covered here.

Table 2 shows some typical loads that may be common at different points in the underwriting cycle. The problem is the total load factor at "high" levels or on large premium groups is too high to expect to sell profitably. An alternative approach, grades down the overall fees as a percent of premium for the larger premium groups. This approach makes it more likely to sell larger groups on a profitable basis, although compensation is less.

MYTH 5: Specific Stop Loss Experience is Generally Not Credible

Myth Promulgators

Actuaries, Reinsurers

The Reality

- Many underwriters use experience rating, but primarily only on "really bad" groups.
- Few MGUs and reinsurers know the basis of the manual rates being used or how good the underlying data and assumptions are that go into building rate tables.
- There are many more factors affecting the risk than are reflected in manual rates.
- Risks are always evolving—hospital charges, network discounts by claim band, treatments, and new diseases.
- Many actuaries want over 25 claims before believing experience, and prefer hundreds.

Resulting Problems

- Homogenous risks are an illusion – for example, although many law firms run "bad," experience rating can uncover "good" ones.
- Manual rates don't provide tools needed to unlock important information provided in the experience.
- Manual rates are not tied in to in force experience and experience on prospective business.
- Manual rates generally fail to provide an expected number of claims.
- Grouping data for more "credibility" may hide key risk variances that should be noted, rather than hidden.

A Solution – Experience Rate Based on Claim Tiers

Relatively few claims can tell an underwriting actuary a lot about the underlying risk. Rather than assuming the manual expected claims are right, my recommended approach is to focus on what the actual claims would suggest as to the appropriateness of the manual rates. Experience

CONTINUED ON PAGE 46

Many underwriters use experience rating, but primarily only on "really bad" groups.

What the New York Yankees ... | FROM PAGE 45

While the Yankees don't win every year or every game, they are consistently one of the best teams in baseball. If you don't yet agree, look at the long-run profitability of the franchise as an indicator of success. The Yankees are the clear winners.

Isn't long-run profitability also the goal of most insurance businesses?

The Yankees and Red Sox

- Invest in the most talented people.
- Offer a competitive product to attract fans.
- Win in the market and make fewer errors than most of their competitors.
- Find new management when they aren't winning championships.
- Sell out every game with huge demand for their product.
- Train and believe in their young players who show promising results.
- Combine good pitching with superb hitting to win games and championships.
- Use statistical analysis and scouting to make better data-driven decisions.
- Overcome obstacles and setbacks and prepare for the upcoming road trip.
- Value diversity in their players and fans, and
- Have fun and celebrate their successes.

Shouldn't we do the same in health insurance... and life? ■

Stop Loss Myths Debunked | FROM PAGE 43

rating unlocks true characteristics of a block as shown under Myth 3.

Commentary

From reviewing thousands of groups, I have developed an approach to applying credibility based on very few claims. Suppose you were looking at experience at a certain level, and over the past three years your manual basis would have expected 5.50 claims. However, there were actually only two. Some actuaries might consider a distribution like Poisson and think –there is a 10 percent likelihood that with 5.50 claims expected there would only be two or fewer claims so maybe they were just lucky. However, knowing the assumptions in developing manual rates and significant factors that are not reflected, with only two claims, I'd suggest it may not be reasonable to assume that 5.50 is the true underlying claim number. Therefore, I would look for an expected claim number, such as 3.63, that is more likely to have only two claims occur. Under this approach, the lowest experience adjustment factor (EAF) to consider using for rating would be .66 (3.63/5.50). Although only one consideration in rating, it does provide a statistical basis to vary rates from manual. Another important use of expected and actual claims is to look for areas where manual rates should be adjusted for future rating cycles (i.e., if several groups with one network all had significantly better than expected actual claims then probably the network factor should be lowered).

Conclusion

Stop loss is an exciting and challenging specialty area in health. I encourage more actuaries to take a close look at the underwriting side and review real case files. The experience may be insightful and you may draw some interesting conclusions. Enjoy! ■