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Level Funding: An Alternative to the ACA for Small Groups

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Under the Affordable Care Act (ACA), groups with 50 or fewer employees will eventually be subject to the ACA's modified community rating rules. While some groups will see lower premiums than they would have without the ACA, others will see significant premium increases. Many of the latter group types are motivated to avoid the ACA for as long as they can, as evidenced by the large number of small groups that chose to keep their transitional coverage at renewal in 2014. With the availability of transitional relief soon to expire, what will these groups do in the long term? Will they purchase ACA-compliant coverage, drop coverage, or maybe find some way to be defined as a large group? Another possibility is for these groups to enter into a self-funding arrangement of some sort.

Though self-funding has historically only been a realistic option for groups with at least a few hundred employees, the premium disruption and potential loss of business caused by the ACA has incentivized insurance carriers and third-party administrators (TPAs) to develop an alternative self-funded product offering, sometimes called "Level Funding," for small groups. This article will provide an introduction to the potentially significant market these products serve, along with an understanding of how the products are designed and priced, why these products have yet to gain significant market share, regulatory and market considerations associated with the products, and the potential risks involved with the products for both insurers and small groups.

SELF-FUNDING BASICS

Self-funding refers to a spectrum of funding methods in which the group bears a significant portion of the financial risk of its members' health coverage rather than having a third party—the insurance company or health plan—bear the risk. Self-funding can take multiple forms including administrative services only (ASO), ASO with stop loss, minimum premium arrangements, and so on, in addition to coverage administered by a TPA with or without stop-loss arrangements.

There are several advantages to groups entering into a self-funding arrangement, such as:

- The group will avoid premium taxes, state health coverage mandates and certain ACA-related fees;
- The group will directly benefit from its favorable claims experience; and
- The group will forgo paying insurance company risk charges.

Disadvantages of self-funding for groups include:

- Less predictable cash flows
- The bearing of financial responsibility for unfavorable claims experience
- The need for the group to obtain and pay for the advice of insurance professionals to help manage their plan
- The potential need for the group to buy stop-loss insurance

For small groups, the disadvantages of self-funding have typically outweighed the advantages, and thus self-funding has historically mostly been the domain of larger groups. However, self-funding may become a much more viable option for a certain segment of the small group market in the near future. The ACA's small group community rating rules will cause significantly unfavorable rate increases for many small groups, often 50 percent or more. Premium disruption of this magnitude may be unacceptable for many of these groups, and those groups will investigate potential alternatives to the ACA including a self-funding option called *level funding*.

LEVEL FUNDING BASICS

Level funding is an ASO product with integrated stop-loss coverage offered by insurance companies, brokers and TPAs. Level funding products are designed to allow the group to benefit from the advantages of self-funding, while limiting the disadvantages. As the name implies, groups with a level funding product will have fixed or level monthly costs associated with the funding of their members' health coverage. For lower-risk groups, the monthly premium equivalents associated with a level funding product are often lower, sometimes much lower, than the premium the group would pay for the same benefits under the ACA's community rating rules.

Level funding products typically have five cost components:

- An ASO fee to cover the administrative and selling expenses associated with a group's health plan
- Aggregate stop-loss coverage
- Specific stop-loss coverage
- A paid claims fund held by the level funding issuer to cover the costs of the group's expected claims costs (non-stop loss) over the current projection period
- An incurred but not reported (i.e., IBNR) fund to cover claims incurred during the projection period, but paid afterward

A sixth, unofficial component of a level funding product's cost is an incurred claims cost projection. The incurred claims cost

projection is used to develop several of a level funding product's official cost components and is necessary to truly assign financial responsibility for the group's expected costs.

The level funding component that allows the group to pay fixed monthly payments is the paid claims fund. The paid claims fund is the product of the aggregate stop-loss (ASL) corridor and the group's projected paid claims below any specific stop-loss (SSL) deductible. The paid claims fund pre-funds the group's maximum liability under a level funding product, as actual paid claims over the ASL corridor are covered by the ASL insurance coverage. If the group's actual paid claims for the coverage period are below the ASL corridor, the group will receive some portion of the paid claims fund's surplus as a refund. The refund allows the group to benefit from its own favorable claims experience, and thus level funding is considered a self-funded product.

A group's projected paid claims fund implicitly includes an expected surplus equivalent to the group's projected paid claims below the SSL deductible times the ASL corridor minus 100 percent. Table 1 shows three scenarios that illustrate the mechanics of a typical level funding product's paid claims fund. The level funding product specifics for the group are identical for the group under all three scenarios, with the only variable item being the percentage of expected cost that the group's actual paid claims below the SSL deductible are (either 100 percent, 130 percent or 70 percent in the three scenarios).

Table 1
Paid Claims Fund Surplus Determination

	Scenario 1	Scenario 2	Scenario 3
Projected paid claims cost PMPM below SSL ded	$176.91	$176.91	$176.91
ASL corridor	120%	120%	120%
Paid claims fund maximum liability PMPM	$212.29	$212.29	$212.29
Actual paid claims cost PMPM below SSL ded	$176.91	$229.98	$123.84
Actual paid claims cost as a % of expected	100%	130%	70%
Actual paid claims fund surplus PMPM	$35.38	$0.00	$88.46

LEVEL FUNDING AND ACA PRICING COMPARISON

The primary appeal of a level funding product for some small groups is price. As mentioned previously, lower-risk small groups can expect to pay level funding premium equivalents that are lower than the group's ACA premium for the same coverage. The reason is that the ACA's community rating rules result in premiums for these groups that contain a "subsidy" used to offset the claims costs of more costly groups in the ACA small group market. The ACA's community rating rules provide relatively few pricing levers to differentiate the cost of small groups and explicitly restrict pricing small groups based on risk. Level funding products do not have these restrictions, as stop-loss pricing is not subject to the ACA's community rating rules, and the rest of the group's claims costs are contractually the group's responsibility.

For illustrative purposes, let's look at two hypothetical groups with 45 subscribers looking for the exact same small group coverage (i.e., they have the same benefit plan) with the same insurance carrier. Both of these groups took advantage of small group transitional relief to the fullest extent allowable in their state and are thus facing the prospects of the ACA's community rating rules upon renewal on Jan. 1, 2018. The two groups are expected to be polar opposites in terms of expected claims costs in future years. The first group, Living Well Graphic Arts, is a commercial art and graphic design firm that uses the latest software to help its clients (mostly health food stores, physical trainers, fitness advocacy groups, etc.) develop marketing materials. The current average age of Living Well's enrollees in 23.8 years and they have very low expected claims costs in the coverage period. The second group is Classic Cabs, a taxi-cab company whose enrollees have an average age of 44.6 years. While Living Well's employees and dependents are all fitness and healthy eating enthusiasts, 20 percent of Classic Cabs' members have Type 2 diabetes and 55 percent are self-reported cigar smokers.

Living Well and Classic Cabs' insurance company uses a rating manual to help develop small group ACA, small group transitional and level funding rates. The rating manual also develops a group-specific projected incurred claims cost that includes a proprietary method to develop a risk adjustment factor to the group's manual claims projection that is believed to be very accurate. Table 2 provides the insurer's projected incurred claims costs for Living Well and Classic Cabs for the plan year beginning January 2017.

Table 2
2017 Projected Incurred Claims Cost for Living Well and Classic Cabs

	Living Well	Classic Cabs
Base projected incurred claims cost (Med + RX)	$280.50	$280.50
Average demo factor	0.824	1.893
Industry factor	0.900	1.100
Area factor	1.000	1.000
Risk adjustment factor	0.850	1.150
Group-specific projected incurred claims cost	**$176.91**	**$671.68**

Living Well's projected claims costs reflect the group's favorable demographics, industry and risk profile, while Classic Cab's reflects the opposite.

Tables 3, 4 and 5 provide the rate development for both groups' small group ACA, small group transitional and level funding monthly premiums or premium equivalents for the plan year beginning in January 2017.

Table 3
Living Well and Classic Cabs' Small Group ACA Rate Development as of Jan. 1, 2017

	Living Well	Classic Cabs
Base premium rate (Med + RX)	$386.54	$386.54
Average age factor	0.955	1.652
Average area factor	1.000	1.000
Average tobacco user factor	1.000	1.055
2017 SG ACA premium	**$368.98**	**$673.67**

The small group ACA premiums for both of these groups do not consider any group-specific claims cost projection, as any such projection using the insurer's small group claims projection methodology would be based on non-allowable rating factors (including industry and demographic factors that consider gender and are not capped at a 3:1 ratio) and group-specific morbidity, which is forbidden under health care reform.

Table 4
Living Well and Classic Cabs' Small Group Transitional Rate Development as of Jan. 1, 2017

	Living Well	Classic Cabs
Base net premium rate (Med + RX)	$280.50	$280.50
Average age factor	0.824	1.893
Industry factor	0.900	1.100
Area factor	1.000	1.000
Group-specific net premium	$208.13	$584.07
Admin, selling, tax, and risk expense	$60.12	$90.60
Group-specific gross premium (prior to risk adj)	$268.25	$674.67
Group-specific risk adjustment factor	0.900	1.100
2017 Small group transitional premium	**$241.43**	**$742.14**

The small group transitional premiums for both of these groups start with an incurred claims projection that is very similar to the group-specific projections shown in Table 2. The one exception is that the risk adjustment factor for each group is applied to the premium rather than in the incurred claims projection. This is consistent with the small group reform rules that existed in the state prior to the passing of the ACA in 2010. The state limits risk adjustment factors to +/-10 percent.

Lower-risk small groups can expect to pay level funding premium equivalents that are lower than the group's ACA premium for the same coverage.

Table 5
Living Well and Classic Cabs' Level Funding Rate Development as of Jan. 1, 2017

	Living Well	Classic Cabs
Group-specific projected incurred claims cost	$176.91	$671.68
ASO fee	$44.38	$44.38
Specific stop loss	$86.25	$163.28
Aggregate stop loss	$14.63	$60.88
Paid claims fund	$124.47	$528.89
Reserve fund	$19.15	$62.22
ACA fees	$2.45	$2.45
2017 Total level funding premium equivalent	**$291.32**	**$862.10**

The total level funding premium equivalents for both of these groups are based on the insurance company's best estimate of a group-specific risk-rated incurred claims projection. The total level funding premium equivalent represents the maximum either group will pay on a per member per month (PMPM) basis for their upcoming plan years. As mentioned previously, if either group's actual paid claims costs exceed the paid claims fund, neither group will pay the insurance company any additional fees. However, if either group's actual paid claims costs are less than the paid claims fund, the group will receive a refund. The level funding premium equivalents are priced based on stop-loss coverage assuming a $20,000 SSL deductible and 120 percent ASL corridor.

Tables 6 and 7 compare the small group ACA, small group transitional, and level funding PMPM premium or premium equivalents for Living Well and Classic Cabs for the same coverage for their plan years beginning Jan. 1, 2017.

Table 6
Comparison of Living Well's 2017 Small Group ACA, Small Group Transitional and Level Funding Premiums

	PMPM Rate	2017 Rate Increase	2017 Rate Rank (Smallest to Largest)
2016 SG transitional	$223.02		
2017 SG transitional	$241.43	8.3%	1
2017 SG ACA FI	$368.98	65.4%	3
2017 level funding	$291.32	30.6%	2

It is in Living Well's best interest to retain its small group transitional plan for an additional plan year beginning Jan. 1, 2017. If transitional relief is not available (e.g., at the time of Living Well's 2018 renewal), level funding will probably offer the group its most affordable coverage option.

Table 7
Comparison of Classic Cabs' 2017 Small Group ACA, Small Group Transitional and Level Funding Premiums

	PMPM Rate	2017 Rate Increase	2017 Rate Rank (Smallest to Largest)
2016 SG transitional	$679.00		
2017 SG transitional	$742.14	9.3%	2
2017 SG ACA FI	$673.67	− 0.8%	1
2017 level funding	$862.10	27.0%	3

It is in Classic Cabs' best interest to migrate to small group ACA coverage as soon as it can. Regardless of the options available to Classic Cabs, a level funding plan will probably represent the most expensive choice.

CONSIDERATIONS WITH OFFERING A LEVEL FUNDING PRODUCT

Ideally, insurance carriers would want the better-risk small groups to migrate to their small group ACA blocks. This is because these better-risk groups are very profitable to insurers under the ACA's community rating rule. Additionally, the migration of better-risk groups to small group ACA plans will help keep carriers' small group ACA rates relatively low while strengthening the long-term prospects of this block of business. For these reasons, an insurance carrier would probably not want to offer a level funding plan to a good risk group that would choose an ACA plan otherwise because doing so could lead to the potential cannibalization of the insurer's small group ACA block.

On the other hand, most groups will eventually make choices that are in their long-term self-interest. The same sort of economic self-interest also applies to insurance companies. Eventually, good-risk small groups will seek alternatives to the ACA's small group community rating rules, and one or more insurance carriers will offer alternatives to those groups including level-funding-type products. While most insurance carriers have yet to have much success with their offering of level funding products, it does not mean that level funding products will never capture a significant share of the small group health coverage market. This is because level funding does not yet offer good-risk groups with their lowest-cost option. As demonstrated in the earlier illustrative pricing comparison, while transitional relief is available to small groups, small group transitional plans will offer the lowest-cost option for these groups. However, once transitional relief goes away, level funding products become a very viable option for better-risk small groups. For this reason, it is in an insurance carrier's best economic interests to offer level funding products, because if it doesn't and its competitors do, the carrier risks losing its better-risk groups to its competition.

Level funding products are not necessarily easy to price, sell and administer. For example, it is vital that insurance carriers offering a level funding product develop the resources and skills to properly project the expected claims costs of individual small groups. Obviously, this is not an easy task, but it is exactly what insurers did prior to the ACA and various small group reform laws in multiple states. Risk rating small groups requires the use of small group underwriting techniques, such as medical underwriting (or medical applications), and other risk assessment tools, such as risk scoring, and detailed examining of current and/or potential high claimants. One thing that may make the process simpler is that better-risk groups are more likely to share the information necessary to receive the best price. Insurers can help promote this tendency by offering groups automatic "discounts" for submitting the information necessary to properly rate the group.

Another issue with pricing level funding plans is offering stop-loss coverage. A significant number of insurers do not currently offer stop-loss coverage and/or have very little experience offering stop-loss coverage to smaller groups. For these insurers it may be necessary to develop a stop-loss rating model and hire actuaries and underwriters familiar with pricing stop-loss insurance. This is especially important since the stop-loss coverage needed to cover small groups tends to be very rich (i.e., low specific deductibles and low aggregate corridors). Furthermore, many states have adopted the National Association of Insurance Commissioners' (NAIC's) model stop-loss law, which suggests setting minimum SSL deductibles (e.g., $30,000) and ASL corridors (e.g., 120 percent). Aggregate stop-loss restrictions can be more nuanced than the application of aggregate corridors, so it is necessary that an insurance company retain legal expertise to understand the stop-loss regulations in its specific state(s) and develop stop-loss contracts appropriately. Finally, the selling of stop-loss policies, which includes level funding products, often

requires the filing of rates and forms with the department of insurance in many states.

Level funding products should be designed, administered and priced to closely resemble the fully insured products that they are replacing. For example, insurance carriers should offer the same or similar plan designs that they currently offer to their small group transitional block. Additionally, it might be advisable to build in the cost of any ACA or state level fee assessments into the ASO fee since these groups are used to paying an all-in premium and are not expecting to have to write a check to the state or federal government. Insurers that offer level funding products should also price the product in such a way that the expected profit is similar to what they would have received from a fully insured group than from a traditional (i.e., larger) self-funding group. Profit (or contributions to surplus or margins) can be built into every component of level funding cost. Specifically, it might be wise for an insurer to retain a portion of the paid claims surplus as profit, as this will lower the upfront cost of a level funding product and signal to the group that the insurer also has "skin in the game."

Most of the small groups that would potentially benefit from a level funding product will not have much, if any, familiarity with self-funding or stop loss. It is, therefore, important that insurers train their sales staff and develop marketing efforts to help small groups understand level funding. These efforts should also include meetings with the brokers that represent these groups, as the brokers need to become experts and proponents of level funding for the good-risk groups that will benefit from the product. Finally, it makes a great deal of sense for insurance carriers to develop a target group list to determine the specific transitional relief small groups to which it plans to offer a level funding product. The target group list can be used to show an ACA versus level funding rate comparison for group renewals on or after Jan. 1, 2018.

THE FUTURE OF SMALL GROUPS AND SELF-FUNDING

There is a real possibility that a significant percentage of small groups will be in a level funding product after 2017. Transitional relief is a better option for groups while available, but better-risk groups in insurers' small group transitional blocks will most likely be interested in a level funding product that provides the same or similar coverage at a significantly lower price. The market for level funding is tied to the groups expected to migrate to the ACA market. The Protecting Affordable Coverage for Employees (PACE) Act, which removed the requirement that groups with 51 to 99 enrollees migrate to small group ACA plans beginning in 2016, did significantly reduce the potential size of the level funding market, but it did not eliminate it. Assuming that the ACA is not thrown out altogether and transitional relief ends as expected, the level funding market should have a meaningful size beginning in 2018.

Another question is how regulators and lawmakers will react to a potentially large level funding market. Earlier in this paper I mentioned the NAIC model stop-loss law. In response to the emergence of level funding products for small groups, more states could look to adopt the model law or strengthen existing stop-loss laws to make level funding less palatable for small groups. Additionally, it is entirely possible that some states, and maybe the federal government, might take direct steps to outlaw self-funding options for smaller groups, as New York has previously done for groups with fewer than 50 subscribers. As of this writing, I am not aware of any efforts to ban level funding products for small groups in any additional state or federal governments.

As mentioned previously, some insurance carriers would prefer to have all of their small group transitional business migrate to their small group ACA blocks. While this would be ideal for insurers with established small group business, it is not reasonable to expect all carriers to take this route. A large number of national insurance carriers have developed, or are currently developing, a level funding product. If you have one or more national insurers in your market, you can expect that a level funding product will be offered to your better-risk transitional small groups in 2018. Even if you don't, a level funding product will likely be offered sooner or later to your better-risk ACA groups. Either way, it is prudent that health insurance carriers develop their own level funding product in 2016 and 2017 to be sure that they are ready to offer it in earnest in 2018. ■

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