Segal Consulting

NewsLetter

Benefits, Compensation and HR Consulting

JANUARY 2015

# Time to Take Another Look at Stop-Loss Insurance

Two developments underscore the importance of taking a fresh look at stop-loss coverage. First, the Affordable Care Act has eliminated annual and lifetime dollar limits on essential health benefits. Second, the prevalence of high-cost claims has risen dramatically and the dollar level of those claims has increased.

The value of self-funding health benefits continues to show material savings over fully insured arrangements. As a result, more than 90 percent of Segal Consulting's health fund clients are now self-funded. For decades, many health plan sponsors that self-insure their medical and prescription drug coverage have purchased stop-loss insurance to avoid the financial impact caused by unanticipated high claims costs. Stop-loss insurance transfers the risk of large claims — also known as "catastrophic" claims or "shock" claims — from the plan sponsor to an insurance carrier that reimburses the sponsor for claims that exceed certain thresholds. This helps plans maintain financial stability.

Purchasing stop-loss insurance is a complicated process. Premium rates are obviously important in comparing policies, but trustees must also understand what their stop-loss insurance policies cover before they can make informed decisions regarding the best-value coverage that will help meet their objectives.

This *NewsLetter* reviews the basics of stop-loss insurance (see the text box "A Primer on Stop-Loss Insurance" on the next page) and how plan sponsors can use it to better manage the added risk and increased cost to plans that have made plan design changes to comply with the Affordable Care Act. It also looks at recent innovations and best practices for purchasing stop-loss insurance.

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**IN THIS ISSUE:**



## The Affordable Care Act

There are two key reasons why the Affordable Care Act has caused many plan sponsors to take a closer look at stop-loss insurance as well as remain self-insured:

- Annual and lifetime dollar limits on essential health benefits are no longer permitted, and
- There is a new federal tax on insured plans.

Many plans that had waiver limits set the stop-loss threshold at the level of those expiring limits. At renewal, they have also raised that threshold to mitigate premium increases in future years. (See the text box "Key Factors: Setting the Threshold, Choosing a Claims Basis, Lasering and Disclosure" on page 3.)

There are also reasons why the Affordable Care Act has made it more attractive for sponsors to self-insure or remain self-insured and purchase stop-loss insurance. Self-insured plans can avoid new federal insurance provider taxes that have begun having an impact on insurance rates. For example, the

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"Insured plans must cover new benefits, including wellness programs and fertility treatments, which can be very expensive."

Annual Health Insurance Industry Fee, which funds some of the provisions of the Affordable Care Act, has increased insurance rates by approximately 2.5 to 3.0 percent (in addition to existing state premium taxes that can also be as high as 2 to 3 percent of premium). Insured plans must cover new benefits, including wellness programs and fertility treatments, which can be very expensive. Plans that self-insure have the flexibility to decide whether they want to cover these new benefits.

## More Reasons to Consider Purchasing Stop-Loss Insurance or Reviewing Stop-Loss Coverage

In addition, plan sponsors should also consider purchasing stop-loss insurance to mitigate risk caused by the following unpredictable and potentially high-cost items.

The expansion of high-cost specialty medications for diseases such as hepatitis C, cancer, hemophilia and rheumatoid arthritis will raise risk significantly. Many of these drugs cost tens of thousands of dollars per month. Specialty medications are replacing less-expensive regular drugs. Segal recommends purchasing stop-loss insurance that covers prescription drugs as well as hospital and medical. (See more on this on page 6.)

Expensive life-saving treatments, such as organ transplants, dialysis and neonatal intensive care, are also contributing to the unpredictability of plan costs and could result in deficit spending for some plan sponsors.

### A Primer on Stop-Loss Insurance

**Stop-loss insurance is commonly offered in two forms:**

- ***Specific (individual) stop-loss insurance*** protects the plan sponsor against a large claim on any individual and limits the plan sponsor's liability to a set dollar figure (the threshold or deductible) per person, per policy year. For example, a plan sponsor may elect a threshold or deductible of $200,000. That means the sponsor is responsible for each individual's claims up to $200,000 and the insurer will reimburse the sponsor for claims that exceed that amount. Although specific stop-loss insurance protects the sponsor against individual "shock" claims, it does not protect against other expenses, such as a large number of high claims from more than one participant that do not exceed the individual threshold.

- ***Aggregate stop-loss insurance*** protects the plan sponsor against total paid claims liability. The sponsor's maximum liability is expressed in terms of a percentage of its total expected claims, typically 120 to 125 percent. The level chosen is known as the "*attachment point*." For example, a plan sponsor with a 120 percent attachment point and expected total annual claims of $10 million would be reimbursed for claims that exceed $12 million, usually up to a maximum of $1 million annually.

The stop-loss insurer determines the plan sponsor's total expected claims amount based on the sponsor's monthly paid claims history and enrollment information, which the sponsor must provide the insurer during the bid process. In most instances, plan sponsors can buy specific stop-loss insurance without aggregate stop-loss insurance, but they cannot typically buy aggregate stop-loss insurance without specific stop-loss insurance. Moreover, claims that are reimbursed under specific stop-loss coverage often do not apply to the sponsor's aggregate stop-loss coverage. As a result, the sponsor's likelihood of exceeding its maximum liability and being reimbursed by its aggregate stop-loss insurer is extremely low. This leads most sponsors to purchase specific stop-loss insurance and not aggregate stop-loss coverage, even though aggregate stop-loss insurance is fairly inexpensive. In general, aggregate stop-loss insurance is usually purchased by small plans (with 300 to 500 participants) that are self-insuring for the first time. Purchasing aggregate stop-loss insurance for the first year or two can help protect against financial shocks in the case that reserves are still being developed or until the sponsor develops comfort with the plan's underlying self-insurance liabilities.

## Determining a Plan's Risk Tolerance

As applied to stop-loss insurance, risk tolerance can best be described as the total annual claims amount a plan is able to pay for during the course of a policy year. Another measure of risk tolerance is the willingness, or lack of will, to spend down current fund assets and reserves. To determine a plan's ability to tolerate risk, plan sponsors must consider the following factors:

- ***Group Plan Size and Reserve Level*** The likelihood of claims higher than $1 million continues to be small from an actuarial basis, but the practical impact of such claims can vary depending on the size and reserve level of a plan. For example, a plan with $2 million in annual claims expenses with $2 million in reserves versus a plan with $10 million in annual claims expenses with $10 million in reserves — both have 12 months of reserves — but the impact of a $1 million claim would lower the $2 million plan reserve to six months (or a 50 percent drop)

### Key Factors: Setting the Threshold, Choosing a Claims Basis, Lasering and Disclosure

#### Setting the Threshold

A plan sponsor's threshold should reflect its risk tolerance — the degree of variability in claims the sponsor is willing to withstand. Although the most common threshold (the per-person, per-policy-year maximum that triggers stop-loss coverage) is in the $200,000 to $250,000 range, there are several factors for sponsors to consider. Most important is the size of the insured group. The smaller the group, the lower the threshold should be because small groups will usually have a harder time absorbing large losses.

#### Choosing a Claims Basis

Before sponsors can choose or renew a stop-loss policy, it is a wise practice to obtain bids from a number of insurers. After this, it is important to compare the contract terms, especially the *claims basis* — the number of *incurred* months covered followed by the number of *paid* months covered.

For example, a common claims basis is expressed as 12/15. Assuming a January 1, 2014 effective date, only claims incurred during calendar year 2014 (12 months) and paid during calendar year 2014 and the first three months of 2015 (15 months) would be covered. Thus, three months of *run-out claims* are covered. This is important, since months can pass between when a claim is initially incurred and when it is ultimately paid.

Although every plan is different, most should choose a policy with a significant run-in or run-out period, such as a 12/18, 12/24 or 24/12 contract. Because large and/or complicated claims can take a long time to be adjudicated, a claim that is incurred near the end of contract might not be paid for several months after the contract has ended. Moreover, this can be an important and relatively inexpensive way to manage risk: a 12/18 claims basis usually costs less than 5 percent more than a 12/15 claims basis and a 12/24 claims basis usually adds only 2 percent to the 12/18 premium.

#### Lasering

Lasering transfers the claims risk of certain individuals with known catastrophic ailments to the plan by increasing the stop-loss threshold for those individuals or increasing the premiums beyond "normal" leveraged trend, which is currently 15 to 22 percent. Theoretically, specific stop-loss premiums, as well as most forms of insurance, are priced based on unknown risk. The insurer chooses to laser an individual to either mitigate those known claims cost risks or the insurer "prices in" a portion of the expected claims cost to the policy year's premiums.

Although it is possible to negotiate a no-laser contract, the economics must be reviewed with care. A no-laser contract will be more expensive and the sponsor's total financial burden could exceed paying for a lasered contract and covering the expenses of any participants who have been lasered.

#### Disclosure

Before an agreement can be reached, all stop-loss insurance insurers will require plans to complete a disclosure statement that includes the diagnosis, prognosis, case management notes and amount spent for any participant who has a claim that exceeds 50 percent of the proposed threshold in the current policy year. The plan also must disclose information on any participant who is currently hospitalized or has certain conditions that have the potential to reach the threshold. Plan sponsors must take the appropriate steps to comply with all HIPAA privacy and security mandates.

and the $10 million plan reserve to 10.8 months (approximately a 10 percent drop). All things being equal, a larger plan is better able to absorb the impact of large claims.

- ***Claims History*** Reviewing the plan's claims history for the past few years can provide insight into claims patterns and some sense of what to expect going forward.

- ***Population*** How stable is the participant population? Does the group go through sizeable swings in turnover? Have the plan's demographics gotten older? Other factors, such as a large group of COBRA participants or pre-Medicare-eligible retirees, will affect a plan's risk tolerance because the utilization and medical cost variability of these groups is higher than average. Any major change to a fund's risk exposure should be evaluated to determine if the change is within the trustees' tolerance level.

Determining and understanding the plan's risk tolerance is an important exercise for plan sponsors.

Segal uses a proprietary **Multiemployer Health Fund Stop-Loss Database** to help clients benchmark what other funds have purchased. Using this database of more than 200 health funds, Segal can tell plan sponsors the most common stop-loss deductibles being purchased for similar-sized health funds. The database can provide insights into other typical policy features, such as the expected range of premiums being paid by coverage level and whether prescription drugs are excluded or included in the stop-loss policy. This data can help plan sponsors determine the right coverage levels to obtain if stop-loss insurance makes sense for a particular plan.

## Innovations in Stop-Loss Coverage

There have been a number of significant recent changes and advances in stop-loss policies. It is important for plan sponsors that are considering the purchase of stop-loss coverage to be aware of the following innovations:

- **Dividend-eligible policies** refund a portion of a plan's premium as a dividend if its annual claims are below a certain level. See the figure below for an example of how such an arrangement is calculated. Under most dividend-eligible contracts, a plan may need to remain with the insurer for two or three years (depending on the plan's size) before becoming eligible for a dividend. Insurers use dividend-eligible contracts to reward plans with consistently good experience and to promote client loyalty.

- **High thresholds** set the plan deductible level at relatively high levels such as $1 million and above, protecting the plan against rare but potentially catastrophic claims for a relatively small premium. Most commonly considered by large plans with healthy reserves, a high threshold, such as $500,000, can also be a good option for self-insured plans that are purchasing stop-loss insurance for the first time because of the Affordable Care Act.

- **Rate cap guarantees** limit the amount that an insurer can raise the premium in a subsequent year or years. A rate cap offers protection from a high-claims year that could cause the sponsor's rates to soar upon renewal. Larger plans will have more leverage to secure second year premium rate increase caps. Segal's **Multiemployer Health Fund Stop-Loss Database** includes information on rate caps.

- **No-new-laser contracts** mandate that the stop-loss insurer cannot laser any new individuals when the contract is renewed. (For a definition of lasering, see the text box "Key Factors: Setting the Threshold, Choosing a Claims Basis, Lasering and Disclosure" on page 3.) This usually adds 5 to 7 percent to the premium and should be used in conjunction with a rate cap to maintain the transfer of risk to the stop-loss carrier at renewal.

- **A defined rate renewal methodology** bases the renewal rate on the plan's claim reimbursements in relation to the premiums paid. For example, the contract might stipulate that a claim reimbursement rate of 70 percent (where 70 percent of the net premium was used to reimburse claims) would produce a renewal rate with a 15 percent increase. This takes the subjectivity out of the renewal process and allows the plan sponsor to clearly understand upfront how the renewal will be determined.

- **Prescription drug-only stop-loss insurance** could be appropriate for some plans. Plans that insure their medical coverage and self-fund their drug coverage and plans that carve prescription drugs out of their medical coverage should be aware that their stop-loss policy may not cover prescription drugs. Some insurers and pharmacy benefit managers (PBMs) are now offering aggregate stop-loss insurance for prescription drugs only.

**Example of a Stop-Loss Dividend Calculation**

| | |
|---|---|
| **Annual Premium** | First year: $500,000<br>Second year: $560,000 |
| **Lives** | 1,000 |
| **Effective Date** | 7/1/2014 |
| **Plan Maximum** | Unlimited |

| Policy Year | Paid Premium | Reimbursed Claims |
|---|---|---|
| 7/1/14 to 6/30/15 | $500,000 | $200,000 |
| 7/1/15 to 6/30/16 | + $560,000 | + $300,000 |
| **Total** | **$1,060,000** | **$500,000** |

| | |
|---|---|
| Total Paid Premium | $1,060,000 |
| Carrier Minimum Loss Ratio* | 65% |
| Total Net Premium | $689,000 |
| Total Reimbursed Claims | $500,000 |
| Excess Surplus | $189,000 |
| Policyholder Share | 25% |
| **Dividend** | **$47,250** |

* The ratio of total claims incurred over the total premium income due for each policy for a specific policy period

## Best Practices in Purchasing Stop-Loss Insurance

Sponsors who purchase stop-loss insurance should consider these best practices:

- ***Select the appropriate specific deductible levels.*** Some large plans can afford to raise the front-end specific deductible to lower future premiums. Other funds that have taken on too high a deductible are vulnerable to one or two catastrophic claim events. Segal can help trustees select a specific deductible for a plan's risk-tolerance and cash-flow needs.
- ***Negotiate a renewal provision.*** Ask the stop-loss carrier to provide a renewal request that outlines the new policy and includes a rate quote 90 days before the current policy expires. This gives the sponsor time to evaluate the renewal and, if necessary, solicit bids to secure better pricing and coverage provisions.
- ***Plan ahead.*** Although multi-year policies are rare, sponsors can negotiate specific stop-loss rates for multiple years under certain conditions and using the strategies discussed above (*e.g.*, rate caps and no-new-laser provisions). A renewal rate methodology that is based on claim reimbursements in relation to net premiums paid will help generate consistency.
- ***Consider including prescription drug coverage under the stop-loss policy.*** When purchasing specific stop-loss insurance, Segal suggests covering prescription drugs in addition to hospital and medical coverage. The emergence of expensive specialty drugs raises the risk that plans will experience extremely high drug costs. Prescription drug coverage, which generally adds 5 to 8 percent to the cost of a stop-loss policy, offers protection against large drug claims.

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- ***Remove retirees and their spouses who are covered by Medicare from the stop-loss coverage.*** Medicare will cover the majority of Medicare retiree and spouse costs. Some insurers may include Medicare retirees and Medicare spouses in setting their rates, which could distort the true underlying cost of the coverage.
- ***Take a close look at aggregating specific stop-loss insurance.*** Not to be confused with aggregate stop-loss insurance, aggregating specific stop-loss insurance is a variation of specific stop-loss insurance. It is unique in that a separate aggregate deductible must be met by all claims that exceed the individual stop-loss deductible before the sponsor is reimbursed for large claims. While aggregating specific stop-loss insurance reduces specific stop-loss premiums, it also reduces the reimbursement amount for stop-loss claims. For example, a plan that pays a $2 million premium for a stop-loss policy might receive a $750,000 reimbursement for a claim. While the same plan might pay $1.9 million for an aggregating specific stop-loss policy, it would receive only $650,000 for the same claim. Although many plan sponsors have found aggregating specific stop-loss policy prices favorable and a good value, it often makes financial sense to raise the deductible slightly on a specific stop-loss policy in lieu of purchasing aggregating specific stop-loss insurance.

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- ***Provide disclosure information to the insurers who are bidding on the contract during the initial bid submission.*** This will avoid last-minute lasering, which could shift significant risk back to the plan sponsor. Following this practice may require that the bid process be conducted within 60 to 90 days of the proposed effective date.
- ***Establish a timeline for the bidding process.*** Putting the carriers on a timeline and having them agree up front can avoid problems. Timing is crucial, particularly with lasering issues, where carriers may ask for more claims information during the final stages of evaluation.

## What to Avoid When Purchasing Stop-Loss Insurance

A proven bid process is an important part of securing competitive rates and meaningful coverage. The Segal bid process features a detailed questionnaire that compares insurers on an apples-to-apples basis. The process requires plan sponsors to provide an extensive claims history in order to get the most aggressive pricing. Asking carriers to make inferences about prior plan history tends to produce less attractive rates and terms. The bid process will help plan sponsors who are purchasing stop-loss insurance avoid the following problems:

- ***Gaps in coverage.*** If the coverage between one stop-loss policy and the next is not seamless, the plan cannot be certain all claims will covered. It is also important that

"A well-run bid process will eliminate unacceptable clauses and provisions such as certain audit and disclosure rules suggested by some insurers."

the plan's existing exclusions and limitations match the terms offered in the specific stop-loss contract to avoid creating a gap in insurance coverage. A Mirroring Endorsement in the stop-loss contract will ensure that the carrier will cover everything that the plan covers.

- ***Carriers with poor financial ratings.*** Plan sponsors should carefully consider the financial rating of a carrier. Many plans will not purchase coverage from a carrier with a rating below B+ from the rating agencies (*e.g.*, the A.M. Best Company, Standard & Poor's and Moody's).
- ***Bids with different assumptions and underlying conditions.*** A well-run bid process will eliminate unacceptable clauses and provisions such as certain audit and disclosure rules suggested by some insurers.

## Conclusion

The main objective of stop-loss insurance is to transfer some of the catastrophic risk to an insurer. This allows plan sponsors to reap the savings of self-funding while avoiding the financial shock that can result from large health plan claims. In doing so, stop-loss insurance makes it easier for plan sponsors to budget, protect reserves and maintain financial stability.

Understanding and purchasing stop-loss insurance is complex. There are many factors for plan sponsors to consider, including the plan's financial situation and risk tolerance.

Plan sponsors that understand the points covered in this *NewsLetter* will be well equipped to review their stop-loss coverage requirements, make the important decisions about what kind of contract to negotiate and, ultimately, procure the right coverage at a competitive price.

"Stop-loss insurance makes it easier for plan sponsors to budget, protect reserves and maintain financial stability."

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*For more information about stop-loss insurance for multiemployer health plans, contact your Segal Consulting benefits consultant or Michael S. Tesoriero at 212.251.5280 or mtesoriero@segalco.com.*