
# High Pressure

Managing general underwriters must find ways to recapture market share in employer stop-loss programs.

by Miriam Kaufman and David Nussbaum

Employer medical stop-loss reinsurance was quite an innovative program for reducing skyrocketing health costs when first introduced in the early 1980s.

This product allowed employers to take risks while also encouraging and introducing cost-saving programs without sacrificing coverage. In addition to avoiding the excessive overhead costs frequently associated with fully insured plans, employers also receive some tax benefits from self-funding. And there are further cost savings as a result of Employee Retirement Income Security Act plans, which allow for opting out of state-mandated benefits.

High-retention programs were offered by managing general underwriters, who marketed, managed and underwrote such programs. Most MGUs worked in conjunction with third-party administrators, who administered and paid claims for the self-insured portion. For the risk portion, an insurance company typically would "front" the business, receiving a fee for providing their "paper"—in other words, their policy forms or certificates—in addition to accepting a minimum share of the risk that ranged from zero to 20%. The remaining portion of the risk would be reinsured by several reinsurers using equal or varying quota share splits.

The medical stop-loss market operates in much the same way today: MGUs generate, underwrite and manage the business. With increased competition from large, direct insurance companies, MGUs are being pressured to lower rates. Although part of these rate reductions come from reduced MGU expenses or broker/TPA compensation, in reality most have come

## Key Points

- **The Situation:** Medical stop-loss reinsurance continues to play a vital role in containing employers' health care costs.
- **The Issue:** Managing general underwriters, who originally handled these programs, have lost market share to large direct writers.
- **The Way Ahead:** Health care reform and highly disciplined underwriting tools offer growth opportunities to MGUs.


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from reduced reinsurance profitability.

Although MGUs are supposed to underwrite risk and leave the pricing to actuaries (or more typically to pricing manuals), in actuality MGUs also make pricing decisions via a mechanism called underwriter's discretion. This allows the underwriter to increase, or more typically, to decrease, manual rates based on underwriting criteria.

Such underwriting is far from clear. Most MGUs do have written underwriting guidelines but those guidelines are just for underwriting, not for pricing. One MGU, or even one underwriter within an MGU, might offer a discount of 10%, while another can just as easily offer a 25% discount, based on exactly the same information. Further, most rating manuals have up to a dozen factors that are evaluated to produce a final rate, including age, gender, plan design, geographic area factors and trend, among others.

### A Vital Savings Factor

Most of these factors are fully determined by the manual. But several factors are actually items that the manual does not consider. The most important of these is the preferred provider organization factor.

In the wake of increasing health care costs, PPOs have become very important to the profitability of health care insurers. PPOs are a vital component of cost savings for stop loss. Savings can range from 5% to 70%. Discounts depend on the specific PPO contract with hospitals and medical providers. In addition, within a specific PPO, savings will vary by geographic area. Finally, many PPO contracts can also vary by what are called outliers; at a certain level of claim, the discount will change.

All this sounds complicated, and it is. The individual underwriter decides what the PPO discount should be for each group. There are PPO manuals available in the market. However, each has its own problems, such as not including a significant percentage of PPOs, or being outdated. Further, often credible data is not available to the manual producers to calculate an appropriate discount by narrow geographic area.

Another factor that underwriters are asked to determine is the credibility of the group's claim experience. Reinsurers often hear that a group is "clean," meaning it has good experience and no individual is currently at risk to exceed the group's self-insured retention. But actuarially speaking, this may be typical, not unusual. Credibility should be based on group size, deductible amount, number of experience years and expected number of claims exceeding the SIR. Some groups will never be credible, regardless of their experiences.

In determining an appropriate rate, underwriters also need to understand that medical stop-loss is a highly leveraged product. An extra dollar of claims for stop-loss is much greater as a percentage of claims than it is for first-dollar medical. (See "Small Change" graphic.) Therefore, a group with superior criteria will result in better experience and should be offered a lower rate, and vice versa for a worse group.

It is critical that all parties' interests are aligned—the MGU's, insurer's and reinsurer's. Typically, MGUs are paid based on premiums; reinsurers based on profitability; and insurers on a combination based on the percentage of risk taken and premium. However, to align interests, MGUs and sometimes insurance carriers are asked to place fees at risk; for instance, if the business is not profitable, some of the fees will be reduced.

### Market Share Erosion

Unfortunately, as the medical stop-loss business has evolved over the past 30 years, MGUs have suffered. While MGUs once controlled more than 75% of the market, large direct-writing companies, retaining 100% of the risk, have overtaken them. Direct writers have lower expenses, better PPO access and more sophisticated claim management. These insurers often capitalize on administrative fees by leveraging their internal or affiliated operations, rather than pay an independent TPA. And they require a lower profit margin, which is ultimately subsidized through profits achieved at the administrative level for the same or affiliated entity.

Most importantly, MGUs are no longer driving the stop-loss market. MGUs are attempting to hold their own, but they need to fully understand the key considerations involved in the rating process.

Here are 11 key ways MGUs can improve their rating/underwriting processes:

## Small Change

How the effect of a smaller increase or decrease in claims results in a larger effect on the cost of stop-loss coverage.

**Example 1 — Leveraged Savings**

**Original Claim: $200,000**

| | Savings | Insured's Retention | Reduced Claim | Percent Savings |
|---|---|---|---|---|
| First-Dollar Medical: | $20,000 | $0 | $180,000 | 10% |
| Stop-Loss Medical: | $20,000 | $100,000 | $80,000 | 20% |

**Example 2 — Leveraged Trend***

**Original Claim: $250,000**

| | Increase | Insured's Retention | Increased Claim | Percent Increase |
|---|---|---|---|---|
| First-Dollar Medical: | $25,000 | $0 | $275,000 | 10% |
| Stop-Loss Medical: | $25,000 | $100,000 | $175,000 | 17% |

* Trend is the total increase in claims costs due to inflation, increased utilization of medical services, new medical technology, etc.
Source: Kaufman and Nussbaum

**1. Fully document** underwriting/pricing decisions. List each positive and negative aspect and offer a quantitative assessment. This also allows the underwriter to review actual vs. expected results at each renewal.

**2. Ask questions** whenever underwriters are asked to re-evaluate a quote based on a competitor's offer. How is this being done without reducing profitability? Who else is sharing in the rate reduction? Are all parties willing to reduce fees—the broker, MGU, insurer and reinsurer?

**3. Work up a rate** without knowing the current rate or what the competition is offering. Do a comparison only afterwards—that is, calculate the rate according to the manual and underwriting guidelines.

**4. For a particular PPO,** have the TPA demonstrate actual cost savings for all or a large sample of large claims within its portfolio. First-dollar savings are usually irrelevant for a stop-loss portfolio. Most PPO's will have lower discounts for very large claims. These are called outliers. Therefore, the savings for a large claim, which stop-loss is meant to cover, will not be in proportion to the savings for overall claims.

**5. Perform experience studies** by producer (TPA or broker). The MGU should discuss these results with the producer and, if they are positive, encourage more business or be a little more liberal with the rates. If the results are negative, investigate if the producer is sending requests to the MGU for all their cases or just the problem ones. Understanding what percentage of the producer's business is being quoted by the MGU may also be useful in determining if there is an anti-selection problem by the producer.

**6. Except for very large groups** with relatively smaller retentions, the underwriter should always realize that the claims experience of a group is not credible and should not be used as rationale for further discounting off the manual rates. Over the long run, unwarranted discounting will lead to unprofitable business.

**It is crucial that managing general underwriters become more sophisticated with their underwriting/pricing tools and decisions.**

**7. Playing the leverage game** can lead to better results. That is, a group with several positive factors (such as a young group in a low-cost area with an excellent PPO) will be equal to more than the sum of its parts.

**8. An MGU who has been in business** for a while and has good reporting systems can perform studies that demonstrate which factors make their business profitable. Some examples include studies on age, rate-to-manual bands, and retention bands or group size, among others.

**9. To compete with major carriers,** MGUs must have excellent cost-containment programs, both within their shops and in conjunction with TPAs. Such programs include large case management, specialty care programs, data mining and hospital audits.

**10. Medical underwriting** by itself is a critical component. Reviewing disclosure statements, case management notes and historic claim experience for known claimants can help set lasers, if appropriate, or increase stop-loss premiums to cover the costs of known claimants. (Lasers are a means of covering members who are expected to cause large claims due to their medical conditions. Each such member's condition is evaluated and an expected claim amount for the renewal year is calculated. This amount becomes the higher specific deductible for that individual in lieu of the lower group specific deductible.) Manual stop-loss rates contemplate new or unknown claimants, not ongoing claims.

**11. Health care reform** will have a definite impact on employer medical stop-loss programs. How, where and when is still uncertain. Things to watch for include: unlimited maximums, family coverage to age 26, rescissions, exchanges, and state-mandated minimum loss ratios for fully insured medical plans, among others.

MGUs have always been key players in the employer medical stop-loss market and they will continue to see opportunity as health care evolves in our nation. However, it is crucial that MGUs become more sophisticated with their underwriting/pricing tools and decisions. BR