Underwriting 101

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Agenda

- The Basics
- Risk Tolerance
- Funding Methods
- Renewal Rating
- Questions

The Basics

Definitions which will be used during our discussion will include:

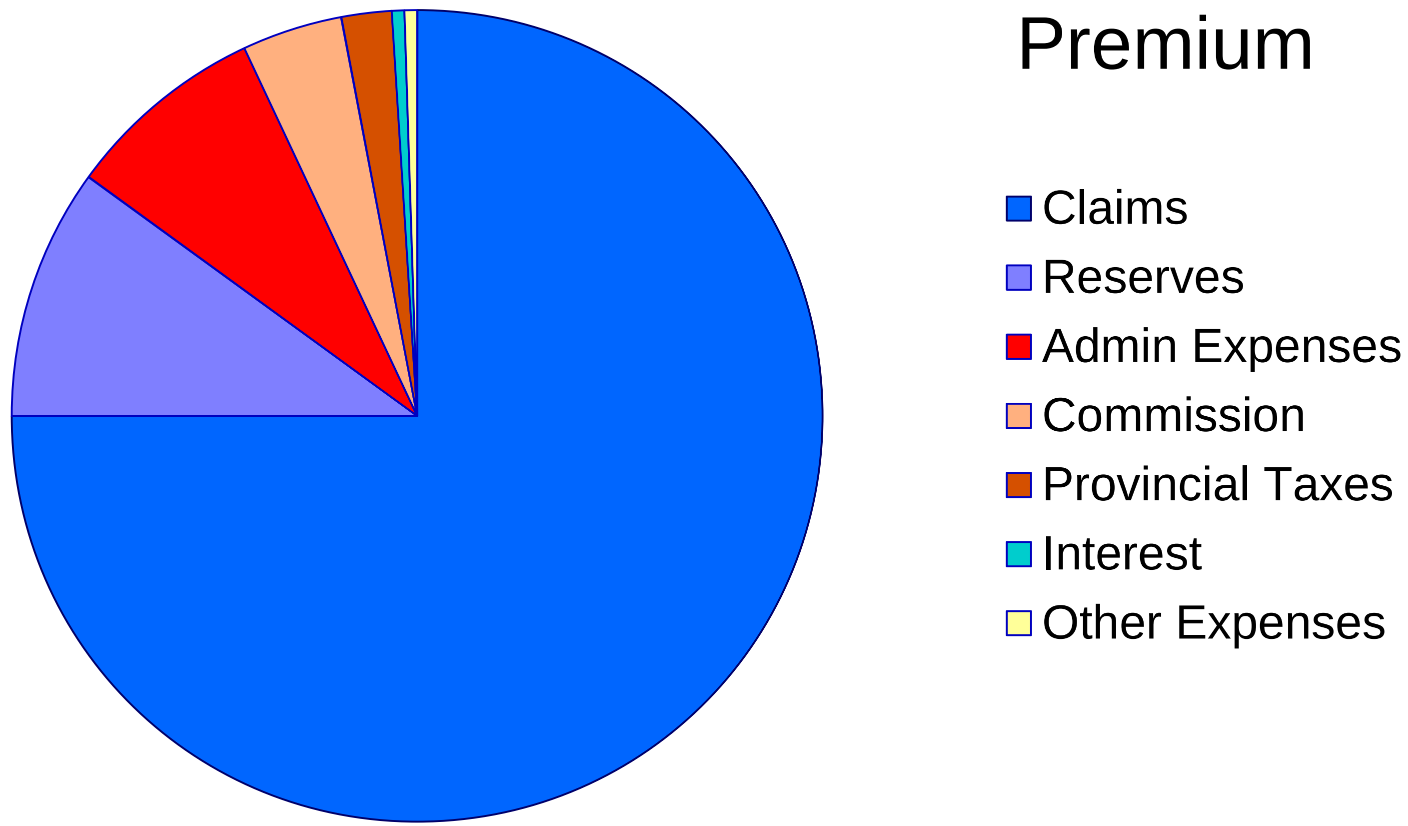
- **Risk**- Exposure to the chance of financial loss
- **Insurance**- Transfer of risk from policyholder to provider
- **Pooling**- The risk-sharing arrangement whereby the provider assumes all liability for claims covered through the pooling arrangement
- **Funding**- The method by which an employer pays the claims and the provider's expenses

The Basics

Risk is present in many forms:

- Number of members covered under the plan
- The demographics of the members
- Industry/occupation
- The plan design
- The frequency and amount of the average claim
- Sharing of premiums between the policyholder and the members and pricing stability
- Deficit responsibility
- Disputed or litigated claims

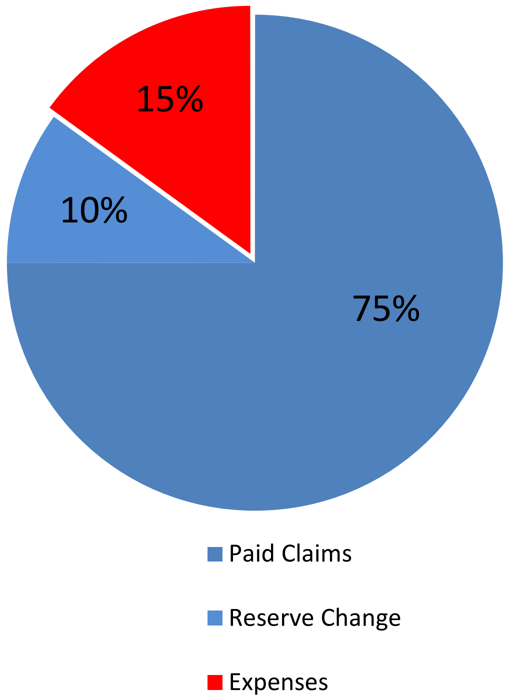
The Basics



Premium
Claims
Reserves
Admin Expenses
Commission
Provincial Taxes
Interest
Other Expenses

The Basics

- Loss Ratio
  - Ratio of claims & expenses to premium
- Target Loss Ratio
  - Expected Claims / Premium
  - 1 - Expenses
- Actual Loss Ratios
  - Paid Claims Loss Ratio
  - Incurred Claims Loss Ratio



The Basics

Reserves

- Sum set aside for future commitments
- Disabled Life Reserve (DLR)
  - Various factors
- Waiver of Premium Reserves
- Incurred But Not Reported Reserve (IBNR)
  - Often a percent of premium

The Basics

After deciding on the plan design(s), there are three additional considerations:

- Policyholder Risk Tolerance
- Funding Approach
- Premium rate determination

Risk Tolerance

Policyholder Risk Tolerance:

- This is the level of exposure to a claim that the employer wishes to take on in the event of a claim (or claims)
- Can range from no risk (limited to the premiums payable) to full risk (where the provider only adjudicates the claims)
- As the risk to the policyholder increases, the ‘insurance’ charges reduce

Risk Tolerance

- Cash Flow
  - Can policyholder financially manage large swings in experience?
- Budget Process
  - Do they need a predictable monthly cost?
- Sharing of Premium
  - Across departments
  - With Employees

Risk Tolerance

Benefit	Small	Medium	Large	Mega
AD&D	High	High	High	High
Life	High	High	High to Medium	Medium
LTD	High	High	High	Medium
WI (STD)	High	Medium	Medium to Low	Low
Health	High	High to Medium	Low	Low
Dental	Medium	Medium to Low	Low	Low

Small- 1-100 employees
Large – 500 to 1,000

Medium- 100 – 500 employees
Mega - 1,001+ employees

Risk Tolerance

Employers take on additional risk in order to:

- Reduce costs on a long-term basis (possibly!)
- Obtain more flexibility in:
  - Plan designs
  - Pricing
  - Claim adjudication (be careful!)
  - Underwriting

Risk Tolerance

- Full Clarity Required:
  - Policyholder Risk Tolerance
  - Benefit Plan Exposure
  - Policyholder Motivation/Understanding
- Generates Funding Methodology Recommendation

Funding Methodology

Financial Accounting or Funding Method:

- Refers to the ‘sharing’ of financial results at the end of the financial period
  - ❖ If no sharing of results, the underwriting is ‘fully insured’ or ‘non-refund’
  - ❖ If sharing occurs, the underwriting is ‘refund/retention’ accounting or ‘administrative services only’
- Non-pooled arrangements require a separate agreement, outside the group contract, which outlines the various charges which will apply

Funding Methodology

Non-Refund Accounting / Fully Insured

- In year risk remains entirely with the insurer
- Policyholder has no access to surplus funds nor responsibility to repay a deficit
- Highest risk charge built into expenses
- Appropriate for low risk tolerant policyholders and/or high risk benefits

Funding Methodology

Refund/Retention Accounting

- The policyholder shares in plan surplus and is responsible to repay deficits
- Risk ultimately remains with the provider
- Annual accounting of the plan is provided
- Should include a pooling arrangement inside the EHC benefit
- Low risk charge built into expenses
- Appropriate for medium risk tolerant policyholders

Funding Methodology

Below is an OVERLY SIMPLIFIED accounting example:

	Example #1	Example #2
Premiums	$500,000	$500,000
Claims Incurred	$350,000	$450,000
Administration Charges (10% of claims)	$ 35,000	$ 45,000
Taxes (2% of premium)	$ 10,000	$ 10,000
Reserves (10% of premium)	$ 50,000	$ 50,000
Surplus (Deficit)	$ 55,000	($ 55,000)

Funding Methodology

Administrative Services Only (ASO) Methodology:

- A self-funded plan!
- Policyholder hires provider to adjudicate claims
- Can be set based on ‘budgeted rates’ or a deposit/float if paying in advance; or may be billed in arrears which means rates are not usually established by the insurer
- Policyholder bears the full risk/liability of the claims experience and claim litigation
  - ❖ Should include a pooling arrangement inside EHC benefit

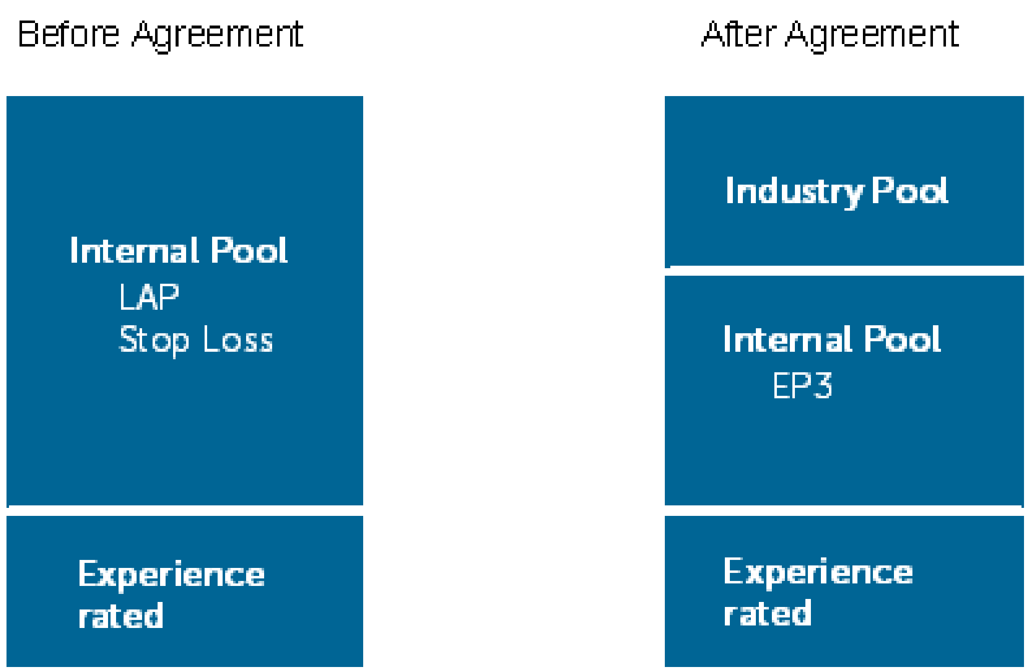
Funding Methodology

Administrative Services Only (ASO) Methodology:

- No IBNR reserves held by the provider
- The policyholder has full access to surplus and is responsible to repay deficits
- Monthly or annual accounting for claims and expenses against deposits (i.e. premiums); administration charges are often % of claims
- If funding stops, claim payments also stop!

Funding Methodology

- Industry pooling introduced in 2012
- What's changed?



Funding Methodology

- ❖ Eligibility Thresholds

Industry / CDIPC pool thresholds and maximum CDIPC pooling level (per certificate)

Year	Initial threshold	Ongoing threshold	Maximum CDIPC coverage
2012	$25,000	N/A	N/A
2013	$25,000	$50,000	$400,000
2014	$27,500	$55,000	$400,000
2015	$30,000	$60,000	$500,000
2016	$32,500	$65,000	$500,000

Funding Methodology

- Fully insured Extended Health Benefit (EHB) policies are required to have an EP3 unless they have one of the following provisions:
  - an annual deductible equal to or higher than $1,100 single or $2,200 family, and/ or
  - a series of annual and lifetime maximums that meet or exceed either EP3 or Industry Pooling thresholds.
- Eligibility under the plan depends on coverage in place June 7, 2011

Funding Methodology

Additional Pooling Arrangements:

- Usually included in EHC benefit (but may also be included in Life or LTD benefits)
  - ❖ Can apply to any and all components
- Annual review of claims and removal of amounts in excess of the set limit
  - ❖ Large amount pooling (i.e. $15,000 per individual)
  - ❖ Aggregate pooling (i.e. exceeding 125% of premium)
  - ❖ 1^{st} $ pooling for Out-of-Province/Canada claims

Funding Methodology - Summary

Feature	Non-refund	Refund	ASO
Risk	Insurer	Shared	Policyholder
Accounting Stmt.	No	Yes	Yes
Limits on Risk to Policyholder	N/A	Yes	No (unless pooling)
Stop Loss & Pooling	Likely	Yes	Yes
Risk Tolerance	Low	Medium	High
Benefit Payment	Unpredictable	Moderately Predictable	Highly Predictable

Funding Methodology - Risk

Risk Factor	Non-refund	Refund	ASO
Number of Plan Members	Low	Medium	High
Plan Design Flexibility	Limited	Moderate	High
Legal Risk	Low	Low	High
Deficits	None	High	Full

Renewal Rating

Premium rate determination (or renewal rating):

- Refers to the method of setting the premium rates
  - ❖Pooled
  - ❖Prospectively rated
- Rates are most commonly set by the insurance provider utilizing their own internal guidelines

Renewal Rating

Process:

- Insurance provider establishes the premium rates based on past experience, plan expenses and other factors (i.e. trend and/or inflationary factors) for the upcoming period
- Approach depends on the benefit, type of underwriting and size of the group
- Premium rates are usually established for a 12-month period
  - Life, AD&D and LTD may be set for a longer period of time (i.e. 2 to 3 years)

Renewal Rating

Factors to be included in establishing renewal rates include:

- Demographics of the group (age, gender, salary)
- Manual rates for the group
- Credibility factors to be applied to experience
- Actual claims experience, by benefit
- Plan expenses or break-even/target loss ratio
- Inflation or utilization factors
- Incurred but Not Reported (IBNR) reserve requirements
- Waiver of Premium and Disabled Life reserves

Renewal Rating

Pooled Methodology:

- Initial and renewal rates are set by the insurance provider based on plan member demographics and benefits insured
- Rates are based on the provider's block of business for similar sized policyholders and make-up of the group
- Reports the premiums and claims experience for information purposes

Renewal Rating

- Demographics of the group (age, gender, salary):
  - Represents the age and volume distribution inside the group
  - How has this changed over the past year
  - Pricing variations
- Manual rates for the group:
  - Uses the insurance providers book/manual rates for each employee's age and gender
  - Also applies industry and location factors
  - Incorporated into the demographics information

Renewal Rating

Prospectively Rated Methodology:

- Initial and renewal rates are set based on the claims experience of the plan, in whole or in part, for future financial periods
- Level of credibility is based on the size of the group
- The provider reports the premiums and claims experience as this is taken into consideration when establishing the renewal rates
- Will exclude premium and claims based on EHC pooling level

Renewal Rating

- Actual claims experience, by benefit:
  - Life and LTD- usually the last 5 years
  - WI- usually the last 2 or 3 years
  - Health and Dental- usually the most recent year, or the last 2 or 3 years if a smaller group
- Plan expenses or break-even/target loss ratio:
  - Expenses are the costs associated with operating a particular benefit and include: general administration; claims administration; pool charges; risk and/or profit charges; premium taxes; commissions; printing charges (if applicable)
  - The target loss ratio represents the break-even point for the account (i.e. the percentage of claims versus premium needed for the plan to break even)

Renewal Rating

Basic renewal calculation:

- Step 1: Paid premiums to adjusted premiums[1]
- Step 2: Paid claims plus change in IBNR[2] = Incurred claims
- Step 3: Incurred Loss Ratio = Incurred claims to adjusted premium
- Step 4: Trended Incurred Loss Ratio = Incurred Loss Ratio x Trend Factor (Health and Dental benefits only)
- Step 5: Expereience Rate Adjustment = Trended Incurred Loss Ratio / Target Loss Ratio – 1

[1]- *The adjusted premium represents the amount that would have been collected over the experience period if the current rate, adjusted for plan design change or rate adjustments had been in force over the period.*

[2]- *The IBNR is an estimate of the value of claims incurred prior to the reporting period but still unreported. The change in IBNR is the difference between the prior period's IBNR and the current period's IBNR.*

Renewal Rating

Credibility factors to be applied to experience:

- The proportion of the rating that is driven by actual claims experience
  - How credible/believe-able is the experience compared to the insurance provider's block
- Credibility factors are based on the number of life years available
  - Life years is a unit of measurement (number of lives x number of years in force) (i.e. 500 employees for 5 years = 2,500 life years)
  - Health and Dental benefits require a relatively lower number of life years than Life and LTD benefits
  - The longer the period, the better the indicator of a pattern

Renewal Rating

- Weightings are Applied when more than one year of Experience is considered
  - Weightings vary by Insurance Provider
  - Weightings vary by benefit
  - Weighting can be applied over a three-year, a two-year or a one-year period
  - Changes by benefit and likelihood of claims
- Example: 5-3-1 weighting
  - Current Year Increase X 5
  - Year 2 Increase X 3
  - Year 1 Increase X 1
  - Divide sum of that by 9 (5+3+1) for weighted increase

Renewal Rating

Inflation or utilization factors:

- Most applicable to Health and Dental benefits where product cost and usage tend to increase year over year
- Inflation on Health and Dental costs are significantly higher than the Consumer Price Index
  - ❖ Health care is a small component of the CPI ‘basket of goods’
- These factors vary by insurance provider
- Generally, older employees have a higher likelihood of illness which can result in higher claims
- Dental fee guides
- Changes in legislation or the economy

Renewal Rating

Incurred but Not Reported (IBNR) reserve requirements:

- Represents the estimated amounts insurance providers need to set aside to pay for future claims that are incurred in one contract year but not reported and paid until the next contract year
- Reserve factors vary by benefit and by provider
  - Life 8% to 12% of premium
  - LTD 40% to 60% of premium (based on
  - qualifying period)
  - WI 15% to 25% of premium (based on duration)
  - EHC 5% to 8% of claims with a drug card
    - 15% to 30% of claims without a drug card
  - Dental 8% to 12% of claims
- Factors vary by group size and/or plan design

Renewal Rating

Waiver of Premium and Disabled Life reserves:

- Represents the estimated cost of the present value of future benefit payments for disabled employees
  - ❖ Waiver of premium relates to the future death claim of a currently disabled employee
  - ❖ Disabled Life Reserve (DLR) relates to LTD benefit payments expected to be made for each claimant
- Reserve amounts are based on the claimant’s age at disability, gender, benefit amount and expected duration of the disability
- At renewal, the providers will report on the aggregate reserve liability of all disabled employees as part of their rating/pricing

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