ADVERSE RISK SELECTION: NO NEW LASERS, RATE CAPS AND CAPTIVES

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Editor's Note: *The author offers an opinion on a timely industry issue. The Self-Insurer welcomes additional opinions should they be suggested.*

Lasers are commonly used in the medical stop-loss industry to manage the cost of known high-cost conditions. Participants on the plan with known high-cost conditions have increased specific deductibles applied against them equal to the anticipated cost of treatment. This removes those known high costs from the medical stop-loss program and leaves them with the employer and its self-funded plan. The argument is that insurance is not an effective mechanism for paying for known events. The equivalent of buying homeowners insurance when your house is on fire.

While insurance may not be an effective mechanism for insuring known high-cost conditions, employers are concerned that they will buy stop-loss only for the costs from

high-cost claimants to be transferred back to them through lasers in future years. This has led to a market practice of employers and their brokers seeking a no new laser (NNL) provision in stop-loss policies. This is usually matched with a rate cap provision, so the additional cost of not being able to laser a high-cost claimant is not just passed on to the employer through higher premiums, or the ability to do so is limited. Rate caps can be anywhere from 30-50%+. The requests for no new lasers and rate caps have become very common and a standard request in many RFPs, without much thought as to whether this is a good strategy in every situation.

THE CASE AGAINST NNLS AND RATE CAPS

Why wouldn't you want to avoid having a laser imposed in a future year and limit any premium increase? Doesn't this transfer the risk of a future high-cost condition to the stop-loss insurer from the employer and the very situation in which you buy insurance? Even within traditional stop-loss policies, this strategy is flawed for a number of reasons.

- No guaranteed renewal: the major problem with trying to transfer the risk of a future high-cost claimant to the stop-loss insurer through the NNL and rate cap provision is that the insurance contract is not a multi-year contract. It is typically a 12-month contract, and unless there is a guarantee to renew, the insurer is not committed to the NNL and rate cap provision. Put another way, the NNL and rate cap are the parameters for renewal, i.e., we will only renew if you don't have a new high-cost condition, or your experience doesn't warrant more than the rate cap increase. If an employer does experience those events and stop-loss is a volatile line of coverage, being non-renewed is not going to be helpful in providing stability to its stop-loss program.

- Other policy provisions: a laser is not the only way for an insurer to protect against the cost of a known or potential high-cost claimant. The use of an aggregating specific deductible or exclusions could be applied without breaching the NNL provision.

- Increased premiums and overall cost: an NNL provision is paid for through premium. It will typically cost an additional 10-15% of premium just to include the provision. That is without knowing whether you will ever benefit from it. Should you have a high-cost claimant that would normally warrant a laser, the additional cost will be passed on through further premium increases. Paying for known costs through insurance increases the cost of care as insurance premiums include administrative expenses and insurer profit. Claims are only likely to account for 70-80 cents of every premium dollar, so paying for care through premiums will increase those costs by at least 25%. The rate cap is intended to limit the impact of this, but someone has to pay. The cost of the known high-cost claimant is socialized across all policyholders, increasing everyone's premiums. The amount of the rate cap becomes the buffer across all policyholders that is needed to absorb the costs that can't be passed on with lasers. The rate cap may be exactly what you should expect for a rate increase for the following year. The impact of this socialization of the lasers in a captive situation is discussed in more detail later in this article.

- Continued upward spiral in premiums: a second impact of absorbing no new lasers in increased premiums is that premiums rarely, if ever, come down. The laser should be a temporary policy condition to address a specific condition and claimant. Once the condition is treated or the claimant is no longer on the plan, the laser will go away. Reducing premiums may not be as responsive, resulting in a continued elevated cost of care.

HOW THIS IMPACTS CAPTIVES

The NNL and rate cap provision is particularly challenging for captives. The captive is a risk-sharing pool where there needs to be a high level of trust in how the shared risk is managed among members. Risk sharing is necessary for the captive to qualify as an insurance company for tax purposes, but there is some flexibility in how the captive is operated, particularly around who gets distributions and when.

A major advantage of a captive is the ability to get returns of premiums through distributions. It is a particularly effective financial tool to recapture investments in cost containment that may not be fully incorporated into premium rates. When employers join a captive, they go from insurance buyers to owners, and with that change, there is a change in focus to limiting claims made against the captive. A second benefit is one of stability. The volatility that is naturally seen in stop-loss can be spread across a pool of employers to smooth this out from year to year. Group captives must establish a balance between the stabilizing effect of the group and rewarding the members of the group that have favorable claims experience.

Including NNLs and rate cap provisions into a captive creates two main problems:

1. Uneven contributions to the risk in the pool. The employer with the high-cost claimant is protected, and the cost of the high-cost condition is socialized by the other members of the captive through increased premiums. This is similar to ordering the Wagyu steak while everyone else in your party is eating burgers and expecting to split the bill evenly. This doesn't do much to keep the group together, even if everyone is promised that the group will pick up the cost of their Wagyu steak at some point in the future.

2. Impact on distributions: Some captive programs are managed to break even rather than for distributions. It is argued that this creates a more tax-efficient structure as premiums can be deducted, but distributions will likely be taxed. These captives also offer NNLs and rate caps. The profit in these programs from the cost containment efforts and good performance of most members is being used to pay for the cost of the NNL and rate cap provision. This creates a double-whammy where the good-performing members are not receiving distributions, and they are also seeing rate increases to absorb NNLs. While all captives differ in how they are structured and run, it is quite common for distributions to only be made to the members with surplus (premiums paid to the captive less claims). Those with deficits do not receive distributions. In that way, the good-performing members are rewarded, and the poor-performing members are not. By using surplus to fund high-cost claimants and limit rate increases, the poor-performing members are being rewarded at the expense of the good. This creates a situation of adverse risk selection. Over time, the good-performing members will leave, and the experience in the captive will increasingly deteriorate.

Unfortunately, the people who benefit most from that approach are the providers and even the stop-loss insurers and reinsurers. Absorbing known high-cost claimants into premium sees an increase in demand and pricing for the stop-loss insurance product. Providers who are usually paid in relation to volume of premium or employees benefit.

This can quite easily move to a situation where the captive is run for the benefit of the providers or sponsors and not for the benefit of the members. This becomes a critical governance issue to ensure the members are actively engaged and have some control over the actions of the providers on the program.

There are many examples of group captives (P&C and benefits) that have failed due to abuse or misaligned interests from the sponsors or providers to the program.

WHAT TO LOOK FOR IN A CAPTIVE PROGRAM

Treat captives offering NNLs and rate caps with caution. As a buyer, this may seem like a good benefit, and it has become a fairly standard ask from the brokers, but as an owner of the captive, accepting NNLs on another member's program may be less appealing. Ask how the captive is going to finance the cost from those provisions.

Understand the captive's distribution philosophy. Is it trying to generate a profit and recapture premium, or is it trying to underwrite to break even? If it is underwriting to break even, how are funds generated from improved cost containment used if they are not returned to the members?

How are distributions calculated, and who is eligible to receive them? When are distributions made? As well as setting expectations on what distributions might be available, it will impact the amount of collateral that is needed. For example, if underwriting years are not closed out for 12 months after the end of the treaty year, there will be a stacking of collateral over two years.

MANAGING HIGH-COST CLAIMANTS AND CONDITIONS

No New Lasers and rate caps are insurance jargon to address employees with serious medical conditions. Employers have taken on a responsibility to provide care to these employees through their self-funded health plan. Instead of trying to transfer responsibility to pay for the employer's obligations, shouldn't we be focused on what is being done to ensure that the affected employees or beneficiaries receive the care they need at an appropriate price? With good case management, many of these cases can be managed with the right care at a lower cost than projected.

Lasers can also play a role in cost containment and reducing the total cost of care. Keeping the cost out of premiums provides a more efficient way of paying for care. There is also some uncertainty around how cases will develop. Imposing a conditional laser rather than including the projected cost, plus expenses, into premium provides a structure where maximum costs are known, but actual costs could be significantly lower.

The TPA might find a lower cost and higher efficacy solution or treatment. The member might leave the plan, take another job, etc. In the event of specialty rx, the drug could be sourced internationally, or they are approved under a patient assistance program. Lasers, especially conditional lasers, encourage the group and TPA to find lower-cost alternatives, as the liability is entirely with the employer. This reduces the employer's cost of care and, in a captive situation, provides protection to the other members of the captive. ■

Andrew Berry is President of SRS Employee Benefits, part of Strategic Risk Solutions. Andrew oversees SRS's activities related to the insurance of employee benefits within captives, both single parent and group captive programs. This includes program management activities, underwriting services and claims administration services within this sector. In this role, he also serves as President of MSL Captive Solutions, the industry's only MGU dedicated to underwriting captive programs for medical stop-loss insurance.