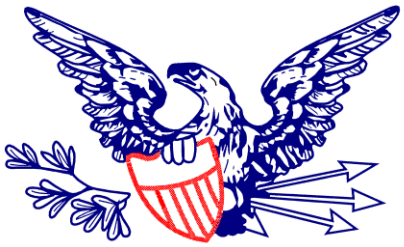
An American Benefits Consulting White Paper



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Funding Arrangements for Group Benefits

Friday, September 24, 2010

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What is Group Insurance

Group Insurance combines ("pools") multiple risks to protect each member of a group against the cost of an individual loss, such as the loss of life. Members pay an amount ("premium") to an insurance company in return for this protection. This amount is less than what an individual would pay if they were protecting just their own risk, because not every member of the group will have a loss at the same time, and so the cost of each loss is spread across every member of the group.

Group Insurance differs from Individual Insurance in several key ways:

- In general, any member of the group is eligible to participate, without proof of good health. Individual Insurance contracts usually require this proof, called Evidence of Insurability.

- Often, every member is charged the same rate. This is generally true when an employer purchases insurance for its employees. When employees pay for optional, or additional, amounts of coverage, rates may vary by age, or sometimes health status, e.g., smoker and non-smoker.

- A significant difference is that most Individual Insurance contracts (called "policies") are non-participating. This means that the insurance company collects and retains the premium, whether or not the insured (the policy-owner) ever has a claim. Conversely, if there is a claim, and the claim amount exceeds the amount of premium paid by the insured, the insurance company cannot collect any additional premium.

- Group Insurance contracts can be participating or non-participating. In a non-participating contract, just as with Individual Insurance, the group pays a premium, and the insurance company may profit if claims are less than the premium, or they may incur a loss, if claims exceed the premium. In future years, premiums may be increased to reduce losses. In a participating contract, if premiums are not sufficient to pay claims, the insurance company may have the right to collect

additional premiums, and/or future rates may increase. If premiums exceed claims, the group may receive a refund ("dividend") at the end of the year.

- Finally, Group Benefit Plans can be also be self-funded ("ASO," "ASA," etc.) In a self-funded, that is, non-insured arrangement, the group pays the insurance company, or a Third Party Administrator, an administrative fee to maintain eligibility, process claims, produce reports, etc., however, the group is responsible for the full cost of actual claims. In some cases, the group may choose to purchase an insurance product that provides a cap on their total risk.

Group Insurance may in some ways be thought of as a loan from the insurance company: the insurance company receives a premium, and guarantees that all claims will be paid during the year, regardless of the amount of premium received. However, as long as the contract remains in effect, the insurer will always seek to ensure that rates are made sufficient to cover all claims and expenses.

Individual insurance policies generally do not have the idea of recovery of past losses: if the contract ends either because it is cancelled ("surrendered" by the insured or terminated for lack of premium payment, i.e., "lapsed"), the insurer may have made a profit. If it ends as a result of a claim payment, the insurer may have incurred a loss, with no hope of recovery.

The Components of Premium

With that background, we can discuss how premiums – the cost to accept risk – are determined and paid.

To insure against the risk of loss, an insurance company requires that a premium be paid. The amount of premium is determined by a number of factors, depending upon the type of risk (e.g., life, disability, accident, etc.), including, but not limited to:

- *The size of the group;*
- *The age and gender of the participants;*
- *The amount of insurance requested;*
- *The industry or occupations of the group members; and/or,*
- *The history of claim activity that the group has incurred.*

Each $1 of premium contains a number of different components, including:

- An amount necessary to pay current claims which have been presented to the insurer;

- An amount necessary to pay future claims which have been incurred (that is, an event has occurred which has resulted in a loss of some type), and received by the insurer, but not yet paid;

- An amount necessary to pay future claims which have been incurred (that is, an event has occurred which has resulted in a loss of some type), but not yet received by the insurer; and,

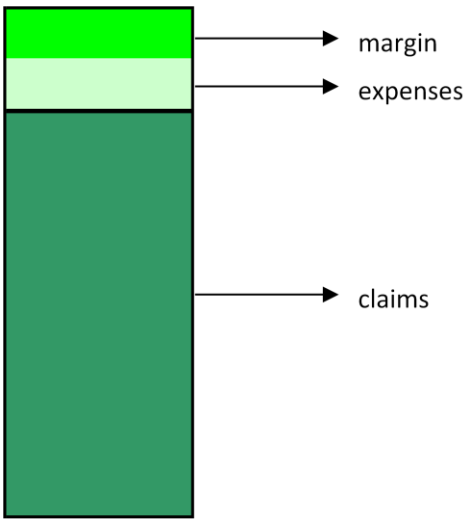
- An amount necessary to pay plan expenses ("retention"), which includes but is not limited to:
  - the cost to process claims;
  - premium taxes;
  - other plan expenses, such as maintenance of eligibility files, production of plan description and communication materials, production of reports, etc., and;
  - insurance company profits.

These expenses may be offset by interest earned on reserves that are held for future liabilities, as well as pre-paid premiums.

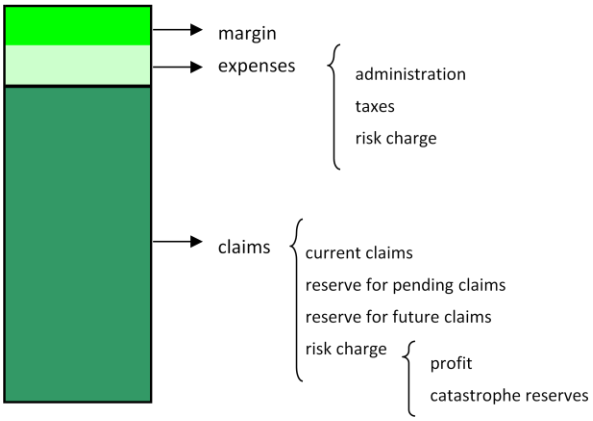
Although there is a good degree of precision in determining the probability that a particular risk event will occur, no groups are so large that predicting both the timing and size of a single loss, or even a set of losses, can be 100% accurate. Therefore, insurers include an amount for margin of error, or what is really unpredictability. In general, this "margin" is about 10% of the total premium.

Depending upon the size of the group, the nature of the risk, the funding arrangement – recall that in a non-par contract, the insurer has no ability to recover losses in the short term – margin requirements may be higher or lower.

The following chart illustrates the components of premium for a standard insured arrangement:



The following chart illustrates a more detailed view of the components of premium for a standard insured arrangement:



Types of Funding Arrangements

There are several different types of funding arrangements for premium payments. Variations are described below.

Premium Drag

In the simplest type of funding arrangement, the insurer allows the group to pay its premiums late, typically by an additional 30 days after the due date. The insurer levies an interest charge for this, however, some employers find that the cost of interest is less than the income from holding funds for an extended period. Groups should be cautious when employee funds are involved.

Retrospective Premium Rating Agreement

In a "retro" arrangement, the insurer collects only 90% of the amount due. This allows the group to hold that "margin" in the premium rates. At the end of the year, if the margin is not needed, no additional funds are remitted. If premiums received by the insurer are insufficient to pay claims and expenses, then the insurer can require the return of up to the full 10% retained by the group.

Minimum Premium Agreement

In this arrangement, the insurer collects only the administrative costs of operating the plan, and the margin. The group holds the amount needed to pay claims, and places that amount in a special bank account that the insurer can access. This way, the group benefits from holding a substantial part of the premium, however, the insurer has access to funds to pay claims whenever they are needed.

Minimum Premium Variations

As previously noted, the claims component of premium is really multiple components. There are a number of additional variations that allow a group to "customize" the way in which reserves are established and funded.

For example, the reserve for claims incurred but not yet paid by the insurer can be allowed to "float," and be

determined at the end of the year, or the end of the contract. Similarly, it may be possible to have no reserve at all, and for the group to pay claims received after year, or contract, end on a pay-as-you-go basis. Groups may be able to pay actual claims only. Such arrangements may include "Flexible Special Premium Accounts," "Flexible Funding," group-specific reserving, etc. In general, these funding arrangements can apply to medical, dental, and short term disability programs.

Life insurance programs are slightly different, as most all life insurance programs are fully-insured due to tax advantages for beneficiaries. While premium drag and retro arrangements can be applied to life insurance programs, minimum premium arrangements cannot usually be used.

However, there are special approaches that can be utilized to achieve a similar effect. These approaches can also be applied to Long Term Disability (LTD) programs, and in addition, there are two special arrangements that can also be used for LTD programs.

Long Term Disability Funding

There are two types of funding arrangements that are unique to long term disability. These are in addition to a drag or retrospective arrangement – *Limited Liability* and *Reverse Limited Liability*.

Limited Liability

With a Limited Liability funding arrangement, the group pays a premium to the insurer to cover LTD claims for a certain period of time, e.g., 3 years. During that time, if the premium is not sufficient to pay for the claims, the insurer bears the risk. After the initial period, the group is liable for the costs.

The assumption is that new claim activity is more difficult to predict, and thus volatile. After a few years, only the most serious, but likely stable, claims will remain, allowing the group to benefit from relatively consistent cash flow needs. There is no premium, and claims are on a pay-as-you-go basis, so taxes, risk charges, etc. are avoided.

Reverse Limited Liability

The second type of funding arrangement for long term disability is Reverse Limited Liability. In this arrangement, the group pays for the cost of claims on a pay-as-you-go basis for an initial time period, e.g., 3 years. During that time, the group bears the full cost of the claims. After the initial period, the group begins paying a premium, and the insurer assumes all future liability.

In this case, the assumption is that only long duration and potentially very costly claims will still remain after several years, and groups would prefer to shift the liability to an insurance company, as the liability may well continue for 20 or 30 years.

Summary

As shown, there are a variety of means to funding Group Benefit plans, not all of which are straightforward. Finding the right funding arrangement for the right plan requires a deep understanding of how insurance carriers underwrite their business, how they manage and administer their plans, and how they plan for growth and profitability.

It's imperative that you have deep insurance expertise on your side of the table when negotiating with insurance carriers on different funding arrangements. Time and time again, we have found room for improvement in the funding arrangements between its clients and the insurance carriers which underwrite the plans. When working with plan participant populations in the thousands, finding the right funding arrangement can potentially translate into tens of thousands of dollars of savings for an organization.