Gallagher Benefit Services

SJVIA Program Recommendations And Response to Outside Actuarial Review

April 29, 2016

BENEFITS | COMPENSATION | RETIREMENT | RISK MANAGEMENT

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BACKGROUND

Sharp increases in the incidence of high claims under the SJVIA PPO and HMO plans in 2015 diminished reserves below the 14% target called for in the Board policy. To address the current and ongoing financial impact on the SJVIA created by this spike in large claims, an in depth review/audit was completed by GBS (document attached entitled Results of Internal Gallagher Audit and Recommendations), and a special outside review was also completed by AON. These reviews were to determine:

- **Were there underwriting errors made in projecting the claims for 2015 and 2016?**
- **Are the current SJVIA underwriting procedures, calculations, trends and projections appropriate and responsible?**
- **What caused the deterioration of reserves?**
- **What other procedures (if any) could have been in place, to avoid the deterioration of reserves?**
- **What changes should be made moving forward to rebuild the reserve to the targeted 14% level?**

Both the GBS and AON evaluation of the rating methodology utilized validate the 2015 rate levels given the claims history available when these rates were established. The net differences between the two were approximately a 1.7% variance. The review of the rating process for the 2016 had a slightly greater difference, but with only limited claims experience so far in 2016, it is impossible to draw firm conclusions on the validity of the rates at this point in time.

Both reports focused on two main drivers that created the funding shortfall in 2015:

- **Primary Direct Cause: Sharp increase in large claim activity under the SJVIA programs, primarily the HMO plan. This is well documented in both reports.**
- **Secondary Cause: Enrollment shifts from SJVIA self-funded, or flex-funded plans to fully insured Kaiser HMO plans.**

At the end of this document we address some of the items raised in the AON report, but our primary focus here is to address the steps we believe the SJVIA should consider taking to rebuild the reserve to the 14% target level.

GALLAGHER RECOMMENDATIONS

The ideas and options covered below are not exclusive, or all inclusive, of options the SJVIA should consider implementing moving forward. However, they are designed to rebuild the reserve levels to the 14% target level, ensuring the continued health and stability of the SJVIA risk pool for all of the member entities and their employees.

Effectively, this refines the SJVIA operating procedures to protect against similar occurrences in the future. The following are suggestions from GBS along that take into account both the near term and long range health of the SJVIA risk pool.

RESERVES

- Gallagher recommends the SJVIA provide an accounting that compares “stated plan reserves” versus “cash on hand”. This will provide both the SJVIA and Gallagher consistent data and the tools needed to evaluate the build-up of future reserves and the ongoing valuation of these reserves.
- Gallagher recommends initiating steps to rebuild the reserve to the 14% target level.
- Gallagher recommends a review with the SJVIA’s outside Actuary before any contingency reserves developed above the 14% level are used to offset future rates.
- Gallagher recommends that reserve and cash balances are communicated to all stakeholders (SJVIA Managers, SJVIA Board of Directors and Gallagher) on a monthly basis.

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GROWTH STRATEGY

- Gallagher recommends responsible growth should still be something the SJVIA considers.
- Gallagher recommends potential new members without claims experience are only considered if their demographic information is better than the profile of the existing SJVIA membership.
- Gallagher recommends a review and modification of the risk scoring process built into the SJVIA underwriting guidelines. These changes would specifically target the impact of Kaiser penetration and contribution formulas that may adversely impact employee plan selections.
- Gallagher recommends adding additional margin of 2 to 5% to all new groups quoted (in addition to the "non-founding member" administrative load).
- Gallagher recommends that future marketing efforts focus on the additional value that the program can bring to new prospective members, rather than specific cost savings.
- Gallagher suggests that marketing efforts should be concentrated on new member entities without a current Kaiser presence.

CHECKS AND BALANCES

- Gallagher recommends that there is a validation process on new groups once the group is enrolled. Each new entity will have their risk scores re-calculated after initial enrollment to validate the assumptions made during the new business process. If demographics change dramatically, more than 10%, rates could be adjusted immediately.
- Gallagher recommends the SJVIA split into three "silos" – County of Fresno, County of Tulare and All Other for experience reporting and evaluation. In order for individual groups to be split out on their own for reporting purposes, they must have 12 months of mature experience for 500 employees or greater.
- Gallagher recommends the SJVIA conduct an independent actuarial review of all rating variables, trend assumptions and methodologies to be used during the "upcoming" renewal process. The approximate cost of this review would be $20,000.
- Gallagher recommends presenting renewals showing each product offering (HMO and PPO) rated based on the respective experience and projections of each program.

KAISER

- Gallagher recommends not quoting any new groups with more than 40% Kaiser penetration.
- Gallagher recommends any new groups with between 20 and 40% Kaiser penetration include a 5% load to all rates quoted.
- Gallagher recommends that a population risk surcharge be included on all Kaiser plan rates. This surcharge will be retained by the SJVIA and used to rebuild the SJVIA reserve to the 14% target level. This surcharge will remain in effect until the reserve is completely rebuilt.

OTHER

- Gallagher recommends an SJVIA policy requiring all premiums be paid by the 1st of the month that coverage is provided, subject to a late fee if not paid on a timely basis.
- Consider rerating the SJVIA mid-year and adjusting the premiums accordingly
- Gallagher recommends establishing member entity contribution guidelines to protect the SJVIA from being placed at an employee premium disadvantage
- Gallagher recommends building a compensation schedule based on growth that takes into account the cost of adding new member agencies, but also adjusts our fees as the program grows. Current Gallagher compensation is less than 0.5% of the total program cost. In the past we have reduced our compensation as the SJVIA grew membership, and we propose developing a schedule to accomplish this same effect moving forward.

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GALLAGHER RESPONSE TO OUTSIDE ACTUARIAL REVIEW

In late 2015, the SJVIA began experiencing claims activity specific to the HMO Population that lead to a diminishing of Cash on Hand. The SJVIA requested that Gallagher Benefit Services (GBS) review the calculations leading to the 2015 renewal action by the SJVIA as well as re-visiting the methodology for developing the 2016 renewal. The SJVIA also requested GBS to review all activity since 2013 (premiums paid, enrollment, claims paid, fixed costs, etc.) for accuracy in an effort to understand why the SJVIA was facing this cash position.

The Board of Directors of the SJVIA, upon the recommendation of staff, contracted with AON Hewitt to review and comment on the 2015 SJVIA renewal methodology and cash flow issues.

AON FINDINGS

AON's summary, presented at the March 18, 2016 SJVIA Board Meeting, included a review of the following components. The complete AON report is available on the SJVIA website however the pertinent findings for each section, and Gallagher comments, are included below:

2015 SJVIA Pricing

- AON Hewitt opines that from an overall technical perspective, Gallagher's 2015 pricing is not unreasonable. However, AON suggests that the SJVIA renewal rating method, *"ignores any adjustments for demographic changes within the population."*

Gallagher Comments:
The experience Gallagher uses to project claims is based on the total risk profile of the population of the SJVIA. In other words, the demographic changes, age-sex adjustments, actuarial value and plan modification calculations are <u>already reflected</u> in the claims experience. Any new entities are rated based on the SJVIA approved underwriting guidelines that reflect all of the above variables.

SJVIA underwriting guidelines, approved by the SJVIA Underwriting Committee and the Board of the SJVIA, take all variables into consideration for new entities as well as the effect of plan migration and demographical changes to the existing risk pool.

- AON also incorrectly states that the SJVIA used a 4.5% trend assumption for the Rx claims projections.

Gallagher Comments:
Gallagher DID NOT use a 4.5% trend assumption for the Rx for this projection period. The 4.5% trend shown on the renewal calculations resulted from a 5% discount in overall Rx trend as a result of an extensive RFP and Gallagher negotiations with the PBM vendor. This reduction in the trend was communicated to the SJVIA managers and fully explained at the July 11, 2015 SJVIA Board meeting (Agenda Item 11). In reality, the claims projection reflected a 9.5% trend for Rx. Because of this, the actual trend assumptions used by Gallagher to project total claims (given the distribution of claims in each of the categories – medical and Rx) was <u>more</u> conservative (on a prospective basis) than even the AON *retrospective* re-rating.

Conclusion:
Gallagher's underwriting methodology was developed and adopted by the SJVIA Board when the JPA moved to the shared risk rating model. The actual rating developed for 2015 SJVIA plan renewal followed this methodology and is validated within the AON Report, with the approved Gallagher rating action varying by only 1.73% when compared with the AON model proposed. This difference is less than the 2% margin included in the AON rating model.

The unexpected increase in utilization and the large claims experienced in the 2015 plan year drove higher than expected claim costs, something that would have been true under both the Gallagher and AON rating models outlined in the report. It is important to note the same underwriting approach used in 2015 was used in prior years

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and resulted in increased reserves during several of these years. Simply put, the AON report validates the 2015 rating, when looking at the same data available at the time the rating was completed.

New Business Rates

- "AON Hewitt reviewed the New Member Underwriting Methodology document (revised April 19, 2013) and found it to be a technically sound document. If followed correctly, this methodology should produce viable long term rates for new members in the Pool." AON did raise the issue of volatility as it relates to growing the SJVIA population.

Gallagher Comments:
Prudent growth has been a tenet of the SJVIA for the past 3 years. Careful consideration to this growth strategy has produced a set of underwriting guidelines that is, by design and direction, conservative. Any new entities expressing an interest in the SJVIA are reviewed based on their demographics and their risk profile relative to the SJVIA as a whole. A decision to proceed with illustrative rates is then discussed with the SJVIA Underwriting Committee (SJVIA Manager and Assistant Manager). After underwriting is complete, the SJVIA Underwriting Committee reviews the offering with Gallagher. The Underwriting Committee then makes a decision to release an illustrative proposal (subject to approval from the SJVIA Board) or decline to offer a proposal. To date, the SJVIA has received requests for proposals from 50+ public entities and have offered illustrative proposals to approximately 35 of those. The SJVIA elected not to offer proposals to the remaining entities.

An underwriting review of the 2015 Premiums Due and Costs for the SJVIA produced the following results:

<u>Legacy members:</u>	
County of Fresno:	49.24% of the SJVIA Premiums Due / 51.10% of the SJVIA Costs
County of Tulare:	21.89% of the SJVIA Premiums Due / 21.18% of the SJVIA Costs
<u>Non-Legacy members</u>	
All other entities:	28.87% of the SJVIA Premiums Due / 27.72% of the SJVIA Costs

Based on the above percentages, in 2015 Non-Legacy entities as a whole performed on par with the pool. These new entities did not negatively impact the 2015 SJVIA costs.

IBNR & Excess Reserve Adequacy

- Multiple times in their report, AON spoke of the "practice of using all reserves in excess of the IBNR to reduce the necessary renewal rates."

Gallagher Comments:
This is a misstatement of the SJVIA guidelines with regards to reserves.

The SJVIA, at Gallagher's suggestion and after a review by an independent actuary hired by the SJVIA (Dempsey Filliger), has maintained between 12.5% - 16% reserve for IBNR claims. Lag studies and actuarial reports suggest that 8-9% IBNR is a conservative estimate to pay claims run-out should the plan end. In other words, the SJVIA has at all times maintained an excess reserves of between 4.5% and 7%. When and where there were "extra" excess reserves identified (above the 12.5% - 16% maintained by the SJVIA), those "extra" excess have been used to offset rate action, however never below the 12.5–16% reserve target set by the SJVIA. AON's statement suggests a practice of using all excess reserves above the 8-9% necessary for IBNR claims. These AON statements, made repeatedly during the report, are demonstrably false and misleading.

Certifications are done on an annual basis and the SJVIA maintains a policy (suggested by Gallagher and approved by the Board) to maintain, at all times between 4.5% and 7% ***more*** than the necessary required for IBNR claims. These excess reserves are already identified and labeled as Contingency/Stabilization reserves.

Conclusion:
Gallagher's renewal calculations projected to utilize a portion of the excess reserves to mitigate renewal increases, not the entire excess. The level for the IBNR, or reserves, was developed by a third party actuarial firm hired by the SJVIA. The IBNR level the actuaries have set is historically between 8% and 9%.

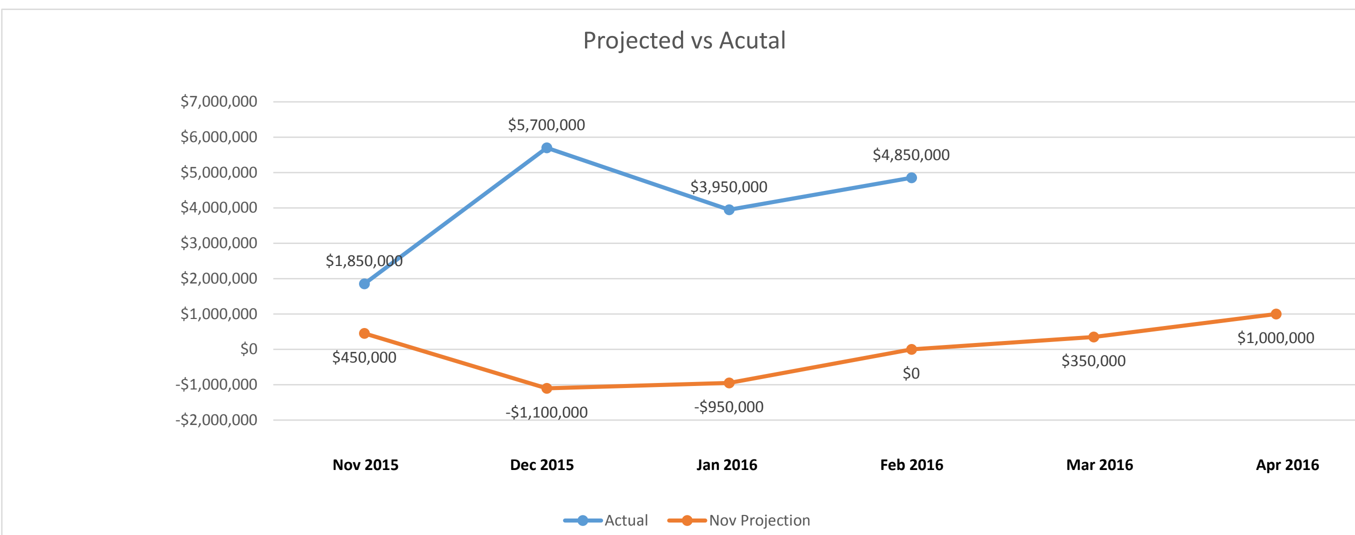
Renewal projections since the inception of the SJVIA have included a combined IBNR and excess reserve level set by the Board. Initially this level was set at 16%, or 7% to 8% over the required IBNR of 8-9%. A decision was made to reduce the combined reserve level to 14% for the 2016 renewal, still 5% to 6% over the required IBNR reserve level. At no time has Gallagher advised the use of all excess reserves in the rating process. The report mentions Gallagher using all the excess reserves in the rating formula, something that is not true, nor is it a practice we would ever recommend to a client.

CONCLUSION

As a result of our review, and given the AON Hewitt findings, Gallagher is confident in the methodology used and the reserves identified at any given point in time (all premiums due, for all eligible employees enrolled, less all fixed costs for all eligible employees enrolled, less all claims paid for all eligible employees enrolled).

By definition, the cash on hand at any point in time will fluctuate (sometime greatly based on claims activity and the timing of premium receivables) and may never equal exactly the amount calculated by Gallagher as reserves. To the extent that the claims activity mirrors the claims projections and all entities are paid current in their premiums, there would be no cause for concern relating to cash on hand. However, if claims begin spiking (as they have) and some entities are paying premiums in arrears (as they are) then cash on hand will diminish. If this trend continues, the potential for exhaustion of the claims reserve becomes very real.

The primary driving force for Gallagher's review (and the subsequent AON review) was the rapidly diminishing cash reserves during the end of 2015. SJVIA staff attempted to project the cash position based on circumstances at that time. To that end, at the special Board meeting in November 2015, staff projected that the SJVIA would be in a *negative* cash position of approximately $1.1 million dollars as of December 31, 2015. In fact, the SJVIA had cash on hand in the amount of $5.7 million as of December 31, 2015 as per the quarterly financial report presented at the March 18, 2016 Board Meeting. This is a delta of $6.8 million. (See graph)



Through careful analysis GBS has determined the HMO had greater than anticipated claims for a period of time and some entities pay premiums in arrears. Those two variables (and only those two variables) led to the temporary cash flow issues experienced.

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