BENEFITS BRIEF

Benefits Pricing and Renewal Calculation

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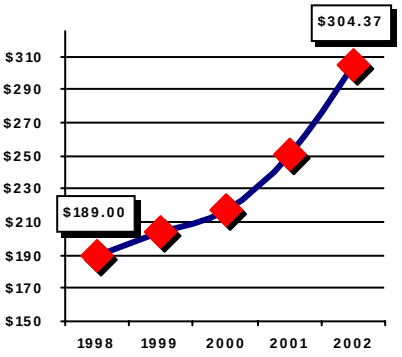
Benemax

Professional Guidance
In Benefits Management

Until recently, employee benefits were not a material expenditure for most firms. However, due to factors such as rising drug costs, government downloading and an aging population, benefits costs have been rising at an alarming rate and this trend will is worsening.

With benefits costs now approaching **20% of payroll**, management can no longer ignore this line item. This brief explains how employee benefits are priced in order to help you better manage these costs over the long term.

Average Annual Prescription Cost
(1998 - 2002)



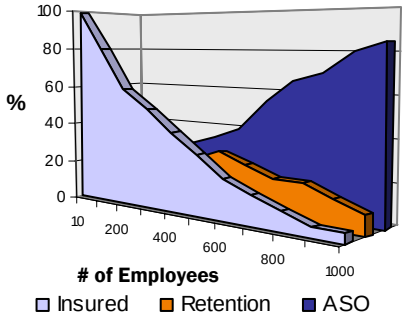
4 year increase = 61.04%

FUNDING ARRANGEMENT OPTIONS

Health and dental benefits, also called ***experience-rated benefits***, represent up to 75% of total group insurance costs. They generate high-frequency, low-cost claims. The rest (Life, AD&D, LTD) are called ***pooled benefits*** and represent pure insurance. In each case, a small premium is paid to insure against a very significant, infrequent occurrence.

Various funding arrangements are available for experience-rated benefits, ranging from insured accounts to ASO (or self-insured) accounts.

Funding Method by Company Size



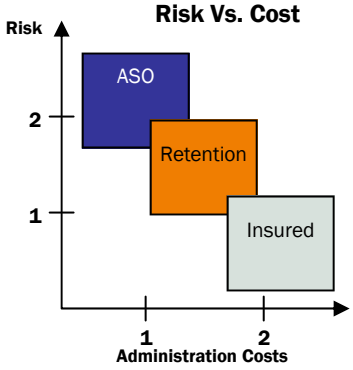
ASO Accounts

Historically, ASO plans *(Administrative Services Only)* were limited to large firms that were able to 'self-insure' their claims and pay insurers only a small charge for administering the plan. Because of their large size, claims patterns are predictable, and lend themselves to this type of arrangement. Smaller firms tend to avoid this method due to the unpredictability of claims.

Insured Accounts

Most small and mid-sized companies rely on traditional, **insured accounts** for their plans. They know what their benefits premiums will be for any given policy year, regardless of their claims, making budgeting straightforward. The drawback of this approach is that insurers charge significant *administration fees* to run these programs. They also set up reserves to cover claims that have been incurred by employees but not yet paid out — protection if a company switches carriers. ***Retention Accounts*** are hybrids of insured plans that allow for a partial sharing (or refunding) of surpluses if claims are lower than forecast.

Risk Vs. Cost



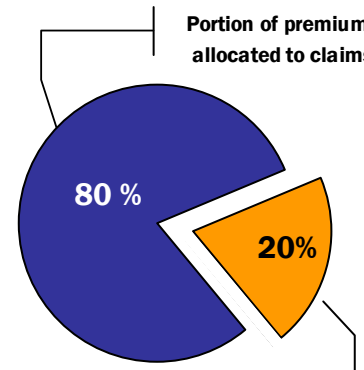
Ultimately, ***all companies 'self-insure' their health and dental claims***, whether through premiums in the insured account arrangement, or directly with ASO. 'Risk' is limited to the predictability of cash flows in and out of the plan. You pay for this predictability in the insured arrangement. The following brief explains how health and dental benefits are calculated in insured accounts.

THE BREAKEVEN CONCEPT

Insured accounts are priced by carriers to cover the cost of claims, plan administration, marketing, taxes and profit. However, insurance companies face an unusual challenge when setting this price — they don't know their *'cost of goods'*, the claims the plan will generate. They estimate claims based on prior experience with the client or with firms of a similar profile (industry, size, age, etc.). The plan then runs its course until its performance is reviewed at year-end and re-priced.

The carrier sets a ***target breakeven*** figure. This represents the portion of every premium dollar required to pay claims. The balance is used to pay for all administrative costs, marketing expenditures, taxes and profit. If the plan is priced with a target breakeven of 80%, 80¢ of every dollar is ***expected*** to go towards claims. The higher the breakeven, the better — more cents on the dollar are going towards claims and less are being allocated to expenses. Generally, target breakevens range from 65% to 90% — the larger the group's premiums, the higher its breakeven.

80% Breakeven Example



- Billing and claims administration
- General administration and overhead
- Marketing expenditures
- Risk charge
- Profit
- Taxes

WHAT HAPPENS AT RENEWAL?

When an insured account renews, the carrier's *underwriters* have three objectives in mind:

- Identify any shortfall in premiums due to higher-than-forecast claims in the previous year
- Anticipate how inflation and trend factors will impact claims in the coming year
- Set a renewal premium that recovers past losses, anticipates trend increases and hits profit targets

INFLATION AND TREND FACTORS

Health benefits ***consumption*** has been rising faster than inflation (CPI). This is due to a number of *trends*, that combine to drive up consumption by between **14% and 20%** annually. The two most significant trends are:

Substitution

Advances in medical technology have created a trend of substituting expensive, newer drugs for older, less expensive ones. For example, *Imatrex* at $15.00 per pill is replacing *Tylenol 3* at 6¢ for the treatment of migraines. Many new drugs are being used to treat conditions that were previously untreatable or required surgery. While older drugs increase in cost only marginally, they are prescribed less often due to the availability of more effective but costlier substitutes.

Utilization

Our aging population is the principal driver of increased utilization. Other factors include increased consumer awareness and acceptance of therapeutic drug use, often driven by aggressive marketing by the pharmaceutical industry. Finally, provincial health plans are continuing to transfer costs from the public to the private sector. Reduced coverage for chiropractic and eye exams, and shorter hospital stays (shifting government-paid drugs to private plans sooner) are examples of how off-loading is contributing to greater plan utilization.

Dental plans are experiencing similar though less dramatic consumption increases due to these trends as well.

THE RENEWAL FORMULA

At renewal, insurers first calculate the ***loss recovery factor*** by dividing claims by premiums, and then dividing the result by the target loss ratio. For example, if claims throughout the year were 90¢, premiums were $1.00 and the target loss ratio was 80%, the *loss recovery factor* would be 1.125 [(.9/1)/.8 = 1.125]. The new premium would be ***increased by 12.5%*** in order to recover the previous year's shortfall. Then, the premium is increased for anticipated inflation and utilization by between 15% and 22 %. The new premium is calculated as follows:

Old Premium x Loss Recovery Factor x Trend & Inflation Factor = New Premium

The following two scenarios assume a target breakeven of 80% and a trend and inflation factor of 16%.

Scenario 1 — Good claims experience

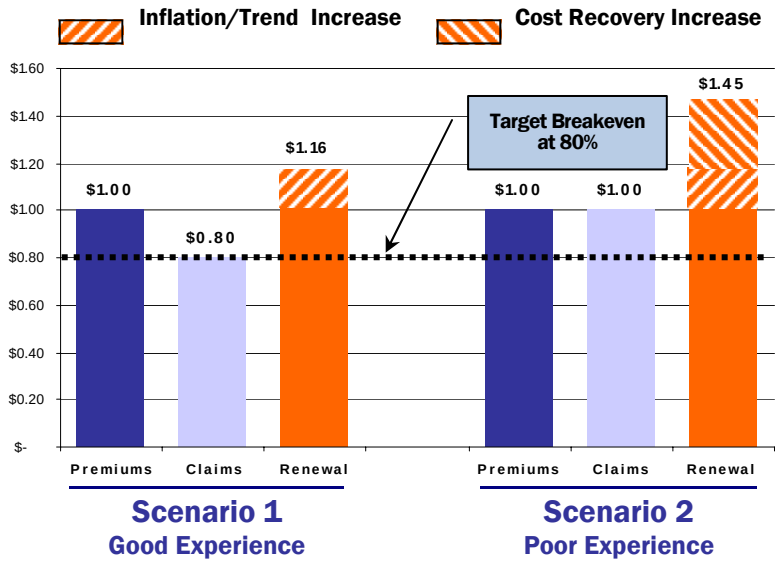
Even with claims at the target breakeven of 80%, the *trend and inflation factor* will generate a 16% premium increase.

$1.00 x [(.8/1.0).8] x 1.16 = $1.16

Scenario 2 — Poor claims experience

Claims represented 100% of premiums — every cent of the $1.00 premium went towards paying claims. The carrier will try to recover this loss **and** account for trend and inflation in its renewal price.

$1.00 x [(1.0/1.0)/.8] x 1.16 = 1.45



THE VALUE OF OUR INPUT

Our **360° Benefits Solution™** is designed to assure fair, consistent pricing. We prepare four quarterly reports, culminating in an ***Annual Audit*** designed to keep carriers honest and accountable. The renewal examples illustrated above cover only a few of the factors that go into our pricing analysis. During our audit we:

- Negotiate the lowest reserves possible so your capital isn't tied up in the hands of your insurance company
- Review workforce demographics to arrive at our own unit rates for both pooled and experience-rated benefits
- Analyze claims history in detail to identify 'one-time-only' events, which should be excluded from experience
- Use assumptions for trend, credibility and weighting linked to our own pool of clients and industry averages
- Utilize our industry contacts and intelligence to validate the carrier's assumptions and pricing requests

Our *professional guidance in benefits management* means long-term savings to your organization and the confidence of knowing that you are receiving the best possible return from your benefits investment.

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