TASK FORCE ON CONTRIBUTION STRUCTURE
MEETING MINUTES

Thursday, December 11, 2014
IRMA Office
9:30 a.m.

PRESENT: David Clark, Glencoe; Mike Braiman, Wilmette; Jessica Frances, Riverside; Drew Irvin, Lake Bluff; Robert Kiely, Lake Forest; Steve Tilton, Tinley Park; Dane Bragg, Buffalo Grove; Julia Cedillo, LaGrange Park; David Danielson, West Dundee; Marlo Kemp, Hazel Crest; Barry Krumstok, Rolling Meadows

ABSENT: Kathleen Rush, Woodridge

ALSO PRESENT: Margo Ely; Susan Garvey; Mary Henzler; Doug Nishimura, Milliman; Rita Boserup; Dan LeTourneau; Peter Wright, Wright Benefit Strategies; Richard Frese, Milliman

Ely thanked everyone for giving up their time to be on this very important task force and asked that everyone introduce themselves.

Ely explained that the plan for today's meeting was to go over some basic information and by the end of the meeting identify some objectives and deliverables. We will have another meeting in the next 30 days. Ely stated that staff as well as the consultants will have some assignments at the end of this meeting based on the input received from the committee.

Ely proceeded with a PowerPoint presentation.

I. BACKGROUND

Financial Fundamentals of IRMA
Ely stated that she thought everyone understands that our contribution structure is based on first our Members' revenues. The revenue base as the determining factor then is really what the impetus is for the conversation today. At what point do revenues become irrelevant to loss or risk? Our actuaries will be able to help us make that assessment. At some point, our large members feel that they are subsidizing our smaller members. We need to determine if that is the case. We do have an experience modifier and later in the presentation we will go through the history of what we have done to our system to be able to provide for more stability and more equity. Our experience modifier is where we identify the losses by individual member and we do it over a five-year period. So based on your losses over five years, you have an experience modifier that is calculated with your revenue base, multiplied by our rate equals your contribution.

Every member has an excess surplus fund that is basically money that comes out of our Interest Income Credit. This year at the upcoming Board meeting the Board is expected to approve a return of Interest Income Credit in the amount of $5 million. Over the past 10 years, we have given an Interest Income Credit every year except for 2 years. Over the history of IRMA, we have returned $86 million in Interest Income Credits.

We also have optional deductibles. Over the years, we have provided optional deductibles with varying success, which will be a topic of conversation. At this point, we have 2 members at $100,000 deductible. Part of our discussion should be why aren't larger members taking larger deductibles? The majority of our members – 42, are at $2,500 deductible.

Ely reviewed pooling fundamentals that include broad coverage, rate stability, financial security, effective loss control programs and self-governance.

Ely reviewed the history and outcomes of recent contribution studies by IRMA.

<u>2007 Ad-Hoc Committee on Contribution Formulas</u>

- Use of 5 years of revenue base instead of current year revenue base
- Revised the Experience Modifier formula to include 5 years of data (increased from 3 years)
- Decreased the credibility factor in the experience modifier from 100% to 80%

<u>2010 Ad-Hoc Committee on Member Retention</u>

- Implementation of sliding scale for losses included in experience modifier formula; to be reviewed by actuary every five years
- Implementation of aggregate cap for optional deductibles with minimum number of members opting in (Ely noted that this has never been used)

<u>2012 Planning Workshop</u>

- Implementation of $250,000 permanent deductible (Ely noted that this has never been used)

Ely turned the presentation over to Peter Wright of Wright & Associates.

Wright stated that he wanted to show the group some work that he had done for a large member that encapsulates some of the points that Ely just made. What does it look like to a large member who actually looked at: first, what deductible level do I pick? Second, if I am interested in taking more risk through a higher deductible or even through an IRMA $250,000 retention (sort of a permanently self-rated program), what do the numbers look like?

Wright presented a graph that depicted what it would look like for a large member in terms of their expected losses and their expected contributions to the pool at various deductible options.

The graph showed the $25,000 deductible – the blue bar shows the IRMA total contribution and the green bar shows the ACE loss cost estimate. Simply put that is your mean expected losses or what the actuary says you should expect to pay under this deductible. The same illustration is done for the $50,000 deductible and you will note that the IRMA contribution drops to $768,996 and the total losses is $351,519. If we were to go to the $250,000 deductible, then our expected losses would go up to $618,481 and the IRMA contribution would drop down to $512,664.

The graph also shows the IRMA Primary Limit. This is the $250,000 permanent deductible program. In effect, the member would be rated totally individually on their own losses and those losses would be limited only to the extent that IRMA's primary limits apply. In other words, whatever IRMA has to pick up before excess liability picks up, that would go into the formula that Milliman would use to come up with an ACE loss estimate and the IRMA excess pooling for the member.

Wright stated that the easiest way to look at this is for the IRMA contribution, the member would pay their share of IRMA's fixed costs – administration and cost of excess coverage. On the graph this is the light blue part of the bar - $205,125. The IRMA Excess Pooling (dark blue bar) - $359,682 is in effect the difference between the loss cost at the $250,000 deductible and how much IRMA would have to collect from the member to make up for the total ACE loss cost estimate. So simply put, the member is paying IRMA $205,125 for their share of the fixed costs and the actuary estimates for losses below $250,000. The way this would work, the member is going to contribute to IRMA the $205,125 for their share of the fixed costs. The member knows that they think their losses below $250,000 for the year will be $639,481. So the member puts that amount into budget for the year. As an example, the member gets a $1 million liability claim and it is a complete and mature claim. The member would pay the first $250,000 and IRMA would pick up the remaining $750,000. The $359,682 is the money that the member would pay to IRMA to fund the $750,000. Ely noted that the member would only pay $250,000 out of the $1 million claim and the remainder comes from the pool. This is what is difficult about this. Wright stated that this presents a little bit of a dichotomy. As far as the pool is concerned, the member actuarially needed to contribute $359,682. But in this $1 million claim example, the pool is liable for anything over $250,000 in that first year.

Clark asked, what's the bigger liability on the pool -- a member with the $250,000 deductible or a member with a $25,000 deductible that has that same claim? Wright noted that this was an excellent question and that's why we are here.

Kiely asked whether in terms of the deductibles and costs, Wright was including all coverages, including workers' compensation. Wright stated that it includes all coverages. Kiely stated that as a larger member, the workers' compensation issue is a recurring problem. Wright stated that if the group and IRMA membership want to pursue that, there is different loss frequency and severity by line of coverage. Wright stated that simply put, we cannot predict the liability claims that show up ten years after they happen. Changing standards today are then applied to something that happened in the past. If we sit down and project claims based on known claim practices and known legal practices today, and we are trying to project what is going to happen ten years from now, politics can be different, technology can be different, etc. Ely added that workers' compensation is easier to project then general liability.

Wright stated that was why he illustrated it the way he did. In effect, this is IRMA's same coverage under any of these options. The only difference is essentially in the IRMA primary limit permanent $250,000 deductible, the idea was, as was communicated to the member, okay you can have your permanent $250,000 deductible, so that you can feel like you are self-funded, but in exchange, we are going to do a proper actuarial underwriting and come up with a number that you need to contribute for our excess pooling. That is partially what is problematic to the member and problematic to the pool with this approach. Pooling is a zero sum game. We want to maintain rate stability and the financial health of the pool, but at the same time the member may say, look I think I am doing a better job in controlling my losses. What those in the underwriting and financial world have to deal with is the implication of what happens today and its financial impact years later. We have to look out to the future and think about how this impacts financing of things.

Wright stated that he pointed out to the large member involved, while this essentially gives you a reasonable estimate of losses and a reasonable estimate of costs, each of these numbers are identified in the normal renewal process that you all go through. It is late September through early November when these numbers are identified. Because IRMA cannot figure out these fixed costs until all the renewals are in. Secondly, we need to figure out what is everyone's member revenue base, and beginning sometime in June IRMA is beginning to work on the credibility formula, the loss banding for the overall IRMA pool. It is very complicated, but it is very fair. When you look at the member grouping as a whole, everyone is treated fairly. The problem is that an individual member may say they think they are getting a good deal, but maybe I'm not getting a good deal.

Wright stated that his basic point is in this primary limit example, since we were not defining any sort of limit to this excess pooling, the rating formula takes into account all losses up to that primary limit, it's difficult to define up front what this number could be. So in that $1 million dollar claim example, if it hits in one year and is all paid in one year, that 100% of that claim number goes into this excess pooling number. So, in theory, if all we had was this one loss, we may have paid $359,000 in one year, but the next year we would pay $600,000 – in other words $1 million less the $250,000 member retention

Doug Nishimura introduced himself and Richard Frese of Milliman. Nishimura stated he was going to provide some background on the actuarial methods, list some prior studies and highlight some of the past issues and concerns.

Nishimura stated that based on everything that Ely and Wright said earlier, the formula is directionally correct. We may have to tweak the formula to make it somewhat better, but based on the analysis that they have done for the individually rating, etc., the numbers you see are very close. That just supports the formula.

Nishimura stated that they use five years of quota share (sliding-scale) average, use five years of revenue to try and get a snapshot of a stable loss. Nishimura stated that there are some pools that use ten years. The formula has to be formulaic – it has to be a + b = c. One of the concerns is how do we know what's going to happen next year. Nishimura stated that the formula used to be three years and they recommended going to five years based on the IRMA history and they way the losses are reported. It smoothes it our more, but it makes that loss big year hang on longer. Or you could look at it the other way -- it makes your good years hang on longer.

Nishimura stated that we use a sliding scale. It used to be $50,000. Milliman recommended this and the reason it happened was that one of the members was hit hard with a lot of little losses and didn't have any big losses. Because of the $50,000 cap, the member was being penalized. Milliman recommended that to get around that, you could use a sliding scale going up and then that wouldn't happen.

Nishimura stated that the credibility is based on your largest member. The max credibility is 80% of that member. That moved down because a member at 100% credibility could get hurt, so at least there is some kind of pooling at 80%.

Nishimura reported that in previous studies we actually did a formula review of exposure and the loss base. We did a credibility review that determined the 80%. We also looked at outsourcing credits. One of the villages formed a separate department for its fire service, so we did a rating for that. We also looked at a permanent deductible under a self-rating.

Nishimura went back to the slide on 2014 Large Member Projected Cost. One of the issues is if you had a large self-rated deductible, then what would happen next year once you got hit. The whole thing centers on the $359,682. Nishimura stated that his concern is that if there was a large loss in the next year, how is that treated? Understand that the losses in excess of $250,000 are much more infrequent than the losses below $250,000. So, do you use a five year average? Probably not appropriate over $250,000. They are not going to get that $2 million dollar hit every five years. They are going to get that $2 million or maybe $10 million hit every ten years. So if we put that in the formula, we're going to kill them. If you do a five year average, on a loss of over $250,000 that's $10 million, they are going to be hit with a surcharge of $8 million over the next five years. So how do you pool them? Nishimura stated that he didn't care about one entity or maybe two, but let's say four or five of the members start to pool their numbers. We are not perfect, they have something we call adverse selection, where the large members are driving the large losses. We don't see that really, but let's say that all of the sudden that happens. How do we change the formula? So we have the formula in place that does the same as it did before, it takes a five year average. Let's say they get no losses, but they are a huge portion of the pool, it's going to affect all the other smaller members. Or it goes the other way. Let's say they get huge losses. How do we surcharge them equally?

Nishimura stated that he was concerned about adverse selection, how does it hurt a large member if they get a large loss, and what was equitable among the members. When you do the pooling above a higher level, the credibility of a large loss becomes much more significant.

Nishimura stated that right now the pool has 63% or 44 members at $2500 deductible, 14% or 10 members at $10,000 deductible, 14% or 10 members at $25,000, 6% or 4 members at $50,000 deductible, and 2 members at $100,000.

Nishimura stated that one question is can you pool with a large deductible? Let's go to an extreme case. Let's say that everyone chose $250,000 deductible. You could surely pool over $250,000 the excess of that and you could be somewhat of a TPA. There are some pools that are excess pools. If you take a large deductible, you have to be credible enough to go on your own. Is it possible to have a large deductible for the smaller members? No, that is not possible.

Nishimura stated that they are concerned with what they call asymmetrical information or adverse selection. When you get insurance where someone knows more than the other person, it could be a problem. Let's say that you had an unscrupulous member that had a high deductible, and the member knew that next year they were going to get hit with a big claim. So the member says that it was at $250,000, but wants to go back to $2500. This is called asymmetrical information – where a member goes in and out of the pool. This is something that we have to think about.

Nishimura stated that the actuaries give members credit for things that they have done, not things they may do in the future. Nishimura stated that they can be a little aggressive in their rate picks and can say to IRMA – here is our high and our low based on the assumption that you have done all these new things and you can fund that. What you fund, we don't really care about that much. What you do have to have is the liability, the assets in the program to pay for future losses.

Nishimura commented that when he sets up a pool he tells the members do not set the pool up to save money. At some point in time you are going to be the good guy and at others the bad guy. You have to buy into the pooling concept. In the long run it is going to be better for you because you are taking the insurance company profit. What you really want to do is control losses. You know your business better than anyone else. It's how you handle claims, how you do your safety program, how you do risk management. How you control your losses is crucial.

Irvin stated that Ely had made a comment about workers' compensation being very predictable and controllable. What adjustments can be made to the formula to reflect that? Is there anything that can be done to massage that element of the formula to maybe improve or reward those members that may feel that they are performing better in that aspect?

Nishimura stated that it could be done. You could have different credibility weights for the different losses. It makes the formula more complicated, but more accurate. The more variables that you add to that regression formula, it's going to increase the accuracy of the regression. At a certain point it doesn't make it better. It makes it a little more accurate.

Ely commented that perhaps there was a way where you didn't touch the formula but after the formula is done you have a credit factor. Nishimura stated that this would be the same thing really. Nishimura stated that this was a good question, and they can look into it.

The question was raised that if you are going to look at changing the formula would it make sense to allow member to choose one deductible for workers' compensation and one deductible for liability? Nishimura stated that you could do that; however, it would create a hassle for IRMA. Boserup stated that with our Risk Master system it would be a major programming change.

Kiely commented that as a larger member, they are very interested in going to a higher deductible. The issue is if we are going to go to a $250,000 deductible and are going to absorb all these workers' compensation claims and know that going in, it reduces the incentive for us to go to a $250,000 deductible. That's the trade-off we need to figure out. Kiely stated that one of the biggest value add that IRMA offers is workers' compensation. The handling part of it is a huge value add for municipalities. How do we price it and structure it to capture that value add, but not have that extra exposure on the workers' compensation side?

Clark stated that speaking as a member who is already at the $100,000 deductible, it already works as is. They put their toe in the water gradually, from $25,000 to $50,000 and for the last three years at $100,000. Since 2008, they have paid in both contribution and deductible $200,000 less than what we would have paid in just contribution prior to going to the higher deductible level. Plus, we used to take out the excess surplus every year to apply toward the contribution. Now, we have left it. So now we have that $200,000 in savings plus an extra $300,000 in excess surplus in case we have some adverse claims. So, the tools are already in place and are working. Clark commented that the other thing they do is charge their departments deductibles and this has helped tremendously to hold them responsible.

Ely reviewed the task force objectives:

- Determine existence of equity/inequity
- If inequity is identified, determine a level of inequity that requires action
- Identify appropriate actions to address inequity
- Determine if individually rated options should be offered and, if so, with what conditions
- Analyze effectiveness of optional deductible offerings

Ely asked if anyone had anything to add.

Kiely commented that a central question is what does IRMA want to be in 10-15 years? One of the biggest risks is in reality only the large members have the luxury of leaving or not. When you take a look at the numbers – there are six members over $40 million that represent 10% of the membership and 40% of the revenue. If those six members got cherry picked for whatever reason, IRMA would be dramatically different than it is today. Kiely stated that one of the concerns that he has is that as we go forward it seems like every year he is looking for more and more savings anywhere he can find them. One of his concerns is reaching some point where his Board says you lay off two firemen or find cheaper insurance. This is an easy decision for an elected official because they are not programmed to think long term.

Kiely stated that when Bush first broached the subject with Lake Forest about the permanent $250,000 deductible and we brought Milliman on everyone thought this was a great idea and we would have the experience that Glencoe had. The more they got into the subject; however, Lake Forest determined this would not be the case. Kiely stated that we originally put the permanent $250,000 deductible in place for Oak Park. If this isn't going to work then we need to get rid of it. If we do that, what are we going to do to attract larger members? Kiely stated that he didn't know whether this was one of our long term goals. Kiely stated that he was broaching this from a long term standpoint of making sure that larger members still feel like they are getting a good deal.

Boserup stated that our largest member, Tinley Park, is at a $10,000 deductible. Tilton stated that he has this conversation with his Finance Director every year. Personally, Tilton stated he would like to be at $25,000 or $50,000; however, the Finance Director is very conservative. From a community standpoint and a budget standpoint they are very conservative and it has treated them well. Tilton stated that he doesn't have a great argument to say they should go to $25,000. Tilton stated that they get the information every year from IRMA about what the savings would be at a higher deductible. But when you look at the risk, their Board is also very conservative and are very happy with getting the credit back every year. These are very difficult concepts to understand.

Kemp also stated that Hazel Crest is looking at the fact that there isn't much reward in saving $25,000 as there is blame for going up $50,000. From their perspective they use the rates themselves, especially with the smoothing, that tend to make the variance nice and steady and it's a lot easier to explain that you went up $5,000 because of inflation.

Boserup asked whether it would make any sense at this point to look at a $5,000 minimum deductible, as she has had some members asking about it. Nishimura answered not really, although you could.

Nishimura commented that the large member retention has to be a priority. The one thing that is missing from the numbers is the administrative costs or claims handling costs that the large members contribute to. The smaller members have to look at this and say if I lose a large member, the fixed costs are going to go up and I am going to pay more. Just on that basis, you could give a little break to large members. It's done all the time – they give a big corporation tax breaks. It's something that you can think about. The fact though that many of you have looked at different deductibles and kept where you are say that the formula really is working.

Kiely asked if he could make a suggestion. It sounds like Milliman, IRMA Staff, Wright, and perhaps others have suggestions. Can we all send them in to one location to start to build model of what options are out there. We could identify some potentials and then analyze them and check them off as a yes or no. Then going through that exercise we will decide -- is there any inequity or not.

The question was raised – does IRMA want members to take on larger deductibles? Margo stated that this was a good question. She commented that she likes what Glencoe has done and she thinks that by taking a larger deductible safety has become more of the culture and the accountability is there and you see their losses going down. Is it directly attributable to the higher deductible? Only if you are also implementing the other mechanisms that Glencoe did.

Ely stated that her concern about higher deductibles is that she wants members to still report everything. The higher deductible level will create an incentive not to report everything and that would not be good.

Ely stated that perhaps we should be looking at a pilot program or a roadmap for larger members to get to the higher deductible by implementing some of the things that Glencoe did. You would also have the financial security through your excess surplus fund. So, you are going to your Board with a 5-year plan and get them to buy into that.

Ely stated that she would act as the clearing house for questions and points to be discussed at the next meeting. Staff would poll the committee for the next meeting date.

Submitted by:

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Margo Ely, Executive Director