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May 15, 2017

***Via E-Mail***

Ms. Leslie Haase
Finance Director
City of Joplin, MO
602 South Main Street
Joplin, MO 64801

Re: **City of Joplin Missouri – Reserve Policy Discussion Guide and Recommendations**

Dear Leslie:

It is important for organizations that self-insure their health benefits, as the City of Joplin (the City) does, to maintain adequate reserves to cover unpaid claim liabilities and insulate them from other unforeseen events that can destabilize financial security. Being appropriately reserved increases the City's ability to meet current and future cash flow demands and future benefit obligations. Moreover, adequate reserves will allow the City to "smooth out" premium increases dictated by the underwriting cycle. Therefore, we have prepared the following reserve discussion guide.

This report is organized into three sections:

- Reserve Categories which describes each reserve type and explains its purpose;
- Comparison of Current Assets and Recommended Reserves; and
- Reserve Policy Guidelines.

## Reserve Categories

### *Incurred But Not Reported Reserve (IBNR)*

Claims that have been incurred but not yet paid are recorded as an obligation by the City. This obligation is called the IBNR. The IBNR reserve represents an estimate of the liability at the end of the fiscal year of claims that have already been submitted, but for which payment has not been made, and incurred claims that have not yet been submitted. For the City, this IBNR amount is comprised of self-funded medical and prescription drug benefit reserves.

Segal calculates these reserves based on formulas representative of reasonable levels of such claims as established by industry standards. The standards are based upon insurance companies' studies, lag studies, and actuarial assumptions. The formulas may vary depending upon plan design, specific lag studies, and claims backlog data.

***Claims Fluctuation Reserve***

The claims fluctuation reserve protects against unpredictable claim fluctuations beyond expected claim levels. Some reasons that claims exceed expected claims levels are due to:

- A small number of very large claims that occur randomly;
- federal action, such as legislation and Medicare/Medicaid cost shifting;
- state action, such as mandated benefits and excise taxes;
- plan sponsor action, such as coverage of costly experimental procedures or drugs and non-contractual payments;
- new technology or treatments;
- natural disasters;
- acts of terrorism;
- medical inflation significantly higher than expected;
- or an influx of new participants that are not as healthy as average.

Segal recommends the claims fluctuation reserve be established for any entity with self-funded benefits.

Segal calculates this reserve using actuarially-accepted methods based on several factors such as benefit level, amount of stop-loss protection, number of participants and number of years of claims experience used for the projection.

The appropriate claim fluctuation reserve for the City is estimated to be approximately 51% of the health fund's self-funded claim expenses. This amount is expected to cover fluctuations in claims experience in 95 percent of all years.

***Economic Reserve***

The purpose of the economic reserve is to cover income revenue shortfalls due to a national or regional recession. For plans with significant levels of assets and investment income, economic reserves can also cover revenue shortfalls due to lower than anticipated investment earnings.

An economic reserve may not be appropriate for the City based on the assumption that any significant revenue reductions would result in corresponding reductions in staff. In other words, a significant reduction in income would be offset by a corresponding reduction in expense. In addition, investment earnings are not a significant portion of income for the health fund.

***Accumulated Eligibility***

An accumulated eligibility reserve covers eligibility earned by active employees but not yet provided as of the end of period, commonly due to the lag between the earnings period and eligibility period for benefits.

Eligibility is provided on a monthly basis for city employees. If a participant is employed with the city as of the first of the month, then they are eligible for benefits for that month. As such, there is no eligibility lag and therefore, an accumulated eligibility reserve is not recommended.

***Other Reserves***

Other reserves can be established for protection from shortfalls in investment returns, and/or for specific programs with segregated assets such as health reimbursement and saving accounts, as well as retiree pre-funding programs.

**Comparison of Current Assets and Recommended Reserves**

The Segal recommendation for Target Reserves for the City includes reserves for IBNR and Claims Fluctuation. The following table estimates 2017 Target Reserves and compares them to the Fund Balance, as of December 31, 2016:

| Comparison of Target Reserves to Fund Balance | | |
|---|---|---|
| | | |
| **Estimated 2017 Target Reserves** | | |
| IBNR | | $ 350,000 |
| Claims Flucuation | | $ 2,470,000 |
| | | **$ 2,820,000** |
| | | |
| **Fund Balance as of 12/31/2016** | | **$ 2,076,389** |
| **Target Reserve Shortfall** | | **$ 743,611** |
| | | |
| **Ratio of Fund Balance to Target Reserves** | | **74%** |

The 2017 Reserve Shortfall is estimated to be approximately $744,000 or 74% of Target Reserves. It is important to note that the Target Reserves are projected to increase at the assumed trend of self-funded claims or approximately 8% annually.

**Reserve Policy Guidelines**

As stated previously, the purpose of adequate reserves is to ensure the City's ability to meet current and future cash flow demands, future benefit obligations, and allow smoothing of annual premium increases. The process of smoothing premium increases involves the following adjustments, which correspond to the three distinct modes of a reserve cycle: building, maintaining, and drawing down reserves.

Reserve policy guidelines may be established to determine the appropriate adjustment in any given year. The recommended premium increase, and a published trend rate, can serve as a guide as to where a health fund stands in the reserve cycle. A typical scenario involves establishing a corridor around a published trend figure to determine if a premium increase is low, average, or high. For example, if the recommended premium increase is within 2 percent of the baseline trend, then the health fund is in the reserve maintenance corridor, and no premium adjustment needs to be made. If the recommended premium increase is above the target corridor, the City should consider drawing down reserves in order to reduce the premium increase. Conversely, if the recommended premium increase is below the target corridor, and there is currently an estimated reserve shortfall, the health fund should consider adding a load in order to build reserves.

Given that the City currently is well below the target reserves, the reserve guidelines could be as follows: Include a reserve load in years with low or standard premium increases, and forego adding a reserve load in years with high premium increases.

Depending on the amount of reserves the City deems appropriate, it will likely be necessary to build-up reserves incrementally over a number of years. The following table lists the City's current estimated reserve shortfall, the projected growth in Target Reserves for 2018 and the necessary premium loads to achieve the target level over 3, 5 and 7 year periods:

| Reserve Build-Up Scenarios | | | | |
|---|---|---|---|---|
| | | Aggregate | | Per Active Employee Per Month* |
| **Estimated Reserve Shortfall (rounded up)** | **$** | **750,000** | **$** | **122** |
| **Growth in Target Reserves - 2018** | $ | 226,000 | $ | 37 |
| **Reserve Loads Based on Funding Horizon** | | | | |
| Over 3 Years | $ | 492,004 | $ | 80 |
| Over 5 Years | $ | 413,422 | $ | 67 |
| Over 7 Years | $ | 393,802 | $ | 64 |

* Based on an assumed enrollment of 512

As mentioned previously, Target Reserves are projected to increase at an assumed trend rate of approximately 8%. For reference, the projected growth in Target Reserves over 2018 is included in the above table. The reserve loads over the 3 year, 5 year and 7 year horizons take into account the projected growth in Target Reserves. Estimation of the reserve shortfall, and whether to include a reserve load and the load amount, would be determined as part of the annual premium rating process.

The projections in this letter are estimates of future costs and are based on information available to Segal Consulting at the time the projections were made. Segal Consulting has not audited the information provided. Projections are not a guarantee of future results. Actual experience may differ due to, but not limited to, such variables as changes in the regulatory environment, local market pressure, healthcare trend rates and claims volatility. The accuracy and reliability of health projections decrease as the projection period increases. Segal Consulting's pricing guidance is not intended to provide legal advice. Issues involving the interpretation of laws/regulations should be referred to legal counsel for authoritative advice.

We hope that you find this discussion guide to be useful. If you have any questions, please let us know.

Sincerely,

Ruth Donahue
Vice President & Benefits Consultant

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