AMERICAN ACADEMY *of* ACTUARIES

March 10, 2014

Patrick McNaughton
Chair, Health Risk-Based Capital Working Group
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2662

Re: General Issues Regarding the Impact of Risk Adjustment, Reinsurance, and Risk Corridors on Health Risk-Based Capital (RBC)

Mr. McNaughton,

On behalf of the American Academy of Actuaries'[1] Health Solvency Work Group, I am pleased to offer comments on the Affordable Care Act's (ACA) three mechanisms intended to mitigate risk to companies – risk adjustment, temporary reinsurance, and temporary risk corridors (3Rs). Based on conversations during several health risk-based capital conference calls, the working group asked the Health Solvency Work Group to elaborate on their ideas on alternatives to increasing risk-based capital factors to cover the 3Rs. Estimating the net effect on the resulting assets and liabilities from these three mechanisms is difficult and creates the risk that ACA-compliant individual and small-group net income may be understated or overstated in their respective contributions to capital and surplus. The assets and liabilities that could be estimated due to the 3Rs include:

1) An asset for a receivable from risk adjustment;
2) An asset for a receivable from the temporary reinsurance (individual only);
3) An asset for a receivable from risk corridors;
4) A liability for a payable from risk adjustment; and
5) A liability for a payable from risk corridors.

There are two risks associated with each 3Rs estimate: the risk of misestimation and the risk of collection of receivables. The larger risk for each component above is the risk of misestimation. The potential magnitude of the misestimation is large enough that it cannot be judged by the amount of the receivables or payables that are in the financial statement. It is possible that an estimated payable really becomes a receivable, or vice versa, after the actual amount is recorded. With that said, there are risk mitigators and potential minimums and maximums to the assets, liabilities, and aggregate impact associated with the 3Rs that may be considered as an indication of the potential magnitude of the misestimate.

[1] The American Academy of Actuaries is a 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States

It is important to remember that the proportionate magnitude of the net financial results of ACA-compliant individual and small group to total issuer/group results varies in materiality. It also should be taken into consideration that there are offsets and interactions within the financials that restrain the net results.

There is a risk of collection of the risk adjustment and the reinsurance receivables. If there are not sufficient funds collected from the reinsurance fees, there may be a risk that reinsurance receivables will be reduced to match the amount collected. However, at least for 2014, low enrollment reduces the likelihood and materiality of fund payment reductions. There also is a risk that some companies that owe risk adjustment payments may not be able to make the transfer payments.

The calculation of a reinsurance receivable should include minimal estimation error as it is a straightforward coinsurance settlement. The range of potential for estimation error in risk adjustment will depend on whether CMS can provide interim estimates to affirm directionality. As noted above, the net result of the risk corridor settlement follows.

The risks from the 3Rs will change over the next three years. In 2014, all three will be in effect, but the reinsurance and risk corridors will end in 2016. The degree of reinsurance impact is reduced in both 2015 and 2016.

The magnitude of the risk from the 3Rs will vary among companies. The financial consequences of misestimation for each year will appear in a restatement in the subsequent calendar year. In the early years, other financial consequences also may result in financial issues in the following year since premium rates will be developed on the basis that the 3Rs were estimated correctly. Therefore, premium rates may be inadequate or excessive due to the misestimation.

If the financials are overstated, it will be important to quickly identify the potential that solvency is threatened. Risk adjustment payables and receivables will be estimated for year-end in February for the financial statement due at the beginning of March, but actual amounts will not be known until June 30. Reinsurance receivables will be estimated in February, but the actual amount will not be known until June 30. Risk corridor receivables and payables will be estimated in February, but actual reporting is not due until July 31. In cases in which a legal entity writes business in multiple states, these values will need to be estimated for each state. The gross results will be reported, not the net estimate.

The work group recommends that the state financial analysts identify companies at risk due to low RBC levels and calculate the revised RBC ratio if the estimated assets are not included and/or liabilities increased. This RBC sensitivity test would further identify companies at risk so that regulators could take action.

If this approach is deemed insufficient, further work would be required. For estimated receivables due to the 3Rs, the maximum error could be that there is no receivable. It is unlikely that a risk corridor receivable actually would result in a payable, but it is possible that a risk adjustment receivable could become a payable. For the risk adjustment payable due to the 3Rs, it is also possible that it may be underestimated. Modeling of the potential maximum for the 3Rs liabilities based on some metric such as premiums may have to be done and more guidance provided to the level of adjustments to recorded risk adjustment and risk corridor payables. Interaction of the 3Rs with rebate liabilities and any premium deficiency reserve would be taken into consideration as part of the stress testing. A modified RBC would be calculated by the financial analyst reducing total adjusted capital by the amount of any receivable from the 3Rs and modifying the risk adjustment and risk corridor payables to a higher level determined based on modeling. This calculation should be done quarterly throughout 2015 and 2016. Consideration would have to be given to the most efficient way to perform quarterly calculations from the data available. If the alternative RBC percentage is less than 200 percent, the regulator should contact the company to determine if corrective actions are needed to protect solvency.

We would be happy to help you refine this idea, if this is the direction the NAIC decide to pursue.

If you have any questions regarding the comments in this letter, please contact Tim Mahony, the Academy's state health policy analyst (202.223.8196; Mahony@actuary.org).

Sincerely,

Donna Novak, MAAA, FCA
Chairperson, Health Solvency Work Group
American Academy of Actuaries