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# Medical Reinsurance: Considerations for Designing a Government-Sponsored Program

*Policy-makers are considering offering government-provided reinsurance to health plans as part of an overall solution to address some of the problems in the health care system.[1] This issue brief provides a primer on the current commercial medical reinsurance market. It then outlines some of the issues policy-makers should consider when designing and implementing a government-sponsored medical reinsurance program.*

*Compared to the health insurance market as a whole, the commercial medical reinsurance market is very small. Reinsurance is typically purchased by small to mid-sized insurers who are primarily looking for help in managing their risks. A similar coverage, called stop-loss insurance, is purchased by small to mid-sized self-funded employer plans for similar reasons. The largest entities that assume medical risk today, whether large health plans or large employers, do not currently purchase any type of protection against large medical claims.*

*Some stated goals of a government-provided reinsurance program include reducing health care premiums, promoting premium stability and decreasing the number of uninsured. To be successful, such a program would need to address several issues, including the design specifics and the expenses that would qualify for government reimbursement. The program should include the proper incentives for plans to manage their risks appropriately. Otherwise, a reinsurance program runs the risk of actually increasing overall health spending, further complicating the problems of high health care costs in the United States.*

1. Health plans in the brief refers to an insurance company, HMO, or self-funded health plan.



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## Medical Reinsurance Primer

This section provides a brief description of medical reinsurance to introduce basic terminology and provide a framework of reference when discussing government-sponsored reinsurance proposals.

*What is reinsurance?*

Simply put, reinsurance is insurance for insurance companies. It is a mechanism whereby one party transfers a portion of its insurance risk to another party. The insurer, or the entity that is transferring or ceding the risk, is called the "ceding" company. The reinsurer, or the entity that assumes the risk, is called the "assuming" company. To make this transfer occur, both parties (typically an insurer and reinsurer) enter into a reinsurance contract.[2]

Under a reinsurance contract, the assuming company agrees to reimburse the ceding company for "losses," typically referred to as reinsurance claims. In medical reinsurance, losses may fall into one of three categories:

- **Claims**—These are medical claims incurred and paid by the ceding company under the insurance polices that are reinsured.

- **Claim adjustment expenses**—These are expenses that are incurred by the ceding company to help reduce overall medical claims. For example, a ceding company may agree to contract with an outside party to negotiate a lower price on a claim. The outside party requires a fee for its services, which would be considered a claim adjustment expense.

- **Extra contractual obligations**—These are court-ordered judgments against the ceding company.

The reinsurance agreement should clearly spell out the term of the reinsurance agreement from the date of inception to the date of termination. Losses occurring during this reinsurance agreement term will then be reimbursed by the reinsurer. Ceding companies pay premiums to the reinsurer, which include provisions for reinsurance losses, expenses, and risk margin.

*Why do entities buy reinsurance?*

There are a number of reasons why an insurance company may want to buy reinsurance. We highlight some of them below. However, the overriding theme is that this transaction (similar to an insurance transaction) protects the purchaser from unforeseen events. Success in the insurance business requires much more than being able to understand and manage statistical risk. There are numerous other business risks to consider. In addition to helping with statistical risk, a reinsurer can be used as a type of business partner or consultant to provide additional services and insights to help insurers better understand and manage their business.

- **Financial protection**—Reinsurance can help insurance companies control their exposure to losses. Whether these losses are on one individual, a series of individuals, or an aggregate block of business, companies may wish to limit their exposure and thereby stabilize their earnings.

- **Increased capacity**—A smaller insurance company may not wish to or be able to absorb large-dollar individual risks. By purchasing reinsurance, a company may be able to offer individual limits in amounts similar to their larger competitors. By passing losses (and therefore risk) to another entity, the insurer may be able to reduce the amount of surplus that is required to allocate to that particular line of business. Reducing required surplus will enable an insurer to improve its overall balance sheet position and may free up capital to allocate surplus to other lines of business or for other investments.

2. This brief describes common structures of a reinsurance agreement and typically refers to an insurer as a ceding company and a reinsurer as an assuming company. While this is common, there are other possibilities. For example, an insurance company can enter into a reinsurance contract with another insurance company. As another example, a reinsurance company can enter into a reinsurance contract with another reinsurance company (known as retrocession). Regardless of the particular arrangement, however, the same basic principles apply.

- **Expertise and services**—Reinsurers also offer resources to help insurers manage their business. By taking advantage of these resources, insurers may be able to compete more effectively against larger competitors. These resources include, but are not limited to, expertise or services regarding: product design and development, market research, claims services, care management services, underwriting, pricing, rate development and management, reserve valuation and financial management, compliance services, and distribution design and management.

*Common types of reinsurance programs—proportional vs. non-proportional.*

In proportional reinsurance, the reinsurer shares an agreed-upon percentage of the ceding company's premiums and losses. In non-proportional reinsurance, the reinsurer's liability is based on claims over a pre-defined threshold—the attachment point—and the premiums are set accordingly. One example of non-proportional reinsurance is specific excess of loss, in which the reinsurer would pay all or a percentage of claims once an individual's claims exceed a pre-determined attachment point. Another example is aggregate excess of loss, in which the reinsurer would pay all or a percentage of claims once a plan's aggregate claims exceed a pre-determined attachment point.

*Reinsurance and stop-loss insurance for self-insured plans.*

To this point, the discussion of reinsurance has been limited to a traditional reinsurance agreement between an insurance company and a reinsurer. In the employer group benefit market, there is a similar structure known as stop-loss insurance. While this is not technically reinsurance, stop-loss insurance is similar in many ways to specific and aggregate excess of loss reinsurance.

As an alternative to purchasing a fully insured product, an employer may choose to set up a group benefit plan for its employees. An employer has a number of advantages when taking this approach, including financial flexibility and the ability to custom design plans to the needs of its employees. Sometimes, this plan is referred to as a self-funded or a self-insured plan because the employer (instead of the insurance company) is responsible for paying the benefits to the employees.

Many employers who offer a self-funded medical benefit plan to their employees, particularly small to mid-sized employers, choose to buy an insurance policy that provides stop-loss insurance protection against individual or aggregate claims. There are two common forms of stop-loss insurance, which are analogous to excess-loss reinsurance. Specific stop-loss insurance provides protection against individual claims above a pre-determined specified amount called the specific deductible. Aggregate stop-loss insurance provides protection against the claims exceeding a total amount of claims going over a pre-defined attachment point. A common aggregate stop-loss attachment point is 125 percent of expected claims in a given time period.

In a stop-loss insurance context, the employer plan acts as the insurance company and the stop-loss insurance company acts as a reinsurer. The employer plan effectively cedes certain losses to the stop-loss insurer.

## The Objectives of a Government-Provided Medical Reinsurance Program

Developing clear objectives for a government-provided reinsurance program is an important step toward designing a program that has a high probability of achieving these objectives while minimizing the chance of unforeseen or unintended consequences. Developing clear objectives will also help to design effective tools to measure whether these goals have been met.

Under some recent proposals, government-provided medical reinsurance would reimburse eligible entities (insurers or self-funded plans) for the costs of individuals who have high claims. This is similar to specific excess-loss reinsurance for insurers and specific stop-loss insurance for self-funded plans. Unlike in commercial medical reinsurance, the government would not charge premiums under most current proposals. The reinsurance claims incurred by the government would be funded through general tax revenues.

*Some of the stated objectives of government-provided reinsurance include:*

- **Lower premiums**—By reimbursing plans for high claims, a primary goal of the program is for health plans to pass along this cost reduction to policyholders in the form of reduced premiums. Some refer to this reduced premium as a savings to policyholders even though there may be no net reduction in overall health care expenditures.

- **Increased premium stability**—By absorbing large individual losses, it is hoped that the government program would lead to less dramatic premium increases from year to year.

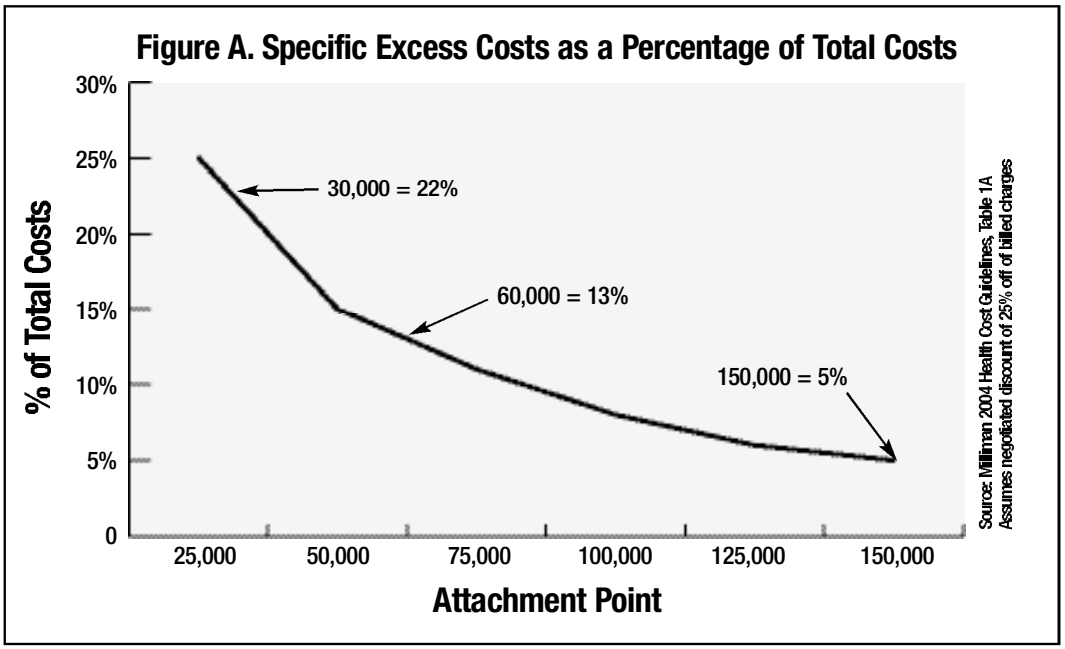
- **Reduce the number of uninsured**—As a result of lower and more stable premiums, it is hoped that coverage will become more affordable to both employers and individuals, thereby reducing the number of uninsured.

## Considerations for Designing and Implementing a Successful Government-Provided Medical Reinsurance Program

Whether a government-provided medical reinsurance program would meets its goals depends on various factors, including the specific design features and claim management provisions. These and other issues are discussed below.

*The impact on costs.*

The extent to which reinsurance can reduce a plan's costs depends, in part, on the reinsurance attachment point. The lower the attachment point, the higher the potential savings. Figure A presents an example of how excess claim costs as a share of total claim costs (i.e. the share of claims that would be covered by reinsurance) vary by attachment point. In this example, an attachment point of $150,000 would reduce a plan's claim costs by 5 percent.[3] Looked at another way, an attachment point of $150,000 would imply that the government would be responsible for 5 percent of claim costs.




3. This example assumes that all plan costs above the attachment point are reimbursed through reinsurance. If plans were made responsible for a portion of claims above the attachment point, plan savings and government costs would be reduced accordingly.

Lowering the attachment point to $60,000 would increase a plan's savings (or the government's costs) to 13 percent of the plan's claim costs. Lowering the attachment point to $30,000 would further increase a plan's savings (or the government's costs) to 22 percent. Note, however, that this is just one example of how reinsurance costs would vary by attachment point. Although other data sources would likely reveal similar patterns, the specific savings at different attachment points could vary significantly using different data.

Reducing claim costs would, in turn, reduce premiums, although the costs of administering reinsurance would lessen these savings. A reinsurance program would result in a one-time premium savings only. Transferring losses from a health plan or insurer to the government would not reduce overall health cost trends unless measures are taken to encourage plans to further manage costs. Reinsurance programs themselves could contain disincentives to manage costs. Therefore, policy-makers need to consider the impact of the program on total health care expenditures. Would the incentives implicit in a proposed reinsurance program lead to decreased cost management? If so, how would this concern be addressed? If overall expenditures were to increase as a result of the reinsurance program, the premium savings will be reduced. This issue is considered in more detail below.

*Potential diffusion of responsibility and alignment of incentives.*

Policy-makers may want to consider implementing incentives to ensure that large individual losses do not increase in incidence or severity as a result of the reinsurance program. An insurer who takes the risk for large losses (i.e. does not purchase reinsurance) generally does all it can to manage its risks efficiently. Shifting some of the insurance risk to the reinsurer may reduce the insurance company's incentives to manage its claims. Therefore, reinsurers often take measures to encourage insurers to manage their claims.

For instance, reinsurers can require that insurers pay a portion of claims even after the attachment point is reached. Although this is still less of an incentive to manage claims than if the insurer bore the full risk for all of its claims, this method does encourage insurers to manage their high-cost claims. Another method that reinsurers can use to encourage claim management is to cover claim adjustment expenses. As discussed above, these expenses may include payments to vendors who help reduce the cost of a claim. Policy-makers should consider designing any government reinsurance program to hold entities at partial risk for high-cost claims and including claim adjustment expenses as a reimbursable loss.

The short-term nature of most commercial reinsurance contracts (typically one year) also encourages insurers and self-funded plans to manage their claims. Because reinsurance premiums can be reset at renewal, premiums will increase significantly for entities with patterns of large claims. This incentive would not be available, however, in a government provided-reinsurance program where the insurer simply passes losses to the government and doesn't pay a reinsurance premium.

*Disease management and care management programs.*

Policy-makers may design a government-provided reinsurance program to include provisions that require or encourage participation in a disease management or care management program. It is important to note that current health plans custom design their care management and disease management programs around the specific characteristics of the population in their plan. When choosing which program to implement, health plans generally consider the following factors:

- The ability of the program to achieve the desired health outcomes
- The impact on the behavior and attitude of the membership affected
- The direct and indirect cost of implementing the program

Because of these considerations and the uniqueness of each particular plan population, it might not be appropriate to require a uniform disease management or care management plan for all plans.

*The impact of the leveraging effect on the cost of the program.*

Due to the leveraging effect of the attachment point, premiums for specific excess- loss reinsurance will increase faster than the underlying medical cost trend, all else equal. Unless the government program adopts specific measures to counter it, this leveraging effect may cause government reinsurance costs to increase faster than underlying medical trend. Indexing the attachment point to at least the level of underlying medical trends would help to neutralize this effect.

*Provider fees and the cost of supplies.*

Many health plans have negotiated fee reimbursement schedules that vary significantly by provider. If a uniform excess attachment point is used in a government-provided health plan, the level of coverage provided could vary significantly based on these fee levels negotiated by the health plans. The health plans that achieve higher discounts than their peers would obtain less coverage because of the reduced incidence and severity of a reinsurance claim.

The existence of these varying coverage levels may change the dynamics of how fees are negotiated with providers over time. One possible scenario would be that providers and health plans would restructure their fees in a way that would increase the government burden to unanticipated levels. Another scenario may be that the government could establish a standard fee schedule that accumulates spending toward the attachment point and/or reimburses providers so that coverage levels to health plans would be more neutral.

*The impact of a fixed attachment point by geographic area and demographic characteristics.*

Health care costs vary significantly depending on geographic location and health plans negotiate different fee schedules for different areas. In addition, medical practice patterns vary across the country. Implementing a government-provided reinsurance program that uses a uniform attachment point for all health plans in effect applies varying levels of coverage, depending on the geographic location of the health plan members. As the attachment point increases, the variation in excess-loss costs tends to narrow. Health care costs also vary significantly by age and gender. As older individuals tend to have higher medical costs than younger individuals, a fixed attachment point would provide more of a subsidy for health plans with a higher cost age/gender demographic mix. Policy-makers may want to consider the impact of the variation in coverage by area when establishing the attachment point(s) for a government-provided reinsurance program.

*Compulsory vs. voluntary.*

The effectiveness of a government-provided reinsurance program may vary depending on whether participation is compulsory or voluntary. Requiring all health plans to participate in a standard reinsurance program runs the risk of providing inadequate coverage to some programs and too much coverage to others. Current purchasers of commercial medical reinsurance tend to be smaller sized health plans that need or want risk management services. Most large, financially strong health plans do not feel that they need excess medical reinsurance and therefore do not purchase it. Introducing a risk transfer program to these entities that have not historically purchased reinsurance may have unintended consequences that policy-makers should evaluate.

If the reinsurance program is voluntary, health plans will evaluate the costs and benefits of participating and will participate only if they feel it is in their best interests to do so. Eligibility requirements that increase the overall cost of coverage will reduce the available premium savings, thereby reducing participation. If premiums are required for the reinsurance coverage, steps may need to be taken to ensure that adverse selection is minimized, especially if premiums are designed to be self-supporting.

Policy-makers should try to avoid establishing entrance and exit rules that will make it difficult for the program to meet intended participation levels. They should also evaluate the cost of any conditions placed on health plans to ensure that the intended financial outcomes are achievable.

*The definition of a loss.*

A government-provided reinsurance program should clearly define what losses would be reimbursable, because plan claims (and the program's costs) may vary significantly depending on which definitions are chosen. Clear rules should be established to define the following:

- The services and supplies that are considered eligible for reimbursement
- The period of time over which claims are to be accumulated to determine the existence and amount of reinsurance loss
- Whether claims are to be accumulated based on when they are incurred (the date the services are rendered or supplies are delivered) or when they are paid by the insurer or health plan
- The appropriate or maximum rate of reimbursement for a given service or supply
- The maximum level of reimbursement allowed for one loss

*Extra-contractual obligations*

Policy-makers should consider the impact of the insurance-related legal process on overall reinsurance costs when designing a government-provided medical reinsurance program. Legal disputes are an inextricable part of the insurance/reinsurance business landscape. When establishing a commercial reinsurance program, a reinsurer generally prefers that an insurer not adopt a different legal philosophy on whether to resist or settle legal disputes depending on whether a reinsurance program exists. If an insurance claim due to a legal settlement or judgment will likely result in a reinsurance claim, the reinsurer may want to participate in the legal process to ensure that its rights are preserved and assets are protected.

If a government-provided reinsurance program is implemented that covers large claims, it is possible that the health plans may change their established practices toward settling legal disputes. A health plan that might have otherwise disputed a claim may choose instead to settle or simply pay the claim because a majority of the cost of the claim may not be their responsibility and it may not be in their best interest to dispute it. As a result, the overall costs of large claims may increase more than anticipated.

When deciding whether to participate in the legal process, the government may find itself in a difficult position. If the government does not participate in the process to protect itself, it may result in increased losses. If the government participates in the process, it may get involved in numerous disputes.

## Conclusion

Designing a program to reduce health care premiums, decrease the number of uninsured, and promote premium stability is a worthwhile goal. Creating a government-provided reinsurance program could potentially meet these goals if designed properly. To be successful, such a program needs to address several issues, including the design specifics and the expenses that would qualify for government reimbursement. In addition, the program should include the proper incentives for plans to manage their claims efficiently. Otherwise, a reinsurance program runs the risk of actually increasing overall health spending and health costs trends, further complicating the problems of high health care costs in the United States.

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