AMERICAN ACADEMY *of* ACTUARIES

# Status Report of the Health Liquidity Work Group
# To the NAIC Health Entities Working Group
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This report was prepared by the American Academy of Actuaries Health Liquidity Work Group.
Donna Novak, ASA, MAAA, FCA, Chairperson
Rowen Bell, FSA, MAAA
Audrey Halvorson, FSA, MAAA
Burt Jay, FSA, MAAA
John Lloyd, FSA, MAAA
Peter Perkins, FSA, MAAA
Julia Philips, FSA, MAAA
Bill Weller, FSA, MAAA

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The Academy's Health Liquidity Work Group has identified a set of potential ratios to be used to test for health organization liquidity, as previously reported. The ratios would be used in a "safe harbor" test. The Health Liquidity Work Group will use actual data to be provided by the NAIC to determine which ratios are good predictors of an entity's liquidity strength and develop a weighting scheme for a first level liquidity test. The Work Group has also developed a second level test that uses off balance sheet adjustments to the first level ratios and finally will describe stress level testing to be done if the safe harbor tests are not passed, as previously reported.

If a company does not pass the safe harbor test or is not eligible for the safe harbor test, then the company must perform a series of cash flow tests (defined below). The series of cash flow tests consists of quarterly cash flow projections for the next two years where independent pre-defined events (stresses) are applied to a base cash flow projection. The purpose of the cash flow projections is to identify sources of funds to cover resulting outlays and, if necessary, assets to be sold to meet cash requirements plus extra cash needs if a pre-defined event should occur.

In order for a company to pass the cash flow tests, it must demonstrate that under the base cash flow and all stress situations:

- Cash is available to pay obligations as they come due in each quarter, *and*
- MCORBC ratios remain above company action level in each quarter.

If a company passes all of the applicable cash flow tests, an actuarial certification would be indicated on the MCORBC filing diskette. The actuarial certification should state that the company performed the required cash flow tests, the company passed all of these tests, and the assumptions and methodology used to perform these tests are, in the opinion of the certifying actuary, reasonable and appropriate for the purpose, and in accordance with Actuarial Standards of Practice. Assumptions should be documented and this documentation should be provided to the regulator upon request.

If a company is not able to pass all applicable cash flow tests, the company would indicate this failure in its MCORBC filing diskette. The company should be prepared to address any requests from the regulator with an explanation or remedial plan, if the regulator requests information from the company with regards to the failed testing; the regulator may decide that the explanation or plan is not satisfactory. In that event, the regulator may use appropriate statutory authority to deal with the remaining concerns.

IIA. Base Cash Flow Projection

A company would perform a base cash flow projection based on expected cash flows. Further definition of the cash flow methodology including guidelines for assumption of valuation of assets, projection of cash flows from premium income, investment income and other positive cash flow items as well as projection of negative cash flow items such as claims costs, administrative costs and other short term expense items. Since the stress tests are expected to create negative cash flows or a least have that potential guidelines should be given concerning assumptions on assets that are available for sale and the value of those assets. Also, a more specific definition of when a cash flow test "fails" may be desirable. The Academy would be willing to assist the Health Entities Working Group identify needed guidelines

IIB. Cash Flow Projection Stressors

Each stressor would be applied against the base cash flow projection. These stressors were described at a high level in the Work Group's original report. Now the Work Group has expanded on the definitions for the stress tests to be preformed, if the safe harbor tests are not passed.

***Stress Test A*** - assume the loss of the largest single employer/client/member source or 10% of prior yearend membership, if that is higher. The test should be run until results of cash flows are stabilized but the company must assume a minimum of 3 months of current expense levels on an absolute dollar basis plus any additional downsizing expense before stabilization.

First determine the category with the largest membership and the premium effect of the loss. Compare the member months for the coming year for the largest employer group, the largest association group, and 10% of prior yearend total membership. Select the category that includes the largest membership. Reduce premium by the appropriate total premium as of the beginning of the year.

Run monthly cash flow and year-end risk-based capital (RBC) projections making adjustments for administrative restructuring including:

- Immediate reduction of premium based commission expense for the block,
- Three months with no reduction in current administrative expense,
- Reduction in appropriate non-payroll administrative expenses after three months,

- Severance pay and benefits for average anticipated severance package starting after three months,
- Anticipated change in FAS 106 liability, if any, and
- Anticipated change in pension liability, if any.

Cash flow projections should use realistic values for the cash available from assets including consideration of timing, interest rates at the time of sale, discounts for large volume sales, etc.

If cash flow projections indicate insufficient liquid assets in any month or year-end RBC ratio is below 200% of ACL RBC, consider the test failed.

***Stress Test B*** - Assume the loss of the largest non-affiliated single medical group or provider group (this may be a physician group or a provider group that includes physicians and facilities in one group) under a single contract or common control. The test should be run until results of cash flows are stabilized. The company must assume that all services being provided by the medical group are now purchased on a fee-for-service basis for three months.

Additionally, the loss of a medical group could impact membership if large numbers of members are associated with the medical group. The reduction in membership should be equal to the proportion of members currently enrolled with the medical group. Although, membership may be less than the proportion enrolled in the medical group, the loss of a medical group may injure a health entity's reputation to a degree that the loss in membership is even larger.

In determining whether the groups are under common control of another group, ownership and contractual management or working relationships should be considered.

First determine which medical or provider group provides the greatest amount of medical care in a year. This should be done using two distinct parameters: Charges and payments. In many cases the parameters will identify the same group. In other cases there may be two groups identified and thus two stress tests will be required.

After identification, assume claim payments for this group are now purchased on a fee for service basis from the same providers for three months.

Run monthly cash flow and year-end risk-based capital (RBC) projections making adjustments for claims cost changes including:

- Immediate change in claim costs from negotiated rates to charges,
- Immediate elimination of claim cost impacts from medical policy in provider contracts, and
- Reduction in membership due to loss of the medical group.

Cash flow projections should use realistic values for the cash available from assets including consideration of timing, interest rates at the time of sale, discounts for large volume sales, etc.

If cash flow projections indicate insufficient liquid assets in any month or year-end RBC ratio is below 200% of ACL RBC, consider the test failed.

***Stress Test C* -** assume an increase in PMPM claim cost trend of 6% over the assumed trend in current financial plan. The increase is assumed to occur immediately with all medical costs adjusted 6% over and above the assumed trend at that date. If component trend projections are used, assume this is an increase in utilization trend of 6%, across all service categories. Projected premium increases to react to the increased trend can be assumed at contract renewal, if allowed, but not sooner than three months following the first month of claims increase.

Capitated medical costs subject to contractual limits are assumed to increase by 6% more than planned at the time of next renewal for each contract.

Administrative expenses not contained by contractual limitations are also assumed to increase by 6% over the assumed trend or dollar amount in the current financial plan also on March 1. However, this additional increase in administrative expenses should be based on a flat dollar percent increase if membership is flat or increasing, but should be based on a PMPM percent increase if membership is decreasing.

Premiums cannot be assumed to increase until June. This assumption can only be used if the actuary can demonstrate that the assumption used is consistent with the company's actual experience for adjusting trend variation. Otherwise, the timing of premium rate increase assumptions must be based on reasonable time periods as experienced by the company.

Timing of premium increases will likely vary by line of business based on state regulations. Adjustments to premium to reflect increasing administrative expenses must also consider any minimum loss ratio requirements.

Premium rate increase levels should be consistent with increased costs in the stress tests from claim and administrative expense trends tested.

For increases in claim cost and administrative cost trend, run monthly cash flow and year-end risk-based capital (RBC) projections making adjustments for potential costs such as:

- Employer group cost guarantees (may increase liabilities if any cost guarantees exist)
- Provider incentive or risk sharing arrangements (may increase or decrease)
- Hospital stop loss provisions
- Reinsurance (stop loss, aggregate, other)
- Other non-system payments which may be affected, such as settlements, rebates, etc.

Cash flow projections should use realistic values for the cash available from assets including consideration of timing, interest rates at the time of sale, discounts for large volume sales, etc. Current lines of credit as defined in the safe harbor test can be taken into consideration.

If cash flow projections indicate negative cash in any month or year-end RBC ratio is below 200% of ACL RBC, consider the test failed.

***Stress Test D* –** assume the largest medical services facility (in contract to largest provider group used in stress test B this would be a loss of a facility) used by the MCO to deliver care to members is rendered unavailable for three months, and that care to members must be met through other arrangements. The test is assumed failed if there are not sufficient liquid assets to cover the projected additional cost associated with alternative service arrangements.

Additionally, the loss of a medical facility could impact membership if large numbers of members are associated with the facility. It may be difficult to determine the final effect of the loss of the facility, but a good faith attempt should be made to estimate the reduction in membership based on the members currently using the facility and contracts with alternative facilities.

First determine the most commonly used facility. The facility is selected on the basis of the portion of the total cost of services associated with that facility.

After identification, assume claim payments for this facility are now purchased on a fee for service basis from the alternative facilities for three months.

Run monthly cash flow and year-end risk-based capital (RBC) projections making adjustments for claims cost changes including:

- Immediate change in claim costs from negotiated rates to charges,
- Immediate elimination of claim cost impacts from medical policy in facility contracts, and
- Reduction in membership due to loss of the facility.

Cash flow projections should use realistic values for the cash available from assets including consideration of timing, interest rates at the time of sale, discounts for large volume sales, etc.

If cash flow projections indicate insufficient liquid assets in any month or year-end RBC ratio is below 200% of ACL RBC, consider the test failed.

***Stress Test E*** - If the company experienced an operating loss in the year, this additional stress uses last year's results, in place of the company's expected operating results for the year following the reporting date.

This test would assume that the operating losses of the previous twelve months would continue for the next year. Monthly cash flow projections for the next twelve months are to be made using realistic values for cash available from assets including consideration of timing, interest rates at the time assets are liquidated, discounts for large volume of asset sales, etc. Other sources of cash, such as lines of credit or parental guarantees may be taken into account.

If cash flow projections indicate insufficient liquid assets in any month or quarter-end RBC ratio is below 200% of ACL RBC, consider the test failed.

***Stress Test F*** - Assume that claim reserves are understated by 10%. The test should determine if there is sufficient cash to fund the additional claims cost over the next 6 months.

Run monthly cash flow and quarter-end risk-based capital (RBC) projections making adjustments for claims payment increased by $2/9^{\text{ths}}$ of 10% of claim reserves in each for the first three months and $1/9^{\text{th}}$ of the underestimate in each of the next three months. Also, increase projected paid claims for current year incurred claims by 110% to allow for missed trends that caused the understatement of reserves. Cash flow projections should use realistic values for the cash available from assets including consideration of timing, interest rates at the time of sale, discounts for large volume sales, etc.

If cash flow projections indicate insufficient liquid assets in any month or quarter-end RBC ratio is below 200% of ACL RBC, consider the test failed.