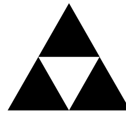

AMERICAN ACADEMY *of* ACTUARIES

# Committee on Small Business
# U.S. House of Representatives

# Hearing on
# Increasing Competition, Reducing Costs, and Expanding Small Business Health Insurance Coverage Using the Private Reinsurance Market

## May 24, 2007


## Statement of
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## Vice Chairperson, Committee on Federal Health
## American Academy of Actuaries



The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

Thank you Madame Chair, Ranking Member Chabot, and distinguished committee members, for inviting me to testify on the current medical reinsurance market, under what conditions reinsurance might provide for the expansion of small business health insurance coverage, how businesses utilize reinsurance to manage their risk, and alternative reinsurance arrangements employers use to control catastrophic health care costs.

My name is Patrick Collins, and I serve as the chairperson of the American Academy of Actuaries' Medical Reinsurance Work Group and vice chairperson of the Academy's Federal Health Committee. The Academy is the non-partisan, public policy organization representing actuaries of all specialties in the United States.

On behalf of the Academy's Reinsurance Work Group, my testimony will first provide a brief description of medical reinsurance in order to introduce basic terminology and provide a framework of reference when discussing reinsurance proposals. And then, it will outline the issues recommended for policymakers to consider when designing and implementing a reinsurance program.

## Medical 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.

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 to cover reinsurance losses, expenses, and risk margin.

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

ways in which to manage 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.

*Why do entities buy reinsurance?*
There are a number of reasons why an insurance company may want to buy reinsurance, and I address some of those briefly later in this testimony. However, the overriding consideration is that this transaction (similar to an insurance transaction) protects the purchaser from unforeseen events. Financial 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 a type of business partner or consultant, providing 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.

- Expertise and services: Reinsurers also offer resources to help insurers manage their business. By taking advantage of these resources, insurers may be able to obtain a more competitive position in the marketplace. 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.

*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 claims exceeding a total amount of claims going over a pre-defined threshold – i.e., the 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.

**Considerations for Designing and Implementing a Successful Medical Reinsurance Program**

Whether a medical reinsurance program would meet its goals depends on various factors, including the specific design features and claim management provisions. The following are common considerations that need to be addressed when designing and implementing a reinsurance program, regardless of the source (e.g., government-sponsored or a private-market arrangement).

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

Some of the objectives of reinsurance would include, but are not limited to:

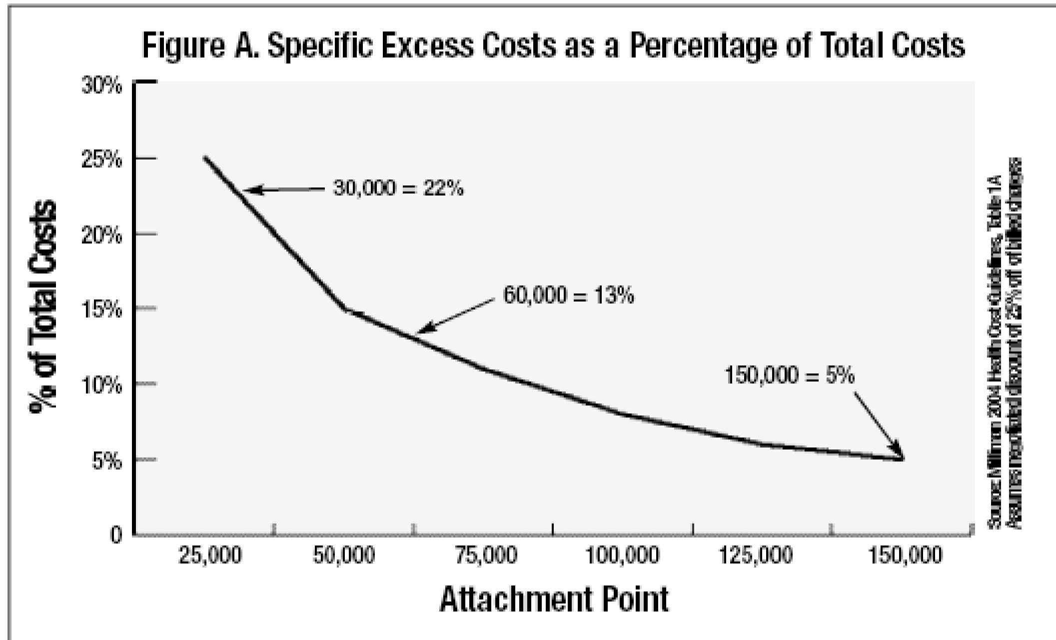
- Lower premiums: By reimbursing plans for high claims, a primary goal of the program is for health plans to pass along this cost reduction to policyholders in the form of reduced premiums. Some refer to this reduced premium as a "savings" to policyholders even though there may be no net reduction in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

- Increasing Competition: By absorbing large individual losses, it is hoped that the reinsurance program would promote more premium stability due to less dramatic premium increases from year to year. Reducing risk and improving stability, could also increase competition and innovation in medical insurance.

- Expanding Health Coverage: As a result of lower and more stable premiums, it is hoped that coverage will become more affordable to both employers and individuals, thereby expanding small business health coverage and reducing the number of uninsured.

*What is the impact on cost?*
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. Looked at another way, an attachment point of $150,000 would imply that the reinsurer would be responsible for 5 percent of claim costs.




Lowering the attachment point to $60,000 would increase a plan's savings (or the reinsurer'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 reinsurer'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. The existence of reinsurance programs could provide an incentive for insurers to reduce cost controls for large claims. Therefore, policy-makers should consider the impact of a reinsurance program on total health care expenditures. Would the incentives intended through such a proposed reinsurance program lead to decreased cost management? If overall expenditures were to increase as a result of the reinsurance program, the premium savings would be reduced.

*Will the attachment point be increased over time, and if so how?*
The cost of a reinsurance program would increase at a rate faster than underlying medical trend due to the leveraging effect of a fixed attachment point. That is, costs of the program would increase not only because underlying medical costs would increase, but also because more claims would exceed the attachment point. Over time, this leveraging effect would increase the costs of the program substantially, and therefore, the costs to a reinsurer would also increase. An option to mitigate this effect would be to

increase the attachment point annually by: the increase in the Medical Consumer Price Index; the increase in health spending; or some other measure of health cost increases.

*How would moral hazard be minimized?*
If reimbursement is based on actual amounts paid by insurers and self-funded plans, the payers probably would alter certain behaviors (e.g., provider contracts, cost-saving measures) as they will no longer be responsible for the catastrophic costs associated with individuals or groups covered by reinsurance. Options to mitigate this effect (known as "moral hazard"), to varying degrees, include:

- Reimbursing payers based on reinsurer-defined nominal costs per service (e.g., Medicare fee-for-service payable amount)
- Requiring coinsurance amount from payers, thereby keeping a portion of the catastrophic claims as the payers' responsibility
- Reimbursing payers based on a risk adjuster or other predictive model (e.g., the CMS-HCC (Hierarchical Condition Category)
- Requiring payers to have in place cost-containment measures, such as disease management, in order to participate in the pool.

*Would participation in the reinsurance program be voluntary or mandatory?*
A program could be voluntary or mandatory. If the program was made voluntary, it would need to be determined what stratum the decision would be made on. There are several choices:

- Insurer stratum: Under this option, insurers who opt to participate in the reinsurance program would be required to do so for all of their health plans, not just select groups.
- Employer group stratum: Under this option, insurers could determine to enroll employer group plans on a case-by-case basis, enrolling some groups, but not others.
- Individual employee stratum: Under this option, insurers could determine to enroll particular employees (and any dependents) on a case-by-case basis, enrolling some employees, but not others.
- Individual insured stratum: Under this option, insurers could determine to enroll particular insureds on a case-by-case basis. This differs from the employee level above, because the insurer could choose to reinsure only a dependent, but not the employee.

If participation in the program was mandatory, it could apply to:

- All health plans
- All self-insured health plans
- All health plans, excluding those that are self-insured
- All health plans with less than some fixed number of members
- Some other subset of health plans

*What types of services are eligible for reimbursement?*
Different insurance plans will have different benefit packages, covering different services. In addition, some benefit packages will be more generous than others. As a result, it is important to define what services are eligible for reimbursement under the reinsurance program. Options include:

- Medicare/CMS reimbursement policy
- Reimbursement based on the underlying insurance plan

*How should the accumulation point be defined?*
Most reinsurance arrangements are based on one year's claims, but it must be determined how this is defined. Options include:

- Reimbursing payers on a "paid-claims" basis, that is, based on all claims pad by the insurer during the year
- Reimbursing payers on an "incurred-claims" basis, that is, all claims for services received by the insured (and thus incurred by the payer) during the year

*How would geographic cost factors be addressed?*
If a reinsurance program is created at the federal level, geographic cost differentials may result in different subsidies for different geographic areas of the country. Because health care costs are high in some parts of the country, due to both cost per unit differences and utilization differences, a fixed attachment point could result in insurers in low-cost areas subsidizing insurers in high-cost areas. Ways to mitigate this potential problem include:

- Adjusting the "national-average" attachment point based on Medicare geographic cost factors
- To the extent that the program is financed by assessing participating insurers, calculating the assessment on a statewide or regional basis, rather than across the entire federal program

*What issues should be taken into account for a reinsurance program at the state level, the federal level, or for a program that has both state and federal elements?*
Issues that would need to be considered include the interplay of state regulations and ERISA with the reinsurance program, how current state high-risk pools and other state reinsurance programs would be impacted, issues unique to multi-state employers, and the desirability of uniform benefits and procedures.

*What other considerations should be addressed?*

- How would the reinsurance program be administered? Through a government agency? Through the states? Through private reinsurers? Through a partnership or combination of public and private entities?
- Would premiums from insurers and self-funded plans be required for participation in the reinsurance program? If so, how should these premiums be determined?

## **Conclusion**

Designing a reinsurance program that attempts to reduce health care premiums, increase competition, and expand small business health insurance coverage is a worthwhile goal. Though reinsurance does not reduce overall health costs by itself, a reinsurance program that addresses the issues described above could help meet these goals if it is designed properly and incentives for all parties involved are properly aligned.

Thank you for your time and consideration, and I welcome the opportunity to answer any questions or assist you as you move forward with your consideration of this important matter.