



AMERICAN ACADEMY *of* ACTUARIES

Date: May 3, 2007

To: Julia T. Philips, Chair, NAIC Health Risk-Based Capital (RBC) Working Group

From: James R. Braue, Chair, American Academy of Actuaries'¹ (Academy) Medicare Part D RBC Subgroup

Re: Update to the December 2005 Academy Report on Medicare Part D Risk Factors

Dear Ms. Philips:

The American Academy of Actuaries' Medicare Part D RBC Subgroup (Subgroup) was established to develop recommendations regarding the treatment of Medicare Part D business in the RBC formulas developed and maintained by the NAIC. In December of 2005, the Subgroup presented a report to the NAIC recommending factors for use during 2006 and 2007. In that report, the Subgroup commented as follows.

'As the risk mitigation features of the Part D program change over time, this recommendation should be revisited since the reduced value of the Risk Corridor Protection will reduce the discount factors. Specifically, we strongly recommend that another similar study be performed after the Plans file Part D bids for the 2008 calendar year in June, 2007 to appropriately modify the above factors for the 2008-2011 period and possibly reflect significant benefits differences that have developed during the initial two years.'

The Subgroup also noted:

'The reporting entities' additional experience with Medicare Part D should improve their ability to price the coverage, thereby reducing the potential for material deviations from expected levels of benefit costs. We therefore recommend that a study somewhat similar to the study undertaken for this recommendation be performed in 2007 ... in order to develop appropriately modified factors for the four-year period, 2008-2011.'

¹ 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.

In accordance with this, the Subgroup is seeking direction from your Working Group as to whether you wish us to proceed with such a follow-up study and analysis, in order to recommend updated RBC factors for 2008 and later.

In considering this matter, it may be helpful to you to recall the following points.

- Medicare Part D incorporates several risk-mitigation features. Among those is the aforementioned Risk Corridor Protection. This feature provides for an adjustment to Part D premiums, dependent upon how actual claim experience varies from the target claim level reflected in the initial pricing of the coverage.

During 2006-07, if actual benefit costs to an entity fall within $\pm 2.5\%$ of the target amount, the entity retains the full deviation. If actual benefit costs fall outside this 2.5% corridor, but are within $\pm 5.0\%$ of the target, then 75% of the deviation is assumed by the federal government: i.e., if experience is worse than anticipated, the government will make an additional payment to the entity equal to 75% of the deviation beyond 2.5%, and if experience is better, then the entity must pay 75% of the deviation beyond 2.5% to the government. If actual benefit costs fall beyond the 5.0% thresholds, then in addition to the 75% payment there will be a payment of 80% of the deviation beyond the second threshold.

For 2008-11, the risk corridors are widened from $\pm 2.5\%$ and $\pm 5.0\%$ to $\pm 5.0\%$ and $\pm 10.0\%$ respectively, and the 75% adjustment factor is reduced to 50% (the 80% factor remains unchanged). All other things being equal, the potential for adverse experience by an entity will increase beginning in 2008, because of the wider corridors and the lower adjustment factor between the two thresholds.

- When the Medicare Part D coverage was first being priced by entities in 2005, most of those entities had little or no relevant experience on which to base their bids. For 2008 and forward, entities (other than new entrants into the business) will have at least one full year of actual experience (up to as much as four years for pricing 2011 coverage). The additional experience should mitigate the potential for mispricing. Therefore, while updating of the RBC factors should reflect the lower level of Risk Corridor Protection, it should also reflect the increased knowledge that can be employed in setting rates.

These considerations suggest that some adjustment of the RBC factors would be appropriate in order to reflect the new risk-corridor parameters in place for 2008-11, but that such new parameters should not simply be applied to the potential adverse experience deviations underlying the 2006-07 RBC factors. Instead, the potential deviations should be re-evaluated, perhaps based both on new input from the entities that provide this coverage and on the very limited amount of experience available from the 2006 reporting period.

Recognizing that your Working Group has multiple issues to address, we would like to know whether you would want to give further consideration to this matter during 2007. We understand there are competing priorities facing the Capital Adequacy (E) Task Force and your Working Group, which may provide reasons to defer this project. If, however, you wish to charge the

Subgroup with updating the 2005 analysis, we will proceed with an update with the goal of offering recommendations for revised factors in time for incorporation into the 2008 RBC formulas. Your thoughts and preferences on this issue would be greatly appreciated. A representative of the Subgroup will be available to discuss this subject further, if you desire, during your conference call scheduled for May 3.

If there are any questions about these comments, I invite you to contact Geralyn Trujillo, the Academy's staff liaison to the Medicare Part D RBC Subgroup, at (202) 785-6924 or trujillo@actuary.org. Thank you for your time and consideration.

Sincerely,

James R. Braue
Chair, Medicare Part D RBC Subgroup
American Academy of Actuaries

cc: Mike Abroe, Chair, Academy Committee on State Health Issues
Darrell Knapp, Chair, Health Practice Financial Reporting Council
Dan Swanson, NAIC staff