



# AMERICAN ACADEMY *of* ACTUARIES

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February 18, 1998

Health Care Financing Administration  
Department of Health and Human Services  
Room 309-G  
Hubert H. Humphrey Building  
200 Independence Avenue. S.W.  
Washington, DC 20201

Re: Response to Solicitation of Public Comments on PSO Solvency Standards  
Negotiated Rulemaking Committee Proposal Development Process

To Negotiated Rulemaking Committee:

The American Academy of Actuaries is pleased to provide preliminary comments on the PSO solvency standards development process. The Academy is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification and practice standards, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of actuarial analysis.

The Balanced Budget Act of 1997, which expanded the PSO role in Medicare, required the Health Care Financing Administration (HCFA) to carry out a rulemaking process with consultation of the Academy and others prior to publication of the notice provided for under section 564(a) of title 5, United States Code.

The Academy has extensive experience in addressing the issue of appropriate levels of risk-based capital for health insuring organizations. These comments are intended to assist HCFA and the rulemaking committee in completing the process of developing, draft solvency standards for PSOs.

## **General Comments**

A solvency standard requires a trade off between simplicity and sophistication. Solvency standards are designed to reduce, but not eliminate, the probability of failure of risktaking entities. There are two decision points when designing solvency protections. First, how important is it to reduce the possibility of financial failure and, therefore, how high should the solvency standard be? Second, how sophisticated, and therefore complicated, should the standard be?

A simple standard will likely not be sensitive to the specific risk characteristics of an organization, in terms of what types of coverage they provide, what assets they employ, and what risk reducing arrangements they have in place. The minimum standard across these categories tends to become the most conservative. Therefore, for the same probability of ruin, a simple standard usually requires more capital in the aggregate than a more complex one would require. A more complicated standard, being more tailored to the organization, may require less capital in the aggregate. Hybrid solvency standards have been designed where there is a simple formula used as a safe-harbor with a more complicated mechanism available for organizations wishing to take advantage of reductions available for their particular characteristics.

Simple solvency standards are also less costly to administer for regulatory agencies. Some governmental jurisdictions have solved this problem by requiring that qualified professionals certify compliance with standards rather than having the regulating agency audit compliance. This is the approach taken in Canada for many and in the U.S. for some aspects of insurance financial regulation.

The Academy of Actuaries has done significant historical analysis and modeling in the area of solvency protection. Although the rigor of the Academy model may not be desirable for HCFA regulation, any new standard should take this analysis into consideration when calibrating capital levels for the current economy and for specific market segments.

### **Determining Capital**

The scope of the proposed solvency standards include defining the level of capital and sufficient liquid assets needed to protect against future risks. To accurately calculate capital, liabilities must be established for all obligations. In insurance terminology, liabilities for future payments on incurred claims are called reserves. If adequate reserves have not been established, capital will be overstated. For this reason, it is imperative that appropriate reserves are required as part of any solvency standard. Because of the importance of maintaining adequate reserves, states have laws that define the reserves that are required of entities assuming risks. It is unclear if these laws would apply to PSOs under federal waiver. If they would not apply, similar requirements should be included in the federal regulations,

It is not appropriate to use intangible assets to meet solvency requirements which are intended to assure that financial commitments can be met in cash or by resources with tangible value.

"Sweat equity" is a term being used for the value of professional services being provided by the PSO itself. Sweat equity is a valid concept, and after reviewing the current

proposals we believe that it is being applied appropriately for the purpose of PSO solvency regulation. In addition, the impact of the reimbursement arrangements with PSO providers is taken into consideration when developing the initial business plan. Also, on an ongoing basis, the use of PSO providers rather than referrals to outside providers will reduce claim reserve levels for unpaid claim liabilities. Withheld provider payments are available as an increase to capital, assuming that reimbursement contracts are structured to allow the amounts to be retained by the PSO until capital and liquidity requirements are met.

### **Initial Capital Requirements**

Initial start up capital is needed, beyond that required on an ongoing basis, to provide for expenses associated with setting up the PSO. In the HMO Model Act this amount is \$500,000 (the difference between the \$1,500,000 initial net worth and \$1,000,000 ongoing minimum net worth). The actual amount needed may be more or less, but in 1973 the authors of the HMO Model Act estimated \$500,000 to be the appropriate amount of startup capital. Startup capital is used to pay initial expenses such as computer hardware and software, office space and equipment, personnel recruiting fees, etc. The \$500,000 set in 1973 has not been increased for inflation in 25 years and may warrant review for appropriateness. This initial amount could be lower if an organization already had some or all of these needs, such as office space or computer systems, provided by a parent.

At startup, there is an additional amount required to fund any losses that will be incurred until the business has reached a breakeven point. The business plan would take into consideration the use of facilities owned by a related organization, the reimbursement arrangements with PSO providers, savings from using PSO health care delivery assets, the effect on capital of provider withholds, etc. Any expenditures made prior to filing an application with HCFA, such as provider contracting expenses and expenses associated with designing marketing materials, would also be taken onto consideration.

The business plan should reflect the specific risks assumed by the PSO. To be useful in solvency protection, the business plan should contain reasonable assumptions and be technically correct. To ensure this reasonableness and technical accuracy, the regulation should specifically require that the plan be certified by an actuary who is a member of the American Academy of Actuaries and therefore subject to the Academy's Standards of Practice, to Qualification Standards, and to the Academy's Board for Counseling and Discipline.

There has been much discussion of how initial losses would be funded and the timing of this funding. Business plans typically include more than one estimate of cash flow and profitability. They usually include optimistic, most likely and pessimistic scenarios. If the business plan provided a most likely projection and a pessimistic projection, there

could be a requirement to fund the most likely losses initially or periodically over a short period, and then require a parental guarantee or letter of credit for the contingency that the more pessimistic projection materialized.

### **Ongoing Capital and Liquidity**

On an ongoing basis, capital is needed to provide for adverse fluctuations in revenue, claims, and administrative expense. The \$ 1,000,000 minimum ongoing net worth requirement was set 25 years ago, and has not been updated for changes in the economy. Since it is unlikely that an organization would experience adverse financial effects in all areas at the same time, capital requirements are normally set to at a level less than the sum of all possible adverse possibilities. Therefore, when methods are used to reduce risk in revenues, claims or expenses, it is not appropriate to subtract the total amount of reduced risk from the capital requirement. Instead, the reduction should be factored down to recognize this covariance phenomenon. We would be glad to discuss this further with the Rulemaking Committee if you would like.

Liquidity is needed to fund obligations as they come due. The problem with using annual statements such as the Orange Blank, despite their usefulness as solvency tools, is that they represent a point in time or a retrospective view, and therefore are not always a good indication of the sufficiency of assets to cover future obligations. One possible resolution to this limitation of annual statements is to require submission of approved business plans when a PSO falls below a predetermined level of liquidity. These plans would illustrate the actions taken by a PSO to ensure that emerging financial experience will not cause solvency problems.

### **Insolvency**

There are many issues that will need to be addressed if a PSO becomes insolvent. These issues include:

- Who is liable for the PSO's unpaid medical expenses? Will there be a requirement for hold harmless agreements from providers of care should the PSO become insolvent" What about services provided by out-of-network providers" Can these providers bill participants directly, if the PSO is unable to pay claims"?
- Will state guaranty funds have to supply funds or in some other way financially support the troubled PSO?
- Will the state departments of insurance get involved? If not, then the responsibility falls to the federal government and will they need processes in place to respond quickly to protect the interests of the participants?

- What happens to the members, especially those in course of treatment'?
- What coverage will participants be able to get to replace their PSO coverage? What type of Medicare Supplement policy can they get, especially if they cannot pass underwriting? Will there be other PSOs in their geographic area that they can apply to?
- Since extreme action isn't always the desirable response to financial impairment. what about responses of varying degrees, such as is included in the NAIC's Risk Based Capital Model Act?

The American Academy of Actuaries welcomes the opportunity to comment on the PSO Solvency regulations.

Thank you for your consideration of our comments. We would like to offer our assistance as HCFA works through some of the details of the regulations including establishing criteria for safe harbors and risk reduction factors. If you have any questions regarding these comments, please contact Alison Kocz (202/223-8196) or me (847/764-6080).

Sincerely,

Donna C. Novak, MAAA  
Chairman  
Federal Health Committee