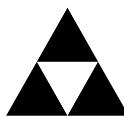

AMERICAN ACADEMY *of* ACTUARIES

Date: June 3, 2007

To: Lou Felice, Chair, NAIC Capital Adequacy (E) Task Force

From: James Braue, Chair, American Academy of Actuaries[1] (Academy) Medicare Part D RBC Subgroup
Darrell Knapp, Chair, Academy Health Practice Financial Reporting Committee
Mike Abroe, Chair, Academy Committee on State Health Issues

Dear Mr. Felice:

In 2005, the NAIC implemented recommendations that the Academy had made, regarding the treatment of the new Medicare Part D program in the risk-based capital (RBC) formulas. For companies participating in the Medicare Part D program, the recently submitted RBC reports for the year ending December 31, 2006 are the first RBC reports that make use of our recommendations.

Very recently, we became aware of an unintended consequence regarding how one aspect of the RBC instructions for Medicare Part D was drafted. As a result, we are aware of at least one Medicare Part D carrier that has reported materially lower Authorized Control Level (ACL) RBC results, as of December 31, 2006, than what was originally intended, and it seems likely to us that other Medicare Part D carriers would be in a similar situation. Any affected carriers will have followed the RBC instructions as written; however, as we discuss below, those instructions produce an inappropriately favorable result for some companies. This has the potential to mislead regulators as to the financial condition of companies writing material amounts of Medicare Part D coverage.

Although we are aware that time is short, we believe it important for the NAIC to adopt revised Medicare Part D instructions for December 31, 2007 reporting. Recommended revisions to the Health RBC and Life RBC instructions are attached to this letter. In addition, the NAIC may wish to make states aware that the December 31, 2006 RBC reports of companies for whom Medicare Part D is an important line of business could be materially misleading due to the unintended consequence found in the published RBC instructions.

Description of the Issue

The issue at hand involves the interaction of the Medicare Part D RBC treatment with existing provisions within the Life and Health RBC formulas regarding premium stabilization reserves.

*Premium Stabilization Reserves*

The Life and Health RBC formulas include an underwriting risk credit for "premium stabilization reserves" (PSR credit). The purpose of this credit is to reflect the risk-mitigation features inherent in retrospectively experience-rated contracts. For some lines of health business, namely FEHBP and TRICARE, the development of a unique underwriting risk factor directly took into account the retrospectively-rated nature of the contract. As such, no additional PSR credit for FEHBP or TRICARE products is allowed in the RBC formula. However, for other lines of health business, such as group major medical, the underwriting risk factor was calculated under the assumption that no premium stabilization reserves existed. Consequently, if the carrier has premium stabilization reserves for

[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.

retrospectively-rated group major medical policies, then the current RBC formula allows an offset to reduce the carrier's underwriting risk via a PSR credit.

The manner in which the PSR credit has been implemented in the NAIC's RBC formulas is a simplified version of the Academy's original Health Organizations RBC Task Force recommendation from the mid-1990s. The Academy had recommended that the PSR credit should be calculated on a group-by-group basis for each retrospectively-rated group, capping the credit given for the group's premium stabilization reserves to no more than the group's contribution to the carrier's experience fluctuation risk. In simplifying the Academy's recommendations, the NAIC set the carrier's PSR credit equal to 50% of the carrier's total premium stabilization reserves, excluding amounts relating to FEHBP and TRICARE (in Health RBC only). Administratively, the NAIC approach to PSR credit alleviates the need for group-by-group calculations. However, it does create the possibility, albeit illogical, that, in certain situations, a retrospectively-rated group's overall contribution to a carrier's RBC could be negative. That is, the carrier's RBC would be higher if it didn't underwrite the group. This would happen if the relationship between the case's premium stabilization reserves to the case's current year incurred claims exceeds a certain threshold. The limitation of the credit to 50% of the statutory liability was explicitly intended to address this concern, but obviously it cannot ensure an acceptable result in every situation.

*Medicare Part D*

One feature of the Medicare Part D program is the risk-corridor adjustment, whereby a portion of favorable or unfavorable benefit experience may be shared with the federal government. In situations where experience has been especially favorable, an entity providing Part D coverage will be obligated to return a portion of its premium to the government. Pursuant to Interpretation 05-05 of the NAIC's Emerging Accounting Issues Working Group, this aspect of the Medicare Part D program is accounted for as a retrospectively-rated insurance contract, which implies that the liability for this return of premium should be reported as a provision for experience rating refunds.

When the Academy's Medicare Part D RBC Subgroup made its recommendations to the NAIC in 2005 on the RBC treatment of Medicare Part D business, the existence of the risk-corridor mechanism was directly taken into account in the development of the underwriting risk factors. The 2006 RBC requirement for Medicare Part D was discounted by 50% to reflect the impact of the risk-corridor protection.

As such, the Medicare Part D program is similar to FEHBP and TRICARE, in that the retrospectively-rated nature of the contract was considered in developing the underwriting risk factor and, consequently, an additional PSR credit is neither necessary nor appropriate.

*The Unintended Consequence*

In light of the discussion above, the intent of our previous recommendation on RBC for Medicare Part D was that carriers would not receive PSR credit for liabilities relating to the risk-corridor mechanism. We are not aware of any discussion by the NAIC that would suggest that its intent was any different.

Unfortunately, this intent was not made clear in the 2006 RBC instructions. Language was added to the instructions to indicate that the carrier's liabilities for amounts owed to the government under the non-insured portions of the Medicare Part D program (i.e., deposit liabilities for excess reinsurance subsidies and/or low-income cost-sharing subsidies) should be excluded from the PSR credit. However, language was not added to the instructions to indicate that the carrier's liabilities under the risk-corridor adjustment should also be excluded from the PSR credit.

Note that some carriers may have risk-corridor liabilities relating to Part D benefits provided through integrated Medicare Advantage products (MA-PD plans). Since MA-PD plans are considered to be comprehensive medical policies for RBC purposes, it would be appropriate under the current RBC formula for carriers to apply PSR credit to risk-corridor liabilities associated with MA-PD plans. This difference arises from the fact that the underwriting risk factor applicable to MA-PD plans did not directly contemplate the retrospectively-rated nature of the contract, unlike the underwriting risk factor applicable to standalone Medicare Part D plans.

Implications for 2006 RBC Results

We believe it is very likely that carriers with Medicare Part D risk-corridor liabilities as of December 31, 2006 would have automatically included those liabilities within the scope of the PSR credit. This means that the H-2 (Health) or C-2 (Life) underwriting risk for these carriers was lower than intended, due to the existence of the PSR credit, which in turn means that the ACL RBC for these carriers was lower than intended.

The impact of this unintended consequence on December 31, 2006 RBC results is potentially profound. Many carriers enjoyed unexpectedly favorable Medicare Part D experience in the first year of the program and, therefore, have recorded substantial risk-corridor liabilities at December 31, 2006. Consequently, it is possible that the 2006 ACL RBC for some Medicare Part D carriers is lower than it would have been if the carrier did not write any Medicare Part D business. That is, it is possible that the PSR credit taken for the risk-corridor liability exceeds the underwriting risk associated with the carrier's Part D premiums and claims. Again, this has always been a possibility with respect to retrospectively-rated business; however, we are concerned that the size of the Medicare Part D program, and the already-reduced level of the underwriting risk charge for this business, may make the problem more acute.

As an example of the potential impact of this issue, one of the members of the Subgroup has reported having knowledge of a Medicare Part D carrier who's ACL RBC at December 31, 2006 would have been 24% larger than what it reported December 31, 2006, if it had not given PSR credit to its Medicare Part D risk-corridor liability. This particular carrier would not have experienced an RBC Event if the risk-corridor liability had not been given PSR credit. However, the magnitude of the impact of this issue on this carrier's ACL RBC raises the distinct possibility that there might be other carriers for whom this issue would have impacted the nature of the carrier's RBC Event at December 31, 2006.

State regulators may wish to quantify the impact of this situation on the carriers they regulate. We note that the 2006 provision for experience rating refunds accrued in connection with Medicare Part D is identifiable from the Medicare Part D Coverage Supplement that is filed as a supplement to the Annual Statement. The amount appears on lines 4.2 and 5.13; in each case, a negative amount indicates a positive liability. These lines are actually defined as the change in the liability. However, because Medicare Part D coverage first became effective in 2006, the opening balance of the liability must have been zero, and the change must be exactly equal to the year-end balance.

It should be possible for the NAIC, or the individual state insurance departments, to determine whether there was a material impact on any entity's required capital for 2006. Additionally, and more specifically, it should be possible to determine whether any entity that did not experience an RBC Event, might have done so; or an entity that did experience an RBC Event might have experienced a more serious Event, if the PSR credit had not been affected by Part D. In these situations, state regulators will have to determine if any additional regulatory response is warranted.

Recommended Actions for 2007

Because the circumstances described above may result in ongoing and unintended reductions of the RBC requirement, we recommend that the NAIC take corrective action in time to impact the December 31, 2007 RBC instructions.

In the attachment, we provide recommended changes to the Other Underwriting Risk (XR013-XR015) section of the Health RBC instructions, and the Premium Stabilization Reserves (LR023) section of the Life RBC instructions.

We hope that this information has been of help to you. If you have any questions regarding this material, or would like any further assistance with this matter, please contact Geralyn Trujillo, the Academy's staff liaison, at (202) 223-8196 or trujillo@actuary.org. Thank you for your time and consideration.

CC: Julia Philips, Chair, NAIC Health Risk-Based Capital (RBC) Working Group
Philip Barlow, Chair, NAIC Life RBC Working Group
Nancy Bennett, Chair, Academy LCAS Work Group
Amanda Yanek, Academy Life Policy Analyst

## Other Underwriting Risk - L(19) through L(42) - XR013 – XR015

In addition to the general risk of fluctuations in the claims experience, there is an additional risk generated when reporting entities guarantee rates for extended periods beyond one year. If rate guarantees are extended between 15 and 36 months from policy inception, a factor of 0.024 is applied against the direct premiums earned for those guaranteed policies. Where a rate guaranty extends beyond 36 months, the factor is increased to 0.064. This calculation only applies to those lines of accident and health business, which include a medical trend risk, (i.e. Comprehensive Medical, Medicare Supplement, Dental, Medicare Part D Coverage, Supplemental benefits within Medicare Part D Coverage. Stop-Loss, and Minimum Premium). Premiums entered should be earned premium for the current calendar year period and not for the entire period of the rate guarantees. Premium amounts should be shown net of reinsurance only when the reinsurance ceded premium is also subject to the same rate guarantee.

A separate risk factor has been established to recognize the reduced risk associated with safeguards built into the federal employees health benefit program (FEHBP) created under Section 8909(f)(1) of Title 5 of the United States Code and TRICARE business. Claims incurred are multiplied by 2 percent to determine total underwriting RBC on this business.

A separate risk factor, consistent with the factor used in the Life RBC formula, is applied to the Stop-Loss Premium. The premiums for this coverage should not be included within Comprehensive Medical. It is not expected that the transfer of risk through the various managed care credits will reduce the risk of stop-loss coverage and this product exhibits much higher variability, so a higher RBC factor of 25 percent is applied.

***Line (22.1) Supplemental benefits within Medicare Part D coverage.*** A separate risk factor has been established to recognize the different risk (as described in Appendix 2) for the additional premium collected from beneficiaries for these supplemental drug benefits.

***Lines (23) through (29) Disability Income.*** Disability Income Premiums are to be separately entered depending upon category (Individual and Group). For Individual Disability Income, a further split is between noncancellable (NC) or other (guaranteed renewable, etc.). For Group Disability Income, the further splits are between Credit Monthly Balance, Credit Single Premium (with additional reserves), Credit Single Premium (without additional reserves), Group Long-Term (benefit periods of two years or longer) and Group Short-Term (benefit periods less than two years). . The RBC factors vary by the amount of premium reported such that a higher factor is applied to amounts below $50,000,000 for similar types. In determining the premiums subject to the higher factors, Individual Disability Income NC and Other is combined**.** All types of Group and Credit *Disability Income* are combined in a different category from Individual.

***Lines (30) through (37) Long Term Care.*** Long Term Care Insurance (LTCI) Premiums are used to determine both a rate risk and the morbidity risk. The rate risk relates to all Noncancellable LTCI premiums. The morbidity risk is partially applied directly to premium with a higher factor (10%) applied to amounts up to $50,000,000 and a lower factor (3%) applied to premiums in excess of $50, 000,000. In addition, the earned premiums and incurred claims for the last two years are used to determine an average loss ratio (incurred claims divided by earned premiums). This average loss ratio times the current year's premium is called Adjusted LTCI Claims for RBC. A higher factor (25%) is applied to claims up to $35,000,000 and a lower factor (8%) is applied to claims above $35,000,000. In certain situation where loss ratios cannot be used because one of the values is zero or negative, the current year's incurred claims are used. In a situation where the current year's premium is not positive, higher factors are applied to current year's incurred claims to reflect the lack of a premium-based RBC. The RBC for LTCI is the sum of these three calculations.

***Line (39) Limited Benefit Plans.*** There is a factor for certain types of Limited Benefit coverage (Hospital Indemnity, which includes a per diem for intensive care facility stays, and Specified Disease) which includes both a percent of earned premium on such insurance (3.5 percent) and a flat dollar amount ($50,000) to reflect the higher variability of small amounts of business.

***Line (40) Accidental Death and Dismemberment.*** There is a factor for Accidental Death and Dismemberment (AD&D) insurance (where a single lump sum is paid) which depends on several items:

© 1998-2007 National Association of Insurance Commissioners

1. Three times the maximum amount of retained risk for any single claim;
2. $300,000 if 3 times the maximum amount of retained risk is larger than $300,000;
3. 5.5 percent of earned premium to the extent the premium for AD&D is less than or equal to $10,000,000; and
4. 1.5 percent of earned premium in excess of $10,000,000.

There are places for reporting the total amount of earned premium and maximum retained risk on any single claim. The actual RBC amount will be calculated automatically as the lesser of 1 and 2. That result is then added to 3 and 4.

***Line (41) Other Accident.*** There is a factor for Other Accident – coverage that provides for any accident-based contingency other than those contained in Line 30. For example, this line should contain all the premium for policies that provide coverage for accident only disability or accident only hospital indemnity. The premium for policies that contain AD&D in addition to other accident only benefits should be shown on this line.

***Line (42) Premium Stabilization Reserves.*** Premium stabilization reserves are funds held by the company in order to stabilize the premium a group policyholder must pay from year to year. Usually experience-rating refunds are accumulated in such a reserve so that they can be drawn upon in the event of poor future experience. This reduces the insurers risk.

For health insurance, 50 percent of the premium stabilization reserves held in the annual statement as a liability (not as appropriated surplus) are permitted as an offset up to the amount of risk-based capital. The 50 percent factor was chosen to approximate the portion of premium stabilization reserves that would be an appropriate offset if the formula were applied on a contract by contract basis, and the reserve offset were limited to the amount of risk-based capital required for each contract.

Companies must list each group having 5 percent or more of the total premium stabilization reserve of the reporting entity. All other groups may be summarized on one line and labeled as various.

No credit is given here for premium stabilization reserves held for FEHBP and TRICARE coverage, because that coverage is already subject to a lesser percentage of premium in the underwriting risk calculation to reflect its reduced level of risk. Similarly, no credit is given here for any amounts held in connection with stand-alone Medicare Part D Coverage (i.e., amounts held as liabilities to the federal government under the risk-corridor mechanism), since Medicare Part D Coverage premium is already subject to a lesser factor in the underwriting risk calculation to reflect the reduced net level of risk. Amounts held as prepayments from the federal government for reinsurance coverage or low-income subsidy (cost-sharing portion) under Medicare Part D coverage are not considered premium stabilization reserves as they relate to an uninsured plan.

As such, the company must exclude all amounts relating to FEHBP, TRICARE, or stand-alone Medicare Part D Coverage in determining the amount of reserves to be reported here.

© 1998-2007 National Association of Insurance Commissioners 

# PREMIUM STABILIZATION RESERVES
LR023

*Basis of Factors*

Premium stabilization reserves are funds held by the company in order to stabilize the premium a group policyholder must pay, from year to year. Usually, experience rating refunds are accumulated in such a reserve so they can be drawn upon in the event of poor future experience. This reduces the insurers risk. Amounts held as prepayments from the federal government for reinsurance coverage or low-income subsidy (cost-sharing portion) under Medicare Part D Coverage are not considered premium stabilization reserves as they relate to an uninsured plan.

For group life and health insurance, 50 percent of premium stabilization reserves held in the Annual Statement as a liability (not as appropriated surplus) are permitted as an offset up to the amount of risk-based capital. The 50 percent factor was chosen to approximate the portion of premium stabilization reserves that would be an appropriate offset if the formula were applied on a contract-by-contract basis, and the reserve offset was limited to the amount of risk-based capital required for each contract. Life and health coverages are aggregated due to many companies combining these coverages.

No credit should be given here for any premium stabilization reserves held in connection with stand-alone Medicare Part D Coverage (i.e., amounts held as liabilities to the federal government under the risk-corridor mechanism), since Medicare Part D Coverage premium is.already subject to a lower factor in the underwriting risk calculation to reflect the reduced net level of risk. As such, the company must exclude all amounts relating to stand-alone Medicare Part D Coverage in determining the amount of reserves to be reported here.

*Specific Instructions for Application of the Formula*

There is some variance for reporting liabilities that are appropriately considered premium stabilization reserves. These possible Annual Statement sources are noted.

The sum of these various types of premium stabilization reserves equals the preliminary premium stabilization reserve credit. The final premium stabilization reserve credit is limited to the risk-based capital previously calculated. Since the limitation is applied on an aggregate basis, there is no need to differentiate the premium stabilization reserve between life and health.

© 1993-2007 National Association of Insurance Commissioners