



AMERICAN ACADEMY *of* ACTUARIES

May 3, 2007

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

From: Darrell Knapp, Chair, American Academy of Actuaries'¹ (Academy) Health Practice Financial Reporting Committee (HPFRC)

RE: Response to Request for Review of Differences of Trend Tests

Dear Ms. Philips:

The Academy's Health Practice Financial Reporting Committee presents the following comments on the suggestion of creating a trend test to be included in the Health RBC formula.

Currently, a trend test is included in the Life and the Property and Casualty (P&C) RBC formulas. Prior discussions have raised the idea of building a similar trend test into the Health RBC formula. Having received your request for our insight into this suggestion, our Committee has had several conversations on the issue and has performed some high-level sensitivity tests to frame our response. Based upon this preliminary work, we would request further guidance from you. Our reasoning is as follows:

- Using the A.M. Best database of companies filing 2005 Orange Blanks, the percentage of companies with Health RBC ratios below the 200% Company Action Level (CAL) does not appear to be particularly high. Since the implementation of Health RBC as part of the annual statement filing, the number, as well as the percentage, of health companies that are below the 200% CAL has continued to decrease. The percentages of companies below the action levels decreased from 28% in 2000, to 15% in 2001, to 8% in 2003, to 3.2% in 2004, to 3.6% in 2005.
- We are not aware of any recent acceleration of actual insolvencies of health companies.
- Unlike the Life and P&C RBC formulas, which are adopted by most states, there are still many states that have not formally adopted Health RBC. Those who have not adopted the Health RBC formula continue to use the flat amount, a percentage of premiums, or a percentage of healthcare claims as the minimum capital requirements. These

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.

requirements are typically much less stringent than the Health RBC requirement. Therefore, there may be some regional or local health plans that will have the RBC level consistently lower than 200% because their domestic state has not adopted the Health RBC formula.

- It is unclear if health companies who are consistently under the 200% CAL have experienced significant financial difficulties.

Based on our high level analysis, using an A.M. Best database of companies filing 2005 Orange Blanks, we have identified forty-eight (48) health companies with Health RBC ratios between 200% to 250% and fifty-one (51) health companies with RBC ratios between 250% and 300% in 2004. Of the 48 health companies between 200% and 250%, two companies fell below the 200% CAL in the following year, 2005. Of the 51 health companies with RBC ratios between 250% and 300%, two fell below action levels (one at Regulatory Control Level and the other at Mandatory Control Level).

We then applied the Life trend test and the P&C trend test, at various combined ratios, to the 2004 base data to see how well it would identify health companies that were likely to go below action levels in the following year.

- A high level Life trend test for the 48 health companies between 200% and 250% in 2004 resulted in twenty-four (24) false positive identifications and correctly identified the two companies whose RBC ratios fell below 200% in 2005. Positive results are defined as the 2005 RBC level being less than 200%, matching the two health companies mentioned above.
- A high level P&C trend test at 105% combined ratio on the 99 health companies with 2004 RBC between 200% and 300% would result in nine (9) false positives, three (3) false negatives, and would only correctly identify one of the four companies whose RBC ratios fell below 200% in 2005. The one correctly identified had a RBC ratio of 181% in 2005.

Using this high level analysis, it appears that neither Trend Test effectively identifies financially troubled versus financially stable health companies.

Based on our discussions and the analysis conducted, we believe that creating a Health trend test would require extensive data definition, collection, and analysis. Furthermore, such an effort would demand a significant commitment of resources by both the NAIC and the Academy. Given this, we would respectfully request additional guidance on the need for creating a trend test for the Health RBC formula as well as the level of interest that the NAIC would have, prior to our committing additional resources to this project.

If there are any questions about these comments, I invite you to contact Geralyn Trujillo, the Academy's staff liaison to the Health Practice Financial Reporting Committee, at (202) 785-6924 or trujillo@actuary.org.

Thank you for your time and consideration.

Sincerely,

Darrell Knapp
Chairperson, Health Practice Financial Reporting Committee
American Academy of Actuaries

cc: Mike Abroe, Academy Committee on State Health Issues
Dan Swanson, NAIC