

# *STATE OF NEW HAMPSHIRE*

*Department of State*

Bureau of Securities Regulation

## **RECOMMENDATIONS CONCERNING THE LIMITATION OF RESERVES AND THE LIMITATION ON ADMINISTRATIVE EXPENSES AS A PERCENTAGE OF CLAIMS OF POOLED RISK MANAGEMENT PROGRAMS**

### **Introduction**

Pursuant to Ch. 149:6, Laws of 2010, this office has been tasked with analyzing and recommending an actuarially-sound method of determining the line between reserves and surplus, as required by NH RSA 5-B:5,I(c), for companies providing pooled risk management group services in New Hampshire (the “Pools”), and the limitation on administrative expenses as a percentage of claims for the Pools, by employing the services of an actuary who has experience with pooled risk management programs and is a qualified member of the American Academy of Actuaries. The statute requires the “[r]eturn of all earnings and surplus in excess of any amounts required for administration, claims, reserves and purchase of excess insurance to the participating political subdivisions.” After consultation with the New Hampshire Insurance Department as required by the law, the Bureau sought the services of a qualified actuary, engaging the services of The Segal Company of Boston, Massachusetts. The Segal actuaries involved in this project are members of the Society of Actuaries, the American Academy of Actuaries and other professional actuarial organizations, and collectively meet their general qualification standards for standards of actuarial opinion to render the relevant actuarial opinion, as required by the law.

The three companies providing New Hampshire Pools are Local Government Center, Inc. (LGC), PRIMEX, and SchoolCare. (While not a Pool itself, LGC offers health coverage through its subsidiary pool Local Government HealthTrust, LLC and property liability and workers compensation coverages through its subsidiary pool Local Government Center Property-Liability Trust, LLC.) PRIMEX operates as a single Pool that offer health, property-liability and workers’ compensation coverage. SchoolCare provides health coverage. While the different risks

(property-liability, workers' compensation, health care) require different approaches, this recommendation covers the primary coverage provided for health care.

This discussion arose amid allegations that LGC was holding sums above and beyond those required for "administration, claims, reserves and purchase of excess insurance", and an unsuccessful legislative attempt to limit Pools to a 5% retention. The legislature ultimately decided to require a review of and recommendations for determining appropriate levels of reserves for Pools. This led to an analysis of the methodology used by LGC to calculate these reserves, and a review of other methodologies for making the same determinations.

As was noted by the actuaries, in general parlance the words "reserve" and "surplus" tend to be used interchangeably whenever health insurance is involved. This is not the case with the New Hampshire statute, which delineates what may be held and by clear inference, what must be returned to member communities as surplus.

### **Other Approaches**

A national association of pooled risk management groups, AGRiP (Association of Government Risk Pools), with members in forty-six states, noted that there was not a consensus on the issue as to the proper amount of reserves versus surplus. Such determinations, AGRiP noted, are dependent upon the broader objectives of the pool, such as "rate stability", "rate certainty", "rate security", "long term solvency", "appropriate use of assessments", etc, etc. Each pool was noted as likely to have very different objectives in regard to any of these issues, depending upon what their members expect from the pool.

For example, members of one pool might deem it more appropriate to rely upon assessments rather than any surplus to achieve their long-term objectives; while others may deem it more appropriate to develop a significant surplus to avoid the need for assessments; or to fund additional services or programs that could not be provided through normal income streams. Some pools set surplus targets or objectives on criteria other than "reserves". One policy may set minimum "surplus" at 15 times annual contributions; another to be not less than three times annual contributions and sufficient to produce interest earnings to fund all operational costs. Given the nose-dive in interest rates the past few years, an increase in "surplus" would most certainly be required at that pool. It would be fairly easy to determine what the "floor" should be

as to surplus; but more difficult to determine the “ceiling” without knowing the total operational objectives of each pool’s unique membership.

As such, the AGRiP reported that their Advisory Standards for Intergovernmental Pools, provide minimal relevant standards in respect to funding as follows:

VI-A. The pool has a policy requiring that an Actuarial study to determining reserve adequacy be conducted and a report issued annually, signed by a Fellow of the Casualty Actuarial Society or a member of the American Academy of Actuaries, **independent of the pool** (emphasis added).

VI-B. The pool allocates funding for losses, loss development, incurred but not reported losses, loss adjustment expenses, unallocated loss adjustment expenses and adverse experience at a level **set by the [pool’s] governing body** based on advice of a Fellow of the Casualty Actuarial Society or a member of the American Academy of Actuaries (emphasis added).

V-F. The pool has a strategy to deal with funding catastrophic losses to prevent financial impairment. (Such as a surplus policy or the funding of an endowment.)

While a comprehensive review of approaches to setting adequate reserves was not within the scope of the Bureau’s mandate nor practicable in consideration of the time and resources available to accomplish such a task, the Bureau notes the following sampling of other states’ approaches to the question.

Connecticut requires that a Pool for healthcare shall “... maintain a reserve for contingencies at a minimum of one hundred thousand dollars for each year such pool is in operation, except that each such pool need have no more than five hundred thousand dollars in the aggregate.” Sec. 7-479e(c). This reserve for contingencies “... means unassigned funds held over and above the liability reserves of the pool”.

Vermont uses an actuary to determine surplus versus reserves. According to an official of the Vermont League of Cities and Towns, the actuary uses the “IRIS”, or Insurance Regulatory Information System. This is a rating method designed to provide information about insurers’ financial solvency, using the financial statements of the insurer to calculate a series of financial ratios, which are then taken as a measure of the insurer’s overall financial condition. If outside of a predetermined range, IRIS may identify the company as troubled, allowing regulators to act.

Pennsylvania adopted RBC as the measure of surplus following receipt of a report prepared for the Pennsylvania General Assembly Legislative Budget and Finance Committee, dated June 13, 2005, in which the structure and operation of Pennsylvania's "Blue Plans" were analyzed. (Considerations for Regulating Surplus Accumulation and Community Benefit Activities of Pennsylvania's Blue Cross and Blue Shield Plans. Final Report, by The Lewin Group.) RBC is therein described as "... a valuable tool developed by the NAIC to measure the risks faced by insurers and to identify a level of surplus necessary to minimize the threat of insolvency resulting from the measured level of risk", and includes factors such as asset risk, underwriting risk, credit risk and business risk. The Pennsylvania report notes that there is dispute about whether RBC is an appropriate measure of risk in the health insurance field. Criticism of this methodology noted that RBC does not aid in determining an appropriate level of surplus for a well-managed going concern or the level of surplus necessary to allow business growth or diversification, service enhancements or catastrophe management. Pennsylvania's report concluded that RBC was an appropriate measure of risk, and further concluded that an RBC of 5.5 to 7.5 was appropriate for non-profit organizations.

### **New Hampshire Approaches**

As noted above, New Hampshire has three companies providing Pools: LGC, PRIMEX, and SchoolCare.

SchoolCare reported that the Coalition's Board of Directors has maintained a policy which designates 20% of expected annual claims for "Medical Risk Corridor" (reserves). Net Assets (surplus) beyond Medical Risk Corridor is designated for Rate Stabilization and returned to the members through reduced premiums, over time, to provide rate stability and predictability, avoiding significant swings in premiums year over year.

PRIMEX reported that it uses what it calls a "Capital Adequacy Policy". This consists of two main factors – Risk Based Capital" or RBC, and loss reserves as recommended by a casualty actuary.

LGC reported that it uses "Risk Based Capital" or RBC as its measure of proper reserves with a reserve level of 4.2 RBC considered appropriate.

## **Actuaries' Analysis**

As noted above, actuaries were engaged to review and make recommendations concerning the limitation of reserves in pooled risk management programs and the limitation on administrative expense as a percentage of claims of pooled risk management programs. The actuaries analyzed RBC in the context of pools. They noted that RBC is a formula developed by the National Association of Insurance Commissioners (NAIC) in conjunction with the American Academy of Actuaries and used by most state insurance regulators, including New Hampshire, to measure solvency of insurance companies. The formula takes into consideration "risk categories", as follows: Asset Risk of Affiliates, Other Asset Risk, Underwriting Risk, Credit Risk, and General Business Risk. Each category represents potential drain on capital and surplus reserves of an insurance company. For the typical health insurance company, overall risk is almost exclusively determined by the Underwriting Risk. RBC Amount equals Asset Risk of Affiliates + the Square Root of (Other Asset Risk squared + Underwriting Risk squared + Credit Risk squared + General Business Risk squared). The Authorized Control Level (ACL) is defined as 50% of the RBC amount. The RBC ratio, the actual measuring stick, is calculated by dividing an insurer's Total Adjusted Capital (TAC) by their ACL amount. If the insurer's RBC is below 2.0, state regulators are to require the insurer to take corrective action to remedy the potential "at risk" situation. There are further break points for additional regulatory intervention for RBC ratios down to .7 RBC, when the insurer would come under regulatory control.

Note that Pools are by definition not insurance companies, reciprocal insurers or insurers under state law.

In sum, RBC was developed as a uniform method for state insurance departments to be able to assess whether an insurance provider has the minimal capital necessary to operate safely. When an insurer falls below the threshold RBC capital minimum, insurance regulators can step in and require adjustments or even take control of the insurer. RBC was never meant to be the measure of an appropriate range of capital for an insurer because the focus of insurance regulators is to prevent insurer insolvency. RBC certainly was never meant to address appropriate levels of reserves for publicly funded Pools that are required by law to return any excess to member cities and towns. For that, a more complex and detailed analysis is required

The actuaries noted LGC's HealthTrust's RBC standard of 4.2 to be somewhat subjective, though not out of line with the range of RBC ratios used in other jurisdictions. It may be considered that, under the 4.2 RBC standard, HealthTrust is essentially declaring that any sums it holds above the 4.2 level is "surplus".

### **Alternative Approach – Stochastic Modeling**

Stochastic Modeling represents a more complex and detailed approach to calculating risk. It accounts for variations in factors affecting actuarial models and can attach probabilities to outcomes. As a result, Stochastic Modeling provides more information that can be used to determine appropriate capital or reserve levels. Stochastic Modeling is in wide use in measuring plan solvency and achieving target surpluses.

Segal used Stochastic Modeling to analyze the amount of reserve (or surplus, as Segal refers to it) maintained by HealthTrust in 2009, comparing the RBC method with the Stochastic Modeling method. It found two things: first, that with an RBC ratio of 4.2 reserves for 2009 would have been \$69.2 million; second, that HealthTrust actually retained \$79.5 million. Using Stochastic Modeling at a 95% confidence level, Segal found that HealthTrust's target reserve level should have been \$40.8 million. At a 99% confidence level (the "hundred-year flood" scenario), the target reserve level should have been \$59.1 million. Thus, LGC is retaining significant surplus.

Using Stochastic Modeling should provide a disciplined and unified method of analysis to assure sufficient reserves for any of the Pools while insuring that as, required by RSA 5-B, surplus is returned to member cities and towns.

### **Administrative Expenses**

The Bureau requested that Segal also review the levels of administrative expenses of HealthTrust. Segal found that the overall 7.7% retention percentage to cover administrative costs, including 4.1% for claims administration to Anthem and 3.6% for general operating expenses, was reasonable. (Analysis of specific spending is ongoing as part of a separate report.) Furthermore, the Bureau notes that the recent federal health care reform requires that insurers

providing group coverage spend no more than 15% for administrative expenses. Given the public nature of the Pools, the Bureau believes that a cap of 10% for administrative expenses is not unreasonable, and recommends its adoption.

Respectfully submitted,

Kevin B. Moquin, Esq.  
Earle F. Wingate, III, Esq.  
Staff Attorneys  
Bureau of Securities Regulation  
Department of State  
State of New Hampshire

December 30, 2010