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March 3, 2011

Wendy Lee Parker
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Re: Target Capital/Surplus for HealthTrust

Dear Wendy,

Background

HealthTrust is a not-for-profit employee benefits pool. It provides medical, prescription drug, long- and short-term disability, life and dental coverage to towns, cities, counties, schools, and quasi-municipal organizations in New Hampshire. Health insurance benefits make up the bulk of HealthTrust's business, accounting for more than 90% of the pool's claims expense in 2009. HealthTrust's member groups purchase guaranteed cost health coverage for their members similar to a fully insured arrangement in an insurance company. The health benefits are provided through Anthem; however, HealthTrust retains the entire risk for these benefits.

HealthTrust is established under Chapter 5-B of Revised Statutes Annotated (RSA) of the State of New Hampshire. RSA5-B:3 I states that "A political subdivision, by resolution of its governing body, may establish and enter into agreements for obtaining or implementing insurance by self-insurance; for obtaining insurance from any insurer authorized to transact business in this state as an admitted or surplus lines carrier; or for obtaining insurance secured in accordance with any method provided by law; or for obtaining insurance by any combination of the provisions of this paragraph."

HealthTrust retains the services of a consulting actuary to develop premium rates and claim reserves for benefits provided to its members. A risk management program established under this statute is not an insurance company[1], however, the services provided by HealthTrust to its members mirror the services provided by health insurance companies to policyholders and like an insurance company HealthTrust holds an additional reserve amount on its balance sheet, called capital, surplus or risk reserve. For any risk bearing entity, adequate capital/surplus is crucial for continued viability. It is needed to

- Protect against unforeseen events and unexpected spikes in experience
- Smooth out large fluctuations in group premium rates from year to year

[1] http://www.gencourt.state.nh.us/rsa/html/I/5-B/5-B-6.htm

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- Offer complementary services and coverage
- Maintain service capabilities
- Ensure all commitments will be met

How is HealthTrust like an insurance company?

1. HealthTrust is liable for the entire cost of benefits provided to its members. HealthTrust's member groups purchase insurance and pay a premium to HealthTrust. This premium is equivalent to a fully insured premium the group would be required to pay if they purchased benefits from an insurance company. Similar to an insurance company the risk remains entirely with HealthTrust.
2. If a member group feels that HealthTrust's premium rate for their health insurance benefits is too expensive, the group is free to go to one of HealthTrust's three major competitors. Therefore, as with any insurance company operating in a competitive environment, HealthTrust must provide benefits for as low a premium as possible, while still ensuring that expected expenses are covered in any one year. A very high premium rate increase as a result of a bad year will likely lead to many groups migrating to one of HealthTrust's competitors.
3. New Hampshire RSA 5-B:5 requires that the "excess of any amounts required for administration, claims, reserves, and purchase of excess insurance" be returned to the member groups. However, if HealthTrust is unable to cover expenses in a year, they cannot impose an assessment on the groups to make up the short fall. Like HealthTrust, nonprofit insurance companies may be prohibited from accumulating large capital and surplus amounts, with regulators expecting such surplus to be used to moderate future rate increases. Also, like HealthTrust, if the nonprofit insurer has a bad year, they cannot approach their enrolled groups to recover the shortfall.
4. HealthTrust faces the same capital needs as any nonprofit insurance company. A nonprofit has no shareholders and so has no access to capital other than its surplus. Similarly, HealthTrust does not have outside sources of capital. While HealthTrust is a wholly owned subsidiary of The New Hampshire Local Government Center (LGC), the LGC does not hold any reserves, so HealthTrust cannot look to its parent should it need additional capital.

As HealthTrust provides similar benefits and takes on similar risks as a nonprofit insurance company, it is, therefore, reasonable to expect HealthTrust to hold a capital/surplus amount on its Balance Sheet consistent with a similarly sized health insurance company.

What is an Appropriate Amount of Capital/Surplus?

A number of states regulate the minimum amount of surplus an insurance company should hold to ensure that the company can satisfy its obligations. If an insurer's surplus falls below this minimum then the State Regulator will step in and take steps to remedy the situation. However, to our knowledge, no state defines the level of surplus a company should target or even the maximum level above which the regulator should step in and require that the excess be returned to policy holders.

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The State of New Hampshire has established minimum capital requirements for companies licensed in the state. This minimum is based on the National Association of Insurance Commissioners (NAIC) risk based capital (RBC) methodology[2].

RBC is a level of surplus that theoretically reduces the probability of insolvency over a five-year period to an "appropriate" minimum level. The approach is to determine the minimum surplus needed to protect an organization from insolvency. It is a mathematical calculation based on an organization's size, structure and retained risk. Four sources of risk are identified and quantified: risk of asset default, underwriting (insurance) risk, credit risk and general business risk. The formula contains a covariance adjustment to reflect the lesser probability (based on an assumption of statistical independence) that all four of these areas will go bad at once. RBC factors are based on stochastic modeling of the probability of ruin using empirical data.

The approach defines the authorized control level (ACL) as 50% of RBC. Four trigger points are identified with varying degrees of regulatory response, as shown in the table below.

RBC Level	Company Response
Company Action Level (CAL = 200% ACL)	The company must notify the insurance commissioner of the corrective actions it plans to take (increase capital)
Regulatory Action Level (RAL = 150% ACL)	The company must submit or resubmit a corrective plan of action to remedy the situation. After examining the company, the insurance commissioner will issue an order specifying the corrective action to be taken
Authorized Control Level (ACL = 100% ACL)	The insurance commissioner is authorized to take whatever regulatory action is necessary to protect the interests of the policyholder, including taking control of the company
Mandatory Control Level (MCL = 70% ACL)	The insurance commissioner is required to place the company under regulatory control

A New Hampshire life/health company must maintain a minimum capital level equal to the Company Action Level (CAL), i.e., 200% of ACL. A HMO must maintain a minimum net worth equal to the greater of[3]:

- Company Action Level RBC or
- HMO minimum net worth requirements of the greater of:
    - $6,000,000, or
    - Seven and one half percent of annual premium as reported on the most recent annual financial statement

[2] http://www.gencourt.state.nh.us/rsa/html/NHTOC/NHTOC-XXXVII-404-F.htm
[3] http://www.gencourt.state.nh.us/rsa/html/XXXVII/420-B/420-B-25.htm

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New Hampshire Statute Chapter 404-F:2 IV states[4] "an excess of capital over the amount produced by the risk-based capital requirement contained in this chapter and the formulas, schedules, and instructions referenced in this chapter is desirable in the business of insurance. Accordingly, insurers should seek to maintain capital above the RBC levels required by this chapter. Additional capital is used and useful in the insurance business and helps to secure an insurer against various risks inherent in, or affecting, the business of insurance and not accounted for or only partially measured by the risk-based capital requirements contained in this chapter." Therefore, an insurance company should target a capital level greater than the minimum requirement. While New Hampshire Statutes do not address how much capital/surplus is too much, the Massachusetts Division of Heath Care Finance and Policy (DHCFP) commissioned a study of Massachusetts Health Insurers' surpluses [5] in 2010 in an attempt to determine how much capital/surplus is too much. The resulting recommendation to the Massachusetts Division of Insurance was an RBC ratio range of 700% to 900% as an appropriate standard for an upper threshold review.

Based on the current New Hampshire minimum of CAL (200% of ACL) and the maximum recommended to the Massachusetts Division of Insurance (700-900% of ACL), an appropriate target capital/surplus for a health insurance company is between 200% and 700% to 900% of ACL.

HealthTrust's Target Capital/Surplus Level

The table below shows HealthTrust's ACL, New Hampshire's minimum capital requirement (200% of ACL), the maximum (low end of the range) recommended to the Massachusetts' Division of Insurance (700% of ACL), and the capital held by HealthTrust and the resulting percentage of ACL, for December 31,2009 and December 31,2010.

	December 31, 2009	December 31,2010
ACL	$16.6m	$20.1m
Minimum (200% ACL)	$33.2m	$40.2m
Maximum (700% ACL)	$116.2m	$140.7m
Health Trust Capital/Surplus Held	$77.1m	$80.4m
Percent of ACL	464%	400%

As a general rule, HealthTrust targets a capital/surplus level of 420% of ACL. Operating gains in 2007 and 2008 resulted in capital/surplus at December 31, 2008 greater than 420%. When developing premium rates for 2009, HealthTrust returned a portion of the excess to member groups, i.e., they set premium rates at a level lower than expected claims and used a portion of the excess surplus to cover the difference.

When HealthTrust's experience results in a capital/surplus greater than target, this excess is returned to member groups over three years. Return of the excess is spread over three years for a couple or reasons:

[4] http://www.gencourt.state.nh.us/rsa/html/XXXVII/404-F/404-F-2.htm
[5] Study of the Reserves and Surpluses of Health Insurers in Massachusetts, DHCFP, May 2010

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- First, while the member groups want premiums to be as low as possible they prefer budget expenses that are predictable.
- Secondly, while the capital/surplus target percentage remains the same over time, the dollar amount must grow as membership grows. A portion of any unexpected excess is used to meet the following year's target in times of membership growth.

HealthTrust's actual claims experience for 2009 was worse than expected, resulting in an operating loss in 2009 of ($14.3m); this is greater than the targeted $9m capital/surplus return. Fortunately, HealthTrust did not have to implement significant premium rate increases to make up for the unexpected adverse experience in 2009 because of its good investment returns that year. However, the current financial downturn has shown how risky it is to rely on investment returns to cover operating expenses. It illustrates how quickly financial circumstances can change and the need for reserves to react or prepare for a downturn.

The Segal Company's letter *Re: Actuarial Services/Pooled Risk Management Programs*, dated December 29, 2010 presents Segal's recommendations for 2009 target and maximum capital levels for the HealthTrust pooled risk management program. These levels are shown in the table below along with HealthTrust's ACL, 200% of ACL, and actual capital held for 2009. The table also shows each as a percent of ACL and the dollar difference from the 2009 minimum (200% ACL).

	Capital	Amount > NAIC Minimum	Percent of HealthTrust ACL
ACL	$16.6m	N/A	100%
Minimum (200% ACL)	$33.2m	$0m	200%
Segal Target Level of Capital (95% Confidence)	$40.8m	$7.6m	246%
Segal Maximum Level of Capital (99% Confidence)	$59.1m	$25.9m	356%
HealthTrust Capital	$77.1m	$43.9m	464%

Segal's recommended target 2009 capital/surplus is equivalent to 246% of ACL. If HealthTrust had held that level of capital/surplus and then experienced the $14m loss the resulting capital/surplus would have fallen below the 200% of ACL minimum, at which point, if HealthTrust were an insurance company, the state would require it to develop a plan describing how it intends to bring the capital/surplus level back up above the minimum. It is extremely difficult to accumulate capital/surplus because competition acts as a limit on how high HealthTrust can increase premiums before their customers start moving to competitors. Holding capital/surplus well above the minimum allows HealthTrust to move back to target over a period of time, if necessary, to avoid serious disruption to their customer base.

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Conclusion

If an insurance company is required to hold a capital/surplus of more than the minimum of 200% of ACL then it is not unreasonable to expect HealthTrust to target the same levels of capital/surplus because it is assuming commitments that are the same as a nonprofit insurance company. If HealthTrust was able to count on its member groups or its parent company for additional capital should the need arise, then it may make sense for it to have different standards. However, HealthTrust does not have this safety net and, similar to an insurance company, it is solely responsible for maintaining capital levels sufficient to cover its obligations.

As RBC is accepted as the industry standard for regulators (including New Hampshire) in determining appropriate solvency levels for insurance companies it is reasonable that the State of New Hampshire would want to hold the risk management pools to the same level of solvency requirements in order to ensure that its towns, counties, schools, and municipal groups will have their obligations honored.

Based on this standard, a target capital level of 246% of ACL is low and will not allow HealthTust to meet minimum standards if its experience is bad, even in a single year. As shown above, if 246% had been HealthTrust's target in 2009, then HealthTrust would have fallen below the minimum of 200% of ACL for that year.

Caveats and Limitations

This report has been prepared for the internal use of and is only to be relied upon by the management of HealthTrust. No portion of this report may be disclosed to any other party without Milliman's prior written consent. In the event such consent is given, the report must be provided in its entirety. Any reader of this report must possess a certain level of expertise in areas relevant to this analysis to appreciate the significance of the assumptions and the impact of these assumptions on the illustrated results.

I am a member of the American Academy of Actuaries and I meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein.

Sincerely,

Catherine Murphy-Barron

Catherine Murphy-Barron, FSA, MAAA
Principal and Consulting Actuary

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