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SOCIETY OF ACTUARIES Entrepreneurial Actuaries Section

THE INDEPENDENT CONSULTANT

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Medical Loss Ratio: An Entrepreneurial Approach to Health Care Reform

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This essay was submitted for the Society of Actuaries' Entrepreneurial Actuaries Section 2010 Papers Competition.

Executive Summary

The minimum medical loss ratio (MLR) requirement introduced in the health care reform bill has created a unique opportunity for our firm. The MLR requirement can place added financial stress on insurers by forcing them to issue rebates to policyholders, even if the overall financial performance of the company is weak. Our firm is well-positioned to perform actuarial services for insurers to assess each company's specific risks associated with MLR. Through partnerships with reinsurers and efficiency improvement firms, we can offer solutions to our clients that will enable them to avoid issuing rebates while maintaining profitability.

Issue Identified

The Patient Protection and Affordable Care Act (PPACA) includes several elements that will dramatically change the business of health insurance. One aspect that has garnered much attention is the minimum medical loss ratio (MLR) requirement. Beginning in 2011, if insurers do not spend at least 85 percent of large group premium dollars and 80 percent of small group and individual premium dollars on patient care, they will be required to provide rebates to policyholders.

The medical loss ratio has always been a standard measure of insurer

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profitability, but there is considerable confusion and debate over the calculation method under the new requirement. Insurance companies are accustomed to a simple calculation of claims cost divided by earned premium. However, the description of MLR found in PPACA indicates that certain administrative costs such as care management and provider networking are considered part of "patient care" and could potentially be included in the numerator with claims costs. It also appears that state taxes and assessments as well as some federal taxes may be removed from premium in the denominator. The National Association of Insurance Commissioners has been working on rules and definitions for the MLR calculation, but it is inevitable that the calculation will be complex and challenging. This creates an opportunity for our firm to capitalize on the new risks and uncertainties surrounding the MLR requirement.

Solution

By developing expertise in the calculation of MLR, our firm can turn this challenge to our advantage and thereby offer solutions to improve the insurer's probability of meeting the MLR requirements. Specifically, actuaries in our firm will offer consulting services to calculate and monitor the insurer's experience and develop models to determine the probability and potential cost of rebate payouts so the insurer can appropriately reflect this risk in its monthly reserve calculations. Insurers will contract with our firm in order to take a proactive, rather than reactive approach to the new MLR requirement.

Non-actuarial staff in our firm can be utilized to research and develop relationships with vendors that offer efficiency-improvement tools for insurers. For example, our sales staff can broker relationships between insurers and document-imaging companies to increase the percentage of claims that can be processed electronically. For some insurers, this service would substantially decrease the cost of claims processing and improve their likelihood of meeting the MLR requirements.

One dilemma facing every insurance company is that if one market segment fails to meet the minimum MLR requirement, the company would have to provide rebates to those policyholders, even if the company as a whole performs poorly. These added losses could threaten the financial viability of the insurer. This situation demonstrates a clear need for reinsurance. Our firm should seek to form a partnership with a reinsurance carrier to create a new product. This product would cover the cost of policyholder rebates in the event that the insurance entity as a whole performs at a loss ratio that is a defined percentage worse than target, but certain lines of business fall below MLR requirements. For example, an insurer may perform at 87 percent compared to a book of business target loss ratio of 85 percent. This insurer's individual line of business, often a small percentage of the insurer's block, may perform at 75 percent and fall below the MLR of 80 percent. In this case, the reinsurer would cover part or all of the expense of the rebates to the individual policyholders. This policy protects against this new risk introduced by the MLR requirement and provides an attractive option for many insurers vulnerable to excess losses. Traditional reinsurance policies do not address MLR, but because our firm will already have access to all relevant experience data for the insurer, we will be able to appropriately price the risk.

Costs

The primary costs of this venture are the time and money spent in training our staff to become experts in MLR and in establishing relationships with reinsurer(s) and efficiency improvement firms. This venture involves substantial upfront cost, with no return likely for several months.

Because we will have to either hire additional staff or pull existing staff off of other projects, it will be necessary to evaluate this project relative to other current or proposed projects.

Risks

There are several potential risks associated with this venture. It is possible that we will be unable to develop the necessary expertise or relationships quickly enough, allowing other consulting firms to enter this market ahead of us. There are several established health care actuarial consulting firms that may already be working on similar endeavors. We have to adapt quickly to changes in the MLR regulations and offer something that our competitors cannot, namely solutions to reduce administrative costs and a new form of reinsurance to minimize the financial risk associated with MLR.

Another major risk stems from the fact that in the post-PPACA climate where insurers are looking to trim administrative expenses, they may be unwilling to hire outside help for MLR evaluation, as this would add to non-claim administrative costs. The price point will be important, and we will need to be able to effectively demonstrate to potential clients that we will add value to their companies.

There is opportunity risk involved in this venture, as it will require a large allocation of resources. We risk missing out on other business opportunities as we concentrate on the MLR project. Since many details are still being worked out in regards to the MLR calculation, it is possible that the final regulations may not present as great a risk and challenge to insurers as it currently appears. In that event, our opportunity would not be as attractive as initially thought. Because this project involves considerable upfront cost, we face the risk of wasting valuable time and financial resources.

Benefits and Measurement of Outcomes

If our firm can quickly gain the expertise and build the necessary relationships to help insurers identify and manage the risks associated with MLR, we could become the premiere firm in this arena. All health insurers will have to meet MLR requirements, so the market has great potential. It is important to note that the MLR requirements will continue into the future, so if we can earn a good reputation in the first year, we will be well-positioned to maintain profitability for many years to come.

While this proposal focuses specifically on the MLR aspect of health care reform, I should note that success in this venture could likely breed similar consulting opportunities in other areas of health care reform. I have targeted MLR because it is in effect for calendar year 2011, and insurers will be looking to plan and implement necessary adjustments during the latter part of 2010 in preparation for the new requirements.

In order to evaluate the success of the venture, it is important to tabulate all of the upfront and ongoing costs associated with the project so we can easily calculate the return on investment (ROI). Our firm must work to establish reasonable prices and sales goals to maximize profitability. Prices will need to reflect not only hours worked for a particular client, but also a share of the costs incurred in the months leading up to the program launch. We will negotiate commissions from the reinsurer and efficiency improvement firms to help defray some of these upfront costs.

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