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SMALL-GROUP REFORM RATE CERTIFICATIONS

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An outline of a proposed Actuarial Standard of Practice (ASOP) with respect to small-group, reform rate certifications will be presented. The proposed ASOP is under development by the Health Committee of the Actuarial Standard Board (ASB). The intent of this session is to present the outline and receive feedback from Society members regarding the proposal.

MR. HARRY L. SUTTON, JR: I'm the only renegade related to health insurance on the board. Jim Swenson will be coming on the board as a health-related member. Our moderator, Ted Lyle, will be doing most of the exposition in the early part of this session. He is chairman of the Health Committee of the ASB. The ASB operates with committees in each major segment of our marketplace and occasionally has task forces that are separate from the rest of it. We have been struggling for a couple of years trying to come up with a number of health standards, including basic health rate making, not pricing, and the small-group reform compliance certification, which has actually been with us for three or four years. We actually had a health practice note before we even had a standard and a lot of people took note of it. We've obviously had much difficulty dealing with this. The health practice note dealt with the National Association of Insurance Commissioners (NAIC) model. Practice standards don't necessarily deal only with the model, since the model has hardly ever been adopted completely by any state anyway. We have had a lot of problems with this. We want to get your input. We have approved an exposure draft, and after changes made at our meeting last week are incorporated, it will be mailed out to you early in December. We wanted to get input here because the regulatory environment and the requirements of the certification required are different from many things that we've dealt with in the past, and it would be very helpful to us to decide what things we should consider if we haven't.

Ted will run through the guts of the standard the way it is crafted now and raise some of the points that we are asking you to comment on when we release the draft. We consider this a very informal give-and-take, and we want you to be blunt. If you think you don't like what we're doing, we want you to tell us, and if you think you want us to do something more or something different, we want you to tell us that also. One of the problems the ASB has in general is getting enough input from its members prior to actually releasing a standard. We need input from all of our members to support this.

MR. TED A. LYLE: As Harry mentioned, this has been a long, arduous process for the Health Committee of the ASB. The words on the slide, "A proposed Actuarial Standard of Practice (ASOP), under development," were carefully chosen because there was a very recent ASB meeting, and we weren't quite sure what the outcome of that meeting was going to be. The one thing we did know was that regardless of what happened, this was still a proposed ASOP under development. It was approved last Friday for release as an exposure draft. As Harry said, I think it is going to be available early in December. It will be, as I think all exposure drafts are now, put on Actuaries Online, and so comments can be made either through this forum or by responding through Actuaries Online or

through formal, written comments. Any comments made on Actuaries Online are considered formal comments only if there's an E-mail sent to the specified address.

The standard deals with actuarial certifications of compliance with regulatory standards for small-employer health benefit plans. In putting this together we prepared four key issues that we, as a committee, felt we had to address in the development of this proposed ASOP. The first is that this is really unlike other things that we've historically considered to be part of actuarial practice, or, at least issues that are being addressed by ASOPs. Specifically, we're dealing here with a certification of compliance. Basically what it gets to, are the actions that a carrier is taking in compliance with the law? It wasn't necessarily clear to us on the health committee that on the front-end this is a hard-core actuarial issue. We finally decided that enough states had enacted statutes and regulations saying an actuary does have a responsibility with regard to certifying compliance and that, in essence, it has become an area where it's appropriate to develop an ASOP.

One key issue is that several of the small-group reform laws that have been enacted require certification of market conduct activities that do not relate to rating structures. This might be enrollment and billing procedures or the types of renewal notices that are sent out. Sometimes they address areas that are not actuarial in nature but are required in the actuarial certification. We decided that the standard would not address those areas. It doesn't remove the impact of a statute that may say that an actuary has to certify to these issues, but to the extent that they're not actuarial in nature, we felt we really couldn't develop an ASOP. Therefore, the ASOP, as it's worded right now, does not address those issues.

The second key issue that we faced was that most of the statutes that have been enacted, and even the NAIC models, include no provision for limited or qualified opinions. There's no way to address what to do if you hit a situation where you can't necessarily certify compliance, or you can't certify to all aspects that are required. We felt it was essential that if you're going to be requiring an actuarial opinion, you give the actuary some provision to give something other than a complete, absolute certification or compliance. So, we did put together provisions for both limited and qualified opinions.

The limited opinion provision basically relates to situations when the actuary, in his or her certification, is only certifying to some of the things for which certification is required. This might get to the market conduct activities mentioned earlier. For example, you might have an actuary certifying to a number of the issues required, and another officer of the company certifying to other aspects. We are giving the actuary under this proposed ASOP a provision whereby they can limit what their opinion is.

A qualified opinion is where there's not an absolute certification of compliance, possibly because there might be some extenuating circumstances. For example, a carrier might not completely fit within the specified rating structures, since it is in a transition period. The qualified opinion provisions provide a procedure to qualify an opinion and to state what the situation is and what is being done to address it. The qualified opinion also potentially comes up in the area of actuarial soundness, since a number of the statutes, as well as the NAIC models, do require a certification of actuarial soundness. Sometimes you hit an issue where you may be able to certify that you're in compliance with the rating constraints imposed by a set of statutes, but you might have some concerns with

regard to actuarial soundness. And so we have provided a provision whereby a qualified opinion could be given with regard to that issue.

Third, we've laid out a set of minimum requirements with regard to the content of a certification and the documentation required. This was a difficult conceptual issue, which I'll go through carefully. One of the key issues we were facing on the front-end was, do we try to write the standard so that it is modeled after the NAIC models (we actually have three model acts and one model regulation), or do we try to draft it so that it fits all of the statutes that have been enacted relating to small-employer health plans? As a general rule, the ASB has taken the stance that when there's a model act, the preference is to try to write the standard to relate to the model act. The issue that comes up in this area is that very few states have enacted the model acts exactly, and so we have an extremely wide variety of requirements in various states.

Our issue was do we try to make this a broad-based standard that would relate to statutes as they are enacted, or do we restrict it to the NAIC model? The approach that we took was to try to make it be a broad-based standard that would relate to statutes as they have been enacted. This, then, raises a related issue regarding documentation and content of certification requirements. Specifically, do we draft the proposed ASOP such that we are bringing everything to the lowest possible level, i.e., what's required in the least onerous enacted statute, or are we going to draft the proposed ASOP such that it potentially raises the bar of what is required in some states? As a committee, we decided on the latter approach. I'm not exactly sure there's complete concurrence on our committee as to whether or not we have actually raised the bar on the requirements in some states, but, in any event, we did put together some minimum requirements with regard to documentation and certification contents. My own opinion is that we have raised the bar.

The fourth key issue was developing a definition of actuarial soundness. Frankly, we spent a long time trying to duck this issue. Sometimes you can look at something and declare it to be not actuarially sound, but it's hard to give a good, universal definition of actuarial soundness, especially when it relates to a single line of business in a single state for a single year. So, the original approach that we took as a committee regarding this was to say this is a very broadly-based issue that affects all areas of actuarial practice, and, therefore, the ASB ought to define actuarial soundness. They sent it back to us and told us to come up with a definition. Basically, we put together a very restrictive definition of actuarial soundness, and note that it only relates to the purpose of preparing certifications of compliance. It's a fairly tight definition, but remember, there is also provision whereby if you don't meet that definition, you can still give a qualified opinion, with the qualifications relating to the fact that this definition of actuarial soundness is not met.

The purpose of the proposed ASOP is to set forth recommended practices in preparing certifications and to provide guidance to actuaries in the interpretation of both statutory and regulatory requirements. The proposed standard applies to actuarial certifications that rating and other actuarial practices applicable to small-employer health benefit plans comply with statutory and regulatory rating constraints. More importantly, the scope of the proposed ASOP is limited to that. It does not apply to other market conduct activities; which is not to say that the statutes don't still apply to other market conduct activities, but this ASOP does not.

When we get into the recommended practice part of this, we outline processes for the testing of rates for compliance. In essence, we are saying that in the development of a certification of compliance, there has to be some positive testing process. The standard also outlines a series of items that should be included in the documentation process.

It also addresses the time period that's covered by the certification. A number of the statutes are actually silent on this. The issue is, is this a retrospective certification of rates or a prospective certification of rates? Quite often it's not clear from the statutes. The example that I've used for this is two health maintenance organization (HMO) clients that we've worked with for a number of years that are both active in the small-group market. For whatever reason, but with great care and deliberation, when we started doing the certification of compliance for Client A, it was always a retrospective certification. So, we were certifying compliance for the last year. For Client B, with equal care and deliberation, we ended up doing a prospective certification of their rates. They didn't publish their rates a year in advance; rather they were publishing them for only six months in advance, so the certification was basically that these are the rates that will be in force for the second and third quarter of the year, and we're anticipating being in compliance for the following two quarters. Of course, Clients A and B merged, and when we did the certification last year, we were faced with the issue of what do we do now? When we did the certifications last March, we still treated them as two separate organizations and still did one on a retrospective basis and one on a prospective basis and sent them in two separate envelopes rather than one. We kind of waited for the state to come back to us and say they're all one merged entity at this point, but the state didn't come back. Hopefully, by next year we'll have a meaningful approach.

The proposed standard says that in the absence of other information or other guidance, the certification should generally be viewed as being a retrospective certification of compliance. Now, this raises an interesting issue. If we're doing a retrospective certification of compliance, generally relating to the prior calendar year, what exactly does actuarial soundness mean? Does actuarial soundness, if you're looking at it retrospectively, relate to whether or not the company went insolvent last year? The actual definition of actuarial soundness is included in the proposed ASOP: "For purposes of this standard, small-employer health benefit plan premium rates are actuarially sound if, for business in the state for which the certification is being prepared, projected premiums in the aggregate are adequate to provide for all costs, including health benefit expenses, health benefit settlement expenses, operational and administrative expenses, and the cost of capital."

That definition brings up a number of issues, and one of them is the use of the carefully chosen words "projected premiums." So, for purposes of preparing the certification, even if it's a retrospective certification, the preparer should go back to when the premiums were developed for the time period covered by the certification and determine if the premiums at that time fit the definition of actuarial soundness. In essence, we are trying to restrict the definition of actuarial soundness from being a retrospective test of whether the premiums were adequate, but rather a check on whether the premiums were anticipated to be adequate at the time they were created.

We also have a provision in the standard relating to subsequent events. If, between the time period to which the certification relates and the time period during which the certification is prepared, the actuary becomes aware of anything that relates to the

certification, he or she has to take it into account in the certification. Also, if the actuary becomes aware of anything in that time period that would potentially put the carrier out of compliance in a future time period, then that also should be noted in the certification. But what it does not do is impose a long-term responsibility on the actuary beyond the date of the certification. So, if the actuary becomes aware of something beyond the date at which the certification is prepared, there is no requirement imposed on the actuary at that point to go back to the regulatory body.

As I previously mentioned, the standard provides for qualified or limited opinions. The limited opinion basically would relate to situations where the actuary is only certifying to actuarial practices and not other market conduct practices. With regard to qualified opinions, we addressed it first from the viewpoint that an opinion may be qualified in the sense of not being in compliance with all of the rating constraints, and the reasons for any deviations should be documented. Second, we addressed the situation when the carrier may be in compliance with the rating constraints, but the actuary does not feel that their rates meet the definition of actuarial soundness as defined by the standard.

The final parts of the proposed standard get into what should be included in the content of the certification. The content of the certification should include: certification of whether all practices as required by statute or regulation are in compliance; a listing of practices that are covered in the certification; identification of the time period covered by the certification; any changes in rating methods or other practices that have occurred during the time period covered by the certification and that affect compliance; subsequent events where a qualified certification is given; any actions that are being taken to bring the carrier into compliance; and, where a limited certification is given, a list of specific sections of the statutory or regulatory certification requirements that are not being addressed. The final section which addresses deviations from the standard is customary. The actuary must be prepared to justify those procedures that depart materially from those set forth in the standard.

That is a very quick overview of the ASOP as it has been developed. This is an interactive forum, so the concept is to elicit feedback.

MR. SUTTON: As a new member of the ASB, Jim Swenson has had no part in these actions to date. I guess he does get to deal with the fallout though.

MR. JAMES R. SWENSON: Actually, I wish I could claim that I had no role in these actions to date, but I have to admit to having been a former regulator in the State of Oregon between the years of 1987 and 1991. It was during that period of time that the NAIC began to develop the small-group reform initiatives, which began in 1989 with the rating reforms. These were really geared primarily toward those few companies that were aggressively using a tier and durational rating structure. Actually, the regulatory process and the industry worked hand-in-hand in coming up with the rating reforms that ultimately became the model that virtually no state has adopted in its entirety, as you have described, but I can't claim complete ignorance in this process. Subsequently, the rating reforms were expanded to also include guaranteed issue requirements. That's where a lot of the market conduct reforms came into play.

When the rating reforms were being adopted, the state regulators realized that there were large numbers of companies that were writing in the small-group market. It would be

almost impossible for the regulators themselves to go out and perform market conduct reviews of each of those companies. As a consequence, it was felt that the actuarial certification was appropriate to help to ensure compliance. I think it's a credit to our profession, if you will, that the regulators did consider that to be an appropriate requirement.

I should mention that this particular initiative did not develop within the Life and Health Actuarial Task Force of the NAIC, but instead, evolved directly from the (B) Committee which is the committee that oversees health insurance matters. I think it is incumbent upon our profession to assure that there is a professional approach to certifying compliance. I empathize with those companies that are operating in a number of states because each state has developed its own nuance, but it is something that is an important obligation of the profession from a regulatory point of view.

The other thing I might admit to is that this action probably did create some good opportunities for the consulting actuarial profession, as there's always good fishing in muddy waters.

MR. LYLE: That's an interesting comment. As an employee of an actuarial consulting firm, I hope we address these issues with a great amount of diligence and concern. As an example, we've been approached by a couple of the major writers that have extensive, internal actuarial staffs, and they want to know whether or not we would be interested in preparing their actuarial certifications of compliance. Now, if you have, say a 25-person small-group actuarial department, and you go to a consulting firm to have them prepare your certification of compliance, on the surface, my reaction to that request is to say I don't think I want to work for you on this issue. So, when we have gone into those conversations with potential clients, we have ended up not having consulting assignments. The issue has been placed before us, and you have to address it very carefully. I'm not sure if these are great consulting opportunities that we actively wanted placed before us.

MR. JAMES GUTTERMAN: I'm with the New York Insurance Department and have been there only a couple of years. It has been a little bit of an eye-opener being on the other side. I just have a couple of comments. I don't want people to believe that this is the rule rather than the exception, but I see a great variety in what comes in. Everyone uses, to the best of my knowledge, language that this filing complies with the laws. On occasion, it's very obvious that the actuary isn't familiar with the laws of the state or what the expected loss ratio is. So I suggest, somewhere in the wording, you include the phraseology that you're knowledgeable of the requirements of the law.

Second, I don't know how you would work this, but I have observed that a lot of filings don't come directly from the actuary, but go through compliance people. What I find is a copy of some sort of generalized statement that is obviously being used in 30 different places. I know of some instances where the actuary whose signature was on the filing wasn't even with the company anymore. So some things tend to occur that could be eliminated if we required an original signature. I know it sounds a little silly, but I think some people would be a little surprised at what gets done under their name.

Last, I was going to mention consultants. The use of consultants I think is a whole separate issue that should get addressed because some companies either have one actuary

who isn't knowledgeable or isn't working in the specific area, or some companies have no actuaries. But a consultant obviously could get himself or herself in trouble, and companies have the beauty of saying the consultant said it was all right. It seems that's a whole different area that should be addressed.

FROM THE FLOOR: I'm one of those consultants that fish in these muddy waters that you're talking about. I have a very basic, mundane question that causes me problems with the clients I work with. I'll call it: what do you do about a basic error? For example, you have a group that's out of compliance, and you look into it, and find out that it was in suspense at the time a rate increase went in, it was put back on an active file, and the rate increase was never implemented. That's your one group that's out of the range and out of compliance. It would help tremendously if we could have some guidance in this area. Clients don't like an exception being made for one group, or for you to give a qualified opinion because of one group out of 300 or 400. Is there any kind of guidance we can have as to when we have to give a qualified opinion and when we can give a clean opinion?

MR. LYLE: The standard addresses the issues of testing, but I don't think we get that specific in the standard right now.

MR. SUTTON: If you've overrated a group so it's outside the rating trends, you can give the money back. It's easy to comply retroactively. If you've underrated a group by mistake, it's hard to go back and collect the money.

FROM THE FLOOR: If a mistakenly underrated group is used as the bottom of the range for testing purposes, that could kick several groups all of a sudden out of the range at the top end.

MR. SUTTON: This is rationality, but everybody is going to make errors, hopefully infrequently. Internally, you may catch it later. When there's just a mechanical error or a human error, you do your best to correct it. I don't necessarily consider that a noncompliance because everybody's going to make errors. But I don't know how the states would interpret this. You'd correct it when the group comes up for rewrite.

MR. LYLE: The wording we have in the proposed standard is that the actuary should ensure that such testing as is necessary is done to satisfy him or herself that there are no material violations of rating constraints. This would seem to imply if you find a group that has been rated in error and that, alone, would prevent the actuary from giving a clean opinion.

MR. SUTTON: "Material" is a term the standards board has never defined, but I caution against using that to have a lot of exceptions.

MR. SWENSON: In your report you probably would comment on the finding that there was a group out of compliance. You would then say what corrective action is being taken. I don't think I would personally consider, if that was the only situation, and you were taking corrective action, that you are out of compliance with the intent of the statute. However, in your report you probably would reference it. The tests you performed should be referenced in your report.

MR. SUTTON: Well, there's the question of documentation versus reporting. If it were really minor, I'd say maybe I wouldn't report it, but it'd be in the documentation. If the state wants to audit your documentation, you could say you considered it not material, and you didn't want to submit something you thought sounded like a questionable certification. I can't tell you to do that.

MR. DANIEL EDWARD WINSLOW: I come at this from a perspective of someone who is signing these actuarial certifications for my company. First off, I'd like to say I agree with all the issues that were just raised. I've faced all those issues. There are a couple of other issues I'd like to raise. First, we're a very decentralized company with multiple business units in the small-group market. No one actuary at our company is in charge of the entire small-group block of business. We have three separate business units in that market. We are submitting multiple signatures. I'm not comfortable signing for my compatriots' actions when I don't have a clue about what's going on inside his business unit. We've had one state regulator object to that, and I ended up praying for my compatriot and signing anyway. I think we're not alone in the situation of having multiple business units and not having one actuary who's in charge of everything. Is there some guidance given in that situation as to what to do?

MR. SUTTON: Are they business units that overlap in the same geographic jurisdiction?

MR. WINSLOW: It varies by size group, and there are many states where two or three different business units are active in the same city. So, it is a real-life problem when you run into it.

MR. LYLE: If you're signing for your compatriot, you should probably be praying for yourself. A number of the statutes give specific information in terms of what must be included. In some instances, it must be all the business written by common carriers.

MR. WINSLOW: What we've done is we've submitted one certification that has three separate pages. In total, it signs for the whole company, but there's a separate page, and each one has one of our signatures on it where we certify to our chunk of the business. It seemed a reasonable way to handle the problem, but, as I've said, we've had one state regulator object to it.

MR. LYLE: Don't you think that in some states you have to certify that the overall rating structure is within the rating constraints of the state, in addition to each business unit's?

MR. WINSLOW: When it's a between-class test, I'm responsible for doing the certifying. The difference is that for the between-class test, I'm testing the rate manual, whereas inside the class, I have to testify for all of the 3,000 or 4,000 clients that they did the right thing. I mean I don't have a clue about what they actually did for their 3,000 or 4,000 clients or whether they actually used the rate manual.

MR. SUTTON: What do you do when a group changes size and drops from one size to the other? Would you then have to rewrite it in accordance with your block the next year?

MR. WINSLOW: Other companies could be doing something differently, but our rules are if a business unit has a client, that's their client.

MR. SUTTON: Does it stay in their business unit so that there's overlapping by size groups, even though the initial underwriting relates to size?

MR. WINSLOW: Yes, and when we submit our size and class definitions for each state, we make that clear. The states say that's fine with them.

A second issue that I would like to raise is the issue of actuarial soundness. I spoke a couple days ago about this and would like to ask this question again. In the state of Florida, which is one state that requires guaranteed issue and modified community rating, my company is losing a ton of money. Under the definition of actuarial soundness that I just heard Ted put forth, I don't think we're "actuarially sound." Would you care to express some guidance as to what we should say?

MR. SUTTON: Well, we've had many discussions. It's a major problem. For example, you could go into this business knowing you're going to lose money because you want to build up your business when you're starting out. Is that actuarially sound? Do you have enough surplus to support it, or do they consider it restraint of trade or something because you're coming in with rates that are too low? Also, you maybe can't break even until your business grows enough to cover your overhead.

What if you want to use the same rates for several states that should be roughly similar in cost, but you lose money in one state and make money in another?

MR. WINSLOW: Well, I'll tell you the specific issue with us is we're getting creamed on the guaranteed issue. We have had many people come to us with very severe health conditions that we've been forced to accept under the guaranteed issue, and our claims have just skyrocketed. We've added roughly 20 points to our loss ratio since guaranteed issue started.

MR. SUTTON: I wouldn't hesitate to say that the rates are actuarially unsound. Then what is the state going to do? While you may have thought your rates were actuarially sound when you started, they actually turned out not to be. Then the question is, what are you going to do with your subsequent filings? If you're going to keep them at such a level that you're going to keep losing money, then under the definition you can't say the rates are actuarially sound. Part of our reason for doing this is to tell regulators they can't socially legislate without companies losing money. You can't have low rates and guaranteed issue coverage at the same time. If regulators are going to put the squeeze on rates, it doesn't ever come out right.

An implication of this is to tell the regulators that things won't work, or at least won't work as well as they thought they might in the beginning.

MR. LYLE: I think you'd end up giving a qualified opinion stating that you aren't meeting the definition of actuarial soundness as outlined in this ASOP, and then you'd probably go on to explain why you're using the rates that you are. I believe Florida also requires, in premium rate filings, a statement of rate adequacy, and it gives a definition that's not completely different than the definition of what adequate rates are.

MR. DAVID G. SCOTT: Our small-group law requires the final approval of rates, as well as an actuarial certification to be filed March 1 of each year that certifies compliance with the law. It seems that the certification that's referenced in the law is a retrospective certification, as Mr. Lyle indicated. Specifically, there is a certification of the compliance, that's required to accompany every rate filing. The law doesn't mention the phrase actuarial certification of compliance. It says certification of compliance. To the extent that it's being submitted with the rate filing, I would have thought that such a certification of compliance would be subject to this kind of standard on a prospective basis, but after listening to your comments, I'm not sure if the board would agree, and I was wondering what your comments were on that.

MR. LYLE: What we were saying was the time period covered by the certification is, in the absence of specific direction by applicable statute, retrospective.

MR. SCOTT: It seems to me that our laws and the regulation create the requirement for at least two different certifications—one to be filed after the fact by March 1 of each year, and one to be required at the time of each rate filing. I don't know if you would agree with that or not.

MR. SUTTON: I think we generally agree with that. First of all, you're almost always going to have to file a certification when you file the rates. So, in the normal course of events, unless you file more frequently than annually, which some companies do, you would file a certification of the rates. Then after you get to the end of the year, in March you're going to certify what happened during the past year. You already would have filed new rates for the current year. Now, this is why we're addressing subsequent events. For example, you may find out that when you filed your rates in November or whenever, you didn't know how bad your recent experience was going to be. You may say that your experience is much worse now than when you refiled the rates. When you come to do an annual certification, you certify regarding the rates you were issuing and what you prospectively thought was going to happen when the rates were developed were correct for the prior calendar year. Each time you file rates for prospective use, you're going to file another rate certification.

MR. LYLE: But one of the things we have to be careful of, and there's a fine line here, is that this proposed ASOP does not relate to rate filings. The ASOP relates to required actuarial certifications of compliance with regulatory standards for small-employer health benefit plans. It's a certification of compliance; they're the things that are generally due about March 15, and they are different than regional rate filings.

MR. SCOTT: I guess I'm still confused because the rate filing, and I expect it's not different from many other states, requires a certification of compliance to accompany it.

MR. LYLE: To the extent it falls within the scope of this standard, then the standard would apply. It sounds like you think that under New Hampshire law, you would require both an annual retrospective certification as well as a prospective certification of compliance.

MR. SCOTT: That's my opinion, yes.

MR. SUTTON: I think that's common in a lot of states.

MR. WINSLOW: I guess I'd like to just add one informational comment. Actually, all three of us have equal rank at my company. We're all vice presidents and actuaries. We're all FSAs. We really do have decentralized business units. There is no single chief actuary at our company that is in charge of everybody else. That's a factually different situation.

MR. SWENSON: From a regulatory perspective I think what the states would be looking for is someone that says that these three, when taken in concert with one another, are going to be in compliance. For example, if your particular state applies to groups between 3 and 50, and your company has one set of standards for the 3–25 and another for the 25 and over cases, the regulator would want to know that those two taken in concert are working properly. So you probably do need someone who will step up to the plate and say that, from an overall company perspective, these three business units are working together properly.

MR. SUTTON: There are a couple of regulators here and at least one ex-regulator. If somebody were losing money in your state with their small-group and said that they're losing money, and in that sense their rates are actuarially unsound, would you permit them to keep offering rates that were going to lose money, if they didn't want to disrupt their marketing?

MR. LYLE: It may depend on whether or not they're printing money in the basement. There is a provision in here whereby the actuary can make a reliance on others and a provision for documenting where that reliance is placed. That reliance provision does not apply if you have people working under your direction.

MR. SUTTON: You take a responsibility for them.

MR. LYLE: Yes.

MR. STEVEN E. KESHNER: I was a little surprised to learn that my rates are perhaps actuarially unsound. I'm with one of the companies that is new and expected to grow. Many states have minimum loss-ratio requirements, and even if they don't, we feel, as a company, that we would be looking for a loss ratio that's reasonable anyway, even if it means we're losing a little bit on the expense side until we grow. When we look at our business plans, we think our rates are actuarially sound, and that we have the surplus to handle it. I would be uncomfortable to have to start reporting to the states that my rates are actuarially unsound today because we're not yet where we need to be in terms of volume. We would then anticipate requests back for business plans and so forth. I would think that could create a lot of headaches.

MR. LYLE: There are a number of issues that can come up regarding the definition of actuarial soundness. It might be because you have a growing book of business, or, for whatever reason, a carrier is opting to subsidize this book of business with other businesses. And you get into expense issues in terms of how you allocate expenses. You might also have a situation where a book of business is under a full expense allocation and losing money, but on a marginal basis the company is better off having it, because it is making a positive contribution toward corporate overhead. You could have a potential situation of permanent actuarial unsoundness under the definition given. I'm expecting that's why this is one of the areas that will elicit a lot of comments. The question is, how

many of these things do you try to address in the general definition of actuarial soundness, as opposed to requiring the actuary to specifically address them in a qualified opinion?

MR. SUTTON: I think we have the same problems in other lines of business, but we just haven't paid much attention to it from the standpoint of each line being self-supporting. Part of the problem we have with this particular standard is, what is meant by actuarially sound, in general? You make the argument that as long as what you're doing won't bankrupt your company, you're not inequitable, and the policyholder is getting a good deal, there's nothing wrong. But I'm not sure what the states mean by actuarially sound. I think they probably mean they want you to subsidize this, but they don't want you to go broke. If small-group is a major portion of your business, then the rate adequacy is more of an issue than if it's a small part of the overall company. We didn't necessarily know how to interpret actuarially sound, so we've tried to frame it within the scope of the filing. It would be helpful if the states would tell us what they mean when they want a certification that something is actuarially sound or prepared using sound actuarial principles.

MR. LYLE: Most companies, when they address actuarial soundness, address it from the viewpoint of the company. When you're doing a certification of compliance, again in a specific state, you might be dealing with 1% or 2% of a company's block of in-force, small-group business. Maybe that business represents only 20% of the total overall health business. You might be required to put together a certification of compliance, including a statement of actuarial soundness that relates to an extremely small part of a company's total operations. Many carriers and actuaries would maintain that actuarial soundness doesn't apply at that level. Nonetheless, states are requiring a certification of soundness. So it's a very difficult issue to address. A company may have a number of very valid business reasons for wanting to underrate a very small segment or portion of its business operations, for whatever reasons.

MR. SWENSON: There is a fundamental conflict between many of these statutes and regulations and the rating statutes that require that each rate be essentially self-supporting. The small-group laws and regulations typically do require a fair amount of cross-subsidization. I think that the definition in this proposed draft is good in the sense that it looks at the overall block of business. Just one modification I might further suggest in the draft is that I think that there should be consideration given to the reinsurance pools. For example, in New York State, there is the specified medical condition pool and the demographic pool. Some companies in New York State that have a superannuated block of business may not be able to show that they're actuarially sound based on the definition presented, but when you take into account the subsidies that are expected from those two pools, perhaps they could certify to actuarial soundness.

MR. SUTTON: Even in the states with reinsurance pools you're going to have to load your rate for what you assume you're going to pay into the reinsurance pool. I assume that when we talk about the rates being adequate, you have to build in whatever tax or income might come from whatever the pooling arrangements are as best you can project them.

MR. DAVE BOND: Another comment that I think Jim has alluded to up there is that you do have some fundamental conflicts between different statutes, regulations, etc. I

know that Florida for years has had a general HMO rate certification statute where you certify (and I forget the exact language), that the rates, in conjunction with other funds available, are adequate and not excessive. It is sort of an implied definition of actuarial soundness, that you could use existing surplus. Now, I'm not sure that statute is still in place. It was in place for a while. Then you also have in Florida the language, and I always get it backwards, where you are certifying that rates are reasonable in relation to benefits or benefits are reasonable in relation to rates, and that has always struck me as being somewhat swishy as a statement as opposed to actuarially sound. I'm just commenting that conflicting statutes and conflicting language exist even within one state. Now you have to overlay on that a different compliance statute.

MR. SUTTON: Those are very good comments. One of the problems we have in dealing with a small-group certification is we don't want to make it a bigger deal than it is. It's already bad enough. We don't want the certifications of soundness to go beyond the small-group line of business. It's too much work to get somebody in there to see that the whole company is not going to go bankrupt. We really have to relate the certification to small groups somehow, unless the regulators will let us fudge it and take the overall company actuary's statement that the whole company is going to be solvent for another year.

MR. LYLE: Conceptually, we were dealing with a required certification of compliance, and compliance seems to be a black-and-white kind of a testing. So what's actuarial soundness doing in here? It's in a number of the statutes. The proposed standard is not requiring a statement of actuarial soundness in states that do not require a statement of actuarial soundness. We have limited the scope of the standard in that regard.

The other issue that comes up is, unlike a "rates are reasonable in relationship to benefits" test, actuarial soundness is a one-way test. The Health Committee of the ASB concluded that actuarial soundness is something that says that, overall, there is enough money coming in to cover the expenses going out. Our view, and I believe the ASB's conclusion, is that whatever definition is given to actuarial soundness, it is still strictly a one-way test and has nothing to do with benefits being reasonable in relationship to premiums. There is a different set of issues that you have to deal with in rate filings.

FROM THE FLOOR: I'd like to add a little different perspective to the discussion on actuarial soundness. In one respect, I like this because it gives me a lot of power because I can tell management, you can't do this, or whatever. On the other hand, it seems like if we back ourselves into a position where we say you can't do this and, in fact, you can't do this, instead of saying here's how we can help you meet your plan most effectively, we will lose all credibility and relevance. That seems to be the opposite of what the Society of Actuaries is trying to build for the profession. I'm curious about whether you have any comments on that or have discussed that at all.

MR. LYLE: Yes. We are talking about a reporting requirement here, and not a business practice. I can think of all sorts of situations where a company may have operations where this definition of actuarial soundness may not be met, and they may have very legitimate business reasons for doing so. Just because that exists in practice—just because you don't meet this definition of actuarial soundness for purposes of a certification compliance is not to say that a company has, by definition, a bad business practice. I don't think that it's the same thing. I don't think that company managements will or

should allow actuaries to use this as a means to say you can't do this or you can't do that. Now, I also suspect that most insurance operations are, in the long term, basically premised on the type of concept used in the proposal standard. It may not be in every year and may not be in every subline of business or in every region where you operate, but in the long haul, there has to be as much or more money coming in than there is going out. So, I think the concept of actuarial soundness will hold up. Again, when preparing certifications related to the operations in a single state, in a single line of business, and for a given time period under this definition, a company's practices may or may not be actuarially sound. To me, this definition is a fundamentally different thing from the question, does the company have sound business practices?

FROM THE FLOOR: I've listened to the presentation on the standard and appreciate that there is to be a standard. Hopefully, that will mean there's a great deal more compliance in Vermont. I listened to my colleagues from New Hampshire and New York on either side of me, and they seem to be getting some certifications. The Vermont law does require annual certification of compliance with the whole small-group health section, and our small-group goes from one life group up through 49 lives. So far I have yet to see an actuarial certification of compliance. And it's not that there aren't any carriers. There are a number. Some of them may think that they are complying by adhering to the filing requirement which requires them to state that rates are not excessive, inadequate or unfairly discriminatory. Some are even missing that point when they think that they have filed for a year and they don't have to file again if they want to change some factors. And so I'm seeing some disturbing things. Hopefully the ASOP, when finalized, will help address a great portion of the problem. Of course, in defense of the industry, the Vermont statute doesn't say on what date you're supposed to do this every year. But when three years have gone by, you know that at some point there was supposed to be an annual certification, and it hasn't happened.

One of the other things that's a little bit tough is that, with the law extending down to one life groups, we know that there are a number of companies that, whether they wanted to or not, have some small groups that have migrated from other states, especially from New York to Vermont, and they have been there more than a year. Therefore, the company is in need not only of registration but of actuarial certification of compliance with the health care reform laws. We do attempt to get annual reports of statistics in the department, and it's very hard to go through those reports and find that there are companies reporting small-group business that aren't registered to do that business in Vermont and, therefore, can't possibly be in compliance with the laws if they don't even know that they're supposed to have filed a number of things.

My caution is more general. There are a lot of small states in the country, and I don't know whether or not the Vermont Insurance Department is big enough to beat up on all the actuaries at all the companies to make sure that they get the certifications that the statute requires. The statute still requires an annual certification, and it says it must be from a member of the American Academy of Actuaries (AAA). It doesn't just extend to the rates. It extends to the whole statute. So, there's a very broad certification that's being required. If you have business that's migrating to Montana or Vermont or wherever there might be some requirements that need to be met, I would hope that the existence of an ASOP would help you be aware that you need to be in compliance. The fact that the Vermont Insurance Department decided to put me hard at work on this roughly a year ago reflects their frustration over two years of trying to make people

aware and not getting any satisfactory response. Almost four years down the road, some of them are furious. They think they've had the statute on the books, and while they know they're small, they hate the thought that New York is getting some reaction, and Vermont's getting ignored. There are a lot of states that feel that way.

MR. BOND: I'm wondering if there are some things getting all mixed up together here that have come out. One of them is the concept of actuarial soundness as it relates to strictly a 12-month period. Now, my background is in individual insurance which is different, but it is getting closer to the small-group insurance where actuarial soundness tends to be measured over the lifetime of a product. Rates could be actuarially sound in year one and produce a 40% loss ratio, and then in, let's say, year 10 or 12 you have a 180% loss ratio, and those rates could be actuarially sound, again measured over the lifetime of the product. I'm wondering on some of the group insurance business whether a one-year snapshot period is really sufficient time for measurement of actuarial soundness.

MR. LYLE: I think you can come at it from a couple of perspectives. I've been contemplating the concept of actuarial soundness a lot, both because it's an interesting thing to think about and primarily because the ASB told me to. There are a lot of things that come into play with regard to actuarial soundness. If you're running a business, basically, do you have adequate capital and surplus to support the inherent risk associated with the expected cash flow in the lines of business that you have? You have both short-term and long-term aspects in terms of how you're trying to run your operations. You should have enough capital to meet your current operating costs, but you should also have a business plan in place, ensuring the financial viability of an organization through time. But the fact of the matter is we're doing a certification of compliance relating to a segment of a book of business, during a specified time period, in a restricted geographic area, and as part of that certification of compliance, we have to address actuarial soundness.

I don't think that the definition of actuarial soundness included in the proposed ASOP that we have put forth is a good one for running a business enterprise. It doesn't address many of the issues that ought to be addressed in that context. We've tried to put together a definition of actuarial soundness that can be used for preparing a certification of compliance as it relates to small-employer health benefit plans. I don't think that for purposes of preparing a certification of compliance for a block of small-group health business, in, say, the State of Wyoming, that we'd want to impose on the actuary a requirement to be addressing actuarial soundness from the same viewpoint from which a fleet of companies might be addressing actuarial soundness for its overall business operations. We've tried to put together a definition that is appropriate for the task at hand, but is restricted to that particular task. Hopefully nobody thinks that this is a good definition of actuarial soundness for trying to run a business enterprise.

MR. SUTTON: The states have put these requirements in, and they somehow want somebody to bless what they're doing.

MR. JOHN A. TULLOCH: In the draft certification that was described to us there was a reference to an absence of material violations. I'd be interested in whether, without putting them legally on the spot, the representatives of the various states here would find that acceptable.

MR. LYLE: I would be interested in that also.

MR. RICHARD H. DIAMOND: I guess from my perspective, in the type of situation that I think we're talking about, in terms of materiality where there was an error, I guess I'd like to get a phone call that explains the situation. Here's how we're going to resolve it. That would be fine, rather than just getting something that says there were no material deviations. I guess I'd like to see more detail available, but not necessarily in the certification. I have one other comment on actuarial soundness. I don't know that it relates directly to the certification, but I think there's a distinction between a situation where a company is selling business at a loss because they're new in the market, they don't have a big enough block of business to spread their expenses and they're covering their losses with surplus, and the situation where they're selling business at a 150% loss ratio to drive their competitors out of the market. I think that raises other legal issues. In the former situation, I don't think anybody would argue that's not actuarially sound.

MR. LYLE: It's an interesting concept. Isn't any company, unless you're in a state that's growing real rapidly, that is trying to gain market share probably doing it by trying to put somebody else out of business? It's just a rhetorical question.

MR. DIAMOND: Well, for instance, there's an HMO that's starting up in Maine right now that filed a business plan that shows they're going to lose money for a number of years before they become profitable. They're basing their rates on an 80% loss ratio which will be sustainable once they have a big enough book of business. So, they're not lowering their rates below a self-sustaining level. It's just that they don't have a big enough book of business to cover part of the expenses.

MR. RICHARD C. TASH: I want to refuel the idea of prospective versus retrospective certification in the sense that as we price products, we recognize the durational impact on rates of costs; in the early years, underwriting and preexisting conditions have some effect that wears off. In states where there's a minimum loss ratio, some of these policies, especially if you're getting into an area that's new, may actually be below the minimum loss ratio, but it might be appropriate where you expect it to grow to be within the acceptable range. But if you're certifying what has happened, you may actually be out of compliance in that sense, yet those are correct rates to be charging.

MR. LYLE: It would seem that if you have a durational impact on your loss ratios in the early years, you might have a point where your retrospective loss ratios are relatively low. To the extent that the definition of actuarial soundness is strictly a one-way test, that wouldn't appear to be a real significant issue. By the time you have some business in an ultimate duration, there's probably other new business that's kind of supporting it, and you might have an overall mix that's reasonable.

MR. SUTTON: We really haven't addressed the question where you also have to meet minimum loss ratios.

MR. LYLE: It's not specifically mentioned in this standard. That generally would have to do with rate filings.

MR. SUTTON: But it is another complexity that you may have to address.