Health Section News

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New Managed Care Risk-Based Capital

by Donna C. Novak

At the end of 1998 the National Association of Insurance Commissioners (NAIC) adopted a new managed care risk-based capital formula (MCORBC) for HMOs and Blue Cross Blue Shield Plans. The new formula is designed to provide regulators with the ability to monitor the solvency of the Blues and managed care organizations in the same manner as they monitor the solvency of life and P&C insurance companies that underwrite similar risks. Prior to the new capital requirements, HMOs and certain other managed care organizations had much lower capital standards than insurance companies underwriting similar risks.

To support the new formula, the 1998 NAIC HMO annual statement blank (orange book) and Blues annual statement blank (white book) were significantly modified. Beginning in March of 2001, the NAIC is expected to change the blanks for health insurance companies to one consolidated format, which is consistent for those areas of the blank dealing with RBC.

The NAIC has published an electronic version of the MCORBC formula accompanied by a 32-page instruction document. As it stands, there are still a lot of “gray areas” as to how the inputs to the formula should be interpreted. These gray areas have caused some inconsistency in the application of the formula from company to company. For example there is confusion in the classification of assets and managed care arrangements for the formula. To add to the inconsistency many companies must estimate certain inputs to the formula until computer systems modification can be made.

To give HMOs time to react to the new capital requirements, there is a “phase-in” provision in the formula. The phase-in will involve a gradual increase in the capital requirement — a 12.5% increase in 1999 and an additional 11.1% in 2000. It is important to plan for these increases in capital requirements while determining future premium rate requirements, as well as for other planning purposes. Unfortunately, since the formula is not part of the insurance laws in many states, HMOs are not taking advantage of this phase-in period to build up capital. Once the laws are passed, the phase-in period will be over, and HMOs in these states will have to comply with the total RBC without the advantage of a phase-in.

Recent Activities

The American Academy of Actuaries MCORBC work group is working to modify the disability income (DI), long-term care (LTC) and stop loss (SL) factors. The DI and SL Work Groups are collecting company data for modeling, which will determine the 95% confidence limit for RBC factors. The LTC Sub Group has collected Annual Statement data from the Long Term Care Schedule, but is still debating on the most appropriate model to use. It is possible that the LTC or the SL Work Group could also use the new DI model to verify the results produced from other models.

All of the RBC formula are regularly updated by the NAIC to keep them as current with changing conditions as possible. It is possible that when codification of statutory accounting is implemented that the RBC formula will be adjusted for changes in asset or liability accounting. The NAIC is also reviewing the different treatment of assets and covariance in the life, P&C and health RBC formulas. It is possible that there will be recommendations for changes to the formulas to make them more consistent. The covariance for each formula is significantly different. The different covariance formulas, along with the different relativities between the different risk categories between lines of business, results in varying effects on the final RBC when identical changes are made to the RBC factors in each formula. For example, changing an asset factor by the same amount in all formulae results in different changes in the final RBC. This is because of the different covariances and in the different relative size of the asset risk compared to other risk between life versus health versus P&C companies.

The MCORBC formula assumes adequate levels of reserves. To bring more consistency to the calculation of reserves and thus the RBC ratios, the NAIC is drafting a health reserve guidance manual. The manual covers claim, contract, deficiency, and provider reserves. Companies deviating significantly from this guidance will have RBC ratios that are not consistent with the market. Therefore any analysis of RBC should verify that reserves are adequate.

Market Uses for RBC

While many states have not passed the model regulation for 1999, the NAIC annual statement blanks require the reporting of the RBC ratios, and the filing of the NAIC blank is required by most states. The RBC ratios and the underlying calculations must therefore be considered as part of financial planning. Although RBC was originally designed as a regulatory tool and the NAIC attempted to prohibited its use for other purposes, the ratio is available for the scrutiny of the public, policy holders, providers, competitors, and rating agencies as soon as an annual statement is filed. Thus, the MCORBC has become a *de facto* standard.

Some insured groups are asking for an HMO's RBC ratios as part of the RFP process. Companies with low RBCs are eliminated from the competition. Employers are very concerned that the HMOs that they contract with will be able to provide services not only for the duration of the contract, but also for future contract years. The problems experienced in some eastern states — where HMOs have pulled out of some geographic areas resulting in employees having to change doctors — are raising general concerns nationwide. In some eastern states, companies have had to change HMOs twice in a year due to HMOs leaving the market or becoming insolvent.

Also, RBC ratios may affect a company's access to future capital. Rating agencies may look at RBC in addition to their own ratios. Some lenders may also look at RBC ratios. Now that RBC ratios are required on annual statements the rating agencies and lenders have access to this information in most states. Even if an HMO decides not to file the information, a rating agency or lender can ask for it and may become concerned when RBC is not readily available.

Company Use of RBC

Companies are finding their own strategic use for RBC. Company use includes return on capital analysis, pricing, strategic market decisions and M&A decisions. RBC has been added to the economic metrics that have to be considered by corporate management.

The MCORBC formula can be used for many strategic purposes. For example, it can be used a management tool to evaluate product-by-product operating performance as a percentage of the capital each product consumes. Companies have seen some surprising results when comparing risk-adjusted profitability. For example, comparing an ASO product to a fully insured product or a small group product to a large group product has sometimes produced results that were not obvious. Product mix decisions can be modeled by seeing if the proposed changes will increase or decrease the MCORBC ratio. The MCORBC ratio can be combined with advanced financial forecasting tools and serve as an "early warning" indicator for management and can be used to evaluate the impact of possible changes in product or pricing strategy.

When analyzing return on capital, some companies use RBC to allocate capital and profits to different lines of business. This is not a simple analysis. Many decisions must be made when determining the appropriate capital and expenses to be allocated to a line. For example, assets must be matched to each line in order to determine the amount of asset risk a specific line of business would generate. Different types of business use different asset types and horizons and these have different RBC requirements. Additionally free capital and off-balance sheet capital must be allocated. RBC can be on item used to allocate free capital, but other factors should be taken into consideration also. For example ASO business creates very little RBC, but there are other capital investments necessary and a straight proportion of RBC may not be appropriate.

Over time, product, pricing, and operational decisions must be aligned with capital requirements. Some companies believe that by creating and managing to such an alignment, that the natural effect will be to enhance long-term return on capital. With the proper balance between market share and profitability, it is actually possible to implement such a policy.

RBC requirements must be taken into consideration when pricing. For current products, premiums should be sufficient to increase capital to target RBC levels. For new product lines, the premium should be sufficient to not only cover incurred claims cost, administrative and other expenses, but also build-up in capital required by RBC and internal return on capital targets.

When acquiring a block of business or considering a business affiliation, the effect on RBC should be considered. In an acquisition, the amount of capital needed will include the increase in RBC

resulting from the acquisition of the new block of business. The same is true in a merger situation. There have been recent examples of potential business affiliations where, due to statutory accounting rules, the combined entities would not have sufficient capital to meet RBC requirements, although the stand-alone entities were above regulatory action levels.

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