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Session 11OF
Deficiency Reserves for Health

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Summary: Through case studies, this session explores the issues (e.g., grouping, expenses, time period, etc.) involved in determining deficiencies reserves for health products. Case studies illustrate accounting guidance and standard industry procedures.

MR. KENNY KAN: Welcome to Session 11, an open forum on "Deficiency Reserves for Health." As valuation actuaries, we enable the provision of health security for our members. One of the key issues that some of us grapple with is what to do when the premiums are insufficient for certain blocks of business.

To shed more light on the topic, we have a panel of four. I am Kenny Kan. I'm a staff vice president and a valuation actuary at WellPoint. I'm also a member of the Academy Health Financial Reporting Committee that is looking at the subject of premium deficiency reserves (PDRs). Jack Sulger is a senior consultant with PricewaterhouseCoopers in Hartford, Conn. He has been involved in the group life and health insurance industry for over 30 years. Vince Mace is a vice president and a valuation actuary at WellPoint Health Networks. He is responsible for valuation and corporate forecasting for WellPoint. Judy Strachan is a senior manager with Deloitte Consulting. She has over 20 years of insurance experience and has performed work for insurance companies, reinsurance and self-funded entities.

Instead of dabbling in pure theoretical knowledge, we're going to get to the heart of the issue of what is involved in setting PDRs. We will explore the issues. First, Jack will present a case study that will highlight some of the issues involved in PDR. Then he, with the other panel members (Vince and Judy), will touch on three issues—expenses, grouping and time period. At the end of the session, we will get

Note: The chart(s) referred to in the text can be found at the end of the manuscript.

into a more in-depth discussion of the example and other issues that you choose to explore. With that, I now turn the session over to Jack.

MR. JACK F. SULGER: We put together a case study. We made up this hypothetical example. It's intended to be a generic situation that includes a lot of the different situations that you might run into. Everyone will probably not have all these types of situations, but we wanted a universal generic model. So when you stand up and ask your questions, you don't have to say, well, a friend of mine who's a valuation actuary has this type of situation. Hopefully, you can refer to our example.

For the example (Chart 1), we came up with various products. We included business, individual, commercial, Medicare, Medicaid, a lot of which you're familiar with, and then different arrangements such as HMO and PPO. We also talked about administrative service organizations (ASOs) and joint ventures, and then just picked some numbers as to the profitability. As we're talking and at the end when we get into the Q&A, if you have a particular situation that looks like one of these, maybe you can ask your question or make your point by coming back to the sample model. Next, Vince is going to talk about grouping.

MR. VINCENT MACE: In the last session, somebody talked about conflicting guidance. It's remarkable how something as nebulous as guidance can be conflicting, but it manages to do that. We will take a look at what that guidance is. Then we'll look at an example that may show some of that conflict or ambiguity.

In Statement of Standard Accounting Practice (SSAP) 54, policies are grouped in a manner consistent with how they are marketed, serviced and measured. That's pretty straightforward. It gives you plenty of room to maneuver. In accounting, they look at it as a rating issue and recommend grouping consistent with the method used in establishing the premium rate. That includes community rating practices, geographic rating areas and statutory requirements.

The NAIC considers everything—product type, case size, how you market, geographic areas as we've seen before, and the length of the rate guarantee period. Then, presumably, you would group together those objects that are of similar guarantee period and, of course, the ever-popular "including but not limited to."

We're going to take a look at a case study. This is a true case, a situation where there was a state uninsurable pool. Anyone who goes into that pool graduates to insurability again after three years, and any carrier who offers individual coverage must guarantee issue to those graduates. The rates are defined as 110 percent of the state pool product range. You don't have to be a participant in the state pool product to offer individual coverage, but you have to provide this. My own company happens to be a participant, so it's not an issue for us.
So how might you group this? It's certainly tied with the individual block by

marketing and self-worth. The rates are tied with the state pool block. Arguably, it's a product unto itself and could stand alone. That could present some interesting issues if it weren't for the fact that the law does sunset, because then you'd have something that was essentially negative for an infinite period of time. There are other ways you could roll them together. Maybe the most natural, looking again at that gross premium valuation, would be to roll it together with all the business of the entity involved.

The argument for grouping it with the individual block is that it's an individual product. That is how it is marketed, to the extent it is marketed, and it's a cost of doing individual business. Why would you group it with a state pool? The rates are linked. If you're going to group based on how the rates are developed, it does reflect how the pool business is managed. If your rates are different on the uninsurable pool, then your rates are different here, and you may not participate in the state program. That presents an issue: What do you link with?

If you group it with individual, and presumably you write individual because you want to make money, there really shouldn't be a deficiency reserve needed. If you group it with the state program, it depends on whether or not the state program is subsidized. If it's not grouped with anything, this is intended to be a loss-leading product or loss contract.

There are some other alternatives. A total legal entity is one rational grouping. Specified lines within the legal entity is conceivably another. I'm throwing that out as a question to the group. What do you think these things ought to be grouped with? Hopefully, we'll talk about that a little later. Jack, I'm turning it over to you.

MR. SULGER: I'm going to talk about expenses within the calculation, first about some definitions with regard to expenses. Besides talking about the statutory side, which I think is the focus, I will also try to bring in some GAAP references, because there are PDRs for GAAP, although for short duration products not too many people would ever necessarily have that kind of situation. On the GAAP side, there is more related to long duration contracts. Within the references that talk about premium deficiency calculations, which are Financial Accounting Standard (FAS) 60 for GAAP and the *Health Reserves Guidance Manual* for the statutory side, we really don't talk too much in terms of definition. On the GAAP side, in the glossary, which is Paragraph 66, they do talk about three different types—acquisition, maintenance and settlement—and they go into some definitions as to what the various categories include. Being generic for all lines of business, they're pretty broad. For example, on acquisition they talk about commissions as well as inspection fees. For health insurance, I don't think we necessarily have many inspection fees associated with policy issuance.

When you look at the *Health Reserves Guidance Manual*, they do talk about overhead. As we heard earlier, it's one of those areas that you can exclude from the calculation. I'll talk a bit more about that in a moment. But, in any event, within the statutory side there are really no specific references about what expenses include and what they don't include. Generally, you need to consider all expenses. They don't make any exceptions other than recognizing that some acquisition expenses don't have to necessarily be considered for PDRs.

As I mentioned earlier, comparing GAAP versus statutory, again, there's this overhead question. On the GAAP side, it's generally perceived that when you talk about expenses, you're talking about direct expenses, which then would exclude overhead. To the extent that you have indirect expenses, that may be a gray area with regard to GAAP. On the statutory side, you really need to consider all of the expenses. Therefore, you need to come up with some way of allocating expenses to the various groupings or the individual products that you're looking at. I would encourage everyone to establish some rules and follow them. Then when you get into the situation where you start to exclude overhead in the calculation, as you're allowed to do, you also need to establish rules within the organization. If you have documentation, when you get into situations where there are premium deficiencies on a particular product and you're allocating money away, there are other products. Conceivably, you could have other lines of business that might not be part of your own responsibility that you can allocate to. But if you start allocating expenses to your property and casualty brethren, for example, and you don't happen to tell them, and they're also utilizing everything in their calculations, then obviously you're going to have some problems. You need a traffic cop, somebody who's going to make sure that when you allocate away, if it's outside of your area, the people who are picking up your overhead know they're picking up your overhead. Otherwise, you might be embarrassed to find that the calculation you did is not correct.

I think, in general, people are profitable, particularly in the health area right now; we're probably going through a favorable phase. But in the long run, you also have to recognize that there may be some turn in the cycle. When you get into situations where you're going to be potentially losing money—I know everybody says we price perfectly, we're never going to lose money, etc.—in the event that it happens, that's when you really need to have some of the ground rules established in advance. If you do get into a cycle where you're producing more losses, that is not the time to be trying to figure out the rules for allocating overhead and doing the grouping that Vince referred to, because you're going to get into a lot of internal squabbles.

In addition, by establishing rules for the allocation up front, you also protect yourselves in the sense that management isn't necessarily going to lean on you, so to speak, to try to come up with a more favorable distribution. At least if you have something up front and everybody's agreed to it, to a certain extent having established documented procedures during bad times will also help you protect yourself.

The only other consideration that is talked about in both FAS 60 and the *Health*

Reserves Guidance Manual is investment expenses, which are usually netted out against investment income. Federal income tax (FIT) doesn't need to be considered in the calculation. Concerning inflation, if you're just projecting out for a year, you don't necessarily have too much inflation on expenses. But if you have several years, then that's also probably going to be a factor that you want to include in your calculation.

I put together Chart 2, titled "Sample Expense Spreadsheet," as an example. It's a basic approach to look at all the expenses in your particular area by function and then try to categorize them into various columns of the acquisition cost, maintenance and settlement. This kind of exercise, particularly on the statutory side when you really need to consider all expenses, if you take the budget for your department and then map it in this fashion, at least you know you have the universe in terms of expenses. Then, to the extent that you're going to move overhead out of the equation because you're able to allocate it to somebody else, you have a clear roadmap as to how you did that.

Finally, and this is probably fairly obvious, you relate the expenses to various factors like claims or premiums, depending on what the expense is for. You need to project out into the future, and so obviously you're projecting out claims. You can relate expenses to claims, then this automatically comes up with what the claims will be in that period of time. This is pretty basic actuarial stuff, but sometimes you just need a reminder when you're doing it to help you along. And with that, I'll turn the program over to Judy.

MS. JUDY STRACHAN: I am going to talk about the length of the projection period. Conflicting guidelines seem to be the watchword of the day. So, we'll talk a bit about the guidelines. If you look at AICPA guidelines, they say that the length of your projection period should be the remainder of the contract period. They assume that premium increases at the beginning of the next contract period will take care of the problem. I looked at this strictly, and this is the way some companies do it. It means January policies have a one-month deficiency, and February policies have a two-month deficiency. You end up looking at cohorts of blocks of business and do your PDR that way. However, I've tried this approach on a couple of companies, and they looked at me like I had three heads. So, that's not a universal thing, but strictly you should be looking at business in renewal date cohorts. It can sometimes be tricky thinking about what the life of the contract period is. You have multiyear contract periods. You have your government. What's the contract period on that government business?

If you look at the NAIC, they want you to do a gross premium valuation. You have to take into account all expected benefits unpaid. You have all unearned and expected premiums, and you have to adjust for future premium increases that you reasonably expect to put into effect. In other words, you should be thinking whether you can make up the entire deficiency by the end of the contract period. If you discover in November that you have a deficiency on this block of business, is it realistic to think that you're going to have that deficiency gone by the end of January, when your January rates are already set? So, the NAIC takes a different view. It says you have to look at it a different way.

The *Health Reserves Guidance Manual* says that you have to use actuarial judgment. You have to use realistic assumptions regarding lapses, rate increases and claim trends and take that into account when you're figuring out when you're going to reach profitability. The length of your projection period needs to be, under the NAIC guidelines, when the product has achieved profitability.

If you have multiple year-ends, you need to use the present value. You need to bring it back to now. You need to go to when you're finally profitable and take the present value of that deficiency back to the present. If you have a deficiency that's within a rating period, you could ignore it. You only have to look at whether you're deficient over the entire rating period. You have to think about things like your small group business. You may not be able to put an increase in place at the next rating period. You may have limits. If you need a huge rate increase, there may be limits on how much you can raise rates. As I mentioned, if you have government business, you need to look at what it's going to take to get profitable. In some cases, it may take exiting the business, and you may need to think about how quickly you can reasonably do that. Those are the things you're going to have to look at in setting your projection period.

In the case study, there's a commercial small group. The issues are right there. That group is losing business. You have to think about who you're going to group it with, what kind of rate increase limitations you have, and how long it can be profitable. You have a multiyear Contract B in the case study. You need to look at when you can raise rates under that contract. And the last one is a Medicaid entity. You will need to think about what it takes to get profitable on that entity, whether you're going to need to exit the business, and how quickly you can do that. If it's beyond the date at which you can file new rates for the next year, you might have to go several years out in the future to determine the PDR. Now, I'm going to turn it back over to Kenny and to Jack.

MR. KAN: I will transfer control to Jack to discuss the case study.

MR. SULGER: I already talked about the case study. Now we want everybody else to talk about the case. If anybody has questions and wants to use our study as an example, feel free.

MR. ROBERT M. SACKEL: I have a couple of questions. Jack, you were talking about the use of overhead expenses. When I was doing that analysis between GAAP for the FAS 60, which you provided me, and the stat, the stat says you can exclude overhead expenses as long as they're allocable to the other lines of business. In terms of GAAP, they're totally silent. You use the formula. They don't include overhead expenses at all. One question I have is if you have a small group HMO and, for example, negative 3.4 is your projected. Let's say that's a period you're projecting for the future losses, and that's due to overhead expenses that could be covered elsewhere, then it would be your position that you would not need a deficiency reserve. Is that correct?

MR. SULGER: Correct, although overhead is probably going to be a pretty small number.

MR. SACKEL: Understood. It also depends on how much the premium is. My other question is for Judy. You mentioned that periods and deficiencies within a rating period do not have to be recognized. Can you perhaps elaborate on that? For example, if you have a block of business that's going to renew in a couple of months, and you are having a deficiency for the next quarter on that block, don't you need to have a deficiency reserve?

MS. STRACHAN: That's a good question. Probably not, though it would depend. Many companies just look at things in a calendar year period. If you were doing the renewal cohorts, and that was your policy, as of the financial reporting date you might actually have to recognize that loss till the next contract period. If you were looking at calendar year periods, and overall for the whole calendar year you were profitable, I'd say, no, you wouldn't have to recognize it.

MR. SACKEL: When you talked about renewal cohorts, you can't combine if you have like business. For example, if you have some cohorts that have renewals each month, a couple of them will be negative, but a couple will be positive. You can't match because it's combining the whole business segment.

MS. STRACHAN: The guidance is pretty inconsistent there, and some companies do it different ways. If there's a rationale and a policy in place, you're probably all right. But if you had set up a policy that said as of the reporting date that you were looking at your business in January, February, March, April, May cohorts, and one of them had a deficiency for a few months until its renewal date, you would have to recognize it. You couldn't change a policy at that point. If you went strictly by the AICPA guidance, that's the way you should probably be doing it. I'd have to say that's probably not the majority of companies. If you're looking at it as a block over a calendar year, and you have little pieces, like your February renewals are going to lose money but the rest of the year is going to be fine, I wouldn't think you'd have to recognize it.

MR. SACKEL: I see. As a matter of fact, in terms of choice the guidance isn't clear, because one of the things FAS 60 is explicit on is that you shouldn't establish a deficiency reserve now, because it will go away in a few months. So in a sense, you've now gotten a gain in future earnings. It seems that FAS 60 in itself estops you in certain cases from establishing a deficiency reserve if it relies on a gain for the future. That's my reading of that.

MR. SULGER: Just to comment on that, Bob, you can't take future gains against current deficiencies, right? Otherwise, nobody would ever have one. There's enough creativity in this room, I'm sure. You could always come up with assumptions that would get you out of the whole, and then you run them long enough.

MR. SACKEL: Maybe I'm wrong, but my recollection in reading this is that you can't set up a deficiency reserve then have that get gains in the future, because you've now taken down the deficiency reserve. In the future period, you receive gains.

MS. STRACHAN: Your deficiency reserve is for the contract period. And now you have to have a policy. You have to set up a policy in advance that says how you're doing your contract period. So, if, as of your report date, you have a loss on your business until the next contract period, you have to recognize it. You can't think about the gains you're going to get in the contract period after that. So I think you have to look at the contract period there, however you've defined it in your policy.

FROM THE FLOOR: I think there's confusion in the terminology that Bob's using. He's not talking about a gain like profitability, but we forget that deficiency reserves not only affect the balance sheet, they affect the income statement. So if you set up the reserve and then take it down, it'll fall to your bottom line and show profitability. It'll hit your income statement. I think that's what he's trying to say.

MR. SACKEL: Yes, exactly.

MS. STRACHAN: I think the GAAP principle is that you're supposed to match revenue to expenses. So if the loss is for the current year, then you need to take it in the current year. That way you're taking the loss now. So the gains that flow through once you've re-rated your policy aren't affected by prior losses.

MR. SACKEL: That's true, but you can't take a graded deficiency reserve hit if, by the takedown, it is going to exceed your losses to get a gain in the future period. If it exactly matches your losses, that's fine.

MS. STRACHAN: I haven't run into anyone trying to take excessive deficiency reserves.

MR. SACKEL: Okay, thank you.

MR. SULGER: I want go back to Bob's question earlier about overhead. When you get to the point where you might run a projection through that includes overhead, you get at the end and you say, all right, I should be able to take it out and allocate it. You need to think about the demonstration of that. I've run into several situations where they're only a little bit over, and so they did everything with regard to overhead that would eliminate the need for deficiency. From my perspective, you really need to demonstrate that. To some extent it sounds a little petty, because it seems like if you look at the person's business in the aggregate, there might be a deficiency reserve on a very small segment. Therefore, the amount of overhead that's being transferred out is probably pretty small, and the rest of the business is fairly profitable. So there's probably plenty of room to pick up the overhead.

Again, it sounds a little petty to be trying to audit and get people to demonstrate it, but I think the exercise is good to go through. There are going to be times where it's not going to be so obvious when you're doing this, so I think it's incumbent upon the valuation actuaries to do the math to demonstrate it to the auditor or the examiner, depending on the situation. I would encourage you to work out the rules and then go through the process. I don't see a need for the process to be very elaborate. We're not talking about setting up dozens of spreadsheets to do this. Keep it fairly simple and reasonable, but also make sure that you're demonstrating all your points so that when somebody comes in to either audit or examine it, they don't need to do the math. They're checking the math; they're not doing the math. So, that would be a good practice to follow.

MR. JOHN PATRICK KINNEY: I have two questions. One is: How would this relate to your legal entities where you might have some convoluted structure, where you have different statutory legal entities that roll up differently for GAAP? Are you ever allowed to allocate things across legal entities? My other question has to do with investment income and how you can take credit for investment income on your reserves and/or on any surplus that's allocated to those lines of business.

MR. MACE: That's a grouping question. With respect to the legal entities, the NAIC guidance talks about the reporting entity. So you're going to need to do things at least at the legal entity level right now. For allocations of various overhead and expenses, however you do that may make a difference, but whatever you do presumably you would be consistent in doing the deficiency reserve calculation as well.

MS. NANCY F. NELSON: I have a question that's similar. I have a question about a product that reminds me of the situation you set up with the graduation from the state risk pool. In Minnesota we have what's called a portability product that we're required to offer to all members leaving fully insured groups. The rates for this product are limited to 100 percent of the rates for the high-risk pool. The high-risk pool's rates are limited to 125 percent of an average for the individual market. However, historically they've been much lower than that. In recent years, they have been as low as 110 percent of the average rate for the individual market. The products are set up as individual contracts. They're guaranteed renewable. We essentially have no chance of ever being in a profitable position on these on renewal. So I'd be interested in your comments on grouping for this, whether it should be grouped against our individual products.

In addition, what do you use for claims assumptions? We have this product in two entities. The experience in one entity has been much worse than in the other, probably because it's a very small block with a couple of particularly catastrophic cases. But if I assume that carries forward, you get a very different result between the two companies. What do you do for the length of the projection period? And what do you do for choosing trend assumptions and discount rates for a long period? I can tell you what we did, but I'm more interested in what you think.

MR. MACE: I don't claim expert status, but I will tell you what we did. We went with the rating approach. We tied it with the state product as opposed to with the individual product. The ambiguity and the fact that things are just not well defined bothers the mathematician in me.

MS. STRACHAN: You asked about the length of the projection period. Assuming you can't group it off with some other group, you're never going to be profitable. I can't think of any other way other than to project when the last person's going to be gone and hold the present value of that deficiency as of the current date.

MS. NELSON: That's basically what we're doing. We've set up using a 30-year projection, very long term using pretty conservative increases on the premium side. We've used a higher trend reflecting recent experience on claims and then moderating to a less steep claim trend and some offset discount rate that's conservative.

MS. STRACHAN: Historically, we've not done that. I feel strongly that we need to blend it or we get a result that's really ridiculous between the two companies.

MR. SULGER: I want to get back to Pat's question about investment income. You can't include investment income in the calculation for statutory reporting. Was that the nature of your question?

MR. KINNEY: Yes. How much investment income can you get? Can you allocate the surplus account?

MR. SULGER: I don't think it's clear as to allocating the surplus account, but in terms of allocating on the cash flow of the product, I would see being able to do that. I'm not sure the state would necessarily view the excess. Again, you need to set up a reasonable approach. Then obviously the final test is going to be the state examiners. They're going to reference the guidance manual, but at the end of the day, obviously acting in the interest of the policyholders and the state, they are going to make the final determination.

MR. STEVEN L. WITULSKI: I have a follow-up comment on Nancy's question. Companies might consider that there are times when you might not want to hide that premium deficiency or avoid reporting a premium deficiency, especially in these situations where a state or regulatory entity is almost forcing you to absorb a loss. You may, for political reasons or for negotiation reasons, want to show it on your financial statements and make it clear and gain allies in your regulatory department by showing that this business is really producing a loss for your company, and it isn't hidden. So, I thought I'd add that.

I do have a question on the expense allocation. Jack, you pointed out some reasons that it could make sense to establish some rules like in a multiproduct company on how you allocate the overhead. On the other hand, I guess you could get into situations where year by year you might want to change that to avoid reporting a deficiency reserve. If you do that, are there any regulation standards that you run afoul of if you change your practice in how you allocate the overhead? Are there things that would require disclosure and certifications, or can you just change it year to year?

MR. SULGER: From my perspective, the intent is always to have consistency in how you do it. I'm not sure I know right off the top of my head what the specific reference would be for GAAP or stat, and maybe somebody else can chime in. But unless you do have consistency from year to year, why bother? You could obviously be fairly creative, depending on your situation, in terms of how you allocated cost. Even in your grouping, if you don't have a set approach, you could probably do a lot to avoid deficiency reserves just by changing the rules. In my mind, it's inherent in the process that there's consistency. If something more material changes in the structure, you're not necessarily locked in. But, again, if I were the examiner and came in and saw that you had a change in the current year, that would raise a red flag unless you had a good rationale that prompted the change, for example that it was no longer practical to do it that way.

MR. WITULSKI: Okay. Thanks.

FROM THE FLOOR: We have a similar situation to what she was referring to on conversion policies. We've grouped conversion policies where it essentially goes to an individual policy and have set up deficiency reserves for that. I was interested in your thoughts on the difference between the stat reserves and the GAAP reserves. We've set up a GAAP reserve for that, but on a stat basis I think we have conservative termination rates. In the *Health Reserves Guidance Manual*, it said "anything reasonable." We took the approach from the contract reserve guidance on the statutory side that limits you on a longer term product to 8 percent termination rates. I was wondering what your comments would be on that. Hopefully that's overly conservative, but I'm not trying to lead you.

MR. SULGER: When you talk about conversions, there are a couple of different things that come to mind. I'm not sure I'm going to answer the question directly, but sometimes people feel conversions on the health or even on the life side are really part of the group business. The other thing that can happen, particularly on individual products, when you set up the reserves sometimes the active life reserves are somewhat conservative. So you end up not having deficiencies on a statutory side, because when you do the gross premium valuation, the conservatism in the statutory reserves offsets it. On the GAAP side, you might not have the same level of conservatism, so you may end up with a loss recognition situation. I'm not sure that covers your situation, but it's not impossible to have one GAAP side have deficiency reserves and not have it on the statutory side.

MS. JINN-FENG LIN: I have a question to Judy with regards to individual comfort period. This particular example is guaranteed renewable, and it's in a HIPAA state, specifically Florida. And they do set up an active life reserve. My question is on running the PDR test. How do you define your contract period? Would it be 30 years? That's how they run their active life reserve. Or would that be just up until the next renewal period? That's my first question. And the second one is on ASO. I have another client who actually is incurring a loss on their ASO business because their expenses are running higher than their actual cost. How would you run ASO through, and what do you do on the ASO situation? Thank you.

MS. STRACHAN: I may have to turn to my fellow panel members. I haven't done that much work in the individual with active life reserves field, and so every time I do, I have to dig out the manuals and read it. If there are members of the audience or members of the panel who have more experience in that area, maybe we could get some thoughts from you on that issue.

MR. MACE: It seems to me that whether or not they're active life reserves is irrelevant. The real question is whether or not you can change your pricing to make the block no longer a loss product. If you can do that, then whatever time frame requires you to do that would be a reasonable one and then it reaches zero. If you are actually constrained, and you've written a product that you can't change the rates on, then you deserve what you get. But it doesn't really fit into medical, because you see that on the disability side.

MS. STRACHAN: The second part of your question was about ASO. My experience with deficiency reserves has been on the insured line. I'm trying to think of a situation that I've run into where someone wanted to hold the deficiency on ASO.

MR. MACE : I'll try that one, too. We've addressed the issue by looking at the expense recovery as being across the entire large group block of business. So, the ASO is included. As long as the total does in fact recover the expenses, then we don't feel there's a need for a deficiency reserve.

MS. STRACHAN: The other thing is you can lay your overhead off the ASO business. So, one would hope your ASO fee actually covered your maintenance expense.

MR. SULGER: A good point on the ASO would probably be the overhead cost you can lay off. It's going to be a bigger percentage. When you talk about overhead, when you talk about fully insured product, it's only a point or so in the whole process. But if you're talking about strictly a cost, then that's going to be a much bigger percentage. It's going to have a lot more leverage to the calculation in an

ASO situation than it would ever have in an insured situation.

MR. ROBERT W. GUTH: We've talked a lot about overhead expenses, as you just did. One of the questions I have thought about a lot, and I'm not sure what good guidance would be, is how much difference could there be in one's models if you do demonstrations compared to how the company actually allocates expenses? Do those need to stay tightly together or can your models allocate to different lines even though the company isn't actually doing that in its internal financial reporting?

MR. SULGER: It's a good question. As long as it's somewhat reasonable an approach, I don't think you necessarily are tied to a strict approach that you might use internally. To a certain extent it's just that; it's your internal process. It's not something you're necessarily going to have to disclose to the state. You do have some breakdowns by line of business in the reporting, but a lot of people's internals exclude a lot of overhead items anyway. They talk about contributions to surplus and things like that. They don't necessarily get into pure profitability that would include everything including overhead. When we were talking earlier, the comment was made about states being more active in this area.

One of the things I was curious about was just how many people have started to see the states active in this area, and if anybody had any experience where the state examiners—sounds like Minnesota—came in and looked at a particular reserve. To some extent, if states are going to become more active, one of the things they're going to have to be a little careful about is that they're changing the rules over time. The guidance manual is already out there. If two years from now they come in and look at your particular books, and they've already looked at them last year, it seems like they are changing the rules. I was hoping that the states would be taking a more active role, but I was more curious about what people had been seeing in terms of states coming in and looking at your grouping and saying, well, you didn't break it down enough, or looking at expenses and not being satisfied with your approach.

MR. SACKEL: There are a couple of things might be helpful for people. One of the things we talked about earlier in the session were best estimates. If you look at the formula for the deficiency reserve calculation, you take your best estimate of future claims, and then you subtract out the current reserve. That portion related to past liabilities as of a valuation date, if your reserves consist of a margin plus your best estimate, would the margin be a deduction to a need for the deficiency reserve?

MR. SULGER: On statutory, it's clear that the formula has a run-out in it. So if you have a margin in your reserves, and then you run it out using more of a best estimate approach, then you do indeed gain the difference.

MR. SACKEL: Right. That's my interpretation. That's what I wanted to get. You think it's just on the statutory side, not on the GAAP side? I know GAAP has a similar formula for longer periods.

MR. SULGER: The GAAP side doesn't include the beginning balances in the formula, if you look at the loss recognition formula in FAS 60, for example.

MR. SACKEL: They do subtract out the current reserve.

MR. SULGER: Yes, if it's the active. If it's a long duration contract, they're going to let you take out the active pieces. If it's not, you can't take out the claim piece. To a certain extent, if the reserves you set up on GAAP are truly best estimates to begin with, it's a self-fulfilling prophecy. I think there's an assumption when they made up the formula that there wouldn't be any excess.

MR. SACKEL: But to the extent that we talked about earlier that it's fuzzy in GAAP, it's not totally clear as to what the situation is in terms of best estimates. On the GAAP side, if you are using best estimates, it would seem to me a conclusion that you would avoid some need for deficiency reserve to the extent you're holding that margin. In a sense you're holding a liability, and you look at the total liabilities that you have.

With respect to time period, Judy, you were mentioning year-ends. In statutory, it's clear to me that you need to consider this for the year-end reporting. On the GAAP, in financial periods it's on a quarterly basis you need to consider deficiency reserves. Is that your understanding?

MS. STRACHAN: Yes, I think so.

MR. SACKEL: I just wanted to clarify that. And the last thing, I'd like some elaboration on contract period, what you mean by it. Let me give you an example. I have a block of business with monthly renewals. I'm just looking at them as a total block of business. Let's say the renewal period goes for a year. What is the contract period for that block of business? Is it when that business starts becoming profitable? Do you only consider the points where it's unprofitable? How would you define the contract period for that type of block?

MS. STRACHAN: There are a lot of different interpretations there, and it's like many of the other things where the guidance isn't clear. You have to have a policy that makes sense. Some companies just look at things on a calendar-year basis, and if it looks like the block is profitable over the next calendar year, then they don't need a deficiency reserve. Others will say, my product's in a deficiency at the end of this year, and I'm going to have rolling renewals during the next year. So they're going to have rolling periods of deficiency, and they'll hold a deficiency reserve for each of those rolling periods.

MR. SACKEL: So there's no right way or interpretation?

MS. STRACHAN: I don't think so. I think the guidance is unclear. I can say I've seen both, and I've seen auditors sign off on both. I don't know about insurance departments, but I've certainly seen auditors sign off on both.

MR. SACKEL: Okay. Thanks.

MR. MARLIN M. MUELLER: I have two questions. First in your hypothetical company, you have 14 different business segments, down to a couple of long-term contracts where the contracts apparently are held individually. Is there any materiality rule that you would apply in terms of assigning your groupings there? We're only shown net income, but those represent one-tenth or two-tenths of a percent of the total. Is there some materiality rule? Some of the cases we talked about with these individual situations are going to be a very small fraction of your business. Is there some reasonableness test or materiality test that you would apply to decide to group that with somebody else because it's just too small to look at individually?

MR. SULGER: The more you break it down, the more likely you're going to have a need for a reserve. The thing that comes to my mind, and somebody correct me, is that as far as the states are concerned or as far as accounting is concerned, materiality only comes into play when you talk about GAAP. So to a certain extent, it's not necessarily a criterion. The other aspect would be, just from a practicality standpoint, in terms of breaking things down, if you get too fine, do you then just run into a situation where it's not credible in terms of trying to project out claims on very small blocks of business, and then not trying to come out with a whole STE just to do PDRs? That would be something that I would consider more than thinking about the materiality aspect. I'm not sure many people are necessarily trying to get into that situation, although one gentleman was talking earlier about wanting to make sure on particular lines of business that they set up PDRs just because the state was controlling the rating. I think for political purposes they certainly wanted to make sure the state realized that they were running a loss at a particular program.

MR. MUELLER: Okay. My second question was following up on the questions about the contract period, in particular for group business, both small group and large group. In our state, we're required to issue the renewal at least 60 days in advance of the renewal date. You have a lot of business that renews January 1. Do you have to consider the next contract period if the proposal is already out there?

MR. SULGER: I think that's clear-cut.

MS. STRACHAN: Yes, you would have to. If you discover that you have a deficiency in November on your January 1 policies, you would have to consider that. You couldn't say, the contract is up January 1, so I don't need a deficiency. You'd have to look at the next period until you could reach profitability. Especially for small group, if you find you have a deficiency, and you know you're not going to be able to get a rate increase big enough even the next January to get rid of that deficiency, you may end up going two full years into the future with your deficiency reserve.

MR. JOHN C. KELLY: I have two questions. The first one is for Vince. It's related to grouping. In the past, I've heard when you've settled on how you're going to group your business for the purposes of doing this analysis, you've locked in how you're going to do it in subsequent years. Is that still an assumption you ought to make, that the same company doesn't have the ability to go and pick a different grouping approach in a subsequent year?

MR. MACE: I think that's correct. That agrees with Jack's consistency argument. Where I disagree with him is what you can do with respect to offsetting expenses. But with respect to what you group, once you make that choice, unless there's an obvious reason, one of these things deteriorates. You should keep it consistent.

MR. KELLY: Okay. That's consistent with my understanding. The other question is for Judy. I think it was Bob who asked the question a couple minutes ago about annual versus quarterly, stat versus GAAP. I want to make sure I interpreted your response correctly. You had said for stat it was annual only, that you don't need to do a premium deficiency analysis in a quarterly statutory filing. If you want me to give the specifics, not a hypothetical example, for a company that I work with, they do some Medicaid business, and they've been offered capitation rates for a contract starting this October, running through next September, that probably are not adequate. So should they be addressing the deficiency in their statutory filing? Should they be addressing the deficiency issue with their September 30 filing for 12 months or can they wait till December 31 for nine months?

MS. STRACHAN: I probably misspoke. I think you have to address it as soon as you know about it. You have to recognize the loss as soon as it's obvious.

MR. KELLY: In the September 30 statutory filing, if that is the conclusion, that these rates are inadequate, it should be addressed there?

MS. STRACHAN: Yes.

MR. KELLY: Okay. Thank you.

MR. SULGER: I would just add the other point would be to try to do the calculation early, if for no other reason than to avoid some surprises at year-end. If you're just doing it at the end of the year, that's probably the least favorable time that you want to find out you have a problem. If you can make it an ongoing process, it would benefit you so that there are no surprises to management.

FROM THE FLOOR: I have a single question. Life deficiency reserves are not considered tax deductible, but how about the health deficiency reserves? Are they treated the same as life?

MR. SULGER: Do we have any tax experts in the room?

MR. DANIEL W. HARRIS: I'm far from a tax expert, but there is an interesting question around tax reserves that I've struggled with. In 807, it wants you to use industry tables to calculate your reserves if they're available. But then there's also some language that says if the contract that you have is going to have benefits that don't fit a table, you can either modify a table or come up with your own claim cost tables. So if you're generating a claim cost table to match the product you have, you fall into tax deductibility. Or in another place in the tax code, if you're setting up a reserve because the net premiums exceed the gross premiums, then you're in a nondeductible situation. To me, you're really doing the same thing.

FROM THE FLOOR: I think you have a greater problem if you have both a GAAP and a stat company. On the GAAP side, if you set something up as a deficiency reserve, and if you're calling it claim cost on a stat, there are disclosure requirements that are part of the GAAP process if you do establish a deficiency reserve. So if you have that disclosure requirement, it's out there, you have to do the same thing on a stat. You just can't label it. It would seem if the IRS were astute, it would probably deny the deficiency reserves. I don't think deficiency reserves are tax-deductible.

FROM THE FLOOR: I work with a company that sells stop-loss insurance, both specific and aggregate. Typically, in the first six months of a one-year contract you get maybe 25 percent of the claims, and in the second six months, 75 percent of the claims. So at any time on any one contract, there could be a fairly large deficiency, at least on a net premium basis. We include all these reserves together and set up a claim reserve and handle the deficiency and claim reserve together, say, at a 70 percent loss ratio. What that also would do presumably, unless, like we said, there is a really astute IRS agent, is make this whole thing tax-deductible.

Chart 1

Actual and Projected Results

Line of Business	Product/Arrangement	2003 Actual	2004 Projected
Individual		$ 2.6	$ 1.7
Commercial			
-Small	HMO	5.2	-3.4
	PPO	13.2	10.4
-Large	HMO	21.7	12.2
	POS	16.3	22.8
	PPO	25.9	23.7
Multi-Year Contracts	Contract A Thru 6/30/04	0.2	0.1
	Contract B Thru 6/30/05	-0.2	-0.4
Medicaid	Entity 1	-10.5	-5.2
	Entity 2	12.4	7.3
Medicare	Risk	8.2	6.9
	Supplement	3.7	1.7
ASO	All	4.0	3.5
Joint Venture	50-50 Quota Share	2.8	3.1
Total		$ 105.5	$ 84.4

2 PRICEWATERHOUSECOOPERS

Chart 2

Sample Expense Spreadsheet

Function Type=>	Acquisition	Maintenance	Settlement	Overhead
Marketing	X			X
Sales/Underwriting	X			X
Commissions	X			
Case Installation	X			X
Claim Processing			X	X
Eligibility		X	X	X
Claim Procedures			X	X
Check Rec			X	
Pricing/Statistical Reporting				X
Renewal Admin		X		X
Compliance/Filing		X		X
Financial Reporting				X
Management				X
Premium Taxes		X		