SOCIETY OF ACTUARIES

Article from
Health Watch
October 2019
Issue 90

Managing Health Insurance Company Risks in a Recession

By Dave Nelson and Keith Passwater

The current U.S. market expansion started in the third quarter of 2009, making this the longest in U.S. history, surpassing the record 120-month expansion of the 1990s.[1] And, given our unsettling memories of past recessions, we thought it might be useful to contemplate how insurance companies would be impacted by the next recession in similar—and new—ways. While we had our own thoughts on this, we were determined to gather a range of input through interviews with several health-insurer chief actuaries of companies large and small.

Although most economists put the probability of a U.S. economic recession in 2019 well below 50 percent,[2] it is a practical certainty that the U.S. will experience a recession at some point in the future and this article may help actuarial leaders prepare. Part of good preparation may include open discussions now between actuarial executives and their leadership peers about the potential implications of the next recession.

DEFINITION OF A RECESSION

While there is no single definition, a recession is generally understood to be at least two quarters of low economic activity, tight credit and high unemployment. If the recession is deep, investment spending, household income and business profits fall; bankruptcies and unemployment increase.

Many of the actions we describe in this article work well in response to the insurance cycle risk, which is caused by aggressive pricing to gain market share. We are focusing here on a recession where many people lose their job, more people worry that they could lose their job, and health insurance companies face financial difficulties.

> Recessions give actuaries great opportunities to shine.

Annual unemployment has exceeded 6 percent several times since World War II.[3] See Table 1.

Table 1
Years With High Rates of Unemployment

Period	Average Annual Rate of Unemployment
1949	6.1%
1960–61	6.1%
1975–86	7.6%
1990–93	6.7%
2008–13	8.2%

Source: *Bureau of Labor Statistics. Databases, Tables & Calculators by Subject,* From: 1949 To: 2019 (straight average across months). Accessed Aug. 8, 2019.

The numbers in Table 1 are nationwide averages, which of course vary significantly by geography. Typically, variances by market are so large that companies in different areas can have very different experiences and needs for corrective action.

CHIEF ACTUARIES' THOUGHTS

The actuaries with whom we spoke reflected on the last recession and identified some consistency in their companies' business experience. One intuitive impact of a recession is weak membership growth. Chief actuaries noted that negative in-group change (a declining number of members among retained employer groups) was a very significant challenge. During expansion periods, in-group change tends to grow as employers hire to meet rising business demands. In the last recession, companies in desirable regions, such as the Sunbelt, saw some influx of displaced workers seeking new opportunities. However, companies in other regions had the double problem of layoffs with worker exodus.

In terms of claim cost, all chief actuaries noted that costs rose materially in the last recession due to employees rushing to get service and prescriptions prior to layoff, and due to the increased use of continued insurance through the Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1985, which was very adversely selective. As the recession deepened, severity of conditions increased noticeably, particularly in mental health, substance abuse and stress-related conditions such as heart disease.

Actuaries struggled to adjust rates in response to increasing claims costs due to a combination of opposing forces:

- Company leaders, concerned about membership issues and perceived excessive actuarial conservatism, pushed for lower rates to meet membership goals, and

- A public sense that carriers should be willing to miss earning targets in recession when citizens are under economic duress and other businesses are losing money.

Additional comments on experience from the last recession included the following:

- Small group enrollment declined, significantly accelerating a long-term trend of a declining percentage of small employers offering coverage. This enrollment decline was anti-selective as a result of less experienced, younger (and generally healthier) employees being more likely to lose their jobs. Additionally, small employers' decision-making was anti-selective when an employee (who is frequently a friend or family member) was being treated for a serious medical condition.

- COBRA enrollment increased (sometimes doubling as a percent of the commercial book of business) as a result of rising layoffs. COBRA enrollment was further increased by the passage of the American Recovery and Reinvestment Act (ARRA) of 2009, which included subsidies up to 65 percent of a laid-off employee's premium, starting March 1, 2009.[4] This made expensive COBRA coverage far more affordable to laid-off employees than in prior recessions. The increased COBRA enrollment was slightly better risk than COBRA in general; however, this incremental COBRA risk was still dramatically worse than the active employee risk. Companies' commercial blocks saw 50 or even a 100+ basis point medical loss ratio (MLR) increase from this tiny incremental membership due to the higher morbidity.

- In some parts of the country, individual enrollment increased as wealthier individuals sought to replace coverage lost due to early retirement or other separation.

- Medicaid enrollment increased as more individuals and families qualified for coverage. Medicaid expansion ushered in by the Patient Protection and Affordable Care Act (ACA) of 2010 further expanded dramatically Medicaid enrollment.

- Providers, who felt the financial pressure from greater levels of uncompensated care (due to increased uninsured patients), sought higher rates from commercial carriers.

As we asked these same actuaries about the next recession, they cited similarities and some noteworthy distinctions for their business:

- The claim cost dynamics mentioned previously are very likely to repeat.

    - Employees at real or perceived risk of layoff accelerate elective surgeries, pharmacy refills and physical exams.
    - Severity of conditions increase noticeably, particularly in mental health, substance abuse and stress-related conditions.

- Fewer small group companies will offer health insurance in the next recession. Further, some of the same forces that drove adverse selection in the last recession are likely to drive adverse selection again.

- COBRA enrollment is much less likely to spike since the ARRA benefits are no longer being offered, and subsidized public exchanges would be a good alternative to COBRA.

- As a result, enrollment on public exchanges is likely to increase significantly in the next recession. Unfortunately, with the elimination of the already-modest penalty for not obtaining health insurance, the incremental exchange enrollment is likely to be high risk.

- The number of uninsured are likely to rise dramatically (even greater than in the last recession) as those with better health morbidity are likely to forego enrollment on the exchange knowing they can elect coverage at the next open enrollment should their health deteriorate.

- Enrollments of dependents up to age 26 who can remain on their parent's plan are likely to increase.

- Given financial stress that states are already experiencing with Medicaid budgets, the next recession is likely to drive eligibility changes that will limit Medicaid enrollment growth. Also, morbidity is likely to grow worse as those with significant health needs retain eligibility, whereas those with better morbidity are more likely to lapse.

- Providers again are expected to experience increased uncompensated care and seek increased revenue from commercial lines. This problem is likely to be worse as a result of the ever-increasing share of lower-pay government business putting pressure on commercial business to offset government shortfalls.

A tightening of administrative expense budgets as a result of shrinking business volumes is also a concern. Chief actuaries should monitor staffing impacts in company operational areas, such as the claims shop, which can affect their visibility into company performance due to disrupted claim payments or premium collection patterns. Chief actuaries should also anticipate the potential demand to shrink actuarial staff just as company executives seek greater and faster insights from actuarial teams. The effective actuarial leader helps their staff increase productivity to match new demands while also persuading other executives to support appropriate actuarial staffing.

Increased actuarial work volumes occurred in the last recession, raising the stature of the actuaries significantly in the subsequent period. Staffing that followed grew dramatically due to a new appreciation for the contributions of the actuarial group and the massive new demand created by the ACA.

It is worth noting that the asset side of the balance sheet suffered some losses due to the mortgage crisis and the commensurate worthlessness of some mortgage-backed securities. Fannie Mae's stock, held by some carriers back in 2008, dropped by 97 percent from Jan. 1, 2008, to Nov. 1 of that year.[5] However, health carriers generally experienced less balance sheet disruption due to their shorter duration holdings as contrasted with life carriers.

ACTUARIAL ROLE IN A RECESSION

Recessions give actuaries great opportunities to shine. While executive leaders are frequently affected by market panic and disconcerting anecdotes, actuaries can bring great value when they accurately measure costs, prepare fact-based reports and initiate corrective actions. When actuaries do their job well, they minimize fearful speculation, thereby keeping company management from overreacting and taking actions that damage the company's long-term interest.

Simple, regularly produced reports are a good place to start. Fact-based discussions can be facilitated by publishing market employment statistics, benefit-adjusted trends, statistics about the average age of the company's membership, COBRA take-up rates and benefit buy-down activity (like the purchase of higher deductibles and higher copays).

Understanding financial results can be challenging in a recession. One needs to accurately measure benefit-adjusted medical cost trends and identify the issues (selection, inaccurate rate relativities, provider cost increases, new drugs, etc.) that are driving higher-than-expected costs and lower-than-expected premiums. The number of confounding issues to quantify is huge, including expected losses:

- If premium relativities are inaccurate since price could drop more than claims.
- On group contacts rated by rate relativities that do not vary as the employer lays off younger workers and employees add sick family members.
- From COBRA, adverse selection from many sources, more and accelerated claims, and provider fee increases.

Even though the work effort can be substantial, all of these impacts—and more—need to be quantified and explained in a way that keeps management from panicking and reacting in ways they will regret later. In that regard, it may be necessary to investigate rumored issues which are unlikely to be a driving problem in order to demonstrate that they are, in fact, irrelevant. Fighting fear with actuarial judgment is less successful than fighting with well-designed, data-rich analysis. Of course, actuarial staffing demand must be managed as well.

Table 2
Issues Actuaries Face and Steps to Resolve Them

Issue	Solutions		
Premium	Raise rates	Make sure benefit relativities are accurate	Maximize risk adjustment revenue
Underwriting	Tighten UW requirements	Make sure renewal rates meet pricing targets after rate negotiations are complete	
Claims initiatives	Revise claims edits	Increase the efficacy of subrogation efforts	
Medical cost initiatives	Renegotiate provider contracts	Introduce a narrow network product which allows customers to "buy down" large rate increases	Increase sales payments for profitable business
Lower sales costs	Cut out sales layers	Increase sales payments for profitable business	
Lower administrative costs	Lay off staff		

Actuaries are often at their best when they help the company take effective corrective actions. When times are tough, actuaries need to engage their colleagues' throughout the company—in underwriting, sales, claims, network management, pharmacy and medical affairs—to generate and evaluate improvement ideas. It is also important to stay in touch with actuarial consultants and actuaries from other companies. They will be facing similar issues. Learn from their experiences and keep an open mind to a wide range of possibilities (see Table 2).

Quantifying improvement efforts is critical. The first item management usually thinks about when faced with financial difficulty is laying off staff. But, of course, the Affordable Care Act requires claims to comprise 80-85 percent of the premium dollar,[6] creating a greater potential to identify claims-related cost savings than staffing reduction savings which, by definition, comprise no more than 15-20 percent of the premium dollar. In fact, this thought process often causes leaders to begin thinking of ways to retain staff critical to the implementation of improvement efforts.

Normally, cost reduction initiatives can be implemented more quickly than rate increases. It takes 12 to 24 months to detect a rate deficiency, secure rate approval from the applicable government entity, and adjust customer rates once contractual rate guarantees expire. Conversely, improving claims edits to identify duplicate or unbundled claims can be implemented retroactively if the claim has not yet been submitted for payment.

It is key to deal with financial difficulties without overreacting. Multi-market companies have geographies and products that experience a recession in very different ways, and consequently require tailored solutions. Even more importantly, all markets and products need accurate cost estimates that do not extrapolate onetime items over a long period and generate excessive rate calculations.

In a recession, routine actuarial work products for reserving, pricing and trend measurement become very important to senior management. There can emerge greater pressure on the actuaries from some business leaders to be conservative and from others to be optimistic.

Actuaries need to present best estimate numbers (as well as the reasonable potential range of outcomes) and continue to ensure that all work is of high quality. Standards for internal peer review need to be vigilantly observed even when work volume and time pressure is high. In addition, to maximize quality and prevent second-guessing, it is often wise to ask actuarial consultants to review potentially contentious work.

Successful leaders inspire their staff to step up during a recession by helping them understand the opportunity for critical contribution. Such leaders also protect their staff from unreasonable work demands through the hiring of extra staff, the use of more consultants, negotiated deadlines and fending off non-productive assignments. Managing the sales challenge is particularly important. Salespeople, actuaries and underwriters are under high stress as customers shop the market in response to large renewal rate increases. It is important that the actuarial team plan ahead for frequent requests for alternate benefits and multiple rounds of tense rate negotiation.

Of course, any variance from expectation (favorable or unfavorable) is cause for closer examination. On the other hand, when an insurance company experiences a negative financial variance, almost everyone in the company gets extremely interested in financial matters. Senior management wants to understand current results and they want to know what will happen next. It is a perfect time for actuaries to add value by preparing fact-based reports, and by providing regular forecasts with explanation of experience drivers. By doing so, actuaries can help the company focus on real improvement opportunities and create understanding about reasonable future results. Lastly, it's worth noting that there is a discernable pattern of interesting actuarial opportunity and promotion following company negative financial variance. By demonstrating excellent risk analysis and calm decision-making under pressure, actuaries can show themselves to be excellent candidates to lead.

Thanks to Ken Avner, FSA, MAAA; Puneet Budhiraja, ASA, MAAA, FCA; Bill Cashion, ASA, MAAA; Janice Knight, FSA, MAAA; Jim Srite, MAAA; and others for their contributions to this article.

Dave Nelson, FSA, MAAA, is a retired actuary in Madison, Wisconsin. He can be contacted at *dave.nelson.111@gmail.com.*

Keith Passwater, FSA, MAAA, is managing director at the health strategy and actuarial firm Pasco Advisers. He can be contacted at *Keith@PascoAdvisers.com.*

ENDNOTES

1 Li, Yun. This is Now the Longest U.S. Economic Expansion in History. *CNBC,* July 2, 2019. *https://www.cnbc.com/2019/07/02/this-is-now-the-longest-us-economic-expansion-in-history.html.* (Accessed Sept. 11, 2019.)

2 Saraiva, Catarina. 2019. U.S. Recession Odds Rise to 35%, Economists Say. *Financial Advisor,* Aug. 8, 2019. *https://www.fa-mag.com/news/is-a-us-recession-coming--odds-rise-to-35---economists-surveyed-50997.html.* (Accessed Sept. 11, 2019.)

3 Bureau of Labor Statistics. Databases, Tables & Calculators by Subject, From: 1949 To: 2019. *https://data.bls.gov/timeseries/LNS14000000.* (Accessed Aug. 8, 2019.)

4 American Benefits Group. Farewell to the ARRA COBRA Subsidy! *https://www.amben.com/article/items/farewell-to-the-arra-cobra-subsidy.html.* (Accessed Sept. 11, 2019.)

5 Yahoo! Finance. Federal National Mortgage Association (FNMA) Closing Price History. *https://finance.yahoo.com/quote/FNMA/history?period1=1199163600&period2=1225512000&interval=1d&filter=history&frequency=1d.* (Accessed Sept. 11, 2019.)

6 CMS, Medical Loss Ratio. *https://www.cms.gov/CCIIO/Programs-and-Initiatives/Health-Insurance-Market-Reforms/Medical-Loss-Ratio.html.* (Accessed August 19, 2019.)