

**Preliminary Issue Identification by Steven Ostlund regarding the  
NAIC Report Responding to Letter of April 12, 2010  
and Assignments to the NAIC made by PPACA**

**Caution**

In order to obtain the best technical input in the short time remaining before submitting recommendations to the NAIC leadership, I am releasing this draft outline of recommendations being considered. This outline has been developed based upon my personal interpretation of input the NAIC has received from state regulators, NAIC Funded Consumer Representatives, Members of Congress, industry representatives, and other interested parties. By focusing comment on these tentative recommendations, I hope to obtain further technical input for our sub-groups to help develop useful recommendations to the NAIC leadership. This draft represents only my evaluation of the stance of drafting groups on the best way to implement the language of the PPACA and is largely intended to focus consideration on issues to be decided. Any language below indicating a final position (such as “has determined”, “have decided”, etc.) is used for grammatical ease and clarity, and is not intended to indicate that a position has been decided. I have also used the term “we” when describing my interpretation of tentative positions.

**Overview**

The formula to determine the MLR for a company is based on the language of the PPACA

(Incurred Claims (IC) plus Expenses to Improve Quality (QI)) divided by

(Earned Premium (EP) less Government Taxes and Fees (GF)).

The elements of this formula are commonly used by insurance regulators, but the specific definitions vary according to the laws of each state and the different reports in which the elements appear. Each element will be further discussed and specifically defined in a later section within this document.

The aggregation level used for calculation and payment of MLR rebates should be by state, by licensed entity within a state, and by the three pools of medical coverage: Individual, small employer group, and large employer group. We are still considering if the small group pool and individual pool should be combined for calculating a rebate. We anticipate the process will involve only direct business and not be adjusted for reinsurance.

The specific recommendations for the definition of QI are being developed by the HCR Solvency (E) Subgroup chaired by the state of New York.

The rebate calculation must reflect any prior MLR rebates paid, as well as any rebates paid to policyholders under contractual experience rating arrangements.

## **Incurred Claims (IC)**

IC includes payments for clinical services and also includes adjustments for the impact of reserves, and statistical credibility. Each is further discussed in the following sections.

### Payments

Payments are derived from benefit (or claim) payments as defined within the statutory financial reporting blanks produced by the NAIC, which the states require to be used by companies licensed to issue insurance coverage. Some companies subject to the PPACA may not use such reporting forms, but we presume all such companies do produce financial reports with similar definitions. Generally we believe these definitions include the criterion that a claim payment is a payment to a licensed medical individual or entity. Payments will generally be allocated to their incurral period, rather than the date when they were paid.

### Reserves

Because PPACA uses the word “incurred”, we adjust these payments, as recommended within the NAIC regulatory reports, for reserves, which are associated with accurate allocation of these payments to the time period to be used for the calculation.

Reserves to be used in the calculation include those referenced on lines 1, 2, 3, and 4 of Part 2D of the Underwriting and Experience Exhibit within the Health Blank and similar items referenced in the other Blanks used by health insurers. These items are defined in the Annual Statement Instructions and in various NAIC models and manuals. Categories of reserves include the following:

- 1) Claim reserves reflect the timing difference between when a claim obligation has occurred due to an insured receiving clinical services and when the reimbursement for that service is paid by the insurer. Claim reserves are also referred to as claim liabilities or “Incurred but not Paid” amounts (IBNP).
- 2) Unearned premium reserves allocate premiums from a paid basis to the earned basis as stated in the PPACA. They are included in the EP calculation, not in the IC calculation.
- 3) Policy reserves reflect timing differences between payment of premium and claims that are associated with the design of the policy. Most commonly, these reserves are used in connection with policy design where premiums are level or increase moderately over several years, but claims are expected to be much higher in the later years
- 4) Experience rating reserves reflect timing differences associated the return of payments of premium under a contractual obligation. We recognize that if an insurer has contractually agreed to a rebate of premium, that PPACA rebates should be made only in the amount of the excess over the PPACA calculation. The contractual rebate program should be considered under PPACA as essentially a preliminary installment of the rebate payment. In the absence of such consideration, such private payments

would represent double payments, and the result would be an unfair and nonsensical disruption of the market, clearly not intended by the PPACA.

Similarly, companies are required to reflect in their financial statements the liability associated with future contractual obligations, which includes the obligation to refund premium under the MLR rebate program. The company thus sets up a reserve for the current obligation for such MLR rebate to be paid in the future on their balance sheet, and that reserve should be reflected within this line.

- 5) Finally, other reserves may be associated with properly identifying the obligations of the company to provide the clinical services anticipated by the insurance contract, and the financial statements provide a line to identify such liabilities. The MLR calculation should exclude such other reserves that are not specifically associated with the payment for clinical services.

### **Credibility and Pooling**

In order to avoid disruption of the market and an unreasonable or nonsensical result in some cases, pooling of large claims will be included within the MLR calculation. Because we are recommending aggregation at the state level, the next level up to accomplish this pooling will be at the national level. The amount of any claim in excess of a specified maximum will be substituted by the proportionate share of all such claims nationwide for the entity in IC.

The credibility factors should be based on a “more likely than not” level to reflect the statistical likelihood of the calculated MLR to reflect experience over time. The factors should be developed to reflect the underlying true experience on a “more likely than not” basis, such as that associated with a one-sided confidence interval reflecting 50% confidence. While this will alleviate some of the problems associated with lack of credibility, we recognize that the actual MLR for a company will exceed the MLR dictated in the law and create the potential for the difficulties described in the CBO report identifying an acceptable MLR target. We intend to recommend a table of factors that will minimize that risk.

One consequence of this credibility approach will be that some enrollees belonging to a non-credible pool will never be eligible for an MLR rebate. We are exploring options to address this issue, such as interstate pooling, or proper prospective. Another approach to avoid the loss of opportunity to receive a rebate by an enrollee would have credibility adjustments accumulated over time. Thus the credibility adjustment will not eliminate the potential rebate, but rather defer it.

### **Earned Premium (EP)**

Within the EP section discussion I consider not only the paid premium and premium reserves, but also the tax deductions incorporated into the calculation by PPACA.

Paid Premium

We will rely upon definitions of premium payments as contained in the AP&P manual of the NAIC, or such similar document of a similar body for entities regulated by other than state insurance departments. Paid premium entering the MLR rebate calculation will include all such payments made during a calendar year.

#### Reserves

Since payments received during a calendar year may relate to other accounting periods, Congress has directed us to use earned premium. The primary reserve used to adjust premium to an earned basis is the unearned premium reserve. We will use a change in reserve as of year-end as the adjustment to paid premium. We recognize that many insurance experts believe that policy reserves should be an adjustment of premium rather than an adjustment of claims. Current NAIC accounting practice has policy reserves adjusting claims, and that is the position we are taking. Our evaluation of the impact of an alternative position suggests it is minimal for the products subject to the MLR rebate calculation, and that such policy reserves are in any case not a common element of the product design for such products.

Similarly a case could be made for the adjustment of premium for the MLR rebate and other return of premium programs. Our evaluation of the impact of such an interpretation leads us to the conclusion this adjustment is best made to IC. Unintended excess MLR rebates would occur if these rebates were not reflected in the numerator.

#### Taxes and Fees

I believe that any tax, fee or assessment paid by a company to a US governmental unit should be included in the deduction from EP in the MLR calculation. Thus local, state, and federal taxes would be included, while taxes to a foreign entity would not. I also believe property taxes and investment related taxes should be included, although an argument might be advanced to exclude them. This category could also include payments for "services" of an insurance department, e.g. examinations. However all punitive payments would be excluded from taxes, such as fines, or compensation required to be paid after a finding of wrongdoing.

### **Calculation Procedures**

We believe the calculation should be based upon calendar year experience. A primary advantage to identifying a plan year other than calendar year would be to provide payments to enrollees leaving at the end of a plan year prior to the end of a calendar year. We believe such enrollees can be identified and provided a rebate through a check. To reduce additional administrative costs and thus provide more value to the enrollee, we are recommending MLR rebates be provided to enrollees as rate credits for those continuing within a plan, and via check to those having left a plan prior to payment. We believe the responsibility of the company is to provide the MLR rebate to the policyholder and for the policyholder to distribute such rebates to certificate holders as appropriate.

The calculation of MLR rebates should incorporate consideration of prior MLR rebate payments or accruals, contractual return of premium payments or accruals, and adjustments to reflect incomplete MLR rebate payments.

The calculation of MLR rebates should be performed as March 31, based upon the prior calendar year and distribution should be made prior to June 30.

### **Final Cautionary Note**

This document was intended to solicit technical input to the decision process and focus discussion on issues requiring resolution prior to a recommendation being submitted by the NAIC to the Secretary. Many of these issues have been identified using words which seem to indicate a position on the issue has been taken. This is not correct. Most of the issues require further evaluation and input is solicited both in favor of and opposed to such positions. I recognize this is awkward, but under the time frame available I believe it is more important to expose these issues than to first generate consensus within the working groups before exposure.