# Cost-sharing reduction subsidies: Requesting adjustments to the advance payment formula to reduce cash flow strain

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Many insurers participating in the individual health insurance marketplace are experiencing significant cash-flow strain. One area contributing to this strain is the administration of the cost-sharing reduction (CSR) program. The Patient Protection and Affordable Care Act (ACA) includes a program in which the federal government shares in the out-of-pocket expenses for low-income individuals.

To administer this program, the U.S. Department of Health and Human Services (HHS) provides advance payments to issuers using a default formula and then provides for a reconciliation after the completion of the plan year. During the plan year, if an issuer can demonstrate that the advance payment formula will produce a "substantially different" result from the actual CSR paid on behalf of low-income members, the issuer may request adjustment to the default formula payment. This demonstration must be supported by an actuarial certification. This paper explores the advance payment formula and some of the assumptions that could cause "substantially different" results that might negatively affect an issuer's cash flow. Early 2016 is a good time to look at the consistency of expected advance payments to expected CSR exposure to see if requesting an adjusted payment will help cash-flow strain.

## BACKGROUND

To provide financial help with the out-of-pocket expenses for low-income individuals, HHS requires the issuer of any silver qualified health plan (QHP) to also offer CSR silver plan alternatives. These alternative silver plans have higher actuarial values (AV) than the standard silver plan. The issuer must offer a 73%, 87%, and 94% AV plan for each standard silver plan offered. Another set of variants, which is outside the scope of this paper, is the zero and limited cost-sharing plans available to certain Native Americans.

HHS subsidizes the additional cost sharing between the standard silver plan and the CSR silver plans. This subsidy is paid to the issuer using an advance payment formula during the plan year, followed by a settlement after the completion of the plan year. If, during a plan year, the issuer can demonstrate that the default advance payment formula will produce a "substantially different" result from the actual CSR paid on behalf of low-income members, HHS has the authority to approve formula payment changes under section 156.430(b)(2)[1] of the federal regulations:

> *HHS may adjust the advance payment amount for a particular QHP during the benefit year if the QHP issuer provides evidence, certified by a member of the American Academy of Actuaries in accordance with generally accepted actuarial principles and methodologies, that the advance payments for a particular QHP are likely to be substantially different than the cost-sharing reduction amounts that the QHP provides that will be reimbursed by HHS.*

Another Milliman paper[2] provides simulations to show that even under a perfect scenario, where the cumulative year-end HHS advance payment is equal to the cumulative year-end actual incurred CSR, there will be differences during the year, such that the actual incurred CSR in a given quarter is often higher in the early quarters and lower in the latter quarters than the HHS advance payment. In this paper, we focus on those scenarios where the cumulative year-end HHS advance payment is not equal to the cumulative year-end actual incurred CSR. It also discusses components of the formula where deviations from the default assumptions could potentially be considered "substantial" and cause an issuer to request a revised advance payment.

This paper assumes that the issuer is using the standard methodology. The standard methodology requires claims to be adjudicated under both the standard silver plan cost sharing and the actual alternative silver plan cost sharing. Prior to 2017, issuers can use either one of two simplified methodologies or the standard methodology in the settlement process. There is evidence that the simplified methodology may under-compensate issuers when credibility thresholds are not met.[3]

1 Electronic Code of Federal Regulation. Title 45: Public Welfare. U.S. Government Publishing Office. Retrieved November 11, 2015, from http://www.ecfr.gov/cgi-bin/text-idx?SID=571ec0e454b0a63821e23c4fee2a5f70&mc=true&node=se45.1.156_1430&rgn=div8.

2 Kolli, S. & Wright, A. (September 2015). CSR Subsidies: Intra-Year Emergence. Milliman healthcare reform briefing paper. Retrieved November 11, 2015, from http://us.milliman.com/insight/2015/CSR-subsidies-Intra-year-emergence/.

3 This Milliman paper gives an overview of CSR subsidies and the financial impact to plans based on the methodology selected. Perlman, D. & Siegel, J. (November 2014). Cost-Sharing Reduction Subsidies: Financial Impact of the Simplified Methodology. Milliman healthcare reform briefing paper. Retrieved November 11, 2015, from http://us.milliman.com/uploadedFiles/insight/2014/csr-subsidies.pdf.

It is also important to note that the CSR advance payment formula was updated between the 2014 calendar year and the 2015 calendar year. While this update was a significant improvement for many issuers, there are still several reasons why the updated advance payment could vary substantially from actual incurred CSRs for a given issuer.

### HOW DOES THE ADVANCE PAYMENT FORMULA WORK?[4]

The advance payment formula starts with the member-level premium specific to each CSR plan. The total member premium is the sum of the premium that the member pays and the advanced premium tax credit paid on behalf of that member by the federal government. This total member premium is the same as the standard silver plan premium. This premium is multiplied by the following factors:

a. 0.80 (for an assumed 80% claim loss ratio)

b. 100/70 (to convert assumed paid claims to allowed claims at the silver level)

c. An induced utilization factor that varies by plan (see Figure 1)

d. A factor to capture the higher AV of the CSR plan relative to the standard silver plan (hereafter called the "AV spread" or simply "spread," see Figure 1)

**FIGURE 1: FACTORS THAT VARY BY CSR PLAN**

| | SILVER 73% | SILVER 87% | SILVER 94% |
|---|---|---|---|
| c) Induced Utilization | 1.00 | 1.12 | 1.12 |
| d) AV Spread | 0.03 | 0.17 | 0.24 |

The formula can be simplified into two parts: one that attempts to predict the expected amount of allowed claims and another that attempts to predict the cost-sharing difference (Figure 2).

**FIGURE 2: SUMMARY OF ADVANCE PAYMENT FORMULA**

| 1 | | 2 | | | | |
|---|---|---|---|---|---|---|
| Predict Allowed Claims (Factors a, b, and c) | X | Predict Cost-sharing Difference (Factor d) | X | Gross Member Premium | = | Advance Payment |

The result is the expected level of cost sharing in excess of what the issuer would have paid if the CSR members enrolled in standard silver plan benefits. At settlement time, these payments are compared with the actual cost-sharing difference to determine the settlement amount.

Underlying the advance payment formula are general assumptions, including:

1. The issuer's gross incurred loss ratio (claims/premium) is 80%.

2. The standard silver plan has an AV of 0.70.

3. The spread between the cost sharing of the standard silver plans and the CSR plans is consistent with the spread between the AV level of 0.70 for the standard silver plan and 0.73, 0.87, and 0.94 for the CSR plans.

4. CSR membership has an average market risk level.

Where the composite of these assumptions is inconsistent with the issuer's experience, issuers have seen significant differences between the CSR advance payment formula results and the issuer's actual results. Although the settlement process ultimately resolves this difference, if the expected magnitude during the plan year can be shown to be "substantial," the federal regulation allows HHS to adjust the advance payment. "Substantial" is not defined and is left to the actuary to support and certify.

### WHAT ARE THE CAUSES OF "SUBSTANTIAL" DEVIATIONS?

When actual experience deviates from the general assumptions used in the advance payment formula, it could result in a substantial variance to the appropriate advance payment for an issuer. While underpayment throughout the plan year (and hence an interest-free loan to the federal government) is a concern, deviations can go in either direction. An overpayment throughout the year could also have negative consequences if the issuer has not accrued a liability in anticipation of repayment. Although each issuer's situation is different, some of the common areas that can help explain the need for a default formula payment adjustment include:

#### 1. Actual incurred loss ratio (claims/premium) does not equal 80%

The 80% factor is used in the formula to convert member-level premiums to incurred claims. For this purpose, the incurred loss ratio is simply defined as claims divided by premium. To the extent that the issuer has pricing targets and/or experience that deviates from 80%, there will be a variance between the CSR advance payment formula and actual results. Some issues to consider when developing the simplified loss ratio to compare to the 80% formula assumption include:

- Reinsurance: The issuer's premium level assumes some level of federal reinsurance recoverable in 2014 to 2016. However, the difference in cost sharing between a silver plan and a CSR variant is not affected by reinsurance. As a result, the advance payment default formula should underestimate the CSR difference, all else equal. During the 2014-2016 period, the advance payment loss ratio needs to be developed as if there were no federal reinsurance program.

4 Federal Register (March 11, 2014). Patient Protection and Affordable Care Act; HHS Notice of Benefit and Payment Parameters for 2015. Section III.E Part 156.1.d describes the CSR Advance Payment factors. Retrieved December 4, 2015, from https://www.federalregister.gov/articles/2014/03/11/2014-05052/patient-protection-and-affordable-care-act-hhs-notice-of-benefit-and-payment-parameters-for-2015.

- Risk adjustment: The issuer's premium is based on its estimate of the market average risk level. However, claim payments subject to CSRs will be on the risk level of the issuer's actual members.
  - When pricing, the issuer incorporates a risk adjustment payment or receivable to bring the premium level in the URRT to the market average risk level. The expected loss ratio for the advance payment should be calculated while ignoring the risk adjustment payable or receivable.
  - The issuer should also consider if the emerging risk level is better or worse than that originally assumed in pricing.
  - Ultimately, the issuer should estimate the expected plan year loss ratio for its emerging risk level, assuming no risk adjustment payable or receivable.
- Actual to expected claims level: If actual claims experience is materially different from the claims levels assumed in pricing, then the advance payment could vary substantially from what is necessary to cover the cost-sharing subsidy throughout the year. Claims experience deviation from pricing can be caused by variances in any of the many underlying pricing assumptions, including but not limited to trend, provider network discounts, service utilization, out-of-network utilization, etc.

Pulling these data points together to provide an updated expected loss ratio compared with the default 80% assumption will help to support an expected loss ratio deviation for the plan year.

### 2. The actual allowed claims level is inconsistent with the assumed 70% AV assumption

The CSR advance payment formula assumes that all standard silver plans have an AV level of 0.70. However, the standard silver plan is allowed a de minimis amount of +/-2%. So, for example, if the issuer is using a standard silver plan AV of 0.68, then the estimate of allowed claims will be understated using the default formula factor of 100/70.

In addition to assuming fixed AV values, the CSR advance payment formula assumes that the paid-to-allowed claim ratio is consistent with the AV level. Milliman research[5] indicates that there can be significant variations between the paid-to-allowed ratio and the AV level for numerous reasons. Because the AV assumes that all utilization is with in-network providers, out-of-network benefits may also contribute to a deviation between the paid-to-allowed ratio and the AV. If the actuary has support for a material deviation between the paid-to-allowed ratio and the AV, this can be used to support further adjustments.

### 3. The actual spread between the cost sharing of the standard silver plans and the CSR variations for an issuer is inconsistent with the assumed spread in the formula

The CSR advance payment formula assumes that all plans have the same AV levels. Specifically, it assumes that the AV level of the standard silver plan is 0.70 and the AV levels of the CSR plans are 0.73, 0.87, and 0.94. Because the standard plan is allowed a de minimis amount of +/-2% and the CSR plans are allowed a de minimis amount of +/-1%, the formula can lose up to 3% of the spread if the issuer is marketing plans at the extremes. For example, if the issuer's silver standard plan has an AV of 0.68 and its CSR 73% plan has an AV of 0.74, the excess cost-sharing factor would need to be 0.06 rather than 0.03, resulting in about one-half the needed payment for this CSR plan.

Additionally, as previously described, if the paid-to-allowed claim ratio is inconsistent with the AV level, there can be even more of an issue with the fixed spread used in the default formula.

### 4. The CSR membership has an average market risk level

As part of the formula, there is an induced utilization factor of 1.12 for the 87% and 94% plans to account for the additional utilization that is normal when cost sharing is decreased. Many issuers have experienced significantly higher utilization in the 87% and 94% plans than the additional 12% assumed. When looking into this further, it is clear that, in some cases, either the risk level and/or the utilization of the CSR members is significantly higher than the market level. Mathematically, the cause of the higher claims levels for CSR members is irrelevant. Either one will cause higher actual CSR payments relative to the default formula. Although the risk adjustment process is expected to address the extra cost of high-risk members in the 87% and 94% CSR variants, it does not cover the additional CSR payments that will also result. If the actuary notices an increasing deviation as CSR actuarial values increase, then a review of the morbidity risk level by CSR plan may be warranted. Because this component of the advance payment varies not only by issuer but also by geographic area within the same issuer, there is not a one-size-fits-all test for this deviation. Some of the issues that may cause these differences by issuer may include such things as the state's transitional policy, the issuer's network, the issuer's market position, and the issuer's market share.

The average market risk assumption can create significant deviation for issuers that are experiencing an increasing morbidity risk as the CSR variant AV increases, given that the largest deviation in risk from the market risk level will typically be in the 94% plan, and the 94% plan often has the most membership volume as well as the highest CSR payment (i.e., the 0.24 factor shown in Figure 1).

### EXAMPLES

Figure 3 illustrates examples of how actual experience can deviate from the default formula and the resulting financial impact. The numbers in bold are assumptions that change for each scenario. The columns are not cumulative but rather are all independent. The illustration is based on the 94% CSR variant because this plan has the largest AV spread and typically has the most membership. We assume in all examples that the reinsurance impact will be common in all situations and to all carriers. As with all the assumptions, the magnitude of the reinsurance assumption can vary by issuer. Finally, while most of these examples show a negative impact to cash flow, we reiterate that actual experience relative to the formula assumptions can create both positive and negative cash-flow impacts.

5 This Milliman paper gives an overview of the variance of the AV of plans compared with the benefit richness. Alcocer, P. (October 2015). Actuarial Value, Benefit Richness, and the Implications for Consumers. Retrieved November 1, 2015, from http://us.milliman.com/insight/2015/Actuarial-value--benefit-richness--and-the-implications-for-consumers/.

**FIGURE 3 : IMPACT OF VARIOUS ASSUMPTIONS ON CSR PAYMENTS USING A 94% CSR PLAN**

| | | LOSS RATIO RELATED IMPACTS | | | AV SPREAD RELATED IMPACTS | | |
|---|---|---|---|---|---|---|---|
| | DEFAULT ADVANCE PAYMENT FORMULA | REINSURANCE[i] | ACTUAL RISK VS. MARKET AVERAGE[ii] | IMPACT OF CLAIMS EXPERIENCE[iii] | 68% SILVER AV[iv] | LARGER PAID-TO-ALLOWED SPREAD[v] | CSR UTILIZATION 10% HIGHER[vi] |
| Member Monthly Gross Premium | $250 | $250 | $250 | $250 | $250 | $250 | $250 |
| a) Loss ratio | 0.8 | **0.84** | **0.756** | **0.924** | 0.84 | 0.84 | 0.84 |
| b) Allowed claims | 1.43 | 1.43 | 1.43 | 1.43 | **1.47** | **1.52** | 1.43 |
| c) Induced utilization | 1.12 | 1.12 | 1.12 | 1.12 | 1.12 | 1.12 | **1.22** |
| Estimate of Allowed Claims | $320 | $336 | $302 | $370 | $346 | $356 | $366 |
| d) Excess cost sharing | 0.24 | 0.24 | 0.24 | 0.24 | **0.26** | **0.29** | 0.24 |
| CSR Payment | $76.80 | $80.64 | $72.58 | $88.70 | $89.93 | $103.35 | $87.84 |
| Overpayment/ (Underpayment) | | ($3.84) | $4.22 | ($11.90) | ($13.13) | ($26.55) | ($11.04) |
| % of CSR Payment | | -5.0% | 5.5% | -15.5% | -17.1% | -34.6% | -14.4% |

i Assumes federal reinsurance impact of 5% of claim costs.

ii Assumes reinsurance impact and issuer is paying 10% of incurred claims in risk adjustment.

iii Assumes reinsurance impact and claims experience is 10% higher than expected.

iv Assumes reinsurance impact and silver plan AV is 68%.

v Assumes reinsurance impact and paid-to-allowed ratio spread between standard silver and 94% CSR plan is 5% greater than AV spread.

vi Assumes that CSR utilization is 10 points higher than induced utilization factor of 1.12 in default formula.

## CONCLUSION

There can be a substantial difference in results between the default CSR advance payment formula and actual CSR results. Because many of the provisions of the ACA have settlements after the completion of the policy year (i.e., risk adjustment, risk corridor, reinsurance, and CSR settlements), estimating quarterly and annual accruals, as well as dealing with the timing of cash flows, has added a new level of complexity to managing an issuer's financials. The issuer needs to be aware if there is a material deviation between the CSR advance payment formula and projected actual payments for accurate reporting in quarterly and annual financial statements. If the issuer can demonstrate during the plan year that a mismatch is "substantially different," then it is in its best interest to ask HHS for a revised payment. A request for a revised payment formula requires a supporting actuarial certification.

## LIMITATIONS

This report has been prepared to discuss certain aspects of the CSR program. The analyses and observations discuss specific areas where the default formula assumptions may cause deviations for a specific issuer. To the extent that the specific assumptions deviate in opposite or overlapping directions, the composite results may differ from expectations. Because cost sharing within a particular issuer's benefit plans is more complicated than any simple default formula based on expected assumptions can duplicate, we recommend more detailed internal modeling of the particular issuer's block of business for financial reporting purposes.

Differences between the results of a formula derived from the adjustments described and actual amounts depend on the extent to which future experience conforms to the assumptions. To the extent that there are differences, results will be different from those cited above.

The discussion in this paper represents our best interpretation of the regulations to date by HHS. These regulations continue to evolve. As of this writing, we have not seen a template for how issuers will request modification of the default CSR advance payment formula, only that an actuarial certification is required with such a request.

### CONTACT

If you have any questions or comments on this document, please contact your local Milliman consultant or one of the authors (Esther Blount, Frederick Busch, and Scott Weltz), who are consulting actuaries with Milliman. The authors are members of the American Academy of Actuaries and meet the qualifications standards of the American Academy of Actuaries to render the actuarial opinion contained herein.

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