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Risk adjustment plus risk corridors: Offsetting impact

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INTRODUCTION

The Patient Protection and Affordable Care Act (ACA), enacted in March 2010, implemented three premium stabilization programs—the risk adjustment program, the transitional reinsurance program, and risk corridors, the so-called 3Rs—to mitigate risks to insurers during the transition to new health insurance rules in the individual and small group markets. While there is uncertainty around the receivables from the transitional reinsurance program for 2014, most is centered around whether or not the coinsurance percent will be increased and/or the attachment point lowered. For the purposes of this paper, we are assuming that the reinsurance claims are payable based on the assumptions shown in the Assumptions sections in this report. This paper will focus on the other two programs—specifically, the risk adjustment program and risk corridors. The risk adjustment program, which is a permanent premium stabilization program, applies to non-grandfathered ACA plans offered inside and outside each state's exchange. Risk corridors, a temporary premium stabilization program applicable from 2014 to 2016, apply to qualified health plans (QHPs) and to certain plans that are substantially similar to QHPs in the individual and small group markets.

The accounting guidance from the National Association of Insurance Commissioners (NAIC) and regulators on admissibility of accruals for the risk adjustment and risk corridor receivables was uncertain until December 2014. The latest guidance from the NAIC¹ shows receivables for risk adjusters and risk corridors as admissible for statutory reporting as long as the amounts are determined collectible. There has been uncertainty around whether states and auditors will allow carriers to record receivables for risk adjusters and risk corridors and, if these estimates are allowed, the extent of conservatism required and/or allowed. To add to this uncertainty, the “Cromnibus” spending bill signed by the president on December 16, 2014, suggests that only the funds from risk corridor collections (from insurers that had good experience) can be used to make risk corridor payments (to insurers that had bad experience). This act will come into play to the extent that there is a shortfall in the risk corridor funds collected relative to those that are owed to insurers. According to a Citi Report² issued in December 2014, most insurers in the surveyed plans recorded a risk corridor receivable. Very few plans recorded a payable and all recorded payables were small. The accounting guidance and rules surrounding risk corridors are continually evolving. This report reflects our best understanding of the guidance and rules to date. To the extent that these rules change in the future, some of the conclusions in this report may no longer hold.

This paper has been prepared to assist actuaries in considering the combined impact of these programs on a company's balance sheet for year-end 2014, the first year these programs are applicable. There is significant uncertainty in the estimates of the 3Rs and their impact on the financial statement. The main focus of this paper will be on the offsetting interactions of the risk adjustment program and risk corridors (assuming an issuer's plans qualify for both risk adjustment and risk corridor programs). Specifically, how much does one program offset the other? By recognizing these offsetting impacts, the appointed actuary may be more confident with determining liabilities to be included in the annual statement and classification of the actuarial opinion. Based on the hypothetical scenarios we ran, the range of impact on balance sheets from potential variability of the combined effect of risk adjuster and risk corridor payments is substantially smaller compared to the variability of either the risk adjuster or risk corridors by themselves.

1 National Association of Insurance Commissioners (December 16, 2014). NAIC Takes Action on Insurance Priorities. Retrieved January 21, 2015, from http://www.naic.org/Releases/2014_docs/naic_takes_action_on_insurance_priorities.htm

2 “Managed Care: What You See Depends On What You Are Looking For—Analyzing The Industry's Individual 3R Accruals Through 3Q 2014” (December 17, 2014).

BACKGROUND

Insurance company statutory annual statements are due March 1. The exact risk adjustment program and risk corridor payables/receivables will not be known until several months later. When the annual statement is due, insurers will only have estimates of the 3Rs available.

The risk adjustment program was established to level the playing field with respect to the health status of enrollees because premiums in the ACA non-grandfathered market do not vary by health status. In theory, the risk adjustment program should be taking gains from covering the healthy enrollees to subsidize losses from covering the less healthy enrollees. As outlined in the article “When Adverse Selection Isn’t,”³ there is significant variability in trying to estimate the risk of an issuer in relation to the market. Because the risk adjustment program is set up to be revenue-neutral, there is not much uncertainty regarding whether the payment will be made, but rather what the amount of the payment will be.

In contrast to the risk adjustment program, there is uncertainty whether the full risk corridor payment will be made to carriers whose experience results in a risk corridor receivable. A recently released paper, “Risk Corridors Episode IV: No New Hope,”⁴ discusses the impact of recent action by Congress to essentially require budget neutrality on risk corridors for fiscal year 2015. Because of this, there is concern in the insurance industry that the risk corridors won’t be paid out in full. Additionally, one of the components of the risk corridor formula used to determine the risk corridor payable/receivable is the payable/receivable from the risk adjustment program; as such, an additional aspect of difficulty in estimating the risk corridor is caused by the difficulty in estimating risk adjusters. The article “Risk Corridors under the Affordable Care Act—A Bridge Over Troubled Waters, but the Devil’s in the Details”⁵ does an excellent job of reviewing the basics of the risk corridor calculation. As stated in the article, “The goal of the risk corridor program is to protect health insurance issuers against pricing uncertainty of their plans, temporarily dampening gains and losses in a risk-sharing arrangement between issuers and the federal government.”

To illustrate the offsetting impacts of the risk adjustment program and risk corridor estimates, we ran several hypothetical scenarios, varying assumptions for premium, administrative expenses, claims, reinsurance receivables, risk adjustment receivables/payables, and risk corridor receivables/payables. From these scenarios we focused on two items:

- What is the impact on the gain from operations under different claims scenarios for various risk adjustment and risk corridor estimates?
- For a given range of risk adjustment variability as a percent of claims, what is the reduction in the variability of the range when the risk adjustment program is considered together with risk corridors?

RESULTS

What is the impact on the gain from operations?

We considered multiple scenarios—varying premiums, administrative expenses, reinsurance, risk adjustment, and risk corridors—in our analysis. To demonstrate the impact on the gains from operations graphically, we only used scenarios based on the following assumptions:

- \$50 million in 2014 premium.
- 20% of premium in profit and administrative expenses.
- 15% of claims in reinsurance recoveries.
- Four scenarios of incurred claims (net of reinsurance) varying between 50% and 200% of premium.
- Risk adjustment program estimates as a percent of claims varying from a payable of 50% to a receivable of 50%. The payment/receivable from the risk adjustment program is based on a company’s risk score relative to the market. Because a risk adjustment of 0% correlates with the market average, the extreme ends of the range are more likely to occur with small plans than large plans.

3 Siegel, J. & Petroske, J. (December 2013). When Adverse Selection Isn’t: Which Members Are Likely to Be Profitable (or not) in Markets Regulated by the ACA. Retrieved January 14, 2015, from <http://www.milliman.com/uploadedFiles/insight/2013/adverse-selection-aca.pdf>.

4 Norris, D., Perlman, D., & Leida, H. (December 2014). Risk Corridors Episode IV: No New Hope. Retrieved January 14, 2015, from <http://www.milliman.com/uploadedFiles/insight/2014/risk-corridors-no-new-hope.pdf>.

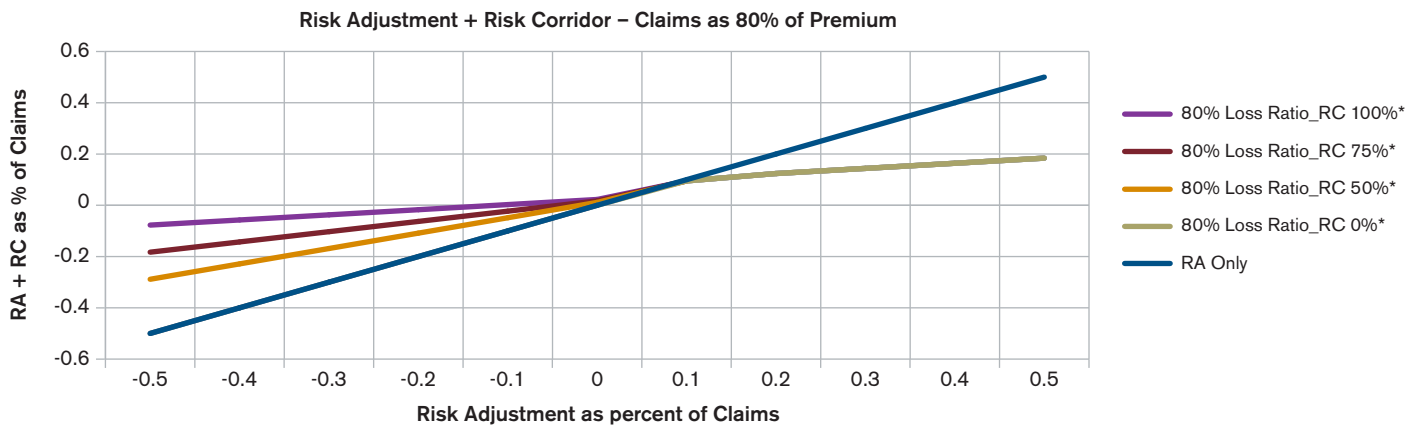
5 Norris, D., Van der Heijde, M., & Leida, H. (October 2013). Risk Corridors Under the Affordable Care Act—A Bridge Over Troubled Waters, but the Devil’s in the Details. Society of Actuaries, Health Watch, no. 73: 1, 5. Retrieved January 14, 2015, from <http://milliman.aiprx.com/uploadedFiles/insight/2013/Risk-corridors-under-the-ACA.pdf>.

- Risk corridor estimates are based on the risk corridor formula, but we included a dampening factor on receivables to account for scenarios where the payout received is not the full estimate from the formula. We considered four scenarios: 100% payout, 75% payout, 50% payout, or 0% payout.
- The scenarios do not include the impact of any medical loss ratio (MLR) rebates.

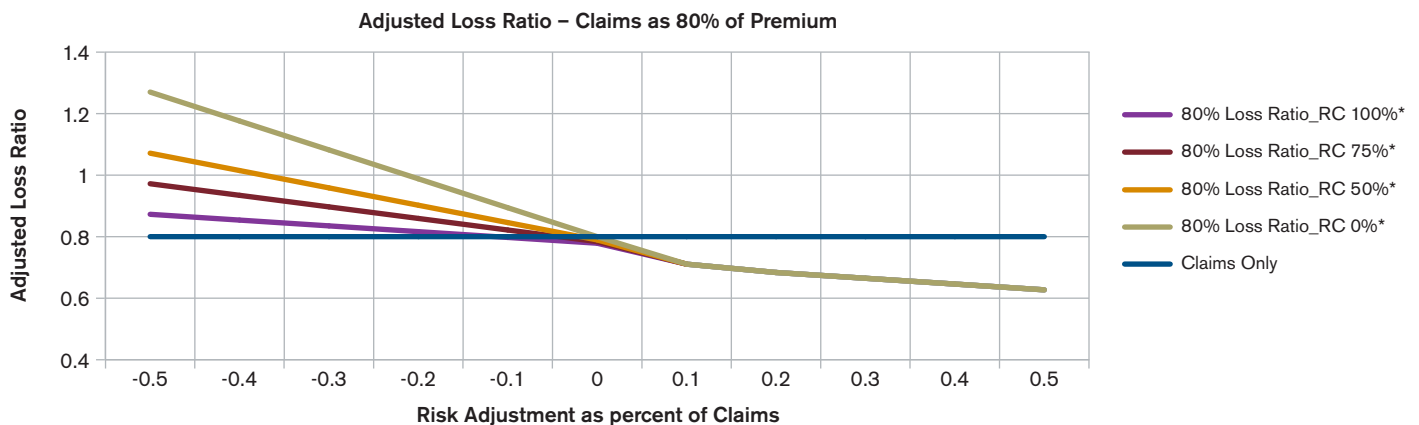
While a company's incurred claims and risk adjustment receivable/payable are not independent, in order to evaluate the range of impact from different risk adjustment and risk corridor estimates, we have treated them as independent in the hypothetical scenarios. For example, in the 50% incurred claims scenario we have included the full range of risk adjustment, even though a risk adjustment receivable of 50% of claims is very unlikely if claims are only 50% of premium.

The figures below show a graphical summary for the scenarios mentioned above. We have included a separate set of graphs for each of the four incurred claims scenarios. The top graph in each scenario compares the amount of the risk adjustment only with the risk adjustment plus risk corridor amount for each of the risk adjustment scenarios, accounting for a potentially reduced payout on risk corridor receivables. The bottom graph shows the adjusted loss ratio after considering the impact of claims, reinsurance, risk adjustment, and risk corridor estimates. The x-axis on both the top and bottom graphs shows the risk adjuster ranging from a payment of 50% of claims on the left to a receivable of 50% of claims to the right. The y-axis on the top graph shows the combined risk adjuster and risk corridor as a percentage of claims, with negatives indicating a net payable and positives indicating a net receivable. The y-axis on the bottom graph shows an adjusted loss ratio. The adjusted loss ratio is not the federal MLR and does not include any medical loss ratio rebates. See Figure 7 for a sample adjusted loss ratio calculation. For all risk corridor scenarios, the dampening was only applied to receivables. In other words, only the receivable payments are dampened—the payables are assumed to be paid out at 100%.

FIGURE 1: NET CLAIMS AS 80% OF PREMIUM



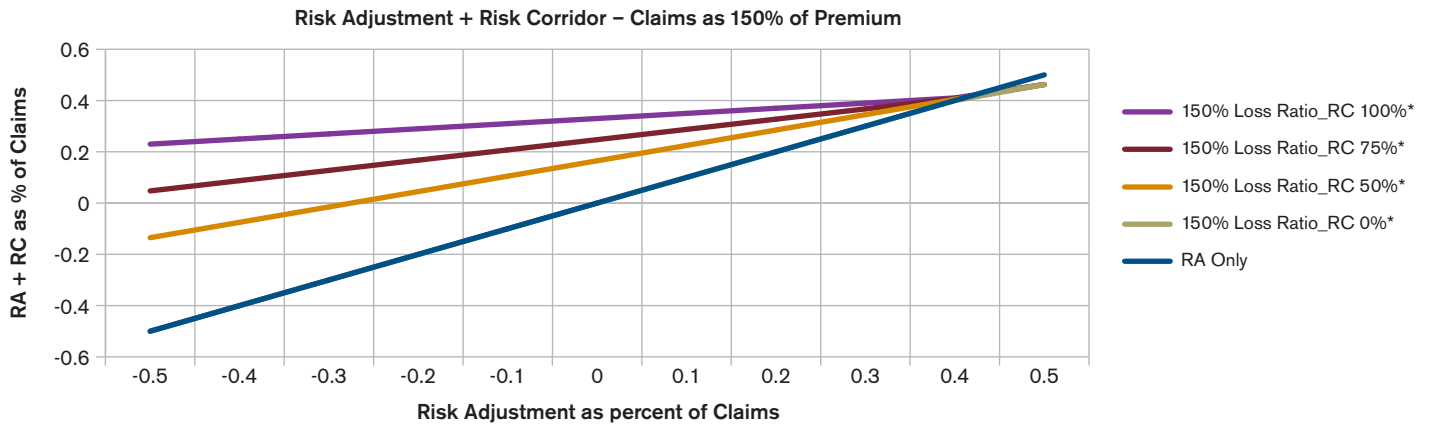
* All risk corridor payables are paid at 100%. Only the risk corridor receivables are impacted by the dampening factor.



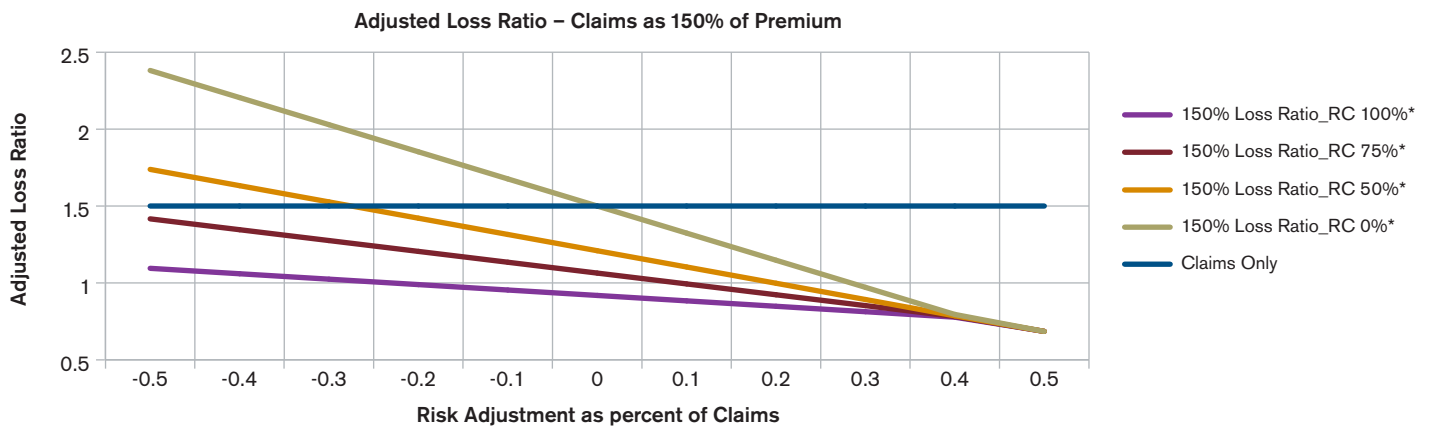
* All risk corridor payables are paid at 100%. Only the risk corridor receivables are impacted by the dampening factor.

Under the target pricing loss ratio of 80%, the risk corridor will be a receivable in about half of the scenarios. When paid out at 100%, the net variability in the risk adjusters and risk corridors as a percent of claims ranges from -8% to 18% compared with the risk adjusters by themselves, which range from -50% to 50%. The variability in the risk corridor payout could also have a significant impact as almost half of the scenarios include a risk corridor receivable. Under the scenario of a 50% risk adjustment payout the adjusted loss ratio ranges between 87% and 127% depending on the portion of the risk corridor paid out.

FIGURE 2: NET CLAIMS AS 150% OF PREMIUM



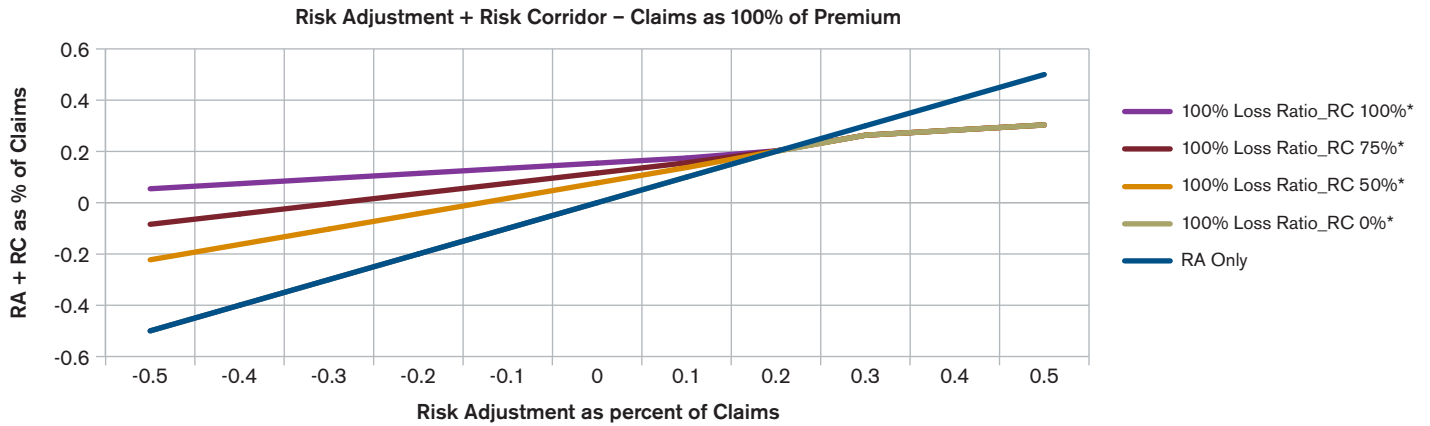
* All risk corridor payables are paid at 100%. Only the risk corridor receivables are impacted by the dampening factor.



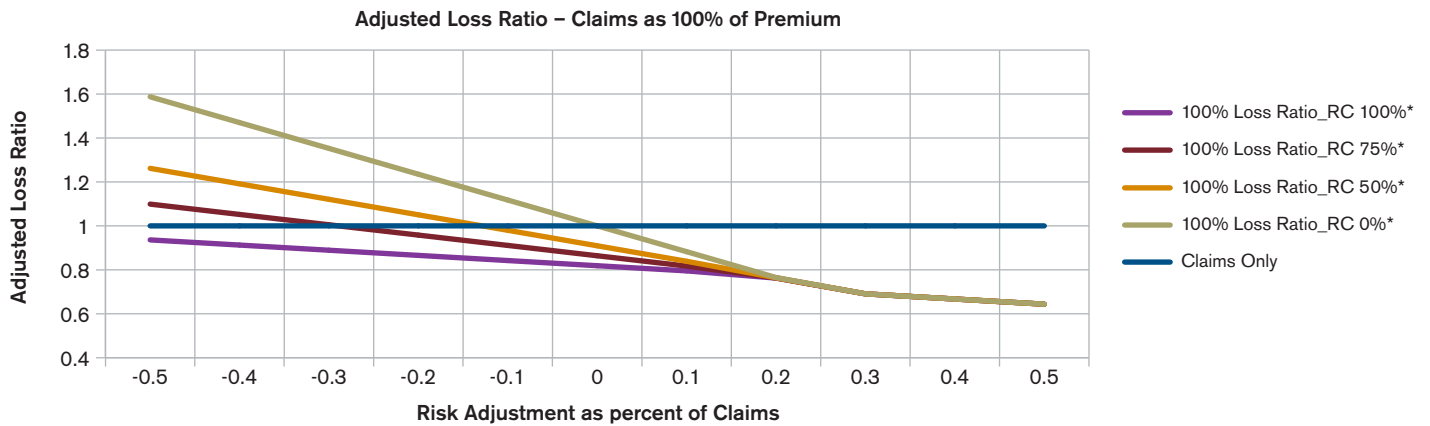
* All risk corridor payables are paid at 100%. Only the risk corridor receivables are impacted by the dampening factor.

If claims net of reinsurance come in at 150% of premium rather than at the target loss ratio of 80%, the risk corridor will be a receivable in almost all scenarios. When paid out at 100%, the net variability in the risk adjusters and risk corridors as a percent of claims ranges from 23% to 46% compared with the risk adjusters by themselves, which range from -50% to 50%. The variability in the risk corridor payout will have a significant impact, as almost all scenarios include a risk corridor receivable. In the scenarios with no risk adjustment the adjusted loss ratio ranges between 92% and 150% depending on the portion of the risk corridor paid out.

FIGURE 3: NET CLAIMS AS 100% OF PREMIUM



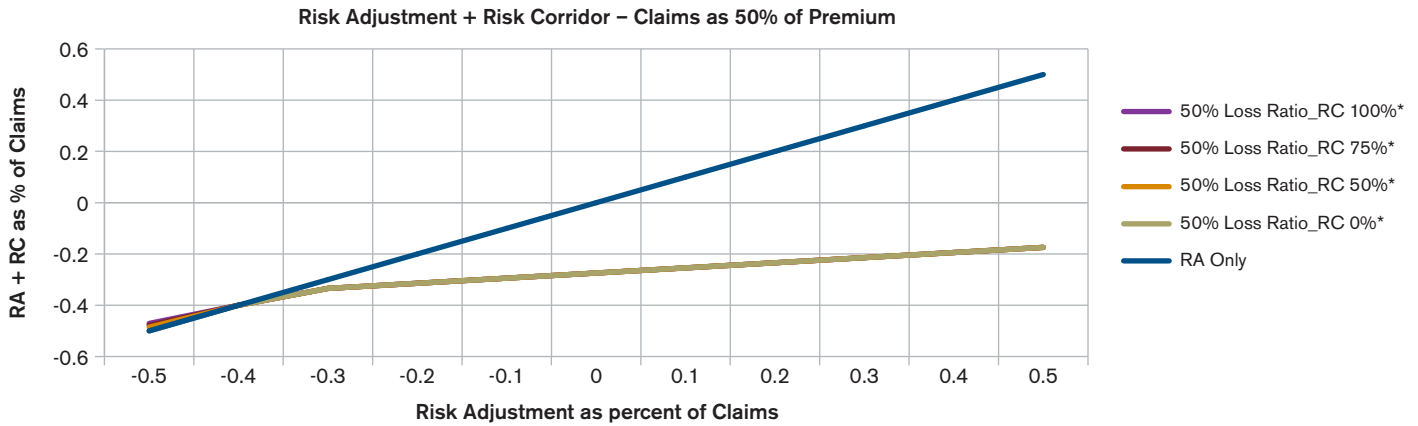
* All risk corridor payables are paid at 100%. Only the risk corridor receivables are impacted by the dampening factor.



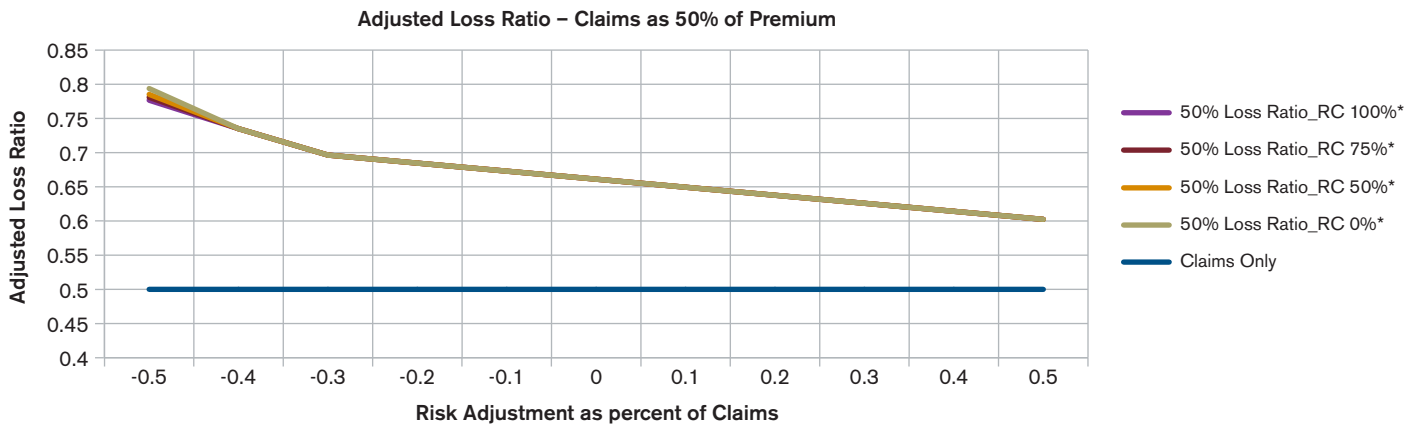
* All risk corridor payables are paid at 100%. Only the risk corridor receivables are impacted by the dampening factor.

If claims net of reinsurance come in at 100% of premium rather than at the target loss ratio of 80%, the risk corridor will be a receivable in the majority of the scenarios. When paid out at 100%, the net variability in the risk adjusters and risk corridors as a percent of claims ranges from 5% to 30% compared with the risk adjusters by themselves, which range from -50% to 50%. The variability in the risk corridor payout will have a significant impact, as the majority of all scenarios include a risk corridor receivable. In the scenarios with no risk adjustment, the adjusted loss ratio ranges between 82% and 100% depending on the portion of the risk corridor paid out.

FIGURE 4: NET CLAIMS AS 50% OF PREMIUM



* All risk corridor payables are paid at 100%. Only the risk corridor receivables are impacted by the dampening factor.



* All risk corridor payables are paid at 100%. Only the risk corridor receivables are impacted by the dampening factor.

If claims net of reinsurance come in at 50% of premium rather than at the target loss ratio of 80%, the risk corridor will be a receivable in about one-third of the scenarios. When paid out at 100%, the net variability in the risk adjusters and risk corridors as a percent of claims ranges from -47% to -17% compared with the risk adjusters by themselves, which range from -50% to 50%. The variability in the risk corridor payout won't be as significant for this group of insurers because the majority of scenarios show the risk corridor as a payout, which will always be paid at 100%. Even under the scenario of a 50% risk adjustment payout, the adjusted loss ratio will only range between 78% and 79% depending on the portion of the risk corridor paid out.

From these graphs, it is apparent that the range of possibilities is smallest in the case where risk corridor is paid out in full. In the case that there is no risk corridor payout, there will be no offsetting impact.

For a given range of risk adjustment variability as a percent of claims, what is the reduction in the variability of the range when the risk adjustment program is considered together with risk corridors?

Taken alone, there is the potential for significant variability in both the risk adjustment program and the risk corridor estimates. However, as shown in Figures 1 to 4 above, when combined, the impact of the variability in the risk adjustment can be substantially offset by the risk corridor estimate, depending on full or partial payout.

In addition to the scenarios included in Figures 1 to 4, we also varied the premium, administrative claims, and reinsurance receivables to look at the maximum variability of the range of risk adjustment plus risk corridor as a percent of claims when compared with a range of risk adjustment only. The largest range is from -50% of claims to 50% of claims, and then we increment it down by 10% to each side of the range. The table in Figure 5 shows the maximum variability of risk adjustment plus risk corridor as a percent of claims for each of the risk corridor payout scenarios for several different risk adjustment ranges. This maximum variability shown incorporates all of the different scenarios, including a range of premiums, claims, administrative expenses, reinsurance, risk adjustment, and risk corridor estimates. The Assumptions section includes details on the scenarios included.

FIGURE 5: MAXIMUM VARIABILITY OF RISK CORRIDOR + RISK ADJUSTMENT AS % OF CLAIMS

RISK ADJUSTMENT RANGE	FULL RISK CORRIDOR RECEIVABLE PAYOUT	RISK CORRIDOR RECEIVABLE PAYOUT @ 75%	RISK CORRIDOR RECEIVABLE PAYOUT @ 50%	NO RISK CORRIDOR RECEIVABLE PAYOUT
+50% to -50%	30.2%	42.3%	61.3%	100.0%
+50% to 0%	16.5%	22.3%	31.3%	50.0%
-50% to 0%	20.2%	21.7%	30.5%	50.0%
+40% to -40%	24.7%	33.9%	48.5%	80.0%
+40% to 0%	14.5%	17.9%	24.5%	40.0%
-40% to 0%	16.7%	17.3%	24.5%	40.0%
+30% to -30%	18.8%	27.5%	37.9%	60.0%
+30% to 0%	12.5%	15.5%	19.9%	30.0%
-30% to 0%	9.2%	12.7%	18.5%	30.0%
+20% to -20%	14.8%	19.9%	25.6%	40.0%
+20% to 0%	10.5%	11.9%	13.6%	20.0%
-20% to 0%	5.0%	8.7%	12.5%	20.0%
+10% to -10%	10.6%	12.5%	14.6%	20.0%
+10% to 0%	7.6%	8.0%	8.6%	10.0%
-10% to 0%	3.0%	4.7%	6.5%	10.0%

In the first row, we see that, although the total variation in the risk adjustment program when considered by itself is 100% of claims (-50% to 50%), when the risk adjustment is considered together with the risk corridor, the net difference is smaller—significantly smaller if risk corridors receivables are paid out in full. If risk corridor receivables are paid out in full the net difference is only 30%—less than a third of the risk adjustment considered alone. Similarly, in the second and third rows, we show the impact for going from the extreme to no risk adjustment estimate. As expected, the maximum variability decreases as the range of risk adjustment decreases.

ASSUMPTIONS

The scenarios chosen were hypothetical. However, because of the formulaic nature of the risk corridor, the results shown should be applicable to actual market experience. The range of each aspect of the formula is shown in Figure 6.

FIGURE 6: RANGE OF EACH ASPECT OF THE FORMULA

Baseline Premium \$50,000,000

	BASIS	MINIMUM	MAXIMUM	INCREMENT
Premium Adjustment	% Premium	50%	150%	25%
Admin Costs*	% Premium	18%	22%	2%
Incurred Claims (net of reinsurance)	% Premium	50%	150%	**
Reinsurance Recoveries	% Claims	10%	20%	2.5%
Risk Adjustment	% Claims	-50%	50%	10%

*The taxes and fees were not included in this percentage nor were they varied. Figure 8 shows the taxes and fees breakout

**The incurred claims scenarios are 50%, 80%, 100%, and 150% of Premium (net of reinsurance)

The risk corridor ratio was calculated as the allowable costs divided by the target amount. The target amount is equal to premium less allowable administrative costs, including taxes and regulatory fees. The allowable costs are equal to the sum of the claims, risk adjustment payables and receivables, and reinsurance receivables. An example of how the fields were calculated is included in Figure 7.

OTHER CONSIDERATIONS

Admissibility

Earlier this year, there was uncertainty about the admissibility of both the risk corridors and risk adjustment program. However, based on the NAIC guidance in Statement of Statutory Accounting Principles (SSAP) No. 107,⁶ both risk corridor assessments and risk adjustment payables meet the definition of liabilities as set forth in SSAP No. 5R, Liabilities, Contingencies, and Impairments of Assets. Risk corridor receivables and risk adjustment receivables meet the definition of an asset and are admissible to the extent that they meet all of the criteria of this statement.

The admissibility of the risk corridor and risk adjustment will have a significant impact on the actuarial opinion.

Timing

Risk adjustment

Based on the Office of Management and Budget (OMB) report for fiscal-year 2015,⁷ risk adjustment payments to issuers will be subject to sequestration. Payments are expected to be made in late summer; as such, 92.7% would be made on time and the remainder would be paid out at the beginning of the federal fiscal year in October.

Risk corridor

It is expected that the risk corridor payments would be made in late summer or early fall.

6 Joint Conference Call, *ibid*.

7 Office of Management and Budget (March 20, 2014). OMB Report to the Congress on the Joint Committee Reductions for Fiscal Year 2015. Retrieved January 14, 2015, from http://www.whitehouse.gov/sites/default/files/omb/assets/legislative_reports/sequestration_order_report_march2014.pdf.

Risk corridors and revenue neutrality

The following statement is from the U.S. Department of Health and Human Services (HHS) fact sheet for the proposed benefit and payment parameters for 2016:⁸

If, in the last year of the risk corridors program, we have excess cumulative risk corridors collections that exceed the cumulative risk corridors payments owed (that is, collections received over the course of the 3-year program exceed total payments requested over the 3 years), we propose to implement an adjustment to the profit floor and administrative cost ceiling to increase risk corridors payments for eligible issuers for benefit year 2016. This adjustment would only be available to issuers whose medical loss ratios (MLR) meet or exceed the 80 percent MLR threshold (and are generally eligible for risk corridors payments) for the 2016 benefit year. We reiterate our previous guidance that in the unlikely event that risk corridors collections, including any potential carryover from prior years, are insufficient to make risk corridors payments for the 2016 program year, HHS will use other sources of funding for the risk corridors payments, subject to the availability of appropriations.

As such, even if HHS has appropriations made available in future years, there is potential for a delay in the payment of the risk corridor receivable by as many as three years. In the event that appropriations are not available, there could be an indefinite delay in payment. Centers for Medicare and Medicaid Services (CMS) guidance indicates that the 2014 risk corridor receivables will be paid in full before any 2015 or 2016 payments.⁹

The graphs in Figures 1 to 4 above consider four scenarios of how the risk corridor receivables will be paid out in a given year. For all scenarios, risk corridors payable are still payable at the full amount.

The government bill¹⁰ for funding the government through September 2015 specifically excludes funding the risk corridors with a substantial portion of the funds appropriated or transferred to CMS for program management funds. At this point, it is not clear how the funding bills will be written for future fiscal years, nor is it clear whether or not CMS will need the appropriated funds.

Because the November NAIC guidance suggests that amounts of 90 days due won't cause the receivables to be treated as non-admissible based solely on aging, a delay in payment should have minimal impact on the financial statement for the time being, although it could affect operations. A lack of risk corridor receivable payout could have a significant impact.

LIMITATIONS

This report was prepared to illustrate the synergistic effect of risk corridors and risk adjusters compared with the effect of each element separately. The analyses and observations may not be appropriate and should not be used for any other purpose.

This report reflects our best understanding of the guidance and rules to date. To the extent that these rules change in the future, some of the conclusions in this report may no longer hold. The NAIC references are based on exposure drafts. As such, this guidance is not final and is subject to change. Additionally, the 2016 benefit payment parameters are also proposed and not yet final, and they are subject to change. Changes made by either the NAIC or CMS will affect the results of this study.

We have not included MLR rebates and their impact on the financial statements. Inasmuch as the MLR results in a rebate, the maximum variability could change.

The range of risk adjustment was limited to +/-50% of claims. Inasmuch as the risk adjustment exceeds this threshold, the maximum variability will increase. Similarly, if the other parameters fall outside the assumptions included, the maximum variability may change.

The maximum variability results shown in the report are for a single scenario of claims, reinsurance, premium, and administrative expense. Any change in claims, reinsurance, premium, or administrative expense estimates will impact the risk corridors estimate and the net result of risk corridor plus risk adjustment.

We are members of the American Academy of Actuaries and meet the qualification standards to render the actuarial opinion contained in the report.

8 U.S. Department of Health and Human Services (November 20, 2014). Proposed HHS Notice of Benefit and Payment Parameters for 2016 Fact Sheet. Retrieved January 15, 2015, from <http://www.cms.gov/CCIIO/Resources/Fact-Sheets-and-FAQs/Downloads/Fact-Sheet-11-20-14.pdf>.

9 Center for Consumer Information and Insurance Oversight (April 11, 2014). Risk Corridors and Budget Neutrality. Retrieved January 15, 2015, from <http://www.cms.gov/CCIIO/Resources/Fact-Sheets-and-FAQs/Downloads/faq-risk-corridors-04-11-2014.pdf>.

10 U.S. Senate (December 9, 2014). Rules Committee Print 113-59 Text of House Amendment to the Senate Amendment to H.R. 83. Retrieved January 15, 2015, from <http://www.gpo.gov/fdsys/pkg/CPRT-113HPRT91668/pdf/CPRT-113HPRT91668.pdf>.

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FIGURE 7: SAMPLE LOSS RATIO AND RISK CORRIDOR AMOUNT CALCULATION

	A	B	C	D	E	F	G = B+C-D	H = A-E-F	I = G/H	J = SEE FORMULA BELOW*	K = (B+C-D-J) / A	L = J-C	M = L/B
CATEGORY	PREMIUM	CLAIMS	RISK ADJUSTMENT	REINSUR- ANCE	ADMINISTRA- TIVE COSTS (INCLUDING PROFITS)	TAXES AND FEES	ALLOWABLE COSTS	TARGET AMOUNT	RISK CORRIDOR RATIO	RISK CORRIDOR AMOUNT	ADJUSTED LOSS RATIO	RISK CORRIDOR + RISK ADJUSTMENT	% OF CLAIMS
Scenario	100% of baseline premium	150% of Premium	-50% of Claims	15% of Claims	20% of Premium	See Figure 8	Formula	Formula	Formula	Formula	Formula	Formula	Formula
Amount	75,000,000	112,500,000	56,250,000	16,875,000	15,000,000	4,005,833	151,875,000	55,994,167	2.71	74,520,894	103.1%	18,270,894	16.2%

***RISK CORRIDOR FORMULA**

RISK CORRIDOR RATIO	RISK CORRIDOR AMOUNT
> 108%	80% Reimbursement
103% - 108%	50% Reimbursement
97% - 103%	No Reimbursement
92% - 97%	50% Fee
< 92%	80% Fee

FIGURE 8: TAXES AND FEES PMPM

Average Premium	\$ 300.00
Exchange Fee (3.5%)	\$ 10.50
Health Insurance Provider Fee	\$ -
Comparative Effectiveness Research Fee	\$ 0.18
Reinsurance Operating Fee	\$ 0.01
Risk Adjustment Operating Fee	\$ 0.08
Reinsurance Contribution	\$ 5.25
TOTAL	\$ 16.02

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