REDUCING THE RESERVES OF THE FEDERAL EMPLOYEES HEALTH BENEFIT PROGRAM

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PREFACE

The large accumulation of reserves of the Federal Employees Health Benefits program (FEHB) has given rise to concern about the necessity of current reserve levels, the manner in which they are held, and the most appropriate way to dispose of excess funds. This study, undertaken at the request of the House Committee on Post Office and Civil Service, addresses these questions and poses several alternatives to current policy on the FEHB reserve system.

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SUMMARY

In setting annual premium rates for the Federal Employees Health Benefits (FEHB) program, the Office of Personnel Management (OPM) and the more than 80 insurance carriers with which it does business negotiate program income that covers costs and overhead, and that usually yields some surplus. The surplus, held partly by the government in individual "contingency reserves" earmarked for each carrier and partly by each carrier in "special reserves," is intended to serve as a hedge against unforeseen adverse cost fluctuations in the contract year. Aside from how they are held, the two types of reserves differ little.

Over the past decade, the FEHB program's reserves have increased about fourfold, reaching $490 million in 1980, or 15 percent of the year's income from premiums; OPM guidelines specify reserve levels of about 14 percent. This growth, partly resulting from overestimates of program costs used in annual rate setting, has drawn attention to three questions:

- What level of FEHB reserves is necessary?
- How should reserve holdings be allocated? and
- By what means should reserve excesses be disposed of?

Reserve Levels

Although holding reserves is a generally accepted way to hedge against future cost variations, no specific level of reserves for FEHB has ever been agreed on. The current practice is to tailor reserve sizes to particular plans, allowing relatively larger reserves for smaller plans, which may have less nonfederal capital to draw on and smaller pools of enrollees among whom to spread risk. Overall reserve levels for the FEHB program as a whole have averaged 19 percent of premium income throughout the past decade. Analyses by various agencies, including the Congressional Budget Office and General Accounting Office, however, suggest that an overall reserve level as low as 6 percent of premium income might well be adequate.

Allocation of Reserves

At present, some 20 percent of FEHB program reserves rests with the participating carriers, and according to the Administration's projections, the carrier-held share will decline to around 13 percent over the next five year. Allowing carriers to hold reserves, however, conflicts with governmental financial management objectives that would prevent nonfederal entities from holding federal cash balances. Indeed, there is little reason for carriers to hold any part of the FEHB reserves. All FEHB reserves could be held by the government, specifically by the U.S. Treasury.

Disposition of Excess Reserves

If overall FEHB reserve levels are to be brought down, a way must be found for disposing of the excess money. Several approaches could be considered. Under current practice, excess accumulations are used over two or three years to defray future premium rate increases. Drawing down all excesses in the next contract year instead would improve equity, because enrollees whose premiums helped create a surplus would more likely be the same enrollees to benefit from its use. Excess reserves could also be disposed of through rebates or through additional benefits. Rebates would be the most equitable approach, but they could increase program overhead and encounter administrative problems. Using excesses for additional benefits could ultimately be more costly than other methods, unless the new benefits were cancelled when the excess was exhausted.

OPTIONS FOR CHANGING THE LEVEL AND ALLOCATION OF RESERVES

In response to the above concerns about FEHB reserves, three options for change are outlined below. Over the next five years, each would reduce total reserve accumulations--by 30 percent under Options I and II and by 70 percent under Option III--below levels now projected by the Administration. Excess reserves would defray future FEHB premium increases by as much as $1.09 billion through 1986. Two of the alternatives, Options II and III, would also transfer all carrier-held reserves to the federal government.

Contrary to what might seem obvious, using excess reserves to defray premium rate increases would increase five-year budgetary

outlays. This would occur because reduced premiums would decrease program income from enrollees and from off-budget agencies, which contribute to the program. Premiums from on-budget agencies represent internal budget transactions that do not affect total federal budget outlays. The additional outlays, however, could be partly offset if the special reserves now held by carriers were transferred to the federal government. Cumulative net outlay increases estimated for each option reflect these impacts and represent changes from the Administration's budget projections through 1986.

Option I. Limit Reserve Accumulations to Present OPM Guidelines and Require Disposal of Excess Reserves in Next Contract Year

Option I would limit total reserve accumulations to the 14 percent of premium income specified in OPM guidelines. Excess reserves under this plan would be used to defray rate increases during calendar year 1982, the next contract year, rather than over two or three years. The lower reserve levels would reduce premium income by some $540 million over five years, of which $230 million would benefit enrollees at an average of $12 per enrollee for each year. Five-year outlays under this approach would increase by $190 million.

Option II. Limit Reserve Accumulations to OPM Guidelines, Require Disposal of Excess Reserves in Next Contract Year, and Have the Federal Government Hold All Reserves

Option II would impose the same reserve levels as Option I, thus achieving the same premium reduction. But in addition, it would transfer carrier-held reserves to the federal government. This transfer, phased in over three years, would bring FEHB into conformance with federal financial management objectives and would thus result in outlay increases of only $85 million.

Option III. Impose Lower Reserve Limitations, Require Disposal of Excess Reserves in Next Contract Year, and Have the Federal Government Hold All Reserves

Like Option II, this approach would transfer carrier-held reserves to the federal government. But, consistent with various

analyses, it would restrict reserves to much lower levels. Cumulative reserves for all FEHB plans would average about 6 percent of premium income instead of the recent 15, with levels for particular plans still determined by plan size. The option also permits short-term Treasury borrowing by FEHB to backstop any shortfalls brought about by underfunding. The lower reserve levels would reduce premiums by $1.09 billion through 1986--about double Option I and II reductions--and increase outlays by $375 million. Of the total premium reduction, about $455 would benefit enrollees at an average annual savings of $23 per enrollee for the five years after implementation.

REDUCING RESERVES OF THE FEDERAL
EMPLOYEES HEALTH BENEFITS PROGRAM

CHAPTER I. OVERVIEW OF THE FEHB PROGRAM AND ITS RESERVES

The Federal Employees Health Benefits (FEHB) program, which provides health-care coverage for some 2.4 million active federal government workers and another 1.2 million retirees, is designed to yield a surplus of income each year. 1/ In the past decade, FEHB surpluses, held in reserve accounts, have increased from $126 million to $490 million in 1980. The accumulation of large reserves has given rise to several concerns--specifically, whether current reserve levels are excessive, whether the manner in which they are held is appropriate, and what is the most appropriate way to dispose of excess funds. In response to these concerns, this study considers the following three questions:

- How large a reserve is necessary?
- What parties should hold the reserve? and
- How should the excess be eliminated?

The remainder of this chapter gives an overview of the FEHB program, including the rationale for maintaining reserves. The second chapter examines FEHB reserve issues. The closing chapter outlines several options for changing FEHB reserve policy.

HOW THE SYSTEM OPERATES

As administrator of the FEHB program, the Office of Personnel Management (OPM) contracts with more than 80 insurance carriers to provide health-care coverage for active and retired federal civilian workers (referred to as enrollees). OPM manages the transfer of FEHB payments through a trust fund (described later in this chapter) and negotiates yearly premium rates. Although the participating carriers bear financial risk in the event of plan termination, they serve mainly as claims processors--managing money that is essentially federal.

1/ The FEHB program was established by Public Law 86-382, approved September 28, 1959.

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Two carriers--Blue Cross/Blue Shield and Aetna Life Insurance Company--offer government-wide plans; together, they account for about two-thirds of all FEHB coverage. Other plans are provided by employee organizations that offer health coverage to members and by local medical groups or individual physicians that offer coverage in certain areas. 2/ Because of their dominant position in the FEHB program, the Blue Cross/Blue Shield and Aetna plans provide the basis for most of the analysis in this study.

Enrollees and the government pay for FEHB premiums and associated costs, which currently total about $4 billion. Employee and annuitant participation in FEHB is voluntary, but only 20 percent of all eligible workers elect not to enroll in the program. The enrollees' contributions are deducted from pay and retirement checks; the government's share is paid from individual agency appropriations. 3/ Income not used to pay benefits or overhead accumulates in reserves. These are held in part by the federal government (the so-called "contingency reserves," which are earmarked for each carrier) and in part by participating carriers (the "special reserves"). 4/

2/ Appendix A summarizes operating data for FEHB plans. Most group and individual practice plans are community rated; that is, premium rates are based on the costs that prevail in the community in which the plan is based, rather than on the cost experience of federal enrollees. Reserves of community-rated plans are not addressed in this paper. These plans hold no reserves in their custody, and federal reserves earmarked for them make up about 4.4 percent of total FEHB program reserves.

3/ The allocation of FEHB costs between enrollees and the government as employer varies for particular groups: cost sharing averages 46/54 percent for nonpostal employees, 25/75 percent for postal workers, and 42/58 percent for annuitants.

4/ Participating organizations also maintain an accrued claims reserve for claims that have been submitted but not paid. Several studies of the accrued claims reserves held by the two government-wide plans have found them adequate; these reserves are not examined in this paper.

Primarily, the reserves provide a hedge against possible underestimates of the annual costs of claims. Both types of reserves, contingency and special, serve this purpose; they differ essentially in that they are held by different parties. Both reserves, and the interest they earn, can be used only for FEHB benefit claims and expenses. According to OPM requirements for the accumulation of reserves for individual plans, the levels targeted for contingency and special reserves combined average 14 percent of annual premium income (1 3/4 months) for the FEHB program as a whole. For the government-wide plans, the guidelines equate to reserves of 12.5 percent of a year's premium income (1 1/2 months). 5/ These reserve requirements, based on past experience and recommendations by consulting actuaries, are designed to maintain accumulated reserves at a constant percentage level. Thus, reserves in absolute dollar amounts increase in proportion to rising enrollment, prices, and use of health care. Other arrangements, however, such as extension of federal credit, might just as well provide a satisfactory safeguard against imperfect cost forecasting.

Premium rate negotiations begin each spring, and the rate arrived at applies during the following calendar, or "contract," year. The premiums OPM negotiates for each plan cover the contract year's expected benefit and overhead costs, including a service charge for participating carriers as remuneration for running their plans. 6/ When premium rates are set, consideration is also given to interest from invested capital, payments received by participating organizations from the contingency reserves held by OPM, and adjustments in the level of carrier-held special reserves. The agreed-upon rates are then raised by 1 percent to cover OPM's administrative expenses and by another 3 percent for payments into reserves for each individual carrier. (The 3 percent add-on is the maximum permitted by current law, and the rate could be lowered administratively without Congressional action.)

5/ The 12.5 percent guideline for government-wide plans includes federal contingency reserves of 8.3 percent of premium income and carrier-held special reserves of 4.2 percent of premium income. For other plans, special reserves vary.

6/ The service charge is usually fixed at a specified percent of premium income, ranging from 0.3 to 0.8 percent.

In negotiating rates, OPM often allows the combination of special and contingency reserves to deviate significantly from guideline targets. For example, combined reserves planned by OPM in 10 recent rate cases (1976-1980 for each of the two government-wide plans) ranged from 109 percent below to 162 percent above the reserve levels stipulated in OPM guidelines. OPM departs from the guidelines in order to defray rate increases in the upcoming contract year or to maintain a cushion for rate increases in future years. Negotiation during the five-year period 1976-1980 anticipated that about half of the annual reserves in excess of guidelines would be drawn down to avoid higher rate increases that would otherwise have accumulated to 4.7 percent. If all of the excesses had been drawn, however, cumulative rate increases of 10.2 percent would have been avoided.

A revolving federal trust fund account finances FEHB as an on-budget program. Premium payments from enrollees and agencies are deposited into the FEHB fund, and semimonthly payments to participating carriers are paid from it. In general, the number of plan participants times the negotiated rates (per enrollee) determines the size of the semimonthly payments to carriers. Annual outlays from the fund essentially represent the difference between income from enrollee and agency contributions and outgo for payments to participating carriers. Because a portion of the payments that pass through the FEHB fund are set aside as part of the program's reserves, income generally exceeds outgo; the program thus generates negative (minus) outlays in the fund. The effect on total budget outlays, however, is quite different: the cost to the carriers is offset by income from enrollees and off-budget agencies.

Rationale for Reserves

Holding funds in reserve is a method widely used by insurance companies as a hedge against adverse cost variation. Should a deficit occur in a given plan, reserves may be drawn down to cover costs until premiums can be adjusted in the subsequent contract year. Also, in the event that a plan involuntarily terminates with a deficit--in the case of bankruptcy for example--reserves help the participating carrier meet its contractual obligations to enrollees. Although carriers serve as claims-processing

agents on behalf of the federal government, they do bear an ultimate financial responsibility--and risk--in the event of plan termination. 7/

Reserves are not the only way to provide for adverse cost variation in FEHB. Another approach, which would require a change in authorizing legislation, would be to make available short-term borrowing from the U.S. Treasury. Treasury advances, subject to appropriate limits, could be simpler than the current system and cheaper for enrollees, because they might obviate the need for premium add-ons to perpetuate large reserves. Such a borrowing plan could be coupled with some minimal reserve level to help cover claims when a plan terminates with a deficit. Without such a resource, some organizations might be unwilling to continue participating in the FEHB program. Also, maintaining some reserve would provide an immediate source of contingency funds that could allay carriers' doubts about the timely availability of Treasury advances.

Contingency Reserves. As authorized by law, the OPM holds separate contingency reserves for each participating organization. The total cumulative contingency reserve designated for each carrier equals one month's premium income, or 8.3 percent of annual income. For 1980, contingency reserves for all plans totaled an estimated $402 million, with about $261 million (65 percent) earmarked for the two largest plans, Blue Cross/Blue Shield and Aetna. Contingency reserves accumulate primarily as a result of the 3 percent add-on to premiums paid by program participants.

7/ The consequences of plans' terminating with deficits would vary. Should the two carriers offering government-wide plans voluntarily quit the federal program with a deficit, both special and contingency reserves would be available to settle claims. Other carriers have access to special reserves only. In the event that available reserves were inadequate to cover contractual obligations, some would rely on other organizational resources, some would call upon reinsurers that underwrite their program, and some would have to rely on assessments to members or other measures.

TABLE 1. GROWTH OF FEHB RESERVES: CALENDAR YEARS 1971-1980

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
	Reserve Levels in Millions of Dollars									
Blue Cross/ Blue Shield and Aetna	100	211	178	196	112	315	428	595	530	368
Other plans	26	40	60	68	72	97	140	197	206	122
Total	126	251	238	264	184	412	568	792	736	490

SOURCE: Annual Statistical Publications of the Office of Personnel Management, 1972-1980.

NOTES: Reserves are reported for the end of each contract year. Reserves of community-based plans are not included.

TABLE 2. COST ESTIMATES FOR GOVERNMENT-WIDE FEHB PLANS: CALENDAR YEARS 1976-1980

	1976	1977	1978	1979	1980	Aggregate Average
Blue Cross/ Blue Shield	7.8	8.5	1.4	2.4	-11.6 a/	1.7
Aetna	15.4	6.2	3.6	3.6	-1.9 a/	5.4
Average b/	11.1	7.5	2.4	2.9	-7.3 a/	3.3

SOURCES: Derived by the CBO from OPM rate recommendation letters and from accounting statements of participating carriers.

a/ Minus indicates underestimate.

b/ The average is weighted to reflect the relative size of each plan based on their respective premium income.

Payments from contingency reserves are advanced to participating carriers both on an annual basis, according to a prescribed formula 8/, and on an ad hoc basis at the discretion of the OPM.

Special Reserves. Pursuant to agreements with the OPM, carriers hold special reserves that represent the excess of income over outgo, measured on an accrued basis. 9/ For the FEHB program as a whole, the targets for accumulation of special reserves represent about three-quarters of a month's premium income, or about 6.0 percent of annual income. The target amounts for specific plans vary from 4.2 to 12.5 percent of annual income, depending mainly on plan size. Smaller plans and those underwritten by the carriers themselves are generally thought to require larger reserves because of the greater chance of estimating error and the more limited resources available to pay claims in the event of plan termination. For 1980, special reserves held by all participating insurers combined totaled $88 million, with some insurers showing a negative balance. The two largest plans held special reserves totaling $107 million.

Reserve Growth

Total FEHB reserves grew almost steadily during the 1970s. Accumulated levels have declined since 1978, but the current reserves of $490 million still represent about four times the 1971 level (see Table 1). Reserves for Blue Cross/Blue Shield and Aetna increased by $256 million from the end of 1975 through 1980, representing about 85 percent of the growth of total FEHB reserves in that period.

Examination of recent experience for the two government-wide plans suggests that most reserve growth above existing targets occurred because of cautious cost estimating by OPM. A comparison of estimated and actual costs for the two government-wide plans shows overestimating in four out of five of the most recent years--averaging 3.3 percent over the 1976-1980 period (see Table 2).

8/ According to the current OPM formula, contingency reserve funds in excess of one month's premium income are advanced to participating carriers so long as the reserves the carriers hold do not exceed five months' premium income.

9/ The accounting for participating carriers uses an accrual rather than cash basis; that is, costs are recorded as they are incurred rather than as they are paid.

CHAPTER II. THE SIZE, ALLOCATION, AND USES OF FEHB RESERVES

The federal government now holds about 80 percent of the $490 million in total FEHB reserves, and individual participating insurance carriers hold the remainder. This chapter analyzes the levels and allocation of the reserves, focusing on the two government-wide plans. It also examines the possible disposal of excess FEHB funds.

HOW LARGE A RESERVE IS NECESSARY?

Whereas reserve funds are considered an acceptable hedge against adverse cost fluctuations, no specific level of FEHB reserves has been uniformly agreed on for the FEHB program. Thus, various reserve levels have been considered and proposed during the past decade. Review and analysis by the Congressional Budget Office suggest that the present cumulative reserves could reasonably be reduced by almost two-thirds and still offer adequate protection against unexpected cost increases.

According to CBO's comparison of expected and actual costs for Blue Cross/Blue Shield and Aetna during the eight years before 1981, an accumulated reserve (contingency and special combined) equal to 4 percent of total premium income would have been sufficient to cover all but the most extreme shortfall. Other federal agencies, notably the General Accounting Office (GAO), have proposed similarly low reserve levels for the two government-wide plans. GAO has recommended a level of 5 percent. 1/

1/ See General Accounting Office, Opportunities for Improving Administration of Government-Wide Indemnity Benefit Plan of Health Insurance for Federal Employees and Annuitants (1972), p. 45; this study calculated a reserve requirement of 5 percent for the Aetna plan, considering only estimating errors due to statistical chance. In October 1972, the Subcommittee on the Retirement, Insurance and Health Benefits of the House Post Office and Civil Service Committee solicited views from

According to an unpublished analysis prepared by OPM staff members, a combined rate of 5.4 percent of premium income would provide sufficient buildup of reserves for the two government-wide plans. If such a level had been set for calendar year 1980, aggregate reserve requirements would have totaled $118 million, rather than the $368 million that actually accumulated. The OPM analysis based its findings on review of recommendations by various insurance specialists and on the estimated impact of various factors that affect most forecasting--including statistical chance, inflation, and use of health-care resources.

The OPM staff analysis resulted in a schedule of reserve target levels determined by plan size. The targets suggested for plans other than the two government-wide ones range from 5.7 percent of premium income for plans covering more than 500,000 persons to 12.0 percent for plans covering fewer than 20,000 persons. If the reserve schedule had been applied for all FEHB plans in 1980, the target level for combined reserves would have been $183 million (averaging 5.6 percent of premium income), or about one-third of the actual $490 million accumulation.

WHO SHOULD HOLD RESERVES?

While the federal government holds about 80 percent of FEHB excess in contingency reserves, the participating carriers hold the other 20 percent in special reserves. The present dollar allocation is $402 million in contingency reserves and $88 million in special reserves (see Table 3). Both pools serve the purpose of cushioning the system in the event of unforeseen cost variation.

Transferring special reserves to the federal government would be consistent with the financial management objectives governing payments to off-budget organizations in other federal benefit programs. For example, in Medicare, Medicaid, and Aid to

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insurance specialists on appropriate FEHB reserve levels. Recommendations from the four respondents included: 16.7 percent of premium income (Insurance Commissioner, State of Illinois); a 10.0 percent level (Insurance Commissioner, State of Michigan); and a 6 percent level (official of the U.S. Department of Housing and Urban Development and the Wyatt Company, an independent actuarial firm).

TABLE 3. ALLOCATION OF FEHB RESERVES: END OF CALENDAR YEARS 1971-1980, IN MILLIONS OF DOLLARS a/

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Government-Held Reserves	125	149	177	208	202	225	268	323	381	402
Carrier-Held Reserves a/	1	102	61	56	-18 b/	187	300	469	355	88
Total	126	251	238	264	184	412	568	792	736	490
Government-Held Reserves as a Percent of Total	99.2	59.4	74.4	78.8	100.0	54.6	47.2	40.8	51.8	82.0

SOURCE: Derived by CBO from Annual Statistical Publications of the Office of Personnel Management, 1972-1980.

a/ Includes Blue Cross/Blue Shield, Aetna, and all other plans except those that are community based.

b/ Minus figure denotes a loss to carriers.

Families with Dependent Children letters of credit are used as needed to secure federal fund advances for cash disbursements. Such arrangements obviate the need for nonfederal entities to hold cash surpluses and, despite the possibility of higher rates of return, correspondingly increase U.S. Treasury cash balances that reduce the need for Treasury borrowing. 2/ Transferring to the federal government that portion of FEHB reserves now held by participating organizations could achieve the same objectives.

2/ Informal analysis by GAO staff shows little difference over the long-run between rates of return on federally held contingency reserves and on carrier-held special reserves.

Such a reallocation could be accomplished either by participating organizations' making payments to the government or, conversely, by the government's reducing its payments to carriers. The change would be administrative and would not necessitate legislative action.

Shifting special reserves to the contingency accounts that OPM holds might raise carriers' concerns about having easy access to federal funds to cover shortfalls. This concern might be particularly critical to smaller carriers, which tend not to have significant nonfederal resources; some carriers might push for higher premiums as recompense for the shift in reserves. At present, however, access to special reserves may be limited by long-term securities included in the reserve investment portfolios of some insurers. For example, it would not be unusual for nearly half of the FEHB portfolio held by Blue Cross/Blue Shield to consist of securities with maturity periods of one year or more. Thus, carriers' concerns about a change in access may be more relevant for some carriers than for others. In any event, new FEHB procedures for making payments from contingency reserves and experience in other federal programs suggest that tighter controls on cash holdings could be effectively implemented.

DISPOSAL OF EXCESS RESERVES

At present, OPM disposes of excess reserves over two or three years in order to lessen future rate fluctuation. OPM could adopt other practices, however. For example, a more equitable approach might be to confine the use of excess FEHB reserves to the next contract year; this would mean that most of the people benefiting from the disposal of excesses would be people who had contributed to it in the first place.

Even greater equity in the disposal of reserves could be achieved under a system of rebates to plan enrollees. FEHB program managers do not believe a rebate system could be easily implemented, and they express strong concern about making rebates in a timely manner; but enrollees would certainly prefer a delayed rebate than none at all. 3/ Such an approach would require

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3/ Implementation of a rebate system might be more difficult than ordinarily expected in view of cited deficiencies in FEHB operations, including data discrepancies and inadequate use of automated data processing. See General Accounting Office, Errors In Health Benefits Enrollment Data Push Up Health Insurance Costs (December 1979).

legislative amendment, however, and solution of various administrative problems, including changes in FEHB data systems. Giving rebates would also increase operating costs, record keeping, postage, and other overhead expenses. To avoid unintentional supplements to agency operating budgets, new rebate legislation could require that the portion of surplus attributable to agency contributions revert to the general fund of the Treasury.

Offering additional health benefits might also be a way to draw down FEHB reserve excesses. This approach would be more costly than other methods unless the added benefits were cancelled when the excess was used up. To maintain the added benefits after reserve excesses were depleted, future premium rates would have to be raised.

Another method of disposing of excess FEHB reserves would be to transfer all excess sums to the general fund of the Treasury. This approach, also requiring new legislation, would be easy to administer. Such a scheme would prevent outlay increases by denying any benefit to enrollees whose premiums contributed to the excess. Enrollees' objections would be well founded although less relevant for people who have changed health plans or who no longer participate in the FEHB program.

CHAPTER III. OPTIONS FOR CHANGING THE LEVEL AND ALLOCATION OF FEHB RESERVES

According to the Administration's budget estimates of March 1981, OPM plans to maintain FEHB program reserves that will average 20 percent of premium income through fiscal year 1986. The estimates also suggest that OPM will continue to reduce the portion of total reserves held by participating organizations--from 22 percent at the end of fiscal year 1982 to 13 percent at the end of fiscal year 1986.

This chapter presents three policy choices that would change the planned level and allocation of FEHB reserves; they could be implemented, for the most part, either administratively or by Congressional mandate. Three financing changes that would not affect FEHB operating costs are outlined below:

- Option I -- Limit reserve accumulations to present OPM guidelines and require disposal of excess reserves in the next contract year.
- Option II -- Limit reserve accumulations to OPM guidelines, require disposal of excess reserves in the next contract year, and have the federal government hold all reserves.
- Option III -- Impose lower reserve limits, require disposal of excess reserves in the next contract year, and have the federal government hold all reserves.

The discussion of each option covers changes in the allocation and cumulative level of reserves and in the disposal of any excess reserves. Also considered is the impact each option would have on carriers, enrollees, and the federal budget. (To simplify implementation, any of the changes could be limited to the two government-wide plans, although the overall effects would be accordingly smaller.)

Even under the status quo, budget estimates for the FEHB program are subject to considerable uncertainty. Analysis by CBO concludes that the three options discussed here would net cumulative budget outlays through fiscal year 1986 ranging from $85 million to $375 million more than the Administration currently estimates. The outlay changes in CBO's analysis result from how the federal budget reflects the diverse effects of each option on agencies, enrollees, and carriers. These estimated impacts would vary if the Administration were to revise its budget projections for the FEHB program. 1/ (See Tables 4, 5, and 6 for projected effects of options on FEHB outlays, reserve levels and allocation, and premium rates.)

Agencies. In the budget, premium payments to the FEHB trust fund from on-budget agencies have no net impact on total federal budget outlays, because they simply represent internal budgetary transactions. Thus, lowering agency premiums to reduce reserves, an element in each of the options below, would not affect net budget outlays. Exceptions would occur in the case of the U.S. Postal Service and other off-budget federal agencies, for which reduced premiums would increase outlays. (Premium payments from off-budget agencies have a different outlay impact because they are treated as income from external sources that offset budget outlays.)

Enrollees. Under current practice, premium income from enrollees offsets budget outlay totals and is reflected in the FEHB trust fund. Each option would reduce premium income to draw down reserves and would thus increase outlays.

Participating Carriers. Payments to carriers from the FEHB trust fund generate federal outlays. Transferring carrier-held reserves to the federal government, as described in Options II and III, would reduce federal outlays because of decreased payments to carriers.

1/ In the past, Administration estimates have tended to understate the level of accumulated reserves. Examination of budget estimates since 1975, for example, shows that in four out of five fiscal years (1976-1980), actual increases in reserves averaged 3.7 times the increases estimated in the current budget year. Reports for the contract year ending December 31, 1980, however, suggest that the current budget estimates may overstate the level of accumulated reserves.

TABLE 4. ESTIMATED EFFECTS OF FEHB OPTIONS ON FEDERAL BUDGET OUTLAYS: FISCAL YEARS 1982-1986, IN MILLIONS OF DOLLARS

	1982	1983	1984	1985	1986	Cumulative Impact
Outlays Under Current Practice a/						
	2,160	2,410	2,695	3,005	3,330	13,600
		(NET REDUCTIONS UNDER ALTERNATIVES)				
Option I	45	25	25	40	55	190
Option II	30	-5 b/	-35 b/	25	70	85
Option III	170	60	-10 b/	55	100	375

SOURCE: Congressional Budget Office.

NOTES: Estimates are rounded to the nearest $5 million; net reductions represent changes from Administration budget estimates. Appendix Tables B-1, B-2, and B-3 provide detailed information on the outlay impact of each option.

a/ Federal outlays for the FEHB program represent the net flow of cash between the Treasury (FEHB fund and individual agency accounts) and the nonfederal sector (carriers, enrollees, and off-budget agencies). Specifically, the outlays to carriers are offset by receipts from the portion of premiums paid by enrollees and off-budget agencies.

b/ Minus figures denote budget savings.

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OPTION I. Limit Reserve Accumulations to Present OPM Guidelines and Require Disposal of Excess Reserves in Next Contract Year

This alternative is posited on a belief that current guidelines are necessary to yield reserves adequate to cover adverse cost variation, but that a more timely disposition of excess reserves would better benefit the enrollees whose premiums created them. Option I would maintain existing OPM guidelines concerning the targeted level of reserves to be accumulated but would require that all excess accumulations be applied during the next contract year to defray rate increases. In other words, the negotiation of premiums would not anticipate holding excess reserves. In addition, the portion of carrier-held special reserves would gradually

TABLE 5. AVERAGE FEHB RESERVE LEVELS AND ALLOCATION UNDER ADMINISTRATION PROJECTION AND CBO OPTIONS: FISCAL YEARS 1982-1986

	Combined Reserves		Percent Allocation of Reserves	
	In Millions of Dollars	As a Percent of Premium Income	Government-Held Reserves	Carrier-Held Reserves
Administration Projection	1,145	20	83	17
Option I	780	14	83	17
Option II	780	14	100 a/	0
Option III	330	6	100 a/	0

SOURCES: Office of Personnel Management and CBO.

NOTE: Dollar amounts are rounded to the nearest $5 million.

a/ Because of phased implementation, the federal government would hold all reserves by the end of fiscal year 1984.

decline. This approach would be consistent with Administration budget estimates for fiscal years 1982-1986. Opponents point out that accelerated disposition of excess reserves would eliminate a cushion against fluctuation of future rates.

Under this option, the contract negotiations for premium rates for calendar year 1982 would limit the accumulation of total FEHB reserves to the 14 percent average of OPM guidelines--compared to the 20 percent average currently projected by the Administration. The special reserves would still vary according to plan size and type. Consistent with OPM estimates, carriers would hold about 17 percent of all FEHB reserves over the next five years.

Drawing down each year's entire excess during the following year would leave some $540 million to defray premium rates negotiated throughout the next five fiscal years. The portion of reductions benefiting enrollees would total $230 million, but it would average only $12 per capita for each of the next five years.

TABLE 6. FEHB PREMIUM REDUCTIONS UNDER CBO OPTIONS: FISCAL YEARS 1982-1986

	Cumulative Reductions a/ (in Millions of Dollars)			Average Annual Savings Per Enrollee (in Dollars)
	Enrollees	Agencies b/	Total	
Option I	230	310	540	12
Option II	230	310	540	12
Option III	455	630	1,085	23

SOURCE: Congressional Budget Office.

a/ Impacts represent changes from Administration budget estimates. Estimates are rounded to the nearest $5 million.

b/ Estimates include premium reductions for both on-budget and off-budget agencies.

Budget outlay increases of $190 million through fiscal year 1986 include costs of $280 million for the loss of receipts from lower premiums paid by enrollees and off-budget federal agencies, less associated savings of $90 million for maintaining the allocation of reserves reflected in the Administration's five-year budget estimates.

Option I could be modified to dispose of excess funds by means other than premium reductions (described in Chapter II in the section on elimination of excess reserves). Either rebates to enrollees or premium rate reductions would have the same effect on enrollees and budget outlays. Instead, however, excess reserves could be applied to new benefits. Under this approach, the excess reserves would benefit enrollees, but outlay increases over five years would be greater--$450 million instead of $190 million. A third variation could be to legislate a transfer of all FEHB excess reserves to the general fund of the Treasury. Because under this approach no benefit would accrue to enrollees or off-budget agencies, program outlays would not increase.

OPTION II. Limit Reserve Accumulations to OPM Guidelines, Require Disposal of Excess Reserves in the Next Contract Year, and Have the Federal Government Hold All Reserves

In other federal programs, the government seeks to limit the amount of federally earmarked cash held outside the Treasury. Accordingly, Option II would transfer to the federal government the special reserves now held by participating carriers. As with Option I, this alternative would limit total reserve accumulations to OPM's targets--averaging 14 percent of premium income. This plan could be implemented over a three-year period, during which FEHB payments to carriers would decrease, and payments into the government-held contingency reserves would increase by the same amounts. The phase-in period would give carriers time to plan for liquidation of invested assets.

The impact of Option II on overall FEHB reserve levels and premium reductions would be the same as that under Option I. But incorporating a transfer of all carrier-held reserves to the federal government would yield five-year outlay costs of some $85 million--in contrast to the $190 million increase under Option I. The net five-year costs result from increases of $280 million for lower premiums paid by enrollees and off-budget federal agencies and decreases of $195 million for transfer of special reserves.

Five-year outlay savings could reach $195 million if Option II were limited to a transfer of reserves only. Similar savings would result if, by legislative action, excess reserves were transferred to the general fund of the Treasury. If excess reserves were used instead to add benefits, on the other hand, five-year costs could increase to about $345 million.

Participating carriers might oppose this option because of fear that federally held funds would be less accessible, even though special reserves now are partly invested in multi-year securities, and arrangements for ready access to federal holdings could be provided through administrative action or legislation.

OPTION III. Impose Lower Reserve Limits, Require Disposal of Excess Reserves in the Next Contract Year, and Have the Federal Government Hold All Reserves

The most stringent alternative, Option III, would markedly lower reserve target levels. Upon full implementation, total cumulative reserves for all plans would average about 6 percent of premium income. Accumulated reserves for the two government-wide plans would average 5 percent of premium income, and for other plans, they would range from 6 percent to 12 percent of premium income, depending on plan size. As with Option II, this alternative would transfer carrier-held reserves to the federal government.

This option, which would require new authorizing legislation, would provide for short-term Treasury borrowing by the FEHB fund as a backstop to the lower reserve levels. The Treasury advances would be limited to 8 percent of premium income per individual plan, thus providing annual levels of contingency financing (reserves averaging 6 percent plus 8 percent borrowing authority) equivalent to OPM guidelines now set at 14 percent of premium income. The Treasury advances would be repaid, with interest, out of the following year's premiums.

As in the other two options, this alternative would discontinue the practice of holding reserves in excess of OPM targets. Because of its lower reserve requirements (which are consistent with OPM staff, GAO, and CBO analysis), Option III would achieve the greatest premium reductions. Premium savings would amount to $1.09 billion through fiscal year 1986. Of this amount, $455

million would benefit enrollees at an average of $23 per enrollee per year. Because of cost increases of $570 million for reduced enrollee and off-budget agency premiums and cost decreases of $195 million for the transfer of special reserves to the Treasury, Option IV would increase five-year budget outlays by $375 million. Much of the cumulative increase would occur in the first year of implementation. If, as a modification, excess reserves were used to add benefits, the increase in cumulative outlays could reach $890 million.

APPENDIXES

APPENDIX A. SUMMARY DATA ON FEHB PLANS

The analysis in this study is based on data for the two government-wide plans, 12 employee health insurance organizations, and the assorted small group and individual practices that participate in the FEHB program. Enrollment and reserve data on these plans are summarized in Table A-1. The employee organization plans covered are:

American Federation of Government Employees Health Benefit Plan (AFGE)

Government Employees Hospital Association Benefit Plan (GEHA)

National Association of Letter Carriers Health Benefit Plan (NALC)

Postmasters Benefit Plan

Rural Carrier Benefit Plan

Foreign Service Benefit Plan

Government Employees Benefit Association Health Benefit Plan (GEBA)

Panama Canal Area Benefit Plan (Canal Zone)

Special Agents Mutual Benefit Association (SAMBA) Health Benefit Plan

Mail Handlers Benefit Plan

Alliance Health Benefit Plan

American Postal Workers Union Plan (APWU)

TABLE A-1. SUMMARY DATA ON FEHB PLANS: CALENDAR YEAR 1979

Plan	Plan Income (in Millions of Dollars)	Enrollees (in Thousands)	Reserves (in Millions of Dollars)		
			Contingency	Special	Total
		Government-Wide Plans			
Blue Cross/ Blue Shield	1,751.3	1,867	153.9	242.8	396.7
Aetna	341.0	482	107.1	26.5	133.6
Subtotal	(2,092.4)	(2,349)	(261.0)	(269.3)	(530.3)
		Employee Organizations			
AFGE	25.8	30	3.9	1.4	5.3
GEHA	60.2	78	8.9	8.1	17.0
NALC	188.9	177	27.8	12.2	40.0
Postmasters	46.6	43	3.9	-3.3	0.6
Rural Letter Carriers	37.7	38	6.2	5.4	11.6
American Foreign Service	10.5	11	1.4	2.5	3.9
GEBA	5.8	6	.4	-0.5	-0.1
Canal Zone	20.5	20	3.0	5.5	8.5
SAMBA	19.0	19	3.4	5.4	8.8
Mail Handlers	61.1	71	8.3	14.9	23.2
Alliance Health	97.9	107	12.0	-2.7	9.3
APWU	215.4	207	26.5	14.3	40.8
Subtotal	(789.4)	(807)	(105.7)	(63.1)	(168.8)
		Group and Individual Practices			
	81.3	88	14.3	23.2	37.5
GRAND TOTAL	2,963.2	3,244	381.0	355.5	736.5

SOURCES: Derived by CBO from data in U.S. Office of Personnel Management, Federal Fringe Benefit Facts 1980, (preliminary). Number of enrollees taken from the 1979 report.

NOTES: Details may not add to totals because of rounding. Data on community-rated plans are not included; reserves for these plans account for only 4.4 percent of total FEHB program reserves.

APPENDIX B. OUTLAY EFFECTS OF OPTIONS

This appendix provides detailed information on the impacts of each option on total budget outlays and those of the FEHB fund. Detail of premium reductions for enrollees and agencies is also provided. All estimates represent changes from current Administration projections implicit in the March 1981 budget materials.

TABLE B-1. OUTLAY EFFECTS OF OPTION I RELATIVE TO ADMINISTRATION ESTIMATES: BY FISCAL YEAR, IN MILLIONS OF DOLLARS

	1982	1983	1984	1985	1986	Cumulative Effect
Impact on FEHB Trust Fund						
Reduction in payments to plans (-)	-30	-15	-15	-15	-15	-90
Reduction in income from lower premiums	140	80	80	105	135	540
FEHB Total	110	65	65	90	120	450
Impact on on-budget agencies	-65	-40	-40	-50	-65	-260
Net budget impact	45	25	25	40	55	190
Detail for Reduced Premium Income						
From enrollees	60	35	35	45	55	230
From off-budget agencies	15	5	5	10	15	50
From on-budget agencies	65	40	40	50	65	260
Total	140	80	80	105	135	540

SOURCE: Congressional Budget Office.

NOTE: Estimates, rounded to the nearest $5 million, reflect difference between FEHB contract (calendar) year and the federal fiscal year.

TABLE B-2. OUTLAY EFFECTS OF OPTION II RELATIVE TO ADMINISTRATION ESTIMATES: BY FISCAL YEAR, IN MILLIONS OF DOLLARS

	1982	1983	1984	1985	1986	Cumulative Effect
Impact on FEHB Trust Fund						
Reduction in payments to plans to eliminate special reserves (-)	-45	-45	-75	-30	a/	-195
Reduction in income from lower premiums	140	80	80	105	135	540
FEHB Total	95	35	5	75	135	345
Impact for on-budget agencies	-65	-40	-40	-50	-65	-260
Net budget impact	30	-5	-35	25	70	85
Detail for Reduced Premium Income						
From enrollees	60	35	35	45	55	230
From off-budget agencies	15	5	5	10	15	50
From on-budget agencies	65	40	40	50	65	260
Total	140	80	80	105	135	540

SOURCE: Congressional Budget Office.

NOTE: Estimates, rounded to the nearest five million dollars, take into account the difference between the program's contract (calendar) year and the federal fiscal year.

a/ No reduction in payments to plans occurs in this year because administration estimates show no change in special reserve levels between fiscal year 1985 and fiscal year 1986.

TABLE B-3. OUTLAY IMPACT OF OPTION III ON ADMINISTRATION BUDGET ESTIMATES: BY FISCAL YEAR, IN MILLIONS OF DOLLARS

	1982	1983	1984	1985	1986	Cumulative Effect
Impact on FEHB Trust Fund						
Reduction in payments to plans to eliminate special reserves (-)	-45	-45	-75	-30	a/	-195
Reduction in income from lower premiums	410	200	125	160	190	1,085
FEHB Total	365	155	50	130	190	890
Impact for on-budget agencies	-195	-95	-60	-75	-90	-515
Net budget impact	170	60	-10	55	100	375
Detail for Reduced Premium Income						
From enrollees	175	85	50	65	80	455
From off-budget agencies	40	20	15	20	20	115
From on-budget agencies	195	95	60	75	90	515
Total	410	200	125	160	190	1,085

SOURCE: Congressional Budget Office.

NOTE: Estimates, rounded to the nearest five million dollars, take into account the difference between the program's contract (calendar) year and the federal fiscal year.

a/ No reduction in payments to plans occurs in this year because administration estimates show no change in special reserve levels between fiscal year 1985 and fiscal year 1986.