Consumer Operated and Oriented Plan (CO-OP) Advisory Board

Testimony of Jay C. Ripps, FSA, MAAA

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My name is Jay Ripps. I am a Fellow of the Society Actuaries (Society) and a Member of the American Academy of Actuaries (Academy). I was a co-author of a 2009 report of the Society and the Academy regarding capital requirements for CO-OPs. I am currently Chief Health Actuary of the State of California Department of Insurance; however, my testimony reflects my personal opinions only and should in no way be construed as the opinions or policy positions of the Society, the Academy, or the California Department of Insurance

I understand that the loans and grants authorized by the Affordable Care Act will be awarded by the Secretary of the US Department of Health & Human Services, taking into account the recommendations of this Advisory Board. The purpose of my testimony is to emphasize the importance of risk capital in assuring that CO-OPs are able to fulfill their implicit and explicit promises to their members.

The Role of Risk Capital

Risk Capital is the capital held by a risk-bearing organization to help assure that the organization will be able to keep its promises to its customers/members, even under very adverse circumstances. Insurance companies are generally required to meet minimum capital standards defined by the National Association of Insurance Commissioners (NAIC). The NAIC standards are calculated according risk-based capital formulas that are intended to established capital requirements reflective of an insurance

company's risk. The standards take into account the amount and quality of the company's assets, the volatility of its future financial commitments, and other company-specific risks.

Risk-based capital standards for insurance companies have served the public well. During the financial crises of recent years insurance companies generally remained financially strong and able to fulfill their commitments -- in contrast to other financial institutions that were not subject to similarly well-defined objective standards. It would be unfortunate if CO-OPs did not adhere strictly to these standards.

Calculation of Risk Capital Requirements For Health Insurance Organizations

Risk-based capital requirements for health insurance organizations involve a combination of four types of risk -- asset risk, underwriting risk, credit risk, and business risk. In most instances underwriting risk is by far the largest component of a company's total risk-based capital requirement. The underwriting risk component is related primarily to the amount and distribution of a company's premium income. Thus, as a company grows, the amount of risk-based capital related to underwriting also grows. If an insurance company pays for health care under contracts that involve transfer of some risk to providers of health care, such as contracts involving payment on a capitation basis, the insurance company's risk is reduced, and the underwriting risk capital requirements are reduced commensurately. As a general rule of thumb, minimum risk-based capital requirements for health insurance companies generally amount to about 10% to 15% of premium income. It is possible that provisions of the Affordable Care Act regarding

reinsurance, risk adjustment, and risk corridors may eventually lower those numbers, but I suggest you bear them in mind for now as you formulate policy recommendations.

Sources of Risk Capital

There are two broad sources of risk capital – investors or net income from operations. Initial risk capital can be provided by investors, either stockholders in public companies or private investors in privately held companies, who are paid back though dividends or appreciation of the value of the company if it is successful. In the case of CO-Ops, initial risk capital is to be supplied via grants from the federal government, with a requirement for repayment within 15 years. (Since they are expected to be repaid, it is not clear whether, in fact, these grants can be treated as surplus and thereby satisfy risk capital requirements.)

Additional capital, beyond initial risk capital, is required as the risk, measured in large part by premium volume, grows. Additional growth capital may be obtained from investors. Most often, however, additional capital to support increased volume of business is obtained from net income from operations; that is, a portion of net income is retained as surplus, which allows the organization to take on additional risk associated with growth.

CO-OPs may be able to obtain such growth capital through additional grants from the Federal government. However, such additional grants do not appear to be the intent of the Affordable Care Act, and it would appear to violate the general notion that CO-OPs are to compete with other health insurance programs on “a level playing field”, as

generally expressed in paragraphs (c)(5) and (f)(2) of Section 1322 of the Affordable Care Act:

(1) "An organization shall not be treated as a qualified nonprofit health insurance issuer unless the organization meets all the requirements that other issuers of qualified health plans are required to meet in any State where the issuer offers a qualified health plan, including solvency and licensure requirements, rules on payments to providers, and compliance with network adequacy rules, rate and form filing rules, any applicable State premium assessments and any other State law described in section 1324(b)".

(2) "Nothing in this section shall be construed as authorizing the Secretary to interfere with the competitive nature of providing health benefits through qualified nonprofit health insurance issuers".

Thus, the primary source of growth capital should probably be retained net income not distributed to CO-OP members in the form of lower premiums or increased benefits.

There is often tension in member-owned organizations between the immediate distribution of all net income to members and the retention of a portion of net income to build infrastructure or otherwise support growth. That tension is very likely to occur in the governance of successful CO-Ops. In fact, it appears to be inherent in paragraphs (c)(4) and (c)(5) of Section 1322. Paragraph (c)(4) requires that, "any profits made by the [CO-OP] are required to be used to lower premiums, to improve benefits, or for other programs intended to improve the quality of health care delivered to its members". On the other hand, paragraph (c)(5) requires CO-OPs to meet State solvency requirements, which include risk-based capital requirements. What then will be the source of growth capital for successful CO-OPs?

<u>Recommended Advisory Board Policy Position On Risk Capital</u>

In summary, CO-OPs can serve their members successfully only if they have the financial resources to keep their promises to their members. Adequate risk capital will help to assure that CO-OPs can keep their promises. The amount of risk capital required will increase as CO-OP membership increases. Federal grants can cover initial risk capital requirements, but such grants are not likely to be available to meet increasing risk capital requirements associated with increasing membership.

Successful CO-OPs will require an assured source of growth capital if they are to sustain their success. This will mean that their premium rates should be set so as to generate a reasonable level of net income. However, there will be pressure not to retain a portion of net income for increasing risk capital. Therefore, I urge the Advisory Board to recommend to the Secretary of Health & Human Services a requirement that any recipient of loans and grants under the CO-OP program incorporate in its governing documents a policy that premium rates will be set with the intention of generating net income and that a portion of the net income be set aside to meet projected risk capital requirements, before any such net income is used to lower premiums, to improve benefits or quality care, or is otherwise distributed to co-op members.

Thank you for the opportunity to testify. I welcome questions and comments.