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General Accounting Office
Washington, D.C. 20548

Human Resources Division

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April 4, 1994

The Honorable Daniel Patrick Moynihan
Chairman
The Honorable Bob Packwood
Ranking Minority Member
Committee on Finance
United States Senate

The Honorable John D. Dingell
Chairman
The Honorable Carlos J. Moorhead
Ranking Minority Member
Committee on Energy and Commerce
House of Representatives

The Honorable Dan Rostenkowski
Chairman
The Honorable Bill Archer
Ranking Minority Member
Committee on Ways and Means
House of Representatives

Title IV, part 5 of the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990, P.L. 101-508, Nov. 5, 1990) amended section 1882 of the Social Security Act, which prescribes standards for individual and group Medicare supplemental (Medigap) insurance policies. The law requires Medigap policies sold to individuals to achieve a 65-percent loss ratio;[1] for policies sold to groups, the required loss ratio is 75 percent. OBRA 1990 also requires insurers to provide policyholders a proportional refund or credit against future premiums if these loss ratio percentages are not met after the policies have been in force for 2 years or longer.

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[1]The loss ratio is the percentage of premiums returned to policyholders as benefits and is one measure of the economic value of these policies. Under federal law before OBRA 1990, the minimum loss ratio requirement for Medigap policies sold to individuals was 60 percent.

The act required us, in consultation with the National Association of Insurance Commissioners (NAIC),[2] to report to the Congress on what loss ratio percentages would be appropriate if the refund and credit provision of OBRA 1990 was extended to provide refunds or credits for the first 2 years a policy is in effect. In meetings with your offices, we agreed also to summarize NAIC's methodology for calculating refunds or credits.

In summary, NAIC interpreted the law in a manner that led it to adopt a cumulative loss ratio approach to implement the credit and refund provision. NAIC's method considers the experience during a policy's first 2 years in determining, in the third and subsequent years, whether the loss ratio requirement has been met. Therefore, under NAIC's interpretation, it would not be necessary to specifically provide for credits or refunds during a policy's first 2 years. However, under NAIC's cumulative loss ratio methodology, a policy that fails to meet the standard for a particular year may not trigger a refund or credit.

An alternative interpretation of the law would be that refunds and credits after the first 2 years should be based on the actual loss ratio for each year. This interpretation would ensure refunds or credits each year a policy fails to meet loss ratio percentages, but it might lead to somewhat more volatility in premiums from year to year.

BACKGROUND

Medigap insurance is private insurance designed to cover Medicare deductibles and coinsurance[3] and some services not covered by Medicare. OBRA 1990 amended section 1882 of the Social Security Act concerning the regulation of Medigap insurance to (1) simplify comparisons of supplemental

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[2]NAIC consists of the heads of the insurance departments of the 50 states, the District of Columbia, and 4 U.S. territories. NAIC encourages uniformity and cooperation in insurance regulation among the states and territories. Among its activities to promote those goals, NAIC promulgates model insurance laws and regulations for state consideration and adoption.

[3]Deductibles are the amounts Medicare beneficiaries must pay for covered services before Medicare pays for services. Coinsurance is the amount of charges for covered services for which beneficiaries are responsible after deductibles are met.

policies offered to Medicare beneficiaries, (2) hold insurers accountable for complying with minimum standards, (3) reduce marketing and advertising abuses in the sale of Medigap insurance, and (4) enhance the economic value of this insurance. In response to the changes contained in OBRA 1990, NAIC revised its Medigap model law and regulation.

This letter reports on another provision of OBRA 1990, which requires insurers to provide a refund or credit against future premiums if a new or existing policy's actual loss ratio does not conform to the loss ratio percentages. The first 2 years a policy is effective were specifically excluded from the refund or credit provision. The law also required GAO to study what adjustments might be appropriate to impose the refund provision during a policy's first 2 years.

NAIC's CREDIT AND REFUND PROVISION IN ITS MODEL LAW AND REGULATION

On July 30, 1991, NAIC adopted a revised model insurance law and regulation (the NAIC model) as necessitated by OBRA 1990. Although the legislative history provides little guidance regarding how compliance with the loss ratio percentages is to be determined, NAIC believed that the Congress intended that a cumulative approach be adopted. Thus, NAIC's methodology for annual refund calculations is based on cumulative data, including a policy's first 2 years' experience.

Under NAIC's methodology, a cumulative 65-percent loss ratio for individual policies (75 percent for group policies) must be met over the life of a policy, which NAIC assumed to be 15 years. NAIC based its methodology on the portion of OBRA 1990 that amended section 1882 of the Social Security Act to read:

> "A medicare supplemental policy may not be issued or sold in any State unless--
> (A) the policy can be expected (_as estimated for the entire period for which rates are computed to provide coverage_, on the basis of incurred claims experience and earned premiums for such periods . . . to return to policyholders in the form of aggregate benefits provided under the policy, at least 75 percent of the aggregate amount of premiums collected in the case of group policies and at least 65 percent in the case of individual policies." (Emphasis added.)

NAIC's methodology compares a policy's actual loss ratio for a given year with a benchmark (or target) ratio for that year, calculated using cumulative premium and claim experience. If a policy's actual loss ratio is below the benchmark ratio, the insurer must complete further calculations to determine whether a refund or credit is necessary to bring the loss ratio into compliance with the standard. Loss ratios for an individual policy are expected to be 40 percent the first year (on a calendar-year basis), 55 percent the second year, and 65 percent the third year. Annual loss ratios would continue to increase until they reach 77 percent by the twelfth year and remain at that level for the remainder of the 15-year period. This approach anticipates that the higher loss ratios in the third and later years would offset the lower loss ratios in the first 2 years. This methodology is designed to ensure a cumulative 65-percent loss ratio for individual policies by the end of a 15-year period. The same approach is used for ensuring a 75-percent loss ratio by the end of a 15-year period for group policies. NAIC officials told us that the 15-year period selected was a compromise between the insurance companies' desire for pricing flexibility and insurance regulators' desire for a reasonable period within which to demonstrate compliance.

NAIC's methodology to determine whether a refund or credit is required includes a tolerance adjustment based on the number of policyholders and the length of time they have held their policies. A policy loss ratio based on less than 500 life-years'[4] exposure since inception is considered "not credible," and no refund or credit is required. In the opinion of NAIC's Actuarial Advisory Group and several insurance regulators, this tolerance adjustment will help ensure that refunds or credits will not occur so frequently in the early years of policy experience that large premium increases will result in later years.

Two other assumptions NAIC included in its methodology are that (1) premiums increase 10 percent each year and (2) lapse rates are 30 percent the first year, 25 percent the second year, 20 percent for each of the next 3 years, and then settle at 17 percent for the sixth through the fifteenth years.

NAIC's approach requires insurers to complete a refund or credit worksheet for each type of individual and group policy, for each state where a particular policy is sold.

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[4]A life-year of exposure is 1 person insured for 1 year.

The refund or credit worksheets are due to the state insurance department by May 31 each year, and the refund or credit must be paid by the following September 30. The effective date of this requirement will be determined by the date each state adopts the NAIC model, and as of October 1993, all states and territories except American Samoa and Guam had adopted this requirement. Beginning with the third year a policy is effective, if the worksheet shows that a policy loss ratio (adjusted for number of life-years exposed) is below the benchmark ratio for the policy, the company must calculate its refund or credit liability. The worksheet contains provision for a de minimis allowance,[5] and if the refund or credit is less than this allowance, no refund or credit is required. The worksheet is based on cumulative data, including earned premiums, incurred claims, refunds, and credits since the policy was first sold. If a company owes a small refund or credit but does not have to pay it because of the de minimis criteria, that amount is carried over into the next year's worksheet calculations.

ADVANTAGE AND DISADVANTAGE OF NAIC'S METHODOLOGY

An advantage of NAIC's methodology is its reliance on cumulative data, which includes all policy experience in determining whether the policy's loss ratio complies with the applicable standard. Higher loss ratios in the later years are expected to offset lower loss ratios in the early years to produce a cumulative loss ratio of at least 65 percent for policies sold to individuals and 75 percent for group policies over the 15-year assumed life of a policy. While refunds or credits are not required in the first 2 years, premiums and claims experience from those 2 years are included in the refund calculations of later years.

NAIC states that its methodology also accommodates various insurance company pricing techniques. NAIC representatives told us that some insurers price their products to meet the loss ratio standards on a year-by-year basis; others set premiums to achieve the loss ratio standard over a longer period of time. NAIC's methodology is compatible with either pricing method. An NAIC actuary said that companies that price on a year-by-year basis should have no difficulty meeting the benchmark level. By applying the test for a refund or credit to a policy's cumulative loss ratio, NAIC's

[5]The de minimis threshold amount is 0.5 percent of the policy's annualized total premiums at the end of the reporting year.

methodology is also compatible with the pricing practices of companies that set premiums for a longer term.

A disadvantage to NAIC's methodology is that a policy's annual loss ratio in the third or later years may be less than the minimum 65 or 75 percent specified in federal law, and the company might not be required to grant a refund or credit. This could happen if

-- relatively high loss ratio experience in early years helps bring the cumulative loss ratio into compliance with the benchmark loss ratio, offsetting low loss ratios in later years.

-- lapse rates differ from those used to establish the benchmarks.

-- the amount of refund or credit due is less than the de minimis amount.

-- the tolerance adjustment for life-years exposed raises a loss ratio to or above the benchmark ratio level. For example, if a policy had 500 to 999 life-years exposed since the policy's inception, the NAIC methodology adds 15 percent to the policy loss ratio. This tolerance adjustment decreases in steps with more life-years exposed, to an adjustment of 5 percent for 5,000 to 9,999 life-years exposed. (If 10,000 or more life-years were exposed, no adjustment is allowed.)

ALTERNATIVE INTERPRETATION OF THE REFUND PROVISION

OBRA 1990 specifically excluded the first 2 years in which a policy is effective from the requirement for providing a refund or credit. Additionally, OBRA 1990 provided that refunds or credits "shall be made to each policyholder insured under the applicable policy as of the last day of the year involved," and "refunds or credits against premiums due shall be made, with respect to a policy year, not later than the third quarter of the succeeding policy year."

Taken in connection with the requirement that we recommend adjustments to the loss ratio standards to make the refund or credit provision applicable to the first 2 years a policy is effective, the law could be interpreted to mean that policy loss ratios be computed on a calendar-year basis and that refunds or credits be paid if a policy's loss ratio for

a particular calendar year failed to comply with the loss ratios stated in the law.

If this interpretation of OBRA 1990 were followed, minimum loss ratio percentages for each of a policy's first 2 years of experience could be considered appropriate to ensure that insurers are held accountable for returning a fair portion of premiums to policyholders. According to the insurance industry, a potential disadvantage of this interpretation of the provision would be somewhat more volatile premium changes from year to year.

The benchmark rates used under NAIC's methodology for the first 2 years (40 percent and 55 percent, respectively, for individual policies and 46 percent and 63 percent for group policies) could be used as standards for refunds or credits if the refund provision were extended to the first 2 years a policy is in effect under the alternative interpretation. However, we do not believe that including the first 2 years for refund calculations would be absolutely necessary. OBRA 1990 required that no more than 10 Medigap policy types, each with identical terms, conditions, and benefits, could be offered to the public. This makes it easier for consumers to compare premium rates for each policy type, and presumably an insurer that offered policies at substantially higher than normal rates would attract little business. Moreover, under the NAIC model, Medigap policies are required to be guaranteed renewable, which means individual policyholders cannot be canceled, and if an insurer discontinues an entire policy (that is, cancels all policyholders), the insurer is prohibited from selling that policy type for 5 years. These provisions make it less likely that policies will be canceled.

SUMMARY

As authorized by OBRA 1990, NAIC developed a methodology for calculating Medigap policy loss ratios. That methodology incorporates an expected loss ratio for individual policies of 40 percent in a policy's first year and 55 percent in the second year, even though no refunds or credits are currently required in either of those 2 years; the expected loss ratios for group policies in the first and second years are 46 percent and 63 percent. Because NAIC has established target loss ratios for the first 2 years of policy experience and the refund or credit calculations include cumulative data, we believe no action is needed at this time to apply the refund or credit provision of OBRA 1990 to the first 2 years of Medigap policy experience. NAIC's loss ratios for a policy's first 2 years could also be used if

the Congress decided to require refunds or credits in the first 2 years a policy is effective.

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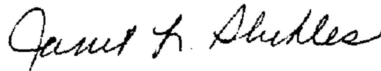
As directed by OBRA 1990, we consulted with representatives of NAIC from its headquarters in Kansas City, Missouri, and its Washington, D.C., office. We also discussed NAIC's methodology with officials of the Health Care Financing Administration (HCFA), the agency within the Department of Health and Human Services that is responsible for administering Medicare. Our methodology included a review of the language of OBRA 1990, a review of NAIC's refund or credit calculation methodology, and interviews with NAIC and HCFA representatives.

We performed our work in accordance with generally accepted government auditing standards.

We are sending copies of this letter to the Director, Office of Management and Budget; the Secretary of Health and Human Services; interested congressional committees; and other parties who request them.



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