Draft: 7/21/21

Health Risk-Based Capital (E) Working Group
Virtual Meeting (*in lieu of meeting at the 2021 Summer National Meeting*)
July 12, 2021

The Health Risk-Based Capital (E) Working Group of the Capital Adequacy (E) Task Force met July 12, 2021. The following Working Group members participated: Steve Drutz, Chair (WA); Jennifer Li (AL); Wanchin Chou (CT); Kyle Collins, (FL); Tish Becker and Brenda Johnson (KS); Rhonda Ahrens, Lindsay Crawford and Michael Muldoon (NE); Tom Dudek (NY); Kimberly Rankin (PA); and Mike Boerner, Matthew Richard, and Sean Fulton (TX).

1. Adopted its June 8, May 25, and April 23 Minutes

The Working Group met June 8, May 25, and April 23. During these meetings, the Working Group took the following action: 1) adopted its March 17 minutes; 2) discussed the 20 bond designation factors; 3) received comments and referred the investment income adjustment to the underwriting risk factors (2021-04-CA) proposal to the Capital Adequacy (E) Task Force; 4) discussed, exposed, and requested the American Academy of Actuaries' (Academy's) assistance in a comprehensive review of the H2 – Underwriting Risk component; 5) adopted revisions to the 2021 health risk-based capital (RBC) working agenda; 6) adopted proposal 2021-09-H (Bond Factors); 7) discussed developing a process and the other lines of business to be considered for investment income in the underwriting risk factors; and 8) received an update on the Health Test and Health RBC Excessive Growth Charge Ad Hoc Groups.

Mr. Chou made a motion, seconded by Mr. Boerner, to adopt the Working Group's June 8, May 25, and April 23 minutes (Attachments Three-A, Three-B, and Three-C). The motion passed unanimously.

2. Adopted its 2021 Health RBC Newsletter

Mr. Drutz said the health RBC newsletter has been updated to include a summary of the proposals adopted for the 2021 health RBC formula, which have been incorporated into the instructions, blanks, and formula.

Ms. Rankin made a motion, seconded by Mr. Dudek, to adopt the 2021 health RBC newsletter (Attachment Three-D). The motion passed unanimously.

3. Approved the 2020 Health RBC Statistics

Mr. Drutz said the 2020 health statistics were run on June 30. He said there were 1,067 health RBC filings loaded onto the NAIC database, up from 1,012 in 2019. Fifteen companies triggered an action level in 2020, of which four were in a company action level, three were in a regulatory action level, two were in an authorized control level, and six were in a mandatory control level. Twelve companies triggered the trend test. He said that both the authorized control level (ACL) and total adjusted capital (TAC) increased from 2019 to 2020.

The Working Group unanimously approved the 2020 health RBC statistics (Attachment Three-E) to be posted to the Working Group's web page.

4. Received a Response from the Academy on H2-Underwriting Risk Component Review

Derek Skoog (Academy) said that the Academy is happy to support the effort and review of the underwriting risk factors. (Attachment Three-F) He asked the Working Group to provide guidance on: 1) the scope and phases of work; 2) desired output/perspective requested by the NAIC from the Academy; and 3) general time frame and key dates/deadlines to assist in putting a project plan together. He said that the Academy wants to be thoughtful and upfront to make sure that the Working Group gets the information needed and in the time frame that is needed.

Mr. Drutz said that the scope and phases of work could include breaking out the work by structure, factors, or potentially by line of business and managed care credit. Mr. Skoog agreed. He said this will allow the Academy to identify where to focus its resources. He said that the Academy plans to approach this review in pieces to ensure that it is providing the Working Group with the information it is looking for, by starting with a survey and review of methodologies.

Mr. Drutz said that the Working Group may address the desired output/perspective requested by the NAIC from the Academy by asking if: 1) the current structure and formula still accurately reflect the risks associated with the types of business included under the H2 component; 2) there are other business types that should be considered; and 3) the structure and format of the H2 component still make sense. Mr. Boerner agreed with the questions outlined on addressing the desired output/perspective.

Mr. Drutz said if a year-end 2023 implementation date was used, the Working Group would need to receive a final report by year-end 2022 in order to expose and address any structural changes that would need to be implemented. He asked if this seemed to be a reasonable time frame to work towards and noted that if additional time was needed, the Working Group could work with the Academy to revise this. Mr. Skoog agreed that this seemed like a reasonable time frame. Mr. Boerner agreed with this approach.

Mr. Skoog said that given the importance and impact of the managed care credit, the Academy would tackle both the underwriting risk and managed care credit together because it is difficult to extricate the managed care credit from how the broader underwriting risk factors work today. He suggested that the Academy discuss both the underwriting risk and managed care credit together within the context of the broader underwriting risk structure.

Lou Felice (NAIC) suggested that additional study be done on "incentives" within the "withholds or bonuses/incentives" portion of the managed care credit to clarify what is still valid with regard to these types of incentive arrangements. Mr. Skoog said that this is something that could be incorporated into the project.

Mr. Skoog said that the information provided will assist the Academy in moving forward. The Academy will then come back to the Working Group to discuss the existing structure, fit for purpose and to the extent necessary suggested structure alternatives, quantification approaches, and come up with a path forward but not yet a full execution. He said that it may make the most sense for the Academy to first focus on the Underwriting Risk – Experience Fluctuation Risk page (experience fluctuation risk) and determine if those columns are the right roll up of the Analysis of Operations page. Mr. Muldoon said it would be worthwhile to understand all the pieces of the experience fluctuation risk page and if it is the correct roll up and combination of how that should be.

Mr. Drutz summarized the Academy's approach as first reviewing the structure to ensure it would meet the purposes going forward and any changes to consider. Then the Academy will go to a more granular level and look at the different lines of business.

The Academy agreed to provide updates to the Working Group.

5. <u>Discussed Bond Factors</u>

Mr. Drutz said that the Working Group adopted the Academy's proposed health bond factors with the bond portfolio adjustment for year-end 2021 reporting. He said the Academy's life model was used as the basis in the development of the health bond factors and adjusted for health assumptions. He said the Life Risk-Based Capital (E) Working Group adopted the proposed Moody's bond factors in June, which used differing assumptions from the Academy model.

Mr. Drutz asked if the Working Group thinks the adopted bond factors should be reevaluated given the differing models used between the life and health formulas. Mr. Chou said the Working Group should reevaluate the bond factors due to major assumption differences in the models by the Academy and Moody's. The Academy used the economic state of the cycle, while Moody's used a correlation model. He also noted that the original scope of the Academy's data was from 2010.

Mr. Drutz said the Moody's analysis used a typical life bond portfolio and not the broad spectrum of bonds available out in the market. He said consideration may need to be given on how a health portfolio may differ from life, as well as how that could drive some of the differences in analysis between the Moody's and Academy's models.

Mr. Drutz said the Working Group would need to gain a better understanding of the Moody's model, as well as compare the differences between each model. He said the Working Group will need to identify the assumptions used by Moody's and how those assumptions would align with health. Mr. Felice said that the Property and Casualty Risk-Based Capital (E) Working Group also adopted the Academy's factors and suggested bringing this to the Capital Adequacy (E) Task Force to identify a justification for each group to look at adjusting the factors based on what the Life Risk-Based Capital (E) Working Group did. Mr. Chou said that he also brought this up to the Property and Casualty Risk-Based Capital (E) Working Group. Mr. Drutz agreed to reach out to the Property and Casualty Risk-Based Capital (E) Working Group and the Working Group will continue to discuss this item further on future calls.

6. <u>Discussed Developing a Process and the Other Lines of Business to Be Considered for Investment Income in the Underwriting Risk Factors</u>

Mr. Drutz said the Working Group previously adopted revised underwriting factors for comprehensive medical, Medicare supplement, and dental and vision business to include a 0.5% investment income adjustment. He said the Working Group agreed to develop benchmarking guidelines for updating the factors in the future for potential changes in investment yields. He suggested the following approach based on the previous discussions: use a three- or six-month Treasury as the basis of the benchmark and round up to the nearest 0.5% mark. For example, if the current rate was 0.4%, the investment yield would remain at 0.5%. However, if the yield increased to 0.7%, the yield would round up to 1%. Mr. Drutz suggested using Jan. 1 for which to base the adjustment. He said his suggestion for rounding up to the nearest half a percent was based on previous discussions where the argument was made to base the adjustment on the investment portfolio as a whole, while other arguments were made to the fact that the premiums that are part of the underwriting components are only held by the companies for a short period of time, and the investment income from those premiums that are held are then later paid out in claims. Therefore the yield on those investments was little. Therefore, the rounding up to the nearest half percent was to provide a compromise between both arguments.

Mr. Muldoon agreed with what has previously been discussed and noted that the Working Group will likely be reviewing this again as part of the H2 review. He suggested using the six-month Treasury and rounding up to the nearest half of a percent, as well as the Jan. 1 date to update annually based on where the Working Group is at right now.

Jim Braue (UnitedHealth Group—UHG) said that UHG thinks that using something like a six-month Treasury is excessively conservative. If one is focusing on the run-out period of the reserves or the lag between premium receipt and pay out of claims, that is basically looking at it from the viewpoint that 100% of the business runs off immediately. He said it was noted during a previous meeting that while it may not be the case that one should expect 100% to run-off immediately, it could easily be the case that 30% runs off immediately. This is true and supports UHG's position. For example, 30% of the business runs off immediately, and then another 30% runs off each year thereafter. Then one still has about two and a half years average maturity of the business. In order to get down to six months, one would have something like 60% of the business running off immediately. This means the day after RBC is calculated and the entirety of the remainder of the business running off the next year, so it is a conservative approach and is not consistent with what is actually going on in the business. Mr. Braue said that investment income adjustment was driven on a charge for a risk associated with the investment portfolio, and it seems appropriate to have an offset for the benefits arising from that portfolio. He said UHG originally suggested that the adjustment be incorporated as part of the bond factors. However, based on the Academy's recommendation, the adjustment was made to the underwriting risk factors. He said as a result one is really only looking at the investments associated with the claim reserves in effect and ignoring some of the longer liabilities that may be out there, such as rate credit reserves that may not pay out until a fair amount of time is past even after the business has run of the books. He said it also does not reflect the earnings on surplus. Mr. Braue said from the extremely conservative viewpoint of how long the business will stay around and the extremely conservative viewpoint of what investment should even be considered, the end result will be extremely conservative. He said UHG understands the arguments for not going out the full five years to be consistent with the bond factors and consistent with the modeling done for those factors, but going down to three to six-months is excessive. He said that an average maturity could be calculated for a reasonable amount of business that is terminated each year and could come out with something in excess of a year and maybe even two years. He asked the Working Group to give further consideration to this.

Mr. Drutz said his understanding of a run-off period is that premium is brought in on month one, and claims are generally paid out on those premiums in months two and three. By the time one gets to month six, those claims have already been paid by those premiums that were initially taken in. Mr. Braue said in terms of cash flow, premiums come in at the beginning of the first month, and claims are paid out in the second month. However, in that second month, additional premiums would be received. He said not everything would be invested in one-month instruments because one is going to be paying out claims in the next month and there is a reasonable expectation of receiving more premium in the next month and more premium in the month after that. The result is that with the net cash inflow over that entire period, one never has to liquidate any investments. Therefore, it is not that one is taking those same premium dollars and paying them out a month and a half later. There is a constant inflow of premiums and a constant outflow of claims. As long as the business is at least a break even, the entity will generally have a net positive cash flow and would not have to liquidate any investments or use the maturity proceeds of any investments to pay claims. Mr. Braue said the assumption cannot be made that business will remain constant or grow forever. Therefore, a conservative short time horizon may be considered. He said typically an entity is not going to invest all of the money back in claim reserves in one-month instruments. He said from a cash-flow standpoint, an entity is not constantly investing money and then immediately liquidating the investment to pay claims. Instead, the entity invests based on what the net cash flow is going to be over time. Mr. Braue said that determining how quickly the business will run-off will determine how far out a company can invest.

Mr. Muldoon said that when reviewing the investment income, the Working Group should look at what carriers are telling state insurance regulators in the rate filings, such as how much investment income they are getting and how much is accounted for in their margins. He said some carriers state it is so negligible (not even one-tenth of a percent) that they do not account for it in their profit margins or contingency margins. Because the investment income on the unpaid claim liability reserves is so small and such a short-term liability, they do not make any investment income on it. He said at some point, the Working Group will need to put those pieces together, where they tell state insurance regulators that there is almost no investment income so it is not identified as part of the retention versus the argument here. Mr. Muldoon said that for the time being, the proposal that Mr. Drutz outlined seems the best approach for moving forward at this time.

Mr. Drutz said that the Working Group will continue to discuss this during future meetings.

Having no further business, the Health Risk-Based Capital (E) Working Group adjourned.

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