May 5, 2023

Ms. Amy Malm, Chairperson  
NAIC Risk-Focused Surveillance Working Group  
Via e-mail to Bruce Jenson, NAIC, at bjenson@naic.org

Re: Risk-Focused Surveillance Working Group Exposure of NAIC Handbook Revisions for Affiliated Agreements

Dear Ms. Malm:

We are pleased to submit the response of the interested parties (IPs) to the Risk-Focused Surveillance Working Group’s (RFSWG) latest exposure of the NAIC handbook revisions involving affiliated agreements.

First and foremost, we thank you for the opportunity to participate in this continuing collaborative and productive effort. We believe that the current exposure is much improved from the Fall 2021 version and addresses the concerns that IPs had at that time. We all agree that there is no single “magic bullet” to demonstrate that market-based agreements with affiliates are fair and reasonable and it remains management’s responsibility to document and support the basis and rationale for its assertions as contained in the Form D including that the agreement is fair and reasonable.

We acknowledge that examiners and analysts have certain authorities, and IPs do not intend to limit those. We believe that the revisions avoid any such inference and include criteria to help guide examiners determine when it would be most appropriate to consider the ongoing fairness and reasonableness of an agreement.

Moreover, the examiner is encouraged to start the assessment by obtaining guidance from the analyst rather than “starting from scratch.” In our view, ongoing communication and coordination between analysts and examiners will help regulators understand what issues, if any, remain following the Form D approval and implementation of the agreement.
Our comments herein are limited to a single open item, i.e., guidance regarding agreements with affiliates for which consideration is based on a “cost-plus” arrangement. The current exposure removed any guidance related to such agreements and seeks feedback from IPs on several questions posed by the Working Group. We understand that the Working Group will then consider the responses to those questions and resolve the open matter about what text, if any, should be included in the handbooks about cost-plus arrangements.

**Handbook guidance for cost-plus arrangements involving agreements with affiliates**

To level set, it is helpful to understand what is currently published in the handbooks about cost-plus agreements, and how that evolved in the current exposure.

The *NAIC Financial Analysis Handbook* as currently published includes very limited text with respect to an insurer’s agreements with affiliates that are based on a cost-plus arrangement:

- In the handbook section on Best Practices for Affiliated Management and Service Agreements, there is the following statement: “Transactions at cost-plus mark-up that is equal to market rate should be reviewed carefully and should be deemed fair and reasonable. Transactions at cost-plus mark-up that is less than market rate should be reviewed carefully to determine if it is fair and reasonable.”

- In each of the sectoral Operational Risk Repositories, there is the following statement if the concern involves a management agreement or service contract: “For any arrangement based on a cost-plus formula or percent of premiums formula, request justification from the insurer for amounts in excess of the actual costs of providing the service.”

In the current exposure, the Working Group deleted the first of those statements. The brief text in each of the Operational Risk Repositories has been retained. The IPs respectfully request that the removed language regarding cost-plus transactions be included in the handbook.

IPs understand that some of the regulators on the Working Group raised questions and regulators excluded that text for purposes of gathering public comment on this issue. However, there is remaining guidance that applies regardless of the nature of the arrangement (e.g., whether based on cost, cost-plus, or market). For example, the following text applies to all agreements with affiliates (emphasis added):

> “Pricing for agreements with affiliates may be negotiated between related parties on a variety of basis including cost and market-based pricing. *Regardless of the method utilized, it is the responsibility of management to appropriately evidence that the terms of the agreement satisfy the “fair and reasonable” standard.* It is management’s responsibility to provide documentation demonstrating that this standard has been met using any of a number of methods including but not limited to those described below. The Form D filing should thus include management’s documented support for its assertion that the transaction meets the “fair and reasonable” standard.”
That text was included at the suggestion of industry representatives for two primary reasons. First, it clarifies that management has the responsibility to demonstrate that an agreement between affiliates is fair and reasonable within the Form D filing. Secondly, and as a practical matter, given the diversity of products and services for which agreements with affiliates may exist – spanning from reinsurance agreements, investment management services, leases, pharmacy benefit programs, and much more – it is not feasible for state insurance regulators to always independently validate management’s analysis. The onus is on management to provide documented support for their assertion and on the regulator to determine if management’s analysis is fair and reasonable under the circumstances.

With that preface, we offer the following responses to the questions posed in the Working Group’s current exposure.

**1. Should guidance on reviewing “cost-plus” reimbursement rates be added to the Handbooks?**

- Yes. While there currently remains references to cost-plus arrangements in the Operational Risk Repositories, omission of any reference to cost-plus arrangements in the Best Practices section of the handbook could be misunderstood to imply that such arrangements are not acceptable for regulatory purposes and should not be accepted by all states.

- States will continue to have the discretion to accept cost-plus arrangements. We recommend adding back the language that is in the currently published version of the handbook and which was omitted from the exposure. That would at least acknowledge that cost-plus arrangements do exist and can be subject to the same regulatory reviews as those based on cost or market but does not require regulators to approve a contract based on a cost-plus methodology. This approach provides the most flexibility to regulators based on the unique circumstances of the insurers operating in their markets and the types of services they require. The existing language in the currently published Best Practices section of the handbook has not created any problems over the years either for the states or for insurers. Including the language deleted in the exposure will promote more consistent reviews and approvals of Form D filings throughout the regulatory community. Including a consistent definition of “cost-plus” within the handbook would also be helpful so that regulators and industry have a more common understanding of what such agreements and their characteristics.

- Furthermore, there is guidance in the current exposure that emphasizes that it is the responsibility of management to demonstrate that an agreement is fair and reasonable regardless of the basis on which consideration is structured. Including the language in the Best Practices section allows for more consistency.
2. In which situations or for what types of services might “cost-plus” reimbursement be appropriate?

- While we cannot identify all situations for which cost-plus arrangements are appropriate, the following are some reasons why insurers need the flexibility to contract on a cost-plus basis.
  
  ➢ **It may be required by law.** In some instances, regulators require affiliated agreements to be executed on a cost-plus basis. This occurs, for example, in certain cross-border situations where multiple jurisdictions and taxing authorities are involved to properly allocate taxable income by jurisdiction. Moreover, certain jurisdictions specify the amount (%) of the “plus”, i.e., the markup. Insurers would therefore have to comply with those requirements.

  ➢ **It is consistent with pricing methodologies in some contracts between unaffiliated parties.** It is customary even among non-affiliated parties for contracts to be negotiated on a cost-plus basis. Therefore, where similar services are offered between affiliates, “fair and reasonable” could be supported by comparable non-affiliated arrangements agreed to on a cost-plus basis.

  ➢ **In some circumstances, cost-plus may be the best and most objective way to establish “fair and reasonable.”** There will be situations where there is no comparable pricing data between non-affiliates and where the providing party cannot commit to a fixed price and must transfer the pricing risk to the buyer. In such cases, cost-plus arrangements may be necessary.

  ➢ Service agreements with partners in joint ventures or other risk sharing arrangements in the health insurance market are frequently reliant on cost-plus agreements. In these arrangements, while the agreement is a related party agreement, there are owners of the joint venture that are unaffiliated entities and have an expectation of fair compensation for services provided to joint venture subsidiaries. These agreements are critical to developing innovative models that incentivize better integration between payers and providers and promote better health outcomes, as they are often entered into with health system and other provider partners and include value-based compensation arrangements, shared savings, quality and performance-based compensation, and other novel risk sharing models.

3. What rationale should the insurer provide to justify the profit margin included within the cost-plus rate, particularly if there is no comparable market data?

- Due to the diversity of the nature of services and situations under which cost-plus arrangements might be utilized, it is difficult to describe means in which the profit in such an arrangement can be justified other than by some examples, such as the following:
➢ Comparison of the mark-up percentage to the gross profit margin of the affiliate, considering the nature and significance of other services it provides to the insurer and to non-affiliates.

➢ Comparison to an appropriate margin that the market would be willing to pay by considering several factors, including industry sales price averages, market conditions, profit objectives, margin achieved on similar products, etc.

➢ In situations where the cost-plus arrangement is a new agreement that replaces a previous agreement with a non-affiliate, it is not uncommon to compare the total consideration with that of the prior agreement on a normalized (e.g., per unit) basis.

➢ In some situations, the parties may have only recently become affiliated and they were previously transacting on a non-affiliated basis. Comparisons could be made of the terms of the agreement prior and post-affiliation.

4. What tools or benchmarks could regulators use in evaluating the fairness and reasonableness of the profit margin included in the cost-plus rate?

- As stated in the current exposure of the handbook, it is the responsibility of management to demonstrate and document the basis and rationale for its assertion of fair and reasonable regardless of the basis on which consideration is determined for an agreement with an affiliate. If management has provided such documentation, the regulator has adequate support for the review and a basis for evaluating the credibility of management's assessment that an agreement is fair and reasonable. Like market-based agreements, there is no magic bullet that regulators can access to provide a reliable indicator of fair and reasonable that is independent of the basis for management’s assertion.

- However, regulators have resources to reference for comparison, including past history of terms of agreements with affiliates involving insurers supervised by the state as well as access to financial information of insurers and their affiliates which can shed light on their operating ratios, profit margins, and similar data to inform what would be considered a reasonable range of profit margins, as well as what might be considered outliers.

- A review of management’s assessment and supporting documentation that an agreement meets the standard of “fair and reasonable” could include a review of third-party benchmarking reports that were obtained by management, or of request-for-proposal information or a pre-acquisition agreement, if applicable, which would have been previously reviewed by regulators.
Conclusion

Based on the research that IPs have performed to respond to your questions, it is apparent to us that cost-plus agreements with affiliates are common. Omitting any reference to them in the handbooks could be misunderstood to remove them as a necessary option in today’s complex and innovative environment. Further, and as our responses to the questions illustrate, there is a wide diversity of instances where cost-plus agreements are appropriate. The reasons these agreements have arisen in industry practice include the specific nature of services that are the subject of such agreements, the facts and circumstances surrounding the parties to the agreements that influence the agreement terms, and the availability and nature of data on comparable transactions involving non-affiliates.

Given that states apparently have different views on the matter, the simplest thing to do is to revert to the existing published text in the Best Practices section of the handbook, which has served insurers and regulators well. In addition, and just as for other agreements on a cost or market-based arrangement, documenting the support and rationale for fair and reasonable of a cost-plus based agreement remains the responsibility of management. Such documentation and dialogue between states and insurers to ensure there is adequate understanding and justification of the information contained in the Form D is necessary to provide states with confidence that management has done its due diligence.

Again, we thank you for allowing us to participate in this collaborative process and to propose revisions to the handbook. We would be glad to discuss this response to the exposure further with you and your colleagues on the Working Group at your convenience.

Sincerely

D. Keith Bell

Rose Albrizio

cc: Interested Parties

NAIC Staff