POLICY brief

Washington Research Council

PB 05-03 February 14, 2005

BRIEFLY

The Insurance Commissioner proposes to form a billion dollar reinsurance enterprise that all health insurers would be required to join.

The available evidence doesn't support the proposal.

Into the Pool Again After the Money's Gone

The state Insurance Commissioner wants to restructure the private market for health insurance in the state. The Commissioner's proposal would force insurers to divert about a billion dollars of health insurance premiums into a new health insurance "pool," from which nearly twenty percent of the claims in the group and individual market segments would be paid. The Commissioner's proposal would also impose a tax of up to $60 million dollars a year on carriers and participating self-funded plans, the proceeds of which would be used to subsidize insurance for people who are currently uninsured.

The Commissioner's staff developed the reinsurance scheme during the deliberations of his "Let's Get Washington Covered Task Force," which met in 2003 and 2004.

Besides the legislation itself (House Bill 1910 and Senate Bill 5861), documentation on the proposal is scant. The Office of the Commissioner (OIC) is circulating a two-page fact sheet, a 14-page PowerPoint presentation prepared by OIC staff, a four-page narration to accompany these slides, and an 11-page PowerPoint presentation prepared by employees of Willis Re, a reinsurance broker.

ORGANIZATION AND GOVERNANCE

The Commissioner's proposal would create an entity called the Health Insurance Market Stabilization Pool. HIMSP would not be a state agency but rather a legally independent not-for-profit enterprise incorporated under the laws of the state.

The members of HIMSP would include all health carriers that operate in the state as well as the state's Uniform Medical Plan (a self-funded health plan for public sector employees). Other self-funded health plans (i.e. employer plans) could elect to become members of HIMSP.

HIMSP would be governed by a twelve-member board of directors. The governor would name nine directors to the board, eight of whom must be chosen from slates of nominees submitted by stakeholder groups: two directors would represent health care consumers, one would represent small employers, one would represent large employers, two would represent members of HIMSP, and two would represent health care providers. The ninth gubernatorial appointee must be an academic with expertise in health insurance. Two additional board members would be appointed by the Insurance Commissioner and must have expertise in reinsurance. Finally, the Commissioner would be a non-voting member of the board.

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OPERATION OF HIMSP

The legislation provides only a broad outline of the manner in which HIMSP would function. The board is to develop a plan of operation for HIMSP, which it will present to the Commissioner for approval. If he approves that plan, it would be implemented without coming again before the Legislature.

OIC staff indicates that the program will work in this way: For each enrollee of a pool member, HIMSP will pay 75 percent of the health care costs in excess of $25,000 in any year. (The member plan remains responsible for the first $25,000 and 25 percent of the excess above $25,000.) Staff estimates that 50,000 of the 2.2 million enrollees of the member plans would have claims in excess of the $25,000 threshold.

HIMSP will contract with one or more reinsurers (insurance carriers that specialize in reinsuring other carriers' risks) to cover these risks. To fund the cost of purchasing reinsurance and its administrative expenses, HIMSP will assess each member a share of these costs proportional to the member's share of total enrollment of all pool members. The draft legislation caps the assessment at 20 percent of the total of annual premiums of health plan members and health care expenditures of self-funded members.

Forecasts for 2006 place the total claims of the members' plans at $5.5 billion, with claims in excess of the $25,000 threshold totaling $1.2 billion. Of this, the reinsurer's share would be $900 million.

SUBSIDIZED ACCESS TO INSURANCE

In addition to the remittances to HIMSP, members would also be required to make annual payments to the state which would be used to subsidize enrollments in various insurance programs. For health carriers, the payments will equal 0.8333 percent of annual premiums; for self-funded plans, the payments will equal 0.9802 percent of payments for health care services. Total payments are to be capped at $60 million dollars (at least initially), $35 million of which would pass to the existing Health Services Account and $25 million to a new Small-Employer-Purchased Health Insurance Assistance Account. Although the draft legislation artfully terms these payments "remittances," in substance they are indistinguishable from taxes.

The funds paid to the Health Services Account would provide premium assistance to enrollees in the state high risk pool and the basic health plan. The funds to the Small-Employer-Purchased Health Insurance Assistance Account would fund a new program that will provide means-tested premium assistance to individuals working for small employers who initiate group health insurance plans. The intent of this program is to provide an incentive for small firms that do not currently offer insurance to do so.

CLAIMED COST SAVINGS

The OIC staff claims that the plan will reduce the long-run cost of insurance in three ways: (1) By reducing risks borne by carriers, HIMSP would lower the risk premium built into health insurance rates. (2) Facing lower risks, carriers would reduce administrative expenses devoted to risk management. (3) Lower risk premiums would bring more carriers into the market, increasing competition and thereby reducing the profit margin on health insurance.

Insurance carriers incur three broad types of costs: the costs of the care itself; the administrative costs of enrolling individuals, and managing and paying claims; and costs of bearing risk. The first two of the costs are "hard" and relatively straightforward to measure. In contrast, the cost of bearing risk (which economists call the risk premium) is a "soft" cost.

OIC staff describes the means through which HIMSP reduces carriers' risks as "pooling," but this is not correct. Pooling is a mechanism whereby members of a group share risks among themselves and thereby reduce the risk each bears individually, thus exploiting what statisticians call "the law of large numbers." HIMSP would not pool risks among its members, but rather shed certain risks completely to third party reinsurers.

Reinsurers require compensation in order to take risks. OIC's prediction of savings in risk bearing costs stems from staff's presumption that the reinsurers will require lower risk premiums for bearing these risks than the health insurance carriers currently require.

Modeling by OIC staff places the value of the reduction in risk premiums at $28 million dollars per year, the reduced administrative expenses devoted to risk reduction at $20 million per year, and the competition-induced reduction in the profit margin at $40 million per year.

Accepting for the moment these estimates, the $60 million that HIMSP members would pay into the Health Services and the Small-Employer-Purchased Health Insurance Assistance Accounts would more than offset the reductions in risk premiums and administrative expenses. The net increase in HIMSP members' annual costs would be $12 million. Assuming that this net increase is passed on to the members' enrollees, it offsets in part their $40 million gain from increased competition. Thus, enrollees' premiums fall by $28 million annually. This represents a modest one-half of one percent of their insurance costs.

The OIC staff also argues that the reinsurance scheme will reduce HIMSP members need for reserves by $253 million. In the initial year of HIMSP operation, carriers could return these reserves to enrollees through a one-time rebate on premiums.

BASES FOR SKEPTICISM

The model developed by OIC staff to quantify these putative savings is not documented and is therefore impossible to evaluate. Nevertheless there are good reasons to be skeptical.

The market for reinsurance of health care risks is highly competitive and easily tapped by health insurance carriers. For example, a 1997 report for the Department of Health and Human Services by the Lewin Group stated

> The market is currently very active. A survey by CIGNA estimated 13 or 14 major reinsurers in the market, and one reinsurer estimated roughly 300 to 400 insurers ceding risk. Competition in the market is high, and one reinsurer noted that no reinsurers have achieved much profit. (Lewin Group 1997)

Since the carriers themselves can tap the reinsurance market directly, it is not clear what is to be gained by requiring them to purchase reinsurance through a mandatory state enterprise. A carrier wanting reinsur-

ance surely would prefer to deal directly with the reinsurer in order to craft a contract tailored to its specific situation, rather than take the one-size-fits-all reinsurance scheme to be provided through HIMSP.

(As editorial writer Thomas Shapley wrote recently in the Seattle Post Intelligencer, "[O]ne need not be a business-lobby shill to sense that when government tries to force a business practice on businesses with the argument that it's good for business, it [does not pass] the smell test . . . ." [Shapley 2005])

A carrier may well find reinsurance to be disadvantageous: The price of reinsurance must reflect the administrative costs of the reinsurer, while the risk premium that the reinsurer requires may not be any smaller than that required by the health insurance carrier, particularly if the carrier is large. In addition, reinsurance contracts introduce a *moral hazard* problem: the insurance carrier has less incentive to control the costs of claims when it has offloaded a share of these costs to a third party. The price of reinsurance must be marked up to account for this inefficiency.

OIC staff seemingly understands that the reinsurance scheme will reduce the incentive to control risks. This reduction explains the forecast $20 million savings in administrative expenses. What OIC analysis does not acknowledge is that rational carriers would only incur these expenses if they believed that the expenses in question save other, greater costs. (If it was irrational for the carriers to incur these expenses in the first place, why would one expect the carriers to eliminate them upon joining HIMSP?)

The OIC belief that HIMSP will stimulate new, small carriers to enter the market and drive down prices is unrealistic. The market does not currently suffer from lack of competition. David Hyman and William Kovacic of the Federal Trade Commission observe

> [T]here is no particular reason to believe that health insurers are receiving supracompetitive profits for the services they receive. . . . [T]he principle complainants about market concentration among health insurers are providers—their self-interest in the matter should be obvious. Conversely, consumer assessments matter in assessing whether market concentration is a problem. In the FTC/DOJ health care hearings, panelists representing employers testified that health insurance markets in most geographic areas enjoy healthy competition. (Hyman and Kovacic 2004)

The market for health insurance in the majority of states is more concentrated than Washington's market. (Robinson 2004)

Small carriers face a number of disadvantages that HIMSP will not remedy. Carriers need to have a large number of enrollees to be able to negotiate advantageous prices with providers, while at the same time they need extensive networks of providers to attract enrollees. Moreover, newer quality control and disease management programs require larger patient populations to be cost effective. (Federal Trade Commission and Department of Justice 2004, Chapter 6)

Finally, we are unconvinced that forcing carriers to purchase reinsurance through HIMSP will have an appreciable impact on their desired level of reserves. They are unlikely therefore to decide on their own to reduce reserves by $253 million. The vigor of competition between carriers directly relates to the level of reserves that they hold. (Grossman and Ginsberg

2004, Rosenblatt 2004) If the Commissioner jawbones carriers' reserve levels down, this would simply make the carriers less aggressive competitors in future years.

COMPARABLE PROGRAMS ELSEWHERE

There is no comparable program in operation anywhere else in the country.

The Commissioner's staff has cited three examples of government-sponsored reinsurance programs: the Florida Hurricane Catastrophe Fund, New York State's Healthy New York program, and Minnesota's Workers' Compensation Reinsurance Association. None closely parallels the reinsurance enterprise proposed for Washington.

The character of risks in insuring against hurricanes is very different from that in health insurance. Pooling works less well in the case of hurricanes because the storms are distinct events that bunch in time a large number of claims, and Florida's reinsurance scheme is aimed at this problem.

Healthy New York is a health reinsurance program. The reinsured claims are paid from state money, however, and this subsidy is arguably the program's key feature. The program is relatively small, with 67,000 enrollees in August 2004. (Chollet 2004, Swartz 2002)

The Workers' Compensation Reinsurance Association is a unique institution that serves to guarantee that long-lived workers' compensation claims will be paid. By law, every worker in the state must be covered by workers' compensation insurance that is reinsured by the Association. The ultimate backing for this reinsurance is the Association's state imposed monopoly. The only risks that the Association itself sheds through reinsurance are for terrorism.

CONCLUSION

The Insurance Commissioner's proposal would create an enterprise with $1 billion a year in revenues. Its reinsurance policies would cover more than a third of the state's population.

The OIC staff believes forcing Washington carriers to pass the risks of high cost enrollees of to out-of-state reinsurers will reduce risk premiums and the cost of health insurance in the small group, large group, and individual segments of the market.

The analysis supporting this conclusion is not documented and therefore difficult to evaluate. Certainly adding two additional layers of administration, at the level of HIMSP and the level of the reinsurers, will add to costs, as will the diversion of premiums to subsidize access. A further worry is the reduced incentive of insurers to control claims costs passed on to the reinsurers.

Benefits are only conjectural at this time; the case has not been made.

At best there may be a case that the idea deserves further study. If so, that study should be conducted outside the Insurance Commissioner's office. The Insurance Commissioner's job is to regulate. The effort to create a new insurance enterprise would involve the Commissioner far too directly as a participant in the market.

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