CHOICES

Impact of Risk Adjustment on Carriers' 2015 Financial Performance in the Individual Market

Introduction

On June 30, 2016, the Department of Health and Human Services (HHS) released its Summary Report on Transitional Reinsurance Payments and Permanent Risk Adjustment Transfers.[1] The HHS report details the risk adjustment and reinsurance transfers for the individual and small group markets for the 2015 plan year as calculated by HHS.

CHOICES' economist and actuary team compared carriers' risk adjustment transfers to their 2015 state individual market filings.[2] Our analysis identified concerning correlations between carrier financial status and the risk adjustment program, which illustrate undesirable market impacts of the risk adjustment program – to individual issuers, state markets, and to the national market as a whole. These identified patterns represent an ongoing threat to the sustainability of both the individual and small group markets. Federal and state regulators should review and address the market challenges related to the risk adjustment program in order to ensure ongoing market stability.

Summary of Findings

Our analysis identified certain inaccuracies and negative impacts of the risk adjustment program that should be promptly addressed by policymakers, including:

- A correlation between risk adjustment payments and indicators of high-risk members exists, but the data show a concerning number of outliers that do not fit this pattern;
- Carriers with relatively low market share in a state are much more likely to have large and distorted risk adjustment transfers per member;
- Carriers with smaller market shares are likely to experience more volatility in year-over-year risk adjustment liability; and,
- A strong association exists between carriers' risk adjustment transfers and their margins, with the largest positive margins reflecting large positive risk adjustment receipts, and a similar correspondence between negative risk adjustment transfers and negative margins.

Methodology

Our analysis included ACA-related health insurers in the individual market with at least 1,000 covered lives in 2015. We aggregated results at the carrier corporate parent level within each state to account for carriers with holding company structures.

[1] HHS: Summary Report on Transitional Reinsurance Payments and Permanent Risk Adjustment Transfers, Released June 30, 2016

[2] Enrollment results were acquired for all carriers but fewer than 10% did not have equivalent financial filings available which includes all carriers operating in the state of California

Carriers' financial filings may include non-ACA compliant products that would not be part of the risk adjustment program. These grandfathered and transitional policies are estimated to represent less than 10% of policies in most states.[3] Results for certain incumbent carriers may be correspondingly muted by a reported membership denominator in their filings that is higher than their actual ACA-enrollment.

Analysis

1. Risk Adjustment liability does not consistently correlate with quantifiable metrics for cost of care

We utilized the number of reported member months for the individual market to compare per member receivables for each carrier to compare insurers' risk adjustment transfers to reinsurance payments.[4] Because reinsurance receipts are based on high member claims costs, a positive correlation between reinsurance receivables and risk adjustment payments should be expected.

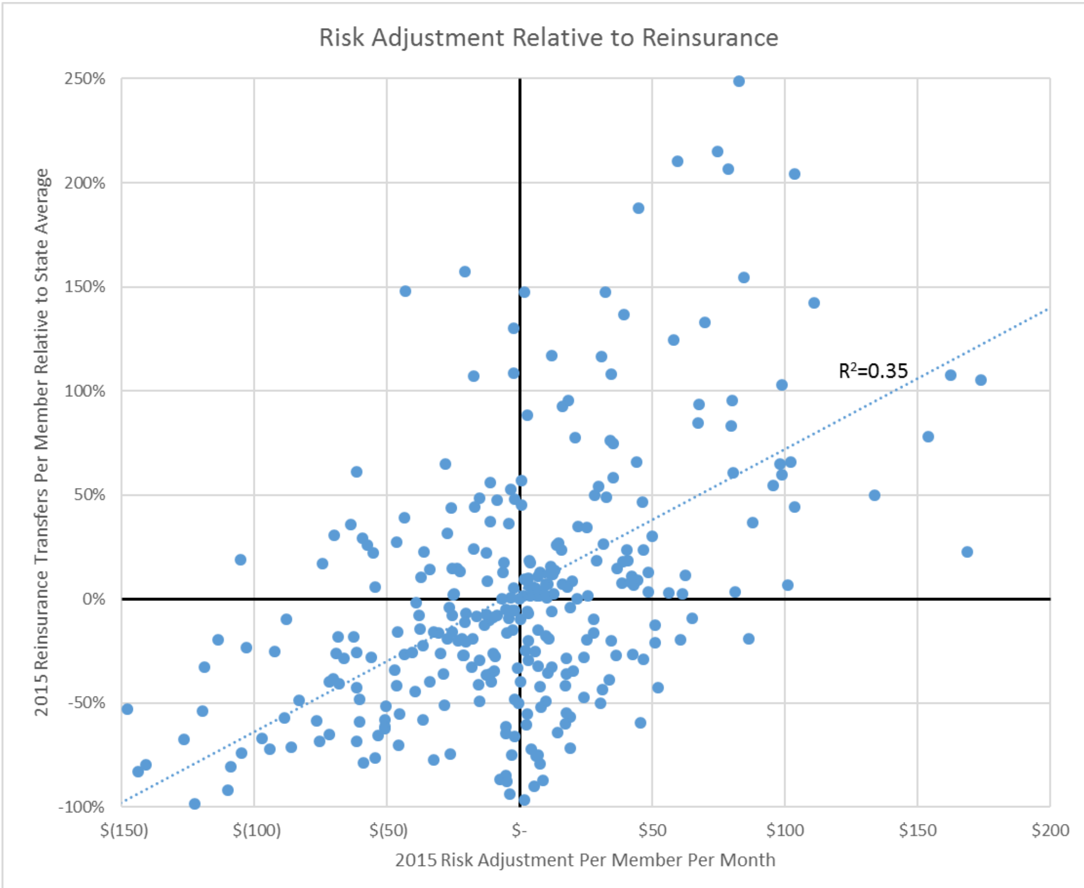
Results, displayed in the chart below, show a positive correlation between relative risk corridor payments within a state and risk adjustment transfers; however, we also identified a material number of carriers, particularly those in the upper left and lower right quadrants of Exhibit 1, that do not follow this trend. A state-by-state analysis identified more drastic instances of carrier outliers. In certain states, carriers with the highest reinsurance payments per member were net payers in the risk adjustment program.

These results are particularly troubling for those carriers in the upper left quadrant that pay into the risk adjustment program and depend on relatively high reinsurance payments that will be discontinued after the 2016 benefit year.

[3] CMS: Report on Transitional Adjustment for 2014 Risk Corridors Program; Transitional Enrollment and Adjustment Percentages by State, Released April 17, 2015

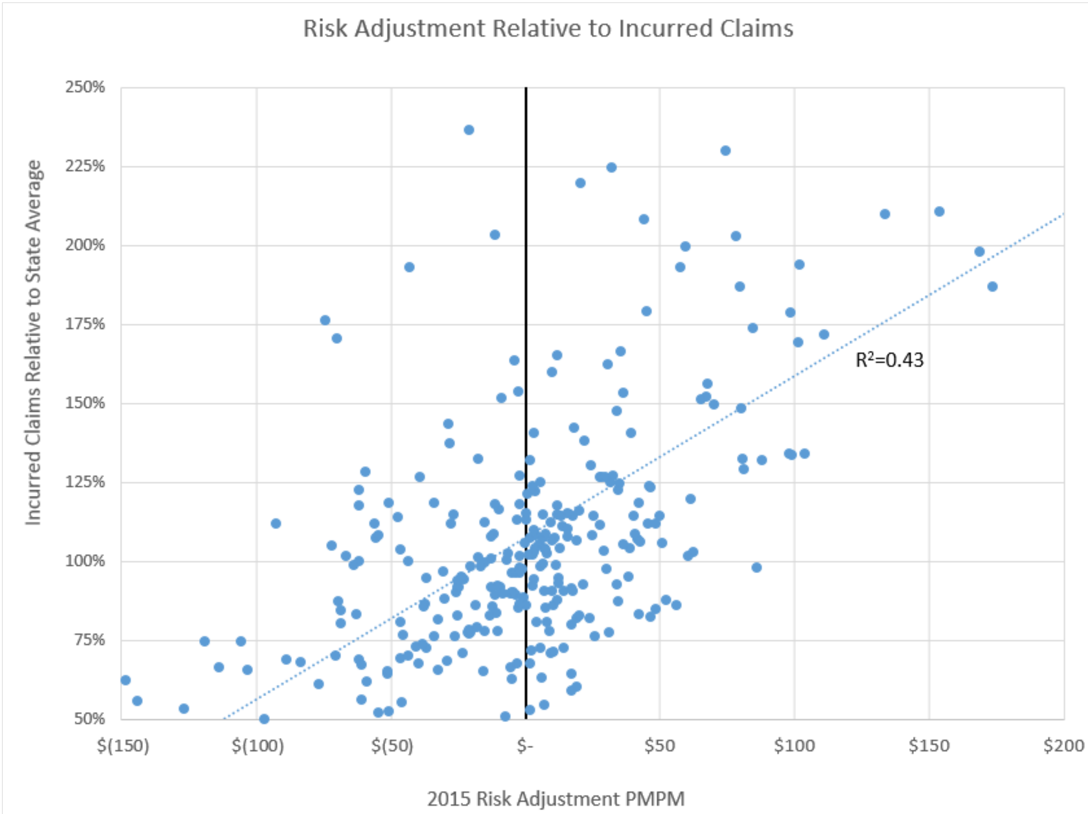
[4] Carriers that operate in higher-cost states are more likely to receive higher reinsurance payments, which could skew the results. We mitigated this issue by benchmarking the reinsurance payment per member to the aggregate state average. The aggregate state average is calculated as the total reinsurance receivable in a state, divided by total member months of all carriers in the analysis. Note, the result is different than taking a simple average of all carriers in a state.

Exhibit 1: Comparison of Risk Adjustment Transfers and Reinsurance Payments in PY 2015



We also examined the relationship between risk adjustment transfer payments and incurred claims to evaluate whether transfers generally corresponded with claims liability. We expected to see a positive correlation between risk adjustment transfer payments and claims expenses, since risk adjustment transfers are intended to be a proxy for actuarial risk, which should in turn correspond to claims liability. We compared incurred claims and risk adjustment by developing a state benchmark for incurred claims per member and assessing each carrier based on its relative results to the state average. While national results showed a positive correlation, a closer examination of a narrow band of risk adjustment transfers between -$50 to $50, where the majority of carriers reside, showed a high level of variation and little correlation.

Exhibit 2: Comparison of Risk Adjustment Transfers and Incurred Claims in PY 2015



The correlation in Exhibit 2 illustrates that the risk adjustment transfer payments may be directionally accurate at the national level, but has clear limitations to compensate issuers that incur higher claims costs. Further analysis at the state level revealed markets where there is very little if any correlation.

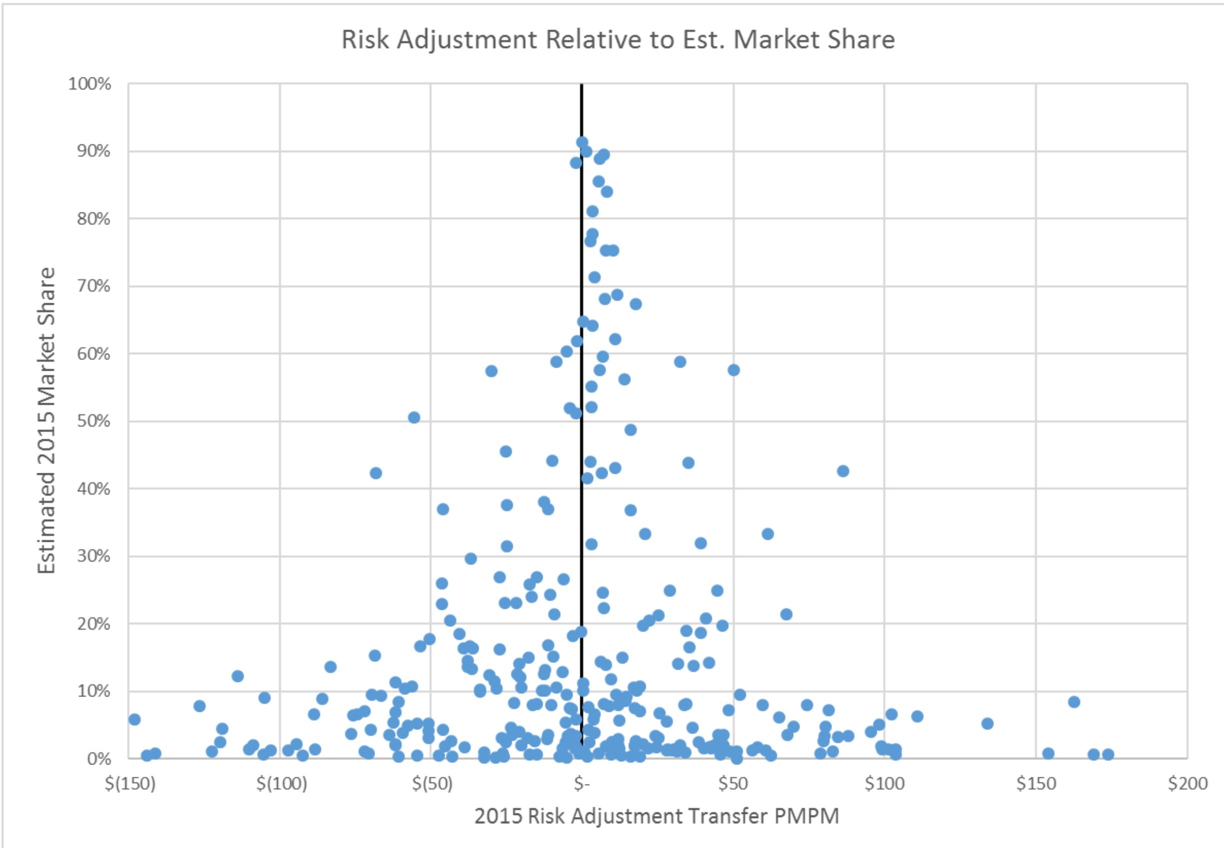
This analysis identified many carriers with net negative risk adjustment payments who also have relatively high incurred claims; conversely, it also showed carriers with net positive risk adjustment payments with relatively low incurred claims.

2. There is a pattern of disproportionate risk adjustment transfers for carriers with smaller market share

We analyzed the size of risk adjustment transfer payment compared to carrier market share. The results of our analysis, represented in Exhibit 3, showed not only that carriers with lower market shares have significantly higher transfer amounts than their larger counterparts, but also that large carriers are more likely to be recipients of risk adjustment payments.

The implications for this observation are important. Carriers with lower market shares and new entrants will have less tolerance for adverse financial performance related to premium stabilization programs (in any way), particularly if such conditions persist over time. Maximizing choice and competition in the market place requires stabilization programs with lower variability and volatility for smaller competitors.

Exhibit 3: Risk Adjustment Transfers Relative to Carrier Market Share for PY 2015



3. Health insurers with lower market shares are likely to experience more volatility in year-over-year risk adjustment liability

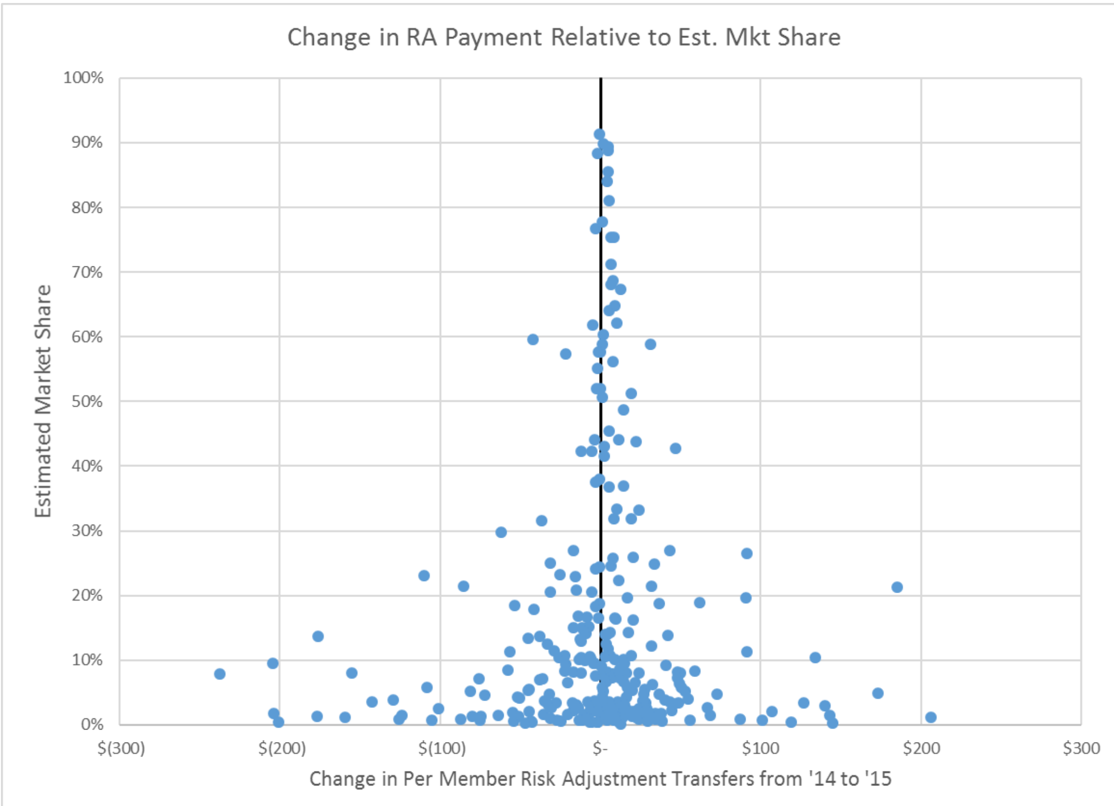
The risk adjustment program is intended to be a market-stabilizing program. However, a current concern is whether the program creates more volatility and unpredictability for smaller carriers. To investigate this volatility, we examined the relationship between the changes in 2014 vs. 2015 risk adjustment liability to determine whether smaller insurers experience greater volatility. We found that changes in risk adjustment transfers from year-to-year appear to generally have a greater impact on carriers with smaller market shares.[5] As shown in Exhibit 4, the change in risk adjustment transfers from 2014 to 2015 was much greater for carriers with smaller market shares. While many carriers did not experience significant changes in transfers per member, carriers with lower market shares tended to experience much more substantial swings in payments and, on average, saw a negative change. Conversely, carriers with larger market shares tended to see a positive increase in their transfer per member.

The pattern presents another clear distinction between carriers with higher and lower market shares. Carriers with smaller market share will struggle with the predictability demanded by business planning, rate-setting, and meeting capital requirements as a result of the impact of the risk adjustment program.

[5] Milliman: Sizing up ACA Risk Adjustment Volatility: How the Interplay Between Risk Adjustment and Issuer Size Influences Profitability Under the ACA. Vandagriff, Petroske, Fink, Krienke. June 15, 2016

This lack of predictability, and the ongoing absence of the other premium stabilization programs designed to mitigate the financial shock, presents smaller participating carriers with another challenge as compared to their larger competitors.

Exhibit 4: YoY Changes in Risk Adjustment Transfers Relative to Market Share from PY 2014 to 2015

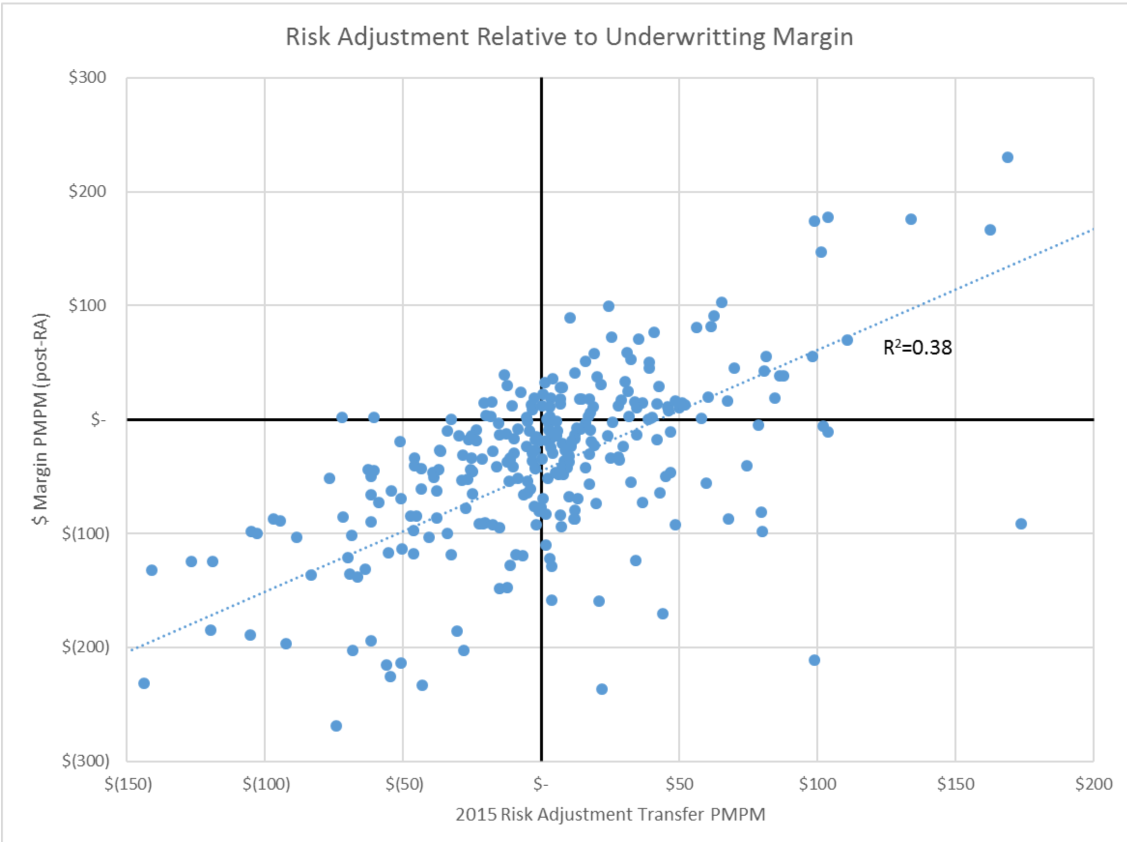


4. Carriers with positive margins tend to have positive risk adjustment transfers

Risk adjustment should be neutral when compared to net underwriting margins. However, incorporating the risk adjustment transfers into 2015 financial filings reveal a strong correlation between these transfers and underwriting margins. This correlation shown in Exhibit 5 is unexpected and striking, given the policy objective of the program is to reduce the incentives for carriers to avoid higher-risk enrollees. Indeed, if the risk adjustment program were functioning optimally, we would expect that other determinants outside of risk adjustment would dictate margin performance, such as product design, premium competitiveness, provider network configuration, and appropriate financial practices. In other words, we would not expect to see any meaningful correlation between risk adjustment liability and underwriting margins.

The end goal of a risk adjustment program is to ensure carriers compete to attract all levels of risk, which should benefit all players as the end result should be a more balanced risk pool. If the incentives of carriers become distorted by risk adjustment, the eventual progress plans can make in the individual or small group markets for improving care and lowering cost become limited. Financial performance should be driven by competitiveness of product offerings and sound market fundamentals and not distortions in premium stabilization programs.

<u>Exhibit 5: Risk Adjustment Transfers Relative to Underwriting Margin for PY 2015</u>



Policy Discussion

A well-functioning risk adjustment program should identify core actuarial risk and facilitate an appropriate, predictable transfer between plans to ensure all market participants can focus on the fundamentals required to improve enrollee health, lower cost, and maximize the patients' experiences.

However, the data included in this analysis, combined with other recently published reports, continues to demonstrate troubling patterns that show the risk adjustment program is not a good indicator of actual issuer risk. The program also has a disproportionately negative impact on plans with smaller market shares and determines "winners and losers" in the health insurance market.

For the individual insurance market to function correctly, carriers must have confidence that the programmatic fundamentals of the risk adjustment program are consistent with sound market objectives. With several carriers leaving the market for the 2017 plan year, and other carriers delaying entrance, we believe it is mission-critical to redress the core challenges with this program now. Waiting until outlying years could result in reduced competition, higher premiums, and many fewer insured individuals; all results wholly antithetical to the goals of the ACA.

CMS could take the following actions to address the findings in our analysis:

1) Work with states to support carriers with disproportional risk adjustment transfers relative to other metrics that correlate with risk (i.e. reinsurance and incurred claims). The current risk adjustment methodology has known weaknesses and is overstating the transfers—both positive and negative—among health insurers.[6] Moreover, it puts a premium on carrier efforts to maximize their risk scores through coding enhancement incentives and other techniques that neither contribute to improved health nor reduce costs. If significant weaknesses in the risk adjustment calculation are discovered, payment resolutions should be made to ensure a fair and equitable market for all participating insurers and one that supports competition.

2) Empower states to apply corrections to the known estimation bias against lower-risk enrollees for PY 2014, 2015, and going forward.[7]

3) Empower states to apply a risk adjustment methodology based on average incurred claims instead of the statewide average premium to prevent the current exaggeration of all risk adjustment transfers (positive and negative) that occur as a result of the non-risk-related factors in premiums, such as fixed administrative expenses. Ideally, the program would be based on plan-specific claims costs rather than state averages. Currently, carriers that are more efficient than average, through such means as effective care coordination or low provider payment rates, are disadvantaged by a system that is based on the statewide average premium as opposed to each plan's own claims costs.

Conclusion

Our analysis uncovers concerning correlations between risk adjustment and other indications of high risk like reinsurance and incurred claims. In addition, there is clearly higher volatility for plans with lower market shares, and a striking correlation between risk adjustment and net underwriting margin. Indeed, there is evidence that the risk adjustment program may in fact be exacerbating some of anti-competitive structural problems that it was mean to prevent.

CMS has indicated it will continue to adapt and make changes to the risk adjustment program over time, but it is critical for regulators to assess current results to ensure known problems with the methodology are not creating imbalances that will reduce competition. As shown in the analysis, the inherent aspect of a zero-sum program at the state level will be less volatile when there are fewer carriers so it should not be viewed as a positive sign if some of these identified problems lessen when there is less competition.

[6] Technical Issues with ACA Risk Adjustment and Risk Corridor Programs, and Financial Impact on New, Fast-Growing, and Efficient Health Plans. Prepared by CHOICES, Published December 4, 2015

[7] Method to Address Estimation Bias in the HHS-HCC Risk Adjustment Model. Memorandum from Richard S. Foster to CHOICES Executive Committee, Published July 15, 2016