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Memo

Date: August 15, 2011

To: Lisa Ellinger

From: Tim Gustafson and Pat Pechacek

Subject: Health Insurance Reserves

Executive Summary

For employers with self-insured health care benefit programs, leading practice is to establish reserves to protect against unexpected claims fluctuations and to provide for premium rate stabilization from year to year. Based on prevailing regulatory capital requirements applicable to the insurance industry, as well as leading practices for self-insured employers, maintaining a Net Fund Balance of 15% to 25% of the annual claims of the medical and pharmacy plans is recommended. The current Net Fund Balance ratio to annual claims for the state program is estimated to be 20.6% for the medical plan and 46.8% for the pharmacy plan.

Background

The State of Wisconsin Department of Employee Trust Funds (the Department), on behalf of the Group Insurance Board, administers the group health plan for state employees and retirees and the group health plan for local employers who voluntarily choose to participate. The group health plan offering is comprised of medical and prescription drug plans on both a fully insured and self insured basis that covers approximately 244,500 lives and $1.5 billion in annual insurance premiums for state, local and retired participants.

Per the Department's request, Deloitte Consulting LLP (Deloitte Consulting) has completed a review of the Department's reserve fund (cash balance) status along with a discussion of the actuarial liabilities and other reserve items that need to be considered. These actuarial liabilities are defined to include incurred but not paid (IBNP) claim liabilities or unpaid claim liabilities, contingency reserve for incurred claims fluctuation and rate stabilization, and reserve for unpaid retention costs.

It is our understanding the information summarized in this memo will provide information which, when combined with the current status of the Department's reserve funds, will aid the Group Insurance Board in determining the level of monies that should be targeted in the reserve fund.

Overview

It is a generally accepted and sound practice for most employers with self insured benefit programs to establish reserves for unpaid claim liabilities and reserves to provide additional protection against potential for unforeseen claims and/or expenses that may exceed the amount of "premium" revenue collected to cover overall self funded plan costs. Additionally, because of the combination of both fully insured and self insured funding arrangements, the Department faces additional risks in terms of the potential for self funded medical plan claims and enrollment fluctuations in any given plan year if any of the fully insured health plans exit the program.

The reserve fund must be adequate to cover both the IBNP or unpaid claim liabilities and any monies needed to cover program contingencies or rate stabilization (historically referred to as Net Fund Balance). The IBNP money is not available to cover program contingencies or rate stabilization and is instead needed to cover run-out claims for the self funded programs. The Department should consider both needs when determining the level of monies that should be targeted in the overall reserve fund.

In terms of providing a recommendation for the level of monies in the Net Fund Balance, one concept recognized by the insurance industry in the United States is Risk Based Capital (RBC). This is a method developed by the National Association of Insurance Commissioners (NAIC) to measure the minimum amount of capital that an insurance company needs to support its overall business operations. RBC is used to set capital requirements considering both the size and degree of risk taken by the insurer.

While the Department is not an insurance company per se, given the Department's composition of both fully insured and self insured health insurance, with the potential of significant annual claims and enrollment fluctuations each year, targeting a similar level of risk protection as an insurance company is a prudent approach, which makes the RBC standard a reasonable benchmark to follow.

It is recommended that the Department maintain approximately 15.0% to 25.0% of annual claims as Net Fund Balance for program contingencies as a prudent funding policy. This amount is to provide protection against the potential for self funded medical plan claims and enrollment fluctuations in any given plan year and sufficient program premium stabilization protection.

It should be noted that the IBNP unpaid claims liability and certain other payables are separate components of the cash balances on hand. The 15% to 25% Net Fund Balance target range is for the remaining portion of the cash balance, net of the IBNP and other payables.

Current Reserve Fund Status

The Department currently contracts with over 15 health plans on a fully insured basis, Wisconsin Physician Services (WPS) to administer the self insured medical plan and Navitus Health Solutions (Navitus) to administer the self insured prescription drug plan.

Presented below is the annual number of members, estimated paid claims and Net Fund Balance for the programs as of June 30, 2011. The benchmark claims for determining the appropriate Net Fund Balance target range are based on 100% of the estimated claims for self-insured coverage and 20% of the estimated claims for fully insured coverage, with the exception of Local Pharmacy, (based on conversations with the Department it is our understanding Local program pharmacy coverage that is fully insured today will move to a self insured basis as of January 1, 2012). We believe this is a reasonable assumption for assessing the Net Fund Balance due to the concern that certain regions of the state, generally the more rural areas, may need to be switched from being fully insured to being self insured in any given year. With the continuing pressure to control escalating health care costs, it is possible the Department may see fully insured plans that cannot compete within the current competitive tiering model leave the program and a sizable increase in claims and enrollment in their self funded medical plan options. This is a significant concern for both the State and Local program medical plans Net Fund Balance.

	Members	Estimated Paid Claims	Net Fund Balance as of 6/30/2011[4]	Net Fund Balance as % of Estimated Paid Claims
State Program - Medical				
Fully Insured Medical	196,900	$1,024,700,000		
Self Insured Medical[1]	11,900	$45,500,000		
Total Medical - Benchmark[2]	**208,800**	**$250,400,000**	**$51,600,000**	**20.6%**
State Program -Pharmacy				
Fully Insured Pharmacy	N/A	N/A		
Self Insured Pharmacy	208,800	$219,000,000		
Total Pharmacy - Benchmark[2]	**208,800**	**$219,000,000**	**$102,600,000**	**46.8%**
Local Program - Medical				
Fully Insured Medical	36,900	$193,000,000		
Self Insured Medical[3]	500	$1,700,000		
Total Medical - Benchmark[2]	**37,400**	**$40,300,000**	**$2,900,000**	**7.2%**
Local Program - Pharmacy				
Fully Insured Pharmacy	1,700	$4,500,000		
Self Insured Pharmacy	35,700	$27,400,000		
Total Pharmacy - Benchmark[2]	**37,400**	**$31,900,000**	**$16,100,000**	**50.5%**

1 Self insured medical offerings are: State Maintenance Plan, Standard Plan and Medicare Plus
2 Benchmark claims equal 100% of self-insured and 20% of fully insured per discussion above, except for Local Fully Insured Pharmacy which contributes 100% to benchmark as is moving to self insured in 2012
3 Self insured medical offerings are: State Maintenance Plan, Standard Plan and Medicare
4 Net Fund Balance as of 6/30/2011 excludes funds from Early Retiree Reinsurance Program (~$14.2 million) as the monies cannot be used as general revenue for the Department

As indicated in the table above, for the state program the ratio of Net Fund Balance to annual claims is currently estimated to be 20.6% for the medical plan, meaning that it is in the recommended target range of 15% to 25%. For the pharmacy plan the estimated ratio is 46.8%, meaning that it is currently above the targeted range. A reduction of $47,900,000 in the pharmacy plan Net Fund Balance would bring the ratio of Net Fund Balance to annual claims to the top end of the target range (25%).

For the local program, the estimated current Net Fund Balance ratios are 7.2% for the medical plan and 50.5% for the pharmacy plan. Therefore, the balance is under the targeted range for the medical plan and over the targeted range for the pharmacy plan. A reduction of $8,100,000 in the pharmacy plan Net Fund Balance would bring the ratio of Net Fund Balance to annual claims to the top end of the target range (25%). However, it may be appropriate to consider the local program as a whole (medical and pharmacy combined), as such, a reduction of $1,000,000 in the pharmacy plan Net Fund Balance would maintain sufficient monies to bring both the medical and pharmacy plans Net Fund Balance to the top end of the target range (25%).

We recommend any spend down of the Net Fund Balance be implemented over multiple years as utilizing fund balance to reduce rate increases is a temporary cost reduction and is additive to the overall trend or spend required in following years. A phased fund balance spend over multiple years will minimize rate fluctuations.

Application of the Target Range

Based on leading practices for self-insured employer health care financing, the recommended target Net Fund Balance is expressed as a range (15% to 25%) rather than a specific single percentage. This is to promote premium rate stabilization over time and to avoid unnecessary short term fluctuations. Typically as long as the Net Fund Balance is somewhere within the targeted range, regardless of whether it is at the low end, high end or in the middle, no special premium rate actions are applied.

When the Net Fund Balance is outside the targeted range, leading practice is to implement a plan to reduce the shortfall or excess over time through premium rate buy-ups or buy-downs. Often the timeframe of the plan to bring the Net Fund Balance into the target range is over a multi-year period in order to avoid unnecessary short-term fluctuations in the premium rate levels. This is in keeping with one of the fundamental purposes of the Net Fund Balance of maintaining rate stability over the long term.

Historical Overview of Reserve Fund Drawdown

During the development of the 2007 self funded premium rates, the Department recommended the beginning of a phased spend down of the medical and pharmacy Net Fund Balances. Utilizing the Net Fund Balance to suppress rate increases is a temporary cost reduction and is additive to the overall trend in following years. As such the Department was prudent in their approach to bring premium rate relief to the program under a step wise structure that will minimize rate fluctuations and provide premium rate stabilization.

Reserve Fund Buy Down History (in millions)

	State Program			**Local Program**			**Grand Total**
	Medical	Pharmacy	**Total**	Medical	Pharmacy	**Total**	
2011	$0.2	$0	**$0.2**	$0	$0.8	**$0.8**	**$1.0**
2010	4.4	1.7	**6.1**	0.1	0.3	**0.4**	**$6.5**
2009	5.8	12.7	**18.5**	0.1	2.1	**2.2**	**$20.7**
2008	4.9	11.0	**15.9**	0.0	2.1	**2.1**	**$18.0**
2007	3.9	6.6	**10.5**	0.2	2.0	**2.2**	**$12.7**

Information supporting the above summary can be found in the appendix of this memo along with the impact on needed rate premium rate increases for each plan year.

In light of recent stock market changes and allocations of 2008 stock market losses, the assumed rate of return for the reserve fund has been conservative in recent years (2.0% for 2009-2012 as provided by the Department). This has contributed to the decrease in Net Fund Balance buy down levels in recent years and the continued uncertainty in the stock market remains a noteworthy concern for the Department.

Summary

It is recommended that the Department maintain a Net Fund Balance of approximately 15.0% to 25.0% of annual claims in the reserve fund for program contingencies as a prudent funding policy. This amount is to provide protection against the potential for self funded plan claims and enrollment fluctuations in any given plan year and sufficient program premium stabilization.

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Appendix

STATE PLAN

		Members	Rating Trend	Needed Rate Increase	Implemented Rate Increase	Buy Down
2011 Plan Year						
RX	Overall	208,768	5.0%	-0.3%	-0.3%	$0
Medical	Standard Plan	2,680	9.5%	7.5%	6.9%	$230,000
	SMP	228	9.5%	not credible	6.9%	$0
	Medicare Plus	9,033	5.0%	4.0%	4.0%	$0
Total		**208,768**				**$230,000**
2010 Plan Year						
RX	Overall	203,044	7.5%	15.7%	14.7%	$1,700,000
Medical	Standard Plan	2,954	9.5%	18.7%	9.0%	$3,400,000
	SMP	272	9.5%	not credible	9.0%	$0
	Medicare Plus	9,301	6.0%	8.8%	6.0%	$1,000,000
Total		**203,044**				**$6,100,000**
2009 Plan Year						
RX	Overall	199,967	6.0%	9.4%	1.9%	$12,700,000
Medical	Standard Plan	3,194	10.5%	22.9%	10.0%	$4,900,000
	SMP	560	10.5%	not credible	10.0%	$0
	Medicare Plus	9,476	7.0%	4.4%	2.0%	$900,000
Total		**199,967**				**$18,500,000**
2008 Plan Year						
RX	Overall	195,772	8.7%	6.6%	0.0%	$11,000,000
Medical	Standard Plan	3,836	10.0%	13.2%	5.0%	$3,000,000
	SMP	148	10.0%	not credible	5.0%	$200,000
	Medicare Plus	9,710	9.0%	12.0%	7.0%	$1,700,000
Total		**195,772**				**$15,900,000**
2007 Plan Year						
RX	Overall	189,851	10.85%	4.0%	0.0%	$6,600,000
Medical	Standard Plan	3,846	12.0%	10.7%	5.5%	$2,000,000
	SMP	534	12.0%	8.2%	3.2%	$300,000
	Medicare Plus	9,856	6.0%	0.0%	-5.0%	$1,600,000
Total		**189,851**				**$10,500,000**

LOCAL PLAN

		Members	Rating Trend	Needed Rate Increase	Implemented Rate Increase	Buy Down
2011 Plan Year						
RX	Active HMO	35,698	5.0%	3.0%	0.0%	$790,000
Medical	Standard Plan	54	9.5%	not credible	6.9%	$0
	SMP	166	9.5%	not credible	6.9%	$0
	Medicare	270	5.0%	not credible	5.0%	$0
Total		**36,188**				**$790,000**
2010 Plan Year						
RX	Active HMO	34,392	7.5%	16.2%	14.8%	$300,000
Medical	Standard Plan	70	9.5%	not credible	8.0%	$0
	SMP	101	9.5%	not credible	8.0%	$0
	Medicare	270	6.0%	not credible	8.0%	$58,000
Total		**34,833**				**$358,000**
2009 Plan Year						
RX	Active HMO	32,467	6.0%	12.4%	2.2%	$2,100,000
Medical	Standard Plan	69	10.5%	not credible	3.0%	$0
	SMP	57	10.5%	not credible	3.0%	$0
	Medicare	269	7.0%	not credible	10.0%	$83,000
Total		**32,862**				**$2,183,000**
2008 Plan Year						
RX	Active HMO	31,054	11.0%	21.5%	10.0%	$2,100,000
Medical	Standard Plan	73	10.0%	not credible	-10.0%	$0
	SMP	48	10.0%	not credible	-10.0%	$0
	Medicare	278	9.0%	not credible	7.0%	$42,000
Total		**31,453**				**$2,142,000**
2007 Plan Year						
RX	Active HMO	30,970	9.20%	-1.5%	-10.0%	$2,000,000
Medical	Standard Plan	64	12.0%	not credible	0.0%	$164,000
	SMP	44	12.0%	not credible	0.0%	
	Medicare	278	6.0%	not credible	0.0%	$36,000
Total		**31,356**				**$2,200,000**