WHITE PAPER

Review of Proposed 2019 Risk Adjustment Changes For State Flexibility

Chia Yi Chin, ASA, MAAA
720.226.9819 • ChiaC@wakely.com

Karan Rustagi, FSA, MAAA
720.282.4965 •KaranR@wakely.com

Ross Winkelman, FSA, MAAA
720.226.9801 • RossW@wakely.com

Zimo Han
480.274.6521 • Zimo.Han@wakely.com

Overview

HHS reduced the statewide average premium in the 2018 Affordable Care Act (ACA) risk adjustment formula by 14% across all states. In HHS' Notice of Benefit and Payment Parameters (NBPP) for 2019[1], HHS proposes that State insurance regulators may request up to a 50% further reduction in the premium used in the risk adjustment transfer calculation for the small group market. HHS also explicitly requests feedback on whether states should be allowed to adjust the statewide average premium in the individual market risk adjustment calculations as well.

This paper discusses the impact of the proposed 2018 change, and the potential impact of states choosing to further reduce risk adjustment premiums starting in 2019. This paper is for discussion purposes only and should not be relied upon to make decisions for any specific situation or state. This paper should be read in its entirety, including the important disclosures and limitation listed below.

The state average premium used in the HHS transfer formula directly affects the magnitude of risk adjustment transfers, but not the direction. If a reduced state average premium is used, then each carrier's risk adjustment amount is reduced (either lower risk transfer receipts or lower risk transfer payments).

A reduction in the state average premium helps issuers who pay into the risk adjustment program since they can price their products more competitively or improve their financial results, while it hurts issuers who receive payments from the risk adjustment system. In our simplified analysis, we have measured whether reductions in the statewide average premiums normalize the financial results (measured using MLR[2]) across the issuers within each state and market. We relied on publicly-available 2015 MLR data. Any state considering making this change should base its analysis on more recent financial

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1 https://s3.amazonaws.com/public-inspection.federalregister.gov/2017-23599.pdf

2 The Medical Loss Ratio (MLR) is a measure of the percent of premium that is spent on the claims costs or the risk adjustment transfers.

experience (using most up-to-date risk adjustment model), input from stakeholders, and a thorough understanding of issuer operations and product offerings in each respective market in their state.

Our modeling using 2015 financial results shows that the 2018 change does not normalize financial results across issuers for the individual market, but does somewhat normalize results in the small group market. Similarly, a further 25% reduction pushes more issuers away from the market average MLR in the individual market, and does not further normalize results compared to the 2018 reduction of 14% for the small group market. Finally, a 50% further reduction from the 2018 change pushes more issuers away from the market average for both the individual and small group market.

Methodology & Results

We used 2015 MLR data[3] to model the 2018 risk adjustment premium reduction of 14%, and additional reductions of 25% and 50% from this level on issuer level financial results. The additional reductions are labeled as 64.5% and 43% respectively of unadjusted state average premiums below. We applied equal weight for each issuer regardless of membership volume. We assume that the intent of the 2018 change and proposed flexibility in 2019 and beyond is to make the risk adjustment system fairer, and increase competition in appropriate areas. For purposes of our analysis, we measure 'fairness' by measuring whether each change in state average premium normalizes MLRs across issuers. While risk adjustment is designed to incentivize issuers to compete on efficiency rather than actuarial risk, if the risk adjustment payment and charges do not appropriately align with claims cost (as represented by the average MLR in the state), the result may be issuer mispricing or issuer exits.

These are important, simplifying assumptions that certainly do not tell the entire story, especially when looking at financial results for 2015 which are in large part dependent on premium assumptions set before actual experience was available. Additionally, there have been significant methodological changes to the risk adjustment model since the 2015 year, which are not be reflected in these results. It is also important to recognize that results for any particular state may be very different and driven by factors not considered in our analysis.

The Table 1 shows the results of our modeling.

3 https://www.cms.gov/CCIIO/Resources/Data-Resources/mlr.html

Table 1: Impact to MLRs of Reductions to the State Average Premium for Risk Adjustment

State-average premium at 86%	Individual Market	Small Group Market
Issuer MLRs moved towards the state average MLR	51%	64%
Issuer MLRs moved away from the state average MLR	49%	36%
State-average premium at 64.5%	**Individual Market**	**Small Group Market**
Issuer MLRs moved towards the state average MLR	46%	64%
Issuer MLRs moved away from the state average MLR	54%	36%
State-average premium at 43%	**Individual Market**	**Small Group Market**
Issuer MLRs moved towards the state average MLR	43%	60%
Issuer MLRs moved away from the state average MLR	57%	40%

In the individual market, the proposed risk adjustment changes move half the issuers' MLR towards the market average and the other half away from the market average. In other words, the proposed changes do not help with normalizing financial performance by issuer. In fact, the larger the magnitude of premium reduction, the more the issuers whose MLRs move away from the market average. For the small group market, more carriers' MLRs moved towards the market average than away from it resulting in better normalization of financial performance across issuers. However, at the maximum 50% premium reduction from 2018 change, small group issuers' MLR start to move away from the market average. The variability in outcomes for the individual market versus the small group market could be driven by less selection in the small group market and hence a reduced need for large amounts of money moving around between issuers.

We also picked one state to take a closer look at the impacts on the issuers within the market. We de-identified the state, the market, and the issuers even though the data we present below is publicly available, so as to not appear to be making any suggestions specific to any plan or state. This analysis is not intended to be relied upon for anything other than to enhance the readers' understanding of the issue and how it may impact market dynamics.

Table 2 shows results by issuer in our selected sample market[4], their transfers as a percent of premium as well as MLRs at varying levels of risk adjustment premium.

[4] We have masked the market and companies used in this analysis as we are only focused on illustrating the impact of adjusting risk adjustment premium. We have also excluded companies with less than 1% of the market share, and grossed up market share for the remaining to equal 100%.

Table 2: Impact of Adjusting Risk Adjustment Premium in Sample Market X

Issuers	Estimated % of Market Share	Risk Transfer as a % of Premium	2015 MLR @ 100% of unadjusted statewide average premium	2015 MLR @ 86% of unadjusted statewide average premium	2015 MLR @ 64.5% of unadjusted statewide average premium	2015 MLR @ 43% of unadjusted statewide average premium
Issuer A	1.6%	-42.3%	111.3%	105.1%	95.4%	85.8%
Issuer B	3.4%	3.0%	88.4%	88.9%	89.6%	90.2%
Issuer C	3.8%	0.7%	92.6%	92.3%	92.9%	93.1%
Issuer D	5.0%	0.8%	90.3%	90.4%	90.6%	90.8%
Issuer E	5.7%	-33.3%	92.0%	87.3%	80.1%	72.8%
Issuer F	7.3%	1.9%	90.8%	91.1%	91.5%	91.9%
Issuer G	10.0%	-4.2%	89.2%	88.5%	87.5%	86.5%
Issuer H	11.5%	-13.9%	98.4%	96.4%	93.2%	90.0%
Issuer I	18.0%	-0.3%	90.3%	90.2%	90.1%	90.1%
Issuer J	33.7%	8.5%	84.5%	85.9%	87.9%	90.0%
Average[5]			89.7%	89.5%	89.2%	88.9%

As shown in the table above, issuers who are paying/receiving a large proportion of their premiums (issuers A, E, H and J) as risk transfers will see a bigger impact to their MLR if states decide to reduce the state average premium used in HHS transfer formula. In the market above, we also observe that reducing the state average premium does move issuers within the market towards market average MLR. However, this observation is specific to the selected market and it is not consistent nationally. In addition, it is worth noting that even if issuers within a state is moving closer towards the market average, there may be issuers such as Issuer E above that deviates further from the market average.

Apart from reducing the risk transfer amounts, the reduction of risk adjustment premium could also have several downstream consequences related to premium rate changes and market share. Below, this issue is explored further using a hypothetical market with four issuers that vary by size and payment/receipt status under the risk adjustment program. The initial make-up of the hypothetical market is shown in the table below.

Table 3: Initial Market Make-Up

Issuers	Expected & Actual Claims PMPM	Admin PMPM	Expected Risk Transfers PMPM	Premium PMPM	Expected MLR
Low-Cost RAF-Receiver	$375.00	$75.00	$25.00	$425.00	83.3%
Low-Cost RAF-Payer	$325.00	$70.00	($25.00)	$420.00	82.3%
High-Cost RAF-Receiver	$425.00	$75.00	$25.00	$475.00	85.0%
High-Cost RAF-Payer	$375.00	$70.00	($25.00)	$470.00	84.3%
Market Average	$375.00		$0.00	$447.50	

[5] The average shown in this table are weighted by market share.

In the market above, we have two low-cost issuers: one in a receivable position under the risk adjustment program (Low-Cost RAF-Receiver) and the other in a payable position (Low-Cost RAF-Payer). Similarly, we have two high-cost issuers – one paying into the risk adjustment program while the other is receiving from the risk adjustment program.

Before diving into how the premium change impacts each issuer, we want to note a few things about the assumed market dynamics. The low cost carriers are assumed to have the same or similar, highly competitive premiums, and it is further assumed that each will get a similar market share to the other. The high cost carriers are also assumed to be similarly priced to each other and to get a similar market share. In the real world, we would expect the low cost carriers to get a higher market share than the high cost carriers. However, to simplify this analysis, we assumed that each of the four carriers gets equal market share (25% each).

Table 4 below shows the results of changes in the risk adjustment premium on the hypothetical market results. We assumed that at the end of the year, the carriers claim cost was the same as what they expected, the actual risk transfers before premium change matches their expectations, and hence the actual MLR at the year-end is equal to the target MLR set during pricing. Then, we show the new risk transfers under the program change, the impact on MLR due to changes in risk transfers, and the required premium increase to bring the MLR back to their target MLRs (outside of premium changes due to other causes, such as trend).

Table 4: Changes in Financial Results for Hypothetical Issuers based State Average Premium at 43%

Issuers	(1) Actual Claims	(2) Current RAF	(3) = (1) – (2) Current Actual MLR	(4) = (2) / 2 New RAF	(5) = (1) – (4) New Actual MLR	(6) = (5) / (3) – 1 Required Rate Increase	(7) New Premium
Low-Cost RAF-	88.2%	5.9%	82.4%	2.9%	85.3%	3.6%	$440.18
Low-Cost RAF-Payer	77.4%	-6.0%	83.3%	-3.0%	80.4%	-3.6%	$405.00
High-Cost RAF-	89.5%	5.3%	84.2%	2.6%	86.8%	3.1%	$489.84
High-Cost RAF-Payer	79.8%	-5.3%	85.1%	-2.7%	82.4%	-3.1%	$455.31

As shown above, the low-cost receiver would likely increase its premiums which would cause a significant difference in premiums between the two low cost plans ($440 vs. $405). This outcome is driven by the fact that those who receive, will now receive less and those who pay, will now pay less after the program change. Of course, the hypothetical situation may not be representative of actual results in markets since it assumes that the loss ratio for these two issuers is similar prior to the change in risk adjustment premium.

The higher premium for the low-cost receiver is now similar to the premium for the high-cost payer. Such a change in competitive positioning may result in member migration from the low-cost receiver to high-cost payer assuming the high cost issuer offers a broader network or some other value in return for the

higher cost prior to the program change. The high-cost receiver could get priced out of the market resulting in steep membership losses, issuer exits, or reduction in network size and/or benefits. The low-cost payer is now the lowest cost plan by a significant margin and will likely attract a large membership. Again, this hypothetical market assumes that we start out in a market with actuarially-sound rates. The reality is that the plans are still struggling to arrive at these actuarially-sound rates. To the extent that plans are mispriced, the proposed changes could exacerbate or ameliorate the financial performance depending on whether the plan is expected to be a receiver or payer in the risk adjustment program.

Conclusion

The 2018 reduction in risk adjustment premium of 14% was a change that had been long discussed, and may result in more equitable risk adjustment transfers, although exceptions exist. Further reducing risk adjustment premiums may or may not be appropriate. In a handful of markets, we observed that reduced risk transfers could potentially reduce the variability in the profitability by issuer (that is, make the issuers' MLRs within a market to be more consistent with the market average MLR). However, such changes may also increase the variability in profitability, and create unintended financial and competitive effects. States considering to adjust the state average premium in HHS transfer formula will have to carefully model out the potential changes in risk adjustment premiums, carefully understand initial sources of any imbalances in MLRs, and monitor ongoing changes to the risk adjustment methodology to maintain stability within their markets.

Disclosures and Limitations

We have modeled the impact of proposed state flexibility changes to risk adjustment based on our understanding of the 2019 proposed Notice of Benefit and Payment Parameters. Actual implementation by HHS may differ, causing results of this analysis to change significantly as well. We used publicly available 2015 MLR data in our analysis. Relying on 2015 issuers and risk transfers introduces additional uncertainty into our estimates. States should use the most recent data and risk adjustment model to determine if they should adjust the risk adjustment premium. We also have not included the impact of other changes such as changing membership and therefore risk pool, premium increases and other changes in the risk adjustment transfer formula (high cost claims pooling, updated risk model, and risk weights).

Wakely is not a legal or audit firm. Please consult your accounting, legal and actuarial experts in developing your internal estimates.

Please contact Chia Yi Chin at ChiaC@wakely.com, Karan Rustagi at KaranR@wakely.com, or Ross Winkelman at RossW@wakely.com with any questions or comments.