



# in focus

## More Answers on Reinsurance

by Donald Cohn, Enrique Martinez-Vidal and Deborah Chollet

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**M**any states are interested in reinsurance as a strategy to maintain or increase health insurance coverage. SCI's October 2004 Issue Brief, *The Role of Reinsurance in State Efforts to Expand Coverage*, concluded that reinsurance programs must be built carefully in order to achieve this goal.<sup>1</sup> This *In Focus* is designed as a supplemental technical guide for state policymakers who are interested in using reinsurance to expand or maintain health insurance.

### 1. How can reinsurance reduce premiums?

Reinsurance can reduce premiums by reducing the volatility of an insurer's loss experience and, therefore, the amount that an insurer would hold to cover unforeseen high medical costs. To understand how this affects premiums, it is helpful to examine the various components of a premium. Premiums are generally divided between what is needed to cover medical costs (including required reserves) and everything else, such as administrative costs, excess reserves, surplus (or unobligated funds), and profit. In 2003, "everything else" accounted for 13.6 percent of the average premium.<sup>2</sup>

The incentive to hold excess reserves reflects insurers' risk-averse behavior and uncertainty

about the health status and short-term medical costs of their insured populations. In addition, insurers may hold greater surplus to help finance potential losses (over the medical underwriting cycle), although they also may draw down surplus to finance unexpectedly high costs in the current year.<sup>3</sup>

Insurers face uncertainty in forecasting the costs of their current risk pool and may hold excess reserves if they have reason to expect unusually high claims. They may also build greater surplus in order to have extra funds available for this reason.

Reinsurance can reduce premium levels by spreading risk more broadly among insurers. If no one insurer is at risk for very high claims, each may feel less need to build high reserves and surplus into premiums. In addition, if the state is the reinsurer and assumes some or all of the reinsured risk, premiums may be reduced even further.

By either spreading risk or assuming risk, reinsurance reduces risk-averse insurers' needs to price premiums with high reserve and surplus targets in mind. The end goal is for insurers to lower premiums by reducing the excess reserves and surplus that they build into premiums.



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## 2. Can a reinsurance program be linked to other programs?

Yes. Reinsurance can be linked to any number of alternative ways to provide coverage—including purchasing pools, small group insurance products, and 3-share access programs.<sup>4</sup> It can be formed either to replace a conventional high-risk pool in the individual market or to play a parallel role in the small group market (see #8).

Some states subsidize the reinsurance strategy in order to make insurance more affordable to a target population, such as small businesses, low-wage businesses, or low-income workers. However, even if the state does not provide a subsidy, reinsurance may still offer value: it can make premiums less volatile by spreading risk more broadly, and it promotes competition by helping to keep insurers in the small-group or individual markets.

## 3. Is state review or approval of insurers' premiums important for a reinsurance strategy to yield consumer savings?

Yes. Rate review is important in forcing savings from a reinsurance program back to the consumer. Additional oversight—such as rate approval—may be helpful but not essential for a successful reinsurance program.

At a minimum, states should require insurers to file rates with the Insurance Commissioner, scrutinize how insurers vary rates within and across products, and question insurers when rate increases seem unjustified by medical cost experience. Insurers should be required to report the percentage of premium spent on medical services (that is, the loss ratio) separately for their major medical business and for segments of the market of interest—for example, the small-group market versus the large-group market.

The goal of such oversight in the context of a reinsurance program is to encourage insurers to respond to lower risk by charging lower premiums. Without the transparency that comes with active rate review, private insurers have greater ability to build and maintain excess reserves and high surplus at the expense of consumers.

Healthy New York (HealthyNY), a state-sponsored and subsidized reinsurance program for low-wage firms and individual workers and their families, requires insurers to report medical loss ratios and also file prospective rates with the State of New York Insurance Department. Yet, the agency does not have authority to deny HealthyNY rate increases. The agency reviews each insurer's rates and posts them as public information, encouraging price competition among insurers.

Aggressive monitoring of rates forces insurers to return the savings from reduced risk and the state reinsurance subsidy to consumers.

Nevertheless, reinsurance is consistent with any type of rating practice—including full or modified community rating (which is typical in the small group market), rating bands (limiting variation in insurers' rates overall or for specific factors such as health or age), or rating unconstrained by specific regulation.

## 4. Are there differences in how reinsurance has been or should be developed to serve the small group market and the individual market?

In principle, reinsurance rules for each market may be the same or different. In the HealthyNY example, small employers, sole proprietors, and working individuals all participate in a single reinsurance program. Idaho has separate reinsurance programs for its small group and individual markets, and its individual reinsurance program is, in effect, the state's high-risk pool. Idaho's programs have similar, though not identical, rules.

## 5. Is it important that the reinsurance program be mandatory for all insurers? If not, how can competition affect it?

All state reinsurance programs with significant enrollment are mandatory. When tried, voluntary reinsurance programs have not succeeded and have been abandoned. In voluntary programs, the largest insurers are unlikely to participate. In effect, they are sufficiently large to reinsure themselves, and therefore may oppose a mandatory reinsurance program.

However, it is unlikely that a reinsurance program can achieve broad policy goals unless it is mandatory. One such policy goal is to stabilize the small-group or individual market and reduce incentives for aggressive underwriting by spreading risk more equitably across the market. To spread risk widely, all insurers that write in a particular market (e.g., small group or individual) must participate, contributing to any reinsurance pool losses net of premiums paid into the pool. Because the largest few insurers typically hold the vast majority of market share, risk cannot be spread across the market effectively unless they participate.

For example, Connecticut has used reinsurance to stabilize the small group (1–50) market since 1990, and the pool is credited with keeping a large number of insurers in the market. Any insurer can purchase reinsurance for any policy holder (a \$5,000 deductible applies), and the pool pays all claims over the deductible. If the pool outspends the reinsurance premiums paid by insurers, the statute triggers a

1-percent assessment on all insurers' small-group premium revenue. Since all insurers can be assessed to pay pool losses, all insurers participate regardless of whether they elect to buy reinsurance.

### 6. How difficult is it to run a reinsurance program? How much monitoring and data tracking does it require? Can good support services be purchased?

A reinsurance program does not require extensive bureaucracies or extensive investment in a new state program. Administration is a small, up-front cost that will not grow proportionally with the size of the program and the number of enrollees. The reinsurance program must accept premiums for risk that insurers cede to it, pay insurer claims submitted to the reinsurance program, and monitor reinsured costs both to identify when the reinsurance cap (if any) is reached and to trigger any assessment or subsidy for expenditures that exceed reinsurance premiums paid in. These activities require tracking the reinsurance fund, enrollment, revenues, and expenditures.

In addition, oversight of a reinsurance program requires:

- ◆ Tracking enrollment eligible for reinsurance.
- ◆ Review of insurer premiums for primary coverage.
- ◆ Review of reinsurance premiums.
- ◆ Certification and periodic review of the benefit packages that qualify for reinsurance.

The state may administer the pool directly (accepting premiums and paying claims), contract with a third-party administrator (TPA), or merely act as the purchasing agent for private reinsurance coverage. In addition, the state may assume a number of other functions directly, such as verifying enrollee eligibility (especially when eligibility depends on individual income or the employer wage profile), marketing, outreach, or providing consumer information. Alternatively, the state may require participating insurers to perform some or all of these functions, or hire a contractor to do them.

### 7. Can a reinsurance program incorporate care or disease management?

Insurers that participate in a reinsurance mechanism generally identify and flag high-cost enrollees; the reinsurer then reimburses all costs above the reinsurance attachment point. By definition, cases that qualify for reinsurance are more costly and, when appropriate, may be targeted for care or disease management.

However, while reinsurance provides an important reason for insurers to identify and track high-cost enrollees, it also reduces their financial incentive to invest in early

care or disease management. The more risk the reinsurance pool assumes, the less likely each primary insurer will perform early and appropriate care or disease management.

The state can design a reinsurance pool to minimize this disincentive. For example, reinsurance uses co-insurance and caps so that the primary insurer retains some risk for high-cost enrollees. Reinsurance programs typically assume only a portion of medical costs above the attachment point, requiring insurers to pay some portion of the medical costs (e.g., 20 percent) after a group or individual is reinsured. Coinsurance might also be tiered, forcing the insurer to hold more risk if it fails to coordinate care or comply with disease management protocols. In addition, reinsurance can be capped, so that the reinsurer covers only a "risk corridor" between the insurer's deductible and the reinsurance cap. For example, HealthyNY caps reinsured expenses at \$75,000 per person; the primary insurer is responsible for all enrollee costs over that amount.

### 8. How is a reinsurance program different from a high-risk pool? Why is transparency important?

High-risk pools are designed to make coverage available in the individual market to applicants who are denied private coverage. One of the main differences between having a high-risk pool and using a reinsurance program to subsidize high-cost individuals relates to the issues of transparency and consumer benefit from the program: How apparent is it to the participants that they are being treated in a special way, and how does that affect consumer decisions to buy insurance?

With a reinsurance program, consumers no longer face the usual process of application, medical underwriting, denial or rate-up, and re-application to the high-risk pool. Instead, reinsurance is transparent to them; using the Idaho example, every insurer must enroll any applicant in any of the standard reinsured plan options and at the same premium statewide. By avoiding the underwriting-denial-reapplication process, it is much less likely that applicants become discouraged and remain uninsured. In addition, reinsurance may also support portability within the individual market, allowing individuals to move more freely among plans when a lower-priced reinsured plan is available to them.

Finally, while high-risk pools are used solely to support the individual market, reinsurance programs also can help stabilize and potentially reduce premiums in the group market. In the group market, transparency is important for privacy reasons. In states with group reinsurance programs, neither the employer nor employee is aware that their coverage is reinsured. The reinsurance program may pay the costs of an entire group or only

some employees or dependents, but they are not informed of this and their premium is not changed.

In both the individual and group markets, transparency resolves any fear of stigma that could be attached to being enrolled in a “special” program.

### Resources

Chollet, D. *The Role of Reinsurance in State Efforts to Expand Coverage*, State Coverage Initiatives Issue Brief, October 2004, [www.statecoverage.net/pdf/issuebrief1004.pdf](http://www.statecoverage.net/pdf/issuebrief1004.pdf)

Profiles in Coverage: Healthy New York  
[www.statecoverage.net/newyorkprofile.htm](http://www.statecoverage.net/newyorkprofile.htm)

EP&P Healthy New York Annual Report  
[www.ins.state.ny.us/website2/hny/reports/hnyep2004.pdf](http://www.ins.state.ny.us/website2/hny/reports/hnyep2004.pdf)

### Endnotes

- 1 Chollet, D. *The Role of Reinsurance in State Efforts to Expand Coverage*, State Coverage Initiatives Issue Brief, October 2004, [www.statecoverage.net/pdf/issuebrief1004.pdf](http://www.statecoverage.net/pdf/issuebrief1004.pdf)
- 2 Smith, C. et al. “Health Spending Growth Slows in 2003,” *Health Affairs*, Vol. 24, No. 1, 2005, pp. 185–94.

- 3 All states require insurers to hold some surplus as a buffer against insolvency during an underwriting cycle—a cycle of rising premiums relative to medical costs followed by falling premiums relative to medical cost. Historically, underwriting cycles have occurred over a six-year period, rising for three years followed by declines for three years. But in the last decade the cycle has lengthened and the difference between the top and bottom of the cycle has lessened, suggesting that insurers may no longer need to build as much surplus as in past decades to survive the underwriting cycle. Nevertheless, many insurers currently are holding very high surplus, potentially for other reasons—for example, to finance capital improvements such as information technology infrastructure; or to finance mergers, acquisitions, or entry into new markets. Some states have asked or in effect required large nonprofit insurers to finance community benefit initiatives by drawing down high surpluses.
- 4 3-share refers to a strategy to expand coverage that typically includes contributions from three sources: employers, employees, and one or more public sources.

### About the Authors

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