

Department of Insurance, Securities and Banking  
District of Columbia

**Hearing on Group Hospitalization and Medical Services, Inc.  
September 10, 2009**

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Hello. My name is Robert Dobson. I am a consulting actuary with Milliman and am here at the request of our client, CareFirst. I am one of the authors of several Milliman studies for Group Hospitalization and Medical Services, Inc. or GHMSI, a Blue Cross and Blue Shield licensee that is an affiliate of CareFirst, Inc., and is domiciled in the District of Columbia. Three of these studies are the subject of my comments today. I will refer to these three as the 2005 Optimal Surplus Study, the 2008 Optimal Surplus Study, and the Attribution Study, which was completed in 2009.

Although the reports on these studies are lengthy and highly technical, their results can be summarized very simply. In the 2005 Optimal Surplus Study, Milliman recommended that GHMSI (the Plan) operate with surplus, the difference between assets and liabilities, in a range from 800% to 1100% of Authorized Control Level Risk Based Capital, or RBC for short. In the 2008 Optimal Surplus Study, based on changes to GHMSI's risk profile, we recommended that the Plan operate with surplus in a range from 750% to 1050% of RBC. In the Attribution Study, we opined that a reasonable way to allocate surplus - based on our understanding of the legislation that requires attribution - is residency of the subscribers. The calculations resulting from this approach are quite involved, but the end result is that some 11.6% of GHMSI's surplus would be considered attributable to the District of Columbia. Note that the legislation requires the DC Insurance Commissioner to review the portion of GHMSI's surplus that is "attributable to the District" and to determine whether the surplus is excessive.

The reports related to Optimal Surplus Studies recommend ranges of surplus measured by as a percentage of RBC. RBC is the measuring stick we use, but the ultimate issue relates to the surplus of GHMSI which is simply the difference between assets and liabilities.

Before providing a brief description of the approach that we have followed, I would like to address the claim by DC Appleseed and others that our model is a "Black Box". Our modeling involves a highly technical process involving a significant degree of detail, reflecting the complexity of the financial operations of an organization such as GHMSI. It is not a process that can be readily described in a report of the type that we prepared for GHMSI. Nevertheless, we have prepared detailed documentation of all

assumptions, methods, formulas and results, and have subjected the process to rigorous review among Milliman consultants.

This detailed documentation has also been presented to consultants working with the Maryland Insurance Administration (MIA) and the District of Columbia Department of Insurance, Securities and Banking (DISB), during on-site meetings at our offices. We described our processes in detail, provided copies of documentation, and responded to questions. In addition, we have provided follow-up information as requested. The details of the description that I am going to outline have been addressed in our documentation and our discussions with these consultants.

Our approach to the Optimal Surplus Studies involves the identification and evaluation of the major risks that GHMSI faces now and into the future. We considered seven major categories of risk, as follows:

- 1) **Rating adequacy and fluctuation**, meaning the risk that actual claims and expenses differ from the assumptions made in developing the premium rates;
- 2) **Unpaid claim liabilities and other estimates**, which considers the risk that the reported liabilities, which are estimates subject to uncertainty, do not make adequate provision for unpaid claims and other items;
- 3) **Interest rate and portfolio asset value fluctuations**, involving risks associated with the investment portfolio and the implications for reported surplus levels;
- 4) **Overhead expense recovery risk**, reflecting the implications of a decrease in business and the inability to cover overhead in the short term before adequate adjustments to operations can be implemented;
- 5) **Other business risks**, such as the potential for default among large administrative services contract (ASC) groups, leaving GHMSI to pay claims with no premium collections from the group;
- 6) **Catastrophic events**, such as epidemics and pandemics, natural or public health disasters, or terrorist attacks; and
- 7) **Provision for unidentified development and growth**, reflecting the possibility of unanticipated investment needs, such as new systems or administrative processes, development of new products, or response to legislation.

For each of these categories, all of which reflect potential costs that could reduce GHMSI's surplus, we developed a distribution of potential outcomes, (both favorable and unfavorable where applicable). To evaluate the financial implications of these possible outcomes, we used an automated process to simulate the tens of millions of possible combinations produced by our distributions. To accomplish this we employed a simulation methodology that is commonly applied in financial modeling.

Based on these simulations, we identified the levels of cumulative multi-year losses that represent the 90<sup>th</sup>, 95<sup>th</sup> and 98<sup>th</sup> percentile, respectively, of all losses. The 90<sup>th</sup> percentile, for example, means that 90% of the simulated losses are at or below that level. These identified loss amounts were used to develop surplus targets that would meet our criteria, which were as follows:

- 1) Provide a **very high likelihood** that the overall surplus level for GHMSI will remain above the Blue Cross Blue Shield Association (BCBSA) Early Warning Monitoring threshold of **375% of RBC**, even after a particularly adverse period of multi-year underwriting losses and/or capital market losses. In order to meet this goal, the surplus target must be high enough to cover 90% to 95% of all loss cycles without allowing the surplus level to drop below the Early Warning Monitoring threshold (375% of RBC-ACL).
- 2) Assure with **virtual certainty** that surplus will remain above the BCBSA Loss of Trademark threshold of **200% of RBC**, even if a severely adverse period of multi-year losses were experienced. In order to meet this goal, the surplus target must be sufficiently high to cover 98% of all loss cycles, without allowing the surplus level to drop below the Loss of Trademark threshold (200% of RBC-ACL).

We also analyzed historical underwriting loss cycles for GHMSI and a comparison set of Blue Cross Blue Shield Plans. We did not use these historical results directly in our analysis. Rather, we used them to evaluate the reasonableness of the cycle losses developed through the simulation process that I just described. Based on a comparison, we found that the historical loss cycles were materially greater in severity than those produced by our simulations. From this we concluded that our simulated loss cycles were reasonable, considering the recent changes in health plan loss patterns and operating environment.

In order to carry out our surplus modeling, we developed and initialized a pro forma projection model based on GHMSI's own internal financial forecasting. This model reflects the overall financial characteristics of the company's operations, including the profits generated by the Federal Employee Program, the treatment of ASC business, and the investment income generated by surplus and other funds. We then developed the surplus target range by "stress testing" the selected loss cycles against a range of surplus thresholds. This allows us to assess the surplus levels that are necessary to withstand the cycle losses

Let me emphasize that the reports on these studies say a lot more than this and a thorough reading of each is necessary to understand them. I will not attempt to summarize the other major points of these studies because it would be impossible to do them justice in the allotted time. Each of these reports is available to the public. I will, of course, be happy to respond to questions related to the reports either following this testimony or later following this hearing.

These assignments for CareFirst and GHMSI are very important to me and to Milliman. We do not take our responsibilities to the Board of Trustees of GHMSI, and ultimately GHMSI's subscribers, the public and their regulators, lightly. Our work on all three

studies involved many hours of detailed financial analysis, interviewing all levels of management and asking many probing questions. All of our work was thoroughly peer reviewed. This is a long-established practice at Milliman, resulting in work products that involve at least two fully qualified professionals. In the case of the 2008 Optimal Surplus Study, five fully qualified professionals were involved. Every assumption, formula, and conclusion was discussed, understood and agreed upon by a minimum of two of these consultants, and in many cases by three or four consultants. We at Milliman are proud of the work we have done on these assignments and stand solidly behind our work.

I will give you more background on myself and on Milliman in a minute, but I want to first mention a group that I chaired back in the late 1970's and early 1980's. This was a technical advisory committee to the NAIC (the National Association of Insurance Commissioners) on the subject of loss reserves and contingency reserves (or surplus) for hospital and medical service corporations. That includes Blue Cross and Blue Shield Plans, similar entities and HMOs or health maintenance organizations. This was, of course, well before risk based capital was implemented. The first conclusion from our report read in part "The nature and magnitude of the risk will vary for each Corporation, but the risk must be recognized and provision must always be made to minimize the ultimate risk of financial failure." One of the themes was that no rule of thumb level for appropriate surplus could be developed. Rather, the specific characteristics of each entity must be studied and evaluated and an appropriate range of surplus developed. That is still what we believe and how we approached our work for GHMSI and for other entities for which we provide consulting services.

Many Blue Cross and Blue Shield Plans have encountered financial difficulty over the years, including GHMSI. While only one Blue Cross Plan has ever gone all the way to bankruptcy, many HMOs and similar organizations have. I have been involved in efforts to resolve many of these situations and studied many others after the fact.

When a corporation of this type goes bankrupt, the consequences are dire. Real people suffer - subscribers, doctors, hospital employees, business owners and others all can lose money, coverage or access to treatment. In fact, I don't think it is an overstatement to say that the public at large is disadvantaged. I have sat in courtrooms as a gallery of subscribers and providers waited to hear a judge declare how the limited proceeds from bankruptcy would be distributed. I have sat with insurance commissioners while they agonized over a decision among very undesirable alternatives to deal with a potential insolvency.

I have observed first hand that there are many worse problems to have than a financially stable Blue Cross and Blue Shield Plan.

I will now give you some background on myself and on Milliman. I am a graduate of MIT and a fully-accredited actuary, holding the professional designations of Fellow of the Society of Actuaries and Member of the American Academy of Actuaries. I first joined Milliman, which was then known as Milliman & Robertson, in 1973. I have been a consulting actuary ever since, with the exception of three years that I spent in the early 1980's serving as Chief Financial Officer of Blue Cross and Blue Shield of

Alabama. In addition to chairing the NAIC technical advisory committee I mentioned earlier, I have served as president of two actuarial organizations and as a vice president of the American Academy of Actuaries. I also served on a technical advisory group on Medicare and was a member of a blue ribbon panel on solvency for the American Academy of Actuaries.

I have been involved in regulatory issues for many years and have consulted for at least twelve state insurance departments over the years as well as the NAIC. In addition, and of particular relevance to my understanding of the operating environment of GHMSI, I have served as the consulting actuary for the Blue Cross Blue Shield Association Federal Employee Program for over fifteen years. Prior to that, I was one of the principal authors of a comprehensive study of the Federal Employees Health Benefits Program. That study was performed directly for the United States Office of Personnel Management.

So that is a quick description of my background and qualifications. Milliman has some 200 fully-qualified health actuaries, many with equally strong or stronger credentials than mine in a variety of sub-specialties. In fact, one of my partners led the group that developed the formulas and factors currently used by the NAIC for health risk based capital calculations. Founded in 1947 by Wendell Milliman, the firm just announced the opening of our 50<sup>th</sup> office worldwide in San Juan, Puerto Rico. Milliman has over 1,100 qualified consultants and actuaries in all specialties. We are independent. We are beholden to no outside ownership or shareholders. The firm is owned by its 300 principals, each of whom is actively employed with the firm. We believe that this ownership and our financial structure allow us to attract and retain the best talent there is. I think it is safe to say that we are widely recognized in the health care industry as the premier actuarial firm. Our opinions are our own and they are formed on the basis of absolute integrity. We have worked for the majority of Blue Cross and Blue Shield Plans and other health insurance companies and performed numerous surplus evaluations in addition to advising companies on surplus related issues. We have an outstanding reputation that we strive diligently to protect.

I want to close by saying a few words about the criticisms that have been directed at Milliman, primarily by DC Appleseed and the actuaries at Actuarial Risk Management (ARM). Many if not all of the assertions made are simply wrong, whether out of lack of understanding or otherwise. Here are some examples of the errors, misunderstandings and mischaracterizations contained in the report:

- 1) It is not true that we exclude gains from the Federal Employee Program or investment income on surplus and other funds. These items are directly reflected in our analysis as an offset to potential underwriting losses on the non-FEP business.
- 2) We do not directly use the prior loss cycle experience. The loss cycle assumptions that we used are substantially lower than the historical cycles, as demonstrated in the table on page 51 of the report on the 2008 Optimal Surplus Study. If we had used the prior loss cycles, our cumulative loss scenarios would have been higher, resulting in higher surplus target levels.

- 3) We can demonstrate that our premium growth assumptions are consistent with past experience. It appears that, in citing a 7% to 8% growth rate, ARM may have failed to consider the premium growth of CareFirst BlueChoice, GHMSI's jointly owned subsidiary.
- 4) ARM states that Milliman most likely used a four-year loss period, and criticizes our use of four rather than three years. We in fact used both three and four-year loss periods. In Milliman's methodology, the four-year loss period actually produces a lower surplus requirement than the three-year period, because the cumulative loss (prior to pricing margins) is the same whereas there are more years of margin to offset the loss.
- 5) We tested the use of an 8% growth rate with a three-year loss period, which ARM estimates would reduce the surplus target ranges by 22.5% to 26%. We found that these assumptions would not change the lower end of our range. In any event, we stand by our assumption and do not believe that 7% to 8% is a reasonable growth rate assumption.
- 6) Appleseed and ARM characterize the Blue Cross Blue Shield Association (BCBSA) Early Warning Monitoring level of 375% RBC as nothing more than some additional reporting requirements, therefore its inclusion as a key measurement of financial soundness by Milliman is inappropriate. Their position is an overly simplistic representation of the insurance marketplace sensitivity to having coverage with a financially strong company, especially given the events of the past year. Furthermore, they underestimate the responsibility that BCBSA has to all Blue Plans to aggressively protect the value of one of the most recognized and respected brands in the nation.
- 7) Appleseed mischaracterizes the conclusions of the Pennsylvania Insurance Commissioner with regard to the analysis carried out by Milliman. Appleseed claims that the Pennsylvania Commissioner "rejected Milliman's methodology." That simply is not so. Rather, the Pennsylvania Commissioner merely disagreed with a few of the assumptions Milliman used out of many. Appleseed has pulled quotes from the Pennsylvania report out of context to improperly suggest that this constituted a wholesale rejection. The Pennsylvania Commissioner disagreed with Milliman over whether to account for low-probability, high-loss events like terrorist attacks. She concluded that it was not appropriate to do so because "they are most efficiently prepared for through a combination of government, industry-wide, societal and individual company specific initiatives." We respectfully question that conclusion.

Where appropriate, other assumptions that were questioned by the Commissioner have been dealt with through refinements to our methodology as applied in the 2008 GHMSI Optimal Surplus Study.

Milliman intends to vigorously defend our work. We stand behind it. We will provide further detail in the post-hearing submission process. Although I have been involved in many adversarial proceedings over the years, I must say that the attacks leveled against us in this case are the most unfounded and unprofessional I have ever seen in my 40 year career.

Questions about our work are certainly welcome; but uninformed allegations presented as fact do a disservice to the Commissioner, the District Council, GHMSI's subscribers, and the citizens of the District as this important but complex matter is considered.

Thank you for your time and attention. I will be happy to respond to any questions you might have.

