

GOVERNMENT OF THE DISTRICT OF COLUMBIA  
DEPARTMENT OF INSURANCE, SECURITIES AND BANKING

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IN THE MATTER OF  
Surplus Review and Determination for Group Hospitalization and Medical Services, Inc.

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DC APPLESEED'S RESPONSE TO QUESTIONS/INFORMATION REQUESTED

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Pursuant to the Commissioner's Third Scheduling Order, Order No. 14-MIE-005 (Aug. 7, 2014), DC Appleseed hereby respectfully submits the following response to questions and information requested.

**C. Questions for/Information Requested from Appleseed**

- 1. Please provide your recommendations regarding how the Commissioner should determine the amount of GHMSI's surplus that is attributable to the District in accordance with 26A DCMR § 4699.2.**

For the reasons explained in the memorandum submitted by Covington & Burling in the 2009 proceeding, DC Appleseed recommends that the Commissioner determine the percentage of GHMSI's surplus attributable to the District according to the percentage of GHMSI premium revenue attributable to the District. Premium revenue, in turn, should be attributed to the District based on contracts written in the District. Covington & Burling, *Analysis of Surplus Attributable to the District of Columbia, in Testimony of DC Appleseed for GHMSI Surplus Hearing: DC Department of Insurance, Securities and Banking* exh. B (Sept. 10, 2009), available at [http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/written\\_statement\\_-\\_walter\\_smith.pdf](http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/written_statement_-_walter_smith.pdf).

- 2. Please address if and how post-2011 results should be factored into the review of GHMSI's 2011 surplus.**

As we stated in our pre-hearing brief, we believe it is appropriate for the Commissioner to consider post-2011 results, particularly to address the reasonableness of predictions made regarding GHMSI's surplus needs as of December 31, 2011. DC Appleseed, *D.C. Appleseed Report to the D.C. Department of Insurance, Securities and Banking: Surplus Review of Group Hospitalization and Medical Services, Inc. ("GHMSI")* 25 n.19 (June 10, 2014) [hereinafter DC Appleseed Pre-Hearing Report]. Examples of this consideration are the Commissioner's questions directed to Rector asking how GHMSI's post-2011 actual results compare to the assumptions Rector made in the Modified Milliman Model concerning the premium growth rate

and equity portfolio factors. Third Scheduling Order, Order No. 14-MIE-005 app. A at 3 questions 6.c and 7.c (Aug. 7, 2014).

**3. Hearing testimony seemed to contemplate that there are four components involved in modeling to determine a required surplus: (1) the model; (2) the assumptions, (3) the surplus threshold, and (4) the confidence level. In Rector's testimony, it brought out a model that is really just a complicated calculator and that all models should return similar results if the same inputs are used. See, e.g., Transcript at 20.**

**a. Do you agree that the model itself should not have material impact on the results if it is function[ing] correctly?**

Yes. We note that there are actually two models used in Rector's analysis: the stochastic model, and the pro forma financial model, each with its own set of assumptions. We also note that Rector's "calculator" analogy is useful but imperfect. The inputs to a calculator are numbers that are themselves not estimates. In the calculation of two times two, no estimation is involved in determining what two is; it is axiomatic. In contrast, the 13 probability distributions that go into the stochastic model, and the financial assumptions that go into the pro formas, are themselves determined by estimation and judgment. And as we have said, those estimations and judgments must be made in accordance with MIEAA and the legal standards set out by the Court of Appeals.

Moreover – and this relates to the nature of models themselves, as distinct from the assumptions that are run through them – a calculator utilizes indisputable relationships between inputted numbers. Two times two always equals four. In contrast, the relationships that a model posits among inputted assumptions are themselves matters of estimation and judgment. For example, a model may posit a relationship between premium growth and medical claims. That relationship is itself an estimate, even if it is derived from empirical data. In response to question 4.a. below, we discuss the implications of these characteristics of a model for the Commissioner's MIEAA determination.

**b. Do you have any reason to be concerned about the operation of the Modified Milliman Model, as opposed to the assumptions and confidence level underlying the Modified Milliman Model?**

We are not in this proceeding questioning the operation of the model. Our concern remains that we do not know how Rector derived the assumptions that it applied to the model.

**4. Applesseed's testimony argued that the modeling done to date, other than by Mr. Shaw, did not incorporate the specific requirements of District law to balance financial soundness and community reinvestment. The testimony also indicated that efficiency should guide the choice of assumptions, and that assumptions should use**

historical results to predict the future, but that you don't tie yourself exclusively to that. *See, e.g., Transcript at 192-193.*

- a. **Are there criteria other than the four components mentioned above (model, assumptions, threshold, confidence level) that should be considered in determining the level of surplus GHMSI should maintain to balance financial soundness and community reinvestment?**

In addition to the four components, there is an additional element that should be considered in ensuring that GHMSI's surplus complies with MIEAA. That additional element may be described as a reality check or an overall judgment that is superimposed on model results to allow for the inherent imprecision of models, and their inability to fully capture all relevant considerations.

As we have previously noted, while we did not agree with using the Milliman model or the Modified Milliman Model for this proceeding, we understand that the Commissioner wishes to rely on it at least in part for his determination. Accordingly, we have recommended adjustments that we think must be made to the assumptions that are run through the models so that the numbers they produce will be calculated in compliance with MIEAA and the Court of Appeals. In addition, however, independent of the choice of confidence level and of any changes the Commissioner may choose to make to the assumptions that are run through the models, the ultimate determination under MIEAA requires the Commissioner to reach a judgment that takes into account considerations beyond the models. We have already discussed the extent to which estimation and judgment are built into the relationships among variables that a model posits, and the resulting inherent imprecision. Sophisticated as it may be, a model is only a theoretical construct that does not fully capture reality; instead, the very purpose of a model is to simplify reality. Were it otherwise, we would not have economic recessions, because economic models would accurately predict them and enable private and public decision-makers to make the needed course corrections.<sup>1</sup>

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<sup>1</sup> The need for judgment that takes into account but goes beyond modeling is underscored by Standard & Poor's in its capital adequacy model for insurers. S&P repeatedly states that "We base our overall opinion of an insurer's level of capital adequacy on insights drawn from this model, evaluated in conjunction with more qualitative factors." Standard & Poor's, *Refined Methodology and Assumptions for Analyzing Insurer Capital Adequacy Using the Risk-Based Insurance Capital Model 3* (June 7, 2010), available at [http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DCapital\\_Model\\_07Jun10.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1243806875720&blobheadervalue3=UTF-8](http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DCapital_Model_07Jun10.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1243806875720&blobheadervalue3=UTF-8). "Our rating process will continue to be based on the belief that the results from the model are not a substitute for a broad-based analysis of an insurer's credit quality." *Id.* at 5.

Consistent with the nature of models, courts have recognized that an agency has an obligation to determine whether the results of any model on which it relies bear a reasonable relationship to reality. The “ultimate responsibility for the policy decision remains with the agency rather than the computer.” *Sierra Club v. Costle*, 657 F.2d 298, 332 (D.C. Cir. 1981). The Commissioner therefore cannot appropriately use the Modified Milliman Model—or any model—without also making “a conscientious effort to take into account what is known as to past experience and what is reasonably predictable about the future.” *Am. Pub. Gas Ass’n v. Fed. Power Comm’n*, 567 F.2d 1016, 1037 (D.C. Cir. 1977). Thus, while a properly constructed model is essential to the Commissioner’s determination of a surplus level that simultaneously meets all the MIEAA standards—maximum feasible, financial soundness, and efficiency—in the end the Commissioner will need to exercise legal judgment, (which, under MIEAA, requires a measure of common sense), in determining what that level should be. This legal judgment should take into account the validation of the model that both Rector and Mark Shaw have advocated. We expect to address this issue further in our Rebuttal Statement.

**b. Are there objectively correct assumptions to be used to balance financial soundness and community reinvestment or is there subjectivity in determining the appropriate assumptions?**

Several kinds of assumptions are employed in the Milliman model; they should be based on objective data, but their ultimate selection involves at least some subjective judgment. That judgment must be informed by and consistent with MIEAA and the Court of Appeals’ legal standards.

Thus, regarding the confidence level, Mark Shaw has determined based on objective data the impact on community reinvestment from using, for example, a 90%, 95%, or 98% level for avoiding 200% RBC. His tables show that using the Modified Milliman Model and making no other changes, at the 98% level the dollars available from surplus for community reinvestment will be zero; and at 90% and 95%, those dollars will be \$283 million and \$148 million, respectively. Mark E. Shaw, *Report to the D.C. Department of Insurance Securities and Banking: Group Hospitalization and Medical Services Inc. MIEAA Surplus Review* 56 ch. 23 (June 10, 2014) [hereinafter Shaw Report]. The determination of which of those confidence levels to use is a matter of judgment for the Commissioner to make in light of the governing legal standards. For reasons we have discussed in our Pre-Hearing Report, the proper choice is 90%.

Similarly, estimation and judgment are involved in the assumptions used in both the stochastic model and the pro forma model. The extent to which those assumptions depart from the historical record can be objectively determined; and the question of how far the output of the model departs from the historical record can also be objectively determined. Again, the selection of those assumptions must accord with the governing legal standards.

- c. Does balancing financial soundness and community reinvestment impact assumptions differently than efficiency? Does balancing financial soundness and community reinvestment impact different assumptions than efficiency?**

The answer to both these questions is “no.” Even though the model’s assumptions are measured against the efficiency standard, while the confidence level must be calibrated under the maximum feasible standard, both standards affect community reinvestment in a similar way: they both ensure that the model is designed to maximize community reinvestment, up to the point where further reinvestment would undermine financial soundness. Both require that each of the 13 probability distributions be as realistic as possible, with a presumption in favor of using historical results, and strong reasons and fully detailed explanations for any departures from historical results. Furthermore, both the efficiency standard and the maximum feasible standard are designed to limit GHMSI’s surplus to an amount needed to protect the company from reasonably probable contingencies.

- d. What criteria should be used to determine when to depart from the historical record when considering future assumptions?**

We believe, as we said in our pre-hearing brief, that “MIEAA requires that surplus be based on probabilities and magnitude of gain or loss that are *realistic* and tied to actual historical experience. It follows that any departures from historical experience must be justified by strong and fully explained reasons.” DC Appleseed Pre-Hearing Report at 18 (emphasis in original). We also said that this definition of “efficiency” is established by the Pennsylvania decision, which the Council relied on in adopting MIEAA. *Id.* This definition, we said, “limits the extent to which surplus may permissibly be keyed to the possibility of remote, extreme adverse or catastrophic events, or to simultaneous combinations of such events.” *Id.* There probably is no single set of criteria for identifying assumptions whose results do not validate against historical results but that may nevertheless be justified. Generally, the circumstances should involve developments that are: not reflected in probability distributions based on the relevant historical period; likely to continue during whatever the relevant future time horizon is (here, three years); and likely to have material net effects after taking into account any likely offsetting developments (for example, the migration of previously insured to the new exchange products offsets to some degree the effects of the ACA on premium growth; the three Rs offset to some degree the ACA impacts on RAAF).

- 5. Appleseed’s testimony raised issues about the use of a range focusing on when GHMSI was above the target about which the range was created, but within the range.**

- a. Do you agree that, when using a surplus range with a targeted midpoint, if GHMSI is below the target but above the low end of the range, GHMSI’s level of community health reinvestment would not decrease?**

Yes.

- b. Do you agree that, if there is a single target point for surplus, GHMSI would reasonably be expected to reduce their community health reinvestment any time they were below the target?**

Yes.

- c. If the answer is “no” to either (a) or (b) above, please explain why situations below the target should be treated differently than those above?**

N/A

- d. Is it Appleseed’s position that the Commissioner must (or should) use a single target RBC number rather than a range? Please explain.**

Our position is that in order to comply with MIEAA’s “maximum feasible” requirement, the Commissioner must select a single target that meets that requirement. As we explained in our pre-hearing brief, in our view a surplus level that commits the “maximum feasible” amount to community reinvestment is by definition a single target. DC Appleseed Pre-Hearing Report at 39-40. That is because only one amount can in fact be the “maximum feasible” amount. To pick a range, instead, as Rector has done—especially a range as broad as 875% to 1040%—is the equivalent of allowing GHMSI to meet “maximum feasible plus or minus \$83 million.” This assumes the Council authorized GHMSI to spend \$83 million less than the “maximum feasible” amount. We do not think this is a sensible reading of the statute’s categorical, mandatory language.<sup>2</sup>

MIEAA requires the Commissioner to identify the “maximum amount” of community reinvestment that is feasible. As a matter of law, that requires a point and not a range. Of course it is true that GHMSI’s surplus is going to vary from year to year. But as a matter of law under MIEAA it would be error to conclude that any excess that is within some “normal” variation justifies retaining dollars that could by definition be feasibly invested in the community.<sup>3</sup> Moreover, Rector’s range would create precisely the wrong incentives under MIEAA with respect to the management of surplus. With a safe harbor, exceeding the proper level is of no

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<sup>2</sup> Rector itself stated that the Court of Appeals decision “requires GHMSI to engage in community health reinvestment right up to the edge of where doing more would present an inappropriate risk of GHMSI becoming financially unsound or inefficient.” Tr. at 31:10–13. It is not possible to reconcile this view with a range of \$165 million around the surplus level at which GHMSI is financially sound.

<sup>3</sup> We say “by definition” because the excess that the range would allow is an amount above what has been determined to be the surplus level that achieves both financial soundness and the maximum feasible amount of community reinvestment. Thus, a point between 400% and 500%, as urged by DC Appleseed, is not the same as a safe-harbor range around a target, which Rector has urged.

consequence, so the operative incentive would be to stay below the upper end of the *range*, and not below the proper level of *surplus*. That the permitted excess is \$85 million under Rector's analysis only underscores the point, although a range is in any event categorically incorrect under MIEAA.<sup>4</sup>

As a practical matter there might be an occasion beyond GHMSI's managerial control when its surplus could temporarily vary from its permissible level; but this should not change its obligation to meet the "maximum feasible" requirement, much less allow it to miss that obligation by \$83 million. That there may be small annual variations around any target is of no moment. If GHMSI is above its permitted surplus by \$1 million, it will not be a great burden to reinvest that amount in the community. If it is below the maximum, it will be free to bring surplus up to the maximum. And, if the excess over the permitted level is large, MIEAA obviously requires community reinvestment.

**6. GHMSI's testimony discussed the relationship of GHMSI and CareFirst BlueChoice and that 40% of GHMSI's surplus comes from its 50% ownership of BlueChoice. See, e.g., Transcript at 100.**

**a. Please describe how the UHAS model incorporates BlueChoice into its process. Do you know if this is similar to the way Milliman/Rector included BlueChoice?**

UHAS tried to use the same approach as Milliman/Rector in the treatment of BlueChoice for creating the assumptions that went into the stochastic model in order to replicate the Milliman/Rector stochastic results. Specifically, UHAS considered the impact of BlueChoice in deriving combined premium growth rates, in the probability distribution for the RAAF factor and in the probability distribution for the EPAV factor. Similarly, UHAS used its stochastic results and the Milliman/Rector Pro Forma results to estimate the Pro Forma results using UHAS's stochastic results. Shaw Report, at 52-53. Thus, the Milliman/Rector Pro Forma approach to BlueChoice in the Pro Forma model is implicit in UHAS's Pro Forma estimates.

**b. Please explain how the inclusion of BlueChoice should affect the assumptions in the model and whether BlueChoice results should be considered in comparing assumptions to historical experience.**

As to whether BlueChoice should be included and affect the modeling results, we believe the main reason that it is appropriate to consider BlueChoice's impact is that due to it being an owned subsidiary the NAIC formulas for deriving the RBC requirements for GHMSI take into

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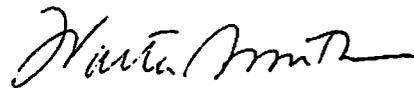
<sup>4</sup> For a surplus below the permitted surplus, there is no difference between a range and a point. In either case, GHMSI would be free to seek to bring its surplus back up to the permitted level.

account certain elements of BlueChoice's financial results. Moreover, changes in BlueChoices surplus have a direct flow-through impact on the surplus of GHMSI.

- 7. Please address any questions, comments or criticisms in Rector's pre-hearing brief or hearing testimony that you wish to address that have not been addressed in your responses to the requests above.**
  
- 8. Please address any questions, comments or criticisms in GHMSI's pre-hearing brief or hearing testimony that you wish to address that have not been addressed in your responses to the requests above.**

As we noted in our pre-hearing report and testimony at the June 25 hearing, we have a number of concerns with Rector's and GHMSI's positions. Because both Rector and GHMSI will be providing additional information regarding their positions in response to the Commissioner's questions, in the interest of efficiency, we will address our concerns in our Rebuttal Statement.

Respectfully submitted,



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