BlueCross BlueShield Association

An Association of Independent Blue Cross and Blue Shield Plans

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The Honorable Chester A. McPherson
Interim Insurance Commissioner
Department of Insurance, Securities, and Banking
810 First Street, NE, Suite 700
Washington, D.C. 20002

Dear Commissioner McPherson:

I am writing to provide the perspective of the Blue Cross and Blue Shield Association (BCBSA) to assist you in your examination of the reserve levels maintained by Group Hospitalization and Medical Services, Inc. (GHMSI), a Blue Cross and Blue Shield licensee domiciled in the District of Columbia. By way of introduction, BCBSA is the owner of the BLUE CROSS® and BLUE SHIELD® Brands as well as the trade association and licensing organization for the 37 independent Blue Plans that collectively provide healthcare coverage for more than 100 million – nearly one in three – Americans. BCBSA is headquartered in Chicago and has a regional office in Washington, D.C., where many of our Washington-based associates receive healthcare coverage from GHMSI.

BCBSA understands that the Department of Insurance, Securities and Banking (DISB) is reviewing the surplus of GHMSI as of December 31, 2011, under the Medical Insurance Empowerment Amendment Act (MIEAA) of 2008, and that the Department is holding a public hearing on June 25, 2014. BCBSA asks that these comments be made part of the hearing record.

In its review, DISB is required to consider the National Association of Insurance Commissioners' Risk Based Capital Requirements for health insurers. As explained in detail below, BCBSA uses Health Risk Based Capital (HRBC) to monitor the financial condition of each of its 37 Plans and appreciates the Department's consideration of GHMSI's stated surplus obligations relative to its requirements, risk exposures and contingencies, including federal healthcare reform and related requirements.

1. ***BACKGROUND ON BCBSA'S MONITORING OF PLANS***

As owner and licensor of the Blue Cross and Blue Shield Brands, BCBSA continually monitors the operating performance and financial condition of each of its 37 Plans, which must submit quarterly financial reports and semi-annual HRBC reports to BCBSA. Many metrics from these financial reports, including the HRBC ratio (i.e., Total Adjusted Capital divided by the Authorized Control Level RBC), are monitored by BCBSA to assess the financial condition of the Plans. BCBSA utilizes a Plan's HRBC ratio among other measures to determine the need for various monitoring and licensure actions and to exempt Plans from certain licensure compliance requirements.

Initial inclusion in intensified monitoring (also known as the "Early Warning" stage) occurs when a Plan's HRBC ratio falls below 375 percent. However, in every case, BCBSA considers the Plan's current and projected HRBC ratio as well as the specific circumstances of the situation.

To retain its license from BCBSA to use the Blue Cross and/or Blue Shield Brands, a Plan must maintain an HRBC ratio of at least 200 percent, the "Licensure Minimum" capital requirement. If a Plan's HRBC ratio were to fall below 200 percent, BCBSA's Board of Directors (composed of the CEOs of all 37 Plans and BCBSA) would immediately commence actions to terminate that company's license to use the Blue Brands. BCBSA intentionally set its minimum capital requirement at the same point as the highest of the four Levels of Action under the NAIC's Risk-Based Capital Model Act. As the owner of the Blue Brands, BCBSA wants to ensure that its Brands carry a clear connotation of financial strength and brand integrity. We believe this goal would be compromised if a BCBSA-licensed company's capital level were to fall below the NAIC's Company Action Level.

The Board is committed to ensuring compliance with the Licensure Minimum capital requirement. In addition, BCBSA maintains a robust license termination contingency plan and re-licensure process that is periodically reviewed with the Board. In the event a Plan is unable to maintain compliance with the Licensure Minimum capital requirement, BCBSA is prepared to initiate its license termination contingency process immediately upon license termination.

2. ***GHMSI's CAPITAL IS MAINTAINED FOR ONE PURPOSE***

Blue Cross and Blue Shield companies maintain strong financial capital for one purpose – to ensure their ability to pay members' medical claims in good times and bad times, including widespread crisis situations such as a major disaster, terrorist event or epidemic. Blue Plans must be prepared to provide their members with rock solid assurance that their health insurance coverage remains in place and claims will be paid, no matter what the circumstance. This commitment is a cornerstone of any reliable insurer. The ability of Blue Plans to meet their obligations to their policyholders, even in the current difficult economy, is not an accident. Maintaining strong capital over time – well beyond minimum levels – protects our customers and is good for the communities we serve.

3. ***RISK-BASED CAPITAL IS NOT A MEASURE OF EXCESS CAPITAL***

The NAIC designed the HRBC formula solely for the purpose of assessing whether an insurer is inadequately capitalized. As noted above, BCBSA makes use of HRBC in its monitoring and compliance programs and utilizes HRBC-based thresholds to establish minimum requirements.

HRBC is a retrospective formula based on industry-wide assumptions. By design, HRBC does not incorporate such factors as the insurer's environment and company-specific business risks, future infrastructure needs, strategies, growth plans or investment needs, and certainly not the requirements of federal and local healthcare reform. When the risk-based capital standard for health insurers was being designed in the early 1990s, the NAIC repeatedly stated that risk-based capital ("RBC") represents a minimum acceptable level of capital rather than a maximum level of capital:

> "The [Life RBC Working Group] discussed problems associated with using RBC results for other purposes...Tying other regulatory provisions to surplus amounts above the RBC thresholds is problematic in that the formula was not developed to measure financial strength or capital adequacy beyond a minimum regulatory requirement.[1]
>
> "The formula that is proposed is a threshold capital formula rather than a target capital formula. It has been designed to identify companies with capital levels that require regulatory attention. The formula has not been designed to differentiate among adequately capitalized companies.
>
> "Therefore, it would be entirely inappropriate to use this formula to rate or rank adequately capitalized companies."[2]

Shortly after the NAIC risk-based capital standard was implemented, the position that the NAIC RBC formula is wholly unrelated to the issue of the appropriate level of capital for an insurance company was reinforced in an NAIC-published journal article co-authored by the NAIC's then-director of research:

> "The NAIC RBC formula was designed to establish a regulatory minimum level of capital based on risk...These new risk-based capital standards do not set a target capital level or even an optimal capital level...Companies are free to hold capital above and beyond the minimum level established by the RBC formula, and virtually all companies do, but the exact level of capital is an internal business decision outside the scope of regulatory monitoring. That optimum capital level chosen by the company can be well outside the company action level RBC determined by the NAIC formula...[I]t is important to appreciate that the RBC formula should not bind an adequately capitalized firm."[3]

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[1] NAIC Proceedings 1993 3rd Quarter, page 228.

[2] NAIC Proceedings 1992 4th Quarter, page 557.

[3] Robert W. Klein and Michael M. Barth, "Solvency Monitoring in the Twenty-First Century," *Journal of Insurance Regulation*, Vol. 13, No. 3, 1995, page 274.

In conclusion, the NAIC has made it clear that the specific purpose of its HRBC formula is as a tool for assessing insurer solvency, and that the HRBC formula was not intended to be used as a metric for determining an insurer's target or maximum capital level, or as a basis of public policy funding.

4. THE NEED FOR CAPITAL MUST CONSIDER GHMSI'S UNIQUE CIRCUMSTANCES AND BUSINESS REQUIREMENTS

A Blue Plan's capital needs are determined by evaluating a variety of factors, some of which are included in the HRBC formula, but others of which are not included, such as the competitive environment, expected growth of benefit costs and future business plans and strategies. For example, GHMSI operates in an extremely limited geographic area and includes a book of business that comprises a higher concentration of risk business (70%) than the Blue System (51%). This limits the ability of GHMSI to spread its risk over a broader base, making it relatively more vulnerable to local risks, such as epidemics, severe weather calamities and terrorist acts, none of which should be considered sufficiently unlikely to occur, particularly given the geographic location of the District.

Also, consideration is given to the impacts of the Affordable Care Act (ACA), local reform requirements and the significant costs incurred by insurers to implement the legislation. For example, the DC Exchange Board recommendation limiting the purchase of individual and small group products only to the exchange creates uncertainty in the regulatory and operational environment and could limit diversification of products and distribution channels. Certain changes in the law have the potential to limit an insurer's ability to build or replace capital, such as the MLR regulations and the limited ability to rate for risk characteristics. Additional enrollment expected as a result of covering people who were previously uninsured could also cause a strain on HRBC levels. GHMSI needs strong capital to operate under the many challenges posed by the ACA.

Additionally, not-for-profit health plans such as GHMSI have only one source of obtaining capital, and that is by generating net gains. Because their access to capital is limited and margins are small (in 2013 GHMSI's net gain as a percent of net revenue was 0.3%), they need to maintain strong reserves to meet their obligations to members, providers and the community.

These risks are not accounted for in the HRBC formula, but are taken into account by independent rating agencies when assessing financial strength and assigning ratings. Capitalization (i.e., the capital position, balance sheet strength, statutory surplus growth, etc.) is a key metric the rating agencies consider when evaluating a not-for-profit Blue Plan. Strong capitalization enhances their strategic flexibility since sources of funds are primarily internally generated whereas for-profits have the added option of accessing public equity markets to build capital.

BCBSA believes that it is appropriate and prudent for GHMSI to hold a level of capital that provides the greatest possible assurance policyholders' benefit claims will be paid. To this end, BCBSA requires its licensees to maintain capital levels significantly above the action-level minimum required by states' insurance regulations. Failure to meet this requirement could result in the loss of GHMSI's right to use the Blue Brands. Among the implications of such an event would be the loss of beneficial BCBSA programs to GHMSI and its policyholders, including access to almost one million participating providers in worldwide Blue networks, valuable "hold harmless" protection, medical services without up-front payments, away-from-home care, and access to the Blue System's transplant and Blue Distinction networks.

5. "ATTRIBUTING" RESERVES TO ANY SINGLE JURISDICTION IS NOT POSSIBLE

In monitoring the financial strength of Blue Plans, BCBSA considers each Plan in its entirety. Attempting to evaluate appropriate levels of reserves "attributable" to any single political jurisdiction within a Plan therefore is logically and practically impossible. The HRBC ratio evaluative tool is based upon the overall risks faced by the organization as a whole, never on a jurisdictional basis. We are not aware of an instance, other than in the District, when such an evaluation has even been attempted. Like any multi-jurisdictional insurer, GHMSI maintains reserves for the protection of its members in all of the jurisdictions it serves. Those reserves exist to protect and cover members in all jurisdictions as needs arise and cannot be divided among those jurisdictions. The existence of reserves supporting all jurisdictions is

beneficial to each jurisdiction since the full amount of the reserve is available to be used in the event of a crisis situation.

Because it is not possible to attribute GHMSI's reserves to a single jurisdiction, we are sending copies of this letter to the Maryland and Virginia regulators to assure that they are aware of our concerns.

6. ***CONCLUSION***

BCBSA firmly believes that it is important to recognize that HRBC has its limitations as an analytical tool. HRBC was designed solely for the purpose of assessing whether an insurer is inadequately capitalized. It is not a metric intended to determine excessive surplus, and there are many metrics and qualitative factors besides HRBC that are relevant to management and regulators in making assessments relating to capital levels.

I appreciate this opportunity to provide BCBSA's perspective on this matter.

Yours in good health,

Scott P. Serota

cc: Hon. Jacqueline K. Cunningham
Commissioner
Virginia State Corporation Commission

Hon. Therese M. Goldsmith
Commissioner
Maryland Insurance Administration