D.C. Appleseed Report to the

D.C. Department of Insurance, Securities and Banking:

Surplus Review of Group Hospitalization and Medical Services, Inc. ("GHMSI")

June 10, 2014

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EXECUTIVE SUMMARY

To hold Group Hospitalization and Medical Services, Inc. ("GHMSI") accountable to its mission to serve community healthcare needs, the D.C. Council passed the Medical Insurance Empowerment Amendment Act ("MIEAA") in 2008 after years of disappointment over GHMSI's failure to meet its charitable mission. MIEAA's centerpiece is the requirement that GHMSI commit the maximum feasible amount of its surplus to community health reinvestment, consistent with efficiency and provided that the additional community reinvestment would not undermine the company's financial soundness.

The District of Columbia Department of Insurance, Securities and Banking ("DISB") is the agency charged with enforcing MIEAA. To do that, it must conduct a rigorous evaluation of GHMSI's surplus according to the MIEAA standards. That is the purpose of this proceeding.

In the 2009 surplus review proceeding, the DISB Commissioner relied primarily on an actuarial model developed by GHMSI's consultant Milliman to support her analysis. However, as the D.C. Court of Appeals held in reversing the Commissioner's approval of the company's then $687 million surplus, the Milliman model did not take into account MIEAA's several requirements and the Commissioner did not adjust the model to account for those requirements. *D.C. Appleseed Ctr. for Law & Justice, Inc. v. D.C. Dep't of Ins., Secs., & Banking*, 54 A.3d 1188, 1215–19 (D.C. 2012).

The Court said the Commissioner had failed to implement two key legal requirements of MIEAA. First, "surplus and community reinvestment are to be calculated and balanced," and this should be done by "calibrating the level of confidence" used in the model to "take into account the obligation to engage in community reinvestment." *Id.* at 1215, 1218–19. Second, GHMSI's permissible surplus must be measured against MIEAA's "efficiency" requirement. That is, the assets of the company must be put to their most productive use. The D.C. Council specified that, once the surplus is consistent with GHMSI'S financial soundness and efficiency, the most productive use of excess surplus is community health reinvestment. *Id.* at 1219 & n.43.

Since the 2009 proceeding, GHMSI's surplus has risen by nearly another $300 million. As of December 31, 2011, the date of the surplus level under review in this proceeding, GHMSI's surplus was $964 million (which is equivalent to a 998% Risk-Based Capital ("RBC")) ratio. As discussed in more detail below, that amount is in addition to the over $250 million that GHMSI maintains in accounts to cover medical claims reported but not paid and claims incurred but not yet reported.

In assessing GHMSI's surplus as of December 2011, the Commissioner's expert, Rector & Associates ("Rector"), again relies on the Milliman model and again fails to make appropriate adjustments to comply with MIEAA. *See* Rector & Assocs., Inc., *Report to the D.C. Department of Insurance, Securities and Banking: Group Hospitalization and Medical Services, Inc.* (Dec. 9,

2013), *available at* http://disb.dc.gov/node/756762 [hereinafter Rector Report]. By following the same approach as was followed in the last proceeding, Rector determines that GHMSI cannot afford to spend a single dollar on community reinvestment and in fact should be allowed to increase its surplus even further—to $1.04 billion—and still be in compliance with MIEAA.

The Commissioner should not accept this analysis. Instead, he should adjust the analysis to comport with both the "maximum feasible" and "efficiency" requirements.

Maximum Feasible. Rector uses the same very high confidence level that Milliman proposed in the last proceeding (98%), and does not balance or calibrate that level in light of the need to maximize community reinvestment. Additionally, Rector overstates the consequences of GHMSI's surplus falling to 200% RBC, thus making its choice of confidence level even more suspect.

To correctly apply the "maximum feasible" standard, the Commissioner should "calibrate" the confidence level as required by the Court, rather than accepting the same 98% level used by Milliman in the last proceeding. That calibration will show that a reduction of only eight percentage points—to 90% confidence—will still leave the company comfortably financially sound with a high degree of confidence. Even if no other changes were made to Rector's analysis, a 90% confidence level makes at least $283 million available for community reinvestment.

Efficiency. Rector also does not apply MIEAA's "efficiency" requirement as the Court required. *See D.C. Appleseed*, 54 A.3d at 1219 (criticizing the Commissioner's "overriding concern . . . with financial 'soundness,' without any discussion of the statute's equal focus on 'efficiency.'") Instead, Rector relies on artificially inflated risks to calculate GHMSI's permissible surplus and thereby allows the company to hold an inefficiently high level of surplus that is far greater than necessary. Specifically, Rector uses the same kind of assumptions as it used in the last proceeding—assuming the occurrence of multiple, extreme adverse events that are entirely inconsistent with GHMSI's historical performance and so wildly remote as to defy any definition of "efficiency." As a result, Rector estimates that, because the company might lose 23% of non-FEP premium revenue[1] per year from 2012 to 2014, it should be allowed to hold approximately $1 billion in surplus. Because the company closed 2012 and 2013 with a surplus of over $934 million, Rector's estimate would be valid only if it is assumed that GHMSI will lose more than $700 million of surplus during the remainder of 2014, or within approximately six months from the current surplus review hearing. Finally, Rector fails

[1] "Non-FEP" premium is all premium that is not attributable to GHMSI's participation in the Federal Employees Health Benefits Program.

altogether to consider whether its estimated surplus target is too high in light of GHMSI's administrative inefficiency.

To apply MIEAA's "efficiency" requirement, the Commissioner should bring Rector's key assumptions into some objective relationship with GHMSI's actual performance and adjust its permissible surplus to account for GHMSI's administrative inefficiency. The attached analysis from Mark Shaw shows how the Commissioner could do this.

Mr. Shaw shows the effects, separately and cumulatively, of introducing realistic probability distributions for the key assumptions used by Rector in the model, with confidence levels of 90% and 95%. These adjustments bring the model into compliance with MIEAA and demonstrate that, far from requiring a surplus of 958% RBC, GHMSI's maximum permissible surplus should be no more than some specific point between 400 and 500% RBC, depending on the assumptions and confidence level the Commissioner selects.

Finally, because the Court of Appeals has held that the previous Commissioner did not provide the detailed explanation for her decision that is required by MIEAA, particularly given the technical subject matter and millions of dollars that turn on even a small variance in the model, the Commissioner should provide a thorough and detailed explanation for his decision.

We recognize that the reduction in surplus required by MIEAA is large—but, as this surplus proceeding will be the first valid application of MIEAA, that is to be expected. The MIEAA statute is now nearly six years old and was passed because the Council thought GHMSI's surplus was *already too high*; yet the surplus has grown still *several hundred million dollars more* during the last six years. Furthermore, the standards of MIEAA are much more demanding than those that Milliman and Rector have previously applied.

As the Commissioner brings GHMSI in line with MIEAA's standards it is inevitable that the change in permissible surplus will be substantial. But it is a change that MIEAA and the Court's decision require—one that will protect GHMSI's financial soundness and ensure that its surplus is efficient so as to maximize community reinvestment. It is therefore the change the Commissioner should order.

BACKGROUND

The concern giving rise to this proceeding. This surplus proceeding arises out of a longstanding effort by the District of Columbia to ensure that GHMSI meets its charitable obligations to the citizens of the National Capital Area. The current proceeding follows the unanimous 2012 decision by the D.C. Court of Appeals concerning the proper application of MIEAA.

GHMSI, a non-profit organization, was established in 1939 as a "charitable and benevolent institution," whose activities "shall not be conducted for profit, but shall be conducted for the benefit of [its] certificate holders." Pub. L. No. 76-395, 53 Stat. 1412 (1939). Over time, GHMSI has become the largest health insurance company in the region. It serves over one million subscribers and takes in billions of dollars in premiums each year.

As GHMSI's size and surplus grew, DISB, the D.C. Attorney General, and the D.C. Council each expressed concern that GHMSI was failing to engage in charitable activity befitting its role as a non-profit, benevolent institution. *D.C. Appleseed*, 54 A.3d at 1193–94. Because GHMSI failed to increase its community health reinvestment voluntarily, the D.C. Council enacted MIEAA to provide a "framework to ensure that [GHMSI] meets its public health obligation to the community." D.C. Council, Report on Bill 17-934, the "Medical Insurance Empowerment Amendment Act of 2008," at 9 (Oct. 17, 2008) [hereinafter Committee Report]. MIEAA requires GHMSI to "engage in community health reinvestment to the maximum feasible extent consistent with financial soundness and efficiency." D.C. Code § 31-3505.01. The statute requires the DISB Commissioner to enforce that obligation. *See id.* § 31-3506(e), (g)(1) (mandating triennial review but authorizing annual review and requiring the Commissioner, upon a finding that the surplus is excessive, to order GHMSI to submit a plan for dedicating excess surplus to community health reinvestment).

The obligation that GHMSI reinvest in community health is the centerpiece of the MIEAA framework and was the "primary motivation" behind the statute. *D.C. Appleseed*, 54 A.3d at 1214. The Council enacted that requirement because, during the five years before passage of MIEAA, GHMSI's surplus grew from $392 million to $754 million, its Risk Based Capital-Authorized Control Level ("RBC") ratio[2] grew from 787% to 916% (a level that was "high" "[b]y any measure"), and "[de]spite the sustained health of its finances, GHMSI's

[2] For simplicity, we will use "RBC" rather than "RBC-ACL." The two numbers are identical. *See* D.C. Code § 31-2001(13)(C) ("Authorized Control Level RBC means the number determined under the risk-based capital formula in accordance with the RBC instructions [adopted by the NAIC.]").

contributions to community health [did] not [keep] pace" with the fast-increasing surplus. Committee Report 6.

MIEAA reflects the Council's judgment that, after a certain point, GHMSI's surplus dollars are more valuable when directed to "community health reinvestment" rather than to achieving marginal reductions in GHMSI's residual financial risk. MIEAA thus placed an upper bound on "financial soundness" as a rationale for ever-greater accumulations of surplus. As the Council stated: "It is in the public interest for GHMSI to continue in its role as a robust non-profit health insurer, and nothing in this bill compromises that objective. It is *excess* funds that will go to community health reinvestments." Committee Report 13 (emphasis in original). To make clear the legal criteria for assessing which funds would be deemed "excess," the Council required in MIEAA both that the "maximum feasible" amount of surplus be committed to community reinvestment, and that permissible surplus be judged against the company's financial soundness and "efficiency."

Before turning to the application of MIEAA to GHMSI's surplus, it is important to understand precisely what that "surplus" is.

The meaning of "Surplus." "Surplus" represents the assets of the company above and beyond its reserves to pay claims.[3] It is *not* the amount set aside to pay accrued or future claims; those sums are the company's "reserves." GHMSI, like any health insurer in the District, maintains liquid assets that are not considered "surplus" in two accounts to cover its medical claims. The "Reported in Process of Adjustment" account covers claims reported but not paid; the "Incurred but Unreported" account covers claims incurred but not yet reported. In colloquial terms, these are monies set aside to pay "pending" and "future" claims. GHMSI's total in these two accounts as of December 31, 2013 for non-FEP insurance was $252.7 million ($35.2 million for claims reported but not paid, and $217.5 million for claims incurred but not yet reported.)

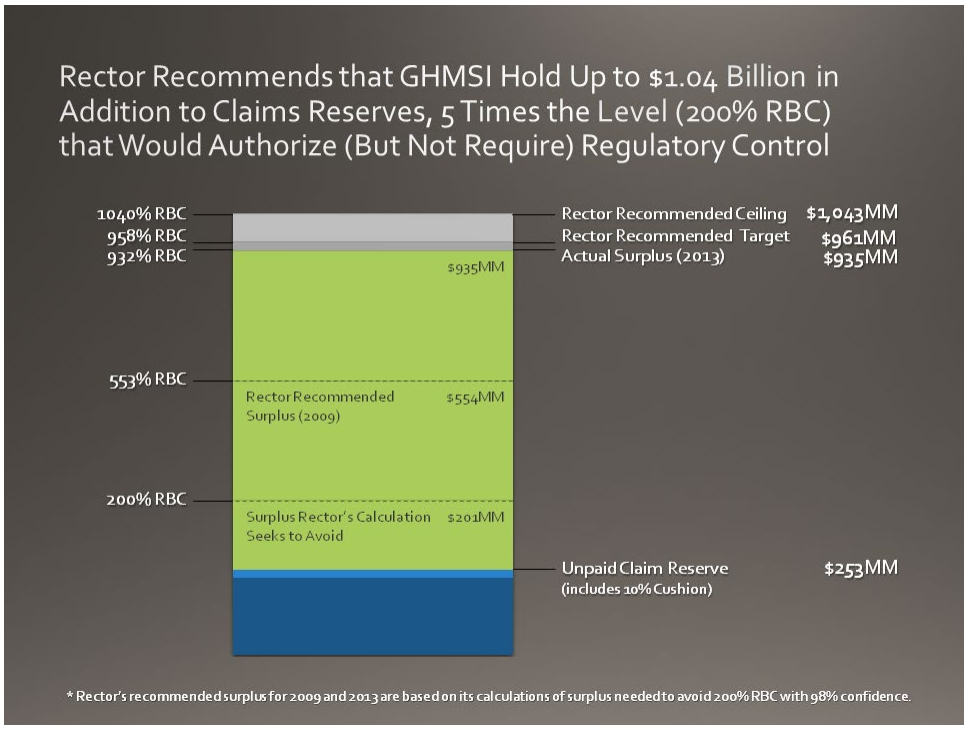
Additionally, each of these reserve accounts already includes an additional allowance for uncertainty, i.e., an embedded surplus. As Rector explained, "GHMSI targets 'redundant reserves of approximately 10%.'" Rector & Assocs., Inc., *Rebuttal to September 3, 2010 Supplemental Report on Effects of Federal Health Care Reform as Submitted by Group Hospitalization and Medical Services, Inc.* 8 (Sept. 20, 2010), *available at*

[3] D.C. law distinguishes "reserves" and "surplus." The distinction is important because "reserves" cover "incurred but unpaid claims (both reported and unreported)." D.C. Code § 31-3509(a). "Reserves" are treated as liabilities of the company. *Id.* § 31-3509(b). "Surplus" is the amount by which "admitted assets of the corporation exceed its liabilities, inclusive of the reserves required pursuant to § 31-3509." *Id.* § 31-3501(11). Thus, the ability of GHMSI to pay accrued medical liabilities is determined primarily by its reserves and not its surplus. Surplus is to cover only uncertainties around these and other costs or revenues.

http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/RA_9-20-10_Rebuttal_1.pdf [hereinafter Rector 2010 Rebuttal]. This means that "GHMSI actually holds in loss reserves" 110% of the amount "its actuaries believe is necessary to pay claims" and therefore has "more in 'real surplus' than it reports." *Id.* at 8.

Thus, surplus is not the company's first-line liquid asset from which to pay medical bills. Rather, it provides an extra cushion above and beyond the amount the company has set aside to pay present and future claims, as illustrated by Figure 1:

FIGURE 1



Applying the MIEAA Standards to Measure Excess Surplus. The purpose of this proceeding is to identify "excess" surplus—the amount that exceeds the "efficient" level, is not necessary for "financial soundness," and is the "maximum feasible" amount that could be dedicated to community health reinvestment. To measure this amount, MIEAA effectively established a four-pronged *legal* standard for the Commissioner to apply: (1) "Maximum feasible"; (2) "consistent with"; (3) "financial soundness"; and (4) "efficiency." When the previous Commissioner reviewed GHMSI's nearly $700 million surplus in 2009, she determined that it was not excessive. However, in reaching that determination she did not apply, or even reference, either the "maximum feasible" standard or the "efficiency" standard. As a result, she incorrectly assumed that the "financial soundness" of the company was the only criterion by which to measure appropriate surplus. She applied the law incorrectly. Under MIEAA, surplus must also be tested against the "maximum feasible" and "efficiency" standards.

The D.C. Court of Appeals Decision. Because the previous Commissioner failed to apply the governing MIEAA standards correctly, the D.C. Court of Appeals unanimously reversed her determination. The Court first faulted the Commissioner for failing to implement the requirement that GHMSI engage in community health reinvestment to the "maximum feasible extent consistent with financial soundness and efficiency." *D.C. Appleseed*, 54 A.3d at 1220. The Court explained that the maximum feasible standard is "a crucial factor in judging whether a surplus is 'unreasonably large' for purposes of MIEAA." *Id.* at 1214 (noting that the "community health reinvestment obligation" "was the *primary motivation* behind the MIEAA" (emphasis added)). The Court also found that the actuarial model used by Milliman and subsequently relied on by the previous Commissioner, had not correctly applied those elements. This was not surprising given that Milliman acknowledged that the model was not designed to comply with MIEAA and in fact took no account of it. Brief of Pet'rs at 23–24 n.17, D.C. Appleseed v. Dep't of Ins., Secs. and Banking, No. 11-15847 (D.C. 2011).

Thus, the Court not only said that the Milliman model used in the previous proceeding does not satisfy MIEAA because it "[does] not take into account the obligation to reinvest in the community to the maximum extent feasible," *id.* at 1219 n.42, the Court also indicated *how* the "maximum feasible standard" should be taken into account. Specifically, it noted that "surplus and community reinvestment are to be calculated and balanced." *Id.* at 1215. The Court also specified that the method of conducting that balancing was to "calibrat[e] the level of confidence" used in the model to take account of "the obligation to engage in community reinvestment." *Id.* at 1218–19.

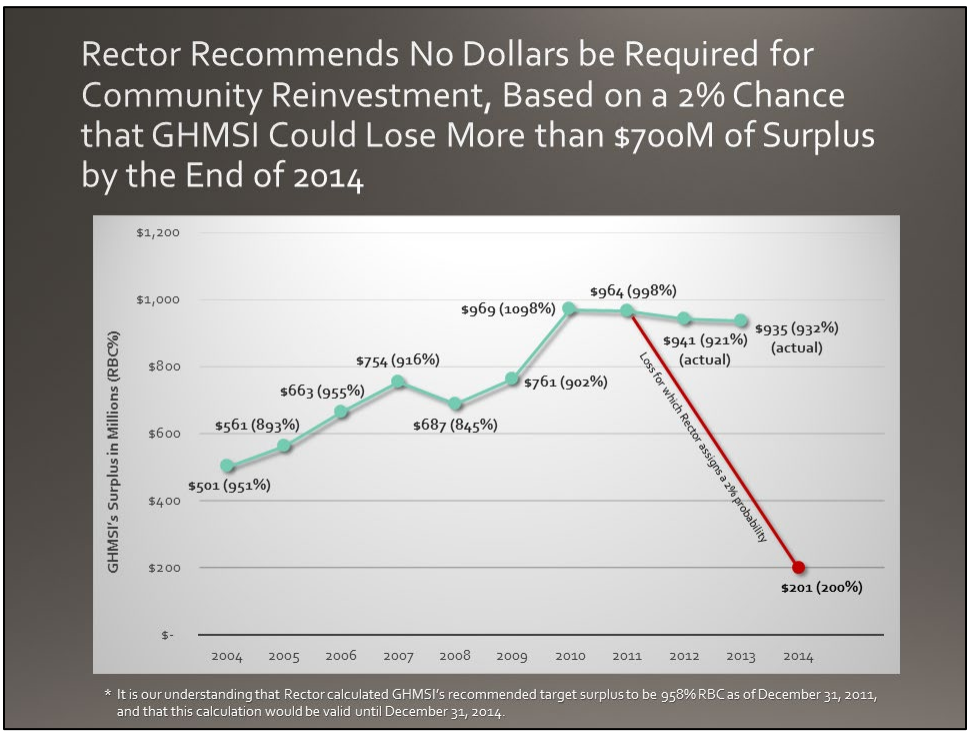
The Court also stated that the model (and the previous Commissioner) failed to account for MIEAA's "efficiency" standard, which, the Court made clear, must receive "equal focus" along with "soundness" in the "Commissioner's determination of what constitutes an 'unreasonably large' or 'excessive' surplus." *Id.* at 1219 & n.43.

Finally, the Court set a high bar for the Commissioner's use of the Milliman model in these proceedings, stating that this use must be "fully and clearly explained." *Id.* at 1216. "The more technical and complex the subject matter, the more explanation the agency ought to provide for its decision." *Id.* at 1217. And that explanation must show "that the [agency] in fact applied the law taking into account the entirety of the record." *Id.* (internal quotation marks and citation omitted).

The Court faulted the previous Commissioner for failing to provide the required explanation. In particular, the Court was critical of the lack of explanation for "why the Commissioner thought it was necessary to have such high confidence levels," and for approving GHMSI's surplus through a "truncated and conclusory explanation, especially where, as here, the technical nature of the actuarial reports requires a far more detailed discussion of a decision in which even a small variance can implicate millions of dollars." *Id.* at 1218, 1219.

The Rector Report. Because the Milliman model was not designed to implement MIEAA's legal requirements, we urged at the outset of this proceeding that Rector develop a different model to comply with MIEAA. Rector did not do so but instead continued to use Milliman's model essentially as it was used in the prior proceeding (albeit with some adjustments). Rector Report 4. As a result, Rector concludes that GHMSI, as of December 31, 2013, GHMSI needs surplus of over $960 million (or nearly 1000% RBC) to be 98% certain that its surplus would not fall to 200% RBC by the end of 2014. To accept this analysis, the Commissioner would have to conclude in this hearing that GHMSI risks losing at least $700 million of its surplus by the end of 2014, and, therefore, that *none* of GHMSI's surplus can be made available for community reinvestment (Figure 2).

FIGURE 2



Rector arrives at this highly implausible conclusion because, in relying on the Milliman model, it did not make adjustments that could have brought the model into compliance with MIEAA—for example, by calibrating the confidence level and by adjusting the model's assumptions in accordance with the "maximum feasible" and "efficiency" requirements. Rector also fails to meet the Court's requirements to fully explain the technical aspects of the model and how the model was used to estimate permissible surplus.

As a result, the Rector Report fails to comply with all three of the key requirements imposed by the Court (applying maximum feasible, applying efficiency, and fully explaining the Commissioner's decision):

(1) Rector uses the same high confidence level that Milliman proposed in the last proceeding (98% confidence of avoiding 200% RBC), but offers the Commissioner no balancing or calibration of this high level to take account of the community reinvestment requirement;

(2) Rector continues to ignore the efficiency requirement by relying on the Milliman model's prediction of multiple extreme, adverse events, failing to justify the substantial departures from the company's actual historical experience, ignoring GHMSI's administrative inefficiency, and thus allowing GHMSI to accumulate highly inefficient surplus levels; and

(3) Notwithstanding the burden imposed by the Court regarding this very technical subject, with millions of dollars turning on small variances, Rector does not fully explain the assumptions it used in the model, or the outputs from the model. Neither does Rector explain why its use of the model in this proceeding calls for a more than $400 million increase in surplus over the amount Rector called for in the last proceeding, which is the difference between Rector's current surplus requirement of 958% RBC and its prior surplus requirement of 552% RBC (assuming the same 98% confidence level had been used in the prior report). Without such an explanation, it is difficult to see how the Commissioner can justify a decision based on the Rector Report as submitted.

Taken together, Rector's departures from the Court's three central requirements render the Rector Report a legally insufficient predicate for the Commissioner's decision in this proceeding.

The Rector Report not only fails to meet the Court's legal requirements, but it recommends results that are wholly implausible and inconsistent with the results Rector reached in the last surplus proceeding using the same Milliman model. At that time, Rector determined that GHMSI needed an RBC of 600% to avoid falling below 200% RBC with 99% confidence. Had Rector used a 98% confidence level in the last proceeding, it would have determined that an RBC of 552% was needed to avoid falling below 200% RBC. Now, despite reducing the confidence level to 98%, Rector has increased its estimate of the required RBC to 958%. In Rector's view, GHMSI's need for surplus has increased by more than 70%—by 406 percentage points or more than $400 million—based on the *same model* Rector used only three years ago. According to Rector's analysis, despite GHMSI's nearly $1 billion surplus at the end of 2011, and despite the fact that MIEAA's central purpose is to maximize community reinvestment, the maximum feasible reinvestment Rector says the company can be required to spend is *zero*. This result raises serious doubts about Rector's use of the model and the conclusions drawn from it. It also increases the need to justify the result the model has produced, and to show that the model's use fully complies with MIEAA.

Bringing the Rector/Milliman Model into Compliance with MIEAA. Rector's continued use of the Milliman model, without the adjustments and explanations required by the

Court's decision, led it to submit a Report that the Commissioner cannot rely on to determine whether GHMSI has met it obligations under MIEAA. Although we continue to believe it would have been better not to use the Milliman model in this proceeding, in the following three Parts we show how the Commissioner could correct Rector's use of that model to bring it closer to compliance with MIEAA.

- In Part I, we show why and how the 98% confidence level used by Rector should be calibrated to meet MIEAA's "maximum feasible" requirement;

- In Part II, we demonstrate that the key assumptions Rector has used in the model should be corrected to meet MIEAA's "efficiency" requirement, and that, in light of the efficiency requirement, Rector has not sufficiently explained or justified recommending 958% RBC, or $406 million more than it recommended three years ago; and

- In Part III, we present to the Commissioner the various adjustments that need to be made to the analysis underlying the Rector Report to bring it into compliance with MIEAA's "maximum feasible" and "efficiency" requirements. Depending on which of these adjustments the Commissioner chooses to make, even a very conservative application of those adjustments would not permit surplus higher than a specific point between $400 to $500 million.

I. MAXIMUM FEASIBLE: Rector Failed to Determine the Confidence Level in Accordance with the Maximum Feasible Standard

The extremely high confidence levels used by Rector do not comply with the requirements of MIEAA because they do not comply with the Court's clear instructions to "calibrate" those levels in terms of MIEAA's requirement to dedicate maximum feasible resources to community health reinvestment. As we will explain, the confidence level needed to take into account these instructions is 90% confidence of avoiding 200% RBC.

A. The Court of Appeals Directed the Commissioner to Adjust the Confidence Level to Comply With MIEAA.

In reversing the Commissioner's determinations, the Court of Appeals held that the Commissioner failed to apply MIEAA's governing standards—including, in particular, the requirement to justify the very high confidence levels adopted.

During oral argument, the Court recognized the stakes involved in the choice of the confidence level. As Judge Ruiz stated, "millions of dollars hang in the balance, and you're right, you can get a little extra security [with a higher confidence level], but there's always an opportunity cost." Compact disc: Oral Argument in *D.C. Appleseed Center for Law and Justice v. D.C. Department of Insurance, Securities, and Banking*, No. MIE-007-09, before the D.C. Court of Appeals at 12:23:09 PM (June 9, 2011) (on file with D.C. Court of Appeals).

Under MIEAA, the opportunity cost of an inflated confidence level is foregone community reinvestment. As Judge Ruiz said, even "one or two percentage points could make a big difference in terms of millions of dollars going to address that immediate need." *Id.* at 12:23:36. Judge Fisher raised a similar point, noting: "I don't think I've ever faced any contingency in life with a 95% certitude. Why is [GHMSI] allowed that luxury?" *Id.* at 12:21:36.

In its opinion, the Court emphasized that the Commissioner must (1) justify the confidence level for avoiding a target RBC ratio in light of the "consequences" of falling below it; and then (2) "calibrat[e]" that confidence level by "tak[ing] into account the obligation to engage in community reinvestment . . . ." *D.C. Appleseed*, 54 A.3d at 1218–19. This requirement to calibrate the confidence level to the consequences flowed from the D.C. Council's "twin objectives" in adopting MIEAA: "[1] obligating GHMSI to reinvest in community health 'to the maximum feasible extent,' [2] without undermining GHMSI's

'financial soundness and efficiency.'"[4] The Court held that the previous Commissioner failed to explain why "it was necessary to have such high confidence levels" in light of the community reinvestment requirement. *Id*. at 1218. The Court also found that the surplus levels proposed by Milliman and Rector, which flowed from those high confidence levels, failed to "take into account the obligation to reinvest in the community to the maximum extent feasible." *Id.* at 1215 n.42. The Court "remand[ed] the case to [DISB] for an express interpretation of the MIEAA *that captures all the relevant provisions, in light of the statute's legislative purpose*." *Id.* at 1214 (emphasis added). In so doing, the Court made clear that the Department must specify "how surplus and community reinvestment are to be calculated and balanced." *Id.*

B. Rector's Justifications for its Choice of Confidence Level Are Inadequate Under the "Maximum Feasible" Standard

Rector essentially used the Milliman model in the same way it was used in the last proceeding—including Milliman's use of a 98% confidence level to avoid falling below 200% RBC. As a result, Rector's analysis does not correct the errors identified by the Court of Appeals. This was even though Rector "generally agree[d]" with DC Appleseed's argument that "assumptions used in the Milliman actuarial model that will only bring about marginal reductions in GHMSI's risk are not consistent with MIEAA's mandate that GHMSI engage in community health reinvestment to the maximum extent consistent with financial soundness and efficiency." Rector Report 31.

Yet Rector did not implement this principle. Instead, Rector adopted the 98% confidence level that the Milliman model uses to ensure "virtual certainty" against the most remote contingencies imaginable. Milliman, *CareFirst, Inc., Group Hospitalization and Medical Services, Inc.: Development of Optimal Surplus Target Range* 13 (May 31, 2011), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/ATTACHMENT_C__-__Milliman_GHMSI_Surplus_Report.pdf. Only after that "virtual certainty" level is reached do Milliman and Rector then consider whether any surplus might be left over for community reinvestment. If nothing is left over, they deem MIEAA's "maximum feasible" requirement to have been met.

Thus, Rector and Milliman focus solely on confidence levels designed to avoid specified RBC levels *at any cost*, but they do not focus at all on confidence levels designed to achieve MIEAA's public policy objectives. This approach does not comply with either MIEAA or the

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[4] *D.C. Appleseed*, 54 A.3d at 1214. "[A] proper surplus determination under the MIEAA requires simultaneous consideration of [1] the requirement to engage in community investment to the 'maximum feasible extent' [2] consistent with 'financial soundness and efficiency.'" *Id.* at 1218.

Court of Appeals' decision. Rather, if the Milliman model is to be used to assess GHMSI's surplus, the mechanism for meeting the "maximum feasible" requirement is the choice of a confidence level that fairly reflects both: (1) a careful assessment of the "consequences" to GHMSI's financial soundness associated with the event the confidence level is intended to guard against (in this case, falling to 200% RBC), *and* (2) in light of those consequences, a "calibrating" of the confidence level that expressly takes into account the statute's command to maximize community reinvestment.

Rector has significantly overstated the "consequences" to GHMSI of falling to 200% RBC; and it has not "calibrated" the confidence level, as the Court required, to maximize community reinvestment. As a result, it would be an error of law for the Commissioner to rely on Rector's proffered confidence level, and the Commissioner should reject it.

1. Rector Has Overstated the Consequences of GHMSI's Surplus Falling to 200% RBC

In justifying its decision to use a confidence level that achieves "virtual certainty" of not falling below 200% RBC, Rector overstates the consequences if GHMSI's surplus were to fall below the that level. *See* Rector Report 15. Rector says that, at 200% RBC, two events would be triggered: (1) RBC "Company Action Level" Oversight by DISB; and (2) Loss of the BlueCross BlueShield Trademark. *Id.* Rector does not fairly assess either of these two events.

To understand the significance of the 200% RBC threshold, it is helpful to understand the high level of conservatism built into the baseline RBC requirements and the additional cushion embedded in GHMSI's claims reserves.

The RBC formula is the insurance industry's foundational risk-management formula. As Rector states, "the individual risk factors that comprise the formula were developed with the intent to achieve a high level of confidence that an insurer would not become insolvent." Rector Report 13. The formula was "constructed with a high degree of [embedded] conservatism." *Id.* at 13. RBC itself provides protection, and having surplus at 200% RBC doubles that protection. *See* Figure 1. At 200% RBC, GHMSI would not be anywhere near a risk of insolvency. Rather, at that level, GHMSI would have approximately $200 million in surplus *in addition to* its reserve accounts for reported and unreported claims. GHMSI would be fully able to pay all medical costs incurred by its subscribers and also have multiple, significant financial cushions to protect against unforeseen events.

Moreover, as Rector itself noted, there is a built-in cushion within GHMSI's existing claims reserves, which in effect creates a surplus within those reserves. According to its 2013 statements, GHMSI had $253 million in the "Reported in Process of Adjustment" and "Incurred but Unreported" accounts. GHMSI maintains reserves that are 10% higher than its expected needs, ensuring that approximately $23 million is available in addition to the amount needed to

pay incurred claims (calculated as $253 million – ($253 million/110%) = $23 million). Thus, even if the company were ever to reach 200% RBC, it would have not only approximately $200 million in surplus remaining, but another $230 million in reserves to pay all incurred claims plus another $23 million cushion.[5] Only when GHMSI had exhausted its claims reserves and this cushion would it have to reach into the approximately $200 million surplus available at 200% RBC.[6]

With this background, we now explain how Rector has overstated the consequences of GHMSI falling to 200% RBC.

a) Rector Is Incorrect in Characterizing "Company Action Level Oversight" as "Deeply Damaging"

Rector's characterizations of what happens at the Company Action Level are both wrong and substantially overdrawn. If a company's surplus falls to 200% RBC, the Company Action Level, DISB *begins* a remedial process. Rather than being "deeply damaging," "severe," or "catastrophic," this process is designed to *prevent* "severe" or "catastrophic" consequences. During this remedial process, the insurer must prepare a comprehensive "RBC plan" that identifies the conditions leading to the decline to 200%; proposes corrective action; provides the key assumptions of the plan forecasts; and assesses the quality of the insurer's business. The Commissioner may then either accept the report or revise the plan.[7]

Falling to 200% RBC would not "trigger" consequences so "severe" and "catastrophic" as to justify a confidence level providing "virtual certainty" that the 200% level would never be reached. In fact, Company Action Level Oversight is designed to *strengthen* company finances and *restore* higher surplus levels.[8] Moreover, because Rector has not demonstrated that such

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[5] In addition, GHMSI's 2013 statement shows that it has $680 million in Rate Stabilization Reserves for its FEP business, and available for any valid FEP-associated claim or expense. Annual Statement for the year 2013 of the Group Hospitalization and Medical Services, Inc. 26.3.

[6] Rector reports that GHMSI may not draw down its reserves for the purpose of replenishing its surplus. That constraint does not affect the point here, which is that, for the purpose of paying medical claims, GHMSI has substantial dedicated liquid assets in addition to RBC (indeed, in addition to 200% RBC).

[7] If the insurer and the Commissioner were ever at an impasse, the Commissioner could, after a hearing, declare a Regulatory Action Event. Rector appropriately does not include in its attempted rationalization of the 98% confidence level any reference to this kind of impasse. We have not identified any occasion where the Commissioner has issued such a declaration with respect to a major health insurer in D.C.

[8] No further regulatory action would be authorized unless the RBC fell below 150% RBC, the Regulatory Action Level. *See* D.C. Code §§ 31-2001(13)(B); *id.* § 31-2004. At 100%, the Authorized Control Level, the
(continued…)

oversight would be severe and catastrophic, it has not done what the Court required—that is, "expla[ined] why . . . it was necessary to have such high confidence levels . . . in light of their . . . consequences." *D.C. Appleseed*, 54 A.3d at 1218. We agree that falling to 200% is something to be avoided. But it does not follow that a confidence level so high that it reduces community reinvestment to zero is justified.

b) GHMSI Would Be Unlikely to Lose Its BCBS Trademark, Even at 200% RBC

Rector's second claim of "deeply damaging" consequences is that a surplus level of 200% could "trigger" GHMSI's loss of the Blue Cross Blue Shield Association ("Blues" or "BCBSA") trademark. Rector Report 15. Rector completely fails to take the next essential step in the required calibration, which is a realistic assessment of the likelihood that BCBSA would withdraw the Blues mark were GHMSI's surplus to fall to 200% RBC.

BCBSA maintains various capital requirements because it and its members consider a failure by any licensee to reduce the credibility of the Blues brand for all licensees. However, termination of the Blues mark requires a supermajority vote of three-fourths of other Blues licensees both with respect to the number of Plans (the "straight" vote) and on a weighted basis (the "weighted vote").[9] Such a vote would bring about the result that the BCBSA and its licensees seek to avoid, i.e., reducing the credibility of the Blues brand. The vote would be self-defeating unless the licensee in question, in addition to having fallen to 200%, *had no reasonable prospect of regaining its footing*.

Rector never considers this critical point. Nor does Rector offer a reason that GHMSI, the dominant insurer in its market, and protected from competition within its service territory from any other Blues licensee, would not be in a position to regain its footing were its surplus ever to fall to 200% RBC. Indeed, there is no reason.

Further, although Rector acknowledges that BCBSA monitoring would begin at 375% RBC, Rector does not account for the fact that this monitoring would itself *reduce* the likelihood that RBC would ever fall to 200%. If GHMSI's surplus were at 375% RBC, it would have to fall

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Commissioner would be authorized but not required to place the insurer under regulatory control. *Id.* § 31-2005(b)(2).

[9] U.S. GEN. ACCT. OFFICE, GAO/HEHS-94-71, REPORT TO THE CHAIRMAN, PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, SUBCOMMITTEE ON GOVERNMENTAL AFFAIRS, U.S. SENATE, BLUE CROSS AND BLUE SHIELD; EXPERIENCES OF WEAK PLANS UNDERSCORE THE ROLE OF EFFECTIVE STATE OVERSIGHT (1994), *available at* http://www.gao.gov/assets/220/219555.pdf.

by an additional $175 million to reach 200% RBC. Rector implicitly assumes that BCBSA monitoring would have no effect and that GHMSI's management would do nothing to counter any decline in GHMSI's surplus. This seems completely implausible for the reasons Rector itself noted in 2009, when it addressed the value of "management intervention" in countering any decline in GHMSI's surplus. As Rector said in 2009, "GHMSI has active and experienced management, and . . . we believe that, if GHMSI were in danger of crossing an important RBC threshold . . . management would take steps in an attempt to keep GHMSI above the RBC threshold . . . ." Rector 2010 Rebuttal 8.[10]

In sum, as with a Company Action Level Event, Rector's attempt to justify a 98% confidence level based on the supposed loss of trademark is misleading. In both cases, the Court's requirement that this very high confidence level be justified on the basis of actual "consequences" has not been met.

2. Rector Has Failed to Calibrate the Confidence Level to Identify the Maximum Feasible Amount of Community Reinvestment

In addition to its failure fairly to assess and analyze the consequences of GHMSI falling to 200% RBC, Rector completely fails to "calibrate" its proposed confidence level against the company's "maximum feasible" obligation, as required by the Court.

Although Rector cites the "maximum feasible" requirement in its report, Rector Report 7, 11, and asserts that use of a 98% confidence level will comply with that requirement, *id.* at 12, 14, these conclusory recitations do not satisfy MIEAA. Rector never actually *engages* in the *calibration* of the confidence level necessary to meet the maximum feasible requirement.

Calibration of the confidence level requires an explicit recognition of the importance of community reinvestment *in the selection of the confidence level*. If Rector had done this calibration, it would have acknowledged and accounted for the serious consequences of picking a confidence level so high that it left nothing available for community health reinvestment. As the Council has made clear: "The health needs of the community are acute and extensive," and

[10] Moreover, the avoidance of BCBSA monitoring—that is, avoiding surplus at 375%—should not drive the permitted surplus ratio. The primary determinant should be the RBC ratio necessary to avoid 200% RBC at the chosen confidence level. What is at issue with respect to avoiding 375% RBC is monitoring by a trade association licensor. To deny tens or hundreds of millions of dollars in community health reinvestment to avoid such monitoring would be impermissible under MIEAA. It would be plain error to consider avoiding such monitoring to be a higher priority under MIEAA than community health reinvestment. For convenience, Mr. Shaw has prepared a table comparing the RBC ratios necessary to avoid 200% and 375% at various confidence levels. Shaw Report 56.

"District residents are fighting an uphill battle in elevating the quality and expectancy of their lives." Committee Report 9, 14.

Instead, in selecting a 98% confidence level, Rector focused *only* on the financial soundness element of MIEAA and never took into account the community reinvestment element. Thus, Rector did nothing more than state that "it is extremely important that GHMSI's surplus remain above a 200% RBC level" and that it "agree[d] with Milliman's selection of a 98% confidence level." Rector Report 16. But this ignores that the D.C. Council made clear in MIEAA that maximizing community reinvestment is *also* extremely important. It furthermore ignores the Court's direction that the Commissioner must specify "how surplus and community reinvestment are to be calculated and balanced" and demonstrate that he has "calibrated" the confidence level "accordingly." *D.C. Appleseed*, 54 A.3d at 1215, 1218–19. As a consequence, Rector's selection of a 98% confidence level does not comply with the Court's requirements and is erroneous as a matter of law.

The Commissioner should now do what Rector did not do: select a confidence level that (1) realistically assesses the consequences to GHMSI of falling to the 200% RBC level, and (2) takes into account GHMSI's obligation to maximize community reinvestment in a way that will not "undermine" its financial soundness.

C. A Confidence Level of 90% Meets the "Maximum Feasible" Standard and Is Consistent With Financial Soundness

Hundreds of millions of dollars in community reinvestment turn on the Commissioner's selection of the confidence level. Although the selection of that level can be informed by actuarial expertise, the selection itself is a legal determination to be made pursuant to the directions in the Court's decision.

1. MIEAA Imposes a Strong Statutory Preference for Community Reinvestment that Must Guide Choice of the Confidence Level

The Court of Appeals indicated that MIEAA's legal prongs of "maximum feasible" and "financial soundness" come together in the Commissioner's selection of the confidence level.

As the primary motivation behind MIEAA, the "maximum feasible" requirement must be taken into account in the Commissioner's choice of a confidence level. *D.C. Appleseed*, 54 A.3d at 1214. When a statute directs that something be adopted to the "maximum feasible extent," and does not specify any limiting consideration, the agency must pursue that goal to the maximum extent possible. For example, the Americans with Disabilities Act requires that alterations to places of public accommodation be made "to the maximum extent feasible." *See* 42 U.S.C. § 12183. The U.S. Courts of Appeal for the Second and Third Circuits have explained that this language requires virtually all possible modifications, even those that come with a high

financial cost. For example, in *Disabled in Action of Pennsylvania v. SEPTA*, the Third Circuit explained that "infeasibility" may exist only when it arises from the nature of an existing facility that makes compliance truly impossible, not from "budget limitations." 635 F.3d 87, 93–97 (3d. Cir. 2011); *see also Roberts v. Royal Atlantic Corp.*, 542 F.3d 363, 371 (2d Cir. 2008). Courts have similarly explained that the phrase, "to the maximum extent feasible" means up to the point of impossibility. *See Greene v. United States*, 207 F. Supp. 2d 1113, 1121 (E.D. Cal. 2002).

When, as in MIEAA, a statute requires the agency to consider other factors in addition to the "maximum feasible" requirement, the agency must require "maximum . . . feasible" efforts up to the point where doing so would threaten those other stated goals. *Alatech Healthcare v. United States*, 89 Fed. Cl. 750, 754 (2009). MIEAA states that the maximum feasible requirement must be applied "consistent with" the company's "financial soundness," *D.C. Appleseed*, 54 A.3d at 1214, and thus, DISB must require that GHMSI "engage in community reinvestment to the 'maximum feasible extent'" up to the point where doing so would undermine financial soundness. *Id.* at 1218–20.

2. A Confidence Level of 90% Adheres to the Court's Instructions for Meeting MIEAA's "Maximum Feasible" Standard

As noted, the Court instructed DISB that "surplus and community reinvestment are to be calculated and balanced." *Id.* at 1215. This requires a realistic assessment of the "consequences" of the company's surplus falling to a selected level, *id.* at 1218, and a proper "calibrat[ion]" of the confidence level in light of those consequences. *Id.* at 1219.

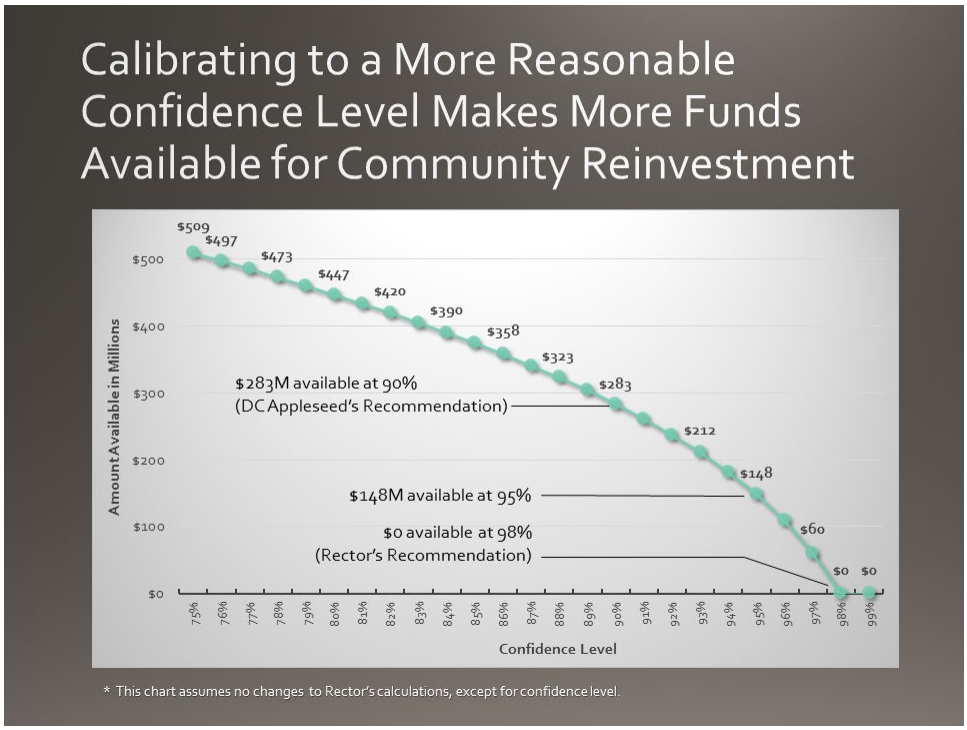
Using this standard, we submit that the proper confidence level is 90%. For several reasons, this level maximizes community reinvestment without undermining financial soundness.

First, as already discussed, the "consequences" of falling to 200% RBC are not nearly serious enough to warrant a confidence level of avoiding 200% with "virtual certainty"—particularly given that using that confidence level (98%) denies all dollars for community reinvestment. A surplus of 200% would trigger cooperative remedial measures by GHMSI and the Commissioner that would be the opposite of "catastrophic." And, the likelihood is low that supermajorities of BCBSA licensees would vote to withdraw GHMSI's license to use the Blues marks. Again, this is not to detract from the importance of avoiding 200% RBC; the point is that the consequences of falling to 200% RBC are not sufficiently dire to justify the complete nullification of community reinvestment through a 98% confidence level.

Second, community investment is greatly enhanced by adjusting the confidence level only slightly. As Judge Ruiz said at oral argument, millions of dollars for community health reinvestment become available when even a slightly lower confidence level is employed. Our actuarial expert Mark Shaw shows that, if everything else in Rector's analysis stayed the same, simply reducing the confidence level from 98% to 95% would reduce GHMSI's permitted

surplus from more than $961 million to $812 million, affording $149 million dollars for community reinvestment rather than zero. 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] (attached). Moving from 98% to 90% would allow an even greater degree of community investment of $283 million. *See* Figure 3.

FIGURE 3

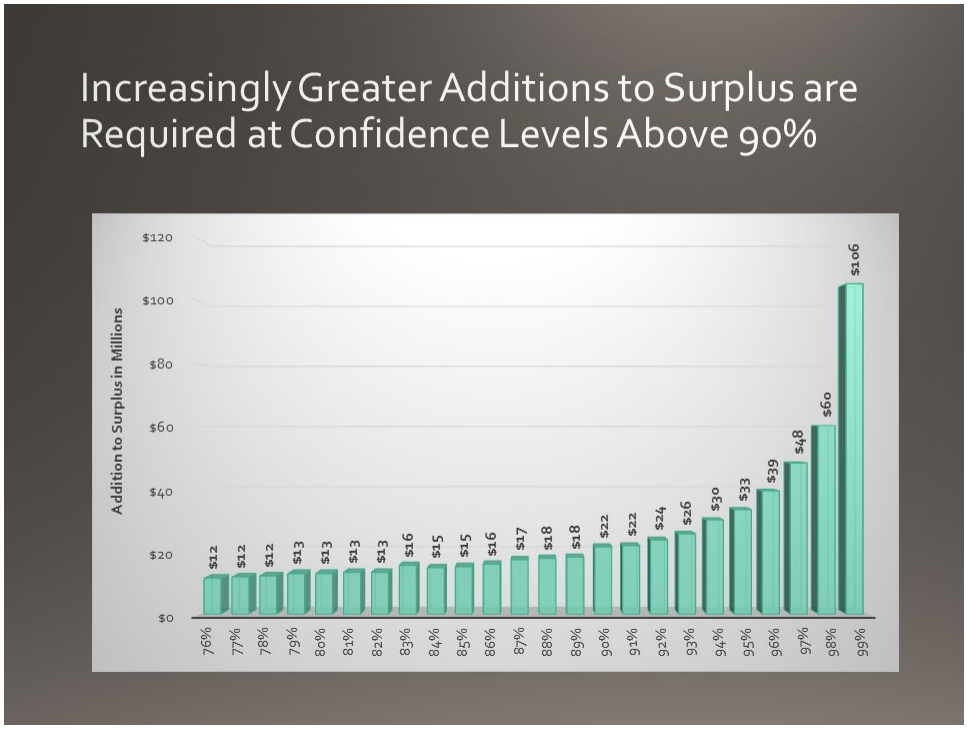


Viewed another way, each percentage point increase in the confidence level from 90% to the 98% is increasingly costly in terms of the additional surplus it allows GHMSI to keep:

- Increasing the confidence level from 90% to 91% increases the permitted surplus by 22 percentage points;
- Increasing the confidence level from 94% to 95% increases the permitted surplus by 33 percentage points;
- Increasing the confidence level from 95% to 96% increases the permitted surplus by 39 percentage points.

The greatly diminishing amount available for community reinvestment above 91% confidence provide support for a confidence level of 90%. Conversely, the marginal protection afforded by 98% over 90% does not justify the enormous increase in surplus and corresponding reduction in community reinvestment it produces.

FIGURE 4



Finally, confidence levels in the 90–95% range have industry support even without the need to take any other priority into account (such as community reinvestment) in establishing those levels. The report from The American Academy of Actuaries Health Solvency Work Group, which is cited in the Rector Report, does not support a level as high as 98%. *See* Rector Report n.21. Rather, as Rector says, "although the health RBC formula was not originally calibrated to achieve specific confidence levels with respect to the entire formula or individual risk factors, certain risk factors were developed on the basis of a 90% to 95% confidence level." *Id.* This confirms that confidence levels in the 90% to 95% range have industry support. Given that those levels were assigned even in the absence of a command to maximize community reinvestment, a 90% level is a sensible accommodation of that command and is the most reasonable level that "calibrates" and "balances" surplus to meet that command.

In short, in applying the requirement to maximize community reinvestment without undermining the GHMSI's financial soundness, the Commissioner needs to judge whether the trade-off in any marginal gain in the company's financial soundness justifies the reduction in community healthcare reinvestment. The trade-off at 90% confidence of avoiding 200% RBC strikes the correct calibration. The impact on GHMSI, if any, from allowing a slightly lower confidence level is small; but the impact on the ability to address community healthcare is enormous. GHMSI will still be financially sound by being 90% confident that it will not at some later date fall to 200% RBC; but at a 90% level the District of Columbia will be guaranteed that

GHMSI will invest at least $283 million in community health. We urge the Commissioner to adopt this level.

II. EFFICIENCY: The Rector Report Would Impermissibly Allow GHMSI to Accumulate Surplus Well Beyond the Point of "Efficiency" Within the Meaning of MIEAA

MIEAA expressly incorporates "efficiency" as a criterion for measuring permissible GHMSI surplus. The Court of Appeals said that MIEAA's "reference to 'efficiency' adds another consideration to be taken into account in the Commissioner's determination of what constitutes an 'unreasonably large' or 'excessive' surplus." *D.C. Appleseed*, 54 A.3d at 1219 n.43. The Court also faulted the prior Commissioner for her "overriding concern" with "financial soundness," "without any discussion of the statute's equal focus on 'efficiency.'" *Id.* Yet far from giving "efficiency" an "equal focus," or showing how it was "taken into account," Rector *never mentions* it. The Rector Report is for that reason alone an insufficient basis for the Commissioner's decision.

In this Part II, we discuss the two concepts of "efficiency" that apply to this proceeding and explain how we believe the Commissioner should apply them.

The first concept, which we address in Subsection A, recognizes that there is no benefit in accumulating surplus dollars to protect against artificially inflated risks.[11] MIEAA requires that surplus be based on probabilities and magnitudes 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. This definition of "efficiency" is thoroughly discussed in a key decision from the Pennsylvania Insurance Commissioner, addressed below. It 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. This concept of efficiency is nowhere addressed or acknowledged by Rector.

The second concept of efficiency, discussed in Subsection B, looks to GHMSI's administrative efficiency—its non-medical costs in relation to its revenues. This measure is relevant because administrative inefficiency involves costs that could be avoided without a proportionate decrease, or any decrease, in revenues. Administrative inefficiency reduces GHMSI's margin, and thus increases the likelihood of negative net income. In turn, the

[11] If a risk does not exist, or is extremely remote—as is the case in the inflated portion of the estimate—the benefit of avoiding it is at or close to zero. Accordingly, community health reinvestment is the higher-valued use for these dollars under the MIEAA priorities. Their unnecessary diversion to surplus would violate the "efficiency" standard, and deny the District "feasible" community health reinvestment.

increased likelihood of negative net income necessitates more surplus. Thus, administrative inefficiency increases surplus needs unnecessarily and diverts dollars that could "feasibly" be directed to community health reinvestment. Rector did not consider whether GHMSI's surplus is higher than it should be owing to inefficiency in the company's operations.[12]

A. Efficiency Concept 1: Rector Relies On Inflated or Extremely Remote Risks That Cannot Justify Further Accumulation of Surplus Under MIEAA.

The leading precedent to address the question of what constitutes an efficient surplus for a Blue Plan is a 2005 Pennsylvania decision. In that case, the Pennsylvania Insurance Commissioner set a maximum surplus above which the Blue Plans would be considered to have "accumulated surplus at an economically inefficient level . . . likely inconsistent with their status as statutory non-profit, charitable and benevolent institutions."[13]

The Blues had contended that an increment of additional surplus always reduces the risk of insolvency and thus that there could be no such thing as "excess" surplus. *See* Pennsylvania Decision 14–15. In rejecting that position, the Pennsylvania Commissioner introduced and defined the concept of an efficient Blues surplus: Because non-profit Blues are "unique entities," it is necessary to examine whether their "surplus levels are becoming inefficient . . . ." *Id.* at 9. This assessment of efficiency has two elements: it recognizes "the diminishing nature of the marginal reduction in probability of ruin or default from successive dollars of surplus," and it "balance[s] this marginal reduction in risk against the benefits of using these same surplus funds in an alternative fashion." *Id.* at 15.

When the D.C. Council drafted MIEAA, it gave "a lot of attention" to the Pennsylvania decision.[14] Then-Commissioner Larry Mirel cited it when he found that GHMSI (although not

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[12] Furthermore, as later discussed, the efficiency standard is violated by allowing an additional $83 million in surplus, as Rector proposes, in order to allow for a permissible range of $167 million above or below Rector's calculation of the maximum permitted surplus. Rector would allow a variation of plus or minus more than $83 million, creating a range of $167 million.

[13] Determination at 37, *In re: Applications of Capital BlueCross, et al.*, Misc. Dkt. No. MS05-02-006 (Ins. Dep't of Commonwealth of Pa. Feb. 9, 2005), *available at* http://www.portal.state.pa.us/portal/server.pt/community/industry_activity/9276/blues_reserve_and_surplus_determination/623159 [hereinafter Pennsylvania Decision].

[14] Public Hearing on Bill 17-834 "Medical Insurance Empowerment Amendment Act of 2008" Before the D.C. Council Committee on Public Services and Consumer Affairs, Oct. 10, 2008 (Catania Statement at end of Panel 1).

then subject to the maximum feasible obligation) "should be engaging in charitable activity significantly beyond its current activities."[15]

In MIEAA, the D.C. Council effectively codified the Pennsylvania concept of efficiency and took three major steps beyond it. First, the Council specified the alternative priority that is to limit the accumulation of surplus: "community health reinvestment." Second, the Council specified the level of commitment that must be given to that priority: "the maximum feasible" amount. And third, to ensure that this priority would be implemented to the maximum feasible extent, the Council provided that GHMSI's surplus would be limited by an "efficiency" standard.

The Pennsylvania decision aids in determining how this "efficiency" standard should be applied. Pennsylvania held that "no individual insurer can or should be permitted to collect or accumulate enough premiums to cover any and all catastrophic events no matter how remote or unforeseeable." Pennsylvania Decision 12. Although stated with reference to "catastrophic events," MIEAA's greater specificity warrants generalizing this point to all of the probability distributions used in modeling. As the Pennsylvania Commissioner stated, once a Blue's surplus is "such that any *reasonably probable* 'drain' will not reduce [it] below a safe operating level, then there is arguably no purpose for accumulating additional surplus . . . ." *Id.* at 35 (emphasis added).

Inherent then in "efficiency" as applied to surplus is a comparison of benefits—the benefit from an incremental reduction in the likelihood of insolvency compared to the benefits of alternative uses, which, under MIEAA, consist of community health reinvestment. As a result, "efficiency" serves to direct the maximum number of dollars to community reinvestment in a way similar to the effect of "calibrating" the confidence level.[16]

Rector and Milliman have departed substantially from this definition. They acknowledge no "efficiency" limitation at all. Instead, they utilize assumptions that involve extreme, remote, simultaneous, adverse outcomes that are not "reasonably probable." As a result, the essence of

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[15] *In the Matter of: Inquiry into the Charitable Obligations of GHMSI/CareFirst in the District of Columbia*, Report of the District of Columbia Dep't of Insurance, Securities, and Banking, Lawrence H. Mirel, Commission, May 15, 2005, at 19, *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/exhibit_n_commissioner_mirel_decision_5_15_2005.pdf [hereinafter Mirel 2005 Report].

[16] This concept of efficiency has also been discussed by the Minnesota Department of Health which has noted that it may not be efficient to accumulate funds originally intended for health care access in capital reserves, and that the status of certain health plans as non-profit entities may "generate an expectation that they will operate efficiently and with relatively modest reserves." MINN. DEP'T OF HEALTH, STUDY OF CAPITAL RESERVE LIMITS IN MINN., at vii, 60 (Mar. 2014), *available at* http://www.health.state.mn.us/divs/hpsc/hep/publications/legislative/capitalreservesreport0314.pdf.

the Milliman model used by Rector is to calculate permissible surplus based on assumptions that depart from any reasonable concept of "efficiency."

1. Rector's Use of a Suspect Model, and the Need for Realistic Assumptions.

Because Rector relied exclusively on the Milliman model and that model takes no account of the efficiency standard, it is legally essential (a) to correct the model's assumptions to align them with MIEAA, and (b) to do so with complete specificity and transparency. The latter is important because MIEAA is not only about establishing limits on the accumulation of surplus, but also about "accountability." *D.C. Appleseed,* 54 A.3d at 1214.

The basic building blocks in Milliman's stochastic modeling consist of numerous hypothesized occurrences, that in turn are based on circumstances or events (for example, greater or lower than anticipated medical costs, equity losses or gains, or interest rates) that would cause GHMSI a hypothetical gain or loss. Each hypothesized occurrence is assigned a probability and a magnitude, and the hypothesized occurrences intentionally include multiple extremely adverse events happening simultaneously. The occurrences of these hypothesized gains and losses (generally referred to as "assumptions") are arrayed in a probability distribution for each of 12 factors. The model considers over 40 million hypothetical combinations of these factors and runs 500,000 random combinations to produce a gain or loss outcome for each combination. The outcome at a chosen percentile representing a confidence level is then run through Milliman's pro forma model to identify the financial impact on GHMSI's surplus. Because Rector used a 98% confidence level, it selected the 490,000th worst outcome to run through the pro forma model.

Unrealistic probability distributions and financial projections will yield surplus levels that violate the "efficiency" standard because they result in projections of surplus that are higher than is reasonably necessary for financial soundness. The "efficiency" requirement thus necessitates thorough validation of the probability distributions against actual company experience for a relevant period *and the discarding of occurrences with magnitudes or probabilities that do not validate against experience, absent strong and fully articulated reasons to include them*.

A number of Rector's probability distributions do not validate against company experience. Rector does not offer strong and fully articulated reasons to justify these hypothesized departures from company experience, much less departures of the magnitude that Rector assumed. These errors lead to a substantial overestimation of GHMSI's surplus needs that does not comport with MIEAA's "efficiency" requirement.

2. Recommended Corrections to the Milliman Model and Rector Report

To determine the effects of introducing realistic assumptions into the Milliman stochastic model—assumptions consistent with the efficiency requirement of MIEAA—Mr. Shaw

replicated the stochastic model based on the descriptions in the Milliman memorandum of February 27, 2014, and information provided by Rector, Milliman, and the Commissioner in response to Appleseed inquiries.[17]

In the remainder of this Part II.A, we discuss Mr. Shaw's corrections to Rector's assumptions concerning premium growth, rating adequacy and fluctuation (RAAF), equity portfolio results, several other risk factors, and management intervention.

For each corrected risk factor, Mr. Shaw ran the replicated model through 500,000 iterations, both separately and cumulatively, and at different confidence levels, to determine the effects of the correction on the outputs of the stochastic model. He then used those outputs to determine how his model corrections affected surplus. Rector, through Milliman, performed this second step by running selected outputs from the stochastic model through financial pro formas. Because we were not given complete information that we had requested concerning the pro formas (in particular, expense assumptions), Mr. Shaw performed this second step using proxies to approximate the results of running the outputs of the stochastic model through the pro formas. Mr. Shaw utilized the information we have[18] and established that his results after applying pro forma estimates to the outputs of the stochastic model provide reasonable estimates of the results Rector would have reached through the use of the pro forma model. Shaw Report 58 ch. 25.

In the remainder of Part II, we show in three different ways how correcting the risk-assumption inputs into the stochastic model affects surplus. Under each approach, we hold all other things constant and merely change:

(a) the correction to the particular risk assumption (for example, the rating adequacy and fluctuation factor (RAAF));

(b) the correction to the particular risk assumption but at two additional confidence levels (90% and 95%); or

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[17] Mr. Shaw validated his replication as against the Milliman model by running 500,000 iterations using the same probability distributions that are in Attachment A to the Milliman memorandum, modified only by the changes Rector itself made to certain of the Milliman assumptions (for rating adequacy and fluctuation, catastrophic events, unidentified growth and development, and premium growth), as described in the Rector Report 19–29. Using all of Rector's assumptions and its confidence level, the result was a reduction in surplus equal to -23.2% of GHMSI's non-FEP premium—a result that is virtually identical to Rector's (-23.3%). Shaw Report 17 n.31.

[18] *See* DISB Apr. 18 Letter; Letter from Chester A. McPherson, Acting Comm'r, D.C. Dep't of Ins., Sec. and Banking, to Walter Smith, Exec. Dir., DC Appleseed 6–7 (May 13, 2014), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/May132014Letter.pdf [hereinafter DISB May 13 Letter].

(c) the correction to the risk assumption at the different confidence levels combined with the corrected premium growth assumption.

These results may be found in the Shaw Report (at page 58, chart 25), or in a slightly simplified version of this chart in this Report. *See infra* Figure 7. Through these charts, the Commissioner can see how certain adjustments to the confidence level and the assumptions in the model affect permissible surplus under MIEAA.

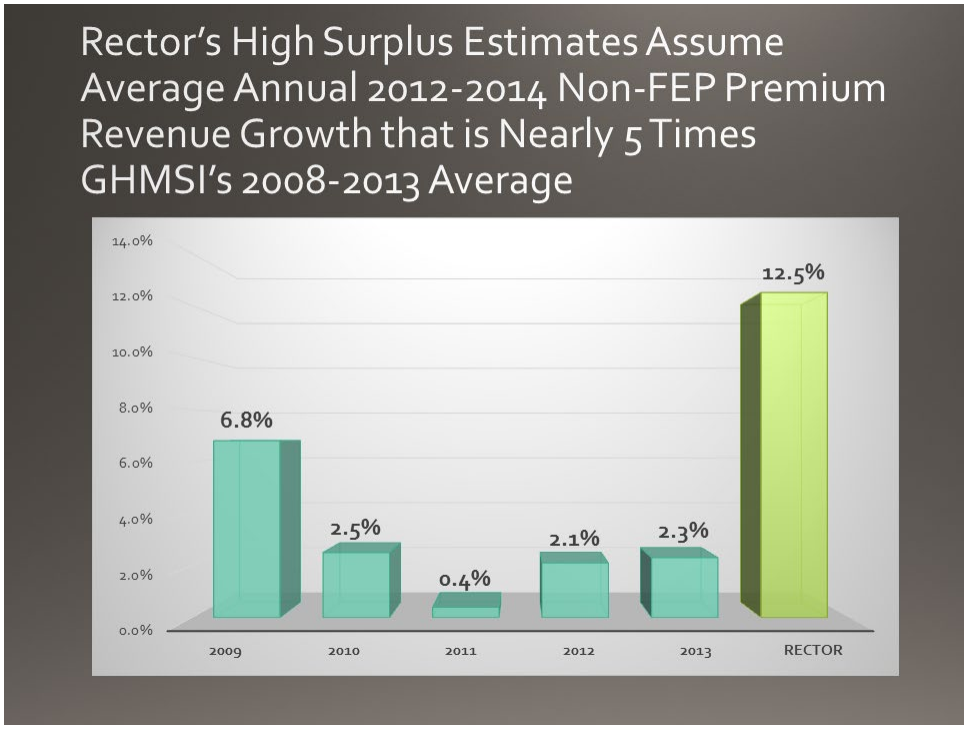
a) Rector's Inflated Assumptions: Premium Growth Rates.

Premium growth is the increase in premium revenues that is a function both of the predicted number of enrollees and the predicted average premium rates they will pay. Because premium growth assumptions affect the Pro Forma model through which all of the gain or loss outcomes from the stochastic model are run, we will begin our examination of efficient surplus by considering Rector's premium growth assumptions.

"The amount and type of premium projected to be written by a health insurer are key determinants of the insurer's future surplus needs." Rector Report 27. That is so because premium growth is a rough proxy for growth in medical claims, and growth in medical claims is an element of RBC itself. Shaw Report 19. Thus, even if there is no increase in the losses predicted by the stochastic model, an increase in premium revenue will increase the surplus needed to maintain a given RBC level. *Id.* For example, even if there were no gains or losses in the outputs of the stochastic model, Rector's use of a weighted average annual non-FEP premium growth of 12.5% (rather than a rate similar to actual historical growth rates) decreases GHMSI's projected RBC ratio by as much as 30%. This makes the company appear less secure against the risk of insolvency than it actually is and thereby allows the company to defend a higher than needed surplus level. *See id.*

Thus, the premium growth factor is a particularly potent determinant of required surplus. As Rector notes, in projecting premiums "it is important to take into account GHMSI's historical premium growth experience." Rector Report 28. Yet Rector's premium growth assumptions depart significantly from GHMSI's recent historical experience and Rector provides no justification for this departure. We believe this violates the "efficiency" requirement of MIEAA that needed surplus be measured by reasonably probable future events, rather than by extreme and remote hypotheticals that are not grounded in actual experience.

FIGURE 5



As set out in Mark Shaw's attached analysis, the average actual non-FEP premium growth rate for GHMSI from 2008 to 2013 (reflecting both the number of enrollees and premium rates) was 2.8%. Shaw Report 21 ch. 5. The highest historical year-to-year non-FEP premium growth rate for GHMSI from 2008 to 2013 was 6.8%. Additionally, in 2013 both FEP and non-FEP rates were 2.9% and 2.3%, respectively, well *below* the lowest possible rates considered in the Rector Report. *Id.* Yet Rector assumes in the Milliman model a weighted average growth rate of 12.5% for non-FEP and 7.5% for FEP. *See* Figure 5. This means that Rector assumes that future non-FEP premium growth rates will be substantially higher than even the highest annual growth rate over the five years from 2008–2013. Shaw Report 19, 21. Rector's non-FEP assumptions are unreasonable on their face. *See id*. As Mark Shaw points out, "only the strongest and most clearly articulated reasons" could justify this departure from historical experience, *id.*; but Rector nowhere provides such reasons.

There is also no evidence of future enrollment increases to justify Rector's premium growth assumptions. For example, FTI makes the assertion that, "*If* GHMSI is able to maintain its market share, then slow but steady membership gains should be assumed." Memorandum from Jim Toole, FTI Consulting, to Rector & Assocs. 3 (May 16, 2013), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/April18 Attachments.pdf [hereinafter May 2013 FTI Memorandum]. But FTI does not substantiate this argument. GHMSI's membership has been stagnant or in decline since 2008, and 2013 only serves to enforce that reality. Combined GHMSI-BlueChoice member months declined by 16%

in the period including 2008 through 2013. Shaw Report 22 ch. 6. The most recent decline, in 2013, was the largest single-year decline in that period.

A Society of Actuaries (SOA) paper cited by FTI also provides no basis for assuming an increase in premium revenues. That cite relates to the individual market which is a very small share of GHMSI's non-FEP business (less than 10%), *id.* at 48–49, and will not drive overall non-FEP premium growth. Moreover, the SOA paper does not support either a near-term increase in the number of enrollees or an increase in average premiums per member. In fact, the SOA paper estimates that, under the ACA, "Reality will likely result in a lag in enrollment shifts." *See id.* at 23.

With open enrollment for 2014 now concluded, the Commissioner need not rely solely on past expectations concerning the number of enrollees.[19] Current data show a decline in those insured under employer-sponsored plans in the wake of ACA, consistent with SOA's expectation that a significant portion of the increase in the individual market under the ACA would come at the expense of reductions in the numbers of those insured through their employer and other sources. *See id.* at 24.[20] Rector offers no reason to believe that GHMSI is somehow an

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[19] The Commissioner clearly has the authority to take into account actual results occurring after the year-end under review. The case law recognizes that, when issues in agency proceedings involve predictions, the agency may take into account subsequent developments. That is so even when the agency has already reached a decision, so that competing considerations of finality and reliance are involved. In *Conservation Law Found. of New England v. Clark*, the court explained that when evidence regarding events underlying an original agency decision subsequently becomes available, a district court's inquiry is not confined to the full administrative record before the agency at the time decision was made. 590 F. Supp. 1467 (D. Mass. 1984). *See also Afghan Am. Army Servs. Corp. v. United States*, 106 Fed. Cl. 714, 724 as supplemented, 106 Fed. Cl. 751 (2012) ("As courts have recognized, post-decisional information correcting erroneous assumptions, predictions, or facts forming the predicate for agency decision-making must be added to the administrative record to permit effective judicial review."). That is particularly evident here, where two and a half years have passed since December 31, 2011. Indeed, MIEAA requires this type of realism. MIEAA requires the maximum amount of community health reinvestment that is "feasible," which is a forward-looking measure that requires feasibility at the time of the reinvestment. And, in the remedial phase, GHMSI must submit a plan to spend down "the excess," which is the same "excess" found in the substantive surplus review. *See* D.C. Code, §§ 31-3506(g)(1). Given the amount of time that has elapsed, the "excess" for spend down and the "excess" surplus can be the same or close to the same only if subsequent developments are taken into account. It would be arbitrary and unreasonable for the Commissioner to blind himself to the realities.

[20] A recent RAND study confirms that point. It estimates that only about 1.4 million of the 7.1 million who signed up for coverage under the ACA were previously uninsured. *See* Katherine Grace Carmen & Christine Ebner, Rand Corp., Changes in Health Insurance Since 2013, at 4 (2014), *available at* http://www.rand.org/pubs/research_ reports/RR656.html. Enrollment in off-exchange plans fell from 9.4 to 7.8 million; there has been a decline of 7.1 million persons in the "other insurance" category; and more than 2 million people who previously had employer-sponsored health insurance are now uninsured. *Id.*

exception to these general patterns, which point away from the very large increases assumed by Rector.

With respect to average premiums per member, the SOA study, consistent with many other studies, anticipates that average individual premiums (before application of the premium tax credit) will likely be lower than premiums for those enrolled in employer-sponsored insurance. *Id.* The May 2013 FTI Memorandum cites a study from PWC to justify assuming a baseline premium trend of 7.5% for 2013, driven by a projected increase in the costs to the insurer per member per month (PMPM) of providing coverage. But as Mr. Shaw explains, the PWC study does not support that assumption. To the contrary, "[e]ven the lowest possible [premium growth] trend assumed by FTI is higher than the central expectation in the PWC report . . . ." *Id.* at 23.[21]

In short, Rector's assumptions for premium growth are significant and unsubstantiated departures from historical results. The evidence offered by Rector, far from justifying its assumptions, points in the opposite direction. Thus, Mr. Shaw has adjusted those growth rates downward to determine the likely impact on Rector's 958% RBC determination.

Mr. Shaw explains that, although the magnitude of Rector's inflated growth rates cannot be justified, a conservative use of the Milliman model would allow for some projected increase in premium revenues. Mr. Shaw finds that ACA open enrollment "***might*** have increased GHMSI's total enrollment 2.1%," for 2014 and he expects the same increase in 2015. *Id.* at 25 & ch. 8 (emphasis in original). That is in sharp contrast to Rector's assumption of 13.8% for 2013 through 2015.

Mr. Shaw also provides more appropriate assumptions for average premium growth rates, derived from the PWC report relied on by Rector. In Mr. Shaw's restated assumptions, *id.* at 26 ch. 9, 80% of predicted premium growth rates reflect GHMSI's actual historical growth rates; the remaining probability assumptions (5% and 15%) are conservative, allowing for growth rates above the historical range to be three times as likely as growth rates below that range. The resulting weighted average premium growth rates are also conservative, remaining above recent historical averages and well above actual 2013 experience.

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[21] FTI acknowledges that benefit reductions and cost-shifting to subscribers have exerted downward pressure on premium rates in recent years. FTI May 16 Memorandum, 4. FTI reports that GHMSI management "suggest[s] the plans have reached a point of diminishing returns with respect to benefit reductions and cost shifting." *Id.* FTI does not otherwise identify the significance it assigned to these trends in its projections for average premium rates through the end of 2015. The PWC study, which it cites, takes these trends into account, and, as we show, does not support Rector's projections for premium rates.

Mr. Shaw then calculates the impact of Rector's inappropriate premium growth rates on its 958% RBC target surplus ratio and estimates how much lower that figure would be had more realistic growth rates been applied, holding everything else equal. He then shows that, if all of Rector's other assumptions are used, with the sole correction being the assumed growth rate for premium revenues, the required surplus at the 98% confidence level is 752% RBC or approximately $207 million less than that calculated by Rector using inflated premium growth rates. *Id.* at 27, 58 ch. 25. At the 95% confidence level, the required surplus is 625% RBC, and at the 90% confidence level, 509% RBC—again, solely due to the use of realistic assumptions for premium growth. *Id.* at 58 ch. 25. This shows the dramatic effect that unrealistic—inefficient—premium growth assumptions have on the calculation of efficient surplus and, therefore, permissible surplus under MIEAA.

In addition to showing how Rector's 2013 surplus recommendation of 958% RBC should be adjusted downwards, Mr. Shaw also addressed Rector's justifications for adjusting its 2009 recommendation upwards. As indicated in DISB's May 13 letter, Rector increased its recommendation from 552% RBC in 2009 to 958% in 2013, in both cases using a 98% confidence level of not falling below 200% RBC. This jump represents a 74% increase in surplus, or more than $400 million.

According to DISB, 40 "basis points" of the increase is attributable to premium growth.[22] DISB May 13 Letter, at 14. However, Mr. Shaw explains why this increase is not justified and why, if anything, a downward adjustment for premium growth is warranted. First, a review of actual premium growth since 2009 shows that growth rates are declining, not rising. Shaw Report 27. Second, it is clear that Rector attributes the possibility of increased premium growth to the ACA, which Mr. Shaw shows is not justified.

With all of Rector's other assumptions unchanged, correcting the premium growth assumption reduces the needed RBC ratio at a 98% confidence level by 206 percentage points, from 958% RBC to 752% RBC. This reduction far exceeds the 40 "basis points" that Rector presents as part of its explanation for the 2009 to 2013 increase in the target ratio.[23] *See id.*

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[22] DISB and Rector refer to "basis points," which we take to mean "percentage points."

[23] Interestingly, Milliman itself projects a 30 basis point decrease—not increase—for premium growth between its 2009 recommendation and its current one. Memorandum from Jim Toole, FTI Consulting, to Rector & Associates 2 (Mar. 6, 2014), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/QuantificationofAssumptionChanges.pdf; DISB May 13 Letter, at 14.

b) Rector's Inflated Assumptions: Rating Adequacy and Fluctuation (RAAF).

The Rating Adequacy and Fluctuation ("RAAF") factor is the variable that addresses whether premiums charged by the company will be sufficient to cover expenses and claims. In other words, it measures the likelihood that the company will suffer an underwriting loss. For this reason, "modeling choices relating to the Rating Adequacy and Fluctuation factor are crucial in the methodology used to select a loss outcome." Rector Report 21.

Rector acknowledges that changes it made to Milliman's assumptions relating to the RAAF factor "had the most significant impact on the modeling results." *Id.* Although Milliman assumed severe negative results several times higher than more appropriate and recent historical results, Rector does not show that its adjustments to RAAF addressed this issue.

In fact, Rector did not disclose the level of detail required to evaluate its revisions to the RAAF factor. Rector asserts that "it is not feasible or appropriate to quantify the reasons behind [its] revisions to the rating adequacy and fluctuation factor." DISB Apr. 18 Letter, at 27 (response to Item 13).[24] This assertion is directly contrary to the standards governing actuarial practice in the United States. *See* Shaw Report 9. Under those standards, Rector is required to "state the actuarial findings, and identify the methods, procedures, assumptions, and data used by the actuary with sufficient clarity that another actuary qualified in the same practice area could make an objective appraisal of the reasonableness of the actuary's work as represented in the report." *See* ACTUARIAL STANDARDS BD., ACTUARIAL STANDARD OF PRACTICE NO. 41: ACTUARIAL COMMUNICATIONS (Rev. ed. Dec. 2010), *available at* http://www.actuarialstandardsboard.org/pdf/asops/asop041_120.pdf.

Rector's position also makes it difficult if not impossible for the Commissioner to rely on Rector's conclusions under the Court's standards. As noted earlier, the Commissioner's decision must "be fully and clearly explained." *D.C. Appleseed*, 54 A.3d at 1216. "[T]he more technical and complex the subject matter, the more explanation the agency ought to provide for its decision." *Id.* at 1217. That is "especially" so here, where "even a small variance can implicate millions of dollars." *Id.* Rector plainly has not met either the actuarial or judicial standards and, as a result, neither DC Appleseed—nor the Commissioner—can assess the reasonableness of Rector's conclusions.

[24] Although the quoted statement was made in a letter from Commissioner McPherson to Walter Smith, we understand, based on our conversations with DISB and Rector, that the statement is attributable to Rector and was forwarded by Commissioner McPherson.

Rector appears to be saying "we have exercised our actuarial judgment and you must trust us." Yet, Rector itself acknowledged during the 2009 proceeding that such a position is unacceptable. At that time, Rector was confronted with an analysis from the Lewin Group that reached different actuarial judgments than Rector's but that failed to sufficiently explain Lewin's conclusions. As Rector rightly pointed out:

> [T]he Final Lewin Group Report did not contain sufficient actuarial detail to allow a reader to determine exactly what the Lewin Group did or what its key assumptions were. In other words, in many ways the Final Lewin Group Report was a "black box." As such, there were limitations as to how much of the Lewin Group's work could be used.

Rector 2010 Rebuttal, at 5.

The same is true of Rector now. Rector has proposed dramatic increases in GHMSI's surplus, based in large part on assumptions it has made about the RAAF factor. But neither DC Appleseed nor the Commissioner have been given "sufficient actuarial detail to allow a reader to determine exactly what [Rector] did." *Id.* As a result, DC Appleseed and the Commissioner are dealing with a "black box" on this issue.

The only explanation in the Rector Report for Rector's revisions to Milliman's probability distribution for Rating Adequacy and Fluctuation states that these revisions were the result of changes to seven components for that factor: trend miss modeling; trend modeling; medical loss ratio (MLR) restrictions; increased regulatory oversight of premium rates; and three distinct possible effects of health care reform (underwriting restrictions; policyholder behavioral changes; and coverage mandates). Rector Report 22–23.[25]

Instead of providing information on the impact of each revised component, Rector provided only a revised probability distribution for Rating Adequacy and Fluctuation as a whole. *See id.* at 22 tbl. DC Appleseed accordingly requested "[d]etails on how much, if any, each of the above aspects impacted the probabilities and charges in the tabular values [for RAAF] presented on page 22 of the Rector Report."[26] But Rector never determined the separate impact of each of those components in its analysis for the Report.[27]

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[25] Rector removed MLR and regulatory delay from the modeling, leaving five elements. *See* Rector Report, 22, 23.

[26] Letter from Walter Smith, Exec. Dir., DC Appleseed, to Chester A. McPherson, Acting Comm'r, D.C. Dep't of Ins., Sec. and Banking (Jan. 29, 2014) (Attachment A, Item 1), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/DCACLettertoDISBwithattachments012914.pdf. DC Appleseed renewed and elaborated the request in a second discovery request on February 19. *See* Letter from Walter Smith, Exec. Dir., DC Appleseed, to Chester A. McPherson, Acting Comm'r, D.C. Dep't of Ins., Sec. and Banking (Feb. 19, 2014) (continued…)

Because Rector's analysis of RAAF remains largely unexplained, Mr. Shaw performed a separate analysis of this factor based on the historical experience of GHMSI and ten peer companies (the BlueCross BlueShield plans that were most comparable to GHMSI in non-FEP premium revenue in the 2000's) in the 12-year period 2002–2013 and, for GHMSI, the 15-year period 1999–2013. *See* Shaw Report 10. In this analysis, Mr. Shaw uses underwriting gains and losses for each company as a proxy for rating adequacy, thereby measuring the probability of negative results for the companies based on actual historical performance. It creates a probability distribution for each 1-year, consecutive 2-year, and consecutive 3-year time period within the overall historical period studied (for example, the 3-year periods included 2002–2004, 2003–2005, etc.).

As Mr. Shaw explains, the comparison to historical data reveals that Rector retained Milliman's errors concerning RAAF "to a degree that . . . significantly inflates their conclusion concerning required surplus." *Id.* at 12. These errors include the *variability* of results; the *probability* of significantly negative results; and the *severity* of negative results. In comparison with the historical data for GHMSI and the ten peers, Mr. Shaw's analysis shows that:

- "Rector assumes greater variability in results, especially on the negative side." *Id.*
- "Rector assumes a much higher probability of significantly negative results." *Id.* Viewing "significantly negative" results as those between -2.0% and -18.2%, Mr. Shaw finds the historical probabilities of these results to be 10.6% for 2 years, and 11.7% for 3 years, yet Rector's probability is 17.4%.
- "The severity of average negative results for Milliman (-8.9% for 2 years, -12.1% for 3 years) is a multiple of between three and four times actual Historical (-2.6% for 2 years and -3.8% for 3 years) negative results." *Id.*

Nowhere are these significant departures explained; nor could they be given the actual historical results.

As Mr. Shaw states, the "**severe negative results combined with the increased probability of negative results are likely by themselves responsible for a significant portion**

(Attachment A, Item 1), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/DCACLettertoDISB021914.pdf.

[27] Email from Philip Barlow, Assoc. Comm'r of Ins., D.C. Dep't of Ins., Sec. and Banking, to Walter Smith, Exec. Dir., D.C. Appleseed (Feb. 10, 2014), #1 ("For item 1.c., R&A is in the process of attempting to determine if it is feasible to separate the various factors in such a way that the impact of each of the revisions made to each of the variables for the rating adequacy and fluctuation factor can be quantified separately.").

of the required surplus calculated from the Rector's revisions to the Milliman modeling." *Id.* (bold and underscoring in original). Although Rector made some adjustments to Milliman, its adjustments "did not correct the central underlying flaw of the Milliman approach—*i.e.*, it assumes severe negative results several times higher than more appropriate and recent historical negative results." *Id.*at 13.

Although Rector never explains or justifies this departure from historical performance, Rector does indicate that a significant element in its calculations was uncertainty associated with the ACA. Accordingly, Mr. Shaw did a separate analysis addressing how historical performance will likely be affected by health reform, taking into account Rector's statements about that issue in its Report.

It was particularly important that Mr. Shaw do a separate analysis of health reform because neither Milliman nor Rector identify, discuss, quantify or take into account any of the important aspects of the ACA which help *insulate* insurers from potential losses from ACA requirements for guaranteed issue and the potential enrollment of less-healthy individuals (adverse selection). *Id.* Accordingly, Mr. Shaw examined those aspects of the ACA, along with the provisions that limit insurer gains, to measure the overall likely effect on GHMSI's risk of severe negative returns going forward, and on uncertainty created by the ACA.

Mr. Shaw examined the three risk mitigation provisions of the ACA: risk adjustments, reinsurance, and risk corridors ("the three Rs"). He also examined the provisions that limit gains: the MLR provisions, and the Risk Adjustment Provision (which transfers funds from plans with lower-risk enrollees to plans with higher-risk enrollees). Because each of the three Rs will mitigate underwriting losses and reduce variability, they must be taken into account for a realistic assessment, as the "efficiency" standard requires, of the impact of the ACA on GHMSI. Rector completely failed to do this.

Through a series of adjustments keyed specifically to the three Rs and the MLR provision, Mr. Shaw simulates the impact that the post-2013 ACA would have had on past results for RAAF for the peer group including GHMSI. *Id.* at 15. Among these adjustments is the conservative assumption that Reinsurance and Risk Adjustment will do no more than offset the impact of guaranteed issue in the individual market. *Id.* In order to be conservative, Mr. Shaw ignores the possibility that Reinsurance and Risk Adjustment may actually *reduce* future losses and that Risk Adjustment would also apply in the Small Group market in 2014–2016, thus further limiting variability. *Id.*

Mr. Shaw finds that, while the overall probability of loss is not materially changed after ACA adjustments to historical data, "**the probability of the largest losses are reduced by more than 50% (4.1% to 1.6%) for a 2-year period and more than 30% (5.4% to 3.6%) for a 3-year period. As the largest losses are the likely drivers of Rector's modeled surplus needs,**

this is a very significant change." *Id.* at 17 (bold and underscoring in original; footnote omitted).[28]

In short, Rector uses the RAAF factor to predict losses that are totally out line with historical data, and it ignores the features of the ACA that reduce risks and limit variability. Its approach therefore again violates MIEAA's "efficiency" requirement.

Correcting for these errors requires two steps: first, running a corrected RAAF probability distribution through the stochastic model, and second, running the resulting output of the model through the pro forma projections. Mr. Shaw performed the first, and—because we were not provided the full information we requested concerning the pro formas—used a reasonable proxy for the second.

Mr. Shaw ran 500,000 iterations of the model that he had validated against Rector's model, using his corrected RAAF probability distribution. Mr. Shaw corrected the probability distribution by building a historical loss distribution for GHMSI and its peer competitors and then adjusting that distribution for the three Rs as described above. The corrected probability distribution was the only change Mr. Shaw made to the model.[29] The corrected model—holding everything else the same except the RAAF factor—results in a 98th percentile surplus loss of -16.6% rather than the -23.2% calculated by Rector.

Mr. Shaw then estimated the effect on required surplus at the 98th percentile when the corrected stochastic model result (-16.6%) is introduced into the pro forma model. Lacking complete information about the pro forma model, Mr. Shaw utilized the ratio of the surplus loss based on the corrected RAAF factor (16.6%) to Rector's surplus loss using its incorrect RAAF factor (23.2%). Applying that ratio (16.6/23.2) to the amount by which Rector's target ratio of 958% RBC exceeds 200% RBC, Mr. Shaw demonstrates that the effect of a corrected RAAF factor is to reduce the RBC ratio required to avoid falling to 200% at 98% confidence from Rector's 958% to 766%, or by 192 percentage points.

This result, as already noted, assumes that no other corrections are made to Rector's assumptions. However, because we urge the adoption of a lower confidence level, Mr. Shaw also calculated the impact of correction to RAAF at other confidence levels:

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[28] The ACA adjustments also cause a "significant reduction in large increases in underwriting gains." Shaw Report 16. This change "does not impact the needed surplus generated by the Milliman model, which is focused on avoiding a substantial decrease in surplus." *Id.*

[29] Thus, Mr. Shaw actually saved the random numbers from the validating run and used them in the run with the adjusted RAAF factor, so that there would not be any change introduced by random statistical fluctuation. Shaw Report 54. That is true for each run of his model for each of the other corrected risk assumptions.

- Using a 95% confidence level, GHMSI's target surplus would be 795% RBC without the corrected RAAF factor and 665% RBC with the corrected factor.
- Using a 90% confidence level, GHMSI's target surplus would be 647% RBC without the corrected RAAF factor and 569% RBC with the corrected factor.

Id. at 58 ch. 25.

If the corrected RAAF assumption is combined with the earlier corrected assumption for premium growth, the target surplus would be:

- 602% at the 98% confidence level;
- 522% at the 95% confidence level; and
- 447% at the 90% confidence level.

Id.

In addition to addressing the impact on Rector's recommended 958% RBC from adjusting the various assumptions used in the model, Mr. Shaw also addressed Rector's justifications for the 406 percentage point increase it recommended over its 552% recommendation in 2009. Of those 406 percentage (or "basis") points, Rector attributes 150 points to the increase in the RAAF factor. *See* DISB May 13 Letter.

This 150 percentage point increase is unjustified for several reasons. First it is quite clear that the entirety of Rector's increase for the RAAF factor is due to ACA. DISB told us in its April 18 letter (p. 24) that the effects of ACA were captured by Rector in the RAAF factor and premium growth; Jim Toole told us in his March 6, 2014 Memorandum that Rector's upward adjustment in 2013 for ACA was "approximately 200%"; and DISB's May 13 letter (p.14) told us that the upward adjustment for the rating factor was 150 basis points and for premium growth was 40 basis points—which added together are approximately 200 basis points. This indicates that the whole of the 150% increase Rector used for the RAAF factor is due to ACA. Yet Mr. Shaw's work shows that a surplus increase for ACA is completely unwarranted. To the contrary, he shows that the impact of ACA is to decrease the possibility of sizable losses for GHMSI, which means that if anything a downward adjustment was appropriate for this factor.

In addition, as Mr. Shaw points out, Shaw Report 48, Rector stated in its 2009 report that it made no adjustment to Milliman's assumptions for RAAF. *See* Rector & Assocs., Inc., *Report to the D.C. Department of Insurance, Securities and Banking: Group Hospitalization and Medical Services, Inc.* 6 (undated), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/Rector_DISB_Report.pdf [hereinafter Rector 2009 Report]. Yet in 2013 Rector made downward adjustments to those assumptions, and still produced a 150-point RBC increase. No explanation is offered for this inconsistency.

Furthermore, Mr. Shaw shows that a corrected RAAF factor reduces the current 958% RBC by 192 points (958% to 766%), still at the 98th percentile and holding everything else in Rector's model the same. Thus, Rector's attempted justification for the increase from 2009 to 2013 for RAAF fails.

c) Rector's Inflated Assumptions: Equity Portfolio Risk

Rector has cited changes in equity portfolio asset value (EPAV) risk as one factor contributing to the increase in permissible surplus from 552% RBC in 2009 to 958% RBC in 2013. When we asked for an explanation of this increase, Rector informed us that an increase in EPAV risk accounted for 70 points of the 406 percentage-point increase, or approximately $70 million of added surplus. Mar. 6 FTI Memorandum, at 3. Despite the significance of this adjustment, the EPAV factor is not discussed at all in the Rector Report and Rector has provided no data to justify or validate this increase.

Mr. Shaw investigated the nature of GHMSI's equity portfolio and the historical basis for assessing risk to that portfolio. He found that Rector's $70 million increase to surplus to account for increased portfolio risk between 2009 and 2013 is based on a period when GHMSI assets invested in stocks significantly *decreased* as a percentage of non-FEP premium revenue. Further, while Rector assumes that 53% of the time there will be a loss, the Dow Jones Industrial Average from 1975 through 2013 shows that portfolio gain was four times more likely than loss over this period, and more than 50% of all the observations were gains that were larger than the absolute value of the largest loss.

Thus, in the face of this historical record, Rector has not justified the EPAV factors it used or an increase in surplus due to equity portfolio risk. As a result the increase does not accord with the "efficiency" requirement of MIEAA and should not be permitted by the Commissioner.

In his statement, Mr. Shaw shows how to adjust the probability distributions for the EPAV assumption to align them with historical data. The effect of a corrected EPAV assumption is to reduce the target surplus ratio, based on the output of the stochastic model, to:

- 743% RBC at the 98% confidence level
- 587% RBC at the 95% confidence level, and
- 427% RBC at the 90% confidence level.

The corrected EPAV assumption combined with the corrected premium growth assumption yields ratios of:

- 584% RBC at the 98% confidence level,
- 461% RBC at the 95% confidence level, and
- 335% RBC at the 90% confidence level.

These adjustments show the magnitude of the effect that the EPAV assumption has on Rector's proposed 958% RBC, and how great the decrease is in needed surplus when that assumption is brought into line with MIEAA's "efficiency" requirement.

In addition, Mr. Shaw again addressed the fact that Rector increased surplus over 2009 to account for this factor in the model—this time the increase being 70 basis points. *See* May 13 DISB Letter, at 14. But again, as Mr. Shaw explains, the increase is not justified. First, as he shows in his report, Shaw Report 35, GHMSI assets invested in stocks have significantly declined since 2009 as a percentage of non-FEP premiums. Second, as was the case with premium growth and RAAF, the downward correction from 958% RBC in 2013 more than cancels the 70-point increase since 2009 that Rector recommends.

d) Rector's Inflated Assumptions: Other Risk Factors

In addition to examining the assumptions Rector used in the Milliman model for premium growth, RAAF, and EPAV, Mr. Shaw also considered the assumptions for various other risk factors: change in interest rates; overhead expense and fee income; catastrophic events; and unidentified growth and development. Each of these has inappropriate values, is already accounted for in other risk factors, or is not really a risk to GHMSI at all.

For example, Mr. Shaw finds to be completely unjustified the assumption in the model that 90% of the time the company should expect its bond portfolio and pension plan to be negatively affected by changes in interest rate/discount rates. He also finds that increases in surplus for overhead expenses or fee income risks are unsubstantiated and/or should have already been captured in the RAAF factor. He finds the same to be true of increased surplus for catastrophic events and for unidentified development and growth.

In his statement Mr. Shaw concludes that these factors should be removed from the model, and that the result of doing so is to decrease the need for surplus by approximately $75 million. Shaw Report 43.

e) Rector's Underestimation of Management's Ability to Mitigate Risk

In its 2009 Report, Rector assumed that GHMSI's management would be attentive and competent to respond to any adverse developments indicative of forthcoming operating losses. Accordingly, in the previous proceeding Rector "adjusted the loss curve downward" in the stochastic modeling process, to account for certain management actions that would head off adverse results: changes to reserve margins, changes to pricing margins and underwriting standards, and deferral of infrastructure investments. Rector estimated that these adjustments reduced by 190 basis points the RBC ratio necessary to maintain 200% RBC at the 99% confidence level. DISB May 13 Letter, at 12–14.

In its 2013 Report, Rector eliminated this 190-point decrease in surplus, apparently eliminating any consideration of management intervention in avoiding losses. As a result, Rector actually *increased* surplus by 190 points—roughly equal to $190 million dollars—between 2009 and 2013. As with its increases for premium growth, RAAF, and EPAV, Rector does not justify this significant increase in surplus.

With respect to reserve margins, DISB has apparently directed Rector not to take into account the possibility that the 10% cushion in claim reserves might be used as an element of management intervention in the event of a company reduction in surplus. But even giving full credit to this preclusion, Rector cannot justify the 190-point increase in surplus.

The claim reserve issue accounts for only 70 of the 190 points attributable to management intervention. DISB May 13 Letter, at 12. With respect to the remaining forms of management intervention—pricing margins and underwriting standards, and deferred infrastructure investments—Rector says that it accounted for them in other assumptions in the model. But it does not say how it did this and there is no indication that the accounting had any effect on surplus.

Although Rector's probability distribution for RAAF now apparently takes into account pricing margins, there is no indication of the extent to which the opportunity to increase premium rates led Rector to change the probability distribution for RAAF in the direction of reduced risk. In fact, as we have shown, a corrected probability distribution for RAAF would completely eliminate Rector's increase of 150 percentage points in that factor, even at the 98% confidence level and accepting all of Rector's other assumptions. Thus, whatever reduction Rector made in the RAAF factor to account for the possibility of increasing pricing margins, it still left that factor too high. Therefore, Rector's 190-point increase is also too high. Moreover, as earlier discussed, it is apparent that the entire 150-point increase in RAAF was attributable to ACA, and there is no indication that the factor would have been higher but for considerations of management intervention.

In addition, any adjustment Rector may have made for pricing margins was too small given Rector's statement that "it is, of course, no longer possible for insurers to employ underwriting techniques due to healthcare reform restrictions enacted by ACA." DISB May 13 Letter, at 11. As Mr. Shaw points out, "[t]his explanation is of course only applicable to underwriting of individuals. Small group policies have been guaranteed issue since the early 1990's. ACA did not change insurer's abilities to underwrite large groups at all. Thus, Rector proposes to eliminate a factor that affects 100% of GHMSI's business due to a change that impacts less than 10% of GHMSI business. Shaw Report 48–49. This is significant since, according to the May 13 Letter, this element of management intervention resulted in a 70-point reduction in surplus in 2009.

Similarly, although in 2009 Rector made adjustments for management intervention through deferred investment in infrastructure—which according to the May 13 letter decreased the need for surplus by 50 basis points—there is nothing demonstrating that any similar adjustment was made in 2013. To the contrary, "[i]t is not clear whether Rector has even made a net reduction to the Unidentified Growth and Development factor in its 2013 Report (or the magnitude of any reduction) from the amounts assumed in its 2009 Report." Shaw Report 49. The likelihood that no comparable adjustment was made is increased by the fact that deferred infrastructure has never been mentioned by Rector at all in its tables describing changes between 2009 and 2013.

In sum, Rector has increased its estimate of needed surplus by $190 million when, at most, only $70 million has been justified.

3. Rector's Failure To Validate Milliman

Validating the model against actual experience to show that the model can fairly predict actual surplus needs is essential under MIEAA, because MIEAA rejects the assumption that more surplus is necessarily better. Therefore, a model that does not appropriately consider actual historical experience violates MIEAA's requirements.

Proper validation should identify the extent to which the model reflects actual and peer experience, and should identify assumptions that do not align with experience and therefore require strong reasons for inclusion. The need for testing is underscored by Rector's exclusive reliance on the Milliman model, which Milliman has apparently not changed at all to take account of MIEAA.

Rector states that it "performed various tests to validate the general accuracy and completeness of the Milliman model and assumptions," which included tests "*both as to specific assumptions* and as to the model as a whole." Rector Report 34 (emphasis added). Rector explains that the tests enabled Rector to conclude that it is appropriate to use the Milliman model . . . and that *key assumptions* incorporated into the model, as adjusted, are appropriate." *Id.* DC

Appleseed accordingly requested "all the validation tests that were performed and . . . the data from these tests that confirm the appropriateness of the Milliman model and the assumptions used in it." Letter from Walter Smith, Exec. Dir., DC Appleseed, to Chester A. McPherson, Interim Comm'r, D.C. Dep't of Ins., Secs. and Banking (Jan. 29. 2014), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/DCACLettertoDISBwithattachments012914.pdf. Rector's response in its entirety is the February 7, 2014, FTI Memorandum.[30] Memorandum from Jim Toole, FTI Consulting, to Rector and Associates (Feb. 7, 2014), *available at* http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/FTIModelValidationAnalysis-2714.pdf [hereinafter Feb. 7 FTI Memorandum]. However, that Memorandum does not validate any of the many assumptions that went into the stochastic model or that constitute the pro forma financial projections. Thus, the FTI Memorandum does not do what Rector says it does.

Mr. Shaw, emphasizes that Rector should have validated each key assumption. Shaw Report 51. Moreover, with respect to its claimed validation of the overall Milliman model, Rector failed in multiple respects to comply with the Actuarial Standards of Practice, which require identification of "methods, procedures, assumptions, and data" sufficient to enable a qualified actuary to make "an objective appraisal." *Id.* at 53.

Even without the disclosure required by the standards of practice, the FTI Memorandum is insufficient to validate the Milliman model (nor does it even purport to validate Rector's use of that model). FTI uses as the measure of validation a comparison of the historical *median* value of GHMSI's annual surplus change with the median values generated by the Milliman model. Feb. 7 FTI Memorandum 1. It finds that the "Milliman [surplus] growth assumption is within one standard deviation of the actual one-year surplus changes." *Id.* at 46.

As Mr. Shaw explains, validating the median output value may be one step in validation, but is not alone sufficient. The "whole purpose of the Milliman model or any model used to calculate needed surplus is not to establish a median, but to provide protection against *outlier* results." Shaw Report 47 (emphasis added). Outlier results are what may endanger the surplus of a company. Thus, comparing the *dispersion* of results "is the most crucial requisite for validation." *Id.*

The median says nothing about the dispersion of results or about outliers. For example, in each of the series below, the median value is identical, 2%.

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[30] Rector's Report is reasonably read to say that the validation testing was both for "general accuracy" and for "key assumptions." But FTI performed only a "model validation of overall results," claiming that doing so "captures the entire range of forces acting on the company's results." FTI Memorandum 1.

- Example 1: -1%, 1%, 2%, 3%, 5%
- Example 2: -40%, -30%, 2%, 3%, 6%

Yet the dispersion in each example is very different (-1% to 5% versus -40% to 6%). Knowing that the medians are identical tells nothing about whether either example correctly predicts outlier results. In the above examples, Example 2 would require significantly more surplus than Example 1. *Id.*

Neither Milliman nor Rector calculated the surplus requirement by using median results. They instead used extreme results—"the 490,000th worst result out of 500,000 stochastic model results . . . to calculate the surplus needed for 98% certainty." *Id.* Thus, Rector's error in failing to test against outliers when attempting to validate the model could not be more fundamental.[31]

Rector's failure to validate the model confirms our view that Rector's use of the model does not meet MIEAA's efficiency standards. In fact, given the number and magnitude of unrealistic assumptions embedded in the model, it is unsurprising that Rector's results do not validate.

4. The Efficiency Standard Is Further Undermined by Rector's Use of an $83 Million "Safe Harbor"

Having determined that GHMSI needs surplus at the 958% RBC level in order to be "financially sound" within the meaning of MIEAA, Rector goes further and concludes that because "the selection of a 958% RBC implies a degree of precision that does not, in fact, exist," it "makes sense to establish a range around the 958% RBC target, which could be considered a 'safe harbor' of sorts." Rector Report 12–13. To create this "safe harbor," Rector first determined that GHMSI's surplus changed an average of 82.5 percentage points from year to year during the 2004–2012 period. It then reasons that GHMSI should therefore be allowed to hold surplus 82.5 percentage points (or about $83 million) above or below the 958% target and still be considered in compliance with MIEAA.

Based on this reasoning, Rector says "we conclude that GHMSI should strive for a target of 958% and that GHMSI's surplus should be measured against a Benchmark Range of 875%–

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[31] Moreover, the FTI validation actually embeds a confidence level of 99.8%—which obviously violates MIEAA and is far higher than is reasonable in actuarial practice. As Mr. Shaw explains, FTI validated to one standard deviation below the historical median. One standard deviation below the median is at the 16th percentile of model results. "If the Milliman model calculates a 98% confidence based on reconciliation at one standard deviation below the median, then statistically Milliman is really calculating a 99.8% confidence level of protection." Shaw Report 47.

1040% RBC." Stated another way, Rector says that "if GHMSI's surplus stays within the 875%–1040% RBC range, it is the functional equivalent of being at the 958% RBC target for purposes of the MIEAA standard." Rector Report 13. For several reasons, we believe this analysis is completely inconsistent with MIEAA and should be rejected by the Commissioner.

First, permitting GHMSI to hold surplus that is 83 percentage points higher than 958% RBC is not "the functional equivalent" of being at 958% RBC. It is the functional equivalent of permitting GHMSI to withhold an additional $83 million from community reinvestment.

Second, MIEAA calls for the Commissioner to determine a point at which GHMSI becomes financially sound. Without determining that point, the Commissioner cannot hold GHMSI to its obligation to commit the "maximum feasible" amount of its surplus to community reinvestment. Deciding that GHMSI is meeting that obligation so long as its surplus is within a nearly 200 percentage point range is the functional equivalent of reading MIEAA to say "maximum feasible plus or minus $83 million." The Commissioner should reject that reading of the statute. Instead, the Commissioner should determine the point at which GHMSI is financially sound, and should read the statute to require all additional dollars above that point to be committed to community reinvestment.

Third, Rector's unwillingness to specify a point at which additional surplus will be considered excessive conflicts with the approach it has taken previously. During the last proceeding Rector relied on the Milliman model to select a single point (600% RBC) above which surplus would be considered excessive. Rector stated, "if one believes that GHMSI's surplus is 'excessive' to the extent that it exceeds what is needed to remain above a 200% RBC target threshold, then GHMSI would have 'excessive surplus' to the extent that its surplus . . . is greater than . . . 600% RBC based on our calculations." Rector 2009 Report 4. We think Rector got it right last time.

Finally, although we agree with Rector that as practical matter GHMSI's surplus will vary over time and the company will not always be exactly at its permissible RBC level, it does not follow from this that MIEAA permits GHMSI therefore to have an additional $83 million in surplus. MIEAA's efficiency requirement precludes Rector's new approach.

B. Efficiency Concept 2: GHMSI's Surplus Should Be Adjusted for Administrative Inefficiency

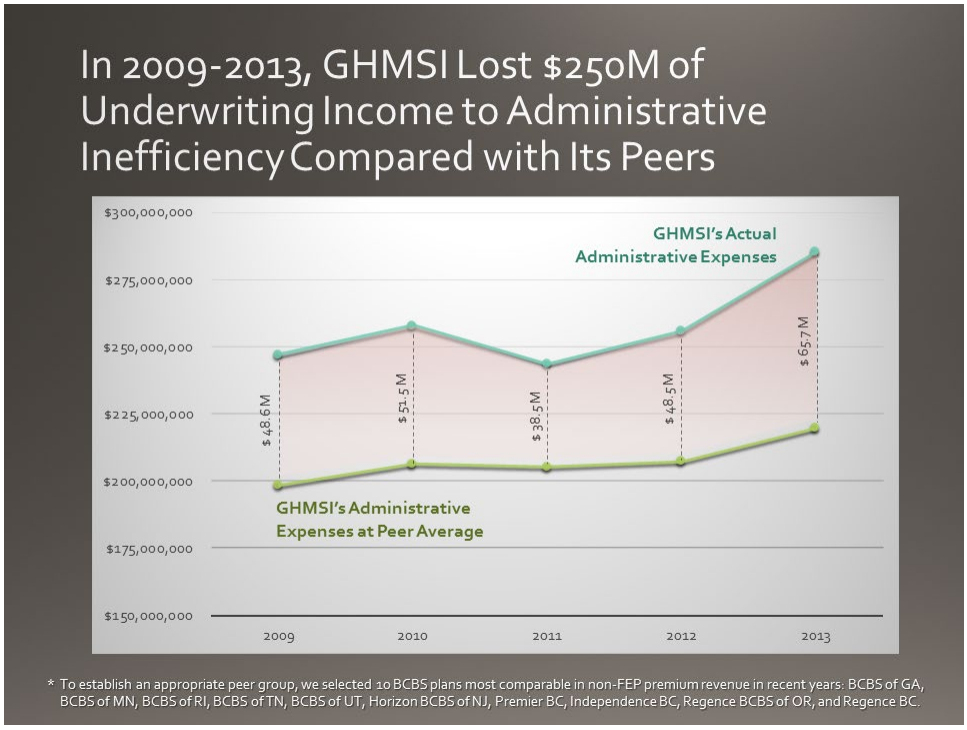
Rector's analysis also fails to address the other key element of MIEAA's efficiency standard—GHMSI's administrative efficiency. This inefficiency increases costs unnecessarily, drives up the need for surplus unnecessarily and therefore drives down the surplus available for community health reinvestment required by MIEAA. Rector should have considered the impact of GHMSI's inefficiency on its surplus, which we address below.

A standard indicator of efficiency in the health insurance industry is the company's expense ratio, that is, the ratio of its general administrative and claims adjustment expenses to its premium revenue. GHMSI's ratio is much higher than its peers reporting similar revenues. As shown in Chart 13 of the attached statement of Mr. Shaw, for non-FEP business, GHMSI's expenses in 2013 as a percent of its revenues were 130% of the average of ten other Blues plans. In each of the past five years, GHMSI ranked among the three least efficient companies in this peer group (that is, the companies with the highest expense to premium ratios). Mr. Shaw's analysis also shows that, over the last five years, GHMSI's expense ratio has increased steadily, from 18.19% in 2009 to 21.18% in 2013, indicating that GHMSI has become less efficient. Because Rector took no account of MIEAA's "efficiency" requirement, it ignored GHMSI's poor performance in this area.

Mr. Shaw calculates that GHMSI's high expense levels in non-FEP business have reduced the company's underwriting gains by more than $250 million over the past five years, thus driving the need for increased surplus. *See infra* Figure 6. Mr. Shaw explains the relationship between high expenses and surplus, noting that inefficient costs reduce an insurer's profit and therefore increase the likelihood of an underwriting loss. The more likely the company is to experience an underwriting loss, the more surplus it needs. This is particularly true under the ACA, because the Medical Loss Ratio requirement obligates insurers to apply a minimum percentage of their premium to pay benefits and to limit their expenses. Shaw Report 39. Lower expenses, all else equal, would have reduced the company's need for surplus, thereby increasing the excess surplus that could have been used for community health needs.

By contrast, if GHMSI were assumed to be as efficient as the average of its peers, the rating adequacy and fluctuation factor would have a less negative impact on estimated required surplus. Specifically, the RAAF probability distribution would shift by an average of +3.69 percentage points (that is, by the excess of GHMSI's expense ratio over its peers) from a range of -18.2% to +30.1%, to a range of -14.5% to +33.8%. *See id.* at 44 ch. 19; *see also* Rector Report 22 tbl. The result is a reduction in GHMSI's underwriting gains of approximately $51 million per year and $153 million over the three-year period being reviewed in this proceeding (2012–2014). Shaw Report 44 ch. 19

FIGURE 6



For the Commissioner to ignore administrative inefficiency would be legal error. By definition, a less efficient company has costs it could eliminate without impairing its financial soundness. As already discussed, such costs narrow margins, increase the risk of loss, and thereby increase the amount of surplus required to avoid 200% regardless of the confidence level used. To allow administrative inefficiency to reduce community health reinvestment would violate the efficiency standard and MIEAA's directive that GHMSI engage in community investment to the "maximum feasible extent."

III. RECOMMENDATION: The Commissioner Should Determine that GHMSI's Surplus is Excessive and Order the Company to Submit a Plan Dedicating that Excess to Community Reinvestment

In Part I we showed that MIEAA's "maximum feasible" standard requires a calibrating and balancing of the confidence level and that this process should lead the Commissioner to approve a confidence level of 90%, rather than the 98% endorsed by Rector and Milliman.

In Part II, we showed that MIEAA's "efficiency" standard requires revisions to the assumptions used by Rector in the Milliman model, and also requires an adjustment for GHMSI's inefficient administrative expenses relative to its peers.

In this Part III, we combine these showings and suggest a course for the Commissioner to follow in this proceeding.

The results we have presented in Parts I and II are summarized in the following chart.

FIGURE 7

	Permissible Surplus (Using Given Confidence Levels of Avoiding 200% RBC)					
	Without Adjustments for Changes in Premium Growth Assumptions			*With* Adjustments for Changes in Premium Growth Assumptions		
Confidence Level	**98%**	**95%**	**90%**	**98%**	**95%**	**90%**
Corrections to Model						
None (Adjusting Rector only for confidence level)	958%	795%	647%	752%	625%	509%
Surplus after correcting RAAF	766%	665%	569%	602%	522%	447%
Surplus after correcting EPAV	743%	587%	427%	584%	461%	335%
Surplus after correcting Other Risk Factors	883%	708%	546%	693%	556%	429%
Surplus after correcting both RAAF and EPAV	587%	465%	352%	461%	365%	276%
Surplus after correcting RAAF, EPAV, *and* Other Risk Factors	508%	386%	262%	399%	303%	205%

This chart shows the impact of the changed assumptions we recommend, both individually and cumulatively, as well as how those changed assumptions affect surplus at three different confidence levels 98%, 95%, and 90%. The chart also shows the impact both with and without the change to premium growth we recommend.

The results of these corrections, separately and cumulatively, contrast dramatically with Rector's target ratio of 958% RBC. If, for example, the corrections are made to both RAAF and EPAV, the required RBC ratio is

- 587% at the 98% confidence level;
- 465% at the 95% confidence level; and
- 352% at the 90% confidence level.

With the introduction of the corrected premium growth assumption, those ratios are:

- 461% at the 98% confidence level;
- 365% at the 95% confidence level, and
- 276% at the 90% confidence level.

These results are probably not a perfect match with those that we would obtain if we had been provided with complete information about the pro forma assumptions, including in particular the expected expenses. But, as Mr. Shaw demonstrates, Shaw Report 49, they are close and highly indicative.

These results from Mr. Shaw demonstrate how much lower GHMSI's surplus should be if the MIEAA standards were followed. It has been nine years since then-Commissioner Mirel found that GHMSI's $500 million surplus was too large, *see* Mirel 2005 Report, *supra* n.15, six years since the DC Council found GHMSI's then RBC ratio of $761 million (or 916% RBC) to

be "high" "[b]y any measure," Committee Report 6; and nearly four years since the first review under MIEAA, in which the Commissioner found that the maximum permissible surplus was around $687 million—even without applying the "maximum feasible" and "efficacy" standards. *See D.C. Appleseed*, 54 A.3d at 1196, (stating that GHMSI's year-end 2008 surplus was $687 million or 845% RBC, and that the maximum permissible RBC was 850%). Yet even in the three years since the Commissioner's decision, the surplus has grown by another by $300 million.

Given how long GHMSI's surplus has been growing unchecked and given that the MIEAA standards are now six years old and have yet to be applied, it is not at all surprising that a rigorous application of those standards results in a finding that GHMSI has a substantial excess surplus as defined by MIEAA.

The delay in this review of surplus at year-end 2011 has a further significance, with respect to GHMSI's financial soundness and the amount of year-end 2011 surplus that GHMSI can feasibly devote to community health. As we have previously discussed, the predictions that underlie Rector's 958% RBC ratio protect against a risk that GHMSI would somehow lose at least $700 million over the three year period that ends this year. As we have already discussed, when, as here, the issues turn heavily on predictions, it is entirely within the Commissioner's authority to take into account actual results occurring subsequent to those predictions. *See supra* n.19. There is no evidence to indicate that GHMSI might sustain a loss of $700 million in the next six months, or any loss even remotely close to that amount. It would be arbitrary for the Commissioner to ignore the extent to which actual results underscore the incorrectness of the assumptions Rector used to predict surplus needs for the 2012–2014 period at issue here.

We think the Commissioner should draw three conclusions from the evidence presented here.

First, Rector has failed to apply either the "maximum feasible" or the "efficiency" requirement in its 2013 Report. By replicating Milliman's stochastic model, and making adjustments to the model as required by MIEAA's "maximum feasible" and "efficiency" requirements, Mark Shaw has provided the Commissioner a way to make the adjustments to the model that are required by MIEAA, and to see the impact they have on surplus. *See infra*, Figure 7; *see also* Shaw Report 58 ch. 25. These adjustments require substantial decreases to GHMSI's allowable surplus. Although there are many combinations of adjustments to be considered, it is clear to us that in no event should the surplus be any larger than a specific point between 400 and 500% RBC, depending on the adjustments the Commissioner approves.

Second, Rector has not justified any increase from its 2009 surplus estimate (600% RBC at 99% confidence level, or 552% RBC if the confidence level were adjusted to the 98% level it uses in its 2013 report). As Mr. Shaw shows, if anything, there should be downward adjustments

from that 552% for premium growth, EPAV, and RAAF. Rector has not justified an upward adjustment in surplus based on the failure of management intervention, let alone adding back in the full 190 points by which Rector *reduced* surplus to account for effective management intervention in the last proceeding. Even if some upward adjustment were required for ineffective management intervention, it would be more than offset by the other downward adjustments for premium growth, EPAV, and RAAF—even *before* taking into account the downward adjustments Rector recommends.

Using Rector's 2009 analysis should therefore lead the Commissioner to conclude that the maximum surplus that should be allowed now is the figure Rector determined was appropriate in 2009 to avoid falling below 200% RBC with 98% Confidence—552% RBC. And in our view, for reasons laid out in Part I, that 552% number should be adjusted downward to 483% RBC or 420% RBC to apply either a 95% or 90% confidence level. This indicates that an efficient surplus that meets the maximum feasible requirement without undermining financial soundness is at most a specific point between 400 and 500% RBC.

Both of these approaches—appropriately reducing the 958% RBC ratio Rector now recommends and precluding increases from the level Rector recommended in 2009—suggest that GHMSI's maximum permissible surplus is a point between 400 and 500% RBC. The fact that both approaches yield the same range for defining that point confirms the reliability of this 400 to 500% range.

Third, we think the evidence before the Commissioner provides an opportunity to establish a number of basic principles in surplus review, setting the course for future surplus reviews and for GHMSI's management of its surplus:

- The Commissioner should establish that the proper confidence level, calibrated to the actual consequences of falling to 200% is 90%. We discussed the reasons for that change at length in Part I. The confidence level is a legal choice under MIEAA. The proper choice does not vary with circumstances, whether historical, current, or forward-looking. It does not depend upon probability distributions for risks. The Commissioner can resolve this issue once and for all.
- The Commissioner should affirm that validation of a model must be with respect to outliers and not medians because outlier results can adversely impact surplus. Moreover, validation should proceed with respect to each major risk factor, and not only for the model as a whole. Reliance on errors to cancel each other out should be impermissible under MIEAA.
- The Commissioner should decide that MIEAA does not allow GHMSI's permissible surplus to take into account GHMSI's own administrative inefficiency. GHMSI's surplus should be calculated on the assumption, as we have described, that it is at least as administratively efficient as its peers. When, as now, it is substantially less efficient, the

surplus attributable to the inefficiency is not "efficient" surplus, and the inefficiency is preventing community reinvestment that, by any reasonable definition of the term, is "feasible." This suggests that at least on a prospective basis the Commissioner should require GHMSI to bring its expenses into line with its peers so that it can maximize community reinvestment.

- The Commissioner should confirm the primacy of historical experience in developing risk factors for stochastic modeling; reject reliance on the historical period preceding the adoption of RBC and stable provider contracts (in other words, the period prior to the mid-1990s); and make clear that any departures from historical experience must be justified by strong and fully disclosed reasons.
- The Commissioner should hold that the calculation of surplus under MIEAA requires taking into account the risk mitigation and gain-limiting factors of the ACA (the three Rs), for their impacts in avoiding large losses and in reducing variability.
- The Commissioner should reject the notion of a "safe harbor" around the properly calculated target surplus (Rector's +/- 83 percentage points). That approach, for reasons we have discussed, undermines MIEAA's commitment to providing the maximum feasible amount for community reinvestment.

Finally, although we believe this proceeding must be the occasion for a substantial one-time correction to an excess built up over a long period, it is also a proceeding that will govern GHMSI's surplus for only a short time. The next mandatory review of GHMSI's surplus is by statute required for GHMSI's surplus as of the end of 2014. If the current proceeding applies the correct legal standards and results in an appropriate reduction of the long-built-up surplus, future proceedings should be easier and of much less dollar consequence. Furthermore, for that proceeding, there will be substantial actual experience under the ACA, which has been a source of much controversy in this proceeding.

CONCLUSION

This proceeding provides the Commissioner the opportunity to make the long-overdue adjustment to GHMSI's surplus, bringing it into compliance with MIEAA's standards. The transitional adjustment is large. Once made, and with MIEAA ground rules in place, GHMSI should be able to manage its surplus as MIEAA intended.