

**COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION**

BUREAU OF INSURANCE

**BUREAU REPORT REGARDING THE IMPACT OF THE
DISTRIBUTION OF GHMSI'S EXCESS SURPLUS
ON VIRGINIA RESIDENTS**

Ex Parte: In the matter of an examination of
Group Hospitalization and Medical Services, Inc.

CASE NO. INS-2015-00007

April 15, 2015

**REPORT OF THE BUREAU OF INSURANCE ON THE IMPACT OF THE
DISTRIBUTION OF GHMSI'S EXCESS SURPLUS ON VIRGINIA RESIDENTS**

Section I: Background

A. GHMSI and the MIEAA

Group Hospitalization and Medical Services, Inc. ("GHMSI" or "the Company") is a health services plan,¹ which, together with its affiliate companies, offers health care coverage to 3.3 million members in the District of Columbia ("DC"), Maryland, and Northern Virginia. GHMSI was created and organized as a "charitable or benevolent institution," by Congressional charter in 1939.² This federal charter required that the Company operate as a nonprofit entity for the benefit of its certificate holders and that GHMSI be both legally domiciled in DC and licensed and regulated in accordance with DC's laws and regulations.³

In 2009, the Council of the District of Columbia enacted a law requiring GHMSI to distribute any surplus that is considered excess and attributable to DC towards community health reinvestment. Specifically, the Medical Insurance Empowerment Amendment Act of 2008 ("MIEAA"),⁴ which amended the Hospital and Medical Services Corporation Regulatory Act of 1996,⁵ requires the Commissioner of the DC Department of Insurance, Securities, and Banking ("DISB") to periodically review the portion of GHMSI's surplus that is attributable to DC and to determine whether this surplus is "excessive." The MIEAA was passed in response to a 2004 report that questioned whether GHMSI was meeting its charitable obligations, as well as a finding by the Commissioner of DISB in 2005 that GHMSI should have been engaging in more charitable activities.

Under the MIEAA, if the Commissioner of DISB determines that the surplus is excessive, he must order the Company to submit a plan for dedication of the excess surplus generated by business in DC to "community health reinvestment to the maximum feasible extent consistent with financial soundness and efficiency."⁶ Although DISB possesses primary regulatory authority over GHMSI's distribution of excess surplus, the MIEAA also requires DC to coordinate with the other jurisdictions in which the Company conducts business. Thus, DISB is required by law to coordinate with both Maryland and Virginia on any actions related to the Company's surplus.

On November 13, 2009, DISB published regulations pursuant to the MIEAA.⁷ These regulations establish procedures for determining excess surplus and require GHMSI to file an annual financial report with DISB detailing "the company's surplus and examin[ing] whether the

¹ Va. Code § 38.2-4201 (defining "health services plan" as "any arrangement for offering or administering health services or similar or related services by a nonstock corporation licensed under this chapter.").

² An Act providing for the incorporation of certain persons as GHMSI, approved Aug. 11, 1939 (Pub. L. No. 76-395, § 8; 52 Stat. 1412, 1414), as amended (the "Charter").

³ Charter at §§ 1, 3, 5.

⁴ DC Law 17-369.

⁵ DC Official Code § 31-3501 *et seq.*

⁶ DC Official Code § 31-3501(1A) defines "community health reinvestment" as "expenditures that promote and safeguard public health or that benefit current or future subscribers, including premium rate reductions."

⁷ See 56 DC Reg. 8841 (2009).

company's surplus is considered excessive."⁸ They also specify that if the Commissioner of DISB determines that the Company's surplus is excessive, a public hearing must be held to determine whether the Company's surplus is "excessive and unreasonably large."⁹

B. Determination of Excess Surplus Attributable to DC

The MIEAA establishes a two-part test to determine whether the surplus held by GHMSI is excessive. Surplus is defined under the MIEAA as "the amount by which all admitted assets of the corporation exceeds its liabilities, inclusive of reserves."¹⁰ Under the two part test, GHMSI's surplus may be considered excessive only if:

- (1) The surplus "is greater than the appropriate risk-based capital requirements as determined by the Commissioner [of DISB] for the immediately preceding calendar year;" and
- (2) The Commissioner of DISB determines, after a hearing, "that the surplus is unreasonably large and inconsistent" with GHMSI's statutory obligation to engage in community health reinvestment to the maximum feasible extent.¹¹

Under the first part of this test, the Commissioner of DISB must determine whether the Company's surplus is greater than certain risk-based capital requirements developed by the National Association of Insurance Commissioners ("NAIC"). Risk-based capital ("RBC") is a method of measuring the minimum amount of capital appropriate for an insurer to support its overall business operations in consideration of its size and risk profile. In general, RBC is a mathematical formula that considers three classes of risk – asset risk, underwriting risk, and other risk – and requires an insurer with greater risk to hold a higher amount of capital in order to protect against insolvency.

RBC standards take into account the calculated minimum amount of capital an insurer should hold, which is often referred to as the "authorized control level" ("ACL"). Typically, an insurer's ACL is compared to its actual capital level, and the resulting percentage, referred to herein as the "RBC-ACL," serves as an early warning system that alerts regulators to undercapitalized companies while there is still time for the regulators to react effectively to minimize the overall costs associated with insolvency. State laws give regulators clear legal authority to intervene in the business affairs of an insurer that triggers one of the action levels specified in the RBC law. For example, a drop in surplus below 200% RBC-ACL will place the insurer at "company action level," which triggers certain requirements such as the filing of a corrective action plan to bring its surplus to a safer level. This was in fact the benchmark level chosen by DISB against which GHMSI's surplus was measured.¹²

Once it has been determined that GHMSI's surplus exceeds the benchmark RBC level of 200%, the Commissioner of DISB must then determine the level of surplus that will maximize the

⁸ 26-A DCMR § 4601.1 (2009).

⁹ *Id.* at § 4601.5.

¹⁰ DC Code §§ 31-3501(11), 31-3509. Virginia has a similar definition of "surplus." Va. Code § 38.2-100.

¹¹ DC Code § 31-3506(e).

¹² The other benchmark selected by DISB was 375% RBC-ACL, which is the Blue Cross Blue Shield Association "Early Warning" threshold.

Company's community health reinvestment without undermining its financial soundness and efficiency. This target level of surplus for the Company is then compared to GHMSI's actual surplus to determine whether there is excess surplus. In addition, confidence levels are used to calculate the amount of surplus that is necessary to provide a specific level of confidence that the Company's surplus will not fall below the benchmark RBC level of 200% during a three year period.

C. DISB Proceeding to Determine Excess Surplus

DISB's initial review of GHMSI's surplus under the MIEAA occurred in 2009. In that proceeding, the Commissioner of DISB concluded that the Company's 2008 surplus of 845% RBC-ACL was not excessive. This decision was appealed to the DC Court of Appeals, which ultimately vacated the ruling and remanded it. On remand, DISB did not return to its 2009 analysis, but instead, incorporated the court's decision into its review of GHMSI's surplus as of December 31, 2011.

For its review of GHMSI's 2011 surplus, DISB retained an insurance regulatory and financial analysis firm, Rector & Associates, Inc. ("Rector"), and an actuarial firm, NovaRest, Inc., to assist in determining a target surplus level. Rector utilized, with certain modifications, an actuarial model developed by Milliman, Inc. ("Milliman") that was used by GHMSI to forecast its long-term surplus needs over a three year projection period. DISB also solicited and analyzed information submitted by GHMSI, the Maryland Insurance Administration and the Bureau of Insurance ("Bureau"), as well as DC Appleseed Center for Law and Justice, Inc.

On December 30, 2014, following a lengthy proceeding, the Commissioner of DISB issued a Decision and Order ("DISB Order").¹³ The Commissioner of DISB found that GHMSI's surplus as of December 31, 2011 was 998% RBC-ACL (\$963.5 million). Based on an evaluation of GHMSI's historical experience and projected future experience, the Commissioner concluded that the appropriate target surplus for the Company was 721% RBC-ACL (\$695.9 million). According to the Commissioner of DISB, any target surplus below this level would neither be financially sound nor efficient for the Company and its subscribers, while any target surplus above 721% RBC-ACL would be inefficient and inconsistent with the statutory requirement that the Company maximize its community health reinvestment. The Commissioner of DISB also utilized a confidence level of 95%, which he believed provided "a high level of confidence that GHMSI's surplus will not fall below 200% RBC-ACL and therefore is consistent with financial soundness and efficiency."¹⁴

Based on the above findings, the Commissioner of DISB determined that GHMSI had excess surplus of approximately \$267.6 million at year-end 2011. Of that amount, \$56.2 million, or 21%, of this excess surplus was found to be attributable to DC. GHMSI was therefore ordered to submit to DISB a plan for dedication of its excess surplus attributable to DC to community health reinvestment.¹⁵

¹³ Order No. 14-MIE-012 (Dec. 30, 2014).

¹⁴ DISB Order at 26.

¹⁵ GHMSI has filed an appeal with the DC Court of Appeals seeking review of the DISB Order and DISB's order dated January 28, 2015, denying GHMSI's Motion for Reconsideration. On April 6, 2015, the Company filed with

In reaching his determination that GHMSI held excess surplus of \$56.2 million attributable to DC, the Commissioner of DISB utilized a target RBC-ACL level and confidence level that was lower than what his consultant Rector had recommended. Rector had estimated that GHMSI would need a surplus range of 875-1040% RBC-ACL to ensure that it would not fall below 200% RBC at a 98% confidence level. Rector's proposal was itself a reduction in Milliman's recommended target surplus range of 1050-1300% RBC-ACL using a 98% confidence level. In a separate proceeding, Maryland had determined that as of September 14, 2012, a target surplus range of 1000-1300% RBC-ACL was "neither excessive nor unreasonably large."¹⁶

D. Actions in Virginia to Address DISB Surplus Review

In 2010, the Virginia General Assembly responded to DISB's surplus review by enacting § 38.2-4229.2 of the Code of Virginia ("Code"). This law authorizes the Commission to determine whether the impact of another state's law requiring "a health services plan operating in Virginia to provide a program or benefits for the residents of the other state" is harmful to the interests of Virginia residents. If the Commission determines that the program or benefits are harmful to Virginia residents, it is authorized to take certain actions to, among other things, prevent the plan from utilizing premium or surplus attributable to Virginia residents to subsidize the program or benefits for the residents of that other state.

The Bureau was not a party to DISB's surplus review proceeding, and its participation was limited to submitting a post-hearing statement dated September 29, 2014, in which it made the Commissioner of DISB aware of the requirements set forth in § 38.2-4229.2 of the Code.

During the 2015 legislative session, the Virginia General Assembly amended § 38.2-4229.2 of the Code to address the impact of the DISB Order issued in December 2014. The amendments, which took effect on March 23, provided the Commission with additional authority to protect the interests of Virginia residents from the impact of any DISB-ordered reduction in GHMSI's surplus.

The law now specifically *requires* the Commission to conduct a proceeding to review the impact of any law "or other regulatory action" that requires a health services plan operating in Virginia to distribute or reduce its surplus on the grounds that it is excessive. It also provides the Commission with authority to, among other things, prohibit a health services plan such as GHMSI from distributing or reducing its surplus for the benefit of residents of another state if it finds that the other state's action is harmful to these interests.

On January 21, 2015, the Commission directed the Commissioner of Insurance to conduct an examination of GHMSI pursuant to §§ 38.2-1317 and 38.2-4229.2 of the Code.¹⁷ The Commission directed the Commissioner of Insurance to file a report that, at a minimum, evaluated the impact of the DISB Order on: (i) surplus; (ii) premium rates for Virginia residents; and (iii) solvency. The Commission also ordered the Commissioner of Insurance to include in her report a recommendation as to whether the DISB Order would result in harm to the interests of Virginia residents covered by GHMSI policies.

the court a request for a temporary stay until any additional appeals of DISB's order approving or disapproving GHMSI's plan are filed.

¹⁶ MIA-2012-09-006.

¹⁷ Case No. INS-2015-00007.

Pursuant to the Commission's Order dated January 21, 2015, the Bureau has conducted its examination as directed and retained Lewis & Ellis, Inc. ("L&E") to prepare a report on the impact of this distribution of surplus by GHMSI on both the Company and on Virginia residents ("L&E Report"). The L&E Report is discussed in detail in Section II of this report.

Section II: Summary of L&E Report

At the direction of the Bureau, the L&E Report focused primarily on the impact of the DISB-ordered distribution on: (i) GHMSI's surplus; (ii) GHMSI's solvency; and (iii) premium rates charged to Virginia residents. As discussed below, L&E concluded that if the DISB-ordered distribution of \$56.2 million is a one-time distribution, surplus will be within L&E's recommended range to protect solvency and it may result in a slower rate of premium growth in Virginia.

The starting point for L&E's analysis was the model developed by Milliman, as modified by Rector ("Modified Milliman model").¹⁸ This model was used in the DISB proceeding to determine how much surplus GHMSI should maintain to ensure that its surplus will not fall below the benchmark threshold of 200% RBC-ACL. The model does this by identifying various risks and contingencies to which GHMSI is subject, and estimating the probabilities and severities for each risk based on historical experience and projections for how future experience may deviate from historical experience.

L&E determined that the appropriate target surplus range for GHMSI was 798-963% RBC-ACL. The difference between this target surplus range and the Commissioner of DISB's target surplus of 721% RBC-ACL resulted primarily from L&E's use of a 98% confidence level with 200% RBC-ACL as the target benchmark, in contrast to the 95% confidence level utilized by the Commissioner of DISB in the surplus review proceeding.

L&E also considered it appropriate to use the most recent financial data available; therefore, it applied its recommended target surplus level of 798-963% RBC-ACL to GHMSI's surplus at year-end 2014 rather than its surplus at year-end 2011 that was used in the DISB surplus review. At year-end 2014, GHMSI's total surplus was \$934.4 million, which was \$29.2 million less than its surplus at year-end 2011. After deducting \$56.2 million from GHMSI's surplus at year-end 2014, L&E determined that GHMSI's surplus would be reduced to \$878.2 million.

L&E determined that the reduction in surplus as a result of the \$56.2 million distribution reduces GHMSI's capital and surplus approximately 6% at each year end for 2011 through 2014. It also lowers the surplus to 824.8% RBC-ACL (and to 940% RBC-ACL for year-end 2011). L&E noted, however, that this falls within its recommended target surplus range and, therefore, does not raise solvency concerns.

¹⁸ As noted in Part C of Section I, Rector modified certain assumptions in the Milliman model that resulted in a lower recommended target surplus than what Milliman had recommended. These changes were based on more conservative estimates of future premium growth, restrictions on rate increases, catastrophic events, and unidentified growth and development.

L&E was also asked to consider the impact on GHMSI's surplus of the annual fee imposed on health insurers pursuant to the Affordable Care Act ("ACA"). GHMSI and its affiliate were assessed a total of \$97.5 million for the 2015 year, which becomes due on or before September 30, 2015. A statutory accounting principle specific to the ACA fee, SSAP No. 106, treats the fee as special surplus until January 1, at which point it becomes a liability on the insurer's balance sheet and results in a reduction in the insurer's capital and surplus by an equivalent amount.

Because GHMSI's ACA fee of \$97.5 million is, as of January 1, 2015, recognized on the Company's balance sheet, the Bureau considered it appropriate to address the impact of the fee as part of its surplus review. The impact of this fee, when combined with the DISB-ordered distribution, would further reduce GHMSI's year-end 2014 surplus to \$780.7 million, or 733.2% RBC-ACL. Recognition of the fee thus causes GHMSI's surplus to fall below the low range of L&E's recommended RBC-ACL of 798%.

L&E took its analysis a step further, however, by observing that GHMSI will in all likelihood collect sufficient revenue to pay this fee. L&E noted that GHMSI's rates charged to its subscribers began including a component for this fee beginning in July 2013 (for the 2014 fee year); therefore, it is anticipated that the Company will have collected enough revenue to pay the fee by the time it becomes due on September 30, 2015. At that point, GHMSI's capital and surplus levels will, all else being equal, return to \$934.4 million. While acknowledging that statutory accounting rules do not allow insurers to recognize uncollected fee revenue as an asset, L&E elected not to consider the fee in its surplus review.

Finally, L&E examined the potential impact on rates charged by GHMSI to Virginia residents as a result of the distribution. L&E noted that GHMSI's current rates were calculated based on Milliman's target surplus range of 1050-1350% RBC-ACL. To the extent GHMSI recalculates its rates based on the lower target surplus of 721% RBC-ACL as required by the DISB Order, L&E determined that, all else being equal, a slower rate of premium growth, and thus lower rates for Virginia residents should result.

Section III: Bureau Analysis and Recommendations

The L&E Report concludes that the single distribution of \$56.2 million from GHMSI's total surplus of \$934.4 million at year-end 2014 does not pose an immediate or long-term threat to the solvency of the Company. However, if the \$97.5 million ACA fee for 2015 is recognized it becomes more difficult to conclude that there is no adverse impact on the Company's financial condition. When the fee is taken into account, GHMSI's surplus drops below the lower end of L&E's recommended target surplus range of 798% RBC-ACL.

The Bureau does not agree with L&E's decision to exclude the ACA fee from its analysis of GHMSI's surplus. Because the \$97.5 million fee was recognized at the stroke of midnight on January 1, 2015, it is proper to consider it alongside the Company's year-end 2014 financials since this provides a more accurate picture of the Company's financial condition as it exists today. The Bureau considers it prudent to adopt a conservative approach when evaluating an insurance company's financial condition. It is skeptical of concepts such as "excess surplus," "divisible surplus," and treating a \$97.5 million fee as surplus when evaluating the adequacy of an insurance company's capital and surplus. SSAP 106 notwithstanding, these approaches are inconsistent with principles of statutory accounting developed by state regulators over the course

of many years to ensure that insurance companies are adequately capitalized to pay future claims.

Consequently, the Bureau finds that the impact of the distribution causes some measure of harm, or more accurately the potential for future harm, to Virginia residents. Simply put, when the ACA fee is properly taken into account, the Company's surplus drops below L&E's target surplus range. On a quantitative level, L&E's model projects that additional surplus of \$69 million is needed to ensure that GHMSI will not fall below 200% RBC-ACL at a 98% confidence level. Nevertheless, determining whether the distribution technically harms the interests of Virginia residents is ultimately less important than deciding what actions the Bureau, and the Commission, should take going forward to best protect their interests.

The Bureau does not recommend at this time that the Commission enter an order prohibiting GHMSI from distributing the DISB-ordered excess surplus of \$56.2 million. The Bureau recognizes and shares the General Assembly's concerns over the potential impact of GHMSI's distribution on Virginia residents. At the same time, requiring an insurer to take a particular action that places it in direct conflict with its domestic regulator is ordinarily disfavored under our state-based system of insurance regulation. This type of decision should therefore be approached with caution.

In order to best protect the interests of Virginia residents, the Bureau would recommend taking a more active role in coordinating with DISB as well as the Maryland Insurance Administration on future actions related to GHMSI's surplus. In particular, participating in the next surplus review of GHMSI, either as a party or participant, would be beneficial. The Bureau acknowledges that the decision by the Commissioner of DISB regarding GHMSI's excess surplus was thorough and deliberative, and that there is a great deal of judgment involved in determining whether an insurance company holds excess surplus as provided for under the MIEAA and the accompanying regulations. However, it believes more weight should be given in certain areas that would better protect the interests of Virginia residents.

First and foremost, future surplus reviews should take into account the fundamental inequity and potential for subsidization that may result from apportioning surplus by jurisdiction for the express purpose of providing a benefit to the residents of that particular jurisdiction. The Bureau disagrees with the concept underlying the MIEAA that the surplus of an insurance company is somehow divisible by jurisdiction. An insurance company's surplus supports all of the debts, obligations, and liabilities of the entire legal entity, and any reduction in surplus by its very nature reduces solvency protection for the benefit of all policyholders.

This concern would be somewhat mitigated if, in future surplus reviews, the Commissioner of DISB were to adopt a higher target surplus level that aligns more closely to the recommendations of DISB's own consultant, as well as those of GHMSI's consultants, the Maryland Insurance Administration, and the Bureau. The lower target surplus level chosen by the Commissioner of DISB was partly based on his decision to use a 95% rather than a 98% confidence level when calculating the target surplus. This confidence level was selected in order to "maximize GHMSI's community reinvestment."¹⁹ However, the Bureau considers the 98% confidence level more appropriate since it would strike a better balance between addressing regulators'

¹⁹ DISB Order at 46.

concerns regarding GHMSI's financial strength and fulfilling the requirement under the MIEAA to dedicate some portion of "excess surplus" to community health reinvestment.

In addition to considering a higher confidence level, the Bureau would argue in favor of recognizing the ACA fee in its surplus review. The Bureau would also recommend that in future surplus reviews, the Commissioner of DISB take a broader approach in determining whether GHMSI possesses the appropriate levels of capital and surplus. Rather than focusing exclusively on RBC-ACL, proper consideration should also be given to GHMSI's Own Risk and Solvency Assessment ("ORSA"), which is an internal process undertaken by an insurer to assess the adequacy of its risk management and current and prospective solvency positions under normal and severe stress scenarios.

In conclusion, the Bureau is prepared to recommend heightened regulatory action, including an order prohibiting the distribution of excess surplus, should the Company's targeted surplus drop to levels that more directly threaten its immediate or long-term solvency. At the present time, however, the Bureau considers such action to be unnecessary despite its finding that some measure of harm may potentially result from the distribution. The Bureau will continue to closely monitor GHMSI's financial condition through its review of the Company's quarterly and annual financial filings as well as its annual financial statement. It will also scrutinize GHMSI's rate filings to ensure that if it seeks to bolster its surplus in the future as a result of prior distributions of excess surplus, Virginia residents are not impacted in the form of higher rates.