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Regarding Proposals for MLR Transition for Individual Health Insurance Plans

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In its May 14, 2010 Letter to the Department of Health and Human Services, the American Academy of Actuaries Medical Loss Ratio Regulation Work Group hypothesized about problems in the individual health insurance market associated with the 80% minimum loss ratio (MLR) standard. CEJ comments on the AAA analysis and proposals for MLR transition for individual health insurance plans.

The premise of the AAA argument is that insurers price individual market policies based on a "lifetime basis" and, consequently, loss ratios increase over time as initial underwriting wears off. There is no empirical evidence presented that this is the case or that the numbers on page 11 are anything other than made up. By the logic of this argument, an insurer would gladly have an individual book of business with very high loss ratios in a particular year because these high loss ratios balance out the low loss ratios of earlier years -- an implausible result.

The AAA also argues that, given loss ratios lower than 80% for new individual market plans, insurers would have to reduce commissions to agents (distribution channel) to meet the loss ratio standard. Their conclusion is that such an action would disrupt the individual market. As an economist versed in insurance markets, I disagree. Even assuming the low initial loss ratio scenario (which is based on a number of undocumented assumptions), an insurer could do at least two things to address the issue -- both of which better align the product with the interests of consumers. First, the insurer could utilize direct sales instead of using an agent. Given that this is the individual market and not group sales, direct sales is feasible and less costly than using an agent. Second, the insurer could offer increasing commission rates to the agent based on the consumer's tenure with the insurer. The initial commission might be low and then increase each year to a maximum in year 5. This not only addresses the situation hypothesized by Bell, but incentivizes the agent to place a consumer in a sustainable product.

The AAA states that lowering distribution expenses will cause agents to discontinue sales. This argument is based on the insurance industry conducting business as usual. The premise of the reform legislation is that the industry needs to change. There is no rationale for discarding an essential consumer protection -- the MLR -- because the industry does not want to change its current business model. Even assuming the AAA’s low loss ratio theory, there are ways for the industry to achieve the MLR with minor changes to distribution practices, agent compensation or both.

The AAA’s list of horrors on page 12 all assume that the only recourse for an insurer is to reduce agent commissions, period. This is illogical because it is an ineffective way of addressing the problem. Even assuming the "lifetime pricing methodology," for which no actual evidence is provided, an insurer that wants to stay in the individual market could easily do so by adjusting the compensation structure for agents, moving to direct sales or both.

As for proposed solutions,

1. Lower the MLR for grandfathered individual business. First, this defeats the purpose of MLR. Second, it would actually be difficult to implement because, if the reason for this fix is "lifetime pricing," which plans are grandfathered? Third, it would inevitably create unfair competition based on when the plan was started. Fourth, it would invite gaming the system -- once you create a loophole, insurers will seek to use it.

2. Develop different MLR by policy year or calendar year of issue. This only works, in theory, if the "lifetime pricing" hypothesis is true and accurate. This is complicated, would take time to develop and becomes a nightmare for developing the regulation and monitoring compliance. It is essentially a actuary employment proposal.

3. Exclude the select period from the MLR calculation. This proposal would exclude the low loss ratio years from the calculation and only include the high loss ratio years? This heads-I-win, tails-you-lose concept is clearly inappropriate and contrary to the purpose of the MLR requirement.

4. Allow use of contract reserves for MLR calculation. Theoretically, this is a reasonable approach. If, in fact, an insurer can reasonably estimate future claims payments and establishes reserves, the MLR becomes an incurred loss ratio instead of a paid loss ratio -- standard practice in many lines of insurance. The downside is that reserves are subject to manipulation and an insurer would likely simply establish reserves sufficient to meet the MLR standard. In fact, the establishment of such reserves would almost be definitional. If you price a product to achieve an 80% lifetime loss ratio, then your reserves will be the remainder of 80% of premium less claims paid. For this to work, there would have to be a severe penalty for significant overreserving. Without such a penalty, there is little downside to manipulating reserves to meet the MLR.

Having reviewed the argument, I am not convinced that this transition a problem severe enough to disrupt the marketplace for individual health insurance plans. Insurers have ample tools to adjust distribution costs to address the problem. It really does come down to whether the regulations assume insurers can or cannot change their current business models. Given that health care reform assumes that insurers can and will change their business practices, there is no rationale for these transition loopholes.