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**TESTIMONY OF WALTER SMITH, EXECUTIVE DIRECTOR
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**DISTRICT OF COLUMBIA DEPARTMENT OF INSURANCE, SECURITIES
AND BANKING
THE HONORABLE CHESTER A. MCPHERSON, INTERIM COMMISSIONER**

**Hilton Garden Inn Astor Conference Room
June 25, 2014**

**Surplus Review and Determination
for Group Hospitalization and Medical Services, Inc.**

INTRODUCTION

I am Walter Smith, Executive Director of the DC Appleseed Center for Law and Justice. I am here to present testimony pursuant to the Commissioner's June 10, 2014 Order. That Order permits DC Appleseed to make a presentation up to 60 minutes addressing whether GHMSI's surplus complies with MIEAA and the decision of the D.C. Court of Appeals in *D.C. Appleseed Center for Law & Justice, Inc. v. D.C. Department of Insurance, Securities, & Banking*, 54 A.3d 1188 (D.C. 2012). With me is Mr. Mark Shaw, Senior Consulting Actuary, United Health Actuarial Services, Inc., who will also present on this issue on behalf of DC Appleseed.

Before briefly summarizing the points that Mr. Shaw and I want to address, I first want to thank the Commissioner for conducting this hearing and for his ongoing efforts to enforce MIEAA. I also want to thank the Commissioner and his staff, as well as Sarah Schroeder, Neil Rector, and their colleagues, for working with us to gather data bearing on the issue now before DISB.

As you know, we believe, as we said in our pre-hearing report filed June 10, that the data and the analyses before the Commissioner show *as a matter of law* that GHMSI's surplus is significantly out of compliance both with MIEAA and the Court of Appeals decision concerning the first surplus evaluation under MIEAA.

To explain why we believe that is so, I want to make three points. First, I want to briefly summarize the reasons we believe Rector's recommendations are legally insufficient to bring GHMSI's surplus into compliance with MIEAA.

I next want to describe the corrections to Rector's analysis we think are necessary to achieve that compliance.

And finally, I want to address the arguments that were made by GHMSI in its June 10 filing. After that, Mr. Shaw will elaborate on the technical aspects of the changes to Rector's Report and to

GHMSI's surplus that we think are legally required to comply with MIEAA. This will include Mr. Shaw's recommendations concerning how the Commissioner should take account of the ACA though the Milliman model.

1. Why Rector's Recommendations are Inconsistent with MIEAA and the Court of Appeals' Decision

As you know, we addressed at some length in our June 10 Pre-Hearing Report the many reasons we believe the Commissioner cannot rely on Rector's December 2013 Report and recommendations, as presented, to determine GHMSI's permissible surplus under MIEAA.¹

The essence of our position is this: although we have concerns with the Milliman model, we agree with Rector that it could be used by the Commissioner to determine GHMSI's permissible surplus. But we think that model—or any other model—can be used *only* if it meets the legal requirements of MIEAA as laid out by the Court of Appeals. And in our view, Rector did not make the changes to the Milliman model needed to meet those requirements, and we conclude as a consequence that GHMSI's surplus is inconsistent with the requirements of MIEAA.

Rector essentially adhered to the same two key elements of the model that were used in the last surplus proceeding and that that led the Court of Appeals to reverse the Commissioner's determination in that proceeding. Those two key elements involve (1) the selection of an appropriate confidence level to use in the model, and (2) the selection of reasonable assumptions consistent with MIEAA's efficiency requirement.

In the absence of MIEAA, different actuarial experts might select different confidence levels or different assumptions for the model. But because of MIEAA, as interpreted by the Court of Appeals, an actuarial expert using the model *must adapt its use to the Court's requirements*. This is what Rector failed to do.

Thus, Rector continued to use the same very high confidence level that Milliman used in the last proceeding and has always used in its assessment of GHMSI's surplus—98%—even though the Court questioned that very high level, said that it had to be clearly justified in light of MIEAA's requirements, and said specifically that it had to be “calibrated” and “balanced” against the

¹ We note a concern regarding Rector's role in this proceeding. Appropriately, the Commissioner has engaged Rector as an independent expert to assist him in making a determination as to whether GHMSI's surplus is excessive, D.C. Code § 3506(h); 26A DCMR § 4602.5, and to question witnesses making presentations at the hearing, 26A DCMR § 4602(d). However, our understanding is that Rector itself will also be a witness making a presentation at the hearing. We think it raises potential difficulties for protecting the integrity of the record for Rector to be a witness while also questioning other witnesses, and advising the Commissioner *ex parte* on assessing the testimony of all witnesses—including its own.

requirement to maximize community reinvestment.² But Rector did not do this. As a result, Rector never addressed the issue whether a slightly lower confidence level should be selected in order to comply with MIEAA—one that would maintain financial soundness but at the same time advance the primary purpose of MIEAA, maximizing community reinvestment.

Similarly, the Court specifically required the Commissioner on remand to assess GHMSI's surplus in a way that "captures *all* the relevant provisions [of MIEAA]." *Id.* at 1215 (emphasis added). Rector did not do this. Thus, the Court faulted the previous Commissioner for her "overriding concern . . . with 'financial soundness,' without any discussion of the statute's equal focus on 'efficiency.'" *Id.* at 1219. The Court was explicit on this point: "the statute'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.*" *Id.* at n.43 (emphasis added). But Rector gave no consideration to this element.

As a result, Rector failed to acknowledge, as the Pennsylvania Commissioner explained at some length in her decision, that an "efficient" surplus for the Blues is one that is based on assumptions concerning reasonably probable outcomes for the company. *In re: Applications of Capital BlueCross, et al.*, Misc. Dkt. No. MS05-02-00615 (Ins. Dep't of the Commonwealth of Pa. Feb. 9, 2005) [hereinafter Pennsylvania Decision]. Rector's assumptions in the model do not adhere to this principle; instead, Rector's assumptions (like Milliman's) are deliberately based on multiple, extremely adverse events that are completely out of keeping with the company's historical record and that are not at all reasonably probable. That approach may be acceptable for a company not subject to the "maximum feasible" and "efficiency" requirements of MIEAA. But as the Court has made clear, it is not acceptable for GHMSI.

It may be that Rector did not intend for its Report to be the vehicle for applying MIEAA as required by the Court. We say that because, when we and GHMSI representatives met with Rector

² Contrary to GHMSI's assertion, DC Appleaseed never "conceded in preliminary discussions in these proceedings that a 98% confidence level that GHMSI would exceed 200% RBC-ACL was an appropriate standard." *See* Group Hosp. & Med. Servs., Inc., *Pre-Hearing Brief: DISB Review of Surplus Pursuant to the Medical Insurance Empowerment Act of 2008, D.C. Code § 31-3501, Et Seq.* 13 n.15 (June 10, 2014) [hereinafter GHMSI Pre-Hearing Brief]. We indicated that we could support such a high confidence level provided it was used as part of an agreed implementation of the Milliman model, and provided that the agreed implementation included a consensus and understanding about the assumptions to be used in the model. *See* Letter from Mark Shaw, Senior Consulting Actuary, United Health Actuarial Servs., Inc., to Walter Smith, Exec. Dir., DC Appleaseed Ctr. for Law & Justice 4 (Jan. 18, 2013). Our hope during the preliminary discussions was that through such an agreement the current—and future—hearings and dispute could be avoided. It was in that spirit that we once suggested that a 98% level could be part of an agreed model we could support. But no agreement was ever sought or reached after our early meetings with Rector and GHMSI. In any case, even if DC Appleaseed may have earlier suggested that a 98% confidence level was "appropriate," this would not substitute for the Commissioner's duty to "calibrat[e] the level of confidence" in light of the community investment obligation. *See D.C. Appleaseed*, 54 A.3d at 1218–19.

early in this process, we urged Rector to specifically implement MIEAA's various elements in its analysis; GHMSI, however, expressly opposed Rector doing so, on the ground that the Commissioner should take account of MIEAA only after Rector issued its recommendations.

Whether or not Rector meant its Report to fully comply with MIEAA and the Court's decision, our point is that *it did not do so*. Our further point is that the Commissioner cannot ensure compliance with MIEAA by simply deferring to the analysis of an actuarial expert performed without regard to MIEAA—whether Rector, or Milliman, or Lewin, or anyone else.

Rather, the Commissioner must ensure that whatever actuarial expertise or model he relies on *has been implemented in a way that complies with MIEAA*. And the determination of how that expertise must be exercised, or how a model must be adapted and utilized, to achieve that compliance is *a legal matter for the Commissioner himself to determine*.

Because in our view Rector's expertise has not been exercised in a way that complies with MIEAA, we urge the Commissioner to adjust Rector's recommendations to ensure that compliance. Before summarizing how we think the Commissioner should do that, we first want to make a point about the data now before the Commissioner that would allow him to make appropriate adjustments.

The Commissioner and DISB staff actively worked to elicit answers to many questions that we had about Milliman's and Rector's work. For that effort we are appreciative. As Mr. Shaw has discussed in detail, however, the matters as to which Milliman and Rector did not provide requested information are significant and mean that they have not satisfied the criteria for transparency, as required by the American Academy of Actuaries. Mark E. Shaw, *Report to the D.C. Department of Insurance, Securities and Banking: Group Hospitalization and Medical Services Inc. MIEAA Surplus Review 6–9*, 45–46 (June 10, 2014) [hereinafter Shaw Report]. It also means, in our view, that GHMSI and Milliman have not fully complied with the Court's requirement “that the regulated entity discloses information (subject to appropriate agreements and limitations on use) necessary to the development of analyses by participants that contribute to the Commissioner's determination.” *D.C. Appleseed*, 54 A.3d at 1219 n.41.

The withheld information (in particular, all assumptions used in the pro forma modeling) could have led to the “catch-22” that the prior Commissioner created by declining to compel the production of information that Mr. Shaw had requested, and then, on the ground that Mr. Shaw did not have the information, refusing to give any weight to Mr. Shaw's analysis. Fortunately, Mr. Shaw was able on his own in this case to replicate the stochastic model—the first stage—and to reproduce to a high degree the results that Milliman obtained from the second stage, involving GHMSI's financials (as to which Milliman withheld even non-proprietary historical data). *See* Shaw Report at

52. But it should not be necessary in a contested case before the DISB, or, at least, in a surplus review, for interested persons or parties to have to try to backwards engineer a model that is being used in a public proceeding. If, as we propose, the Commissioner takes the opportunity to establish a number of basic principles for annual surplus review, we would urge that he include among such principles that actuarial work must comply with actuarial standards as adopted by the Academy of Actuaries. *See* DC Appleseed Pre-Hearing Report at 45-46.

2. How the Commissioner Should Adjust Rector's Report to Comply with MIEAA and the Court's Decision

In our June 10 pre-hearing report, we explained the two major adjustments we think should be made to Rector's use of the Milliman model to bring it into compliance with MIEAA.

First, after "calibrating" and "balancing" the confidence level in light of MIEAA's "maximum feasible" requirement, we think the Commissioner should conclude that the 98% "virtual certainty" level cannot be justified as the appropriate calibration to ensure that GHMSI's surplus stays above the 200% RBC level. Instead, because GHMSI's financial soundness will still be maintained at a slightly lower confidence level—90%—that is the level the Commissioner should select. At that level, GHMSI would have available \$283 million for community reinvestment. That \$283 million represents additional surplus *beyond* the point at which GHMSI would be financially sound. The Court of Appeals recognized that a few percentage points can mean many millions of dollars. The Court's recognition is amply confirmed by the fact that, at a 95% confidence level, \$148 million would be available. And adding three percentage points to the confidence level, from 95% to 98%, reduces community reinvestment by \$148 million, to zero. D.C. Appleseed, *Report to the D.C. Department of Insurance, Securities and Banking: Surplus Review of Group Hospitalization and Medical Services, Inc.* 16 fig.3 (June 10, 2014) [hereinafter DC Appleseed Pre-Hearing Report].

In its most recent report to the Commissioner concerning its surplus, GHMSI itself acknowledges that its own actuarial experts have "recommended surplus ranges that achieve a 'confidence level' between 95–98 percent certainty that the Company would not fall below the 200 percent RBC-ACL level . . ." Group Hosp. & Med. Servs., Inc., *Pre-Hearing Brief: DISB Review of Surplus Pursuant to the Medical Insurance Empowerment Act of 2008, D.C. Code § 31-3501, Et Seq.* exhibit 7 at 3 (June 10, 2014) [Hereinafter GHMSI Pre-Hearing Brief]. If GHMSI's own experts have relied on a confidence level lower than 98%, it seems reasonable that the Commissioner should be able to

rely on a lower level as well.³ For all these reasons, the Commissioner should reduce the 98% confidence level in accordance with MIEAA and the Court's decision.

In addition, in order to implement MIEAA's "efficiency" requirement, the Commissioner should adjust the assumptions Rector has made in the model regarding premium growth, the rating and adequacy factor, and the equity portfolio factor. With regard to all three of those factors, Rector has made assumptions that are not reasonably probable and are completely out of keeping with GHMSI's historical performance. As Mr. Shaw shows in his report, bringing only those three assumptions into line with MIEAA's "efficiency" requirement makes a significant difference in the model's output: it reduces the permissible surplus down to 461% RBC, even if the confidence level is kept at 98%. Shaw Report at 58 ch. 25.

Significantly, in GHMSI's Pre-Hearing Brief, the company now acknowledges that, in measuring whether GHMSI's surplus complies with MIEAA, the Commissioner should determine whether it guards against "*reasonably foreseeable* undue risk to the institution." GHMSI Pre-Hearing Brief at 14 (case citation omitted) (emphasis added). We agree with this standard. In fact, it is almost precisely the one we proposed in our Pre-Hearing Report, relying on the Pennsylvania Commissioner's decision: "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" DC Applesed Pre-Hearing Report at 20 (citing Pennsylvania Decision at 35 (emphasis added)).

Yet, as we showed in our pre-Hearing Report and in Mr. Shaw's statement, that is *not* the standard used in the assumptions Rector made in the model for premium growth, the rating and adequacy factor, or the equity portfolio factor. As a consequence, to bring the model into compliance with MIEAA, those assumptions should now be adjusted by the Commissioner.

Figure 7 of our Pre-Hearing Report shows the impact on RBC depending on how the Commissioner makes the adjustment needed to meet the stated "maximum feasible" and

³ GHMSI asserts in its Pre-Hearing Brief that, when a carrier—any carrier—falls below 200% RBC, the carrier is at "significant risk of imminent insolvency." GHMSI Pre-Hearing Brief at 4. "Imminent," according to the dictionary, means "likely to occur at any moment." Random House Webster's College Dictionary 673 (1991). The RBC regulatory structure does not take that categoric view even at 100% RBC; instead, it leaves it to the regulator to make a judgment, based on the particular circumstances of the carrier at the time, whether to take control. In any case, for reasons we show in our report, GHMSI's assertion is not true at 200%. See DC Applesed Pre-Hearing Report at 10–13. GHMSI cites an NAIC document, entitled *Risk-Based Capital General Overview* (2009). We have searched that document, and nowhere find any statement as to "imminent insolvency."

“efficiency” requirements of MIEAA. DC Applesseed Pre-Hearing Report at 43 fig.7. Again, it is important to say that adjustments to the model are required *as a matter of law* in the wake of the Court of Appeals decision, and that Rector did not make them.

3. GHMSI’s Defense of Its Surplus is Inconsistent with MIEAA and the Court’s Decision

In its Pre-Hearing Brief, GHMSI contends that for three reasons, its surplus is not “excessive” within the meaning of MIEAA.

First, it says that nine actuarial analyses (including Rector’s) have now confirmed that its surplus is not “excessive” and the Commissioner should therefore accept those analyses. The answer to this is that not one of those analyses has applied MIEAA’s requirements as laid out by the Court.

Second, GHMSI says that its surplus complies with MIEAA because it meets the surplus requirements of the nine actuarial analyses. This argument is not only circular, but in complete contravention of the Court’s decision; obviously, if it were enough that GHMSI’s surplus were consistent with the previous actuarial analyses, the Court would not have reversed the previous Commissioner’s decision. What the Court has required is that the Commissioner expressly take account of and specifically apply MIEAA’s “maximum feasible” and “efficiency” requirements—and that has not yet happened.

Third, GHMSI appears to argue that, wholly apart from Rector’s or Mr. Shaw’s application of the Milliman model, because ACA poses uncertainty for the company, the Commissioner should approve its surplus. GHMSI’s six claims about ACA uncertainty are overstated. But, beyond that, GHMSI provides no quantification of any ACA uncertainty and therefore offers no evidence as to *how* the Commissioner should take the ACA claims into account in assessing GHMSI’s permissible surplus under MIEAA. *See* GHMSI Pre-Hearing Brief at 17–19.

We understood that the Commissioner was committed to using the Milliman model in this proceeding to assess GHMSI’s permissible surplus, and that any valid uncertainties associated with ACA would therefore be taken into account through that model. That is what Rector did, and that is what Mr. Shaw did. Even if GHMSI’s latest assertions about the ACA were correct, and we do not think they are, they are entitled to little weight because they do not constitute evidence that systematically and objectively takes them into account. Without such evidence, GHMSI is essentially arguing that, because ACA brings uncertainties, the Commissioner should allow it to have a \$1 billion surplus. This argument plainly cannot be accepted under the rigorous standards the Court has established for reviewing GHMSI’s surplus.

The Nine Actuarial Analyses. While GHMSI may be able to count nine actuarial analyses previously reviewing its surplus, not one of those analyses applies MIEAA and not one complies with the Court of Appeals decision. Five of the nine analyses are by Milliman and Lewin, two are by the entities engaged by the Maryland Insurance Administration (Invotex and McGladrey), and the other two are by Rector (2009 and 2013).

The Milliman, Lewin, Rector, and Invotex analyses were all found legally inadequate by the Court of Appeals in the last proceeding because they “did not take into account the obligation to reinvest in the community to the maximum extent feasible.” *D.C. Appleseed*, 54 A.3d at 1219 n.42. In addition, although Milliman has several times endorsed GHMSI’s surplus, to this day Milliman has not *ever* attempted to apply MIEAA to that surplus.⁴ Nor has Milliman actually applied its model to GHMSI’s surplus since its analysis as of December 31, 2010.

Further, as the Court of Appeals noted, the Commissioner herself in the last proceeding found both the Invotex and the Lewin analyses to be wanting because their methodologies and assumptions were not clear. *Id.* at n.41. Indeed, Rector itself rejected Lewin’s work as “in many ways . . . a ‘black box’” because it “did not contain sufficient actuarial detail to determine exactly what [it] did or what its key assumptions were.” Rector & Assocs., *Rebuttal to September 3, 2010 Supplemental Report on Effects of Federal Health Care Reform as Submitted by Group Hospitalization and Medical Services, Inc.* 5 (Sept. 20, 2010).

That leaves the McGladrey Report, done for the Maryland Insurance Administration in 2012. That report, like the one from Invotex, did not apply the MIEAA standard because Maryland’s standard is less stringent than the District’s, and does not contain the “maximum feasible” requirement the Court said must be applied.⁵

⁴ In the previous hearing before the Commissioner, Milliman admitted that its analyses of GHMSI’s surplus “were not done in view of this specific statute at all.” Transcript, D.C. Dep’t of Ins., Secs., & Banking, Public Hearing on Surplus and Review of GHMSI 197 (Sept. 10, 2014), *available at* <http://disb.dc.gov/sites/default/files/dc/sites/disb/publication/attachments/0910disb.pdf>. Nor are we aware of any subsequent Milliman analysis that takes MIEAA into account.

⁵ GHMSI urges the Commissioner to confer with Maryland regarding GHMSI’s surplus. GHMSI Pre-Hearing Brief at 3. We agree with that of course. But if GHMSI is implying that the Commissioner should defer to Maryland’s approval of GHMSI’s surplus, that is wrong for two compelling reasons. First, MIEAA directs the Commissioner to determine whether the portion of GHMSI’s surplus allocable to the District is excessive. D.C. Code § 31-3506(e). Obviously, the Commissioner will make that determination under MIEAA, not under the less strict standard applicable in Maryland. Md. Ins. Code § 14-117(e)(1). Second, if there were a conflict between Maryland’s determination and the District’s determination regarding GHMSI’s permissible surplus, it is the District’s standard and determination that would control because under GHMSI’s federal charter GHMSI “shall be licensed *and regulated* by the District of Columbia in

In summary, none of the previous reports can be fairly relied on to show that GHMSI's surplus complies with the MIEAA standards as interpreted by the Court of Appeals—because none of them applies those standards.

The Claim that GHMSI's Surplus Can Be Upheld on the Basis of Milliman and Rector, even though neither applies the MIEAA standards. GHMSI argues that because its surplus is supported by Milliman and Rector, it therefore complies with MIEAA. But this argument is completely circular and ignores what the Court said is required to comply with MIEAA.

Thus, GHMSI contends that its surplus “is not ‘unreasonably large’ because it is at or slightly below the target range adopted by GHMSI’s Board, based on the advice of independent, respected actuarial experts, and it is at the target determined by Rector, the Commissioner’s own expert.” *Id.* at 12. In other words, according to GHMSI, the company complies with MIEAA because Milliman and Rector have approved its surplus.

That does not comport with MIEAA's requirements as the Court of Appeals made clear. The Court said: “the Commissioner’s ‘unreasonably large’ determination *must consider the mandate to reinvest in the community to the ‘maximum feasible extent.’*” *D.C. Applesseed*, 54 A.3d at 1215 (emphasis added). Yet as we have shown, neither Milliman nor Rector applied that mandate. Still, GHMSI says its surplus “fully meets the standards defined by Rector.” GHMSI Pre-Hearing Brief at 13. But it is not Rector’s standards that govern here; it is MIEAA’s standards, as they were interpreted by the Court. GHMSI can urge reliance on Milliman and Rector, and Lewin, Invotex, and McGladrey, only by reverting to what the Court characterized as a “two-step” analysis, *D.C. Applesseed*, 54 A.3d at 1212, under which “unreasonably large” is “divorced” from the community reinvestment obligation, *id.* at 1215, so that “unreasonably large” means the same thing in MIEAA as it does, for example, in the Maryland statute. The Court of Appeals flatly rejected this two-step approach, saying that “unreasonably large” and the community investment obligation “are not only interrelated, but mirror each other.” *Id.* at 1214.

GHMSI never comes to grips with the Court’s construction of the statute. It says that “When GHMSI engages in community health reinvestment in a manner that keeps its surplus at an actuarially-determined reasonable level, GHMSI fully meets [its] obligation.” *Id.* at 14. Under this approach, MIEAA and the Court (and the Commissioner) would become irrelevant. Provided

accordance with the laws and regulations of the District of Columbia.” Pub. L. No. 103-127, 107 Stat. 1336 (1993) (emphasis added). Finally, we agree with GHMSI that the Commissioner need not decide the allocation issue at this stage of this proceeding, and we wish to be heard on that issue once the Commissioner determines the amount of excess surplus being held by GHMSI. *See* GHMSI Pre-Hearing Brief at 12 n.14.

GHMSI's surplus is reasonable according to its own actuarial experts, it is in compliance with the statute. This, of course, is not the law.

As we have shown, the Court has required the Commissioner to show "how surplus and community reinvestment are to be calculated and balanced." *D.C. Appleseed*, 54 A.3d at 1215. It has required the Commissioner to do this by "calibrating" the confidence level, taking into account that even a small variance in the confidence level produces millions for community reinvestment. *Id.* at 1219. Neither Milliman, nor Rector, nor GHMSI has done this.

Nevertheless, GHMSI contends that it meets the "maximum feasible" requirement when it "engages in giving in a manner such that its surplus does not exceed the benchmark." GHMSI Pre-Hearing Brief at 16. In other words, because "GHMSI's surplus does not exceed the benchmarks set by either Milliman or Rector," its surplus therefore "is not inconsistent with the MIEAA's community-health-reinvestment obligation." *Id.* It is mystifying that GHMSI would say this. The Court reversed the previous Commissioner for failing to specifically address the community reinvestment obligation and for relying on actuarial analyses that had not addressed that obligation. Yet now GHMSI asks the Commissioner to find that obligation met so long as its surplus meets the benchmarks set by actuarial analyses that have not themselves addressed the obligation in setting the benchmarks.⁶

GHMSI's approach to the "efficiency" requirement is similar. The Court said, "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. Perhaps recognizing that none of the actuarial analyses have taken this requirement into account, GHMSI now argues that it meets the "efficiency" requirement "because it has kept surplus appropriately low without going too low." GHMSI Pre-Hearing Brief at 15. This of course is completely conclusory and circular; it says nothing whatever about how "efficiency" was actually taken into account in computing the surplus (and, indeed, it was not); it simply assumes, again, that because Milliman and Rector found the surplus reasonable, it is therefore "efficient."

GHMSI also misapplies its own definition of efficiency. GHMSI suggests that "'efficient' means '[m]arked by qualities, characteristics, or equipment that facilitate the serving of a purpose or

⁶ In a footnote, GHMSI goes even further and says that the Court of Appeals "did not conclude that the Commissioner's ultimate determination was incorrect. Rather, the Court asked the Commissioner to look in tandem at whether surplus is unreasonably large and whether it is inconsistent with the community-health-reinvestment obligation and to articulate the Commissioner's reasoning in greater detail." GHMSI Pre-Hearing Brief at 11 n. 13. This appears to be a suggestion that if the Commissioner had only explained things better, the Court would not have reversed. This is not correct. The Court reversed because neither the Commissioner nor the studies she relied on took into account and applied two key requirements of the statute—"maximum feasible" and "efficiency." That failure cannot be explained away; it can be addressed only by actually applying those two requirements as the Court directed.

the performance of a task in the best manner . . . effective to an end.” *Id.* (quoting *Webster’s Third New International Dictionary (Unabridged)* 725). As the Court stated, the “primary” purpose of MIEAA—the “purpose” or “task”—was to maximize community health reinvestment to the full extent consistent with financial soundness. *D.C. Appleseed*, 54 A.3d at 1214. Thus, an “efficient” surplus is one that “facilitate[s]” maximizing community reinvestment “in the best possible manner.” GHMSI makes no attempt to demonstrate this. And neither did Milliman or Rector.

In the end, GHMSI is asking the Commissioner to accept that the company has met the several requirements of MIEAA simply because Milliman and Rector have approved its surplus—even though neither Milliman nor Rector actually applied the requirements of the statute. The Court rejected that argument before, and the Commissioner should not accept it now.

Taking the ACA into Account. We agree with GHMSI that the implications of ACA should be taken into account by the Commissioner in determining GHMSI’s permissible surplus. Rector did so in its Report, and Mr. Shaw did so in his Report. And both Rector and Mr. Shaw show how the ACA should be taken into account *in the Milliman model*—by adjusting two key factors in that model: premium growth and rating and adequacy.

But GHMSI has not done that in its Pre-Hearing Brief. Instead, although it lists ways in which it says GHMSI’s surplus will be affected by ACA, it offers no quantification of the effects on surplus of the ACA, and it does not show *how* the Commissioner should take the ACA into account. GHMSI simply concludes that the Commissioner should approve Milliman’s overall recommended surplus range. And it reaches this conclusion even though Milliman itself never incorporated these effects into its own model. To the contrary, Milliman said only that due to these effects, a surplus 100 to 150 points higher could be justified. GHMSI Pre-Hearing Brief at 10. This was the same approach Milliman took in the 2009 proceeding and, as the Court of Appeals pointed out, the then-Commissioner rejected it as “arbitrary and unsupported by actuarial data.” *D.C. Appleseed*, 54 A3d at 1198. The same is true now. The Commissioner could not possibly write an opinion that satisfies the heavy burden of explanation imposed by the Court of Appeals based on GHMSI’s bald assertions.

Milliman said in its June 28, 2013, report that it expected to re-run the model later that year to reflect additional information concerning the ACA. GHMSI Pre-Hearing Brief, exhibit 13 at 2, 6. But, so far as reflected in any public document, that update never happened. Rather, it does not appear that Milliman has actually applied its model to GHMSI’s surplus since its analysis as of December 31, 2010. It is hard to see, therefore, how GHMSI can rely on Milliman for its end-of-2011 surplus, much less for its current one.

This is particularly so given that Milliman itself has recognized that GHMSI’s target surplus “range should be updated periodically, to reflect fundamental changes in operations and the

environment.” Phyllis A. Doran, et al., Milliman, Inc., *CareFirst Inc. Group Hospitalization and Medical Services, Inc.: Development of Optimal Surplus Target Range 7* (May 31, 2011) [hereinafter Milliman May 31, 2011, Report]. It is furthermore evident that Milliman’s use of its model can show dramatic differences in surplus needs from year-year. In just two years, from end-of-2008 to end-of-2010, Milliman’s reported “optimal target surplus range” changed by approximately 300 percentage points, moving from 750%–1050% RBC to 1050%–1300% RBC. *See id.* at 5; Rector & Assocs., *Report to the D.C. Department of Insurance, Securities and Banking: Group Hospitalization and Medical Services, Inc.* 4 (July 21 2010). Indeed, the ACA alone would seem reason for Milliman to have updated its analysis, given its stated view that “changes in the marketplace are likely to be profound, and could significantly alter the composition on GHMSI’s membership and risk profile.” Milliman May 31, 2011, Report at 8. An out-of-date Milliman analysis—one that does not incorporate the ACA in the model—cannot form a sound basis for the Commissioner’s decision, particularly given that “even a small variance can implicate millions of dollars.” *D.C. Applesseed*, 54 A.3d at 1219. Nevertheless, in its pre-hearing brief, GHMSI says that it “believes that Milliman’s analysis should be adopted here.” GHMSI Pre-Hearing Brief at 1.

The Commissioner should reject GHMSI’s unquantified, out-of-date, and unsupported approach to the ACA and to GHMSI’s surplus. The Commissioner can and should rely on Mr. Shaw’s use of the Milliman model, a use that integrates appropriate probability distributions for the ACA. From the beginning of this proceeding the Commissioner has made clear that GHMSI’s surplus would be assessed through use of the Milliman model, and that participants in the proceeding were expected to show how the model could be used or adjusted to calculate allowable surplus under MIEAA. Even if GHMSI’s assertions about the ACA were valid, and we do not believe that they are, GHMSI has not shown how its assertions are to be incorporated into the model. Without such incorporation, the Commissioner cannot make appropriate adjustments based on actuarial data. GHMSI’s assertions are simply not usable.

In any case, in his written testimony for this hearing, Mr. Shaw responds to GHMSI’s assertions and explains how, if at all, they should affect the Milliman model. As he says, nothing in GHMSI’s Pre-Hearing Brief affects the calculations he has made that reflect the ACA in the premium growth and rating and adequacy factors in the model. As he also shows, several of GHMSI’s assertions are unfair or misleading. In fact, three of GHMSI’s assertions are so wide of the mark that I want to address them here.

First, GHMSI makes much of the alleged thinness of the company’s margins and appears to contend that this in itself justifies a large surplus. But that is not so. The truth is that as a nonprofit with a charitable mission, the company should intentionally have small profit margins so as not to overcharge its subscribers. And GHMSI has in recent years been successful in operating with thin margins. As GHMSI points out, its average underwriting gain for the last five years has been +.66%.

Moreover, as Mr. Shaw shows in his work, if the company were of even average efficiency regarding its expenses—as compared to its peers—its profit margin would have been 3.69 percentage points higher. GHMSI should not be heard to complain about low profit margins when its own choices and inefficiency are primary causes. And in any event, low profit margins are not a justification for an otherwise excessive surplus.

Further with respect to its supposedly thin margins, GHMSI states that it can “build and hold surplus from only a single source: the difference between what it collects in premiums and what it spends to conduct its business.” GHMSI Pre-Hearing Brief at 6. As Mr. Shaw documents, however, GHMSI’s net investment income contributed 30% *more* than its premium revenues did to its \$776 million increase in surplus from 1998 to 2013. And, in each of the three years in which GHMSI had underwriting losses, it had substantial, positive net investment income.

Second, GHMSI appears to argue that because it has recently experienced losses in the individual market, this shows it is facing greater risks and therefore it should be allowed greater surplus. But this does not follow at all. In the first place, the individual market is less than 10% of GHMSI’s business. And the “losses” the company has experienced, as GHMSI itself explains, were intentional ones that GHMSI deliberately caused in order to subsidize premiums for certain customers. GHMSI Pre-Hearing Brief at 14–15. It is not only contradictory for GHMSI to contend that, because it chose to decrease its surplus in order to reduce certain premiums, it should be allowed to recoup that surplus now. It is also circular: GHMSI’s position assumes that the surplus before the reduction was permissible. That of course remains to be determined.

Third, the heart of GHMSI’s position about the ACA appears to be that the effect of health reform will be both to reduce its surplus and to make it harder to “rebuild” that surplus once reduced. Every element in that argument is misconceived. GHMSI’s surplus will be reduced only to the extent its expenses exceed its premium revenues and investment income. GHMSI makes much of its asserted need for rate increases due to ACA. But the only reason it gives for why that need creates new risks is that regulators in its jurisdictions are likely to deny its justified rate increases because of “political pressures” and “publicity.” Letter from Chet Burrell to the Hon. Chester A. McPherson at 3; GHMSI Pre-Hearing Brief at 17. GHMSI never says that it would be without legal recourse if it were denied rate increases necessary to cover legitimate, increased expenses, such as increased medical claims. In any event, its argument of regulator error is simply an unacceptable basis for allowing GHMSI to retain or increase a surplus that is otherwise in violation of MIEAA.

Moreover, the idea of “rebuilding” surplus again assumes that the prior surplus, before reduction, was permissible. Further, in arguing that ACA Medical Loss Ratio (“MLR”) provisions prevent rebuilding of surplus, GHMSI ignores both its own administrative inefficiency and the fact that MLR imposes no restraint on investment income. In the end, we are confident that once the

The Honorable Chester A. McPherson, Interim Commissioner
D.C. Department of Insurance, Securities and Banking

Page 14 of 14

June 25, 2014

Commissioner determines the amount of “excess” surplus the company is holding, he will allow the company the flexibility needed to manage its surplus at a permissible level under MIEAA.

CONCLUSION

For the reasons stated, and those presented in our Pre-Hearing Report, we urge the Commissioner to determine a specific point, no higher than between \$400 and \$500 million, that defines GHMSI’s permissible surplus under MIEAA, and to require the company to submit a fair and equitable spend down plan.