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Reinsurance in Health Insurance

Overview

Reinsurance, also known as insurance for insurers, is a mechanism aimed at reducing an insurer's financial liability associated with unexpectedly high health care costs. The availability of reinsurance may be one of many factors an insurer considers in assessing potential exposure to loss in a certain market. This may affect whether or not to enter a market, what types of products to offer, and how premiums are set. Reinsurance may be structured and funded in a variety of ways. The potential impact of reinsurance on health insurance premiums is highly dependent on the amount of funds available for reinsurance as well as whether the program is funded internally or externally.

Insurance Risk

The concept underlying insurance is *risk* (i.e., the likelihood and magnitude of financial loss). In any type of insurance arrangement, all parties seek to manage their risk, subject to certain objectives (e.g., coverage and/or profit goals). In health insurance, consumers (patients as insurance beneficiaries) and insurers (as providers or sellers of insurance) approach the management of insurance risk differently. From the consumer's point of view, a person (or family) buys health insurance to protect against financial losses resulting from the unpredictable use of potentially high-cost medical care. The insurer employs a variety of methods to manage the risk it takes on when providing health coverage to consumers, to assure that the insurer operates a viable business (e.g., balancing premiums against the collective risk of the covered population). The insurer uses these methods when pooling risk so that premiums collected from all enrollees generally are sufficient to fund claims (plus administrative expenses and profits).

Sometimes, however, even with the variety of methods an insurer may employ to manage risk, the risk taken on by the insurer may not be sufficient to protect against the chosen risk management strategies. For example, a single health insurance company may be unable to cover a catastrophic loss. To limit their risk exposure, insurers often transfer some of their liability or risk to another insurer, a reinsurance company. That is, just as an insurer pools the risk of its covered consumers, a portion of that risk gets further spread to other insurance companies, known as reinsurers.

Reinsurance

Reinsurance, thus, is an extension of insurance and further acts as a risk transfer and risk spreading mechanism. Reinsurance works by spreading the costs associated with high-cost incidents across insurers. Insurers often purchase reinsurance for four reasons:

1. To limit liability on specific risks. That is, reinsurance allows insurers to offer coverage limits higher than they otherwise might. This is particularly useful for smaller insurers (where risk is spread among fewer enrollees), allowing them to compete with larger insurers.
2. To stabilize loss experience. A unique feature of insurance is that actual costs associated with enrollees is not known until sometime in the future. Reinsurance stabilizes fluctuations in an insurer's loss experience, particularly those associated with high-cost enrollees.
3. To protect against catastrophes. An insurer may experience a catastrophic loss due to a one-time event (e.g., expenditures associated with a natural disaster). Through reinsurance, insurers can reduce any fluctuations in their loss experience.
4. To increase capacity. That is, reinsurance allows an insurer to assume a larger overall capacity of risk than it may otherwise be able to.

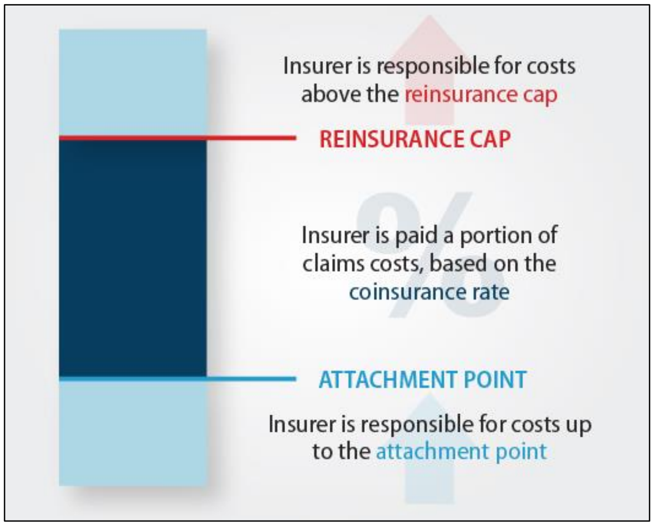
Reinsurance Arrangements and Payment Structures

Reinsurance may be structured in a variety of ways depending on the insurer's need and can range from simple to complex. Generally, however, a reinsurance contract either may be a broad agreement covering some portion of the business or may cover a specific risk.

Reinsurance may also be funded using a variety of methods. Reinsurance can be funded by internal resources; this may include insurers assessing a surcharge on premiums or insurers voluntarily purchasing reinsurance from a reinsurance company. Reinsurance can also be externally funded; this may include the government appropriating funds for reinsurance. Reinsurance can also be funded through a combination of internal and external funding. An example of this combination mechanism may include all insurers being assessed a reinsurance charge, but only certain insurers being eligible for reinsurance payments.

The reinsurance arrangement typically involves various payment parameters. Generally, in order for a health insurer to receive a reinsurance payment, an enrollee's total claims costs must exceed a specified level (referred to as the *attachment point*; see **Figure 1**). The insurer is then paid a portion of the claims costs (referred to as the *coinsurance rate*) beyond the attachment point until total claims costs reach a cap (referred to as the *reinsurance cap*; see **Figure 1**).

Figure 1. Illustrative Example of Reinsurance Payment Structure



Source: CRS.

Government as the Reinsurer

Occasionally, the government may act as the reinsurer or facilitate reinsurance in certain health insurance markets to provide a stabilizing influence. This section provides three examples for which the government is the reinsurer.

The Medicare Part D Reinsurance Program is a permanent program, with respect to covered prescription drug costs. Under this program, the attachment point is the enrollee annual out-of-pocket threshold. For drug costs above the threshold, the government pays an amount equal to 80% (coinsurance rate) of allowable reinsurance costs. The enrollee and insurer are responsible for 5% and 10% of allowable reinsurance costs, respectively. There is no reinsurance cap under the Medicare Part D Reinsurance Program.

The Early Retiree Reinsurance Program (ERRP), created by the Patient Protection and Affordable Care Act (ACA; P.L. 111-148, as amended), was a temporary program (ended January 1, 2014) that provided reimbursement to participating employment-based plans for a portion of the costs of providing health insurance coverage to early retirees (ages 55-64). Under the program, the attachment point was set at $15,000, and the reinsurance cap was set at $90,000. The government reimbursed 80% (coinsurance rate) of the costs; $5 billion from the Treasury was appropriated for the program.

The ACA's Transitional Reinsurance Program was a temporary program (2014-2016) that provided reimbursement to most individual market health plans that enrolled high-cost enrollees. The payment parameters in the program changed from year to year. For example, in plan year 2014, the attachment point was $45,000, the coinsurance rate was 100%, and the reinsurance cap was $250,000. The program was funded through collections from certain health insurers in the individual and group markets; the government then used those contributions to make reinsurance payments to plans offered in the individual market only. Statute specified the collection amounts to be used for reinsurance payments; those amounts were $10 billion, $6 billion, and $4 billion for plan years 2014, 2015, and 2016, respectively.

Potential Impact of Reinsurance on Health Insurance Premium Rates

The potential impact of reinsurance funds on premiums is highly dependent on the amount of funds available and whether the reinsurance program is funded internally or externally.

The goal of reinsurance in health care is to offset an insurer's risk associated with unexpectedly high-cost enrollees. The availability of reinsurance allows insurers to reduce their risk exposure and may affect whether or not to enter a market, what types of products to offer, and how premiums are set. Thus, in determining premiums, an insurer would take into account the availability of reinsurance funds.

The potential impact of reinsurance funds on premiums is highly dependent on the amount of funds available for reinsurance payments and whether the reinsurance program is funded internally or externally. In general, as the availability of funds for reinsurance payments increases, health insurance premiums may decrease. The source of the funds (internal versus external) also may influence any changes in premiums. That is, in determining premium rates, an insurer takes into account a number of components, including any surcharges or payments the insurer may have to pay. These considerations are packaged into the premium, which is paid by the enrollee. Thus, the availability of reinsurance through internal funds (e.g., an insurer voluntarily purchasing reinsurance from a reinsurance company) would not have as large of an impact on lowering premium rates compared to the impact from the availability of external reinsurance funds.

For example, according to analysis from the American Academy of Actuaries, the availability of reinsurance funds "[reduced] the risk to insurers, allowing them to offer premiums lower than they otherwise would be." Recall that the ACA's Transitional Reinsurance Program was funded by both internal and external funds (certain insurers in the individual and large-group markets paid into the program, but only insurers in the individual market were eligible for reinsurance payments). Correspondingly, the American Academy of Actuaries estimated that availability of reinsurance funds and their associated payment parameters reduced health insurance premium rates by 10%-14% in plan year 2014, 6%-11% in plan year 2015, and 4%-6% in plan year 2016. Thus, as the reinsurance funds decreased, there was corresponding upward pressure on premium rates.

For additional information, see CRS Report R44690, *The Patient Protection and Affordable Care Act's (ACA's) Transitional Reinsurance Program*, by Namrata K. Uberoi and Edward C. Liu.

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