

Some Parting Comments...

Since this is the last issue of the Health Cost Index Report, I would like to thank all our loyal readers over the past 23 plus years. It has been an interesting experience following the ups and downs of health cost trends for nearly a quarter of a century.

exceeded the range of historical results. Because of this, I would caution readers to consider this when doing their own forecasting. For example, in many instances, based on anecdotal information, many carriers have experienced very low trends in 2010. Some saw trends peak in 2008 and others in 2009. The 2008 and 2009 results were affected by layoffs and COBRA experience and 2009 was also affected by the H1N1 flu epidemic. For some insurers these effects, as well as the severity of the economic downturn may have accelerated the normal decline we see post recession. Therefore, 2010 might represent the low watermark on trends, and they could turn up this year.

Forecast Issues and S&P Index

As you can see from our forecasts, our historical econometric models project a continuing decline of HCI trends for the next couple of years. For the most part, this forecast is driven by the severity and length of the recent economic slowdown/recession. The severity of this recession exceeds those in the prior history of the HCI, and, therefore, the economic relationships used in our forecast models have

Chart 1 below shows the comparison of the three month and twelve month

Commentary



by

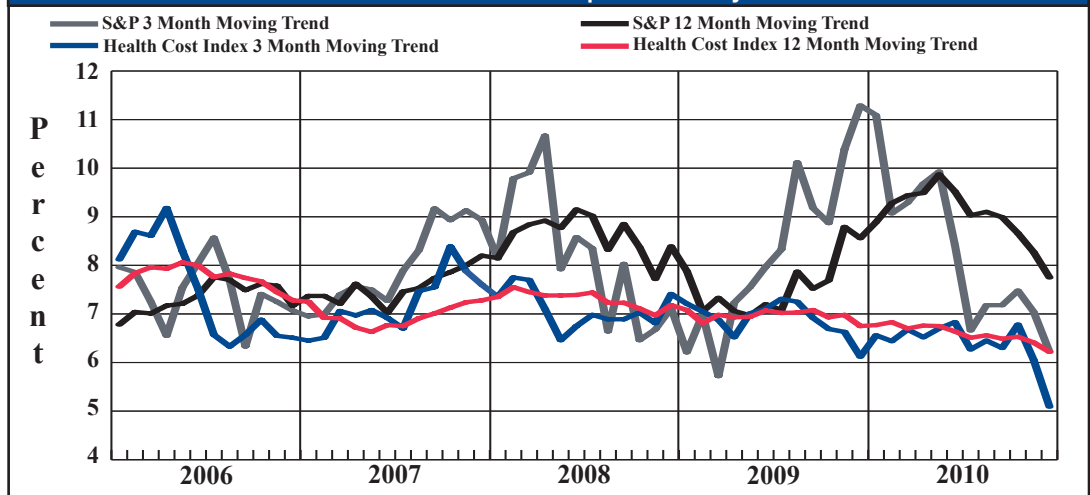
John P. Cookson,

F.S.A.

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Chart 1: S&P Healthcare Economic Commercial Index vs. Health Cost Index Hospital and Physician



Final Edition

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Commentary**

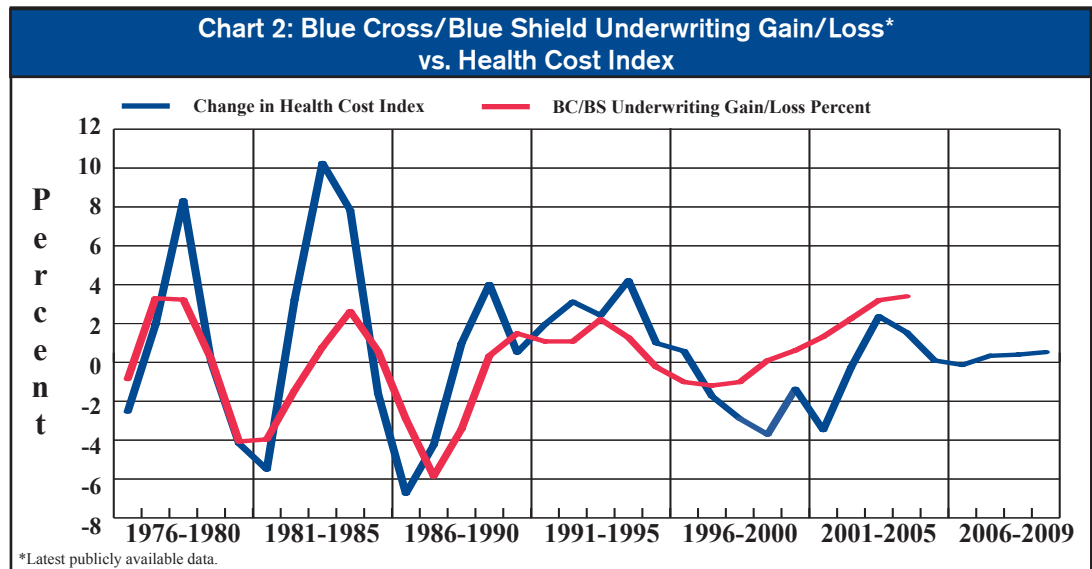
moving average trends between the S&P Healthcare Economic Commercial Index* (SPMDEC) and the HCI non-Drug composite for 2006 to 2010. By comparing the S&P Healthcare Economic Commercial Index and the HCI the difference in the pattern of trends is evident. We believe this difference is attributable to removing the Medicaid and uninsured in the S&P Index and also the more direct recognition of the flu seasons. Thus, the S&P Index is showing a steeper decline in 2010 than the HCI. In general, the trend impact of factors such as economic recessions and flu seasons is reflected differently in the S&P Indices than the HCI, mainly due to the removal of uninsured and Medicaid from the S&P Index. More information on the calculation of the S&P Healthcare Economic Indices is available in the index methodology documents, which can be found on the S&P website: (<http://www.standardandpoors.com>). This difference in the pattern of trends between the S&P Indices and the HCI is likely to cause future forecasts of the S&P series to differ from the traditional HCI forecasts.

In addition, the impact of Healthcare Reform will reduce Medicare pay-

ment rates for facilities below what they would have otherwise been before reform. Although the hospitals agreed to this in negotiations for reform, and anecdotal evidence indicates that they plan to adjust to these changes, this will still keep cost-shift pressure on commercial payment levels. This can be further exacerbated by state budget problems and implications for Medicaid reimbursement levels.

Issues Related to Minimum Loss Ratios

Another Healthcare Reform issue is the Minimum Loss Ratio standards and the interaction between trends and Risk Capital requirements. Historically, trends have been cyclical, and the industry has not done a good job anticipating significant changes. This can be observed by looking at Chart 2 below, which shows the historic relationship between the Health Cost Index and Underwriting Cycle (latest publicly available data). In order to display a meaningful comparison between the Health Cost Index and the underwriting results, the change in Health Cost Index trends 18 months apart was used. The scale was reversed for this modified HCI variable (changing positive num-



bers to negative and vice versa). The 18 month time period is intended to highlight the lag between healthcare cost changes and health insurance premiums. This time differential is due to health insurers needing time to collect and analyze historical claims data, and to then implement changes in premiums. In the past, if trends turned up unexpectedly, underwriting losses would accrue for several years, depleting Risk Capital, while insurers adjusted trend assumptions and rate increases. Eventually, the trends would turn down again, and the losses would generally be recouped, restoring Risk Capital. During much of those times, the current NAIC Risk Based Capital requirements did not exist. More recently, trends and financial results have been more stable, so there has not been a significant industry-wide test of the Risk Based Capital requirements since they have been adopted.

Unless the Minimum Loss Ratio refund requirements are suspended after a significant underwriting downturn, it will be difficult for the industry to easily recoup Risk Capital. Thus, health insurers need to consider ways to protect against unforeseen upturns in cost trends. One way might be to institute some hedging (using swaps) with the S&P Index as the benchmark. Because this is a published index it can qualify as the basis for mark to market assets under new financial regulations. Implementing such a hedge would necessitate finding a counterparty to take the other side of the swap, and also some rigorous analysis of the statistical relationships between the historic S&P Index trends and the insurer's trends. Alternatively, it may be necessary to analyze the risks of trend fluctuations on future capital needs and include this information as part of rate filings to justify rate increases. ■

***More information on the calculation of the S&P Healthcare Economic Indices is available in the index methodology documents, which can be found on the S&P Web site: (<http://www.indices.standardandpoors.com>).**