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EVALUATION OF PREMIUM RATES FOR GOVERNMENT-WIDE UNIFORM HEALTH BENEFIT PLAN UNDER THE RETIRED FEDERAL EMPLOYEES HEALTH BENEFITS ACTS Public Law 86–724


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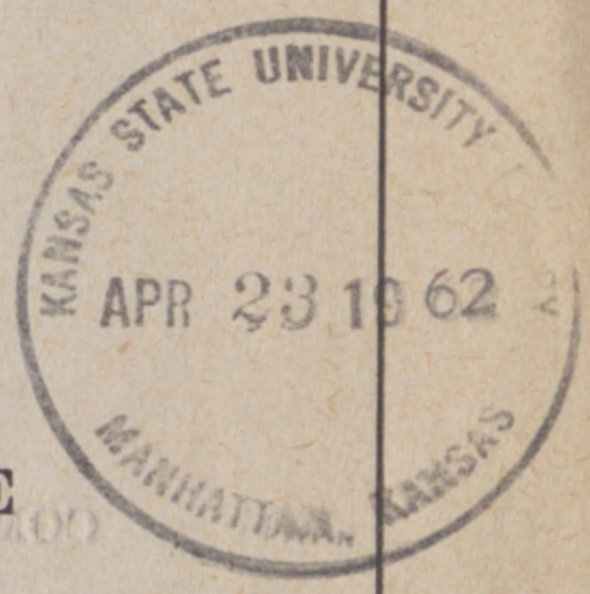
KANSAS STATE UNIVERSITY
APR 23 1962
MANHATTAN, KANSAS

COMMITTEE ON
POST OFFICE AND CIVIL SERVICE
UNITED STATES SENATE
Congress 3
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BY THE
UNITED STATES CIVIL SERVICE COMMISSION
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FOREWORD

This committee print, consisting of a letter from the Chairman of the U.S. Civil Service Commission and a report of "Evaluation of Premium Rates for Government-Wide Uniform Plan for Retired Federal Employees," has been prepared for use by the Senate Post Office and Civil Service Committee in the performance of its responsibility to review operations under the Retired Federal Employees Health Benefits Act. It also will be helpful to individual Members of Congress in answering the numerous inquiries being received with respect to the health benefits program under the act.

The Commission obtained this evaluation in order to provide the Congress and retired Federal employees and survivor annuitants with an expert opinion as well as to assure itself that benefits and premium rates were in balance.

The committee emphasizes that the health benefits program provided by this legislation represents an entirely new area of retired Federal employees' benefits in which the Government is without previous experience. Furthermore, the group of annuitants covered by the Government-wide uniform plan is unique in that it is a closed group. The fact that there will be no new, younger participants in the group, coupled with the inevitable increases in cost of medical care make it virtually certain that the cost of this health insurance will increase.

With respect to the Government-wide uniform plan, the act requires the Commission to enter into a contract which calls for premium rates that are commensurate with the benefits provided.

The Civil Service Commission is to be commended for the care and foresight it has exercised in carrying out its responsibility under the act.

OLIN D. JOHNSTON,
Chairman, Committee on Post Office and Civil Service,
U.S. Senate.

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LETTER OF SUBMITTAL

U.S. CIVIL SERVICE COMMISSION,
Washington, D.C., September 11, 1961.

Hon. OLIN D. JOHNSTON,
Chairman, Committee on Post Office and Civil Service,
U.S. Senate.

DEAR SENATOR JOHNSTON: The Retired Federal Employees Health Benefits Act requires that rates charged for the uniform health benefit plan approved by this Commission under Public Law 86–724 reasonably and equitably reflect the costs of the benefits provided.

Before reaching a decision on this matter, which is of such great importance to so many of our retired Federal employees and survivor annuitants, the Commission deemed it prudent to secure professional actuarial advice from an impartial and independent source. For this purpose, Milliman & Robertson, Inc., of Seattle, Wash., a nationally recognized firm of consulting actuaries, was retained to present a report following a study of the rates and benefit structures of the Government-wide health benefit plan.

After careful consideration of all available information, including the findings of the actuarial consulting firm, the Commission approved the plan which became effective July 1, 1961.

I am enclosing for your information a copy of the report presented by Milliman & Robertson, and a brochure describing the uniform plan.

Sincerely yours,

JOHN W. MACY, JR., *Chairman.*

EVALUATION OF PROPOSED PREMIUM RATES FOR GOVERNMENT-WIDE UNIFORM PLAN FOR RETIRED FEDERAL EMPLOYEES

BY

WENDELL MILLIMAN, F.S.A.

JUNE 7, 1961

LETTER OF TRANSMITTAL*

MILLIMAN & ROBERTSON, INC.,
Seattle, Wash., June 7, 1961.

Mr. JOHN W. MACY,
Chairman, U.S. Civil Service Commission,
Washington, D.C.

DEAR MR. MACY: At your request, I have studied the Retired Federal Employees Health Benefits Act, the group health insurance policy prepared for issuance by Aetna Life Insurance Co. to insure the coverages under the Government-wide uniform plan, and the premium rates proposed by Aetna for coverage of retired Federal employees. This study was made for the primary purpose of advising the Commission as to the reasonableness and equity of the premium rates included in this policy.

Under date of February 27, I advised your office that, on the basis of our studies, the premium rates included in Aetna's policy reasonably and equitably reflect the cost of the benefits provided. The attached report spells out in more detail the basis of this conclusion.

Sincerely,

WENDELL MILLIMAN.

*See also letter on p. 9 from Mr. Milliman to Mr. Macy referring to new information supplied subsequent to the evaluation.

SECTION I

SUMMARY

The Retired Federal Employees Health Benefits Act (Public Law 86–724) directs the U.S. Civil Service Commission to establish a uniform Government-wide health benefits plan. For this purpose, the Commission is authorized—

> without regard to section 3709 of the Revised Statutes or any other provisions of law requiring competitive bidding (to) enter into a contract with a qualified carrier for one uniform Government-wide health benefit plan for retired employees.

The act further provides that:

> The rates charged for the * * * (plan) * * * shall reasonably and equitably reflect the cost of the benefits provided.

In order to obtain, among other things, a measure of assurance that this provision of the act has been complied with, the Commission has requested this consultant to produce a report with respect to the basic and major medical coverages under the Government-wide plan negotiated with the Aetna Life Insurance Co. (the uniform plan) which covers the following items:

1. An assessment of the value of the specific benefits provided by each of the coverages;
2. A recommendation, with supporting reasons, of what constitutes a reasonable charge for the Aetna's administrative expenses in administering the uniform plan;
3. A recommendation, with supporting reasons, of what constitutes an equitable risk charge to be retained by Aetna;
4. An opinion, with supporting reasons, as to whether the premium charged for each of the coverages reasonably and equitably reflects the cost of the benefits offered for the group to be insured;
5. General comment on a proposal by the Aetna Life Insurance Co. for a reinsurance agreement between itself and reinsuring companies.

Health benefits coverage was made available to active Federal employees, effective July 1, 1960, under the provisions of the Federal Employees Health Benefits Act of 1959. Provision is made, in the health benefits plans qualified under that act, for permitting Federal employees insured under these plans to continue their coverage after retirement. The 1960 law is intended to provide a measure of financial assistance to Federal employees who retired before the 1959 act became effective.

In general, the following individuals are eligible for coverage under the Retired Federal Employees Health Benefits Act:

An employee who retired on an immediate annuity, either after 12 or more years of service or under the disability provisions of a retirement system;

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A member of a family who received an immediate annuity as the survivor of such a retired employee, or as the survivor of an employee who died after completing 5 or more years of service.

It is estimated that about 415,000 persons are eligible for coverage under the Retired Federal Employees Health Benefits Act. According to a recent study by the Civil Service Commission, between 60 and 65 percent of these individuals already carry some form of health benefits coverage. In order to provide a minimum of disruption of existing protection, a retired employee is permitted by the act to elect to continue coverage, or to obtain such coverage, under a qualified private plan and to receive a Government contribution toward the cost of such coverage. While the Government contribution will be the same whether a retired employee participates in the uniform plan or elects to have the Government contribution applied to a qualified private plan, this type of election may have an unfavorable effect on the cost of benefits under the uniform plan because of the opportunity for adverse selection against the plan. Neither the effect of this option upon the enrollment nor the cost of the benefits under the uniform plan can be predicted with any degree of confidence.

This is but one of several factors complicating the problem of assessing the value of the benefits provided under the uniform plan. Additional complications arise from the following factors:

1. The rate of utilization of health care services increases steadily with advancing age. The group of individuals eligible under this plan is substantially a closed group. As a consequence, the average age of those covered will increase steadily.

2. Within age classifications, there has been a distinct tendency for the rate of use of health care services to increase over the years.

3. The cost of the different types of health care services has been increasing, and the rate of increase has been particularly rapid in recent years.

4. Because this is a closed group, both the number of participants in the plan and the aggregate plan costs can be expected to diminish steadily. However, the average cost of benefits per covered individual can be expected to increase steadily and substantially because of increasing average age.

The insurance of health care services for the aged is a relatively recent development. Consequently, there is no substantial body of statistical information available for estimating the cost of benefits such as are involved under the uniform plan. Within the limitations imposed by presently available statistics, we have estimated the probable cost of the benefits provided by the uniform plan. On the basis of our estimate and with due regard for the factors cited above, we conclude that the premium rates to be charged under the group health insurance policy prepared by the Aetna Life Insurance Co. to provide the uniform plan for retired Federal employees reasonably and equitably reflect the cost of the benefits provided. The supporting reasons for this conclusion are set forth more fully in the following sections.

Section IV contains our comments on the proposal by the Aetna Life Insurance Co. for a reinsurance agreement between itself and reinsuring companies.

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SECTION II

VALUATION OF BENEFITS

The uniform plan, underwritten by the Aetna Life Insurance Co. as the primary carrier, offers to each eligible retired Federal employee the option of electing to participate (for himself alone or for himself and eligible members of his family) in either one, or both, of two forms of health benefits coverage. These are described as basic coverage and major medical coverage.

The basic coverage provides the following benefits:

A. Reimbursement of hospital room and board charges up to $15 a day for up to 31 days during any calendar year—but not more than $465 during any one confinement.

B. An allowance for hospital charges for services and supplies (other than room and board) up to $150 in any calendar year.

C. Reimbursement of surgeons' fees up to the amounts set forth in a surgical schedule. The maximum allowance in this schedule for any one operation, or for more than one operation in a calendar year, is $240.

The major medical coverage provides the following benefits, subject to a lifetime maximum of $5,000 for each family member:

A. Room and board expenses:

(1) Reimbursement of hospital room and board charges up to $12 a day, beginning with the 32d day of hospitalization in a calendar year, for a maximum of 90 days in a calendar year.

(2) Reimbursement of charges by a convalescent hospital for room and board charges up to $6 a day for a maximum of 31 days a calendar year.

B. Other medical expenses: Seventy-five percent of the following expenses to the extent that they exceed a calendar year deductible of $100 per person or $150 per family:

(1) Hospital charges, other than room and board, after deducting the first $150 of such charges in any calendar year.

(2) Surgical charges in excess of the amounts which would be payable under the surgical schedule of the basic coverage.

(3) Doctors' charges for their professional services other than surgery.

(4) Charges for special or private-duty nursing (by registered nurses) in or out of a hospital, subject to a maximum of $16 a day for all such charges for a maximum of 31 days in a calendar year.

(5) Other out-of-hospital charges for itemized services, including prescription drugs, X-rays, radium treatment, blood or blood plasma, and rented equipment such as hospital beds and wheelchairs.

The monthly premium rates guaranteed for the first policy year ending June 30, 1962, for these coverages are:

	Per covered retired employee	
	Self only	Self and family
Basic coverage	$6.50	$13
Major medical coverage	6.00	12
Both coverages	12.50	25

Because of the absence of mature and pertinent experience, the assessment of the probable cost of any plan of health benefits for people of advanced ages must be quite approximate. The present problem is further complicated by the fact that information as to ages and incomes—both important factors in assessing probable costs—of the eligible retired employees was available for only a 5-percent sample compiled in 1957.

On the basis of this sample, we have estimated the average monthly value of benefits during the policy year commencing July 1, 1961, before provision for expenses or risk charges, as follows:

	Per covered retired employee	
	Self only	Self and family
Basic coverage	$6.11	$12.10
Major medical coverage	5.36	10.72
Both coverages	11.47	22.82

On the basis of our estimates, the indicated ratio of value of benefits to premiums, i.e., the expected claim ratios, are as follows:

[In percent]

	Self only	Self and family
Basic coverage	94	93
Major medical coverage	89	89
Both coverages	92	91

The Aetna based its cost calculations upon estimates that between 100,000 and 150,000 eligible retired employees would take the basic coverage, and between 250,000 and 300,000 would take the major medical coverage. Using the mean figures in these ranges, and assuming that 75 percent of those enrolling would enroll on the "with family" basis, the average expected claim ratios in the first policy year, based on our estimates of the value of the benefits, would be:

	Percent
Basic coverage	93
Major medical coverage	89
Both coverages	90

The foregoing estimates may be substantially affected by several factors. The nature of the effect of some of these factors can be foreseen with some confidence, while the effect of other factors is conjectural. Among the factors involved are the following:

(1) *Effect of selection.*—Retired employees have the option to have Government contributions applied toward the cost of qualified health benefits plans in lieu of participating in the uniform plan. The existence of this option makes the uniform plan vulnerable to adverse selection.

(2) *Effect of level of benefits.*—The extent to which a health benefit plan covers the full cost of medical care, and thereby removes financial barriers to the utilization of health care services, can be expected to directly influence the rate at which such services are used. Most of the data which are available for predicting the frequency of use of health care services by the aged have been obtained by studies involving those without insurance. Only experience can tell whether the effect of the particular level of benefits provided by the uniform plan on the rate of utilization of health care services has been predicted with reasonable accuracy.

(3) *Effect of aging.*—The group of retired employees eligible to participate in the uniform plan is substantially a closed group and, as a consequence, there will be practically no new entrants into this eligible group. Consequently, the average age of the participants can be expected to increase steadily from year to year. The rate of utilization of health care services and the average period of hospitalization both increase with advancing age. We estimate that the effect of the aging process alone will be to increase the average annual cost of benefits per retired employee covered under the uniform plan by about 3 percent a year.

(4) *Effect of medical care costs.*—Costs of many health care services have increased rapidly during the past several years. The increase in hospital costs has been relatively greater than the increase in the cost of living. The design of the uniform plan, with its fixed dollar maximums for basic benefits and percentage of total charges for major medical benefits, is to dampen the effect of this increase upon the cost of the basic coverage, and to accentuate its effect upon the cost of the major medical coverage. We estimate that the cost of the basic coverage will increase about 6 percent a year due to the increased cost of services (and the increased utilization which could be expected aside from the effect of aging upon the rate of utilization) and that the cost of the major medical coverage will increase for these same reasons by about 12 percent a year.

SECTION III

EXPENSE AND RISK CHARGES

The group health insurance contract prepared for issuance by the Aetna Life Insurance Co. to the U.S. Civil Service Commission to provide the uniform plan of benefits for retired Federal employees includes the following "Schedule of expense and risk charges."

Item:	*Amount*
Expense charges:	
Taxes	The actual accrued amount of taxes.
Administrative charges	Actual expenses, but not to exceed 12.5 percent of the 1st $1,000,000 of premiums accrued in the policy year, plus 5.4 percent of the balance.
Reinsurers' expense allowances.	0.2 percent of premiums.
Risk charges	1.3 percent of premiums.[1]

[1] 1 percent of premiums for any policy year at the beginning of which the special reserve referred to in subsec. B hereof exceeds $5,000,000.

This schedule is to be applicable for the first policy year, and for subsequent policy years—

except that it may be changed by the Aetna (on its own initiative or at the request of the Commission) for any policy year by agreement with the Commission.

The basis of allowance for expense and risk charges, as well as most of the specific factors in the foregoing schedule, follows the precedent established a year ago for the expense and risk charges allowed under the Government-wide indemnity benefit plan which is also administered by Aetna. The two specific factors with respect to which there are differences are the limit on administrative expense charges and the point at which the risk charge would be reduced from 1.3 percent to 1 percent.

The administrative expense charges, for which Aetna is to be reimbursed in connection with the administration of both the Government-wide indemnity benefit plan and the uniform plan for retired Federal employees, are to be determined by cost-accounting methods, with the amount of such expenses subject to audit by the Commission and the General Accounting Office. The limit on the amount of such expense charges was established for the Government-wide indemnity benefit plan as 5.5 percent of premiums. This figure was divided approximately as follows:

	Percent
Expense of a central office	1.0
Expense of settling claims	3.3
Other administrative expenses of the primary carrier	1.2
Total	5.5

The limit on administrative expense charges under the uniform plan for retired Federal employees would also be 5.5 percent if the annual premiums were $71 million, but grades up as a percentage of premiums as the size of the premium decreases. The first year premium on the

basis of the enrollment assumed in section II of this report would be about $52 million and at that level the limit on administrative expenses would be 5.54 percent of premiums.

The limit for reimbursement of administrative expenses in connection with the uniform plan for retired Federal employees is consistent with that adopted for the Government-wide indemnity benefit plan. Since the amount of expenses charged cannot, in any event, exceed the amount determined on a cost-accounting basis (and verified by Government agencies) this limit appears entirely reasonable.

The provision for reimbursement of the actual accrued amount of State premium taxes and other taxes attributable to the policy is obviously appropriate.

The allowance of 0.2 percent of premiums for reimbursement of reinsurer's expenses follows the precedent established in connection with the Federal employees group life insurance plan and the Government-wide indemnity benefit plan. The expenses which will be incurred by the reinsurers in connection with the administration of the uniform plan will be of the same general character as those involved in the above-named plans. Such an allowance appears reasonable.

The initial allowance of 1.3 percent of premiums as a risk charge (subject to reduction to 1 percent of premiums after the accumulation of a special reserve of $5 million) is consistent with the level of risk charge allowed to the carriers for the Government-wide indemnity benefit plan. The risk of loss to the carrier of the uniform plan is proportionately greater than the corresponding risk under the Government-wide health benefits plans. This is so, first, because the statistical foundation for the premium rates for retired lives is less reliable than that for active employees; and, second, because the retired group is a closed group, there is less opportunity to recoup losses due to adverse experience during subsequent years of favorable experience.

The value of benefits under the uniform plan was estimated, in section II, to be 90 percent of premiums in the first policy year. Using this figure and the same estimate for taxes (2.4 percent) as was used in our evaluation of the Government-wide indemnity plan, the allocation of the proposed premiums can be stated as follows:

		Percent of premiums
Benefit payments		90.00
Expenses and taxes:		
Operating expenses, not to exceed	[1] 5.54	
Reinsurers expense allowance	.20	
Taxes	2.40	
		8.14
Risk charge		1.30
Margin for contingencies		.56
Total		100.00

[1] If premiums for the year amount to $52,000,000.

On the basis of the foregoing figures we are of the opinion that the rates charged for the uniform plan could not be soundly calculated at any lesser amount, and we conclude that they "reasonably and equitably reflect the cost of the benefits provided," as required by the act.

SECTION IV

REINSURANCE AGREEMENT

The Retired Federal Employees Health Benefits Act provides that—

> The carrier shall, if the (Civil Service) Commission so directs, cede reinsurance to such other companies which regularly issue group health insurance as may elect to participate, or shall allocate its rights and obligations under the contract among such of its affiliates as may elect to participate in accordance with an equitable formula to be determined by the carrier and approved by the Commission.

The Commission having directed that reinsurance be ceded, a proposed reinsurance agreement between the primary carrier, Aetna Life Insurance Co., and various reinsuring companies was submitted for review. Under date of May 19, 1961, the following comments on this proposed agreement were sent to Mr. Andrew E. Ruddock, Director, Bureau of Retirement and Insurance, Civil Service Commission:

> This proposed agreement follows the form of the reinsurance agreement used in connection with the Government-wide indemnity benefit plan established in accordance with the provisions of the Federal Employees Health Benefits Act of 1959. This reinsurance agreement form is appropriate for the retired Federal employees health benefits plan, and the modifications in the body of this agreement, and in appendix II attached thereto, are in order. The reinsurer's allowance, which includes the reinsurer's risk charge, both of which are defined in appendix II, are at the same level as provided in the reinsurance agreement for the Government-wide indemnity benefit plan. The risks assumed by the reinsurers are, if anything, greater under the retired Federal employees health benefits plan than under the Government-wide indemnity benefit plan. Consequently, in my opinion, these allowances are entirely in order.
>
> The provisions of appendix III set forth the rules for allocating the insurance between Aetna Life Insurance Co., the primary carrier, and such other insurance companies as agree to be reinsurers. These rules have no effect on the cost of the program to the retired employees or to the Federal Government, and fall within the realm of policy which is appropriately determined by the Commission in conference with the insurance industry. For this reason, I consider the proposed text of appendix III to be in order.

ADDENDUM

MILLIMAN & ROBERTSON, INC.,
Seattle, Wash., August 15, 1961.

Mr. JOHN W. MACY,
Chairman, Civil Service Commission,
Washington, D.C.

DEAR MR. MACY: Under date of June 7, 1961, I supplied you with an evaluation of the proposed premium rates for the Government-wide uniform plan for retired Federal employees. Subsequently, Mr. Andrew E. Ruddock, Director of the Bureau of Retirement and Insurance, has supplied me with a copy of the completed contract between Aetna Life Insurance Co., the carrier underwriting this plan, and the Civil Service Commission, together with a summary of the number of retired employees who had enrolled under the uniform plan and under plans provided by qualified private health benefit carriers. With this information at hand, I would like to make some observations supplementing my report of June 7.

First, I find nothing in the completed contract which alters the conclusions set forth in my report.

Second, the enrollment under the uniform plan, as indicated by the figures supplied to me by Mr. Ruddock, shows a substantially lower participation in this plan, and a different distribution of participation between the basic coverage and the major medical coverage than was anticipated by the estimates upon which my report was based. The cost estimates of the report were based upon the assumption that 125,000 eligible retired employees would take the basic coverage, and 275,000 would take the major medical coverage, and that 75 percent of the participating retired employees would enroll on the "with family" basis. The following tabulation compares these assumptions with actual participation:

	Actual enrollment	Estimated enrollment
Enrolled for self only under—		
Basic coverage	55,822	31,250
Major medical coverage	44,876	68,750
Enrolled for self and family under—		
Basic coverage	48,140	93,750
Major medical coverage	28,971	206,250

The total enrollment under the uniform plan and the plans of the qualified private health benefit carriers was 227,868. It was our understanding that there are slightly over 400,000 eligible retired employees. One can only speculate as to the reasons why such a small proportion of the eligible retired employees chose to take advantage of the Government contribution provided by the Retired Federal Employees Health Benefits Act, and why such a large proportion participated on a "self only" rather than "family" basis.

The effect of the lower enrollment under the uniform plan and the shift in distribution of enrollment as compared with the anticipated enrollment is, first, to reduce the aggregate amount of Government contributions; second, to increase the uncertainty as to the level of claim costs which will develop under the plan; and third, to increase the percentage of premium expense allowance while decreasing the aggregate amount of such allowance to the carrier.

The total Government contribution toward the cost of the coverage of retired employees enrolled under the uniform plan, based upon the foregoing figures, would be approximately $570,000 a month. This is only 35 percent of the Government contribution which would have been required for those enrolled under the uniform plan on the basis of the "estimated enrollment" figures shown above.

As indicated in our report, there is considerable uncertainty as to the level of claim costs which can be expected under plans of health benefits for people of advanced ages. This uncertainty is accentuated when there is an opportunity for the eligible individuals to choose between different plans, and even further accentuated when the proportion of the total eligibles participating is relatively low, as appears to be the case among the retired Federal employees. We would expect that a higher proportion of those who expect to have above average costs for medical care would participate than would be the case among those who expect below average medical costs. If this expectation is borne out in the experience under the uniform plan, the claim ratios can be expected to be even higher than set forth in our report. Since the margin for contingencies indicated in our report, after provision for benefit payments, and for operating expenses, taxes, and risk charge in accordance with the terms of the contract, was only 0.56 percent of premiums, and since any estimate of the effect of selection upon the claim ratio would be purely speculation, no useful purpose would be served by revising our estimate of the expected claim ratios.

The contract negotiated between the Commission and Aetna provides that Aetna is to be reimbursed for administrative expenses, determined by cost accounting methods, up to a limit defined in the contract. This formula applied to a first-year premium income of $52 million would result in a limit of administrative expenses of 5.54 percent of premiums. The actual enrollment under the plan indicates an annual premium income of about $17,700,000. The limit on the amount of administrative expense charges would, as a result, be increased to about 5.80 percent of premiums, an increase of 0.26 percent.

On the basis of the information now available as to the enrollment under the uniform plan, combined with our estimates of claim costs, we are forced to the conclusion that there will be little, if any, margin in the premium rates under Aetna's contract after provision for expenses and claims.

Sincerely,

WENDELL MILLIMAN.

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