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UNDERWRITING GAIN ASSUMPTIONS AND THE NEW CORPORATE TAX RATE IMPACT

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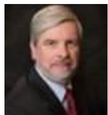

The Tax Cuts and Jobs Act, which was signed on December 22, 2017, reduced the federal corporate income tax rate on 2018 income to 21%. Previously, the rate had averaged 35% on corporations with taxable income of $18,333,333 or more, grading down slightly to 34% on corporations with taxable income of $335,000 to $10,000,000 per year. The reduction in the corporate income tax rate means that Managed Care Organizations (MCOs) subject to corporate income tax will be able to retain a larger portion of their pre-tax income. Therefore, state Medicaid agencies should look at their particular circumstances to see whether the corporate income tax rate reduction provides a reason that premium rates could be a little lower than they would have been had the income tax rates not been reduced.

To explore this issue, we will look at the components of the premium rate, particularly the underwriting gain, as well as a description of the effect of the statutory risk-based capital (RBC) formula on the level of capital that MCOs seek to maintain.

Components of the Premium Rate

The table below illustrates the components of a modeled premium rate (before consideration of the federal Health Insurance Providers Fee). The level of premium-based taxes varies by state, so it is useful to separate them from the administrative expenses that the MCO can affect.

Premium Component (Before the Federal Health Insurance Providers Fee)	Per Member Per Month (PMPM)	As a Percent of	
		Premium Before Premium-Based Taxes	Total Premium
Medical claims expense	$360.00	90.00%	87.30%
Administrative expense	$32.00	8.00%	7.76%
Underwriting gain (before income taxes)	$8.00	2.00%	1.94%
Premium before premium-based taxes	$400.00	100.00%	97.00%
Premium-based taxes	$12.37		3.00%
Total premium	$412.37		100.00%

Underwriting Gain Premium Component

As shown in the table of premium components above, an MCO's underwriting gain before income taxes is equal to the premium minus the sum of claims expense, administrative expenses and premium-based taxes. The total pre-tax income of the MCO is the underwriting gain plus the income from investments, which is not displayed in the table above.

In addition to the costs for claims, administration, and taxes, MCOs also have a cost of capital. The underwriting gain premium component provides for this cost of capital and a margin for risk. MCOs that are owned by shareholders are in business to provide those shareholders with an opportunity of a return on their investment. Similarly, not-for-profit MCOs must also have capital to support the risk that they bear and may need to repay loans for their starting capital. The risk that an MCO bears can be affected by the risk mitigation arrangements in the contract, such as risk-adjustment methodologies that use actual or inferred diagnoses of covered persons, provider performance withholds and incentive arrangements, reinsurance, risk corridors, minimum medical loss ratios, and other risk-sharing arrangements.

Risk-Based Capital

State insurance regulators use the RBC formula to determine the amount of capital that insurers need to have in order to responsibly bear the risk that they are assuming. For a typical MCO that covers Medicaid, the Authorized Control Level (ACL) RBC is 0.45 to 0.50 months' worth of claims (or less, if the MCO has a significant portion of its claims cost in capitation to providers). If an MCO has capital of 300% or more of the ACL RBC, then it can avoid additional regulatory scrutiny that insurers with lower levels of capital would face. This 300% ACL level is the threshold for the RBC Trend Test, which would be triggered if (1) claims plus administrative expenses exceed 105% of revenue and (2) capital is between 200% and 300% of ACL RBC. The 300% ACL RBC is typically equivalent to 1.35 to 1.50 months' worth of claims.

If medical costs increase from year to year, the dollar amount of capital that an MCO needs to maintain its capital at a certain percentage of the ACL RBC will also increase. The source of the increase can be higher costs per covered person, a larger number of covered persons, or both. Therefore, if an MCO is looking to maintain market share when the number of Medicaid recipients in a state is increasing and when medical costs are increasing, then its capital needs will also increase on a dollar basis. Without an infusion of capital from outside sources, the source of that additional capital must be retained earnings — the underwriting gain and investment income that the MCO retains after income taxes.

Lower Underwriting Gain

The table below shows that the $8.00 PMPM pre-tax underwriting gain from the earlier example results in after-tax income of $4.89 PMPM when a typical 6% state corporate income tax rate and the 2017 federal corporate income tax rate of 35% are applied. A lower pre-tax underwriting gain of $6.59 PMPM would, when the 2018 federal rate of 21% is applied, result in the same $4.89 PMPM after-tax income, so the premium before premium-based taxes could be reduced by $1.41 PMPM to $398.59 PMPM and the total premium (including premium-based taxes) reduced to $410.92 PMPM, a reduction of $1.45 PMPM, or 0.35%.

	Original PMPM Underwriting Gain		Lower PMPM Underwriting Gain
	Federal Corporate Income Tax at		
	2017 Rate of 35%	**2018 Rate of 21%**	**2018 Rate of 21%**
Pre-tax underwriting gain PMPM	$8.00	$8.00	$6.59
State corporate income tax at 6%	$0.48	$0.48	$0.40
Amount subject to federal income tax	$7.52	$7.52	$6.19
Federal corporate income tax (2017 and prior)	$2.63		
Federal corporate income tax (2018)		$1.58	$1.30
After-tax income PMPM	$4.89	$5.94	$4.89

Determining the Underwriting Gain Component of the Premium

When an actuary works with a state Medicaid agency to determine the underwriting gain component of the premium rates offered by the state, the level of capital that MCOs need to maintain and a reasonable rate of return on it are key issues, as are the state's tax rates and any risk mitigation incorporated in the contract. For example, a new population without any experience data would be higher risk than a well-established population with years of experience data, but a risk corridor arrangement for that new population could reduce the risk to the MCO, while leaving that risk with the state. Investment income can also be considered in the determination of the underwriting gain. For example, an MCO has the opportunity to earn investment income on assets supporting the unpaid claim liability when it receives premiums in the month of coverage, but that opportunity is significantly reduced if the state pays premiums the month after coverage, since the MCO has, instead of cash, an uncollected premium asset at the end of the month of coverage.