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FEDERAL HEALTH BENEFITS PROGRAM

Analysis of Contingency and Special Reserves

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The Honorable David H. Pryor
Chairman, Subcommittee on Federal Services,
Post Office, and Civil Service
Committee on Governmental Affairs
United States Senate

The Honorable William V. Roth, Jr.
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

This report responds to your request for our evaluation of the financial soundness of proposed changes to reserve requirements of the Federal Employees Health Benefits Program (FEHBP). The Federal Employees Health Benefits Act of 1959 requires that contingency reserves be maintained separately for each health plan's high and/or standard benefits option to guard against unexpected costs. In March 1990, the Office of Personnel Management (OPM), which administers FEHBP, proposed a mix of legislative and administrative initiatives that included amending the act to permit pooling of the experience-rated plan options' contingency reserves, which it said were excessive in view of the risks confronting the program as a whole.

According to OPM's proposal, even if unexpected costs depleted the reserves of some individual plan options, the program as a whole could remain solvent. If the contingency reserves were pooled, OPM said it could (1) reduce its goal for each option's year-end combined contingency and special reserve balance from 2 months to 1 month of benefits and administrative expenses and (2) permit plan options that deplete their own reserves to borrow from the contingency reserve pool. OPM estimated that pooling and reducing the reserves would result in a onetime, calendar-year savings from lower premium payments of $850 million ($629 million for government agencies, including the Postal Service, and $221 million for enrollees).

Although after 1990 OPM did not renew its proposal for pooling and reducing the reserves for subsequent years, you asked us to determine whether the changes would affect the stability of FEHBP or put the plans, enrollees, and/or the government at risk. We briefed your offices on the results of our evaluation on November 10, 1992. This report summarizes the information we presented.

Background

The FEHBP's health plans are categorized as "experience-rated" or "community-rated" for rate-setting and accounting purposes. The experience-rated plans adjust premiums on the basis of actual claims and administrative costs and are required to maintain accounts for FEHBP separate from their other lines of business. The community-rated plans charge FEHBP the same premiums charged other insured groups with the same level of benefits and are not required to keep separate accounts for FEHBP. The community-rated plans were not included in our review.

In 1991, about 3 million (76 percent) of FEHBP's participants were enrolled in the experience-rated plans. The premiums for the 35 experience-rated plans totaled $10.1 billion. The government paid $7.5 billion (74 percent) of those premiums, and the enrollees paid the remainder.

The experience-rated plans include the governmentwide Blue Cross and Blue Shield plan, 14 employee organization plans, and 20 prepaid plans that are commonly called health maintenance organizations (HMO). The governmentwide and employee organization plans permit enrollees to choose their doctors and other health care providers; HMOs use a specific group of providers to provide enrollees with medical services. All of the plans offer "self " or "self and family" coverage, and some of the plans also offer both "high" and "standard" benefits options.

The contingency and special reserves are important to FEHBP's financial soundness and stability because, combined, those reserves represent the financial ability of the individual experience-rated plan options to pay benefits and administrative costs that exceed annual premium income. Generally, if an option's expenses are overestimated when the premium is set, its reserves will increase; if the expenses are underestimated, its reserves will decrease. The reserves also help to moderate changes in the annual premiums and minimize the risk that the plan options' sponsors, underwriters, enrollees, and/or the government would experience a financial loss if the option was terminated without adequate premium income and reserves to cover any outstanding claims for benefits. Appendix I provides more information on the types and purposes of the reserves and the current and proposed reserve requirements.

Results in Brief

The implementation of OPM's proposal to reduce the goal for the experience-rated plan options' combined contingency and special reserves from 2 months of benefits and administrative expenses to 1-month's expenses could result in a onetime, calendar-year premium savings for government agencies and enrollees. The savings would occur if the premiums for plan options with combined reserves above 1-month's expenses were reduced to draw the reserves down to that level.

However, from a financial management perspective, our analysis of the total of the plan options' combined ending reserve balances for 1980 through 1989, and the responses to a letter we sent to the plan options' sponsors and underwriters, indicated that a 1-month goal may not be prudent for the future soundness and stability of FEHBP and the individual plan options.

During the 10-year period that we reviewed, the total combined reserve balance fluctuated widely. Although at the end of 2 of the 10 years (1984 and 1985) the combined balance was double or triple the 2-month goal, at the end of 2 other years (1981 and 1987) the balance totaled only about one-third of a month's expenses. Because the total combined balance decreased by more than 1-month's expenses during those 2 years, a beginning balance that was at or under the proposed 1-month goal would not have been adequate to cover the total of the plan options' unexpected costs. Also, we reviewed the estimates OPM used to set the 1987 premiums for nine of the largest plan options and found that the weighted average of the estimating errors for that year was greater than 1-month's expenses. Thus, we believe that a reserve goal of 1-month's expenses would not have afforded FEHBP adequate protection against unexpected costs in the past.

Additionally, the plan sponsors and underwriters that responded to a letter we sent expressed strong concerns about other potential adverse effects of the proposed changes to the reserves. The 15 respondents were generally opposed to pooling the reserves and reducing the reserve goal. They thought that the risk for the plans, enrollees, and/or government would increase because the changes would (1) jeopardize the stability of options that were financially sound, (2) result in larger future annual premium increases, and (3) increase the possibility that plan sponsors and underwriters would suffer a financial loss and that enrollees' benefits claims would not be paid.

The Combined Reserve Balance Fluctuated Widely and for Some Years Was Substantially Under the Reserve Goal

The individual experience-rated plan options' combined contingency and special reserve balances can be expected to fluctuate because when OPM and the sponsors negotiate the annual premiums, uncertainties about medical cost inflation, health care utilization, and open season enrollment migration make it difficult to estimate benefits costs. Generally, the reserve balances increase when costs are lower than estimated and decrease when costs are higher than estimated.

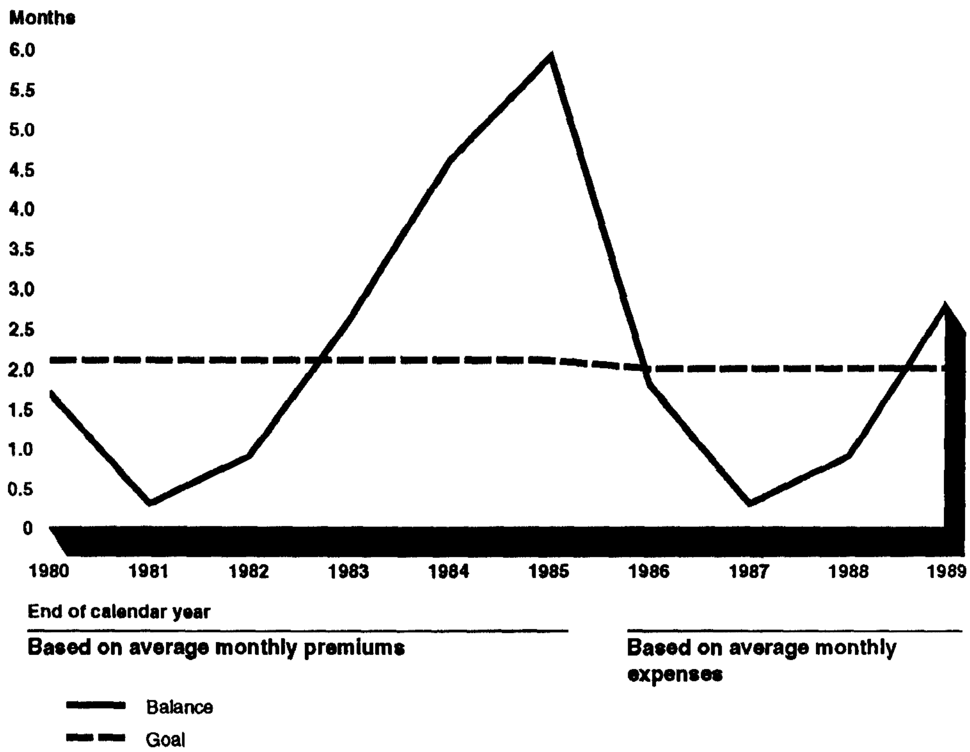
According to OPM, fluctuations in the total of the combined reserve balances should be more moderate than fluctuations in the individual balances. However, we found that the total combined balance fluctuated widely. It grew from $476 million at the end of 1980 to $1.9 billion at the end of 1989. During that 10-year period, however, the balance fluctuated from a low of $81 million at the end of 1981 to a high of $2.8 billion at the end of 1985. It then decreased to $186 million at the end of 1987 before increasing to $1.9 billion at the end of 1989. At various times the balance was at levels that OPM considered to be excessive or dangerously low.

For 1980 through 1985, OPM's reserve goals varied by plan size and the risk to enrollees if the plan terminated. The weighted average of OPM's goals for the options' combined contingency and special reserves was 2.1 months of premiums. For 1986 through 1989, the goal for all of the options was 2 months of benefits and administrative expenses. Our comparison of the total of the actual combined balances to the total of the goals for the years 1980 through 1989 showed that the total balance was over the goal for 4 of the 10 years (1983, 1984, 1985, and 1989) and under the goal for 6 of the years.

Although FEHBP's reserves were not completely depleted when the total actual balance was under the goal, the balance at the end of 4 of the 6 years was less than the proposed reduced goal of 1 month of benefits and administrative expenses. In 1982 and 1988 the total balance equaled 0.9-month's expenses, and in 1981 and 1987 it equaled 0.3-month's expenses. In those years, many FEHBP enrollees were in options with combined reserve deficits. For example, in 1988 about one-half of the experience-rated plan options, with a total enrollment of about 630,000, had reserve deficits totaling about $150 million.[1] Figure 1 shows the total of the experience-rated plan options' ending reserve balances and goals for 1980 through 1989. Appendix II provides more detailed information about the reserves for the 10-year period we reviewed.

[1]Plans' combined reserve deficits reflect past operating losses but do not necessarily mean they have no cash to pay enrollee claims.

Figure 1: Experience-Rated Plan Options' Total Combined Contingency and Special Reserve Balances and Goals, 1980-1989



Source: Compiled by GAO from OPM data.

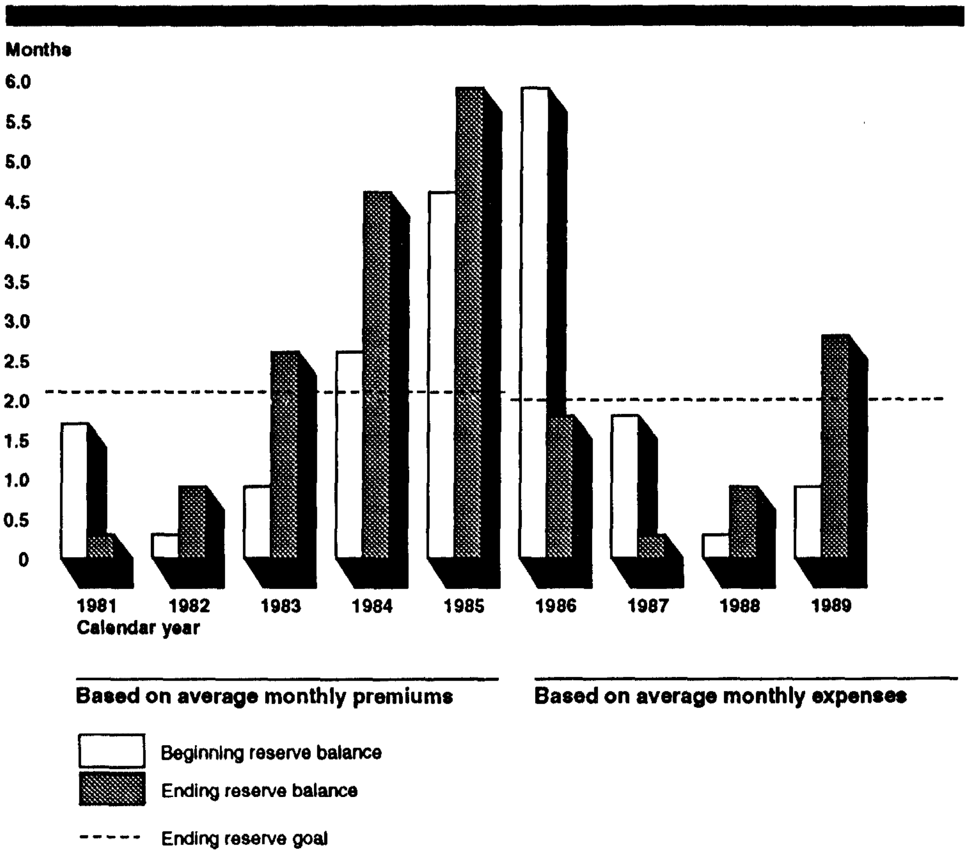
The Proposed Reserve Goal May Not Be Adequate to Protect FEHBP From Unexpected Costs

Although the total of the options' combined reserve balances would probably continue to fluctuate if the goal for the options' combined contingency and special reserves were reduced from 2 months to 1 month of benefits claims and administrative expenses, we would expect the year-end balances to be lower than they have been in the past. For example, while under the 2-month goal the annual premium for an option with a reserve balance of 1.5-months' expenses would probably be raised to increase the balance, under the 1-month goal, the premium would probably be lowered to decrease the balance.

Because reducing the goal would also reduce the margin for error in estimating the options' expenses and the estimating error for some of the years that we reviewed appeared to have been greater than the proposed goal for the ending reserves of 1-month's expenses, it is questionable whether a reduced goal would ensure that FEHBP's reserves would always be adequate to cover unexpected expenses. OPM did not maintain summary information that would have enabled us to determine the extent to which decreases in the total reserve balance during the 10-year period that we reviewed were caused by errors in estimating the expenses of the individual plan options. Therefore, to determine if a balance equal to 1-month's expenses would have been adequate to cover underestimated costs on a programwide basis, we assumed that when the beginning reserve balance was under the 2-month goal, a decrease of 1-month's or more expenses was at least partially caused by estimating errors.

Our analysis showed that the balance decreased in 2 of the 6 years when the beginning balance was below the goal and that both of the decreases were greater than 1-month's expenses. During 1981, the balance decreased from 1.7-months' premiums to 0.3 months, or by 1.4 months, and during 1987 it decreased from 1.8-months' expenses to 0.3 months, or by 1.5 months. Figure 2 compares the total of the options' beginning and ending combined reserve balances for 1981 through 1989.

Figure 2: Annual Change in the Experience-Rated Plan Options' Total Combined Contingency and Special Reserve Balances, 1981-1989

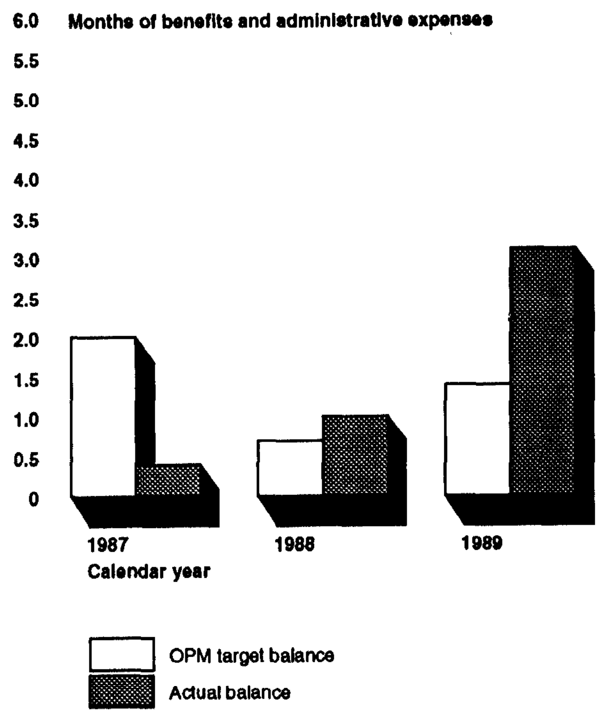


Source: Compiled by GAO from OPM data.

Because the premiums for the individual plan options may have been set to achieve combined reserve "targets" that were below the 2-month reserve goal for 1981 and 1987, we also analyzed the accuracy of the estimates OPM used in setting premiums. We compared the reserve targets established when premiums were set to the actual year-end reserve balances for the nine options offered by the six largest plans for 1987 through 1989, the latest years for which information on the targets was readily available.

Our comparison showed that for 1 of the 3 years (1987), the weighted average of the nine options' actual balances was 1.6-months' expenses below the weighted average of the targets used in setting the options' premiums. That year, the balances for six of the nine options were 1-month's expenses or more below their targets. Although the weighted averages of the ending balances were above the targets for the other 2 years, the actual balances for three options were 1-month's expenses or more below the targets for at least 1 of those years. Overall, 9 of the 27 ending reserve balances reviewed for the 3-year period were underestimated by from 1-month's to 3.5-months' expenses. Figure 3 shows the weighted average of the target and actual balances for the 3 years. The targets and actual balances for the nine options in 1987 through 1989 are shown in appendix III.

Figure 3: Weighted Averages of Nine Plan Options' Combined Contingency and Special Reserve Targets and Actual Ending Balances, 1987-1989



Source: Compiled by GAO from OPM data.

Plan Sponsors and Underwriters Believe That Pooling and Reducing the Reserves Would Have Adverse Effects

We wrote to all 45 of the experience-rated plan sponsors and underwriters identified by OPM as FEHBP participants in 1990 to obtain their views on (1) pooling the contingency reserves of the experience-rated plan options and (2) reducing the goal for the options' combined contingency and special reserves from 2-months' to 1-month's benefits claims and expenses. The 15 respondents were generally opposed to pooling and reducing the reserves, which they believed would adversely affect individual plans and enrollees and could be detrimental to the program. [2] However, eight respondents indicated that their opposition may have been at least partially due to the lack of sufficient information on how the proposed changes would work. Only 1 of the 15 respondents supported pooling the reserves; 2 others supported reducing the reserve goal. The 15 responses that we received may not be representative of the views of all experience-rated plan sponsors and underwriters. Table 1 summarizes the respondents' views on the proposed changes. The 15 respondents are identified in appendix IV.

Table 1: Plan Sponsors' and Underwriters' Views on the Proposed Changes to the Experience-Rated Plan Options' Combined Contingency and Special Reserves

Proposed change/respondent	Favor change	Oppose change	No comment	Total
Pool contingency reserves:				
Governmentwide plan sponsor	•	1	•	**1**
Employee organization plan sponsors	1	8	•	**9**
Underwriters	•	2	•	**2**
Health maintenance organizations	•	2	1	**3**
Total	**1**	**13**	**1**	**15**
Reduce combined reserve goal:				
Governmentwide plan sponsor	•	1	•	**1**
Employee organization plan sponsors	1	7	1	**9**
Underwriters	1	1	•	**2**
Health maintenance organizations	•	3	•	**3**
Total	**2**	**12**	**1**	**15**

[2]The Blue Cross and Blue Shield Association, which sponsors the governmentwide plan, specifically requested that its strong opposition to the proposed changes be noted in our report.

Respondents' Concerns About Pooling Reserves

The plan sponsors' and underwriters' responses to our letter indicated that pooling the experience-rated plan options' contingency reserves could undermine the basic reason for funding those reserves—to provide a source of funds for a particular option's use in the event of higher-than-anticipated medical costs or benefits utilization. One concern was that if options were permitted to borrow from the pooled contingency reserves, adequate reserve funds might not be available when needed by the option whose premiums funded them. Another concern was that there would be no guarantee that loans made to options with combined contingency and special reserve deficits would be repaid if those options terminated their FEHBP participation.

The respondents' comments also indicated concerns that the sounder and more prudently managed options would be subsidizing those plan options that were not sound or had not prudently managed their activities and the prospects of obtaining loans could encourage (1) premium underpricing to gain more enrollees and (2) financially troubled plan options to continue operating beyond their viability.

Respondents' Concerns About Reducing Reserves

Generally, the respondents believed that reducing the combined contingency and special reserve goal to 1-month's benefits and administrative expenses would jeopardize their options' financial stability. Among the reasons the respondents cited for this concern were that (1) the lower reserve level would be inadequate to fund long-term cyclical fluctuations in medical cost inflation and health care utilization, (2) the reserves could be quickly depleted if the assumptions used in setting the premiums were wrong, and (3) larger annual premium increases would be required to recoup operating losses and replenish the reserves in less time. Also, two respondents said that the lower reserve level would not adequately protect them from financial loss, and one respondent said it would make it more difficult for the smaller plans to obtain underwriting services.

Respondents Believe Proposed Changes Would Increase Risk

Of the 15 respondents, 3 sponsors of employee organization and HMO plans did not comment on whether pooling and reducing the reserves would increase the risk for the plans, enrollees, and/or the government. The majority of the 12 respondents that commented believed that the risk would increase for the plans, the enrollees, and/or the government. They generally associated the expected increase in risk to the reasons cited in opposition to pooling and reducing the reserves. Table 2 shows the number of respondents who specifically commented that the proposed changes to the current reserve requirements would result in increased risk for the plans, enrollees, and/or government.

Table 2: Number of Respondents Who Believed That Pooling and Reducing Reserves Would Increase the Risk for Plans, Enrollees, and/or the Government

	Increase risk for		
Respondent	**Plans**	**Enrollees**	**Government**
Governmentwide plan sponsor	1	1	1
Employee organization plan sponsors	7	5	3
Underwriters	2	2	2
Health maintenance organizations	2	1	1
Total	**12**	**9**	**7**

Note: Of the 12 respondents, 9 commented on the risk for the government.

Conclusions

We do not believe it would be prudent for the financial management of FEHBP to implement the proposal OPM once made to pool and reduce the experience-rated plan options' combined contingency and special reserves. Although the proposed changes could produce a onetime reduction in the calendar-year premiums paid by government agencies and enrollees, they could, in turn, jeopardize the ability of FEHBP's combined contingency and special reserves to (1) cover the experience-rated plan options' unexpected costs; (2) stabilize premium and benefits levels; and (3) minimize the possibility of a financial loss for plan sponsors, underwriters, enrollees, and/or the government.

Although for 2 of the 10 years we reviewed, the total combined reserve balance exceeded OPM's goal of having 2-month's benefits and administrative expenses in reserve by several months, for 2 other years it was only one-third of a month's expenses. Thus, it appeared that a reserve balance equal to 1-month's benefits and administrative expenses might not have been adequate to cover unexpected costs. Because past balances fluctuated frequently by large amounts in relation to reserve goals and targets, it appears that OPM could find it difficult to maintain the balance at or above the proposed level. Thus, if the balance continued to fluctuate as much after the combined reserve balance was reduced, FEHBP's financial soundness and stability would be endangered.

Agency Comments

We discussed the contents of this report with OPM program officials, who agreed with the facts presented.

Scope and Methodology

To evaluate the 1990 proposal to pool and reduce FEHBP's experience-rated plan options' reserves, we

- reviewed studies of FEHBP reserves by GAO, the Congressional Budget Office, the Congressional Research Service, and OPM and congressional consultants;
- interviewed OPM officials and reviewed relevant information about the reserves and OPM's proposal to change the reserve requirements;
- analyzed the options' contingency and special reserve balances and goals for 1980 through 1989; and
- analyzed OPM's reserve targets for the nine high and standard options offered by the six largest plans in 1987, 1988, and 1989.

Also, in October 1990, we wrote to all of the sponsors and underwriters of experience-rated plans that OPM identified as FEHBP participants in 1990 to obtain their views on the proposed changes to the reserve requirements. The 45 sponsors and underwriters that we sent letters to represented 54 plans. Of these 45 sponsors and underwriters, 20 responded and 15 of the respondents provided comments. The comments were provided by the presidents, executive directors, or other senior officials. Four of the five respondents did not comment because they no longer participated in FEHBP and the other response was from a community-rated plan, which would not have been affected by the proposal. Of the 25 nonrespondents, 6 were no longer either in FEHBP or experience-rated and 19 either preferred not to comment or could not be contacted by telephone when we attempted to follow up with nonrespondents. Because of the low response rate to our letter, the comments provided may not be representative of the views of all the sponsors and underwriters.

We obtained data on the options' ending reserve balances and benefits and administrative expenses from OPM. The 1989 data were the latest available at the time we initiated our review. However, it is doubtful that the data for 1990 and 1991 would have changed our conclusions due to the wide variations in the reserve balances for the 1980-1989 period and the inherent difficulties OPM and the plans have in predicting expenses. We did not verify the accuracy of the data, which were subject to change after audit by OPM's Inspector General and other adjustments.

We did our work from October 1990 to August 1992 in accordance with generally accepted government auditing standards.

As agreed with you, unless you publicly release its contents earlier, we plan no further distribution of this report until 5 days from the date of this letter. At that time, we will send copies to OPM, other congressional committees, and other interested parties. We will also make copies available to others upon request.

Please contact me at (202) 275-5074 if you or your staff have any questions concerning this report. The major contributors to this report are listed in appendix V.

Bernard L. Ungar

Bernard L. Ungar
Director, Federal Human Resource
Management Issues

Contents

Abbreviations

FEHBP	Federal Employees Health Benefits Program
HMO	Health maintenance organization
OPM	Office of Personnel Management

Federal Employees Health Benefits Program Reserves and Proposed Changes to Plan Reserve Requirements

The maintenance of reserves is standard practice in the insurance industry. The Federal Employees Health Benefits Act of 1959 and Office of Personnel Management (OPM) regulations provide for the maintenance of four types of reserves within the Federal Employees Health Benefits Program (FEHBP). Each experience-rated plan option has a contingency reserve, special reserve, and accrued claims reserve, and OPM maintains an administrative reserve to cover its costs to administer the program.

The contingency reserves and special reserves are designed to provide funds that can be drawn on when an option's benefits claims exceed its annual premium income. When OPM and plan sponsors negotiate the annual premiums, accurate predictions of claims costs are difficult to make because of uncertainties, such as open season changes in enrollment, utilization of health care services by enrollees, and medical cost inflation. Thus, an option's premium is intended to (1) cover estimated benefits and administrative costs and (2) provide surplus funds that can be used to pay unexpected costs.

A major difference between the contingency and special reserves is the method of funding. The 1959 act requires the continuous funding of a contingency reserve for each option through a premium surcharge of up to 3 percent annually. Other additions to the options' contingency reserves include the pro rata shares of surplus funds in OPM's administrative reserve at the end of each year and income earned by OPM from the investment of FEHBP funds in federal securities. The special reserve consists of the cumulative net gains and losses from the option's operations and income earned from the investment of FEHBP funds. At the end of the contract year, funds are transferred between the option's special and contingency reserves in accordance with criteria established by regulation.

The plans' accrued claims reserves and OPM's administrative reserve were not included in our evaluation. In accordance with accrual accounting, an accrued claims reserve is maintained for each experience-rated plan option to cover the estimated cost of covered health care that had been provided to enrollees but not claimed by the end of the year. The act provided for the funding of OPM's administrative reserve through a premium surcharge of up to 1 percent.

Contingency and Special Reserves Serve Several Important Functions

Together, the contingency and special reserves represent a plan option's financial ability to pay benefits and administrative costs that exceed annual premium income. The reserves contribute to FEHBP's financial soundness and stability by

- protecting plan sponsors and/or underwriters from annual operating losses caused by underestimates of the options' expenses,
- reducing the risk that sponsors and/or underwriters could experience financial losses because their options or underwriting contracts were terminated with cumulative operating losses in excess of the option's contingency reserves,
- moderating changes in the annual premiums paid by enrollees and the government, and
- reducing the risk that enrollees or the government would have to pay outstanding claims for benefits because options with inadequate reserves to pay those claims were terminated.

When an experience-rated plan option's combined reserves fall below zero, the option is in the serious financial position of having inadequate income and reserves to pay expenses. The option's sponsor and/or underwriter is responsible for funding any cash shortfalls that may result from such deficits until the loss can be recouped through premium increases in subsequent years. However, if the option or underwriting contract is terminated before any net cumulative losses are fully recouped, and the option's combined contingency and special reserve balance is below zero, the sponsor and/or underwriter must suffer the loss. In the past 14 years, underwriter losses have totaled about $125 million. [3] Although the program is not responsible for an option's losses in excess of its reserves, any reserves remaining after all of a terminating option's claims and expenses have been paid belong to the program and are distributed among the contingency reserves of the participating plans.

The reserves also benefit enrollees and the government because they can be increased or decreased to help stabilize the levels of premiums and benefits. Additionally, although each plan option has an accrued claims reserve, the contingency reserve further reduces the risk that the enrollees or government would have to pay outstanding claims for medical bills if the sponsor and/or underwriter of an option become bankrupt.

[3] John J. Creedon, Theodore Allison, Richard Mellman, and Warren Sherman, Report on Federal Employees Health Benefits Program, prepared for the Committee on Post Office and Civil Service, U.S. House of Representatives, 102d Cong., 2d sess. (May 14, 1992), p. 117.

OPM's Reserve Goals and Targets

OPM has established a goal for each plan option's combined ending contingency and special reserve balance. From 1980 through 1985, OPM stated its goals in terms of a plan option's average monthly premium income and had different goals for the various types of plans, as shown in table I.1.

Table I.1: Goals for Experience-Rated Plan Options' Combined Ending Contingency and Special Reserves, 1980-1985

Goals in months of premium income

Type of plan	Goal
Governmentwide	2
Employee organization:	
Self-insured by sponsoring organization	2.5
Underwritten by commercial insurer	2
Health maintenance organization	3

Since 1986, OPM has stated its goals in terms of the options' average monthly benefits and administrative expenses (including taxes and profits) and has had the same goal of 2-months' costs for all of the experience-rated plans.

Because estimating uncertainties cause the accuracy of premiums to vary from year to year and option to option, the actual ending reserve balances can be well above or below the goals. When an option's reserves would require a large upward or downward adjustment to reach the goal, OPM's practice has been to moderate premium and/or benefits changes by spreading the adjustment over more than 1 year. Thus, although the reserve goal is important, an option's premiums and benefits may be negotiated to achieve an ending reserve balance significantly different from the goal. Those balances are referred to as OPM's reserve "targets" in this report.

Proposed Changes to Plan Reserves

As part of its budget proposal for fiscal year 1991, OPM recommended that (1) the contingency reserves of the experience-rated plan options be pooled and (2) the goal for the options' combined ending contingency and special reserve balances of 2-months' benefits and administrative expenses be reduced to 1-month's expenses. According to OPM, reserves of 2-months' expenses were excessive for the overall program because unexpected costs were likely to be greater for a single option than for the program as a whole. Because individual options occasionally exhausted their separate reserves, OPM believed that the reduction was viable only if the contingency reserves were pooled. Thus, if an option depleted its own reserves, it would have been able to borrow from the contingency reserve pool.

Under OPM's proposal, the pooled reserves would have continued to be accounted for separately by option and would only have been used to finance loans to options that provided evidence of a cash shortfall. Interest would have been charged for the loans, and the loans would have been amortized from future credits to the borrowing options' contingency reserves. Upon program termination, OPM would have redirected the premium income of options with loans outstanding to options with positive contingency reserve balances so that those options would have the full amount of their contingency reserves available to pay outstanding claims for benefits. Any reserves remaining after all claims had been paid would have been prorated among options with negative reserve balances in proportion to their premium income.

Fluctuations in the Experience-Rated Plan Options' Combined Contingency and Special Reserve Balances, 1980-1989

The total combined reserve balance of the experience-rated plan options was almost depleted at the end of 1981 following 3 successive years of net operating losses. In 1981, the options' net operating losses totaled $387 million because underestimates of health care costs and utilization caused their premiums to be underpriced. By the end of 1981, the options' combined reserves had declined to a total of $81 million. Although the contingency reserves of a majority of the 35 experience-rated plan options were adequate to cover their cumulative losses, 11 of the options had a combined contingency and special reserve deficit that totaled $133 million. Those options had about 870,000 enrollees.

In 1982, premiums were increased to begin recouping the losses. Also, OPM mandated reductions in benefits of about 13 percent to curb health care utilization and costs. The benefits reductions were achieved primarily through higher enrollee deductibles and coinsurance. Those measures—together with (1) lower-than-anticipated medical cost inflation and enrollee use of benefits and (2) large enrollment shifts to plans with more moderate benefits and premium levels—resulted in significantly lower-than-estimated costs. As a result, the options' total net operating gains for 1982 through 1985 ranged from between $256 million and $879 million. By the end of 1984, the options with combined reserve deficits in 1981 that had remained in the program had recouped their cumulative losses and rebuilt their reserves.

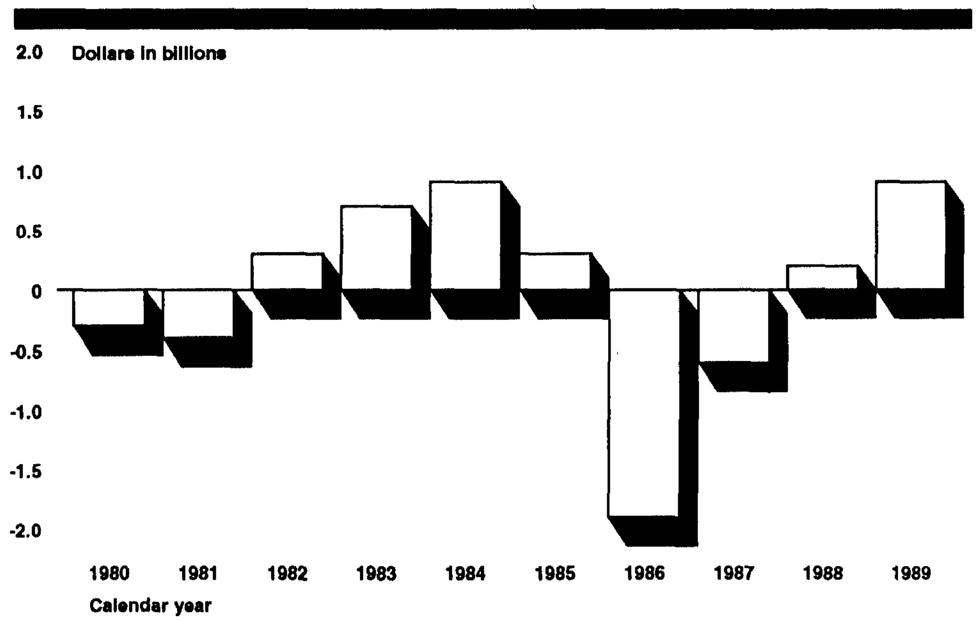
At the end of 1985, although 6 of the 48 experience-rated plan options had combined contingency and special reserve deficits, the total combined reserve balance had reached an unprecedented high of $2.8 billion. In 1986, to reduce the reserves, OPM had the sponsors draw down their options' excess reserves by making rebates to enrollees and the government and/or depressing premiums.

However, the options' total combined reserve balance was almost depleted again when unexpected sharp increases in medical cost inflation and utilization caused the reserves to decline more than expected in 1986 and 1987. In 1987, the options' net operating losses totaled $568 million. By the end of that year, the combined reserves had declined to $186 million. This time, the majority of the experience-rated plan options did not have adequate contingency reserves to cover their cumulative losses. Of the 65 options, 35 had a combined contingency and special reserve deficit that totaled $123 million. Those options had about 580,000 enrollees.

Premiums were significantly increased in 1987, 1988, and 1989 to begin recouping the losses and rebuild reserves. In 1989, the options' net operating gains totaled $913 million. By the end of 1989, the total of the options' combined reserves had reached $1.9 billion, the third highest level during the 10-year period. However, the majority of the 35 options with a combined reserve deficit in 1987 are no longer in the program. All of the remaining 10 options had recouped their cumulative losses and reserve deficits by the end of 1989. Of the 59 experience-rated plan options in 1989, 20 had a combined contingency and special reserve deficit that totaled $131 million. Those plans had about 370,000 enrollees.

Figure II.1 shows the plan options' total net operating gains and losses during the 10-year period. Table II.1 shows the number and percentage of options with combined reserve deficits and the enrollment in those options.

Figure II.1: Experience-Rated Plan Options' Total Operating Gain or Loss, 1980-1989



Note: The loss for 1986 includes $1 billion rebated to the government and enrollees.

Source: Compiled by GAO from OPM data.

Table II.1: Number and Enrollment of Experience-Rated Plan Options With Combined Contingency and Special Reserve Deficits, 1980-1989

	Experience-rated plan options				
		With deficits[a]			
				Enrollment[b]	
Year	Total	Number	Percent	Number[c]	Percent of total
1980	37	8	22	499,000	15
1981	35	11	31	869,000	26
1982	37	11	30	491,000	15
1983	39	5	13	76,000	2
1984	41	3	7	3,000	[d]
1985	48	6	13	9,000	[d]
1986	57	13	23	50,000	2
1987	65	35	54	577,000	17
1988	69	36	52	629,000	20
1989	59	20	34	374,000	12

[a]Plans' combined reserve deficits reflect past operating losses but do not necessarily mean they have no cash to pay claims.

[b]As of June 30, 1980, and September 30 for 1981 through 1989.

[c]Rounded to the nearest thousand.

[d]Less than one-half of 1 percent.

Source: Compiled by GAO from OPM data.

Combined Contingency and Special Reserve Targets and Actual Ending Balances for Nine Experience-Rated Plan Options, 1987-1989

In months of benefits and administrative expenses

Plan option	Target	Actual ending balance	Over/under target[a]
1987:			
Aetna-High[b]	1.5	-0.6	-2.1
Aetna-Standard[b]	1.4	-1.4	-2.7
American Postal Workers Union	2.4	2.4	-0.1
Blue Cross and Blue Shield-High	2.3	0.4	-1.9
Blue Cross and Blue Shield-Standard	2.3	0.1	-2.2
Government Employees Health Association	2.0	1.0	-1.0
Mail Handlers-High	1.6	0.8	-0.8
Mail Handlers-Standard	1.6	1.6	0.0
National Association of Letter Carriers	1.7	0.2	-1.5
Weighted average[c]	2.0	0.4	-1.6
1988:			
Aetna-High[b]	0.7	1.9	1.2
Aetna-Standard[b]	2.9	-0.3	-3.2
American Postal Workers Union	1.9	1.8	-0.1
Blue Cross and Blue Shield-High	-0.1	0.8	0.9
Blue Cross and Blue Shield-Standard	0.3	1.4	1.1
Government Employees Health Association	0.2	0.8	0.7
Mail Handlers-High	2.7	1.8	-0.9
Mail Handlers-Standard	3.6	0.1	-3.5
National Association of Letter Carriers	-0.2	-0.6	-0.3
Weighted average[c]	0.7	1.0	0.3
1989:			
Aetna-High[b]	0.9	7.5	6.6
Aetna-Standard[b]	2.0	7.9	5.9
American Postal Workers Union	1.7	3.0	1.3
Blue Cross and Blue Shield-High	1.2	4.6	3.5
Blue Cross and Blue Shield-Standard	0.9	3.1	2.3
Government Employees Health Association	2.6	2.2	-0.3
Mail Handlers-High	2.2	3.5	1.2

(continued)

In months of benefits and administrative expenses

Plan option	Target	Actual ending balance	Over/under target[a]
Mail Handlers-Standard	1.1	2.8	1.7
National Association of Letter Carriers	0.8	-0.4	-1.2
Weighted average[c]	1.4	3.1	1.7

[a]The difference between the actual ending balance and the target may not equal the number of months shown because of rounding.

[b]Aetna's high and standard options were not offered after 1989 because it withdrew from FEHBP.

[c]The weighted averages were computed on the basis of the dollar amounts rather than the months of benefits and administrative expenses shown.

Source: Compiled by GAO from OPM data.

Respondents to GAO's Letter to Experience-Rated Plan Sponsors and Underwriters

Plans

Governmentwide:

Blue Cross and Blue Shield Association

Employee Organization:

American Postal Workers Union
Beneficial Association of Capitol Employees
Government Employees Hospital Association
Mail Handlers Health Benefit Plan
National Association of Postal Supervisors
National League of Postmasters
National Rural Letter Carriers' Association
Panama Canal Area Benefit Plan Group Insurance Board
Special Agents Mutual Benefit Association

Health Maintenance Organization:

HMO Midwest
Kitsap Physicians Service
Seguros de Servicio de Salud de Puerto Rico, Inc.

Underwriters

CNA Insurance Companies
Mutual of Omaha

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