



State of Wisconsin
Department of Health and Family Services

Jim Doyle, Governor
Helene Nelson, Secretary

MEMORANDUM

August 10, 2006

To: Jason Helgerson
Jim Johnston
Michelle Pink

From: Milda Aksamitauskas

Re: Federal and state reinsurance programs

Risk is a business of insurance companies. When a large group of people is insured, the risk is spread; however, in a small group or individual markets, the group is not large enough to spread the risk of high medical expenses.

Insurers use selection mechanisms to avoid covering individuals who might have very high medical expenses. Adverse selection occurs when an insurer experiences higher than expected costs for a group or book of business. Insurers in the small group and individual markets are most concerned about adverse selection because people who know that they will need medical care are more likely to apply and there are less covered lives over whom the risk can be distributed.

Reinsurance is an insurance product for insurers serving two primary functions. One, reinsurance protects insurers against events that are unlikely to happen but could ruin the insurer financially. Two, reinsurance shifts the risk of a low probability event to a different entity and, therefore, reduces the required amount of capital in reserves and frees up that capital for other business activities.

Reinsurance pools for health insurance can alleviate the consistent problem of adverse selection that insurers experience and fear. The idea that the private market can operate more efficiently if the government takes over the responsibility for the worst case scenarios is not new. The flood loss insurance and the secondary mortgage insurance markets are prime examples. The 2002 Terrorism Risk Insurance Act is the most recent federal reinsurance example.

Flood insurance was not available for homeowners and factory-owned property until the late 1970s. Insurers did not have an actuarial rate structure to adequately reflect risks of flood. For a private market in flood insurance to succeed, these risks had to be identified for all geographic areas. No private company or a group of companies could identify and map all regions that may be affected. Finally, the Army Corps of Engineers conducted hydrological studies to identify the nature and extent of the risk of flooding in various areas. Congress passed the National Flood Insurance Act in 1968 creating the National Flood Insurance Program (NFIP). After several restructures, the program brought in

private insurers through what is called “write-your-own” program. Insurers sell and service the policies and the federal government bears all the risks. The insurers are permitted to keep about 32% of the premium for administrative and production costs. In 2003, 93 companies participated and about 4.4 million policies were written. Without federal government intervention, there might not be a private insurance company willing to sell flood insurance in many areas.

Flood is only one example of the natural disasters that could occur. In 1978, the Federal Emergency Management Agency (FEMA) was created to coordinate federal disaster relief efforts. It is now part of the Department of Homeland Security. FEMA sets standards and allocates financial aid to areas struck by natural disasters.

Terrorist attacks became another low probability, high cost event for which insurers cannot build actuary risk models. When insurers refused to issue liability insurance and catastrophe insurance for losses due to terrorist attacks, the need for the government to take responsibility for high losses became clear. This particularly effected owners of tall buildings in the largest U.S. cities. To help insurers, the federal government passed the Terrorism Risk Insurance Acts, which calls for the government to pay 90% of the costs of any terrorist attack after losses exceed \$10 billion.

The federal government also plays an important role in the secondary mortgage market. By mid-1930s, the federal government started assisting working families, who did not have enough savings for a down payment, to obtain mortgages. Later, the government helped soldiers returning from the World War II to secure mortgage loans. The Federal Housing Administration (FHA) and the Home Owners Loan Corporation (HOLC) ran these mortgage programs. The FHA provided mortgage insurance to mortgage borrowers so mortgage investors would not fear borrowers defaulting in large numbers as happened during the Great Depression. The HOLC used government-backed bonds to purchase mortgages on which people had defaulted. The HOLC bought mortgages from banks and then reinstated them with new terms. In effect, such practice standardized mortgages to be longer terms (usually 20 years), fixed rates, and fully amortized over the life of the loan. The intent was to reduce borrowers’ desire to refinance mortgages and to provide security to lenders. Almost a decade later, the HOLC was replaced by the Federal National Mortgage Association (known as Fannie Mae), which changed its focus from defaulted mortgages to the secondary mortgage market. To provide finances for the secondary market, Congress authorized Fannie Mae to issue stock and bonds, which enabled Fannie Mae to borrow below the market rate. Existence of the secondary market allows lenders to pool mortgages, resell them, and, therefore, shift the risk of defaults. The government assumes the risk that high-risk mortgage borrowers might default on repaying their loans. By taking on this risk, the federal government has been widely credited for expanding home ownership.

Wisconsin also has several state-wide, successful reinsurance programs. The Unemployment Insurance System and Worker’s Compensation Insurance involve employers and employees, while the Patient Compensation deals with the medical malpractice liability insurance market.

In 1932, Wisconsin became the first state in the nation to implement an unemployment insurance program. The program was designed to provide a temporary source of income, financed by employers, for workers who were laid off from their jobs. The

maximum benefits are the lesser of 26 times the weekly benefit rate or 40% of total base period wages. Employers are required to make payments to the unemployment insurance reserve fund; the amount of payment reflects fluctuation in the level of employment. Wisconsin requires the following employers to participate in the program: all governmental units and Indian Tribes regardless of the number of people employed, non profit organizations if they employ at least 4 individuals, and for profit businesses if they pay wages of at least \$1,500 during a calendar quarter or if they employ at least 1 individual for at least 20 weeks.

Workers who experience job-related injuries or illnesses receive medical treatments and wage replacement through the Wisconsin Worker's Compensation Insurance program. Worker's Compensation is a form of insurance that is paid for in advance by employers which entitles employees to full medical coverage and part of their salary for job-related injuries and illnesses. Nearly all employees in Wisconsin are covered. The exceptions include domestic servants, some farm employees, volunteers, religious sect members, and federal government employees. Coverage for Workers Compensation purposes begins on the first day of work. Basic benefits may include: coverage of all reasonable and necessary medical costs, disability benefits, retraining, and if a death occurs, death benefits and burial expense up to specified limits. The coverage also applies to employers who are self-insured.

The Wisconsin Patient Compensation Fund was created in 1975 to provide excess medical malpractice insurance for Wisconsin health care providers. Health care providers are required to pay yearly assessments into the fund. The fund covers providers above \$1 million per occurrence or \$3 million in the annual aggregate. Providers must purchase their own insurance up to that amount. The fund provides compensation for claimants whose damages exceed the provider's liability insurance. As of 2005, there were almost 14,000 participants. Physicians comprised 84% of the fund participants, corporations 10%, and all other participants made up the remaining 6%. Pennsylvania and Kansas also have mandatory patient compensation funds.