Locke Lord LLP

111 South Wacker Drive
Chicago, IL 60606
Telephone: 312-443-0700
Fax: 312-443-0336
www.lockelord.com

Jon Biasetti
Direct Telephone: 312-443-1866
Direct Fax: 312-896-6566
jbiasetti@lockelord.com

September 12, 2018

VIA ELECTRONIC MAIL and FEDERAL EXPRESS

Demetrios.Kouzoukas@cms.hhs.gov

Demetrios Kouzoukas
Principal Deputy Administrator
& Director of the Center for Medicare
U.S. Centers for Medicare
& Medicaid Services
The Hubert H. Humphery Building
200 Independence Ave., S.W.
Washington, DC 20001

paul.spitalnic@cms.hhs.gov

Paul Spitalnic
Director and Chief Actuary of
the Center for Medicare
U.S. Centers for Medicare
& Medicaid Services
7500 Security Boulevard
Baltimore, MD 21224

RE: **Use of Quota Share Reinsurance By Medicare Advantage Organizations**

Dear Messrs. Kouzoukas and Spitalnic:

I am writing to seek your guidance regarding the ability of Medicare Advantage Organizations ("MAOs") to enter into quota share indemnity reinsurance transactions ("Quota Share Reinsurance") with respect to their Medicare Part C business.

I previously corresponded with Cynthia G. Tudor, Acting Director, by letter dated February 16, 2017, a copy of which is attached for your reference. My earlier correspondence was written in response to CMS's indication in the draft CY 2018 Call Letter that Quota Share Reinsurance was not permitted under Section 1855(b) of the Social Security Act of 1935 ("Act"). As stated in my letter to Ms. Tudor, from a public policy perspective, denying MAOs the ability to continue engaging in Quota Share Reinsurance transactions would significantly restrict the ability of MAOs to manage their financial risk exposure, grow their Medicare Advantage business and operations, and, for small and middle market MAOs, compete with the larger MAOs that may be able to rely less on Quota Share Reinsurance for purposes of managing their financial risk. The end result of such a denial could very well be fewer choices for consumers in the Medicare Advantage marketplace.

Quota Share Reinsurance is widely used by MAOs and is subject to comprehensive state insurance regulation and solvency oversight.[1] Because MAOs have engaged in Quota Share Reinsurance transactions for many years, possibly decades, MAOs were relieved when on April 3, 2017, in connection with its final CY 2018 Call Letter, CMS announced that it had reconsidered its prior indication that Quota Share Reinsurance is not permissible under Section 1855(b) of the Act. In its reconsideration, CMS acknowledged that Quota Share Reinsurance *"could be used in connection with the risks identified in section 1855(b)(1) through (4)[2], [and that] CMS is not proceeding with the interpretation that quota share reinsurance itself is not permitted by the statute."* In addition, CMS advised that it "may provide further clarifying guidance and/or potential future rulemaking to which MAOs would be held accountable at that time … [and that to] the extent any issues are identified [CMS] would work with MAOs to address concerns."

Following CMS's retraction of its prohibition on the use of Quota Share Reinsurance, and in reliance on such retraction, MAOs have continued to engage in Quota Share Reinsurance transactions in the ordinary course of business as they have been doing for many years.

Therefore, we were very surprised when, in connection with a MAO's submission to CMS of its application for a CY 2019 CMS Medicare Advantage contract, which application included a Quota Share Reinsurance treaty, the MAO was advised by CMS representatives that although "[q]uota share arrangements are not prohibited" the MAO's Quota Share Reinsurance treaty did not comply with Section 1855(b) of the Act. As a result, the MAO was told that it had to either modify the reinsurance treaty to comply with "at least one of the four exceptions listed under §1855(b)" or abandon the reinsurance treaty in order for the MAO's application not to be rejected by CMS. In their various communications with this MAO, the CMS representatives advised that they were "particularly concerned" that the MAO's Quota Share Reinsurance treaty did not comply with Section 1855(b)(3).

The difficulty with CMS' application of Section 1855(b)(3) to Quota Share Reinsurance is that the limitations set forth therein are not applicable to Quota Share Reinsurance so it is not possible for the MAO to comply with the CMS representatives' directions to modify the Quota Share Reinsurance treaty to comply with that provision. Section 1855(b)(3) of the Act states:

> "(b) ASSUMPTION OF FULL FINANCIAL RISK.—The [MA] organization shall assume full financial risk on a prospective basis for the provision of the health care services for which benefits are required to be provided under section 1852(a)(1), except that the organization— . . .

[1] We cite, as examples of the comprehensive state regulation of reinsurance including Quota Share Reinsurance, the following NAIC model laws and regulations that have been adopted, or substantially adopted, in all states: NAIC Credit For Reinsurance Model Law (Model 785); NAIC Credit For Reinsurance Model Regulation (Model 786); and NAIC Life And Health Reinsurance Agreements Model Regulation (Model 791). Furthermore, in order to protect the solvency of insurers, state insurance laws and regulations are designed to ensure that the ceding company reinsures its risks with a statutorily authorized reinsurer and that the reinsurance agreements satisfy certain minimum protective requirements.

[2] The risks identified in Section 1855(b) are the cost of providing health care services and benefits to MAO members.

> (3) may obtain insurance or make other arrangements for not more than 90 percent of the amount by which its costs for any of its fiscal years exceed 115 percent of its income for such fiscal year, and . . ."

Quota Share Reinsurance is first dollar proportional reinsurance. What this means is that the ceding company (in this case, the MAO) is indemnified by the reinsurer for a fixed percentage of the losses on each risk covered by the reinsurance treaty. More importantly, all losses (and premiums) for the reinsured risks are shared proportionally by the parties from the first dollar up of losses (and premiums). *This is the defining feature of Quota Share Reinsurance which distinguishes it from all other forms of reinsurance.* In its final CY 2018 Call Letter, CMS incorrectly stated that Quota Share Reinsurance "in some cases" shares risk between the insurer and the reinsurer based upon an agreed percentage from the first dollar of expenses. On the contrary, Quota Share Reinsurance in *all* cases shares risk proportionally from the first dollar of expenses. Interpreting Section 1855(b)(3) as only authorizing the use of Quota Share Reinsurance for losses in excess of a specified retention, i.e., "for not more than 90% of the amount by which [the MAO's] costs for any of its fiscal years exceed 115 percent of its income for such fiscal year," means that the reinsurance being authorized by CMS based on this interpretation is no longer Quota Share Reinsurance because it does not provide protection to the MAO on a proportional basis from the first dollar up.

Section 1855(b)(3) on its face imposes limitations on stop-loss insurance or, arguably, on excess of loss and/or surplus share reinsurance but certainly not on Quota Share Reinsurance. Excess of loss reinsurance is a reinsurance arrangement that indemnifies a ceding company against the amount of loss in excess of a specified retention. Excess of loss reinsurance is thus non-proportional reinsurance and is not Quota Share Reinsurance. Surplus share reinsurance, on the other hand, is a hybrid form of reinsurance which includes both non-proportional and proportional features and is used primarily for property and casualty risks, not health insurance risks. In surplus share reinsurance transactions, the ceding company determines the maximum loss that it will retain on each risk (such retention is often referred to as a "line"), above which line the ceding company and the reinsurer will share in the risk on a proportional basis. Although Quota Share Reinsurance and surplus share reinsurance share similarities once the loss in a surplus share treaty exceeds the line, surplus share reinsurance is not Quota Share Reinsurance because it does not share risk proportionally from the first dollar up. Therefore, the limitations set forth in Section 1855(b)(3) are not applicable to Quota Share Reinsurance and should not be used to prohibit the use by MAOs of Quota Share Reinsurance.

In addition, the remaining limitations set forth in Section 1855(b) of the Act are also not applicable to Quota Share Reinsurance. Section 1855(b)(1), (2) and (4) of the Act state that the MAO:

> "…(1) may obtain insurance or make other arrangements for the cost of providing to any enrolled member such services the aggregate value of which exceeds such aggregate level as the Secretary specifies from time to time,

> (2) may obtain insurance or make other arrangements for the cost of such services provided to its enrolled members other than through the organization because medical necessity required their provision before they could be secured through the organization,…
>
> (4) may make arrangements with physicians or other health care professionals, health care institutions, or any combination of such individuals or institutions to assume all or part of the financial risk on a prospective basis for the provision of basic health services by the physicians or other health professionals or through the institutions."

The first example in Section 1855(b)(1) is similar to Section 1855(b)(3) insofar as it also imposes limitations of an excess of loss or stop-loss nature. As noted above, such limitations are not applicable to Quota Share Reinsurance.

The second example in Section 1855(b)(2) appears to permit MAOs to obtain insurance or other coverage for the cost of services that the MAOs cannot themselves provide or arrange for in emergency or out-of-service area circumstances. Arguably, because Section 1855(b)(2) does not contain limitations of an excess of loss or stop-loss nature, such emergency or out-of-service area risk could theoretically be ceded on a Quota Share Reinsurance basis. But if this were to be the only risk that could be ceded by a MAO pursuant to Section 1855(b) through a Quota Share Reinsurance arrangement, the scope of this risk is so narrow that MAOs are unlikely to use or receive much benefit from such limited use of Quota Share Reinsurance, thus making its permissibility largely illusory. More importantly, limiting the use of Quota Share Reinsurance to such a narrow risk would be a very material and unexpected departure from how MAOs have long been using Quota Share Reinsurance arrangements, would adversely impact the small and middle market MAOs that are more dependent on Quota Share Reinsurance than the larger MAOs, and very likely result in adverse consequences to the Medicare Advantage market.

The fourth example in Section 1855(b)(4) is not reinsurance and, in many states, may not even be insurance but direct contractual risk shifting between MAOs and providers through, for example, capitation, withhold or pooling arrangements.

In light of the above, we do not believe that the examples (and limitations) set forth in Section 1855(b)(1), (2) and (4) are applicable to Quota Share Reinsurance and should similarly not be used to prohibit the use by MAOs of Quota Share Reinsurance. In fact, even a CMS Regional Office Account Manager conceded, in connection with CMS' rejection of the aforementioned MAO's Quota Share Reinsurance treaty, that "[b]ased on my knowledge and experience, I am not aware that it is possible for a quota share arrangement to satisfy exceptions (1), (3), or (4). Exception (1) is structured like individual stop-loss insurance. Exception (3) is structured like aggregate stop-loss insurance. Exception (4) is structured like a provider capitation arrangement. I do not know whether or not a quota share arrangement could satisfy exception (2). This may be possible."

Furthermore, we do not believe that a fair reading of Section 1855(b) leads to the conclusion that such listed examples were intended to limit the type of financial arrangements that an MAO may engage in, particularly those like Quota Share Reinsurance where the MAO retains full financial risk to its members for the cost of providing health care services and benefits.[3] Despite the fact that CMS on April 3, 2017, in connection with its final CY 2018 Call Letter, stated that the "statute permits MA organizations to share risk proportionally, so long as the risk (the type and amount) is in the exceptions", CMS also acknowledged that "a quota share structure could be used in connection with the risks identified in section 1855(b)(1) through (4)" and that the "details of an arrangement (whether reinsurance or otherwise) for an MAO to share, transfer, or otherwise shift the risks identified in the exceptions listed in the statute *are generally not limited by the statutory text* [emphasis added]." Quota Share Reinsurance is used by MAOs precisely to cover the risks identified in Section 1855(b)(1) through (4) and the "details" in such provisions that are not applicable to Quota Share Reinsurance should not be used to prohibit the longstanding use by MAOs of Quota Share Reinsurance.

The application by CMS of the limitations set forth in Section 1855(b)(1), (2), (3) and (4) to Quota Share Reinsurance is contrary to CMS's guidance and assurances on April 3, 2017 that MAOs may continue to reinsure their risks for the cost of providing health care services and benefits to their members on a Quota Share Reinsurance basis. Applying such limitations to Quota Share Reinsurance effectively prohibits Quota Share Reinsurance by an MAO because it cannot be modified to comply with limitations that would transform it into other forms of reinsurance. Quota Share Reinsurance serves many beneficial purposes for MAOs and their members and we encourage CMS not to prohibit the use of such a prudent financial tool which is particularly critical to small and middle market MAOs.

We question whether CMS is concerned about "fronting," whereby a MAO could cede one hundred percent (100%) of the risks of its Medicare Part C business to a non-CMS approved insurer. While we note that a handful of states view fronting arrangements unfavorably as attempts to avoid statutes prohibiting insurers from transacting business in their state without obtaining a certificate of authority, such states nonetheless do not prohibit Quota Share Reinsurance but instead require the licensed ceding company to retain a minimum percentage on the risks being reinsured with an unauthorized insurer (i.e., at least a ten percent (10%) retention of such risks). Perhaps CMS might consider such a limitation if its concerns about Quota Share

[3] Quota Share Reinsurance is a contract of indemnity solely between the MAO and the reinsurer. The contractual indemnification of the MAO by the reinsurer for losses under a Quota Share Reinsurance treaty is invisible to the members, does not affect their benefits or contractual rights with the MAO in any way, and does not release the MAO from its contractual liabilities and obligations owed to its members for the provision of health care services and benefits, regardless of whether or not the Quota Share Reinsurance is recoverable (as compared to assumption reinsurance which effects a novation and release of the ceding company from its contractual liabilities and obligations owed to its members). Furthermore, because Quota Share Reinsurance is a contract of indemnity, the MAO only receives reinsurance coverage *after* it has paid its members' claims. Consequently, the "exceptions" in Section 1855(b) should not apply to Quota Share Reinsurance because the MAO retains full financial risk irrespective of the reinsurance. We also question whether the "exceptions" in Section 1855(b) were intended to limit the type of reinsurance that an MAO may engage in. Nowhere in that sub-section does the Act expressly refer to reinsurance, nor did we find any legislative history with respect to that particular sub-section that refers to reinsurance (we note that the Act, in other sections, does expressly refer to "reinsurance" so it is reasonable to conclude that had Section 1855(b) been intended by Congress to limit the type of reinsurance that an MAO may engage in, it would have expressly referred to "reinsurance").

Reinsurance relate to fronting rather than imposing an outright prohibition on the use of Quota Share Reinsurance by MAOs which we believe will result in material adverse public policy consequences.

We are not aware that CMS has publicly issued any regulatory guidance on this latest interpretation of Section 1855(b) by the CMS representatives that rejected the above MAO's Quota Share Reinsurance treaty. This interpretation for all intents and purposes once again prohibits the use of such reinsurance by MAOs. Furthermore, upon information and belief, we question whether the above interpretation (and limitations) is being uniformly applied by CMS representatives with respect to all Quota Share Reinsurance arrangements of MAOs.

Considering the wide use of Quota Share Reinsurance by MAOs and its critical role in managing their risk, it would be much appreciated if CMS would publish clear guidelines regarding its position on the permissible uses by MAOs of Quota Share Reinsurance. In addition, because the aforementioned MAO and possibly others had to abandon their Quota Share Reinsurance treaty in connection with their CY 2019 CMS Medicare Advantage contract applications, we respectfully request, in order to have a level playing field between large and small to middle market MAOs, that CMS address this issue as promptly as possible (and not wait for the annual Call Letter process).

I thank you in advance for your consideration of this correspondence and am available at your convenience for any questions or concerns you may have.

Respectfully,

LOCKE LORD LLP

Jon Biasetti
Partner