December 1, 2022

Market Segment Outlook: US Health

Our outlook remains at Stable, owing to declining pressure from COVID-19 medical costs and strong levels of risk-adjusted capitalization, among other factors—both positive and negative

AM Best is maintaining its outlook for the US health insurance industry for 2023 at Stable, based on the following factors:

- Declining pressure from COVID-19 medical costs
- Diversified revenues and earnings for large insurers and industry overall
- Strong levels of risk-adjusted capitalization
- A rise in investment income due to changing interest rate environment

Counterbalancing factors include the following:

- The negative impact of unrealized losses due to investment market volatility
- Anticipated end of the Public Health Emergency (PHE) and Medicaid eligibility redeterminations
- Possible increase in utilization and intensity of medical services
- Impact of inflationary pressures from providers and potential economic weakness in the commercial segment

The US health insurance industry reported strong underwriting results in 2021 and through the first six months of 2022. Carriers saw a decline in the profitability of the commercial segment in 2021 and 2022, driven primarily by higher COVID-19 costs. However, earnings from government business remained very strong, supported by elevated margins in the Medicaid segment due to the continued PHE and lack of eligibility checks. Insurers with diversified lines of business found themselves in a better financial position than carriers with revenue and earnings concentrations in the commercial segment. However, the anticipated end of the PHE and Medicaid redetermination will dampen Medicaid results in 2023.

Despite the strong overall earnings through the first six months of 2022, capital and surplus was negatively impacted by sizeable unrealized losses, which counterbalanced about a third of underwriting gains. Given the direction of interest rates, unrealized losses are likely to grow through the end of 2022 and into 2023.

As a result, AM Best expects the industry's capitalization to decline in 2022 but to remain solid, to support underwriting and investments risks. The decline due to unrealized losses is viewed as temporary in nature, and, as fixed-income holdings mature, insurers will have an opportunity to recover the losses and reinvest proceeds at a higher rate.

AM Best does have concerns about smaller, less diversified carriers and their ability to withstand challenges from investment market volatility, as well as potential pressures on the commercial segment due to economic decline. Less diversified companies did not experience the favorable earnings of the past two years from government programs, particularly Medicaid, which helped bolster capital levels.

Analytical Contact:
Doniella Pliss, Oldwick
+1 (908) 439-2200 Ext. 5104
Doniella.Pliss@ambest.com

2022-153

Anticipating the End of the PHE

The main change tied to the end of the PHE is the redetermination of Medicaid eligibility. Medicaid has supported the industry's revenue and earnings growth since the early days of the pandemic—it became the main source of industry earnings in 2021. As states are not allowed to conduct Medicaid eligibility checks during the PHE, membership and revenue stayed above historical levels. In addition, utilization in the Medicaid segment remained relatively low, resulting in higher profitability for carriers. Many industry participants believe that, during 2021 and 2022, many Medicaid members experienced changes in circumstances, including employment status, which provided access to other health insurance coverage. As a result, these members reduced or completely stopped using their Medicaid coverage. The general industry estimates that 30%-35% of Medicaid members who have joined the program since 2020 will remain eligible for the program once redeterminations are completed.

States will have 12 months to complete their eligibility checks after the PHE ends, but many states may lack proper resources to undertake and complete the task in a timely manner. Additional Medicaid funding provided by the federal government will be discontinued at the end of the quarter in which the PHE concludes, which may prompt some states to complete the redetermination process quickly. Carriers will likely continue to have elevated Medicaid membership during 2023 and even into 2024, although this may differ by state. Insurers may try to identify members who are likely to lose their Medicaid eligibility and proactively reach out to offer enrollment into ACA exchange products where appropriate. Overall, AM Best expects the Medicaid segment's revenue and profitability to moderate in 2023 following the end of the PHE.

While not related to the end of the PHE, the federal government supply of vaccines and treatment is expected to run out in the near term without any additional funding appropriated by Congress. Insurance companies will have to cover some of the costs paid by the government in both 2021 and 2022—for example, costs for COVID-19 vaccines. In addition, the end of government funded purchasing is likely to lead to some price increases for both vaccines and treatments. The magnitude of impact will depend on the severity and persistency of COVID-19, but many carriers are budgeting for the annual cost of at least one COVID-19 booster shot per member.

Changes in COVID-19 Cases and Costs

The health insurance industry was materially impacted by COVID-19 claims starting in the second half of 2021 and through the first six months of 2022. The unexpected surge of the Delta and Omicron variants and the mass scale of the disease constituted a significant change from the original COVID-19 costs in 2020 and resulted in much higher-than-anticipated medical claims for many carriers in 2021. The bulk of COVID-19 costs hit the commercial segment, as working age adults resumed their normal activities but seniors remained relatively cautious. Many smaller and less diversified companies with concentrations in the commercial business faced sizeable underwriting losses. Large carriers and those with exposure to the Medicaid and Medicare segments were able to offset weaker results in commercial business with the persistently stronger profitability in government lines.

However, the overall industry saw a decline in COVID-19 costs starting in the third quarter of 2022, as both case counts and severity dropped. Carriers do not foresee a repeat of the spike in COVID-19 claims that occurred in late 2021/early 2022; they expect that COVID-19 expenses will level off and ease pressure on the commercial segment. Despite the potential for seasonal fluctuation, a large number of market participants believe that overall costs are unlikely to reach the previous scale, given that most of the population has already experienced at least one case of COVID-19.

Elective Utilization Expected To Increase

The utilization of elective medical services was disrupted by pandemic starting in 2020. The industry expected the return of regular utilization and a potential spike in claims due to missed diagnostic services, but the majority of carriers reported lower non-COVID claims in both 2021 and 2022 compared with pre-pandemic levels.

For 2023, carriers are again budgeting higher utilization and an increase in severity. Insurers are concerned that the expenses for some already high-cost conditions may be materially impacted by many newly approved treatments, including gene therapies. The cost of these therapies can run into millions of dollars per case and significantly pressure smaller insurers in particular. However, small and medium-sized companies usually utilize excess of loss reinsurance to protect themselves against such catastrophic losses.

In 2023, healthcare costs are expected to be positively impacted by the growing volume of value-based care and a partial shift of risk from insurance companies to providers. The industry continues to implement value-based programs and assist providers to proactively identify members' care needs. Innovative tools and strategies such as virtual care or shifting care from clinical settings to homes will lead to a gradual but steady reduction in overall care costs.

Inflation and Potential Recessionary Pressure

For the past several decades, the increase in health insurance costs has far outpaced overall inflation. That has changed somewhat in 2022—general inflation is at its highest level in 30 years but increases in health insurance costs have been relatively consistent with historical averages. When general inflation accelerates, health insurance trails behind since it takes time for higher wages and medical supplies and equipment costs to be reflected in contracted rates.

Healthcare infrastructure, including hospitals and providers, has experienced significant wage and general inflation. Insurance carriers will likely be seeing greater rate pressure from providers when contracts are negotiated and renewed in 2023. However, most insurance carriers have two- to three-year contracts with providers, so only a portion of the contracts are renewed each year. Furthermore, insurers may face challenges passing higher medical costs on to employer groups in 2023 and may have to make products and benefits adjustments to partially offset higher rates.

Recession is a negative factor for the health insurance industry since job losses lead to membership declines in the commercial segment. Group membership declines can become an issue for carriers in 2023 should a recession materialize and unemployment rise. However, the balance of membership and revenue between commercial and government business for the health insurance industry has changed substantially since the Great Recession of 2007-2009. The industry has become more diversified and less dependent on the commercial segment. Medicare Advantage and Medicaid are generally less affected by a recession and can even gain membership during an economic downturn. However, for smaller carriers with concentrations in commercial business, a recession can be a significant negative factor if membership drops and pressures their economies of scale.

Investment Markets and Interest Rates

Health insurance obligations are short-term, leading to relatively smaller reserves than for other types of insurance and limiting the dependence on investment income and interest rates. However, health insurers' investment portfolios are composed of mostly fixed-income investments, which are subject to sizeable unrealized losses in the event of a sharp rise in interest rates. Unrealized losses will negatively affect the segment's capital and surplus and risk-adjusted capitalization in 2022 and into 2023. However, the average duration of insurers' fixed-income portfolio is less than six years, and carriers have an opportunity to reinvest at higher rates when bonds mature—which will lead to higher investment income and ease pressure on underwriting, especially for smaller carriers.

The industry maintains a good level of liquidity, as many large and medium-sized insurers have access to additional funds through lines of credit and Federal Home Loan Bank borrowings. Most publicly traded insurers have issued debt in recent months, although at higher interest rates. Such financial flexibility protects carriers from the potential need to sell investment holdings at a loss during a downturn. In addition, a shorter claims payment cycle and improved data analytics allow insurers to better anticipate liquidity needs.

Non-profit and mutual carriers with sizeable exposures to higher-risk assets may see material fluctuations in their investment portfolios due to market volatility. However, many of these carriers have very high risk-adjusted capitalization levels, and even with some decline due to investment value declines, capitalization is likely to remain more than sufficient to support the organizations' risks. Health insurers who turn to higher-risk assets to increase yields may face less pressure in 2023, as higher interest rates will ensure more investment income from lower risk instruments. Investing in higher-quality, lower-risk assets will have a positive impact on risk-adjusted capitalization.

Top ERM Considerations

The industry has recorded stable to growing earnings and has solidified prudent practices for capital and liquidity management in recent years. As a result, many companies shifted the focus of their enterprise risk management (ERM) from financial performance to operational issues. Many of the health insurers AM Best rates consider human capital the greatest risk for 2022-2023; they are concerned that a lack of available hires can negatively impact their ability to meet strategic goals and transition to new ways of serving customers. To mitigate this risk, carriers are becoming more flexible about hiring, with a growing volume of remote working arrangements. However, smaller companies in local geographies will find themselves in new competition for talent with large diverse organizations. Another notable operational risk for insurers with growing vertical integration segments is maintaining organizational cohesion and effectively integrating new elements into an enterprise. This is partially mitigated by rotating executives among organizational segments and implementing clear strategies to incorporate new technologies and tools into insurance products and services.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies. Best's ratings take into account the manner in which companies manage these factors and trends.

A Best's Market Segment Outlook, like a Best's Credit Rating Outlook for a company, can be Positive, Negative, or Stable.

Best's Market Segment Outlook	
Positive	A Positive market segment outlook indicates that AM Best expects market trends to have a positive influence on companies operating in the market over the next 12 months. However, a Positive outlook for a particular market segment does not mean that the outlook for all the companies operating in that market segment will be Positive.
Negative	A Negative market segment outlook indicates that AM Best expects market trends to have a negative influence on companies operating in the market over the next 12 months. However, a Negative outlook for a particular market segment does not mean that the outlook for all the companies operating in that market segment will be Negative.
Stable	A Stable market segment outlook indicates that AM Best expects market trends to have a neutral influence on companies operating in that market segment over the next 12 months.

We update our market segment outlooks annually, but may revisit them at any time during the year if regulatory, financial, or market conditions warrant.

Published by AM Best

BEST'S MARKET SEGMENT REPORT

A.M. Best Company, Inc.
Oldwick, NJ
CHAIRMAN, PRESIDENT & CEO **Arthur Snyder III**
SENIOR VICE PRESIDENTS **Alessandra L. Czarnecki, Thomas J. Plummer**
GROUP VICE PRESIDENT **Lee McDonald**

A.M. Best Rating Services, Inc.
Oldwick, NJ
PRESIDENT & CEO **Matthew C. Mosher**
EXECUTIVE VICE PRESIDENT & COO **James Gillard**
EXECUTIVE VICE PRESIDENT & CSO **Andrea Keenan**
SENIOR MANAGING DIRECTORS **Edward H. Easop, Stefan W. Holzberger, James F. Snee**

AMERICAS
WORLD HEADQUARTERS
A.M. Best Company, Inc.
A.M. Best Rating Services, Inc.
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
A.M. Best América Latina, S.A. de C.V.
Av. Paseo de la Reforma 412, Piso 23,
Col. Juárez, Alcadía Cuauhtémoc, C.P. 06600, México, D.F.
Phone: +52 55 1102 2720

EUROPE, MIDDLE EAST & AFRICA (EMEA)
LONDON
A.M. Best Europe - Information Services Ltd.
A.M. Best Europe - Rating Services Ltd.
12 Arthur Street, 8th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

AMSTERDAM
A.M. Best (EU) Rating Services B.V.
NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands
Phone: +31 20 308 5420

DUBAI*
A.M. Best - MENA, South & Central Asia*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
*Regulated by the DFSA as a Representative Office

ASIA-PACIFIC
HONG KONG
A.M. Best Asia-Pacific Ltd
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
A.M. Best Asia-Pacific (Singapore) Pte. Ltd
6 Battery Road, #39-04, Singapore
Phone: +65 6303 5000

Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Credit Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

Rating Disclosure: Use and Limitations

A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance, business profile, and enterprise risk management or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services, Inc. (AM Best) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AM Best.

Version 010320