Month XX, 2023

Market Segment Outlook: US Health Insurance

The segment outlook remains at Stable, based on persistently favorable earnings, which have driven strong risk-adjusted capitalization, and on expected growth in the Medicare Advantage business

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

- Continued favorable earnings
- Positive impact of investments and interest rates, and favorable liquidity
- Growth in Medicare Advantage (MA) business
- Strong levels of risk-adjusted capitalization

Counterbalancing factors include the following:

- Inflationary pressure on providers' costs and the impact on contracts
- Narrower margins on government business (MA and Medicaid managed care)

The US health insurance industry's underwriting income was flat through the first half of 2023, after generally increasing every year for several years. The MA market had achieved strong underwriting results the past few years, as many seniors—among the most vulnerable to COVID-19—delayed care, bolstering results. However, this trend has changed notably in 2023, as COVID spikes have lessened. Several health insurers have reported greater pent-up demand in the MA segment for certain types of procedures, although MA earnings have been profitable. The number of reported COVID cases has increased very slightly lately but nowhere near any of the previous spikes. As claims experience in 2023 tracks more toward pre-COVID volume, some carriers have reported an increase in the incidence and severity of medical conditions.

Despite challenges, the industry is well positioned to thrive in 2024. Margins are expected to narrow, as the profitability of government programs (Medicaid managed care and MA) is expected to return to more normal levels. Earnings in both government lines of business have been above normal the past few years, driving profitability for some insurers and for the industry as a whole. Health insurers continue to look for ways to lower overall health care spend, focusing on improving patient health outcomes through initiatives such as value-based care models, which pay providers based on patient outcomes and quality, as well as the use of advanced data analytics to better reach members and aid in population health and disease/care management.

Health insurers are prioritizing cost controls and directing care to high-quality/low-cost locations in an effort to bend the cost curve. To encourage plan adoption, insurers are introducing strong financial incentives while still allowing members to choose their preferred place of care, whether in the doctor's office, at home, or an alternate site. This approach is complementing the use of narrower networks to control costs. Insurers are seeing gradual positive results, which could have a pronounced impact on trend-related rate increases over time. The escalation in provider risk-sharing arrangements, including full capitation, withholds, and acceptance of up- and downside

Analytical Contacts:
Joseph Zazzera, Oldwick
+1 (908) 882-2442
Joseph.Zazzera@ambest.com

Sally Rosen, Oldwick
+1 (908) 882-2284
Sally.Rosen@ambest.com

2023-149

risk, is helping insurers lower costs and generate better outcomes and financial results. Advances in data analytics and personalized care, supported by targeted medical management, have also contributed to cost control efforts and better outcomes.

AM Best remains less optimistic about smaller, less diversified health carriers. Over the last year, several financially impaired or struggling companies have either gone out of business or exited markets such as individual ACA (Patient Protection and Affordable Care Act) products and select geographies, where there was too much pressure on operations and financial results were poor. Typically, these companies experienced difficulties due to rapid growth, a lack of underwriting discipline, government reimbursement lags and related cash flow management issues, pricing problems, and excessive claims, across the commercial and, in particular, government segments. These marketplace disruptions also affects the rest of the industry.

Industry Remains Well Capitalized

The strong earnings reported the past few years reflect the industry's capital strength, with a 9.8% five-year compound annual growth rate in capital and surplus despite the sizable realized and unrealized investment losses reported. Capitalization remains strong in 2023, with another year of favorable, albeit lower, capital expansion expected in 2024. However, AM Best expects more dividend payments to parent organizations in 2024, owing to a decline in capital-intensive Medicaid premiums as a result of Medicaid redeterminations. Organizations will not need to maintain the same level of absolute capital, given the drop in premium revenues in these regulated entities.

Investments and Liquidity

Health insurance claims are generally short-tailed. As such, the investment portfolios of most health insurers tend to be conservative, with higher percentages of fixed-income and cash and short-term investments. The higher interest rates have not only improved investment income, but insurers no longer need to increase credit risk to obtain higher yields. Through the first half of 2023, we have seen a slight increase in allocations to Class 1 bonds and slightly lower allocations to higher-risk investment classes. We expect this trend to continue into 2024.

Although interest rates caused a decline in net investment income (NII) for full-year 2022, rising interest rates have resulted in a sizable increase in net income through second-quarter 2023 and, for many, a reversal of unrealized losses. With realized losses decreasing and unrealized gains turning significantly positive, along with a growing asset base and more fixed-income and short-term investments, AM Best expects investment results to contribute to overall net income for year-end 2023 and into 2024.

As for liquidity, health insurers generate strong cash flows from operations, a trend we expect will continue. Additionally, many insurers have access to Federal Home Loan Bank borrowings or lines of credit for contingent liquidity needs.

Inflationary Pressure on Provider Costs Could Impact Health Insurers

Health insurers across the country are well prepared to deal with anticipated challenges in 2024, focusing on rising medical costs across all lines of business, by both higher utilization and costs, as well as the need for related rate increases. When the inflationary pressures hit the economy, health insurance was showing only modest signs of higher costs due to longer contracts and COVID-related declines in utilization. Health insurance for a long time led the way in annual price increases compared to the rest of the economy, only recently showing relatively modest inflation.

Health care providers are facing staffing shortages, salary pressures, and supply cost increases. Staffing challenges can limit the number of beds available for in-patient needs or require hospitals to pay overtime, incentivize nurses to take extra shifts, or hire more expensive traveling nurses. Although health insurance provider (hospital, physician, other provider) contracts are multi-year, many are facing higher pricing and longer negotiations at contract renewal time, given the recent challenges.

Overall, the industry has been balancing lower earnings in the commercial segment with steady profitability in government programs the last few years, including 2023. However, with costs on the rise, higher rate increases have been occurring. To maintain favorable earnings, carriers, especially in the commercial segment, have responded to the rise in medical costs with sizable rate increases in 2023, which will likely continue into 2024. In some geographies, combined rate increases for 2023 and new 2024 rates are exceeding 20%. However, more publicity on rate increases may generate more regulatory scrutiny. Pressure from employer groups and individuals, as well as media scrutiny of rate increases, is coming at a time when individuals and employer groups are seeing the impact of inflation on their own financial conditions and results. However, the rate increases are generally actuarially justified and go through extensive regulatory review.

Government Programs

MA and Medicaid managed care are typically narrow-margin, high-volume businesses. Earnings and margins for both have been outsized the past few years, which AM Best does not expect will continue into 2024 or beyond. The higher earnings have been driven partly by COVID-related issues, including the public health emergency (PHE) declared during the pandemic and its impact on Medicaid enrollment, as well as the decline in provider visits under MA given the vulnerability of this population to COVID. Earnings on both products are expected to remain profitable, as underwriting income returns to more typical, pre-COVID levels.

Medicare Advantage Growth Continues, but Potential Challenges Ahead

MA growth in recent years can be attributed to new age-ins (seniors reaching retirement age), individuals converting from traditional Medicare and Medicare supplements, and carriers' geographic and product expansion. Pricing in this market can be more challenging, presenting a barrier to entry for smaller and new carriers.

Whether the pent-up demand and rise in utilization in the senior segment in 2023 will continue into 2024 is uncertain. Additionally, the assumptions insurers used for the resumption of care/pent-up demand in MA pricing for 2024 filed in June 2023 are unclear. If the assumptions were not correct, the segment's underwriting income and margins could be pressured.

As in prior years, companies with higher STAR ratings and more appropriate risk-adjustment revenue payments will have an advantage absorbing a lower level of profitability. A number of carriers reported losing significant revenue bonuses through the declines in their STAR ratings. Carriers are working to improve their STAR ratings for the next year, although many have opted to absorb the price adjustment in the interim rather than increase rates and potentially lose membership. For these carriers, a miss in expected utilization patterns or trends could have a substantially greater impact.

Even with the potential pressure on the MA segment for 2024, earnings from the segment are expected to remain profitable, albeit lower than in with recent years.

Medicaid: Impact of Rising Costs and Redeterminations on Revenue & Earnings

The Medicaid managed care market has been more insulated from rising costs than the commercial segment. The unique circumstances brought on by the COVID PHE led to much lower utilization and higher revenue in the Medicaid managed care line of business, with these trends persisting through mid-2023.

States were authorized to begin Medicaid redeterminations starting in April 2023, with a reduction in the additional Federal Medical Assistance Percentage (FMAP) phasing out by the end of 2023. Given the amount of work involved, states have 14 months to complete the Medicaid redeterminations. As such, Medicaid rolls have declined through the latter part of 2023. AM Best expects that most of the redeterminations will be completed in the first half of 2024 and could lead to a substantive decline in membership and revenues for health insurers with large blocks of Medicaid business. With states unable to disenroll members the past few years, Medicaid rolls and premiums continued to increase. Thus far in 2023, Medicaid redeterminations have been slower than projected owing to a lack of resources in many states to complete these reviews more quickly. Medicaid managed care revenue streams began to decline for many insurers in the third quarter of 2023, with a more precipitous drop expected for 2024, although the timing will vary by state. AM Best expects that carriers with larger blocks of Medicaid business will see declines in both revenue and earnings from this line of business in mid- to late 2024.

Some of the individuals who had been covered by Medicaid had other coverage and thus were not utilizing their Medicaid benefits, which resulted in higher profitability for the line. As these non-utilizing members are disenrolled, the risk pool will contain a greater number of members who do use their Medicaid benefits, resulting in lower profitability and deterioration in the risk pool. However, some of these lives could be picked up by carriers either on or off exchange through ACA individual health coverage, balancing out the overall risk pools for insurers. Since Medicaid rates are determined based on claims experience and trends, adjusting pricing may take time, but rates, which are set by the states, will eventually be raised. Additionally, some states are being proactive and implementing an acuity adjustment to Medicaid rates for 2024, to account for the change in the risk pool. Health insurers have been expecting Medicaid enrollment to decline for the past two years, but the public health emergency lasted longer than expected. Health insurers are prepared to absorb the impact and return to a more normal level of profitability in this line of business in 2024 and beyond.

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.

A Best's Market Segment Outlook 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 PRESIDENT & TREASURER **Cynthia Young**
SENIOR VICE PRESIDENTS **Lee McDonald, Thomas J. Plummer**

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