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MIA BULLETIN _06-29__

TO: Presidents, Maryland Domestic Insurance Companies, Health Maintenance Organizations, Nonprofit Health Service Plans, Provider Sponsored Organizations, Managed Care Organizations and Dental Plan Organizations

RE: Fair and Reasonable Charges under Agreements between an Insurer and an Affiliated Company

DATE: December 1, 2006

Purpose
The purpose of this Bulletin is to provide general guidance concerning the "fair and reasonable" standard for agreements between insurers and affiliated companies. This standard is outlined in §7-702 of the Insurance Article. This section provides that:

> "each transaction within an insurance holding company system to which an insurer subject to registration under Subtitle 6 of this title is a party is subject to the following standards:…the **terms shall be fair and reasonable** in light of the purposes of this title;…" (emphasis added).

Fair and reasonable
The Administration considers whether or not the charges under agreements between insurers and affiliated companies are fair and reasonable in relation to the services received or provided. Agreements with affiliated companies should generally be based on the cost of the services provided, including reasonable overhead charges. The Administration considers whether the services provided by the affiliated entity are only being provided to other affiliated entities or are also being provided to non-affiliated entities when making its determination regarding what terms are fair and reasonable.

Profit margin
An insurer should be fully compensated for the cost of services it provides to affiliated companies, but should not necessarily expect or be required to make a profit for providing those services. With that in mind, the MIA considers the following:

- If services are **only** being provided between affiliated entities without additional services provided to non-affiliated entities, the charges between affiliated entities should generally be based on the cost of the services provided, including reasonable overhead charges.

- In cases where the affiliate providing the services also provides such services to unrelated third parties, and such outside services comprise a significant amount of the affiliate's revenues, the charges to the insurer under the agreements may include a certain profit margin to the affiliate. It is important to note, however, that in a case where it is proposed that an amount in excess of the costs incurred by the affiliate providing the services will be charged under a service agreement, the insurer will be required to provide evidence to the Administration of the reasonableness of the charges (e.g., documentation of amounts charged by the affiliate to outside parties, market rates from other providers of similar services, etc.).

Examples
While it is not possible to address every possible type of agreement within an insurance holding company system, the following examples of scenarios are presented to further clarify what may be considered to be "fair and reasonable" by the Administration under certain agreements:

- An insurance holding company system consolidates administrative functions, such as accounting, legal services and claims processing, in one company which then performs these functions on behalf of affiliated companies. Charges to an insurer under an administrative service agreement with this affiliate should be based on the cost of the services provided, including reasonable overhead charges. Where costs are not specifically identified with a particular company, the costs should be allocated using an appropriate method (e.g., space occupied, transactions processed, etc.). The charges should not exceed the cost the insurer would incur if it performed the functions itself.

- A holding company system containing several health insurers also includes a company that has a network of health care providers. This affiliate contracts with several unaffiliated groups to provide access to its network of health care providers. Under an agreement with this affiliate, in which the insurer can access the network of health care providers in order to provide health care services to policyholders, charges may be up to the market price for using such a network.

- The Internal Revenue Code includes specific guidance on accepted methods affiliated companies can use to allocate federal income tax expenses and

- credits among parties to consolidated federal income tax filing agreements. Although various allocation methods are acceptable, an example of an acceptable agreement would be one that allocates tax liabilities based on separate tax return computations, with current benefit being given for tax losses and credits utilized on the consolidated return. See 26 U.S.C. §1552.

- A holding company system containing several insurers also includes a company that provides investment advisory services. If the investment advisor does not provide investment advisory services to unaffiliated companies, the charges under the agreement should be based on the cost of the services provided, including reasonable overhead charges. The charges should not exceed the cost the insurer would incur if it performed those functions itself. If the investment advisor provides investment advisory services to unaffiliated companies, the charges under the agreement may be up to the market price for such a service.

- An insurance holding company system includes a company that acts as a managing general agent (MGA) for an insurer. If the MGA only provides services for the insurer and does not provide similar services to unaffiliated companies, the charges under the agreement should be based on the cost of the services provided, including reasonable overhead charges. If the MGA provides services to unaffiliated companies, the charges under the agreement may be up to the market price for such services.

Reinsurance
With regard to reinsurance agreements, premiums charged and ceding commissions allowed under reinsurance agreements should be based on the risks assumed and costs incurred by the parties to the agreement, and should be comparable to amounts charged by unaffiliated reinsurers. In addition to meeting statutory accounting requirements such as transferring risk, the terms of reinsurance agreements should be fair and reasonable to the insurer. Although there are numerous variations of reinsurance agreements, examples of acceptable agreements include quota-share treaties where expenses and the risk of loss are shared proportionately, and excess-of-loss treaties where the reinsurance premium is based on the reinsurer's normal risk charge and is comparable to premiums charged to unaffiliated insurers. Provisions such as sliding commission scales that can significantly affect the timing and amount of reinsurance recoveries will be reviewed on a case-by-case basis.

If you have any questions regarding this Bulletin, please contact Neil A. Miller, Chief Financial Analyst, at (410) 468-2122.

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By: <u>*Signature on file with original document*</u>
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