Reinsurers can provide capital for health plans' strategic initiatives

Structured Reinsurance: An Alternative Capital Source for Health Plans' Initiatives

How Structured Reinsurance Works & Financial Benefits

When health plans hear the word "reinsurance", most often they think of protection for catastrophic risk. While that is certainly one use, reinsurance is a lot more versatile and has some interesting applications. For one, reinsurance can be used as a source of capital. With few exceptions, like Aetna's Vitality Re insurance-linked securitizations, reinsurance as a capital source hasn't been utilized commonly or effectively in the health insurance industry. When capital is required, most CFO's in the industry consider private equity, VCs and the capital markets, focusing on equity and debt. Reinsurance provides an additional option that often results in higher earnings, a lower cost of capital, and improved returns, all without the impacts of dilution (equity) and leverage (debt) making it worthwhile to understand how the product works.

Funding New Business Growth

To the extent that a health plan seeks new business growth through, for example, winning a Medicaid state contract, reinsurance could provide the necessary capital to maintain stable RBC ratios. In the following example, we assume that a health plan wins a Medicaid contract and is awarded USD 500 million in revenue. Let's assume the health plan has an RBC ratio of 318% just prior to winning the contract. To maintain its 318% risk based capital ratio after giving

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effect to the Medicaid contract, the health plan would need approximately USD 55 million in additional statutory capital.

Figure 1 – The Impact of Adding New Business with no Additional Capital (USD in millions and percent)

Income Statement	Existing Business	New Business	Combined Business
2014 Earned Premium	1,918.1	500.0	2,418.1
Incurred Claims	1,718.7	435.0	2,153.7
Medical Loss Ratio	+89.6%	+87.0%	+89.1%
SG&A + LAE Ratio	209.1	54.5	263.6
SGA + LAE Ratio	+10.9%	+10.9%	+10.9%
EBITDA	(9.6)	10.5	0.9
EBITDA margin	-0.5%	+2.1%	0.0%
Net investment income	19.2	5.0	24.2
Interest Expense	9.6	0.0	9.6
Pre-tax gain / loss	0.0	15.5	15.5
Margin	0.0%	+3.1%	+0.6%
Balance Sheet			
Capital & surplus	211.6	0.0	211.6
ACL RBC	66.5	17.3	83.9
RBC Ratio	+318%	0.0%	+252%

To maintain the same 318% RBC ratio, the health plan would have to contribute USD 55 million in capital to support the new business

In most cases, the additional statutory requirement is funded through internally generated capital, or in certain situations, through debt. Neither of these scenarios is ideal, however, since funding the new growth using internal capital reduces the health plan's RBC ratio from 318% to 252% and funding the new growth using debt would dramatically increase the debt to capital ratio and would cost about USD 2.5 million based on a 5% interest rate[2].

In the following exhibit, we've assumed the incremental capital is funded through debt.

Figure 2 – Impact of Funding Incremental Statutory capital through Debt (USD in millions and percent)

Income Statement	Existing Business	New Business	Combined Business
2014 Earned Premium	1,918.1	500.0	2,418.1
Incurred Claims	1,718.7	435.0	2,153.7
Medical Loss Ratio	+89.6%	+87.0%	+89.1%
SG&A + LAE	206.1	54.5	263.6
SG&A + LAE Ratio	+10.9%	+10.9%	+10.9%
EBITDA	(9.6)	10.5	0.9
EBITDA margin	-0.5%	+2.1%	0.0%
Net investment income	19.2	5.0	24.2
Interest Expense	9.6	2.8	12.3
Pre-tax gain / loss	0.0	12.7	12.7
Margin	0.0%	+2.5%	+0.5%
Balance Sheet			
Capital & Surplus	211.6	55.2	266.8
ACL RBC	66.5	17.3	83.9
RBC Ratio	318%	318%	318%
Pre-tax return on capital	0.0%	+23.1%	+4.8%

Beyond funding the additional capital using retained earnings or debt, a health plan can fund the incremental required capital through reinsurance. To obtain USD 55 million in capital, the insurer could cede USD 500 million in premiums to Hannover Re. The actual business ceded could be from one or more lines of business. For this example, let's assume the health plan cedes to Hannover Re premium associated with its Medicaid business.

[2] Assumes a 5% weighted average based on a laddered bond offering of 3, 5 and 10 year tenor.

Figure 3 – Impact of Funding Incremental Statutory Capital through Reinsurance (USD in millions and percent)

Income Statement	Combined Business	Adding Reinsurance	Statement After Reinsurance
2014 Earned Premium	2,418.1	500.0	1,918.1
Incurred Claims	2,153.7	445.3	1,708.3
Medical Loss Ratio	+89.1%	+89.1%	+89.1%
SG&A + LAE	263.6	0.0	263.6
SG&A + LAE ratio	+10.9%	0.0%	+13.7%
Expense Allowance		**(15.0)**	
% of premium		3.0%	
Experience Refund		**(37.8)**	
% of premium		+7.6%	
EBITDA	0.9	1.9	-1.0
EBITDA margin	0.0%	+0.4%	-0.1%
Net investment income	24.2	0.0	24.2
Interest Expense	9.6	0.0	9.6
Pre-tax gain / loss	15.5	1.9	13.6
Margin	+0.6%	+0.4%	+0.7%
Balance Sheet			
Capital & surplus	211.6		211.6
ACL RBC	83.9		66.5
RBC Ratio	+252%		+318%
Pre-tax return on capital	+7.3%		+6.4%

Notes:

1. Expense allowance = 3% of ceded premium
2. Experience refund = ceded premiums – ceded claims – expense allowance – reinsurance fee (USD 37.8 = 500 – 445.3 – 15 – 1.9)
3. Reinsurer's fee = 3.5% x capital relief (USD 1.9 = .035 x 55.2)
4. Capital relief = ACL on ceded premium x desired RBC ratio (USD 55.2 = 17.3 x 318%)

Hannover Re would be responsible for the underlying medical expenses on its portion of the premium (in this example, 89.1% or USD 445.3 million) plus pay the health plan an expense allowance of 3% on the ceded portion of the premium, which translates to USD 15 million. After paying medical expenses and the expense allowance, Hannover Re would be left with USD 39.7 million, all of which Hannover Re would return to the health plan through an experience refund (USD 37.8 million in this example), less its fee for the financing. The USD 1.9 million difference between the USD 39.7 million calculated above and the USD 37.8 million experience refund is what Hannover Re would earn on the transaction, and is equal to a 3.5% (by way of example) interest charge on the USD 55 million in capital relief provided.

The interest charge is highly dependent upon the level of subordination that is structured in the transaction and can be reduced based on many factors, including counterparty credit, predictability of the line of business supporting the capital and other factors. By using reinsurance, the health plan also realizes a modest increase in pre-tax income, which in our example works out to be USD .9 million (i.e. USD 13.6 million compared to USD 12.7 million).

Another benefit to using reinsurance is a significant increase in return on capital.

Funding the incremental statutory capital through debt results in a return on capital of 4.8%, whereas funding the statutory capital through reinsurance pushes the return on capital to 6.4%, a nearly 35% increase in ROE. This is due

to Hannover Re holding the capital on the health plan's behalf while experience refunding back to the health plan all of the profits on the business reinsured.

Importantly, reinsurance does not operate as debt so there is no change to the debt to capital ratio for the health plan, which would not be the case if the health plan were to fund the additional capital through debt. Unlike debt which handcuffs the borrower to restrictive covenants and operational inefficiencies, and requires first dollar repayment, reinsurance is reflected in a reinsurance treaty that does not incorporate negative covenants of the kind in debt instruments, and is not repaid from first dollar but instead is contingent upon the underwriting performance of the business reinsured. If the business underperforms, Hannover Re bears the risk of non-payment of its interest charge.

The tenor, or duration, of the reinsurance transaction is flexible (typically 3 years) but can be structured to match the financing needs of the health plan, and can include the latitude to allow the health plan to increase or decrease the amount of capital relief provided each year.

Finally, the reinsurance utilizes a "funds withheld coinsurance" structure, which provides credit for capital relief and is recognized in all U.S. jurisdictions. In addition, the health plan will hold all the cash and reserves including earning interest on all reserves and cash flow. The funds will never be held by Hannover Re. Each quarter, if the business performs as expected, the only cash that is exchanged is the reinsurance fee (interest charge) paid to Hannover Re. This mitigates cash flow concerns that companies may ponder when considering reinsurance.

It's important to examine the impact that reinsurance has on revenue. In our example, what would have been USD 2.4 billion of statutory revenue naturally turns into USD 1.9 billion after considering the premium that is ceded to Hannover Re. However, under GAAP accounting, the health plan would report the full USD 2.4 billion in revenue since the transaction is expected to be accounted as deposit accounting under FAS 113. Under normal reinsurance accounting, a company ceding premiums to a reinsurer would see top line volatility as premiums would be transferred from the books of the company to the reinsurer. Not so under FAS 113 GAAP accounting where the company retains premiums on its revenue line thereby eliminating top line volatility. Likewise, the health plan would report the full gross claims and expenses, including an additional expense that represents the fee paid to Hannover Re.

Funding M&A

In the next example, we assume that the health plan is considering an acquisition target with USD 300 million in revenue and a purchase price equal to USD 75 million. If the purchase price were financed solely using surplus, the health plan's consolidated capital base would drop by USD 75 million. In the example shown in Figure 4, this scenario would result in the risk based capital ratio falling by 97 percentage points from 318% (as of year-end 2014) to 221%. Maintaining a stable 318% RBC level would require a capital injection equal to the purchase price of USD 75 million.

Figure 4 – Assume an M&A Transaction Reduces Capital by USD 75 million (USD in millions and percent)*

Income Statement	Existing Business	M&A Target	Combined Pro Forma
2014 Earned Premium	1,918.1	300.0	2,218.1
Incurred Claims	1,718.7	261.0	1,979.7
Medical Loss Ratio	+89.6%	+87.0%	+89.2%
SG&A + LAE	209.1	30.0	239.1
SG&A + LAE ratio	+10.9%	+10.0%	+10.8%
EBITDA	(9.6)	9.0	(0.6)
EBITDA margin	-0.5%	+3.0%	0.0%
Net investment income[1]	19.2	3.0	22.2
Interest Expense	9.6	1.5	11.1
Pre-tax gain / loss	0.0	10.5	10.5
Margin	0.0%	+3.5%	+0.5%
Balance Sheet			
Capital & surplus	211.6	33.1	169.7
ACL RBC	66.5	10.4	76.9
RBC Ratio	+318%	+318%	+221%

1. Net investment income before any capital gains or losses

We're assuming the deal results in a USD 75 million reduction in capital for the combined company to cover the purchase price.

Beyond conventional commercial sources of capital like (i) Private Equity, where returns and maturities can be draconian, (ii) capital markets, where equity dilutes current shareholders, and (iii) debt, where leverage ratios are impacted and the company is constrained by numerous and significant restrictive and negative covenants, reinsurance provides an alternative source of financing but without the draconian terms, dilution, leverage or restrictive/negative covenants, all at competitive pricing. In the current example, the health plan could fund the purchase price by means of capital made available by a structured reinsurance transaction.

In Figure 5, the health plan cedes USD 680 million in premiums (about 30% of the combined company) to Hannover Re, significantly reducing the required capital level. As in the first example, Hannover Re would be responsible for the underlying medical expenses on its portion of the premium plus pay the health plan an expense allowance of 3% on the ceded portion of the premium. All profits on the ceded business in excess of the Hannover Re's fee would be returned to the health plan through an experience refund. In this example, Hannover Re's fee of USD 2.6 million is based on a 3.5% interest charge on the USD 75 million in capital relief provided to the health plan.

Figure 5 – Impacts of Funding M&A through Reinsurance (USD in millions and percent)

Income Statement	Combined Pro Forma	Adding Reinsurance	Pro Forma After Reinsurance
2014 Earned Premium	2,218.1	680.0	1,538.1
Incurred Claims	1,979.7	606.9	1,372.8
Medical Loss Ratio	+89.2%	+89.2%	+89.2%
SG&A + LAE	239.1	0.0	239.1
SG&A + LAE ratio	+10.8%	0.0%	+15.5%
Expense Allowance		**(27.2)**	
% of premium		+3.0%	
Experience Refund		**(43.3)**	
% of premium		+6.4%	
EBITDA	(0.6)	2.6	(3.2)
EBITDA margin	0.0%	+0.4%	-0.2%
Net investment income	22.2	0.0	22.2
Interest Expense	11.1	0.0	11.1
Pre-tax gain / loss	10.5	2.6	7.9
Margin	+0.5%	+0.4%	+0.5%
Balance Sheet			
Capital & surplus	169.7		169.7
ACL RBC	76.9		53.35
RBC Ratio	+221%		+318%

Pre-tax income shown in the reinsurance example is slightly lower, but note that the pro forma analysis in Figure 4 includes no assumption for increased interest expense that would be necessary to pay for the deal.

Notes

1. Expense allowance = 3% of ceded premium
2. Experience refund = ceded premiums – ceded claims – expense allowance – reinsurance fee (USD 43.3 = 680.0 – 606.9 – 43.3 – 2.6)
3. Reinsurer's fee = 3.5% x capital relief (USD 2.6 = .035 x 75)
4. Capital relief = ACL on ceded premium x desired RBC ratio (USD 75 = 23.6 x 318%)

Other Items to Note

- **In order for Hannover Re to proceed with a reinsurance transaction, it should be a predictable block of business.** Therefore, it makes more sense for a health plan to reinsure an established, profitable book of business rather than structuring the arrangement on a block with significant level of new and less predictable lives or business with a history of significant medical loss ratio (MLR) volatility. The MLR is more important than the overall level of pre-tax profits, so a block of business with a reasonable MLR and a high administrative cost ratio could still be a candidate for a reinsurance transaction.

- **Reinsurance tends to be more effective on certain products than others.** For example, the capital charge on Medicare Supplement products is much lower at around 12% while Medicaid, Medicare Advantage and comprehensive major medical products have a much higher capital charge. Using products with a higher capital charge makes it easier to free up more capital.

- **These reinsurance products can be arranged for any size transaction.** We've used some big numbers in the examples provided, but it is possible to enter into a smaller transaction in order to see exactly how it works, and scale the size of the transactions as needed.

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