Quota Share Reinsurance Solutions for Risk-Based Capital Relief

By Mark Troutman

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Health care insurance programs require capital. Those who require capital include policyholders, rating agencies and regulators. The focus of this article is on the regulators who determine risk-based capital (or RBC) standards applicable to health plans.

Health reform will bring many health plans opportunities for growth. Medicaid enrollment, for example, is expected to grow by an estimated 14 to 16-million lives due to the expanded Medicaid eligibility provisions of the Patient Protection and Affordable Care Act. As a result, many Medicaid health plans have legitimate concerns about meeting risk-based capital requirements. This article explores the opportunity for quota share reinsurance to meet risk-based capital requirements for all health plans with growth opportunities.

SOURCES OF CAPITAL

There are many potential sources of capital. The most common is capital contributions from investors, i.e., equity. Another source of capital is borrowed money, or debt. A third source of capital is retained earnings. If you price your program for profit in addition to expected claims and expenses in the operating results, those earnings become capital and surplus via retained earnings. Lastly, reinsurance is a form of capital because it provides capital relief when the risks that require that capital be employed are removed from the company's balance sheet and income statement via a reinsurance treaty.

Each of these sources of capital has advantages and disadvantages. For example, equity is the most permanent form of capital, but is dilutive. It has no required repayment or interest provisions. However, investors do expect a return on capital. Debt is non-dilutive leverage but must be paid back with interest in a pre-arranged timeframe. Retained earnings don't materialize unless you price for them and succeed in your operating results. Hence, they are uncertain and one cannot count on them definitively for capital required to grow.

Reinsurance assumes claim risk in addition to providing capital relief and often comes with other value-added services from the reinsurer. Reinsurance is typically easier to put in place and modify or terminate than debt or equity.

TYPES OF REINSURANCE

There are two main types of reinsurance, excess of loss and quota share. Excess of loss is often called a non-proportional coverage and quota share is a proportional coverage. The following examples describe how quota share and excess of loss claims are allocated between the parties. With quota share, is it the same regardless of the size of the claim? With excess of loss coverage, one determines the proportions to be paid by the cedant and reinsurer based on the size of the claim and the deductible chosen.

EXAMPLE 1: $400,000 CLAIM			
80% Quota Share		100% Excess of Loss (assume $50,000 deductible)	
Plan pays	Reinsurer pays	Plan pays	Reinsurer pays
$80,000	$320,000	$50,000	$350,000

EXAMPLE 2: $1,000,000 CLAIM			
80% Quota Share		100% Excess of Loss (assume $50,000 deductible)	
Plan pays	Reinsurer pays	Plan pays	Reinsurer pays
$200,000	$800,000	$50,000	$950,000

A quota share arrangement covers the same amount of the claims between the parties, regardless of whether the claim is very large or very small. One can see from the above examples that in a quota share arrangement, the proportion was always the 80/20-percent split assumed for the risk between the reinsurer and the cedant. However, in the excess of loss example, the proportional sharing in one situation was one-eighth to seven-eighths, and the other was one-twentieth to nineteen-twentieths. Hence, it is non-proportional coverage because the amount shared between the parties is based on the size of the claim and the deductible chosen.

WHAT'S THE BENEFIT?

Benefits to a health plan of quota share reinsurance are numerous. They reduce the plan's required capital and provide a temporary source of capital, particularly for growth. In simplistic terms, if a company desires to grow by 50 percent, its risk-based capital will have to grow by roughly 50 percent (with some adjustments for premium economies of scale in the RBC formulas).

Quota share reinsurance reduces financial exposure to adverse claim fluctuation for the company. The cedant can continue to participate in the underwriting gains in some negotiated percentage even though it has reinsured the business. It has access to outside expertise from a professional reinsurer in the areas of claims, underwriting, administration and managed care services.

A reinsurer typically provides a fixed expense allowance to cover the plan's cost for general administration, sales and marketing, provider relations and medical management. A plan's deviations from the expected expense levels provided in the expense allowance are absorbed by the plan.

Excess of loss protection is still important to cover catastrophic claims even when a quota share reinsurance treaty also exists. An excess of loss reinsurance treaty provides protection to the variability of the quota share reinsurance treaty results. Unfortunately, typical excess of loss premium is only 0 to 5 percent of total premium, so it's an ineffective tool for lowering risk-based capital requirements since it only involves a small percentage of the premium. That's why a quota share arrangement for a significant percentage of premium is the best approach when risk-based capital is the primary issue rather than the risk of catastrophic claims.

Improving financial ratios often improves or maintains claim paying ratings and debt ratings from rating agencies such as A.M. Best, Standard & Poors, Moody's or Duff & Phelps. Acquiring a block of business and ceding a portion of the risk to the reinsurer allows the company to control the business but minimize risk-based capital requirements.

"A REINSURANCE TREATY, LIKE AN INSURANCE POLICY, IS A PROMISE TO PAY AND IS ONLY AS GOOD AS THE REINSURER MAKING THE PROMISE."

REINSURER OVERSIGHT AND REINSURANCE STRUCTURE

As the reinsurer has a significant financial stake in the business, its oversight may include a review of the current plan operations and any proposed changes in products, reinsurance limits, vendors, utilization review activities, provider network and contracts, underwriting guidelines, administrative expense loads, claims system and coverage terms.

A reinsurer becomes the plan's partner when it is sharing in the profits and losses on the business. Therefore, it desires some involvement in how the business is run, particularly if the quota share percentage it assumes is large (i.e., 50 to 100 percent). The greater the percentage of risk ceded to the reinsurer, the greater the desired involvement by the reinsurer.

The structure of a sound risk-based capital reinsurance deal is designed to meet all risk transfer regulations of state and federal regulators, minimize asset transfer through the use of modified coinsurance (or modco) rather than cash coinsurance and provide the plan with the ongoing ability to participate in favorable operating results via an experience refund if the business results are favorable. A cash coinsurance transaction would actually cede the portion of the premiums to the reinsurer. A modco transaction cedes the risk to the reinsurer, but actually retains the cash on their balance sheet (essentially ceding the premium to the reinsurer as an account receivable). Given that most accident and health business is short-tail and investment income is not a critical factor in profitability, there is no financial incentive to cede the business to the reinsurer to let them make their own investment decision.

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A common requirement for a reinsurer engaging in financial reinsurance transactions is that the plan can't voluntarily terminate with experience in a deficit position without repaying that deficit to the reinsurer. However, if the reinsurer elects to terminate the treaty and the plan's financial result is in a deficit position, the reinsurer must suffer the losses for proper reinsurance credit to be obtained. A typical treaty involves a three to four year expected treaty duration with 90 to 180 day termination provision that can be executed by either party. In the event that the quota share reinsurer decides to terminate the relationship, the plan must find a new reinsurance partner, be in a position to provide the required capital to support the business or exit the line of business at the next opportunity.

A typical quota share percentage (to the reinsurer) is 50 to 80 percent. This allows a significant amount of premium and risk to be shifted to the reinsurer while maintaining the cedant's economic interest in the business results. Although most treaties allow for the reinsurer to participate in investment risk as well as insurance risk, the investment income on cash flow in health business, which is short-tail, is immaterial.

FACTORS IMPACTING PRICE

The main factors impacting the price of a potential risk-based capital reinsurance deal include the level of risk, which is embodied in the type of business, historical and projected profit margins, guarantee types and duration, the amount of risk-based capital relief actually made available (the benefit), as well as other terms and provisions which may cap the loss exposure of the reinsurer at some higher level. Lastly, if assets are transferred in cash to the reinsurer, there might be some frictional costs associated with a bank trust or letters of credit for security and reserve credit purposes.

One can see through the two illustrative examples on the left the similarities and differences between a conventional quota share and a financial quota share reinsurance transaction.

Medical Quota Share Example #1							
50% Quota Share Conventional Coinsurance Transaction 25% Expense Allowance							
Month							
Before Reinsurance	Jan	Feb	Mar	Apr	May	Jun	YTD
Earned Premium							
Claims Incurred	1,000	1,000	1,000	1,000	1,000	1,000	6,000
Expense Allowance	650	800	950	600	550	700	4,250
Total Combined Ratio	250	250	250	250	250	250	1,500
	0.90	1.05	1.20	0.85	0.80	0.95	0.96
Reinsured Portion							
Reinsured Premium	500	500	500	500	500	500	3,000
Claims Incurred	325	400	475	300	275	350	2,125
Expense Allowance	125	125	125	125	125	125	750
Stop Loss Premium	0	0	0	0	0	0	0
Loss Net of S.L.	0	0	0	0	0	0	0
Reinsurance Fee	0	0	0	0	0	0	0
Experience Refund	0	0	0	0	0	0	0
Loss Carry Forward	0	0	0	0	0	0	0
Settlement	0	0	0	0	0	0	0

Medical Quota Share Example #2							
50% Quota Share Financial Reinsurance Transaction, 110% Stop Loss @ 0.5% fee. 0.6% Reinsurance Fee. 22% Expense Allowance for 25% Actual Expenses.							
Month	Jan	Feb	Mar	Apr	May	Jun	YTD
Before Reinsurance							
Earned Premium	1,000	1,000	1,000	1,000	1,000	1,000	6,000
Claims Incurred	650	800	950	600	550	700	4,250
Expense Allowance	250	250	250	250	250	250	1,500
Total Combined Ratio	0.90	1.05	1.20	0.85	0.80	0.95	0.96
Reinsured Portion							
Reinsured Premium	500	500	500	500	500	500	3,000
Claims Incurred	325	400	475	300	275	350	2,125
Expense Allowance	110	110	110	110	110	110	660
Stop Loss Premium	2.5	2.5	2.5	2.5	2.5	2.5	15
Loss Net of S.L.	0	12.5	50	0	0	0	0
Reinsurance Fee	3	3	3	3	3	3	18
Experience Refund	59.5	0	0	16	109.5	34.5	219.5
Loss Carry Forward	0	15.5	68.5	0	0	0	0
Settlement	3	-12.5	-50	71.5	3	3	18

Example #1 is more straightforward. The reinsurer participates in the agreed-upon percentage of financial results, both positive and negative, with a given expense allowance. There are no additional experience refund calculations or loss carry forward provisions. It is as if the quota share portion of the block has been sold to the reinsurer.

In Example #2, the reinsurer is providing reinsurance protection to the plan but also providing an experience refund for favorable experience. Therefore, the reinsurer will usually attempt to be more conservative with respect to the risk it assumes and to also cap its risk exposure in certain regards. This may include an expense allowance that only covers marginal expenses rather than all expenses, a stop-loss limit that caps the reinsurer's exposure (e.g., claims and expenses in excess of 110 percent of premium are returned as a risk to the cedant, and termination and duration provisions that allow for smoothing the results of several years of experience. Hence, the financial reinsurer's implicit margins are the original target underwriting gain, the marginal or full expense allowance adjustment (if any), and the stop loss cap on the risk assumed by the reinsurer.

Note from Example #2 that the financial reinsurer's "settlement" entries sum to 18, which is the same as its reinsurance fee (6 x 3=18). The cash payments required between the parties to cover losses ultimately are covered via net favorable experience and the only amount of profit the financial reinsurer retains is its fees.

BUSINESS TARGETS AND DEAL UNDERWRITING

Medical blocks to target for the risk-based capital relief include any profitable group and individual health business, including major medical, Medicare/Medicaid, specific and aggregate stop-loss and HMO/PPO business.

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To evaluate the potential for an RBC reinsurance treaty, the reinsurer will typically accumulate certain company underwriting information in its initial due diligence with the potential cedant. Such information may include company financials (annual statutory, GAAP and audited financial statements), a good understanding of the need for reinsurance relative to sales projections and operating results, the policy forms being reinsured, expense levels, historical results, marketing strategy and underwriting philosophy. To assume significant risk, the reinsurer must understand the business and have a comfort level regarding future expected results.

	Financial Reinsurance	Conventional Reinsurance
Advantages	1. Lower cost (i.e., expense, risk and profit charges to reinsurer). 2. Cedant retains more upside profit potential. 3. More flexibility (i.e., ability to recapture quickly or adjust quota share).	1. Less regulatory/rating agency scrutiny. 2. More services from reinsurer (e.g., facultative underwriting, claim management). Truer "partnership" with follow form features. 3. Simpler agreement form.
Disadvantages	1. Cedant retains more downside risk. 2. Potential for oversight controls by reinsurer given risk-reward potential (e.g., warranties to do certain things). 3. Potential for more regulatory scrutiny given complexity.	1. Higher expense, risk and profit charges. 2. Cedant loses some upside profit potential.

How might one look at the cost of capital for an arrangement like this? One approach is to divide the reinsurer's fee by the amount of risk-based capital relief provided. For example, in a typical financial reinsurance transaction, the reinsurance fee may be 1 percent of premium, and the capital relief may be 14 percent of premium. Therefore, the cost of capital for this transaction is 1 percent divided by 14 percent = 7 percent. This can be compared to the availability of capital from other sources and constraints thereon as described previously.

Both the financial reinsurance and conventional reinsurance transactions have advantages and disadvantages. Neither one is superior to the other; it depends on the needs of the cedant. The following chart provides a very general comparison of the advantages and disadvantages of the two quota share alternatives.

CAVEAT EMPTOR

A reinsurance treaty, like an insurance policy, is a promise to pay and is only as good as the reinsurer making the promise. Any company considering engaging in a quota share reinsurance transaction should consider the ratings, capital and surplus of the reinsurer as well as the diversification of its business lines, its pricing discipline, and its expertise in structured reinsurance transactions. ■