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Aetna Enters the Capital Markets with the First Medical Benefits ILS Transaction

By Albert J. Pinzon and Robert W. Tomlinson
Cozen O'Connor

The first health insurance linked securities (ILS) deal transferring the reinsured risk of medical benefit claims of a major U.S. health care company, Aetna Life Insurance Company (Aetna), to capital market investors closed on January 10, 2011. Aetna secured surplus capital relief through the transaction by entering into a quota share reinsurance agreement with Health Re, Inc. (Health Re), a newly formed, Vermont, special purpose financial captive insurance company. Simultaneously, Health Re entered into a three-year, indemnity-based, annual aggregate excess-of-loss reinsurance agreement (XOL reinsurance agreement) with Vitality Re Limited (Vitality Re), a newly formed, Cayman Islands exempted company licensed as a restricted Class B insurance company. Vitality Re sold $150 million of Class A notes, rated "BBB" by Standard & Poor's (S&P), to Goldman Sachs as initial purchaser, which were in turn sold to qualified institutional investors (also known as QUIBS) pursuant to Rule 144A of the Securities Act of 1933. The proceeds of the offering were used by Vitality Re to collateralize and fund its obligations to Health Re (Aetna) under the XOL reinsurance agreement. Aetna made clear that this was the first of several such capital markets transactions it would undertake.

Aetna's motivation in engaging in this uncharted venture appears to be solely the cost of capital and not reimbursement on potential losses.

Traditionally, large U.S. health care companies, such as United Healthcare, Wellpoint, Aetna, CIGNA, and Coventry Health Care, have believed that their memberships (ranging from 5 to 50 million subscribers) adequately spread their risk, eliminating the need to transfer such risk to the capital markets or reinsurers. Aetna's motivation in engaging in this uncharted venture appears to be solely the cost of capital and not reimbursement on potential losses. Joseph M. Zubretsky, Aetna's chief financial officer, stated that the deal has "improved [Aetna's] capital efficiency, enhanced our financial flexibility, and reduced our weighted average cost of capital." The terms of the Aetna deal are favorable (in today's market) to investors, and future deals on similar terms would likely draw the interests of institutional investors looking for steady, low-risk returns. If successful, Aetna's foray into the capital markets may herald the arrival of the health care industry in the ILS market and, perhaps, the reinsurance market as well. Given the size of the health care sector (the top five U.S. health care companies have combined annual revenues of more than $250 billion), Aetna's use of the reinsurance and the capital markets to transfer risk has the potential to fundamentally transform both of these markets.[1]

Terms of the Deal

In November 2010, Aetna announced that it was entering into two distinct, collateralized, three-year XOL reinsurance agreements with Vitality Re, which would then issue health insurance linked bonds to collateralize its obligations under the agreements. The deal entailed Aetna ceding a portion of its overall commercial group health insurance risks to its affiliated, self-funded reinsurance captive, Health Re. Health Re and Vitality Re would enter into the $200 million annual, aggregate XOL reinsurance agreements. Vitality Re would then enter into a tri-party repurchase agreement with Goldman Sachs who would sell it a pool of permitted securities in return for cash, with an obligation for Vitality Re to repurchase the securities at maturity. On a quarterly basis, Goldman Sachs, as the repurchase counterparty, pays a fee to Vitality Re and receives all of the income earned on the permitted investments. The pool of permitted investments would be overcollateralized, and the market value marked to market on a daily basis by the tri-party agent. If the market value of the collateral dropped below the

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required level on any given day, Goldman Sachs would be obligated to deliver additional permitted investments in order to maintain the required over collateralization. The repurchase agreement could be terminated by the repurchase counterparty following a change in law event.

The bonds were to have a target of $200 million and would be issued in two tranches. S&P rated the first tranche, $125 million Class A notes, at “BBB-,” and the second tranche, $75 million Class B notes, at “BB.” The attachment point for the reinsurance, and hence the point at which investor capital would be eroded by losses under the reinsurance agreement, was to be an agreed upon percentage of Aetna’s medical benefits loss ratio (MBR), a ratio of claims to premium. The risk modeling for the transaction was provided by Milliman Inc. (Milliman), who created a simulation based stochastic model for the transaction. In rating the transaction, S&P said it expected actual results to differ somewhat from Milliman’s modeled results. Accordingly, Milliman adjusted the probability of attachment using stress indicators and cited a pandemic as the transaction’s greatest risk of loss. Finally, bondholders’ return was projected at LIBOR plus 4.25% for the Class A notes and LIBOR plus 6.25% for the Class B notes.

Medical benefits risks, fundamentally different from life and disability risks, tend to be short tail, with premium more closely tied to experience and adjusted annually, and reserves more accurately reflecting future liabilities.

The Aetna transaction closed on January 10, 2011 and followed closely on the November announcement, save for a few wrinkles and greater disclosure of the deal terms. Specifically, the three-year agreement provided Aetna $150 million (not $200 million) in annual aggregate excess of loss coverage. Rather than issue two tranches of notes, Vitality Re issued a single $150 million tranche of the Class A notes. Accordingly, as the XOL reinsurance agreements were linked to each class of notes, Health Re entered into one XOL reinsurance agreement rather than two. The XOL reinsurance agreement has an attachment point of 104% of Aetna’s MBR for 2011. The ratio is calculated on an annual aggregate basis, acting as an index of claims. If the MBR for 2011 reaches 114%, Aetna receives the full $150 million of coverage. The targets are to be reset (or renegotiated) for 2012 and 2013. The collateral is invested in highly rated assets and the account over-collateralized so the arrangement can provide credit for reinsurance for capital relief purposes.

Health Care Sector Transferring Risk

Aetna and its competitors are not unfamiliar with the reinsurance and securitization markets. In addition to medical benefits, most health care companies offer their employer clients both group life and group AD&D coverage, risks often reinsured by independent third-party reinsurers. Likewise, Triple-X, or redundant, reserving is a financial burden on life carriers who, in the past, have regularly offloaded these risks through securitization.[2] Medical benefits risks, however, are fundamentally different from life and disability products. Medical benefits tend to be short tail risk; premium is more closely tied to experience and is adjusted annually, and reserves more accurately reflect future liabilities. Moreover, individual subscribers for the largest health care companies number in the millions. An individual medical catastrophe could hardly alter the loss experience for a health care company’s largest clients, let alone the carrier’s overall performance. As a result, the use of reinsurance and the capital markets in this segment has been limited. The increasing desire for capital surplus, and perhaps the uncertainty of health care reform and medical inflation, may make offloading such risks a more common practice in the health care sector.

Appeal for Investors

Most catastrophe bonds securitize U.S. hurricane and worldwide earthquake exposure. Investors are likely to welcome the Aetna transaction as it diversifies the ILS market with a low risk investment alternative. Aetna bondholders, like CAT bondholders, will lose all or a portion of their principal and interest on the notes if Vitality Re, as the issuer, is required to make loss payments under

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the XOL reinsurance agreement. The bondholders have limited recourse to the assets of Vitality Re and no recourse to the assets of Aetna or Health Re. The risk of loss, however, is estimated at 1%. Clearly the bondholders stand an excellent chance of realizing their full principal and interest. For the fourth quarter of 2010, Aetna disclosed that its earnings rose 30% as the health insurer's MBR declined to 83% from 85.4% a year earlier. By contrast, the attachment for 2011 under the XOL reinsurance agreement is 104 MBR, truly a catastrophe cover.

The Aetna transaction demonstrates that the convergence of traditional reinsurance and the capital markets is continuing to produce new issuances covering various types of ceded insurance business. Michael Millette, managing director at Goldman Sachs, indicated that the Vitality Re notes were placed with traditional ILS investors "that were made up of cat funds and reinsurers." He added that the number of investors was "similar to that in a cat bond of the same size." With many ILS market participants projecting a return to net growth in 2011, and new issuances between $5 billion to $6 billion, the "health insurance linked bonds could represent an important, though relatively small, component of the overall market." In this respect, it appears that the health care sector could potentially provide additional deal flow for yield-hungry capital market investors who are also continuing to seek investments with relatively low correlations to other financial markets. With reinsurance rates projected to level off in 2011, the ILS market could represent a cost effective and diverse method for health insurers to transfer risk, address regulatory concerns, and enhance capital surplus. Whether third-party life and health reinsurers will attempt to capture a piece of this "emerging" market remains to be seen.

Endnotes

1. Aetna alone served approximately 35.4 million people on September 30, 2010. Aetna offers a broad range of traditional and consumer-directed health insurance products and related services, including medical, pharmacy, dental, behavioral health, group life and disability plans, medical management capabilities, and health care management services for medical plans.

2. Since 2007 the life carriers have been unable to securitize these risks that formerly guaranteed the bondholders' return through the purchase of insurance from mono-line insurers. These same carriers now enter into syndicated, long-dated letter of credit facilities.

By Albert J. Pinzon, member (212.883.4946, apinzon@cozen.com) and Robert W. Tomilson, member (215.665.5587, rtomilson@cozen.com), Cozen O'Connor.

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