

# HEALTHCARE FINANCE **NEWS**

THE BUSINESS NEWSPAPER FOR HEALTHCARE FINANCIAL MANAGERS

FEBRUARY 9, 2015

## Risk-spreading tools for healthcare financing

*Innovative tools could become more important as organizations seek new ways to innovate, grow, and protect themselves against risk.*

By KEITH KENNERLY and JOHN COOKSON, Contributing Writers

The transfer of risk from a business entity to a reinsurer or third-party capital provider (securitization) is a common practice among many types of insurers. The concept is simple: insurers spread risk to third parties to limit or control their claims exposure.

The list of tools insurers use to spread risk tends to get longer every day – sometimes, there’s an opportunity for the list to grow wider, and not longer, by finding new value in the tools and resources already being used by certain insurance industry sectors.

**“Health insurers are starting to look beyond traditional reinsurance — and examining the merits of other risk spreading tools.”**

### Old tools

Insurance risk securitization is an old tool that came to prominence in the mid-’90s in the property and casualty (P&C) segment after Hurricane Andrew, which caused damages that were significantly higher than expected. Catastrophe bonds, known as “cat bonds,” enabled P&C insurers to effectively offload a portion of the catastrophic risk into the capital markets and improve their capital efficiency.

As such, other insurance industries have followed. Life insurers have used mortality catastrophe bonds and swaps to transfer extreme mortality risks to the capital markets. There are a variety of innovative ways in which risk spreading tools enable both large and small companies to become more competitive in the marketplace.

### New tricks

Health insurers are starting to look beyond traditional reinsurance – and examining the merits of other risk spreading tools, such as cat bonds and



**Keith Kennerly, Vice President, Structured Health and Financial Solutions, Hannover Re US**

**John P. Cookson, Principal, Consulting Actuary, Milliman**

similar collateralized reinsurance vehicles, to help them meet the challenges they face. A recent case was Aetna’s securitization of medical loss risks, primarily pandemic exposures, in which Aetna used a cat bond structure to transfer a portion of its accident and health insurance exposure to the capital market (Vitality Re Series bonds, inception 2010).

In short, the cat bonds cover a portion of Aetna’s medical claims if their medical benefits ratio exceeds a certain threshold on an annual aggregate basis. Moreover, this transaction is a vital testament as to how the innovations of risk transfer tools can help healthcare entities become

more efficiently managed – for both risk and financial management.

### Health insurance segment

Over the past several years, significant developments in the U.S. healthcare industry have begun to change how provider institutions and payers are aligned to achieve better health, affordability, and experience for targeted populations. As many insurers and providers are progressively focusing on population management, there is also an opportunity to develop risk management tools that can enable participants to spread the risk of above-average healthcare expense outcomes to third parties.

For instance, accountable care organizations (ACOs) are (or are evolving towards) taking risk and, as result, they must essentially be equal parts insurance company, clinical manager, financial manager, and resource/operations managers. Thus, at times, ACO risk management strategy may require a comprehensive approach to risk management for which traditional risk transfer options may not be fully effective.

### Risk spreading

Risk-spreading tools that make use of the capital markets can help ACOs and other organizations, both large and small, mitigate the aggregate population risks. Given the trend spikes and volatility inherent to health risks, these capital

structures would rely on a combination of transparency, predictive analytics, and specially-designed indices to provide insight into the actuarial risk and actuarial underwriting opportunity.

By providing a heightened degree of visibility into the underlying actuarial risks, organizations can have a higher comfort level in underwriting those exposures at much lower attachment points that are very close to current Medical Loss Ratios (MLR). This could also set the stage for transforming a large portion of healthcare spending from a cost into a tradable asset (investment opportunity) for capital markets participants/investors.

### Broader concept

Another recent issue receiving needed attention involves specialty and other high cost drugs for which utilization can be volatile and difficult to predict. This is another area where a capital-markets approach can leverage the concept of risk spreading to offset the specialty drug cost spikes.

This approach can be focused on drug risk, i.e., tailored exclusively for unexpected peak risks that could be triggered in response to a spike in drug cost trends or a particular slice of costs. (A much-discussed recent example would be the recent release of the Hepatitis C drug Sovaldi, but organizations that are having difficulty either controlling

or comfortably forecasting spikes in cost trends can use these instruments.) Alternatively, rather than focusing specifically on pharmacy spending or a particular disease state, the contracts can be tied to a specific medical loss ratio in a fashion similar to traditional reinsurance contracts.

While risk-spreading mechanisms using the capital markets are not yet a major feature of the health insurance landscape, new and innovative tools could become more important as organizations seek new ways to innovate, grow, and protect themselves against risk. In fact, any organization taking on new risk or taking more risk than it traditionally has, can consider partnering with a reinsurer or third-party capital provider to reach otherwise unattainable capital requirements.

Innovative ideas such as those outlined above can provide critical capital infusion and risk spreading to help ensure the long-term financial viability of the healthcare system.■

*Keith Kennerly is Vice President, Structured Health and Financial Solutions, Hannover Life Reassurance Company of America, a member of Hannover Re Group. John P. Cookson is Principal, Consulting Actuary, Milliman.*

**hannover re**<sup>®</sup>

**Keith W. Kennerly**  
Vice President, Structured Health & Financial Solutions  
Hannover Life Reassurance Company of America,  
A member of Hannover Re Group  
[keith.kennerly@hlramerica.com](mailto:keith.kennerly@hlramerica.com)

 **Milliman**

**John Cookson, FSA, MAAA**  
Principal, Consulting Actuary  
Milliman  
[john.cookson@milliman.com](mailto:john.cookson@milliman.com)

### About Hannover Life Reassurance Company of America

Hannover Life Reassurance Company of America (Hannover Re US), which is licensed and/or accredited in all 50 U.S. states, District of Columbia, Puerto Rico, and Guam, is the North American life and health reinsurance subsidiary of Hannover Re Group. Hannover Re, with a gross premium of EUR 14.0 billion (USD 19.2 billion), is the third-largest reinsurer in the world. It transacts all lines of property & casualty and life & health reinsurance and is present on all continents with around 2,400 staff. Hannover Re US is rated "AA-" by Standard & Poor's and "A+" by A.M. Best. Additional information about the Company can be obtained from its web site at [www.hlramerica.com](http://www.hlramerica.com).

### About Milliman

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in healthcare, property & casualty insurance, life insurance and financial services, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe. For further information, visit [www.milliman.com](http://www.milliman.com)