EXECUTIVE SUMMARY

Health insurance providers are under intense pressure to maintain margins in the face of increasing competition and anticipated regulatory changes. For nonprofit insurers, the challenges are formidable. In 2011, the Affordable Care Act (ACA) established minimum medical loss ratio (MLR) requirements, providing further incentive for companies to devise methods for offsetting the loss in underwriting margins and mitigating the increase in associated risks. With MLRs in the 90s and combined ratios at or above 100%, nonprofit insurers have little room for adverse claim development. Any increased government pressure on reimbursement for Medicare and Medicaid patients should only exacerbate these concerns.

The goal for our enterprise risk management (ERM) analysis is to help health insurance providers improve the efficacy of their investments by providing an in-depth analysis of risk on both the liability and asset sides of the balance sheet. Our ERM analysis of nonprofit insurance providers has led us to believe there is ample room to increase potential income levels by selectively adding risk to investment portfolios.

Nonprofit companies have historically tended to hold less cash and have maintained larger allocations to common stock than other types of health insurers. As companies grow in size, their allocation to riskier asset classes has tended to increase with a corresponding decrease in investment in cash and bonds. Although opportunities to invest for yield have fallen along with bond yields over the last decade, high-yield corporate bonds, bank loans, securitized mortgages or income-producing equity securities may offer additional options for potentially improving current income while remaining within a targeted risk spectrum.

As companies increasingly rely on income from investments to maintain margins and improve claim coverage, we suggest that the need for proper evaluation of the composition and risk level of their investment portfolios is becoming more urgent. We believe companies in the health insurance industry should consider the potential benefits of ERM as they seek to enhance margins and meet the financial and regulatory challenges that lie ahead.
THE CLAIM COVERAGE SQUEEZE

Increasing competition and expected regulatory changes in the health insurance industry are placing significant pressure on margins for insurance providers. The challenge lies in finding ways to improve claim coverage capabilities while maintaining appropriate liability coverage and capital ratios.

While increasing the asset base may seem like a daunting task, we believe enterprise risk management analysis can provide valuable insights and a path toward implementation by employing a holistic view of risk to include both the asset and liability sides of the balance sheet. Our ERM analysis of health insurance companies leads us to believe they have an opportunity to potentially increase investment income by selectively raising risk tolerance levels. Our methodology and results are set out in this paper, which focuses on nonprofit health insurance companies.

THE FOUNDATION

Risk-Based Capital

We suggest ample room exists to potentially increase income levels by selectively adding risk to investment portfolios.

Our analysis is based on an initial review of risk-based capital (RBC). The importance of RBC ratios is twofold:

- Insurance companies must maintain a minimum amount of capital on the balance sheet to remain in business and avoid increased regulatory scrutiny.
- Comparing RBC ratios across a competitive set provides a measure of risk tolerance, particularly when evaluating a company relative to other insurers of similar size and type.

Since 2011, the industry has on average returned to pre-2008 RBC ratio levels. As shown in Figure 1, nonprofit companies tread the middle ground in terms of RBC targets. Ratios, as defined by invested asset base, vary by company size, with those of larger nonprofit companies tending to be higher than smaller companies.

In the 2010 National Association of Insurance Commissioners (NAIC) report on RBC results for health insurers, underwriting risk was, not surprisingly, listed as the largest component of the ratio at 79.4%. More intriguing from our perspective, however, was the discovery that investment risk, which accounts for a significant portion of total income, comprises a much smaller component of total RBC—only 4.3%. Another unexpected finding was the contribution breakdown. Fixed income, in which the majority of invested assets is held, contributes less than 1% of RBC as opposed to 1.62% for common stock and 1.70% for “other” assets.
We next considered the liability side of the balance sheet and possible implications for the invested asset base.

**LIABILITY RISK ANALYSIS**

**Medical Loss Ratio**

Medical loss ratios (MLRs) tend to differ by company size, resulting in varying levels of risk tolerance. The average MLR for nonprofit companies is 92%.

Analysis of liabilities-related risk management activity focuses on the MLR. In 2010, the Affordable Care Act established minimum MLR requirements, providing further incentive for companies to devise methods for offsetting the loss in underwriting margins and mitigating the increase in associated risks. From the perspective of enterprise risk management, a higher MLR indicates lower underwriting margins, suggesting to us:

- Greater reliance on investment income for profitability or pressure to lower administrative expenses.
- A higher probability of writing business at a loss, which can heighten liquidity and operational risks.

Figure 2 compares MLRs of nonprofit companies of various sizes over the past seven years.

![Figure 2: Medical Loss Ratio (%) for Nonprofit](image)

With MLRs in the 90s and combined ratios at or above 100%, nonprofit insurers have little room for adverse claim development. Increased government pressure on reimbursement for Medicare and Medicaid patients will, in our view, only exacerbate MLR concerns.

**Capital and Surplus Ratio**

MLR and RBC ratios vary by company size and type. Our analysis shows that a meaningful relationship appears to exist between company size and the amount of liabilities written for a given level of surplus.

We observe a meaningful difference in the level of business companies are willing to underwrite or generate for a given level of capital and surplus (Figure 3). Liabilities—consisting primarily of claim reserves related to the amount of business written by a company—range mostly between 80% and 100% of capital and surplus. The largest companies tend to write even greater amounts; for example, a company with $100 million in assets and $50 million in liabilities would have $50 million remaining for capital and surplus, equating to a 100% ratio.

In general, capital and surplus ratios increase with company size. Ratios for smaller companies tend to hover around 80% or 80 cents in liabilities for every dollar of capital on the balance sheet. Larger companies with ratios near 105% assume additional risk; however, they appear comfortable with writing relatively more business and holding relatively less capital for protection against adverse deviations in claim reserves.
1. Our analysis of risk tolerance levels related to liquidity showed that larger companies tend to have lower current liquidity ratios (calculated as cash and liquid assets as a percent of liabilities) than smaller companies.

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In addition to evaluation of liquidity and credit risks, a review of investment portfolio composition is also revealing. Figure 5 compares the asset allocation decisions of nonprofit health insurance companies by size.

**Figure 5: Asset Allocation (%) of Nonprofit Companies**

Source: SNL Financial LC. Contains copyrighted and trade secret material distributed under license from SNL. For Recipient’s Internal Use Only.

**Bond Allocations**

*The average portfolio rating tends to decrease as the invested asset base increases.*

Examination of bond portfolios in isolation provides further evidence of the relationship between risk tolerance and invested asset base (Figure 6). As the invested asset base increases, the allocation to NAIC1-rated bonds (AAA through A) declines, while the allocation to NAIC 2 (BBB) and NAIC 3 through 6 (high-yield) bonds rises.

**Figure 6: 2012Y – Bond Rating Distribution for Nonprofit Companies**

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**IN SEARCH OF YIELD**

Recent capital market trends may drive further changes in asset allocation decisions and risk tolerance levels. Opportunities to invest for yield have diminished. With the exception of the 2008 crisis period, bond yields have declined meaningfully over the last decade. Prior to 2008, an AAA-rated security yielded approximately 4%; today, the same security would yield closer to 2%. If this trend persists, we believe investment income levels could continue to decline unless risk tolerance levels are re-evaluated and the credit quality of investment portfolios is adjusted accordingly.

Health insurers seeking to boost investment income in an environment of diminishing yields may benefit from a shift in asset allocation to potentially higher-yielding opportunities such as high-yield corporate bonds, bank loans, securitized mortgages or income-producing equity securities, which may generate yields ranging from 3.5% to over 7%, though they present greater risk. We believe these asset classes may represent an attractive option for improving current income while remaining within a targeted risk spectrum.

**UNCOVERING OPPORTUNITIES WITH ERM**

Against a backdrop of increasing pressures on profitability spurred by growing competition and regulatory changes, health insurance companies face the challenging task of improving margins while maintaining appropriate liability coverage and capital ratios.

As companies rely more on income from investments, we expect the need for proper evaluation of the composition and risk level of investment portfolios to become more urgent. Our ERM analysis has led us to believe there is an opportunity to increase profitability by selectively adding risk to the investment portfolio—just one demonstration of how ERM’s holistic approach can provide a suggested path forward.

The process of balancing the drivers of both assets and liabilities can be challenging. In skilled hands, however, enterprise risk management holds the potential to support the evolving needs of growing companies, particularly in a dynamic financial and regulatory environment. We believe companies in the health insurance industry should consider the potential benefits of ERM as they seek to enhance margins and meet the financial and regulatory challenges that lie ahead.
Increasing Liquidity and Profitability with Federal Home Loan Bank Borrowing Programs

To reduce allocation to low-return, cash-equivalent investments and increase investment income, many health, life and property and casualty (P&C) insurers manage their liquidity requirements through Federal Home Loan Bank (FHLB) funding.

Formed in 1932, the government-sponsored Federal Home Loan Bank provides a readily available, low-cost source of funds in a wide range of maturities. Currently, more than 282 insurance companies are members of the FHLB, with aggregate borrowing in excess of $54.5 billion.2 Advances to member institutions are based on the security of collateral pledged, typically government securities and mortgage-related assets. To be eligible to borrow, a financial institution must first become a member and purchase FHLB stock. Shares are nonmarketable and dividend rates vary. Because the stock is redeemable only at par (subject to a waiting period, it is not subject to market volatility and typically carries a lower rating-agency risk charge.3 We feel that FHLB funding, compared to Treasuries, enhances both the size and risk level of the invested asset base (Figure 7).

Figure 7: FHLB Fixed-Rate Advance and Treasury Curve

<table>
<thead>
<tr>
<th>Yield/Rate (%)</th>
<th>Duration</th>
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<tbody>
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<td>≤ 5</td>
</tr>
<tr>
<td>5.0%</td>
<td>6-10</td>
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