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To: Health Risk-Based Capital (E) Working Group Members

From: Pat Tracy, LeeAnne Creevy and Craig Moore, Risk & Regulatory Consulting, LLC (RRC)

Date: December 2, 2014

Subject: Comment Letter on Excessive Growth Risk Scenarios for Startup Companies

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The Health Risk-Based Capital (E) Working Group (HRBCWG) is considering an RBC charge for startup health entities. At the November NAIC National Meeting, the HRBCWG asked for comments from interested parties on both the definition of a startup entity and comments on the proposed excessive growth charge. RRC is pleased to offer comments in this important area.

By way of background RRC (and its predecessors), working with our state regulatory customers, has been using alternative tools to gain solvency insight on health entities. We provided the Health Entities Working Group a tool called the "z-score" which they adopted as a Financial Analysis Solvency Tool (FAST) about 15 years ago. The z-score focuses on working capital, which is a leading indicator of potential solvency problems. See embedded SOFE *Examiner* article that describes the z-score using audited SEC Form 10-K information from 5 large publicly held health entities. Due to limitations on the annual statement (it no longer shows current assets and current liabilities in a classified balance sheet), the z-score cannot be easily calculated from regulatory filings. However, working capital is easy to calculate for health entities and is critical for evaluating risks startups face concerning solvency as indicated below. Please access the link below to the Industrial Articles

Using the Z-Score as a Tool to Analyze Health Entities Capital Risks under the Affordable Care Act by Pat Tracy, CPA, CFE, Jan Moenck CFE, CIA, CRP, CBA, CFSA, and Alex Quasnitschka, CFE

We suggest any company with less than 4 years of premium and claims history be considered a startup entity. We believe it makes sense to cover the transition risk period of the ACA which runs until at least 2016, and possibly longer. The transition period should flesh out the following solvency risk factors:

1. Effectiveness of the 3-R's in mitigating adverse selection risk.
2. Timing of payments both to and from the government relating to the 3-R's. As indicated below, any company dependent on the 3-R's to pay its hospitals and doctors needs to plan for a significant time lag. For example, 2014 adverse development will probably be paid in the fall of 2015.
3. Capital support for ACA startups likely will take several years to develop. These companies need financial backing beyond the initial startup capital and could suffer significant losses. It is likely that ACA 'winners and losers' will take years to determine.
4. The limited business experience of healthcare startups, and their ability to stay solvent, is not a given. The lack of operating history, dependence on government support, and adverse selection risk embedded in the ACA all magnify the potential for insolvency.
5. Possible negative impact of the current Supreme Court hearing on subsidies.
6. Unknown future changes to the ACA.

We believe emphasizing working capital (which in turn points to liquidity) is a better approach than trying to add an excessive growth RBC charge for several reasons: (1) liquidity will be the immediate problem for any startup that is growing fast, (2) liquidity can be easily calculated as the liabilities are current (most paid within 90 days), and (3) liquidity planning should be the highest priority for a startup company that expects to be a long-term player. As such, we would recommend reviewing the following considerations relative to liquidity for all start ups:

1. The current working capital as of year-end: Working capital is represented as current assets minus current liabilities. The % relationship of working capital to total capital also should be calculated. Showing the % of liquid assets to capital would avoid putting reliance on capital that is not available to pay claims.
2. An analysis of the cash flow impact of the 3-R's: For 2014 we expect no payments until late in 2015, and companies depending on these payments will need to demonstrate how they will pay their claims timely.
3. If a company projects fast growth in 2015, a liquidity projection should be reviewed. We think the same cash flow problem will exist in 2015, meaning payments under the 3-R's will not be received until late 2016.
4. Any adverse selection risk could create cash flow problems. These problems could be temporary (if the 3-R's work) or some portion might be permanent. Startups should attempt to address this risk in their business and strategic planning process.
5. Access to debt and equity capital should be reviewed.
6. Any payback terms and restrictions with startup funding should be reviewed and understood.

If the HRBCWG wants to use an excessive growth charge, we suggest it be based on projected growth as an after-the-fact charge would trail the liquidity event. As noted above, we believe a strong focus on actual liquidity and liquidity planning as part of an effective risk management program would address the solvency risk more directly. A direct focus on liquidity by State regulators might also help startups mitigate this high risk area.

In closing, RRC appreciates the opportunity to submit these comments and would be glad to respond to any questions that the HRBCWG members may have.