

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**CONVERSIONS OF STARTUP LOANS
INTO SURPLUS NOTES BY CONSUMER
OPERATED AND ORIENTED PLANS
WERE ALLOWABLE BUT
NOT ALWAYS EFFECTIVE**

*Inquiries about this report may be addressed to the Office of Public Affairs at
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Office of Inspector General

<http://oig.hhs.gov>

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OFFICE OF AUDIT SERVICES FINDINGS AND OPINIONS

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EXECUTIVE SUMMARY

Startup loans were converted into surplus notes in accordance with Centers for Medicare & Medicaid Services guidance and accounting principles, but Consumer Operated and Oriented Plans continued to cease operations and report low levels of risk-based capital.

WHY WE DID THIS REVIEW

The Patient Protection and Affordable Care Act (ACA) authorized the Secretary of Health and Human Services (the Secretary) to make startup and solvency loans to new consumer-governed, nonprofit health insurance issuers, known as Consumer Operated and Oriented Plans (CO-OPs). A prior Office of Inspector General (OIG) audit showed that CO-OPs had limited private monetary support and budgeted startup expenditures that exceeded available funding. Another OIG report indicated that member enrollment and profitability for most CO-OPs were considerably lower than initially projected and could limit the CO-OPs' ability to repay government loans.

A hearing entitled "Examining the Costly Failures of Obamacare's CO-OP Insurance Loans" before the United States House Committee on Energy & Commerce, Subcommittee on Oversight & Investigations, on November 5, 2015, addressed financial challenges CO-OPs faced and the effects on consumers and taxpayers. During the hearing, members expressed interest in OIG auditing the Centers for Medicare & Medicaid Services' (CMS) conversions of startup loans to surplus notes.

Our objective was to determine whether the CO-OPs complied with CMS guidance and applicable accounting principles when converting startup loans into surplus notes.

BACKGROUND

The ACA established health insurance exchanges (commonly referred to as "marketplaces") to allow individuals and small businesses to shop for health insurance in all 50 States and the District of Columbia. To expand the number of health plans available in the marketplaces, the ACA established the CO-OP program. The ACA authorized the Secretary to provide startup and solvency loans to help establish CO-OPs in every State. The Secretary delegated this responsibility to CMS.

Startup loans were intended to help CO-OPs cover approved costs for beginning operations. CMS has awarded \$2.4 billion to 23 CO-OPs, of which \$358 million was for startup loans; the remaining \$2.08 billion was for solvency loans.

Loans and Reserve Requirements

CMS established loan agreements with the CO-OPs to provide startup and solvency loan funding. The startup loans were originally treated as debt that each CO-OP was expected to repay within 5 years of the disbursement. Solvency loans were structured to comply with

applicable State insurance laws to meet capital reserve requirements and were expected to be repaid within 15 years. State insurance regulators require insurance issuers (issuers) to maintain specified levels of capital reserves to continue to conduct business.

On the basis of an issuer's size and risk, risk-based capital (RBC) estimates the minimum amount of capital needed to support the issuer's business operations. Issuers with a higher level of risk must reserve a larger amount of capital. RBC is usually expressed as a percentage. CMS generally required CO-OPs to maintain an RBC of 500 percent but allowed for lower levels to increase the long-term sustainability of some CO-OPs.

Centers for Medicare & Medicaid Services' Notice to Consumer Operated and Oriented Plans on Surplus Notes

CMS issued a memo to the CO-OPs, on July 9, 2015. The memo provided guidance that would allow the CO-OPs to amend their startup loan agreements. According to the guidance, the amendments would allow CO-OPs to convert startup loans into surplus notes. A surplus note is a bondlike instrument issued to provide needed capital. Under the terms of a surplus note, CO-OPs are not required to make any repayment on the surplus note that could lead to financial distress or default. In accordance with National Association of Insurance Commissioners (NAIC) accounting principles, CO-OPs that converted their startup loans into surplus notes could record and report these loans as capital and surplus rather than as debt in financial filings with regulators.

The purpose of CMS's guidance for the conversion of CO-OP startup loans to surplus notes was to ensure that the conversions were consistent with the NAIC Statement of Statutory Accounting Principles No. 41. This accounting principle allows reporting entities to issue surplus notes to attract capital when surplus levels are inadequate to support their operations. Surplus notes provide a source of capital for issuers that do not have access to traditional equity markets.

WHAT WE FOUND

We determined that the CO-OPs complied with CMS guidance and applicable accounting principles when converting startup loans into surplus notes. However, CMS did not adequately document the potential impact of the conversions on the Federal Government's ability to recover the loan payments if the CO-OPs were to fail. Although the conversions provided increased levels of capital and surplus, 4 of the 12 CO-OPs approved for conversions ceased operations within 6 months after the conversion. Despite the conversions allowing CO-OPs to record the startup loans as capital and surplus instead of debt, RBC percentages were at levels below the CMS requirement of 500 percent for four of the eight operational CO-OPs as of December 31, 2015.

WHAT WE RECOMMEND

We recommend that CMS perform the following steps prior to approving additional conversions of startup loans to surplus notes:

- document any potential negative impact from changes in distribution priority and
- quantify the likely impact on the Federal Government's ability to recover loan payments.

CENTERS FOR MEDICARE & MEDICAID SERVICES COMMENTS

In written comments on our draft report, CMS concurred with our recommendations. CMS stated that distribution priority is one of several factors in determining whether the Federal Government recovers funds in the event that a CO-OP ceases operations and liquidates its assets. CMS stated that it would continue to assess the overall impact of accepting surplus notes for startup loans in the future if additional CO-OPs request a conversion. CMS also provided technical comments on our draft report, which we addressed as appropriate.

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INTRODUCTION

WHY WE DID THIS REVIEW

The Patient Protection and Affordable Care Act (ACA)¹ authorized the Secretary of Health and Human Services (the Secretary) to make startup and solvency loans to new consumer-governed, nonprofit health insurance issuers, known as Consumer Operated and Oriented Plans (CO-OPs). A prior Office of Inspector General (OIG) audit showed that CO-OPs had limited private monetary support and budgeted startup expenditures that exceeded available funding.² Another OIG report indicated that member enrollment and profitability for most CO-OPs were considerably lower than initially projected and could limit the CO-OPs' ability to repay government loans.³

A hearing entitled "Examining the Costly Failures of Obamacare's CO-OP Insurance Loans" before the United States House Committee on Energy & Commerce, Subcommittee on Oversight & Investigations, on November 5, 2015, addressed financial challenges CO-OPs faced and the effects on consumers and taxpayers. During the hearing, members expressed interest in OIG auditing the Centers for Medicare & Medicaid Services' (CMS) conversions of startup loans to surplus notes.

OBJECTIVE

Our objective was to determine whether the CO-OPs complied with CMS guidance and applicable accounting principles when converting startup loans into surplus notes.

BACKGROUND

The ACA established health insurance exchanges (commonly referred to as "marketplaces") to allow individuals and small businesses to shop for health insurance in all 50 States and the District of Columbia. To expand the number of health plans available in the marketplaces, the ACA established the CO-OP program. The ACA authorized the Secretary to provide startup and solvency loans to help establish CO-OPs in every State. The Secretary delegated this responsibility to CMS. Startup loans were intended to help CO-OPs cover approved costs for

¹ P.L. No. 111-148 (Mar. 23, 2010), as amended by the Health Care and Education Reconciliation Act of 2010, P.L. No. 111-152 (Mar. 30, 2010), collectively referred to as "ACA."

² *The Centers for Medicare & Medicaid Services Awarded Consumer Operated and Oriented Plan Program Loans in Accordance With Federal Requirements, and Continued Oversight Is Needed* (A-05-12-00043, issued July 30, 2013).

³ *Actual Enrollment and Profitability Was Lower Than Projections Made by the Consumer Operated and Oriented Plans and Might Affect Their Ability to Repay Loans Provided Under the Affordable Care Act* (A-05-14-00055, issued July 29, 2015).

beginning operations. CMS has awarded \$2.4 billion to 23 CO-OPs, of which \$358 million was for startup loans; the remaining \$2.08 billion was for solvency loans.⁴

Loans and Reserve Requirements

CMS established loan agreements with the CO-OPs to provide startup and solvency loan funding. CO-OPs were required to meet all terms, conditions, and provisions included in the loan agreements and applicable Federal requirements. The startup loans were originally treated as debt that each CO-OP was expected to repay within 5 years of the disbursement. Solvency loans were structured to comply with applicable State insurance laws to meet capital reserve requirements and were expected to be repaid within 15 years.⁵ State insurance regulators require insurance issuers (issuers) to maintain specified levels of capital reserves to continue to conduct business. Capital reserves are intended to help ensure that issuers have enough money set aside to pay potential policyholder claims. Specific capital reserve requirements vary by State.

On the basis of an issuer's size and risk, risk-based capital (RBC) estimates the minimum amount of capital needed to support the issuer's business operations. The National Association of Insurance Commissioners (NAIC) developed the RBC formula as an additional tool to assist State insurance regulators in the financial analysis of issuers. The risk factors for the NAIC's RBC formula focus on three major areas: asset risk, underwriting risk, and other risk. Issuers with a higher level of risk must reserve a larger amount of capital. RBC is usually expressed as a percentage. State departments of insurance typically require 200 percent to 300 percent RBC. CMS generally required CO-OPs to maintain an RBC of 500 percent but allowed for lower levels to increase the long-term sustainability of some CO-OPs. RBC is not intended to be a standalone tool in determining the financial solvency of a CO-OP; rather, it is one of many tools that CMS uses to evaluate a CO-OP's financial risk.

CMS Oversight

CMS oversight of the CO-OP program includes monitoring the CO-OPs' overall financial condition by reviewing the CO-OPs' quarterly, semiannual, and annual financial statements as well as semiannual statements of compliance with relevant State licensure requirements. Although CMS has oversight authority as it relates to the CO-OPs' responsibilities under the terms of the loan agreements, State insurance regulators have primary oversight authority over the CO-OPs' operations. The State insurance regulators' authority generally includes issuing and revoking licenses to offer health plans, monitoring issuers' financial solvency and market conduct, and reviewing and approving premium rates.

CMS's Notice to Consumer Operated and Oriented Plans on Surplus Notes

CMS issued a memo to the CO-OPs on July 9, 2015. (See Appendix A.) The memo provided guidance that would allow the CO-OPs to amend their startup loan agreements. According to the

⁴ No additional amounts have been awarded since December 2014.

⁵ 45 CFR § 156.520.

guidance, the amendments would allow CO-OPs to convert startup loans into surplus notes. A surplus note is a bondlike instrument issued to provide needed capital. Under the terms of a surplus note, CO-OPs are not required to make any repayment on the surplus note that could lead to financial distress or default.

In accordance with NAIC accounting principles, CO-OPs that converted their startup loans into surplus notes could record and report these loans as capital and surplus rather than as debt in financial filings with regulators. As part of the guidance in the memo, CMS required that each CO-OP interested in converting its startup loans provide a written request that included the following:

- a justification or explanation of the specific benefit or benefits that the CO-OP expected to receive from the conversion;
- actuarially certified life-of-loan financial projections that reflected the conversion, and an explanation of any key assumptions in those projections;
- a description of the adverse impact to the CO-OP if the conversion were not implemented; and
- actuarially certified life-of-loan financial projections that did not reflect the conversion.

The purpose of CMS's guidance for the conversion of CO-OP startup loans to surplus notes was to ensure that the conversions were consistent with the NAIC Statement of Statutory Accounting Principles (SSAP) No. 41.

Statement of Statutory Accounting Principles No. 41

The SSAP No. 41 established accounting principles for issuers and holders of surplus notes.⁶ This accounting principle allows reporting entities to issue surplus notes to attract capital when surplus levels are inadequate to support operations. Surplus notes provide a source of capital for issuers that do not have access to traditional equity markets.

The SSAP No. 41 states that surplus notes shall be reported as surplus and not as debt if the notes contain the following provisions:

- subordination to policyholders,⁷
- subordination to claimant and beneficiary claims,

⁶ SSAPs can be found in the NAIC Accounting Practices and Procedures Manual. The manual is available for purchase online at www.NAIC.org.

⁷ If an issuer falls into liquidation or bankruptcy, subordination identifies the distribution priority of the issuer's assets to its creditors.

- subordination to all classes of creditors other than surplus noteholders, and
- interest payments and principal repayments require prior approval of the commissioner of the State of domicile.

Distribution Priority of Creditor Claims

Most States have enacted statutes that govern the liquidation of issuers and are patterned after one of three model acts adopted by the NAIC over the years: the Uniform Insurers Liquidation Act, the Insurers Rehabilitation and Liquidation Model Act, and the Insurer Receivership Model Act. The models set forth the distribution priority of creditor claims (distribution priority) from the insolvent issuer's estate. The distribution priority requires that every claim in a class be paid in full before members of the next class receive any payment on their claims. Distribution priority differs from State to State. For illustration purposes, we provide Michigan's distribution priority below:⁸

- Class 1. Costs of administration;
- Class 2. Policyholder, third-party claims, and guaranty association claims under policies;
- Class 3. Claims of the Federal Government;
- Class 4. Limited compensation for employee services;
- Class 5. Unearned premium, other premium refunds and general creditor claims;
- Class 6. Claims of a State or local government;
- Class 7. Late filed claims;
- Class 8. Surplus notes or similar obligations; and
- Class 9. Claims of shareholders or other owners in their capacity as shareholders.

⁸ Michigan Compiled Law 500.8142.

HOW WE CONDUCTED THIS REVIEW

Our review covered the 12 CO-OPs that converted startup loans to surplus notes on or before December 31, 2015.⁹ As of December 31, 2015, three operating CO-OPs had not converted their startup loans to surplus notes.¹⁰

We reviewed the CO-OPs' financial statements, CMS guidance, and applicable accounting principles related to reporting startup loans as surplus notes. We held discussions with CMS, State insurance regulators, and NAIC regarding the conversion of startup loans into surplus notes. On the basis of those discussions, we reviewed relevant financial data to determine the financial impact of the CO-OPs' startup loan conversions.

We limited our internal control review to obtaining an understanding of CMS's procedures for approving conversions and the CO-OPs' procedures for converting startup loans to surplus notes.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The details of our audit scope and methodology are included in Appendix B.

FINDINGS

We determined that the CO-OPs complied with CMS guidance and applicable accounting principles when converting startup loans into surplus notes. However, CMS did not adequately document the potential impact of the conversions on the Federal Government's ability to recover the loan payments if the CO-OPs were to fail. Although the conversions provided increased levels of capital and surplus, 4 of the 12 CO-OPs approved for conversions ceased operations within 6 months after the conversion. Despite the conversions allowing CO-OPs to record the startup loans as capital and surplus instead of debt, RBC percentages were at levels below the CMS requirement of 500 percent for 4 of the 8 operational CO-OPs as of December 31, 2015.¹¹

⁹ The AZ, CO, CT, IL, MD, ME, MI, MT, NM, OH, OR (HRI), and WI CO-OPs converted startup loans to surplus notes on or before December 31, 2015. Health Republic Insurance of Oregon (HRI) is one of two CO-OPs that offered health insurance in Oregon.

¹⁰ Massachusetts, New Jersey, and Oregon's Health CO-OP (OHC). After our audit period, OHC converted its startup loans to surplus notes on February 26, 2016. However, OHC recorded the conversion retrospectively on its NAIC annual statement dated December 31, 2015.

¹¹ On January 27, 2016, CMS issued general guidance titled "Frequently Asked Questions on the Consumer Operated and Oriented Plan (CO-OP) Program" that addressed whether a CO-OP should be placed in default if it has an RBC level below 500 percent. Failure to maintain an RBC level that is within at least 10 percent of this RBC level could result in a default of the terms and conditions of the loan agreement. However, according to the guidance, CMS evaluates CO-OPs that fall below 500 percent RBC to determine whether the CO-OP should be placed on a corrective action plan or notified that the drop in RBC constitutes a default of the loan agreement.

Consumer Operated and Oriented Plans Complied With CMS Guidance and Applicable Accounting Principles

We determined that each of the 12 CO-OPs provided a written request for the loan conversions, as required by CMS, that included an actuarial analysis that projected the CO-OPs' financial condition before and after the conversions. In addition, each State insurance commissioner's office approved the loan conversions for the 12 CO-OPs that converted their startup loans into surplus notes on or before December 31, 2015. The approvals were generally made to improve the capital and surplus levels needed to support the CO-OPs' operations. CMS approved amended loan agreements for each of the 12 CO-OPs to reflect the additional terms related to the loan conversions.

Additionally, each of the 12 CO-OPs met the requirements of SSAP No. 41 when converting the startup loans into surplus notes. The CO-OPs' amended loan agreements contained the required surplus note provisions of subordination to creditors, and that prior approval is required from the State's insurance commissioners for interest payments and principal repayments. The 12 CO-OPs also reported the loan conversions as surplus on their NAIC financial statements.

Loan Conversions Increased Capital and Surplus Levels but Actual Risk-Based Capital Percentages Generally Did Not Reach Projected Levels

One of the key reasons for converting startup loans to surplus notes was to improve the capital and surplus levels of the CO-OPs and to meet the 500-percent RBC requirement generally imposed by CMS. The CO-OPs demonstrated an appropriate need and benefit to increase capital and surplus from the conversions, as evidenced by the projected RBC rates before and after conversion. Table 1 on the next page provides details on the loan conversions and change in capital and surplus levels. Specifically, the loan conversions resulted in an increase of capital and surplus equal to the amount of the startup loans converted to surplus notes.

Table 1: Consumer Operated and Oriented Plan’s Startup Loan Conversions and Change in Capital and Surplus Levels

CO-OP	Date of Amended Loan Agreement	Startup Loans Converted to Surplus Notes¹²	2015 Projected Risk-Based Capital Percentage Before Loan Conversion	2015 Projected Risk-Based Capital Percentage After Loan Conversion	2015 Actual Risk-Based Capital Percentage¹³	CO-OP Ceased Operations as of 12/31/2015
AZ	9/30/2015	\$20,890,333	127%	550%	N/A ¹⁴	X
CO	8/11/2015	15,205,529	184%	307%	(1,176)%	X
CT	9/30/2015	21,011,768	718%	1042%	631%	
IL	12/31/2015	15,940,412	310%	473%	333%	
MD	11/11/2015	13,341,700	479%	500%	573%	
ME	12/15/2015	12,506,124	326%	432%	343%	
MI	9/28/2015	18,687,000	500%	776%	N/A	X
MT ¹⁵	11/23/2015	8,556,488	500%	479%	423%	
NM	8/11/2015	13,050,282	500%	643%	778%	
OH	12/21/2015	15,977,304	477%	784%	561%	
OR (HRI)	8/12/2015	10,227,005	391%	727%	130%	X
WI	8/11/2015	7,635,155	572%	671%	333%	

Although CMS generally required CO-OPs to maintain an RBC of 500 percent to help ensure financial solvency, four CO-OPs projected that their RBC would not meet CMS’s required 500-percent level after the loan conversion. All four CO-OPs reported actual RBC percentages of less than 500 percent for 2015 after the loan conversion.

Despite projected increases in RBC percentages after the conversion of startup loans to surplus notes, 4 of the 12 CO-OPs ceased operations within 6 months after the conversions. Actual RBC percentages as of December 31, 2015, for four of the eight operational CO-OPs were under

¹² When converted, all disbursed startup funds become subject to the surplus note. Conversions to surplus notes resulted in a decrease to borrowed money and an increase to surplus per the CO-OPs’ NAIC Liabilities, Capital and Surplus statements.

¹³ Per annual statement data submitted by the CO-OPs to NAIC as of December 31, 2015 (unaudited).

¹⁴ The AZ and MI CO-OPs had not filed a December 31, 2015, NAIC annual statement as of March 31, 2016.

¹⁵ The Montana CO-OP provided an actuarial analysis that used financial projections for two different time periods to show RBC before and after the loan conversion. The projected RBC after the conversion included a larger estimated net loss for the year.

500 percent even after accounting for the surplus note conversion.

Conversions of Consumer Operated and Oriented Plan Loans Likely Reduced the Federal Government's Ability To Recover Loan Payments

Although all of the 12 CO-OPs appropriately amended their loan agreements, we determined that the conversion of startup loans to surplus notes likely reduced the Federal Government's ability to recover loan payments because the conversions lowered the distribution priority of CMS. CMS stated that the conversion would provide additional capital to all CO-OPs to address capital issues and may also facilitate additional third-party borrowing to address liquidity issues. CMS informed us that it had considered the change in distribution priority prior to converting the startup loans to surplus notes and will continue to do so in the future. We requested from CMS documentation that supported these considerations; however, on April 28, 2016, CMS stated that it did not have documentation to demonstrate the effect of the distribution priority change.

Most States enacted statutes that govern the liquidation process of issuers and established a distribution priority that requires every claim in a class to be paid in full before the next class receives any payment. Because of the change in distribution priority, we determined that the conversion of the startup loans into surplus notes likely reduces the Federal Government's ability to recover the loan funds if a CO-OP ceases operations and liquidates its assets.¹⁶ For example, the Federal Government was third on the distribution priority list before the Michigan CO-OP converted its startup loan into a surplus note. After the startup loan was converted to a surplus note, the Federal Government was reduced to eighth on the distribution priority list. Additionally, while the CO-OPs remain in business, interest and principal repayments of surplus notes to CMS will require prior approval from the State's department of insurance.

¹⁶ Distribution priority is just one factor in determining whether the Federal Government recovers loan funds after liquidation.

The Federal Government’s distribution priority for each CO-OP before and after the conversion is listed below:

Table 2: Consumer Operated and Oriented Plan Startup Loans Distribution Priority Before and After the Loan Conversions

CO-OP	Total Number of Distribution Classes	Federal Distribution Priority Before Conversion	Federal Distribution Priority After Conversion	Distribution Priority Change
AZ	11	4	10	6
CO	8	3	7	4
CT	9	4	8	4
IL	9	6	8	2
MD	6	3	6	3
ME	10	5	9	4
MI	9	3	8	5
MT	9	3	8	5
NM	10	5	9	4
OH	10	3	8	5
OR (HRI)	6	3	6	3
WI	11	3	10	7

RECOMMENDATIONS

We recommend that CMS perform the following steps prior to approving additional conversions of startup loans to surplus notes:

- document any potential negative impact from changes in distribution priority and
- quantify the likely impact on the Federal Government’s ability to recover loan payments.

CMS COMMENTS

In written comments on our draft report, CMS concurred with our recommendations. CMS stated that distribution priority is one of several factors in determining whether the Federal Government recovers funds in the event that a CO-OP ceases operations and liquidates its assets. CMS stated that it would continue to assess the overall impact of accepting surplus notes for startup loans in the future if additional CO-OPs request a conversion. CMS also provided technical comments on our draft report, which we addressed as appropriate. CMS’s comments, excluding technical comments, are included as Appendix C.

APPENDIX A: CMS MEMORANDUM ISSUED TO CONSUMER OPERATED AND ORIENTED PLANS ON JULY 9, 2015

DEPARTMENT OF HEALTH & HUMAN SERVICES
Centers for Medicare & Medicaid Services
Center for Consumer Information and Insurance Oversight
200 Independence Avenue SW
Washington, DC 20201



TO: CO-OP Project Officers
FROM: Kelly O'Brien, CO-OP Division Director
RE: Amending CO-OP Loans Agreement to Apply Surplus Notes to Start-up Loans
Date: July 9, 2015

Dear CO-OP Project Officers:

This notice is to inform you that the Centers for Medicare & Medicaid Services (CMS) will now allow CO-OPs to request that surplus notes be applied to Consumer Operated and Oriented Plan (CO-OP) Program start-up loans. Applying surplus notes to the start-up loans will enable CO-OP borrowers to record those loans as assets in financial filings with regulators. The start-up loans will be subject to commensurate terms of subordination, interest accrual, and repayment.

To pursue this change, a CO-OP loan recipient must provide CMS a written request that includes the following:

1. A justification or explanation of the specific benefit or benefits that the CO-OP expects to receive from the change;
2. Actuarially certified life of loan financial projections that reflect the implementation of the change, and an explanation of any key assumptions in those projections. Projections should include, but not be limited to:
 - a. debt service coverage ratios;
 - b. actual and/or projected payments made or received through the Risk Adjustment, Reinsurance, and Risk Corridors programs; and
 - c. risk based capital levels with respect to state requirements;
3. A description of the adverse impact to the CO-OP if the change is not implemented. For example, if a CO-OP anticipates they will fall below RBC level requirements absent this action; and
4. Actuarially certified life of loan financial projections that do not reflect the implementation of the change. Projections should include, but not be limited to:
 - a. debt service coverage ratios;
 - b. actual and/or projected payments made or received through the Risk Adjustment, Reinsurance, and Risk Corridors programs; and

- c. risk based capital levels with respect to state requirements.

Please note the following:

- It is necessary to amend the loan agreement to subject your start-up loan to a surplus note. **Attachment A** is the CMS-approved template to amend your loan agreement for these purposes. Proposed revisions to the template that are material will likely require further administrative review and approval, so we urge acceptance of the amendment as proposed here unless a material revision is absolutely necessary.
- Repayment due dates, interest rates, and disbursement processes are unaffected by this amendment.
- All active CO-OP loan recipients may request to enter into this amendment. In evaluating whether to approve these requests, CMS will consider the likelihood that the request will result in the overall benefits outlined by the applicant.
- Please communicate any questions or concerns related to the template of the amendment at your earliest convenience. Once the template is agreed to, CMS will provide a proposed amendment that includes amounts and parties.
- The proposed amendment that reflects amounts and parties must be approved by your state regulator before it can be executed. CMS will arrange calls with you and your regulator to discuss the proposed amendment, and make any necessary revisions.
- Once approved by your regulator, borrowers will execute the amendment and provide an image of the executed amendment to CMS.
- CMS will execute the amendment last, and provide an image of the executed amendment to each borrower.
- A CO-OP loan recipient who chooses not to apply at this time or whose application is denied may apply at their discretion in the future, and requests will be reviewed on a rolling basis.

Please communicate questions, concerns, and your intent to amend your loan agreement consistent with this notice by emailing your account manager, Kevin Kendrick at kevin.kendrick@cms.hhs.gov, and Jamaca Mitchell at Jamaca.mitchell@cms.hhs.gov.

APPENDIX B: AUDIT SCOPE AND METHODOLOGY

SCOPE

Our review covered the 12 CO-OPs that converted startup loans to surplus notes on or before December 31, 2015.¹⁷

We limited our internal control review to obtaining an understanding of CMS's procedures for approving conversions and the CO-OPs' procedures for converting startup loans to surplus notes.

We conducted the audit from November 2015 to June 2016.

METHODOLOGY

To accomplish our audit objective, we:

- reviewed CMS guidance and applicable accounting principles;
- discussed the treatment of startup loans as surplus notes with CMS, NAIC, and applicable State insurance commissioners' offices;
- reviewed applicable State distribution priority of claims procedures for insolvent issuers;
- reviewed the unaudited NAIC quarterly financial statements dated September 30, 2015, and available NAIC annual statements dated December 31, 2015, for each of the 12 CO-OPs that converted startup loans and the remaining operational CO-OPs;
- reviewed the 12 CO-OPs' written requests and amended loan agreements to CMS to convert startup loans to surplus notes;
- verified that the 12 CO-OPs followed CMS guidance and SSAP No. 41 and obtained State approval for conversions;
- verified the date of conversion and total dollar amount of startup loans that had been converted by December 31, 2015;
- verified which CO-OPs ceased operations after their loan conversions; and
- discussed the results of our review with CMS officials.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain

¹⁷ The AZ, CO, CT, IL, MD, ME, MI, MT, NM, OH, OR (HRI), and WI CO-OPs converted startup loans to surplus notes on or before December 31, 2015.

sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX C: CMS COMMENTS




DEPARTMENT OF HEALTH & HUMAN SERVICES

Centers for Medicare & Medicaid Services

JUL - 8 2016

200 Independence Avenue SW
Washington, DC 20201

TO: Daniel R. Levinson
Inspector General

FROM: Andrew M. Slavitt 
Acting Administrator

SUBJECT: Office of Inspector General (OIG) Draft Report: "Conversions of Startup Loans into Surplus Notes by Consumer Operated and Oriented Plans Were Allowable but Not Always Effective" (A-05-16-00019)

The Centers for Medicare & Medicaid Services (CMS) appreciates the opportunity to review and comment on the Office of Inspector General's (OIG) draft report on Consumer Operated and Oriented Plans (CO-OPs). CMS takes seriously its commitment to both CO-OP members and taxpayers in managing the CO-OP program.

Section 1322 of the Affordable Care Act (ACA) established the CO-OP program to foster the creation of non-profit health insurance issuers to give more choices and control to consumers, promote competition, and improve quality in the health insurance market. To this end, section 1322 provided start-up and solvency loan funding to eligible entities to help establish and maintain these new plans. CMS closely monitors and evaluates the CO-OPs to assess performance and compliance, and has engaged regularly with state Departments of Insurance (DOIs), which are the primary regulators of insurance issuers in the states. CMS is committed to continuing its work with the current CO-OPs to facilitate progress and continue its rigorous ongoing monitoring and oversight processes.

Understanding that CO-OPs face additional requirements compared to other issuers in the insurance field, CMS has allowed CO-OPs to utilize certain financial restructuring changes consistent with authority provided in the ACA, such as converting startup loans into surplus notes. This process allowed CO-OPs the opportunity to record and report startup loans as capital and surplus rather than as debt in financial filings with regulators.

CO-OPs were required to submit a written request to CMS explaining the specific benefit or benefits that the CO-OP expected to receive from the conversion, a description of the adverse impact to the CO-OP if the conversion were not implemented, and actuarially certified financial projections that reflected the conversion and one that did not reflect the conversion. Although CO-OPs were allowed to convert startup loans into surplus notes, CO-OPs are still subject to repayment terms of startup loans, including beginning the repayment process within the 5-year time frame.

CMS responses to the OIG's recommendations are below:

OIG Recommendation

The OIG recommends that CMS document any potential negative impact from changes in distribution priority.

CMS Response

CMS concurs with this recommendation. As the OIG notes, CMS issued a memo to the CO-OPs on July 9, 2015. This memo provided guidance to the CO-OPs on converting startup loans into surplus notes. A CO-OP must obtain two layers of approval before their request for conversion is approved, first from the relevant DOI as the regulator and then from CMS as the loan holder. As part of this process, the potential negative impact from changes in the distribution priority was considered by CMS, and will continue to be considered and documented in the future if additional CO-OPs request a conversion. However, it is important to note that distribution priority is one of several factors in determining whether the Federal government recovers funds in the event that a CO-OP ceases operations and liquidates its assets.

OIG Recommendation

The OIG recommends that CMS quantify the likely impact on the Federal Government's ability to recover loan payments.

CMS Response

CMS concurs with this recommendation. The process described in the July 9, 2015 memo includes consideration of the potential impact of the change in the priority of the loan in relation to other obligations. Before issuing the July 9 memo, CMS revised the credit risk profile of start-up loans to assess the overall impact of accepting surplus notes for start-up loans. CMS will continue to assess the overall impact of accepting surplus notes for start-up loans in the future if additional CO-OPs request a conversion.