

AETNA INC /PA/
Form 10-Q
October 31, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2017
or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 1-16095

Aetna Inc.
(Exact name of registrant as specified in its charter)

Pennsylvania	23-2229683
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
151 Farmington Avenue, Hartford, CT	06156
(Address of principal executive offices)	(Zip Code)
Registrant's telephone number, including area code:	(860) 273-0123

Former name, former address and former fiscal year, if changed since last report: N/A

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter)

during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated

Edgar Filing: AETNA INC /PA/ - Form 10-Q

filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

There were 326.1 million shares of the registrant’s voting common stock with a par value of \$.01 per share outstanding at September 30, 2017.

Aetna Inc.
 Form 10-Q
 For the Quarterly Period Ended September 30, 2017

Unless the context otherwise requires, references to the terms “we”, “our” or “us” used throughout this Quarterly Report on Form 10-Q (except the Report of Independent Registered Public Accounting Firm), refer to Aetna Inc. (a Pennsylvania corporation) (“Aetna”) and its subsidiaries (collectively, the “Company”).

Table of Contents	Page
Part I Financial Information	
Item 1. <u>Financial Statements</u>	<u>1</u>
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>40</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>55</u>
Item 4. <u>Controls and Procedures</u>	<u>56</u>
Part II Other Information	
Item 1. <u>Legal Proceedings</u>	<u>56</u>
Item 1A. <u>Risk Factors</u>	<u>56</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>57</u>
Item 3. <u>Defaults Upon Senior Securities</u>	<u>57</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>57</u>
Item 5. <u>Other Information</u>	<u>57</u>
Item 6. <u>Exhibits</u>	<u>58</u>
<u>Signatures</u>	<u>60</u>

Form 10-Q Table of Contents

Part I. Financial Information

Item 1. Financial Statements

Index to Consolidated Financial Statements

	Page
Consolidated Balance Sheets at September 30, 2017 and December 31, 2016	<u>2</u>
Consolidated Statements of Income for three and nine months ended September 30, 2017 and 2016	<u>3</u>
Consolidated Statements of Comprehensive Income for three and nine months ended September 30, 2017 and 2016	<u>4</u>
Consolidated Statements of Shareholders' Equity for the nine months ended September 30, 2017 and 2016	<u>5</u>
Consolidated Statements of Cash Flows for the nine months ended September 30, 2017 and 2016	<u>6</u>
Condensed Notes to the Consolidated Financial Statements	<u>7</u>
Report of the Independent Registered Public Accounting Firm	<u>39</u>

Index to Consolidated Financial Statements

Consolidated Balance Sheets

(Millions)	(Unaudited)	
	September 30, 2017	December 31, 2016
Assets:		
Current assets:		
Cash and cash equivalents	\$ 5,928	\$ 17,996
Investments	2,869	3,046
Premiums receivable, net	2,577	2,356
Other receivables, net	2,388	2,224
Accrued investment income	228	232
Income taxes receivable	—	44
Other current assets	2,444	2,551
Total current assets	16,434	28,449
Long-term investments	21,507	21,833
Reinsurance recoverables	705	727
Goodwill	10,683	10,637
Other acquired intangible assets, net	1,273	1,442
Property and equipment, net	581	587
Other long-term assets	1,865	1,480
Separate Accounts assets	4,335	3,991
Total assets	\$ 57,383	\$ 69,146
Liabilities and shareholders' equity:		
Current liabilities:		
Health care costs payable	\$ 6,139	\$ 6,558
Future policy benefits	611	645
Unpaid claims	812	801
Unearned premiums	2,046	556
Policyholders' funds	2,914	2,772
Current portion of long-term debt	1,998	1,634
Income taxes payable	79	—
Accrued expenses and other current liabilities	5,048	5,728
Total current liabilities	19,647	18,694
Future policy benefits	5,770	5,929
Unpaid claims	1,705	1,703
Policyholders' funds	781	812
Long-term debt, less current portion	8,161	19,027
Deferred income taxes	72	4
Other long-term liabilities	1,094	1,043
Separate Accounts liabilities	4,335	3,991
Total liabilities	41,565	51,203
Commitments and contingencies (Note 15)		
Shareholders' equity:		
Common stock (\$.01 par value; 2.5 billion shares authorized and 326.1 million shares issued and outstanding in 2017; 2.5 billion shares authorized and 351.7 million shares issued and outstanding in 2016) and additional paid-in capital	4,707	4,716
Retained earnings	12,037	14,717

Edgar Filing: AETNA INC /PA/ - Form 10-Q

Accumulated other comprehensive loss	(1,161) (1,552)
Total Aetna shareholders' equity	15,583	17,881	
Non-controlling interests	235	62	
Total equity	15,818	17,943	
Total liabilities and equity	\$ 57,383	\$ 69,146	

Refer to accompanying Condensed Notes to Consolidated Financial Statements (Unaudited).

Page 2

Index to Consolidated Financial StatementsConsolidated Statements of Income
(Unaudited)

(Millions, except per common share data)	Three Months		Nine Months	
	Ended September 30, 2017	Ended September 30, 2016	Ended September 30, 2017	Ended September 30, 2016
Revenue:				
Health care premiums	\$12,710	\$13,525	\$39,152	\$40,623
Other premiums	562	549	1,658	1,636
Fees and other revenue ⁽¹⁾	1,443	1,454	4,404	4,395
Net investment income	233	219	730	688
Net realized capital gains (losses)	46	34	(262)	85
Total revenue	14,994	15,781	45,682	47,427
Benefits and expenses:				
Health care costs ⁽²⁾	10,412	11,092	31,905	33,172
Current and future benefits	548	535	1,632	1,589
Operating expenses:				
Selling expenses	401	408	1,224	1,245
General and administrative expenses	2,211	2,422	7,793	7,232
Total operating expenses	2,612	2,830	9,017	8,477
Interest expense	90	189	349	414
Amortization of other acquired intangible assets	58	61	176	187
Loss on early extinguishment of long-term debt	—	—	246	—
Reduction of reserve for anticipated future losses on discontinued products	—	—	(109)	(128)
Total benefits and expenses	13,720	14,707	43,216	43,711
Income before income taxes	1,274	1,074	2,466	3,716
Income taxes:				
Current	470	580	955	1,697
Deferred	(44)	(103)	(140)	(109)
Total income tax expense	426	477	815	1,588
Net income including non-controlling interests	848	597	1,651	2,128
Less: Net income (loss) attributable to non-controlling interests	10	(7)	(9)	(4)
Net income attributable to Aetna	\$838	\$604	\$1,660	\$2,132
Earnings per common share:				
Basic	\$2.54	\$1.72	\$4.95	\$6.07
Diluted	\$2.52	\$1.70	\$4.92	\$6.02

Fees and other revenue include administrative services contract member co-payments and plan sponsor reimbursements related to our mail order and specialty pharmacy operations of \$31 million and \$100 million (net ⁽¹⁾ of pharmaceutical and processing costs of \$350 million and \$1.0 billion) for the three and nine months ended September 30, 2017, respectively, and \$34 million and \$93 million (net of pharmaceutical and processing costs of \$342 million and \$983 million) for the three and nine months ended September 30, 2016, respectively.

Health care costs have been reduced by Insured member co-payments related to our mail order and specialty ⁽²⁾ pharmacy operations of \$30 million and \$96 million for the three and nine months ended September 30, 2017, respectively, and \$27 million and \$89 million for the three and nine months ended September 30, 2016, respectively.

Refer to accompanying Condensed Notes to Consolidated Financial Statements (Unaudited).

Page 3

Index to Consolidated Financial StatementsConsolidated Statements of Comprehensive Income
(Unaudited)

(Millions)	Three		Nine Months	
	Months	Months	Months	Months
	Ended	Ended	Ended	Ended
	September	September	September	September
	30,	30,	30,	30,
	2017	2016	2017	2016
Net income including non-controlling interests	\$848	\$597	\$1,651	\$2,128
Other comprehensive income, net of tax:				
Previously impaired debt securities	(1)	—	(2)	1
All other securities	8	(2)	132	384
Derivatives and foreign currency	1	4	229	(165)
Pension and other postretirement employee benefit (“OPEB”) plans	11	9	32	29
Other comprehensive income	19	11	391	249
Comprehensive income including non-controlling interests	867	608	2,042	2,377
Less: Comprehensive income (loss) attributable to non-controlling interests	10	(7)	(9)	(4)
Comprehensive income attributable to Aetna	\$857	\$615	\$2,051	\$2,381

Refer to accompanying Condensed Notes to Consolidated Financial Statements (Unaudited), including Note 12 for further information about other comprehensive (loss) income.

Index to Consolidated Financial StatementsConsolidated Statements of Shareholders' Equity
(Unaudited)

(Millions)	Number of Common Shares Outstanding	Attributable to Aetna Common			Accumulated Other Comprehensive Loss	Total Aetna Shareholders' Equity	Non-Controlling Interests	Total Equity
		Stock and Additional Paid-in Capital	Retained Earnings					
Nine Months Ended September 30, 2017								
Balance at December 31, 2016	351.7	\$4,716	\$14,717	\$ (1,552)	\$ 17,881	\$ 62	\$17,943	
Net income (loss)	—	—	1,660	—	1,660	(9)	1,651	
Other increases in non-controlling interest	—	—	—	—	—	182	182	
Other comprehensive income (Note 12)	—	—	—	391	391	—	391	
Common shares issued for benefit plans, net of employee tax withholdings	1.4	(9)	—	—	(9)	—	(9)	
Repurchases of common shares	(27.0)	—	(3,845)	—	(3,845)	—	(3,845)	
Dividends declared	—	—	(495)	—	(495)	—	(495)	
Balance at September 30, 2017	326.1	\$4,707	\$12,037	\$ (1,161)	\$ 15,583	\$ 235	\$15,818	
Nine Months Ended September 30, 2016								
Balance at December 31, 2015	349.5	\$4,647	\$12,797	\$ (1,330)	\$ 16,114	\$ 65	\$16,179	
Net income (loss)	—	—	2,132	—	2,132	(4)	2,128	
Other comprehensive income (Note 12)	—	—	—	249	249	—	249	
Common shares issued for benefit plans, net of employee tax withholdings	1.4	52	—	—	52	—	52	
Dividends declared	—	—	(263)	—	(263)	—	(263)	
Balance at September 30, 2016	350.9	\$4,699	\$14,666	\$ (1,081)	\$ 18,284	\$ 61	\$18,345	

Refer to accompanying Condensed Notes to Consolidated Financial Statements (Unaudited).

Index to Consolidated Financial StatementsConsolidated Statements of Cash Flows
(Unaudited)

(Millions)	Nine Months Ended September 30, 2017 2016	
Cash flows from operating activities:		
Net income including non-controlling interests	\$1,651	\$2,128
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized capital losses (gains)	262	(85)
Depreciation and amortization	499	511
Debt fair value amortization	(14)	(22)
Equity in (earnings) losses of affiliates, net	(80)	1
Stock-based compensation expense	135	147
Reduction of reserve for anticipated future losses on discontinued products	(109)	(128)
Amortization of net investment premium	54	62
Loss on early extinguishment of long-term debt	246	—
Changes in assets and liabilities:		
Premiums due and other receivables	(184)	(278)
Income taxes	(15)	387
Other assets and other liabilities	(1,196)	57
Health care and insurance liabilities	931	1,841
Distributions from partnership investments	44	—
Net cash provided by operating activities	2,224	4,621
Cash flows from investing activities:		
Proceeds from sales and maturities of investments	8,854	10,747
Cost of investments	(7,860)	(10,876)
Additions to property, equipment and software	(301)	(197)
Cash used for acquisitions, net of cash acquired	(24)	—
Net cash provided by (used for) investing activities	669	(326)
Cash flows from financing activities:		
Issuance of long-term debt	988	12,886
Repayment of long-term debt	(11,734)	—
Common shares issued under benefit plans, net	(132)	(103)
Common shares repurchased	(3,845)	—
Dividends paid to shareholders	(420)	(262)
Net payment on interest rate derivatives	—	(274)
Contributions, non-controlling interests	182	—
Net cash (used for) provided by financing activities	(14,961)	12,247
Net (decrease) increase in cash and cash equivalents	(12,068)	16,542
Cash and cash equivalents, beginning of period	17,996	2,524
Cash and cash equivalents, end of period	\$5,928	\$19,066
Supplemental cash flow information:		
Interest paid	\$301	\$214
Income taxes paid	791	1,201

Refer to accompanying Condensed Notes to Consolidated Financial Statements (Unaudited).

Index to Consolidated Financial Statements

Condensed Notes to Consolidated Financial Statements
(Unaudited)

1. Organization

We conduct our operations in three business segments:

Health Care consists of medical, pharmacy benefit management services, dental, behavioral health and vision plans offered on both an Insured basis (where we assume all or a majority of the risk for medical and dental care costs) and an employer-funded basis (where the plan sponsor under an administrative services contract (“ASC”) assumes all or a majority of this risk) and emerging business products and services that complement and enhance our medical products. We also offer Medicare and Medicaid products and services and other medical products, such as medical management and data analytics services, medical stop loss insurance, workers’ compensation administrative services and products that provide access to our provider networks in select geographies.

Group Insurance primarily includes group life insurance and group disability products. Group life insurance products are offered on an Insured basis. Group disability products are offered to employers on both an Insured and an ASC basis. Group Insurance also includes long-term care products that were offered primarily on an Insured basis. We no longer solicit or accept new long-term care customers.

Large Case Pensions manages a variety of retirement products (including pension and annuity products) primarily for tax-qualified pension plans. These products provide a variety of funding and benefit payment distribution options and other services. Large Case Pensions also includes certain discontinued products (refer to Note 17 for additional information).

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial reporting. Accordingly, they do not include all of the information and footnotes required by GAAP for annual financial statements. We have omitted certain footnote disclosures that would substantially duplicate the disclosures in our 2016 Annual Report on Form 10-K (our “2016 Annual Report”), unless the information contained in those disclosures materially changed or is required by GAAP. The accompanying unaudited consolidated financial statements and related condensed notes should be read in conjunction with the consolidated financial statements and related notes presented in our 2016 Annual Report.

These interim financial statements necessarily rely on estimates, including assumptions as to annualized tax rates. In the opinion of management, all adjustments necessary for a fair statement of results for the interim periods have been made. All such adjustments are of a normal, recurring nature. The Company has evaluated subsequent events that occurred after September 30, 2017 through the date the financial statements were issued and determined there were no subsequent events to disclose other than as disclosed in Notes 3 and 14.

Reclassifications

Certain reclassifications were made to 2016 financial information to conform with the 2017 presentation.

New Accounting Standards

Accounting for Financial Instruments - Hedge Accounting

During the third quarter of 2017, we elected to early adopt new accounting guidance which simplifies the application of hedge accounting. The new guidance expands our ability to hedge non-financial and financial risk components, eliminates the requirement to separately measure and report hedge ineffectiveness, requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item and simplifies certain documentation and assessment requirements. The adoption of this new guidance did not have a material impact

on our financial position or operating results.

Simplifying the Test for Goodwill Impairment

Effective January 1, 2017, we adopted, on a prospective basis, new accounting guidance which simplifies the accounting for goodwill impairment. The new guidance eliminates the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge. A goodwill impairment charge would be recognized if the carrying amount of a reporting unit exceeds the estimated fair value of the reporting unit. The adoption of this new guidance did not have a material impact on our financial position or operating results.

Page 7

Classification of Certain Cash Receipts and Cash Payments in the Statement of Cash Flows

Effective January 1, 2017, we adopted, on a retrospective basis, new accounting guidance which clarifies the classification of certain cash receipts and cash payments in our Consolidated Statements of Cash Flows. As a result, we classified \$44 million of cash distributions received from our partnership investments as cash inflows from operating activities for the nine months ended September 30, 2017, that previously would have been classified as cash inflows from investing activities. There were no material reclassifications in our Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 as a result of the adoption of this new guidance.

Future Application of Accounting Standards

Revenue from Contracts with Customers

Effective January 1, 2018, we will adopt new accounting guidance related to revenue recognition from contracts with customers. While industry-specific guidance related to contracts with customers within the scope of Accounting Standards Codification (“ASC”) 944 Financial Services - Insurance remains unchanged, most other industry-specific revenue recognition requirements have been removed. The new guidance requires that an entity recognize revenue for the transfer of goods or services to a customer at an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The new guidance also requires additional disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts. We currently anticipate adopting the new guidance using the retrospective approach. We anticipate that any impact will only relate to contracts with customers outside the scope of ASC Topic 944. Adoption of this new guidance will result in reclassifications within our Consolidated Statements of Income; however, we do not anticipate any material changes in the timing of our recognition of revenue or net income.

Recognition and Measurement of Financial Assets and Financial Liabilities

Effective January 1, 2018, we will adopt new accounting guidance related to the recognition and measurement of financial assets and financial liabilities. Under the new guidance, all equity investments in unconsolidated entities will be measured at fair value with changes in fair value recognized in net income. A reporting entity may elect to report equity investments without a readily determinable fair value at cost. The new guidance also revises certain disclosures regarding financial assets and liabilities. The adoption of this new guidance is not expected to have a material impact on our financial position or operating results.

Leases

Effective January 1, 2019, we will adopt new accounting guidance related to the recognition, measurement and disclosure requirements for leases. Under the new guidance, lessees will be required to recognize a right-of-use asset and corresponding lease liability on their balance sheets for all leases other than those that meet the definition of a short-term lease. The new guidance also revises certain disclosure requirements regarding leases. While we are still evaluating the impact of adoption of this new guidance, we anticipate that we will be required to record an asset and corresponding liability related to our operating leases (as described in Note 17 in our 2016 Annual Report) on our Consolidated Balance Sheets.

Accounting for Interest Associated with the Purchase of Callable Debt Securities

Effective January 1, 2019, we will adopt new accounting guidance related to the amortization of purchased callable debt securities held at a premium. Under the new guidance, premiums on callable debt securities are amortized to the earliest call date rather than to the contractual maturity date. Callable debt securities held at a discount will continue to be amortized to the contractual maturity date. We are still evaluating the impact of the adoption of this new guidance on our financial position and operating results.

Measurement of Credit Losses on Financial Instruments

Effective January 1, 2020, we will adopt new accounting guidance related to the measurement of credit losses on financial assets and certain other instruments. The new guidance requires the use of a new forward-looking expected loss impairment model for trade and other receivables, held-to-maturity debt securities, loans and other instruments. The new guidance also requires impairments and recoveries for available-for-sale debt securities to be recorded through an allowance account and revises certain disclosure requirements. We are still evaluating the impact of the adoption of this new guidance on our financial position and operating results.

3.Divestiture, Terminated Acquisition and Terminated Divestiture

Divestiture of Group Life Insurance, Group Disability Insurance, and Absence Management Businesses

On October 22, 2017, we entered into a definitive agreement to sell a substantial portion of our Group Insurance business segment consisting of our domestic group life insurance, group disability insurance and absence management businesses to Hartford Life and Accident Insurance Company (“HLAIC”) for cash consideration of \$1.45 billion. The transaction is being

accomplished through an indemnity reinsurance arrangement, under which HLAIC will contractually assume certain of our policyholder liabilities and obligations, although we will remain directly obligated to policyholders. Assets related to and supporting the life and disability insurance policies will be transferred to a trust established by HLAIC for our benefit, and we will record a reinsurance receivable from HLAIC. The transaction is expected to result in an after-tax gain of approximately \$900 million, a significant portion of which will be deferred and amortized into earnings as we recover amounts due from the reinsurer over a period estimated to be approximately 30 years. The amount of the gain will depend on the actual amount of assets transferred and liabilities contractually assumed from us at the closing date.

The transaction is expected to close in early November 2017, subject to customary closing conditions.

Terminated Acquisition of Humana

On July 2, 2015, we entered into a definitive agreement (the “Merger Agreement”) to acquire Humana Inc. (“Humana”). On July 21, 2016, the U.S. Department of Justice (the “DOJ”) and certain state attorneys general filed a civil complaint in the U.S. District Court for the District of Columbia (the “District Court”) against us and Humana charging that our acquisition of Humana (the “Humana Transaction”) would violate Section 7 of the Clayton Antitrust Act, and seeking a permanent injunction to prevent Aetna from acquiring Humana. On January 23, 2017, the District Court granted the DOJ’s request to enjoin the Humana Transaction.

On February 14, 2017, Aetna and Humana entered into a mutual termination agreement (the “Termination Agreement”) pursuant to which the parties thereto (collectively the “Parties”) agreed to terminate the Merger Agreement, including all schedules and exhibits thereto, and all ancillary agreements contemplated thereby, entered pursuant thereto or entered in connection therewith (other than certain confidentiality agreements) (collectively with the Merger Agreement, the “Transaction Documents”), effective immediately as of February 14, 2017 (the “Termination Date”). Under the Termination Agreement, Aetna agreed to pay Humana the Regulatory Termination Fee (as defined in the Merger Agreement) of \$1.0 billion in cash in full satisfaction of any amounts required to be paid by Aetna under the Merger Agreement. The Parties also agreed to release each other from any and all liability, claims, rights, actions, causes of action, suits, liens, obligations, accounts, debts, demands, agreements, promises, liabilities, controversies, costs, charges, damages, expenses and fees, however arising, in connection with, arising out of or related to the Transaction Documents, the transactions contemplated therein or thereby or certain related matters. We paid Humana the Regulatory Termination Fee on February 16, 2017 and recorded the expense in general and administrative expenses. We funded that payment with the proceeds of the 2016 senior notes (as defined below).

In June 2016, we issued \$13.0 billion of senior notes to partially fund the Humana Transaction (collectively, the “2016 senior notes”). In accordance with the terms of the 2016 senior notes, on February 14, 2017, we issued a notice of redemption for \$10.2 billion aggregate principal amount of certain of the 2016 senior notes (collectively, the “Special Mandatory Redemption Notes”) at a redemption price equal to 101% of the aggregate principal amount of those notes plus accrued and unpaid interest. We redeemed the Special Mandatory Redemption Notes on March 16, 2017, and we funded the redemption with the proceeds of the 2016 senior notes. As a result of the redemption of the Special Mandatory Redemption Notes, we recognized certain costs in our net income during the nine months ended September 30, 2017. Refer to Note 9 for additional information.

Terminated Divestiture to Molina

In order to address the DOJ’s perceived competitive concerns regarding Medicare Advantage relating to the Humana Transaction, on August 2, 2016, we entered into a definitive agreement (the “Aetna APA”) to sell for cash to Molina Healthcare, Inc. (“Molina”) certain of our Medicare Advantage assets. On February 14, 2017, Aetna and Molina entered into a Termination Agreement (the “APA Termination Agreement”) pursuant to which Aetna terminated the Aetna APA, including all schedules and exhibits thereto, and all ancillary agreements contemplated thereby or entered pursuant thereto. Under the APA Termination Agreement, Aetna agreed to pay Molina in cash (a) a termination fee of

\$53 million and (b) approximately 70% of Molina's transaction costs. We paid Molina the termination fee on February 16, 2017 and the applicable transaction costs of \$7 million on February 27, 2017 and recorded the expense in general and administrative expenses. The payments were funded with the proceeds of the 2016 senior notes.

4. Investments

Total investments at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	September 30, 2017			December 31, 2016		
	Current	Long-term	Total	Current	Long-term	Total
Debt and equity securities available for sale	\$2,714	\$ 18,606	\$21,320	\$2,876	\$ 18,866	\$21,742
Mortgage loans	155	1,342	1,497	170	1,341	1,511
Other investments	—	1,559	1,559	—	1,626	1,626
Total investments	\$2,869	\$ 21,507	\$24,376	\$3,046	\$ 21,833	\$24,879

Debt and Equity Securities

Debt and equity securities available for sale at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2017				
Debt securities:				
U.S. government securities	\$ 1,571	\$ 53	\$ —	\$ 1,624
States, municipalities and political subdivisions	4,555	204	(13)	4,746
U.S. corporate securities	8,217	440	(20)	8,637
Foreign securities	3,011	208	(8)	3,211
Residential mortgage-backed securities	733	9	(4)	738
Commercial mortgage-backed securities	1,240	8	(20)	1,228
Other asset-backed securities	1,040	8	(3)	1,045
Redeemable preferred securities	26	5	—	31
Total debt securities	20,393	935	(68)	21,260
Equity securities	54	9	(3)	60
Total debt and equity securities ⁽¹⁾⁽²⁾	\$ 20,447	\$ 944	\$ (71)	\$21,320
December 31, 2016				
Debt securities:				
U.S. government securities	\$ 1,643	\$ 51	\$ —	\$ 1,694
States, municipalities and political subdivisions	5,047	152	(61)	5,138
U.S. corporate securities	8,145	385	(55)	8,475
Foreign securities	2,958	163	(33)	3,088
Residential mortgage-backed securities	793	11	(9)	795
Commercial mortgage-backed securities	1,382	5	(39)	1,348
Other asset-backed securities	1,077	7	(9)	1,075
Redeemable preferred securities	22	5	—	27
Total debt securities	21,067	779	(206)	21,640
Equity securities	84	20	(2)	102
Total debt and equity securities ⁽¹⁾⁽²⁾	\$ 21,151	\$ 799	\$ (208)	\$21,742

- At both September 30, 2017 and December 31, 2016, we held securities for which we previously recognized an
- (1) immaterial amount of non-credit related impairments in accumulated other comprehensive loss. These securities each had an immaterial amount of net unrealized capital gains at both September 30, 2017 and December 31, 2016.
 - (2) Investment risks associated with our experience-rated and discontinued products generally do not impact our operating results (refer to Note 17 for additional information on our accounting for discontinued products). At September 30, 2017, debt and equity securities with a fair value of approximately \$2.9 billion, gross unrealized capital gains of \$216 million and gross unrealized capital losses of \$14 million and, at December 31, 2016, debt

and equity securities with a fair value of approximately \$2.9 billion, gross unrealized capital gains of \$195 million and gross unrealized capital losses of \$35 million were included in total debt and equity securities, but support our experience-rated and discontinued products. Changes in net unrealized capital gains (losses) on these securities are not reflected in accumulated other comprehensive income.

The fair value of debt securities at September 30, 2017 is shown below by contractual maturity. Actual maturities may differ from contractual maturities because securities may be restructured, called or prepaid, or we intend to sell a security prior to maturity.

(Millions)	Amortized Fair	
	Cost	Value
Due to mature:		
Less than one year	\$ 1,298	\$1,310
One year through five years	6,697	6,872
After five years through ten years	4,553	4,737
Greater than ten years	4,832	5,330
Residential mortgage-backed securities	733	738
Commercial mortgage-backed securities	1,240	1,228
Other asset-backed securities	1,040	1,045
Total	\$ 20,393	\$21,260

Mortgage-Backed and Other Asset-Backed Securities

All of our residential mortgage-backed securities at September 30, 2017 were issued by the Government National Mortgage Association, the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation and carry agency guarantees and explicit or implicit guarantees by the U.S. Government. At September 30, 2017, our residential mortgage-backed securities had an average credit quality rating of AAA and a weighted average duration of 4.2 years.

Our commercial mortgage-backed securities have underlying loans that are dispersed throughout the United States. Significant market observable inputs used to value these securities include loss severity and probability of default. At September 30, 2017, these securities had an average credit quality rating of AAA and a weighted average duration of 6.7 years.

Our other asset-backed securities have a variety of underlying collateral (e.g., automobile loans, credit card receivables, home equity loans and commercial loans). Significant market observable inputs used to value these securities include the unemployment rate, loss severity and probability of default. At September 30, 2017, these securities had an average credit quality rating of AA- and a weighted average duration of 1.2 years.

Summarized below are the debt and equity securities we held at September 30, 2017 and December 31, 2016 that were in an unrealized capital loss position, aggregated by the length of time the investments have been in that position:

(Millions, except number of securities)	Less than 12 months			Greater than 12 months			Total ⁽¹⁾		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
September 30, 2017									
Debt securities:									
U.S. government securities	84	\$279	\$ —	7	\$4	\$ —	91	\$283	\$ —
States, municipalities and political subdivisions	164	540	5	114	368	8	278	908	13
U.S. corporate securities	617	961	5	291	525	15	908	1,486	20
Foreign securities	192	344	2	110	230	6	302	574	8
Residential mortgage-backed securities	173	275	2	100	48	2	273	323	4
Commercial mortgage-backed securities	79	293	4	114	426	16	193	719	20
Other asset-backed securities	194	326	1	77	142	2	271	468	3
Total debt securities	1,503	3,018	19	813	1,743	49	2,316	4,761	68
Equity securities	—	—	—	9	7	3	9	7	3
Total debt and equity securities ⁽¹⁾	1,503	\$3,018	\$ 19	822	\$1,750	\$ 52	2,325	\$4,768	\$ 71
December 31, 2016									
Debt securities:									
U.S. government securities	26	\$39	\$ —	1	\$1	\$ —	27	\$40	\$ —
States, municipalities and political subdivisions	865	2,228	58	37	75	3	902	2,303	61
U.S. corporate securities	1,428	2,277	44	114	101	11	1,542	2,378	55
Foreign securities	649	970	27	62	76	6	711	1,046	33
Residential mortgage-backed securities	188	455	8	104	17	1	292	472	9
Commercial mortgage-backed securities	285	1,038	39	3	3	—	288	1,041	39
Other asset-backed securities	226	403	4	208	177	5	434	580	9
Total debt securities	3,667	7,410	180	529	450	26	4,196	7,860	206
Equity securities	2	3	—	8	3	2	10	6	2
Total debt and equity securities ⁽¹⁾	3,669	\$7,413	\$ 180	537	\$453	\$ 28	4,206	\$7,866	\$ 208

(1)

At September 30, 2017 and December 31, 2016, debt and equity securities in an unrealized capital loss position of \$14 million and \$35 million, respectively, and with related fair value of \$516 million and \$890 million, respectively, related to experience-rated and discontinued products.

We reviewed the securities in the tables above and concluded that these are performing assets generating investment income to support the needs of our business. In performing this review, we considered factors such as the quality of the investment security based on research performed by our internal credit analysts and external rating agencies and the prospects of realizing the carrying value of the security based on the investment's current prospects for recovery. At September 30, 2017, we did not intend to sell these securities, and we did not believe it was more likely than not that we would be required to sell these securities prior to anticipated recovery of their amortized cost basis.

The maturity dates for debt securities in an unrealized capital loss position at September 30, 2017 were as follows:

(Millions)	Supporting discontinued and experience-rated products		Supporting remaining products		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Due to mature:						
Less than one year	\$ 7	\$ —	\$232	\$ —	\$239	\$ —
One year through five years	50	1	1,423	12	1,473	13
After five years through ten years	139	2	637	9	776	11
Greater than ten years	140	5	623	12	763	17
Residential mortgage-backed securities	7	—	316	4	323	4
Commercial mortgage-backed securities	153	4	566	16	719	20
Other asset-backed securities	18	—	450	3	468	3
Total	\$ 514	\$ 12	\$4,247	\$ 56	\$4,761	\$ 68

Mortgage Loans

Our mortgage loans are collateralized by commercial real estate. During the three and nine months ended September 30, 2017 and 2016 we had the following activity in our mortgage loan portfolio:

(Millions)	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2016	
	2017	2016	2017	2016
New mortgage loans	\$ 27	\$ 66	\$209	\$155
Mortgage loans fully repaid	90	56	190	142
Mortgage loans foreclosed	—	8	—	8

We assess our mortgage loans on a regular basis for credit impairments, and annually assign a credit quality indicator to each loan. Our credit quality indicator is internally developed and categorizes our portfolio on a scale from 1 to 7. These indicators are based upon several factors, including current loan to value ratios, property condition, market trends, creditworthiness of the borrower and deal structure. The vast majority of our mortgage loans fall into categories 2 to 4.

Category 1 - Represents loans of superior quality.

Categories 2 to 4 - Represents loans where credit risk is minimal to acceptable; however, these loans may display some susceptibility to economic changes.

Categories 5 and 6 - Represents loans where credit risk is not substantial, but these loans warrant management's close attention.

Category 7 - Represents loans where collections are potentially at risk and, if necessary, an impairment is recorded. Based upon our most recent assessments at September 30, 2017 and December 31, 2016, our mortgage loans were given the following credit quality indicators:

(In Millions, except credit ratings indicator)	September 30, 2017		December 31, 2016	
	2017	2016	2017	2016
1	\$ 42	\$ 45		
2 to 4	1,445	1,449		

Edgar Filing: AETNA INC /PA/ - Form 10-Q

5 and 6	10	17
7	—	—
Total	\$ 1,497	\$ 1,511

Page 13

Net Investment Income

Sources of net investment income for the three and nine months ended September 30, 2017 and 2016 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	2017	2016	2017	2016
Debt securities	\$184	\$187	\$564	\$578
Mortgage loans	22	24	65	74
Other investments	43	17	138	64
Gross investment income	249	228	767	716
Investment expenses	(16)	(9)	(37)	(28)
Net investment income ⁽¹⁾	\$233	\$219	\$730	\$688

Net investment income includes \$61 million and \$186 million for the three and nine months ended September 30, ⁽¹⁾ 2017, respectively, and \$48 million and \$158 million for the three and nine months ended September 30, 2016, respectively, related to investments supporting our experience-rated and discontinued products.

Realized Capital Gains/Losses

Net realized capital gains and losses for the three and nine months ended September 30, 2017 and 2016, excluding amounts related to experience-rated contract holders and discontinued products, were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	2017	2016	2017	2016
Other-than-temporary impairment (“OTTI”) losses on debt securities recognized in earnings	\$(3)	\$—	\$(5)	\$(10)
Other net realized capital gains (losses)	49	34	(257)	95
Net realized capital gains (losses)	\$46	\$34	\$(262)	\$85

The net realized capital gains for the three months ended September 30, 2017 were primarily attributable to gains from other investments and the sale of debt securities. The net realized capital losses for the nine months ended September 30, 2017 were primarily attributable to the recognition into earnings of the entire unamortized effective portion of the related hedge losses upon the mandatory redemption of \$10.2 billion aggregate principal amount of the Special Mandatory Redemption Notes and the redemption of \$750 million aggregate principal amount of senior notes due 2020. The net realized capital gains for the three and nine months ended September 30, 2016 were primarily attributable to gains from the sale of debt securities.

We had no individually material realized capital losses on debt or equity securities that impacted our operating results during the three or nine months ended September 30, 2017 or 2016.

Excluding amounts related to experience-rated and discontinued products, proceeds from the sale of available for sale debt and equity securities and the related gross realized capital gains and losses for the three and nine months ended September 30, 2017 and 2016 were as follows⁽¹⁾:

	Three Months Ended September 30,	Nine Months Ended September 30,
--	----------------------------------	---------------------------------

(Millions)	2017	2016	2017	2016
Proceeds on sales	\$1,205	\$1,481	\$3,877	\$4,796
Gross realized capital gains	23	31	74	131
Gross realized capital losses	6	3	33	38

(1) The proceeds on sales and gross realized capital gains and losses exclude the impact of the sales of short-term debt securities which primarily relate to our investments in mutual funds. These investments were excluded from the disclosed amounts because they represent an immaterial amount of aggregate gross realized capital gains or losses and have a high volume of sales activity.

Variable Interest Entities

We have investments in certain hedge fund and private equity investments and real estate partnerships that are considered Variable Interest Entities (“VIEs”). We do not have a future obligation to fund losses or debts on behalf of these investments; however, we may voluntarily contribute funds. In evaluating whether we are the primary beneficiary of a VIE, we considered several factors, including whether we (a) have the power to direct the activities that most significantly impact the VIE’s

economic performance and (b) the obligation to absorb losses and the right to receive benefits that could potentially be significant to the VIE.

Variable Interest Entities - Primary Beneficiary

We have one majority owned hedge fund investment where we are the investment manager and have the power to direct the activities that most significantly impact the VIEs economic performance, including determining the hedge fund's investment strategy. Accordingly, we are the primary beneficiary and consolidate the investment in our operating results. The fund invests in additional hedge funds that are VIEs; however, we are not the primary beneficiary of these underlying funds as discussed in further detail below.

Substantially all of the assets of the VIE hedge fund are comprised of hedge fund investments reported as long-term investments on our Consolidated Balance Sheets. The VIE hedge fund had no material liabilities at September 30, 2017 or December 31, 2016. The total amount of the VIE hedge fund's assets included in long-term investments on our Consolidated Balance Sheets at September 30, 2017 and December 31, 2016 were \$436 million and \$472 million, respectively.

Variable Interest Entities - Other Variable Interest Holder

Our involvement with VIEs where we are not determined to be the primary beneficiary consists of the following:

Hedge fund and private equity investments - We invest in hedge fund and private equity investments in order to generate investment returns for our investment portfolio supporting our businesses.

Real estate partnerships - We invest in various real estate partnerships, including those that construct, own and manage low-income housing developments. For the low income housing development investments, substantially all of the projected benefits to us are from tax credits and other tax benefits.

We are not the primary beneficiary of these investments because the nature of our involvement with the activities of these VIEs does not give us the power to direct the activities that most significantly impact their economic performance. We record the amount of our investment in these VIEs as long-term investments on our Consolidated Balance Sheets and recognize our share of each VIE's income or losses in earnings. Our maximum exposure to loss from these VIEs is limited to our investment balances as disclosed below and the risk of recapture of previously recognized tax credits related to the real estate partnerships, which we do not consider significant.

The total amount of other variable interest holder VIE assets included in long-term investments on our Consolidated Balance Sheets at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	September 30, December 31,	
	2017	2016
Hedge fund investments	\$ 347	\$ 384
Private equity investments	447	454
Real estate partnerships	248	278
Total	\$ 1,042	\$ 1,116

The carrying value of the total assets and liabilities of our other variable interest holder VIE investments at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	September 30, December 31,	
	2017	2016
Assets:		
Hedge fund investments	\$ 51,574	\$ 32,926
Private equity investments	29,640	25,368
Real estate partnerships	6,855	6,743
Total	\$ 88,069	\$ 65,037
Liabilities:		
Hedge fund investments	\$ 10,579	\$ 2,819
Private equity investments	3,537	2,354
Real estate partnerships	5,038	4,938
Total	\$ 19,154	\$ 10,111

Non-controlling (Minority) Interests

At September 30, 2017 and December 31, 2016, continuing business non-controlling interests were \$235 million and \$62 million, respectively, primarily related to third party interests in our investment holdings as well as third party interests in certain of our operating entities. The non-controlling entities' share was included in total equity. Net income attributable to non-controlling interests was \$10 million for the three months ended September 30, 2017, and net loss attributable to non-controlling interests was \$9 million for the nine months ended September 30, 2017. Net loss attributable to non-controlling interests was \$7 million and \$4 million for the three and nine months ended September 30, 2016, respectively. These non-controlling interests did not have a material impact on our financial position or operating results.

5. Fair Value

The preparation of our consolidated financial statements in accordance with GAAP requires certain of our assets and liabilities to be reflected at their fair value, and others on another basis, such as an adjusted historical cost basis. In this note, we provide details on the fair value of financial assets and liabilities and how we determine those fair values. We present this information for those financial instruments that are measured at fair value for which the change in fair value impacts net income attributable to Aetna or other comprehensive income separately from other financial assets and liabilities.

Financial Instruments Measured at Fair Value in our Balance Sheets

Certain of our financial instruments are measured at fair value in our Consolidated Balance Sheets. The fair values of these instruments are based on valuations that include inputs that can be classified within one of three levels of a hierarchy established by GAAP. The following are the levels of the hierarchy and a brief description of the type of valuation information ("inputs") that qualifies a financial asset or liability for each level:

Level 1 – Unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2 – Inputs other than Level 1 that are based on observable market data. These include: quoted prices for similar assets in active markets, quoted prices for identical assets in inactive markets, inputs that are observable that are not prices (such as interest rates and credit risks) and inputs that are derived from or corroborated by observable markets.

Level 3 – Developed from unobservable data, reflecting our own assumptions.

Financial assets and liabilities are classified based upon the lowest level of input that is significant to the valuation. When quoted prices in active markets for identical assets and liabilities are available, we use these quoted

market prices to determine the fair value of financial assets and liabilities and classify these assets and liabilities in Level 1. In other cases where a quoted market price for identical assets and liabilities in an active market is either not available or not observable, we estimate fair value using valuation methodologies based on available and observable market information or by using a matrix pricing model. These financial assets and liabilities would then be classified in Level 2. If quoted market prices are not available, we determine fair value using broker quotes or an internal analysis of each investment's financial performance and cash flow projections. Thus, financial assets and liabilities may be classified in Level 3 even though there may be some significant inputs that may be observable.

The following is a description of the valuation methodologies used for our financial assets and liabilities that are measured at fair value, including the general classification of such assets and liabilities pursuant to the valuation hierarchy.

Debt Securities – Where quoted prices are available in an active market, our debt securities are classified in Level 1 of the fair value hierarchy. Our Level 1 debt securities are comprised primarily of U.S. Treasury securities.

The fair values of our Level 2 debt securities are obtained using models, such as matrix pricing, which use quoted market prices of debt securities with similar characteristics, or discounted cash flows to estimate fair value. We review these prices to ensure they are based on observable market inputs that include, but are not limited to, quoted prices for similar assets in active markets, quoted prices for identical assets in inactive markets and inputs that are observable but not prices (for example, interest rates and credit risks). We also review the methodologies and the assumptions used to calculate prices from these observable inputs. On a quarterly basis, we select a sample of our Level 2 debt securities' prices and compare them to prices provided by a secondary source. Variances over a specified threshold are identified and reviewed to confirm the price provided by the primary source represents an appropriate estimate of fair value. In addition, our internal investment team consistently compares the prices obtained for select Level 2 debt securities to the team's own independent estimates of fair value for those securities. We obtained one price for each of our Level 2 debt securities and did not adjust any of these prices at September 30, 2017 or December 31, 2016.

We also value certain debt securities using Level 3 inputs. For Level 3 debt securities, fair values are determined by outside brokers or, in the case of certain private placement securities, are priced internally. Outside brokers determine the value of these debt securities through a combination of their knowledge of the current pricing environment and market flows. We obtained one non-binding broker quote for each of these Level 3 debt securities and did not adjust any of these quotes at September 30, 2017 or December 31, 2016. The total fair value of our broker quoted debt securities was \$68 million at September 30, 2017 and \$80 million at December 31, 2016. Examples of these broker quoted Level 3 debt securities include certain U.S. and foreign corporate securities and certain of our commercial mortgage-backed securities as well as other asset-backed securities. For some of our private placement securities, our internal staff determines the value of these debt securities by analyzing spreads of corporate and sector indices as well as interest spreads of comparable public bonds. Examples of these private placement Level 3 debt securities include certain U.S. and foreign securities and certain tax-exempt municipal securities.

Equity Securities – We currently have two classifications of equity securities: those that are publicly traded and those that are privately placed. Our publicly-traded equity securities are classified in Level 1 because quoted prices are available for these securities in an active market. For privately-placed equity securities, there is no active market; therefore, we classify these securities in Level 3 because we price these securities through an internal analysis of each investment's financial statements and cash flow projections. Significant unobservable inputs consist of earnings and revenue multiples, discount for lack of marketability and comparability adjustments. An increase or decrease in any of these unobservable inputs would result in a change in the fair value measurement, which may be significant.

Derivatives – Where quoted prices are available in an active market, our derivatives are classified in Level 1. Certain of our derivative instruments are valued using models that primarily use market observable inputs and therefore are classified in Level 2 because they are traded in markets where quoted market prices are not readily available.

Edgar Filing: AETNA INC /PA/ - Form 10-Q

There were no financial liabilities measured at fair value on a recurring basis in our Consolidated Balance Sheets at September 30, 2017 or December 31, 2016. Financial assets measured at fair value on a recurring basis in our Consolidated Balance Sheets at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	Level 1	Level 2	Level 3	Total
September 30, 2017				
Assets:				
Debt securities:				
U.S. government securities	\$1,499	\$125	\$—	\$1,624
States, municipalities and political subdivisions	—	4,745	1	4,746
U.S. corporate securities	—	8,553	84	8,637
Foreign securities	—	3,207	4	3,211
Residential mortgage-backed securities	—	738	—	738
Commercial mortgage-backed securities	—	1,228	—	1,228
Other asset-backed securities	—	1,045	—	1,045
Redeemable preferred securities	—	24	7	31
Total debt securities	1,499	19,665	96	21,260
Equity securities	40	—	20	60
Total	\$1,539	\$19,665	\$116	\$21,320
December 31, 2016				
Assets:				
Debt securities:				
U.S. government securities	\$1,514	\$180	\$—	\$1,694
States, municipalities and political subdivisions	—	5,137	1	5,138
U.S. corporate securities	—	8,395	80	8,475
Foreign securities	—	3,067	21	3,088
Residential mortgage-backed securities	—	795	—	795
Commercial mortgage-backed securities	—	1,348	—	1,348
Other asset-backed securities	—	1,075	—	1,075
Redeemable preferred securities	—	26	1	27
Total debt securities	1,514	20,023	103	21,640
Equity securities	59	—	43	102
Total	\$1,573	\$20,023	\$146	\$21,742

There were no transfers between Levels 1 and 2 during the three or nine months ended September 30, 2017 or 2016. During the three months ended September 30, 2017, we had gross transfers out of Level 3 of \$12 million primarily related to foreign debt securities for which observable market data was subsequently received. During the nine months ended September 30, 2017, we had gross transfers out of level 3 of \$54 million primarily related to commercial mortgage-backed securities and foreign debt securities for which observable market data was subsequently received. During the three and nine months ended September 30, 2016, we had an immaterial amount of gross transfers out of Level 3. During the three and nine months ended September 30, 2017 and 2016 we had an immaterial amount of gross transfers into Level 3.

Financial Instruments Not Measured at Fair Value in our Balance Sheets

The following is a description of the valuation methodologies used for estimating the fair value of our financial assets and liabilities that are carried on our Consolidated Balance Sheets at adjusted cost or contract value.

Mortgage loans: Fair values are estimated by discounting expected mortgage loan cash flows at market rates that reflect the rates at which similar loans would be made to similar borrowers. These rates reflect our assessment of the creditworthiness of the borrower and the remaining duration of the loans. The fair value estimates of mortgage loans of lower credit quality, including problem and restructured loans, are based on the estimated fair value of the underlying collateral.

Bank loans: Where fair value is determined by quoted market prices of bank loans with similar characteristics, our bank loans are classified in Level 2. For bank loans classified in Level 3, fair value is determined by outside brokers using their internal analyses through a combination of their knowledge of the current pricing environment and market flows.

Equity securities: Certain of our equity securities are carried at cost. The fair values of our cost-method investments are not estimated if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investment.

Investment contract liabilities:

• With a fixed maturity: Fair value is estimated by discounting cash flows at interest rates currently being offered by, or available to, us for similar contracts.

Without a fixed maturity: Fair value is estimated as the amount payable to the contract holder upon demand. However, we have the right under such contracts to delay payment of withdrawals that may ultimately result in paying an amount different than that determined to be payable on demand.

Long-term debt: Fair values are based on quoted market prices for the same or similar issued debt or, if no quoted market prices are available, on the current rates estimated to be available to us for debt of similar terms and remaining maturities.

The carrying value and estimated fair value classified by level of fair value hierarchy for our financial instruments carried on our Consolidated Balance Sheets at adjusted cost or contract value at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	Carrying Value	Estimated Fair Value			Total
		Level 1	Level 2	Level 3	
September 30, 2017					
Assets:					
Mortgage loans	\$ 1,497	\$—	—	—\$1,540	\$1,540
Bank loans	8	—	—	7	7
Equity securities ⁽¹⁾	45	N/A	N/A	N/A	N/A
Liabilities:					
Investment contract liabilities:					
With a fixed maturity	8	—	—	8	8
Without a fixed maturity	371	—	—	360	360
Long-term debt	10,159	—	—	11,042	11,042
(Millions)					
December 31, 2016					
Assets:					
Mortgage loans	\$1,511	\$—	—	—\$1,540	\$1,540
Bank loans	8	—	—	8	8
Equity securities ⁽¹⁾	35	N/A	N/A	N/A	N/A
Liabilities:					
Investment contract liabilities:					
With a fixed maturity	8	—	—	8	8
Without a fixed maturity	378	—	—	364	364
Long-term debt	20,661	—	—	21,468	21,468

(1)

It was not practical to estimate the fair value of these cost-method investments as it represents shares of unlisted companies.

Separate Accounts Measured at Fair Value in our Balance Sheets

Separate Accounts assets in our Large Case Pensions segment represent funds maintained to meet specific objectives of contract holders. Since contract holders bear the investment risk of these assets, a corresponding Separate Accounts liability has been established equal to the assets. These assets and liabilities are carried at fair value. Net investment income and capital gains and losses accrue directly to such contract holders. The assets of each account are legally segregated and are not subject to claims arising from our other businesses. Deposits, withdrawals, net investment income and realized and unrealized capital gains and losses on Separate Accounts assets are not reflected in our Consolidated Statements of Income, Shareholders' Equity or Cash Flows.

Separate Accounts assets include debt and equity securities and derivative instruments. The valuation methodologies used for these assets are similar to the methodologies described above in this Note 5. Separate Accounts assets also include investments in common/collective trusts that are carried at fair value. Common/collective trusts invest in other investment funds otherwise known as the underlying funds. The Separate Accounts' interests in the common/collective trust funds are based on the fair values of the investments of the underlying funds and therefore are classified in Level 2. The assets in the underlying funds primarily consist of equity securities. Investments in common/collective trust funds are valued at their respective net asset value per share/unit on the valuation date.

Separate Accounts financial assets at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	September 30, 2017				December 31, 2016			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Debt securities	\$1,036	\$2,610	\$ 2	\$3,648	\$766	\$2,378	\$ —	—\$3,144
Equity securities	—	6	—	6	166	6	—	172
Common/collective trusts	—	448	—	448	—	582	—	582
Total ⁽¹⁾	\$1,036	\$3,064	\$ 2	\$4,102	\$932	\$2,966	\$ —	—\$3,898

⁽¹⁾ Excludes \$233 million and \$93 million of cash and cash equivalents and other receivables at September 30, 2017 and December 31, 2016, respectively.

During the three and nine months ended September 30, 2017 and 2016, we had an immaterial amount of Level 3 Separate Accounts financial assets.

Offsetting Financial Assets and Liabilities

Certain financial assets and liabilities are offset in our Consolidated Balance Sheets or are subject to master netting arrangements or similar agreements with the applicable counterparty. Financial assets, including derivative assets, subject to offsetting and enforceable master netting arrangements were \$16 million and \$17 million at September 30, 2017 and December 31, 2016, respectively.

There were no financial liabilities, including derivative liabilities, subject to offsetting and enforceable master netting arrangements at September 30, 2017 or December 31, 2016.

6. Premiums and Fees Receivable

The State of Illinois has experienced budget difficulties which have contributed to the state being delinquent in paying certain of our premiums and fees. At September 30, 2017, the total amount due to Aetna was approximately \$828 million. In July 2017, the State of Illinois passed a budget. Given the state's progress towards obtaining funding, a federal judge's ruling that prioritizes Medicaid payments and the federal government's match of a percentage of payments made by the state to managed care organizations under the state's Medicaid program, we continue to believe the amounts due to us are collectible.

7. Health Care and Other Insurance Liabilities

Our insurance liabilities below were disaggregated by reportable segment. Health care costs payable relate to our Health Care segment, and unpaid claims relates to our Group Insurance segment.

Health Care Costs Payable

The following table shows the components of the change in health care costs payable during the nine months ended September 30, 2017 and 2016:

(Millions)	Nine Months Ended September 30,	
	2017	2016
Health care costs payable, beginning of the period	\$6,558	\$6,306
Less: Reinsurance recoverables	5	4
Health care costs payable, beginning of the period, net	6,553	6,302
Add: Components of incurred health care costs		
Current year	32,611	33,804
Prior years	(783)	(717)
Total incurred health care costs ⁽¹⁾	31,828	33,087
Less: Claims paid		
Current year	26,959	27,382
Prior years	5,364	5,222
Total claims paid	32,323	32,604
Health care costs payable, end of period, net	6,058	6,785
Add: Premium deficiency reserve	77	85
Add: Reinsurance recoverables	4	3
Health care costs payable, end of period	\$6,139	\$6,873

Total incurred health care costs exclude from the table above \$77 million and \$85 million, respectively, related to ⁽¹⁾ the premium deficiency reserve recorded during the nine months ended September 30, 2017 and 2016 for the 2017 and 2016 coverage years primarily related to our individual Commercial products.

Our estimates of prior years' health care costs payable decreased by \$783 million and \$717 million in the nine months ended September 30, 2017 and 2016, respectively, resulting from claims settled for amounts less than originally estimated (i.e., the amount of claims incurred was lower than we originally estimated), primarily due to lower health care cost trends as well as the actual claim submission time being faster than we originally assumed (i.e., our completion factors were higher than we originally assumed) in establishing our health care costs payable in the prior year. This development does not directly correspond to an increase in our current year operating results as these reductions were offset by estimated current period health care costs when we established our estimate of the current year health care costs payable.

At September 30, 2017, total Health Care liabilities for (i) services rendered to our medical members but not yet reported to us and (ii) medical claims reported to us but not yet paid (collectively, "IBNR") plus expected development on reported claims totaled approximately \$5.2 billion. Substantially all of the total Health Care IBNR liabilities plus expected development on reported claims at September 30, 2017 related to the current year.

Long-Term Disability Unpaid Claims

The following table shows the components of the change in unpaid long-term disability claims during the nine months ended September 30, 2017 and 2016:

(Millions)	Nine Months Ended September 30,	
	2017	2016
Long-term disability unpaid claims beginning of the period	\$ 1,904	\$ 1,819
Less: Reinsurance recoverables	26	27
Long-term disability unpaid claims, beginning of the period, net	1,878	1,792
Add: Components of incurred claims		
Current year	377	397
Prior years	25	34
Total incurred claims	402	431
Less: Claims paid		
Current year	20	20
Prior years	379	341
Total claims paid	399	361
Long-term disability unpaid claims, end of period, net	1,881	1,862
Add: Reinsurance recoverables	30	29
Long-term disability unpaid claims, end of period	\$ 1,911	\$ 1,891

Our estimates of prior years' long-term disability unpaid claims liability were relatively consistent with actual results in each of the nine month periods ended September 30, 2017 and 2016.

The reconciliation of the long-term disability unpaid claims liability to the total unpaid claims liability in our Consolidated Balance Sheets is as follows at September 30, 2017 and 2016:

(Millions)	September 30,	
	2017	2016
Long-term disability unpaid claims	\$ 1,911	\$ 1,891
Term life unpaid claims	489	469
Other unpaid claims	117	116
Total unpaid claims	\$ 2,517	\$ 2,476

8. The ACA's Reinsurance, Risk Adjustment and Risk Corridor Programs (the "3Rs")

We participate in certain public health insurance exchanges ("Public Exchanges") established pursuant to the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (as amended, collectively, the "ACA"). Under regulations established by the U.S. Department of Health and Human Services ("HHS"), HHS pays us a portion of the premium ("Premium Subsidy") and through September 30, 2017, paid a portion of the health care costs ("Cost Sharing Subsidy") for low-income individual Public Exchange members. In addition, HHS administers the 3Rs risk management programs. The ACA's temporary Reinsurance and Risk Corridor programs expired at the end of 2016.

Our net receivable (payable) related to the 3Rs risk management programs at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	September 30, 2017		December 31, 2016	
	Risk Reinsurance Adjustment	Risk Corridor	Risk Reinsurance Adjustment	Risk Corridor

Edgar Filing: AETNA INC /PA/ - Form 10-Q

Current	\$37	\$ (42)	\$ (6)	\$202	\$ (690)	\$ (10)
Long-term	—	28	—	—	—	—
Total net receivable (payable)	\$37	\$ (14)	\$ (6)	\$202	\$ (690)	\$ (10)

We estimate that as of September 30, 2017, we are entitled to receive a total of \$314 million from HHS under the three-year ACA risk corridor program for the 2014 through 2016 program years. In November 2016, HHS announced that all 2015 ACA risk corridor collections will be used to pay a portion of the balances on the 2014 ACA risk corridor payments. At September 30, 2017 and December 31, 2016, we did not record any ACA risk corridor receivables related to the 2016 or 2015 program years or any amount in excess of the HHS's announced pro-rated funding amount for the 2014 program year because payments from HHS are uncertain.

We expect to perform an annual final reconciliation and settlement with HHS of the 3Rs in each subsequent year. The final reconciliation and settlement with HHS of the 2014 and 2015 Cost Sharing Subsidies occurred in 2016 and 2017, respectively. The final reconciliation and settlement of the 2016 Cost Sharing Subsidy is scheduled to occur in 2018.

Fees Mandated by the ACA

Beginning January 1, 2014, the ACA imposes an annual premium-based health insurer fee ("HIF") for each calendar year payable in September which is not deductible for tax purposes. In December 2015, the Consolidated Appropriation Act was enacted which included a one-year suspension in 2017 of the HIF. Accordingly, there was no expense related to the HIF for the three and nine months ended September 30, 2017 compared with an expense of \$211 million and \$628 million for the three and nine months ended September 30, 2016, respectively.

Beginning January 1, 2014, the ACA established a temporary reinsurance program that expired at the end of 2016. Accordingly, there was no expense related to our estimated contribution for the funding of the ACA's reinsurance program for the three or nine months ended September 30, 2017, compared with an expense of \$30 million and \$89 million for the three and nine months ended September 30, 2016, respectively.

9. Debt

Long Term Debt

The carrying value of our long-term debt at September 30, 2017 and December 31, 2016 was as follows:

(Millions)	September 30, December 31,	
	2017	2016
Senior notes, 5.95% due March 2017 ⁽¹⁾	\$ —	\$ 386
Senior notes, 1.75% due May 2017 ⁽¹⁾	—	250
Senior notes, 1.5% due November 2017 ⁽¹⁾	500	499
Senior notes, floating rate due December 2017 ⁽¹⁾	500	499
Senior notes, 1.7% due June 2018 ⁽¹⁾	998	997
Senior notes, 2.2% due March 2019	374	374
Senior notes, 1.9% due June 2019	—	1,642
Senior notes, 3.95% due September 2020	—	745
Senior notes, 2.4% due June 2021	—	1,839
Senior notes, 5.45% due June 2021	651	661
Senior notes, 4.125% due June 2021	496	495
Senior notes, 2.75% due November 2022	987	986
Senior notes, 2.8% due June 2023	1,291	1,290
Senior notes, 3.5% due November 2024	743	742
Senior notes, 3.2% due June 2026	—	2,771
Senior notes, 4.25% due June 2036	—	1,480
Senior notes, 6.625% due June 2036	765	765
Senior notes, 6.75% due December 2037	527	527
Senior notes, 4.5% due May 2042	479	478
Senior notes, 4.125% due November 2042	489	489
Senior notes, 4.75% due March 2044	371	371
Senior notes, 4.375% due June 2046	—	2,375
Senior notes, 3.875% due June 2047	988	—
Total long-term debt	10,159	20,661
Less current portion of long-term debt	1,998	1,634
Total long-term debt, less current portion	\$ 8,161	\$ 19,027

At September 30, 2017, our 1.5% senior notes due November 2017, floating rate senior notes due December 2017 and 1.7% senior notes due June 2018 are each classified as current in our Consolidated Balance Sheet. At ⁽¹⁾ December 31, 2016, our 5.95% senior notes due March 2017, 1.75% senior notes due May 2017, 1.5% senior notes due November 2017 and floating rate senior notes due December 2017 are each classified as current in our Consolidated Balance Sheet.

2017 Senior Notes

In August 2017, we issued \$1.0 billion of 3.875% senior notes due 2047. We intend to use the net proceeds of this offering to repay a portion of our 1.5% senior notes due in November 2017, repay a portion of our floating rate senior notes due in December 2017 and for general corporate purposes.

2016 Senior Notes

In June 2016, in connection with the Humana Transaction, we issued the 2016 senior notes, which were comprised of: \$500 million of floating rate senior notes due December 2017, \$1.0 billion of 1.7% senior notes due June 2018, approximately \$1.7 billion of 1.9% senior notes due June 2019, approximately \$1.9 billion of 2.4% senior notes due June 2021, \$1.3 billion of 2.8% senior notes due June 2023, \$2.8 billion of 3.2% senior notes due June 2026, \$1.5

billion of 4.25% senior notes due June 2036 and \$2.4 billion of 4.375% senior notes due June 2046.

Early Extinguishment of Long-Term Debt Special Mandatory Redemption Notes

As a result of the termination of the Merger Agreement, we redeemed the entire \$10.2 billion aggregate principal amount of the Special Mandatory Redemption Notes, which were due in 2019, 2021, 2026, 2036 and 2046, at a redemption price equal to 101% of the aggregate principal amount of those notes plus accrued and unpaid interest. We redeemed those notes on March 16, 2017, and we funded the redemption with the proceeds of the 2016 senior notes. As a result of the redemption, we recorded a loss on early extinguishment of long-term debt of \$125 million (\$192 million pretax) in the nine months ended September 30, 2017.

Prior to issuing the 2016 senior notes, during 2015 and 2016 we entered into various interest rate swaps and treasury rate locks that were designated as cash flow hedges against interest rate exposure related to the forecasted future issuance of fixed-rate debt to be primarily used to finance a portion of the purchase price of the Humana Transaction. In addition, we redesignated existing interest rate swaps with an aggregate notional value of \$500 million as cash flow hedges against interest rate exposure related to the forecasted future issuance of fixed rate debt.

Prior to issuing the 2016 senior notes in June 2016, we terminated all outstanding hedges and paid an aggregate of \$348 million to the hedge counter parties upon termination. The aggregate effective portion of the hedge loss of \$342 million pretax was recorded in accumulated other comprehensive loss, net of tax. Upon the redemption of the Special Mandatory Redemption Notes, the entire remaining unamortized effective portion of the hedge loss of \$323 million pretax recorded in accumulated other comprehensive loss was recognized as a realized capital loss in the nine months ended September 30, 2017.

2020 Notes

On February 27, 2017, we announced the redemption for cash of the entire \$750 million aggregate principal amount outstanding of our 3.95% senior notes due September 1, 2020 (the "2020 Notes"). We redeemed the 2020 Notes on March 29, 2017 at a redemption price that included a make-whole premium, plus accrued and unpaid interest. We funded the redemption from available cash and short-term debt. As a result of the redemption, we recorded a loss on early extinguishment of long-term debt of \$35 million (\$54 million pretax) in the nine months ended September 30, 2017. Upon redemption of the 2020 Notes, the entire remaining unamortized effective portion of the hedge loss of \$13 million pretax related to the issuance of the 2020 Notes recorded in accumulated other comprehensive loss was recognized as a realized capital loss in the nine months ended September 30, 2017.

Refer to Note 12 for additional information regarding hedge losses reclassified from accumulated other comprehensive loss to net income during the three and nine months ended September 30, 2017.

Revolving Credit Facility

On March 27, 2012, we entered into an unsecured \$1.5 billion five-year revolving credit agreement (the "Credit Agreement") with several financial institutions. On September 24, 2012, and in connection with the acquisition of Coventry Health Care, Inc. ("Coventry"), we entered into a First Amendment (the "First Amendment") to the Credit Agreement and also entered into an Incremental Commitment Agreement (the "Incremental Commitment Agreement"). On March 2, 2015, we entered into a Second Amendment to the Credit Agreement (the "Second Amendment"). On July 30, 2015, in connection with the Humana Transaction, we entered into a Third Amendment (the "Third Amendment"). On March 17, 2017 we entered into a Fourth Amendment to the Credit Agreement (the "Fourth Amendment," and together with the First Amendment, the Incremental Commitment Agreement, the Second Amendment, the Third Amendment and the Credit Agreement, resulting in the "Facility"). The Facility is an unsecured \$2.0 billion revolving credit agreement that matures on March 27, 2021. The Third Amendment modified the calculation of total debt for purposes of determining compliance prior to the closing date of the Humana Transaction (the "Closing Date") with certain covenants to exclude debt incurred by us to finance the Humana Transaction, the other financing transactions related to the Humana Transaction and/or the payment of fees and expenses incurred in connection therewith so long

as either (A) the net proceeds of such debt were set aside to finance the Humana Transaction, the other financing transactions related to the Humana Transaction and/or the payment of fees and expenses incurred in connection therewith or (B) such debt was subject to mandatory redemption in the event that the Merger Agreement was terminated or expired. Among other things, the Fourth Amendment extended the maturity date of the existing Credit Agreement to March 27, 2021, eliminated the availability of swingline loans, provided us with additional time on each business day to provide notice of borrowings and added customary provisions to reflect European Union “bail-in” directive legislation.

In addition, upon our agreement with one or more financial institutions, we may expand the commitments under the Facility by an additional \$500 million. The Facility also provides for the issuance of up to \$200 million of letters of credit at our request, which count as usage of the available commitments under the Facility.

Various interest rate options are available under the Facility. Any revolving borrowings mature on the termination date of the Facility. We pay facility fees on the Facility ranging from .050% to .150% per annum, depending upon our long-term senior unsecured debt rating. The facility fee was .100% at September 30, 2017. The Facility contains a financial covenant that requires us to maintain a ratio of total debt to consolidated capitalization as of the end of each fiscal quarter at or below 50%. For this purpose, consolidated capitalization equals the sum of total shareholders' equity, excluding any overfunded or underfunded status of our pension and OPEB plans and any net unrealized capital gains and losses, and total debt (as defined in the Facility). We met this requirement at September 30, 2017. There were no amounts outstanding under the Facility at any time during the nine months ended September 30, 2017 or 2016.

Term Loan Agreement

On July 30, 2015, in connection with the Humana Transaction, we entered into a senior three-year \$3.2 billion term loan credit agreement (the "Term Loan Agreement") with a group of seventeen lenders. The lenders' commitments under the Term Loan Agreement terminated on February 14, 2017, as a result of the termination of the Merger Agreement.

Federal Home Loan Bank of Boston

We are a member of the Federal Home Loan Bank of Boston (the "FHLBB"), and as a member we have the ability to obtain cash advances, subject to certain minimum collateral requirements. Our maximum borrowing capacity available from the FHLBB at September 30, 2017 was \$925 million. At both September 30, 2017 and December 31, 2016, we did not have any outstanding borrowings from the FHLBB.

10. Pension and Other Postretirement Plans

Defined Benefit Retirement Plans

Components of the net periodic benefit (income) cost of our defined benefit pension plans and other postretirement employee benefit ("OPEB") plans for the three and nine months ended September 30, 2017 and 2016 were as follows:

	Pension Plans				OPEB Plans			
	Three Months Ended September 30,		Nine Months Ended September 30,		Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	2017	2016	2017	2016	2017	2016	2017	2016
Amortization of prior service credit	\$—	\$—	\$—	\$—	\$(1)	\$(1)	\$(3)	\$(3)
Interest cost	51	65	153	195	2	3	6	8
Expected return on plan assets	(95)	(97)	(285)	(292)	—	(1)	(3)	(2)
Recognized net actuarial losses	16	15	48	46	1	1	3	2
Net periodic benefit (income) cost	\$(28)	\$(17)	\$(84)	\$(51)	\$2	\$2	\$3	\$5

Effective as of the beginning of 2017, we changed the approach used to estimate the interest cost component of net periodic benefit cost for pension and OPEB plans that utilize a yield curve approach. Historically, we estimated the interest cost using a single weighted average discount rate derived from the yield curve used to measure the projected benefit obligation. We have now elected to measure interest cost by applying the specific spot rates along that yield curve to the relevant projected cash flows for each component. We believe the new approach provides a more precise estimate of such interest cost. This refinement has no effect on the estimation of our plan obligations. We have accounted for this change as a change in accounting estimate and, accordingly, have accounted for it on a prospective basis beginning in 2017. The reduction in net periodic benefit cost associated with this change for the three and nine months ended September 30, 2017 was \$7 million (\$10 million pre-tax) and \$19 million (\$30 million pre-tax),

respectively. We expect this change to result in a reduction in net periodic benefit cost of approximately \$26 million (\$41 million pre-tax) for the full year 2017. For our pension benefits, the 2017 weighted-average discount rate for interest costs under the new approach adopted as of the beginning of 2017 is 3.51%. Under the prior methodology, the 2017 weighted-average discount rate would have been 4.22%.

11. Shareholders' Equity

Share Repurchases

On November 21, 2014 and February 28, 2014, our Board of Directors (our "Board") authorized two separate share repurchase programs of our common stock of up to \$1.0 billion each. On February 17, 2017, our Board approved a new share repurchase program that authorized us to repurchase up to \$4.0 billion of our common stock. The repurchases are effected from time to time in the open market, through negotiated transactions, including accelerated share repurchase agreements, and through plans designed to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended.

On February 22, 2017, we entered into accelerated share repurchase (“ASR”) agreements with two unrelated third party financial institutions to repurchase an aggregate of \$3.3 billion of Aetna’s common shares. Under the terms of the ASR agreements, we made an approximately \$1.7 billion payment to each unrelated third party financial institution on February 22, 2017 and received from each of them an initial delivery of approximately 10.4 million of our common shares on the same day, which represented approximately 80 percent of the total common shares expected to be repurchased under the ASR agreements based on the closing price of \$126.34 per share on the day before we entered into the ASR agreements. In August 2017, we settled the ASR agreements and received approximately 2.7 million of our common shares based on the volume-weighted average share price of our common shares during the term of the applicable transaction, less a discount. The average price of our common shares repurchased under the ASR agreements was \$140.09 per share.

We recorded the initial delivery of our common shares as a decrease to retained earnings of approximately \$2.6 billion, and recorded the remaining approximately \$0.7 billion as a decrease to additional paid-in capital on our Consolidated Balance Sheet. In August 2017, we reclassified the approximately \$0.7 billion recorded as a reduction to additional paid-in capital to a reduction of retained earnings upon final settlement of the ASR agreements.

During the three months ended September 30, 2017, we repurchased approximately 3.4 million of our common shares in the open market at a cost of approximately \$545 million.

At September 30, 2017, we had remaining authorization to repurchase an aggregate of up to approximately \$1.2 billion of our common shares under the February 17, 2017 program.

Dividends

During the nine months ended September 30, 2017 our Board declared the following cash dividends:

Date Declared	Dividend Amount Per Share	Shareholders of Record Date	Date Paid/ To be Paid	Total Dividends (Millions)
February 17, 2017	\$.50	April 13, 2017	April 28, 2017	\$ 166
May 19, 2017	.50	July 13, 2017	July 28, 2017	166
September 29, 2017	.50	October 12, 2017	October 27, 2017	163

Declaration and payment of future dividends is at the discretion of our Board and may be adjusted as business needs or market conditions change.

Stock-based Employee Incentive Plans

On February 17, 2017, 0.3 million performance stock units (“PSUs”), 0.4 million restricted stock units (“RSUs”) and 2.1 million stock appreciation rights (“SARs”) were granted to certain employees. The number of vested PSUs (which could range from zero to 200% of the original number of units granted) is dependent upon the degree to which we achieve certain operating performance goals, as determined by our Board’s Committee on Compensation and Talent Management, during a three-year performance period which began January 1, 2017 and ends on December 31, 2019. The vesting period for the PSUs ends on February 17, 2020. Each vested PSU and RSU represents one share of common stock and will be paid in shares of common stock, net of taxes, at the end of the applicable vesting period. The RSUs generally will become 100% vested approximately three years from the grant date, with one-third vesting each December. The SARs, if exercised by the employee, will be settled in common stock, net of taxes, based on the appreciation of our common stock price over \$125.27 per share, the closing price of our common stock on the grant date. SARs will generally become 100% vested approximately three years from the grant date, with one-third vesting on each anniversary of the grant date.

The SARs granted to certain employees during first quarters of 2017 and 2016 had an estimated fair market value of \$32.30 and \$34.33 per unit, respectively. The fair value per unit was calculated on each respective grant date using a modified Black-Scholes option pricing model using the following assumptions during the first quarters of 2017 and 2016:

	2017		2016	
Expected term (in years)	7.21		7.11	
Volatility	26.52	%	32.9	%
Risk-free interest rate	2.22	%	1.52	%
Dividend yield	1.71	%	0.91	%
Initial price	\$125.27		\$103.45	

The expected term is based on historical equity award activity. Volatility is based on a weighted average of the historical volatility of our stock price and implied volatility from traded options on our stock. The risk-free interest rate is based on a U.S. Treasury rate with a life equal to the expected life of the SARs grant. This rate was calculated by interpolating between the 7-year and 10-year U.S. Treasury rates for both the 2017 and 2016 SARs grants. The dividend yield is based on our expected dividends for the upcoming 12 months subsequent to the grant date.

Regulatory Requirements

Under applicable regulatory requirements at September 30, 2017, the amount of dividends that may be paid through the end of 2017 by our insurance and HMO subsidiaries without prior approval by regulatory authorities was \$771 million in the aggregate. There are no such regulatory restrictions on distributions from Aetna to its shareholders. During the third quarter of 2017, our insurance and HMO subsidiaries paid \$727 million of dividends to the Company.

The aggregate statutory capital and surplus of our insurance and HMO subsidiaries was \$11.1 billion and \$10.4 billion at September 30, 2017 and December 31, 2016, respectively.

12. Other Comprehensive (Loss) Income

Shareholders' equity included the following activity in accumulated other comprehensive loss for the three and nine months ended September 30, 2017 and 2016:

(Millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Previously impaired debt securities: ⁽¹⁾				
Beginning of period balance	\$ 15	\$ 20	\$ 16	\$ 19
Net unrealized losses (\$ (5), \$ (1), \$ (8) and \$ (5) pretax)	(3)	—	(5)	(3)
Less: Net reclassification of losses to earnings (\$ (3), \$ 0, \$ (5) and \$ (6) pretax) ⁽²⁾	(2)	—	(3)	(4)
Other comprehensive (loss) income	(1)	—	(2)	1
End of period balance	14	20	14	20
All other securities:				
Beginning of period balance	421	698	297	312
Net unrealized gains (\$ 48, \$ 4, \$ 298 and \$ 620 pretax)	31	3	194	403
Less: Net reclassification of gains to earnings (\$ 35, \$ 8, \$ 95 and \$ 30 pretax) ⁽²⁾	23	5	62	19
Other comprehensive income (loss)	8	(2)	132	384
End of period balance	429	696	429	696
Derivatives and foreign currency:				
Beginning of period balance	(7)	(243)	(235)	(74)
Net unrealized gains (losses) (\$ 0, \$ (1), \$ 8 and \$ (271) pretax)	—	—	5	(176)
Less: Net reclassification of losses to earnings (\$ (2), \$ (7), \$ (345) and \$ (17) pretax) ⁽³⁾	(1)	(4)	(224)	(11)
Other comprehensive income (loss)	1	4	229	(165)
End of period balance	(6)	(239)	(6)	(239)
Pension and OPEB plans:				
Beginning of period balance	(1,609)	(1,567)	(1,630)	(1,587)
Less: Net amortization of net actuarial losses (\$ (17), \$ (16), \$ (51) and \$ (48) pretax) ⁽⁴⁾	(12)	(10)	(34)	(31)
Less: Net amortization of prior service credit (\$ 2, \$ 1, \$ 3 and \$ 3 pretax) ⁽⁴⁾	1	1	2	2
Other comprehensive income	11	9	32	29
End of period balance	(1,598)	(1,558)	(1,598)	(1,558)
Total beginning of period accumulated other comprehensive loss	(1,180)	(1,092)	(1,552)	(1,330)
Total other comprehensive income	19	11	391	249
Total end of period accumulated other comprehensive loss	\$(1,161)	\$(1,081)	\$(1,161)	\$(1,081)

Represents specifically identified unrealized gains and losses on the non-credit related component of impaired debt

⁽¹⁾ securities that we do not intend to sell and subsequent changes in the fair value of any previously impaired security.

Reclassifications out of accumulated other comprehensive income for specifically identified previously impaired

⁽²⁾ debt securities and all other securities are reflected in net realized capital gains (losses) within the Consolidated Statements of Income.

⁽³⁾

Reclassifications out of accumulated other comprehensive income for specifically identified foreign currency gains (losses) and derivatives are reflected in net realized capital gains (losses) within the Consolidated Statements of Income, except for the specifically identified effective portion of derivatives related to cash flow hedges which are reflected in interest expense. During the nine months ended September 30, 2017, we redeemed the entire \$10.2 billion aggregate principal amount of the Special Mandatory Redemption Notes and the entire \$750 million aggregate principal amount outstanding of the senior notes due 2020 and reclassified out of accumulated other comprehensive income the remaining \$336 million pre-tax unrealized hedge losses as a realized capital loss within the Consolidated Statements of Income. Refer to Note 9 for additional information.

⁽⁴⁾ Reclassifications out of accumulated other comprehensive income for specifically identified pension and OPEB plan expenses are reflected in general and administrative expenses within the Consolidated Statements of Income. Refer to Note 10 for additional information.

13. Earnings Per Common Share

Basic earnings per common share (“EPS”) is computed by dividing net income attributable to Aetna by the weighted average number of common shares outstanding during the reporting period. Diluted EPS is computed in a similar manner, except that the weighted average number of common shares outstanding is adjusted for the dilutive effects of our outstanding stock-based compensation awards, but only if the effect is dilutive.

The computations of basic and diluted EPS for the three and nine months ended September 30, 2017 and 2016 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions, except per common share data)	2017	2016	2017	2016
Net income attributable to Aetna	\$838	\$604	\$1,660	\$2,132
Weighted average shares used to compute basic EPS	329.7	351.4	335.3	351.1
Dilutive effect of outstanding stock-based compensation awards	2.3	2.9	2.2	3.0
Weighted average shares used to compute diluted EPS	332.0	354.3	337.5	354.1
Basic EPS	\$2.54	\$1.72	\$4.95	\$6.07
Diluted EPS	\$2.52	\$1.70	\$4.92	\$6.02

The stock-based compensation awards excluded from the calculation of diluted EPS for the three and nine months ended September 30, 2017 and 2016 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	2017	2016	2017	2016
SARs ⁽¹⁾	—	—	—	.1
Other stock-based compensation awards ⁽²⁾	.6	.7	.8	.8

(1) SARs are excluded from the calculation of diluted EPS if the exercise price is greater than the average market price of Aetna common shares during the period (i.e., the awards are anti-dilutive).

PSUs, certain market stock units with performance conditions, and performance stock appreciation rights are

(2) excluded from the calculation of diluted EPS if all necessary performance conditions have not been satisfied at the end of the reporting period.

14. Reinsurance

On October 22, 2017, we entered into a definitive agreement to sell a substantial portion of our Group Insurance business segment consisting of our domestic group life insurance, group disability insurance and absence management businesses to Hartford Life and Accident Insurance Company (“HLAIC”) for cash consideration of \$1.45 billion. The transaction is being accomplished through an indemnity reinsurance arrangement, under which HLAIC will contractually assume certain of our policyholder liabilities and obligations, although we will remain directly obligated to policyholders. Assets related to and supporting the life and disability insurance policies will be transferred to a trust

established by HLAIC for our benefit, and we will record a reinsurance receivable from HLAIC. The transaction is expected to close in early November 2017, subject to customary closing conditions.

In January 2017, we entered into two four-year reinsurance agreements with an unrelated reinsurer. The agreements allow us to reduce our required capital and provide collateralized excess of loss reinsurance coverage on a portion of our group Commercial Insured Health Care business.

15. Commitments and Contingencies

Guaranty Fund Assessments, Market Stabilization and Other Non-Voluntary Risk Sharing Pools

Under guaranty fund laws existing in all states, insurers doing business in those states can be assessed (in most states up to prescribed limits) for certain obligations of insolvent insurance companies to policyholders and claimants. The life and health insurance guaranty associations in which we participate that operate under these laws respond to insolvencies of long-term care insurers as well as health insurers. Our assessments generally are based on a formula relating to our health care premiums in the state compared to the premiums of other insurers. Certain states allow assessments to be recovered over time as offsets to premium taxes. Some states have similar laws relating to HMOs and/or other payors such as not-for-profit consumer-governed health plans established under the ACA.

In 2009, the Pennsylvania Insurance Commissioner (the “Commissioner”) placed long-term care insurer Penn Treaty Network America Insurance Company and one of its subsidiaries (collectively, “Penn Treaty”) in rehabilitation, an intermediate action before insolvency, and subsequently petitioned a state court to convert the rehabilitation into a liquidation. Penn Treaty was placed in liquidation in March 2017. During the first quarter of 2017, we recorded a discounted liability and expense of \$231 million pretax for our estimated share of future assessments by applicable life and health guaranty associations which reflects a 3.5% discount rate. The undiscounted estimated liability was \$347 million. The expense was recorded in general and administrative expenses in our Consolidated Statements of Income, and the liability was recorded in accrued expenses and other current liabilities in our Consolidated Balance Sheets. We did not record an asset for expected premium tax offsets for our in force business at September 30, 2017 as the amount was not material. It is reasonably possible that in the future we may record a liability and expense relating to other insolvencies which could have a material adverse effect on our operating results, financial position and cash flows. While historically we have ultimately recovered more than half of guaranty fund assessments through statutorily permitted premium tax offsets, significant increases in assessments could lead to legislative and/or regulatory actions that may limit future offsets.

HMOs in certain states in which we do business are subject to assessments, including market stabilization and other risk-sharing pools, for which we are assessed charges based on incurred claims, demographic membership mix and other factors. We establish liabilities for these assessments based on applicable laws and regulations. In certain states, the ultimate assessments we pay are dependent upon our experience relative to other entities subject to the assessment, and the ultimate liability is not known at the balance sheet date. While the ultimate amount of the assessment is dependent upon the experience of all pool participants, we believe we have adequate reserves to cover such assessments.

Litigation and Regulatory Proceedings

Out-of-Network Benefit Proceedings

We are named as a defendant in several purported class actions and individual lawsuits arising out of our practices related to the payment of claims for services rendered to our members by health care providers with whom we do not have a contract (“out-of-network providers”). Among other things, these lawsuits allege that we paid too little to our health plan members and/or providers for these services, among other reasons, because of our use of data provided by Ingenix, Inc., a subsidiary of one of our competitors (“Ingenix”). Other major health insurers are the subject of similar litigation or have settled similar litigation.

Various plaintiffs who are health care providers or medical associations seek to represent nationwide classes of out-of-network providers who provided services to our members during the period from 2001 to the present. Various plaintiffs who are members in our health plans seek to represent nationwide classes of our members who received services from out-of-network providers during the period from 2001 to the present. Taken together, these lawsuits allege that we violated state law, the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), the Racketeer Influenced and Corrupt Organizations Act (“RICO”) and federal antitrust laws, either acting alone or in

concert with our competitors. The purported classes seek reimbursement of all unpaid benefits, recalculation and repayment of deductible and coinsurance amounts, unspecified damages and treble damages, statutory penalties, injunctive and declaratory relief, plus interest, costs and attorneys' fees, and seek to disqualify us from acting as a fiduciary of any benefit plan that is subject to ERISA. Individual lawsuits that generally contain similar allegations and seek similar relief have been brought by health plan members and out-of-network providers.

The first class action case was commenced on July 30, 2007. The federal Judicial Panel on Multi-District Litigation (the "MDL Panel") has consolidated these class action cases in the U.S. District Court for the District of New Jersey (the "New Jersey District Court") under the caption In re: Aetna UCR Litigation, MDL No. 2020 ("MDL 2020"). In addition, the MDL Panel has transferred the individual lawsuits to MDL 2020. On May 9, 2011, the New Jersey District Court dismissed the physician plaintiffs from MDL 2020 without prejudice. The New Jersey District Court's action followed a ruling by the United States District Court for the Southern District of Florida (the "Florida District Court") that the physician plaintiffs were enjoined from

participating in MDL 2020 due to a prior settlement and release. The United States Court of Appeals for the Eleventh Circuit has dismissed the physician plaintiffs' appeal of the Florida District Court's ruling.

On December 6, 2012, we entered into an agreement to settle MDL 2020. Under the terms of the proposed nationwide settlement, we would have been released from claims relating to our out-of-network reimbursement practices from the beginning of the applicable settlement class period through August 30, 2013. The settlement agreement did not contain an admission of wrongdoing. The medical associations were not parties to the settlement agreement.

Under the settlement agreement, we would have paid up to \$120 million to fund claims submitted by health plan members and health care providers who were members of the settlement classes. These payments also would have funded the legal fees of plaintiffs' counsel and the costs of administering the settlement. In connection with the proposed settlement, the Company recorded an after-tax charge to net income attributable to Aetna of \$78 million in the fourth quarter of 2012.

The settlement agreement provided us the right to terminate the agreement under certain conditions related to settlement class members who opted out of the settlement. Based on a report provided to the parties by the settlement administrator, the conditions permitting us to terminate the settlement agreement were satisfied. On March 13, 2014, we notified the New Jersey District Court and plaintiffs' counsel that we were terminating the settlement agreement. Various legal and factual developments since the date of the settlement agreement led us to believe terminating the settlement agreement was in our best interests. As a result of this termination, we released the reserve established in connection with the settlement agreement, net of amounts due to the settlement administrator, which reduced first quarter 2014 other general and administrative expenses by \$103 million pretax.

On June 30, 2015, the New Jersey District Court granted in part our motion to dismiss the proceeding. The New Jersey District Court dismissed with prejudice the plaintiffs' RICO and federal antitrust claims; their ERISA claims that are based on our disclosures and our purported breach of fiduciary duties; and certain of their state law claims. The New Jersey District Court also dismissed with prejudice all claims asserted by several medical association plaintiffs. The plaintiffs' remaining claims are for ERISA benefits and breach of contract. We intend to defend ourselves vigorously against the plaintiffs' remaining claims.

We also have received subpoenas and/or requests for documents and other information from, and been investigated by, attorneys general and other state and/or federal regulators, legislators and agencies relating to, and we are involved in other litigation regarding, our out-of-network benefit payment and administration practices. It is reasonably possible that others could initiate additional litigation or additional regulatory action against us with respect to our out-of-network benefit payment and/or administration practices.

CMS Actions

The Centers for Medicare & Medicaid Services ("CMS") regularly audits our performance to determine our compliance with CMS's regulations and our contracts with CMS and to assess the quality of services we provide to Medicare beneficiaries. CMS uses various payment mechanisms to allocate and adjust premium payments to our and other companies' Medicare plans by considering the applicable health status of Medicare members as supported by information prepared, maintained and provided by health care providers. We collect claim and encounter data from providers and generally rely on providers to appropriately code their submissions to us and document their medical records, including the diagnosis data submitted to us with claims. CMS pays increased premiums to Medicare Advantage plans and prescription drug program plans for members who have certain medical conditions identified with specific diagnosis codes. Federal regulators review and audit the providers' medical records to determine whether those records support the related diagnosis codes that determine the members' health status and the resulting risk-adjusted premium payments to us. In that regard, CMS has instituted risk adjustment data validation ("RADV") audits of various Medicare Advantage plans, including certain of the Company's plans, to validate coding practices and

supporting medical record documentation maintained by health care providers and the resulting risk adjusted premium payments to the plans. CMS may require us to refund premium payments if our risk adjusted premiums are not properly supported by medical record data. The Office of Inspector General (the "OIG") also is auditing our risk adjustment-related data and that of other companies. We expect CMS and the OIG to continue these types of audits.

CMS revised its audit methodology for RADV audits to determine refunds payable by Medicare Advantage plans for contract year 2011 and forward. Under the revised methodology, among other things, CMS will project the error rate identified in the audit sample of approximately 200 members to all risk adjusted premium payments made under the contract being audited. Historically, CMS did not project sample error rates to the entire contract. As a result, the revised methodology may increase our exposure to premium refunds to CMS based on incomplete medical records maintained by providers. Since 2013, CMS has selected certain of our Medicare Advantage contracts for various contract years for RADV audit. We are currently unable to predict which of our Medicare Advantage contracts will be selected for future audit, the amounts of any retroactive refunds of, or prospective adjustments to, Medicare Advantage premium payments made to us, the effect of any such refunds or

adjustments on the actuarial soundness of our Medicare Advantage bids, or whether any RADV audit findings would cause a change to our method of estimating future premium revenue in future bid submissions to CMS or compromise premium assumptions made in our bids for prior contract years or the current contract year. Any premium or fee refunds or adjustments resulting from regulatory audits, whether as a result of RADV, Public Exchange related or other audits by CMS, the OIG, HHS or otherwise, including audits of our minimum medical loss ratio rebates, methodology and/or reports, could be material and could adversely affect our operating results, financial position and cash flows.

Other Litigation and Regulatory Proceedings

We are involved in numerous other lawsuits arising, for the most part, in the ordinary course of our business operations, including claims of or relating to bad faith, medical malpractice, non-compliance with state and federal regulatory regimes, marketing misconduct, failure to timely or appropriately pay or administer claims and benefits in our Health Care and Group Insurance businesses (including our post-payment audit and collection practices and reductions in payments to providers due to sequestration), provider network structure (including the use of performance-based networks and termination of provider contracts), provider directory accuracy, rescission of insurance coverage, improper disclosure of personal information, anticompetitive practices, patent infringement and other intellectual property litigation, other legal proceedings in our Health Care and Group Insurance businesses and employment litigation. Some of these other lawsuits are or are purported to be class actions. We intend to defend ourselves vigorously against the claims brought in these matters.

Awards to us and others of certain government contracts, particularly Medicaid contracts and contracts with government customers in our Commercial business, are subject to increasingly frequent protests by unsuccessful bidders. These protests may result in awards to us being reversed, delayed or modified. The loss or delay in implementation of any government contract could adversely affect our operating results. We will continue to defend vigorously contract awards we receive.

In addition, our operations, current and past business practices, current and past contracts, and accounts and other books and records are subject to routine, regular and special investigations, audits, examinations and reviews by, and from time to time we receive subpoenas and other requests for information from, CMS, the U.S. Department of Health and Human Services, various state insurance and health care regulatory authorities, state attorneys general, treasurers and offices of inspector general, the Center for Consumer Information and Insurance Oversight, OIG, the Office of Personnel Management, the U.S. Department of Labor, the U.S. Department of the Treasury, the U.S. Food and Drug Administration, committees, subcommittees and members of the U.S. Congress, the U.S. Department of Justice (the "DOJ"), the Federal Trade Commission, U.S. attorneys and other state, federal and international governmental authorities. These government actions include inquiries by, and testimony before, certain members, committees and subcommittees of the U.S. Congress regarding our withdrawal from certain states' Public Exchanges for 2017, certain of our current and past business practices, including our overall claims processing and payment practices, our business practices with respect to our small group products, student health products or individual customers (such as market withdrawals, rating information, premium increases and medical benefit ratios), executive compensation matters and travel and entertainment expenses, as well as the investigations by, and subpoenas and requests from, attorneys general and others described above under "Out-of-Network Benefit Proceedings." We also have produced documents and information to the Civil Division of the DOJ in cooperation with a current investigation of our patient chart review processes in connection with risk adjustment data submissions under Parts C and D of the Medicare program.

A significant number of states are investigating life insurers' claims payment and related escheat practices. These investigations have resulted in significant charges to earnings by other life insurers in connection with related settlements. We have received requests for information from a number of states, and certain of our subsidiaries are being audited, with respect to our life insurance claim payment and related escheat practices. In the fourth quarter of 2013, we made changes to our life insurance claim payment practices (including related escheatment practices) based

on evolving industry practices and regulatory expectations and interpretations, including expanding our existing use of the Social Security Administration's Death Master File to identify additional potentially unclaimed death benefits and locate applicable beneficiaries. As a result of these changes, in the fourth quarter of 2013, we increased our estimated liability for unpaid life insurance claims with respect to insureds who passed away on or before December 31, 2013, and recorded in current and future benefits a charge of \$36 million (\$55 million pretax). Given the judicial, legislative and regulatory uncertainty with respect to life insurance claim payment and related escheat practices, it is reasonably possible that we may incur additional liability related to those practices, whether as a result of further changes in our business practices, litigation, government actions or otherwise, which could adversely affect our operating results and cash flows.

There also continues to be a heightened level of review and/or audit by regulatory authorities of, and increased litigation regarding, our and the rest of the health care and related benefits industry's business and reporting practices, including premium rate increases, utilization management, development and application of medical policies, complaint, grievance and appeal processing, information privacy, provider network structure (including provider network adequacy, the use of performance-based networks and termination of provider contracts), provider directory accuracy, calculation of minimum medical loss ratios

and/or payment of related rebates, delegated arrangements, rescission of insurance coverage, limited benefit health products, student health products, pharmacy benefit management practices (including the use of narrow networks and the placement of drugs in formulary tiers), sales practices, customer service practices, vendor oversight and claim payment practices (including payments to out-of-network providers and payments on life insurance policies).

As a leading national health and related benefits company, we regularly are the subject of government actions of the types described above. These government actions may prevent or delay us from implementing planned premium rate increases and may result, and have resulted, in restrictions on our business, changes to or clarifications of our business practices, retroactive adjustments to premiums, refunds or other payments to members, beneficiaries, states or the federal government, withholding of premium payments to us by government agencies, assessments of damages, civil or criminal fines or penalties, or other sanctions, including the possible suspension or loss of licensure and/or suspension or exclusion from participation in government programs.

Estimating the probable losses or a range of probable losses resulting from litigation, government actions and other legal proceedings is inherently difficult and requires an extensive degree of judgment, particularly where the matters involve indeterminate claims for monetary damages, involve claims for injunctive relief, may involve fines, penalties or punitive damages that are discretionary in amount, involve a large number of claimants or regulatory authorities, represent a change in regulatory policy, present novel legal theories, are in the early stages of the proceedings, are subject to appeal or could result in changes in business practices. In addition, because most legal proceedings are resolved over long periods of time, potential losses are subject to change due to, among other things, new developments, changes in litigation strategy, the outcome of intermediate procedural and substantive rulings and other parties' settlement posture and their evaluation of the strength or weakness of their case against us. Except as specifically noted above under "Other Litigation and Regulatory Proceedings," we are currently unable to predict the ultimate outcome of, or reasonably estimate the losses or a range of losses resulting from, the matters described above under "Litigation and Regulatory Proceedings", and it is reasonably possible that their outcome could be material to us.

16. Segment Information

Our operations are conducted in three business segments: Health Care, Group Insurance and Large Case Pensions. Our Corporate Financing segment is not a business segment. It is added to our business segments to reconcile our segment reporting to our consolidated results. The Corporate Financing segment includes transaction and integration-related costs, income taxes, interest expense on our outstanding debt and the financing components of our pension and OPEB plan expense (the service cost and prior service cost components of this expense are allocated to our business segments).

Effective March 31, 2017, to more clearly differentiate between the GAAP and non-GAAP financial measures used in our reports filed with or furnished to the Securities and Exchange Commission and our other disclosures, we changed the naming convention for our non-GAAP financial measures from "operating" measures to "adjusted" measures. The underlying calculations of our consolidated non-GAAP financial measures did not change. Prior to March 31, 2017, operating earnings was the measure reported to the chief executive officer for purposes of assessing financial performance and making operating decisions, such as the allocation of resources among our business segments. Effective March 31, 2017, the chief executive officer assesses our consolidated results based on adjusted earnings and assesses business segment results based on pre-tax adjusted earnings because income taxes are recorded in our Corporate Financing segment and are not allocated to our business segments. Also effective March 31, 2017, transaction and integration-related costs were reclassified to our Corporate Financing segment because they do not reflect our underlying business performance. Prior periods have been restated to reflect this presentation. Non-GAAP financial measures we disclose, such as adjusted earnings and pre-tax adjusted earnings, should not be considered a substitute for, or superior to, financial measures determined or calculated in accordance with GAAP.

Summarized financial information of our segment operations for the three and nine months ended September 30, 2017 and 2016 were as follows:

(Millions)	Health Care	Group Insurance	Large Case Pensions	Corporate Financing	Total Company
Three Months Ended September 30, 2017					
Revenue from external customers	\$ 14,127	\$ 576	\$ 12	\$ —	\$ 14,715
Pre-tax adjusted earnings (loss) ⁽¹⁾	1,297	34	5	(64)	1,272
Three Months Ended September 30, 2016					
Revenue from external customers	\$ 14,950	\$ 564	\$ 14	\$ —	\$ 15,528
Pre-tax adjusted earnings (loss) ⁽¹⁾	1,314	22	3	(65)	1,274
Nine Months Ended September 30, 2017					
Revenue from external customers	\$ 43,474	\$ 1,698	\$ 42	\$ —	\$ 45,214
Pre-tax adjusted earnings (loss) ⁽¹⁾	4,545	109	12	(186)	4,480
Nine Months Ended September 30, 2016					
Revenue from external customers	\$ 44,932	\$ 1,683	\$ 39	\$ —	\$ 46,654
Pre-tax adjusted earnings (loss) ⁽¹⁾	4,111	104	7	(194)	4,028

⁽¹⁾ Pre-tax adjusted earnings (loss) excludes net realized capital gains or losses, amortization of other acquired intangible assets and the other items described in the reconciliation below.

A reconciliation of income before income taxes to pre-tax adjusted earnings ⁽¹⁾ for the three and nine months ended September 30, 2017 and 2016 was as follows:

(Millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Income before income taxes (GAAP measure)	\$1,274	\$1,074	\$2,466	\$3,716
Less: Income (loss) before income taxes attributable to non-controlling interests (GAAP measure)	14	(9)	(6)	(5)
Income before income taxes attributable to Aetna (GAAP measure)	1,260	1,083	2,472	3,721
Loss on early extinguishment of long-term debt	—	—	246	—
Penn Treaty-related guaranty fund assessments	—	—	231	—
Transaction and integration-related costs	—	164	1,202	333
Reduction of reserve for anticipated future losses on discontinued products	—	—	(109)	(128)
Amortization of other acquired intangible assets	58	61	176	187
Net realized capital (gains) losses	(46)	(34)	262	(85)
Pre-tax adjusted earnings ⁽¹⁾	\$1,272	\$1,274	\$4,480	\$4,028

In addition to net realized capital gains and losses and amortization of other acquired intangible assets, the ⁽¹⁾ following other items are excluded from adjusted earnings and pre-tax adjusted earnings because we believe they neither relate to the ordinary course of our business nor reflect our underlying business performance:

During the nine months ended September 30, 2017, we incurred losses on the early extinguishment of long-term debt due to (a) the mandatory redemption of the \$10.2 billion aggregate principal amount of the Special Mandatory Redemption Notes following the termination of the Merger Agreement and (b) the early redemption of \$750 million aggregate principal amount of our outstanding senior notes due 2020.

During the nine months ended September 30, 2017, we recorded an expense for estimated future guaranty fund assessments related to Penn Treaty, which was placed in rehabilitation in 2009 and placed in liquidation in March 2017. This expense does not directly relate to the underwriting or servicing of products for customers and is not directly related to the core performance of our business operations.

We recorded transaction and integration-related costs during the nine months ended September 30, 2017 and the three and nine months ended September 30, 2016 primarily related to the Humana Transaction. Transaction costs include costs associated with the termination of the Merger Agreement, the termination of our agreement to sell certain assets to Molina Healthcare, Inc. and advisory, legal and other professional fees which are reflected in our GAAP Consolidated Statements of Income in general and administrative expenses. Transaction costs also include the negative cost of carry associated with the debt financing that we obtained in June 2016 for the Humana Transaction. Prior to the mandatory redemption of the Special Mandatory Redemption Notes, the negative cost of carry associated with these senior notes was excluded from adjusted earnings and pre-tax adjusted earnings. The negative cost of carry associated with the \$2.8 billion aggregate principal amount of our senior notes issued in June 2016 that are not subject to mandatory redemption (the "Other 2016 Senior Notes") was excluded from adjusted earnings and pre-tax adjusted earnings through the date of the termination of the Merger Agreement. The components of the negative cost of carry are reflected in our GAAP Consolidated Statements of Income in interest expense and net investment income.

Subsequent to the termination of the Merger Agreement, the interest expense and net investment income associated with the Other 2016 Senior Notes were no longer excluded from adjusted earnings and pre-tax adjusted earnings.

- In 1993, we discontinued the sale of fully guaranteed large case pensions products and established a reserve for anticipated future losses on these products, which we review quarterly. During both the nine months ended September 30, 2017 and 2016, we reduced the reserve for anticipated future losses on discontinued products. We believe excluding any changes in the reserve for anticipated future losses on discontinued products from adjusted earnings provides more useful information as to our continuing products and is consistent with the treatment of the operating results of these discontinued products, which are credited or charged to the reserve

and do not affect our operating results.

17. Discontinued Products

Prior to 1993, we sold single-premium annuities (“SPAs”) and guaranteed investment contracts (“GICs”), primarily to employer sponsored pension plans. In 1993, we discontinued selling these products to Large Case Pensions customers, and now we refer to these products as discontinued products. In November 2016, the last outstanding GIC matured.

We discontinued selling these products because they were generating losses for us, and we projected that they would continue to generate losses over their life (which is currently greater than 30 years); so we established a reserve for anticipated future losses at the time of discontinuance. This reserve represents the present value (at the risk-free rate of return consistent with the duration of the liabilities) of the difference between the expected cash flows from the assets supporting these products and the cash flows expected to be required to meet the obligations of the outstanding contracts.

Page 36

Key assumptions in setting the reserve for anticipated future losses include future investment results, payments to retirees, mortality and retirement rates and the cost of asset management and customer service. In 2014, we modified the mortality tables used in order to reflect the more up-to-date 2014 Retired Pensioner's Mortality table. The mortality tables were previously modified in 2012, in order to reflect the more up-to-date 2000 Retired Pensioner's Mortality table, and in 1995, in order to reflect the more up-to-date 1994 Uninsured Pensioner's Mortality table. In 1997, we began the use of a bond default assumption to reflect historical default experience. Other than these changes, since 1993 there have been no significant changes to the assumptions underlying the reserve.

We review the adequacy of this reserve quarterly based on actual experience. As long as our expected future losses remain consistent with prior projections, the results of the discontinued products are applied against the reserve and do not impact net income attributable to Aetna. If actual or expected future losses are greater than we currently estimate, we may increase the reserve, which could adversely impact net income attributable to Aetna. If actual or expected future losses are less than we currently estimate, we may decrease the reserve, which could favorably impact net income attributable to Aetna. As a result of this review, we released \$71 million (\$109 million pretax) and \$84 million (\$128 million pretax) of the reserve in the nine months ended September 30, 2017 and 2016, respectively. The reserve release during the nine months ended September 30, 2017 was primarily due to favorable mortality experience compared to assumptions we previously made in estimating the reserve. In addition, the reserve release in the nine months ended September 30, 2017 and 2016 also reflects favorable retirement experience as well as favorable investment performance compared to assumptions we previously made in estimating the reserve. The reserve at each of September 30, 2017 and December 31, 2016 reflects management's best estimate of anticipated future losses, and is included in future policy benefits on our Consolidated Balance Sheets.

The activity in the reserve for anticipated future losses on discontinued products for the nine months ended September 30, 2017 and 2016 was as follows (pretax):

(Millions)	2017	2016
Reserve, beginning of period	\$962	\$1,067
Operating income (loss)	34	(20)
Net realized capital gains	55	49
Reserve reduction	(109)	(128)
Reserve, end of period	\$942	\$968

During the nine months ended September 30, 2017, our discontinued products reflected operating income and net realized capital gains, primarily attributable to gains from other investments and the sale of debt securities and investment real estate. During the nine months ended September 30, 2016, our discontinued products reflected an operating loss and net realized capital gains, primarily attributable to gains from the sale of debt securities.

Assets and liabilities supporting discontinued products ⁽¹⁾ at September 30, 2017 and December 31, 2016 were as follows:

(Millions)	2017	2016
Assets:		
Debt and equity securities available for sale	\$1,924	\$1,913
Mortgage loans	346	370
Other investments	582	646
Total investments	2,852	2,929
Other assets	103	104
Receivable from continuing products ⁽²⁾	507	554
Total assets	\$3,462	\$3,587
Liabilities:		
Future policy benefits	\$2,201	\$2,326
Reserve for anticipated future losses on discontinued products	942	962
Current and deferred income taxes	78	42
Other liabilities ⁽³⁾	241	257
Total liabilities	\$3,462	\$3,587

⁽¹⁾ Assets supporting the discontinued products are distinguished from assets supporting continuing products.

At the time of discontinuance, a receivable from Large Case Pensions' continuing products was established on the discontinued products Balance Sheet. This receivable represented the net present value of anticipated cash

⁽²⁾ shortfalls in the discontinued products, which will be funded from continuing products. Interest on the receivable is accrued at the discount rate that was used to calculate the reserve. The offsetting payable, on which interest is similarly accrued, is reflected in continuing products. Interest on the payable generally offsets investment income on the assets available to fund the shortfall. These amounts are eliminated in consolidation.

⁽³⁾ Net unrealized capital gains on the available-for-sale debt securities are included in other liabilities and are not reflected in consolidated shareholders' equity.

The distributions on our discontinued products consisted of scheduled contract maturities, settlements and benefit payments of \$80 million and \$244 million for the three and nine months ended September 30, 2017, respectively, and \$85 million and \$265 million for the three and nine months ended September 30, 2016, respectively.

Participant-directed withdrawals from our discontinued products were not significant during the three or nine months ended September 30, 2017 or 2016. Cash required to fund these distributions was provided by earnings and scheduled payments on, and sales of, invested assets.

Index to Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Aetna Inc.:

We have reviewed the accompanying consolidated balance sheet of Aetna Inc. and subsidiaries as of September 30, 2017, and the related consolidated statements of income and comprehensive income for the three and nine month periods ended September 30, 2017 and 2016, and the related statements of shareholders' equity and cash flows for the nine-month periods ended September 30, 2017 and 2016. These consolidated financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole.

Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Aetna Inc. and subsidiaries as of December 31, 2016, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated February 17, 2017, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2016, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Hartford, Connecticut

October 31, 2017

Form 10-Q Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")

OVERVIEW

We are one of the nation's leading diversified health care benefits companies, serving an estimated 44.6 million people. We have the information and resources to help our members, in consultation with their health care professionals, make better informed decisions about their health care. We offer a broad range of traditional, voluntary and consumer-directed health insurance products and related services, including medical, pharmacy, dental, behavioral health, group life and disability plans, medical management capabilities, Medicaid health care management services, Medicare Advantage and Medicare Supplement plans, workers' compensation administrative services and health information technology products and services. Our customers include employer groups, individuals, college students, part-time and hourly workers, health plans, health care providers ("providers"), governmental units, government-sponsored plans, labor groups and expatriates. Our operations are conducted in three business segments: Health Care, Group Insurance and Large Case Pensions.

The following MD&A provides a review of our financial condition at September 30, 2017 and December 31, 2016 and operating results for the three and nine months ended September 30, 2017 and 2016. This Overview should be read in conjunction with the entire MD&A, which contains detailed information that is important to understanding our operating results and financial condition, the consolidated financial statements and other data presented in this Quarterly Report on Form 10-Q as well as the MD&A contained in our 2016 Annual Report on Form 10-K (our "2016 Annual Report"). This Overview is qualified in its entirety by the full MD&A.

Summarized Results for the Three and Nine Months Ended September 30, 2017 and 2016:

	Three Months Ended September 30,		Nine Months Ended September 30,		Change Three Months Ended September 30, 2017 vs 2016		Nine Months Ended September 30, 2017 vs 2016	
	2017	2016	2017	2016	\$	%	\$	%
(Millions, except where indicated)								
Total revenue	\$14,994	\$15,781	\$45,682	\$47,427	\$(787)	(5)%	\$(1,745)	(4)%
Net income attributable to Aetna	838	604	1,660	2,132	234	39%	(472)	(22)%
Adjusted earnings ⁽¹⁾	814	734	2,898	2,339	80	11%	559	24%
Total medical membership (in thousands)			22,165	23,121			(956)	(4)%
Cash flows provided by operations			2,224	4,621			(2,397)	(52)%

A reconciliation of net income attributable to Aetna to adjusted earnings ⁽¹⁾ for the three and nine months ended September 30, 2017 and 2016 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
(Millions)				
Net income attributable to Aetna (GAAP measure)	\$838	\$604	\$1,660	\$2,132
Loss on early extinguishment of long-term debt	—	—	246	—
Penn Treaty-related guaranty fund assessments	—	—	231	—

Edgar Filing: AETNA INC /PA/ - Form 10-Q

Transaction and integration-related costs	—	164	1,202	333
Reduction of reserve for anticipated future losses on discontinued products	—	—	(109)	(128)
Amortization of other acquired intangible assets	58	61	176	187
Net realized capital (gains) losses	(46)	(34)	262	(85)
Income tax benefit	(36)	(61)	(770)	(100)
Adjusted earnings ⁽¹⁾	\$814	\$734	\$2,898	\$2,339

Adjusted earnings excludes from net income attributable to Aetna net realized capital gains and losses, amortization of other acquired intangible assets and the other items described in the reconciliation in Note 16. In addition, adjusted earnings excludes from net income attributable to Aetna the corresponding tax benefit or ⁽¹⁾ expense related to the items excluded from adjusted earnings discussed above. The tax benefit or expense was calculated utilizing the appropriate tax rate for each individual item excluded from adjusted earnings. The three months ended September 30, 2017 include a \$29 million tax benefit which reflects anticipated incremental tax benefits related to certain costs associated with the Humana Transaction.

Effective March 31, 2017, to more clearly differentiate between the GAAP and non-GAAP financial measures used in our reports filed with or furnished to the Securities and Exchange Commission and our other disclosures, we changed the naming convention for our non-GAAP financial measures from “operating” measures to “adjusted” measures. The underlying calculations of our consolidated non-GAAP financial measures did not change. Our discussion of consolidated operating results is based on adjusted earnings, which is a non-GAAP measure of net income attributable to Aetna (the term “GAAP” refers to U.S. generally accepted accounting principles). Effective March 31, 2017, we began recording income taxes in our Corporate Financing segment and are no longer allocating income taxes to our business segments. Accordingly, our discussion of operating results for our reportable business segments is based on pre-tax adjusted earnings which is a non-GAAP measure of income before income taxes attributable to Aetna. Also effective March 31, 2017, transaction and integration-related costs were reclassified to our Corporate Financing segment. Prior periods have been restated to reflect this presentation. Non-GAAP financial measures we disclose, such as adjusted earnings and pre-tax adjusted earnings, should not be considered a substitute for, or superior to, financial measures determined or calculated in accordance with GAAP. Refer to “Segment Results and Use of Non-GAAP Measures in this Document” for a discussion of non-GAAP measures.

Commentary - Overview

Our results for the three and nine months ended September 30, 2017 include several items that impact comparability with results in prior periods. Our results for the nine months ended September 30, 2017 reflect costs associated with the termination of the Merger Agreement (as defined below) and an expense related to estimated future guaranty fund assessments as a result of Penn Treaty (as defined below) being placed in liquidation, each of which occurred in the first quarter of 2017. Results for the three and nine months ended September 30, 2017 reflect the temporary suspension of the health insurer fee (“HIF”). Pricing actions designed to recover the HIF and other ACA-mandated fees represented approximately three percent of our Health Care premiums in 2016. Our results for the three and nine months ended September 30, 2017 also include the impact of reduced participation on the ACA’s individual public health insurance exchanges. We expect to significantly reduce our exposure to individual Commercial products in 2018 and do not plan to participate on any ACA individual public health insurance exchange in 2018. Finally, we incurred transaction and integration-related costs related to the Humana Transaction during the three months ended September 30, 2016 that did not recur during the three months ended September 30, 2017 due to the termination of the Humana Merger Agreement in the first quarter of 2017.

Commentary - Three Months Ended September 30, 2017 vs 2016

Net income attributable to Aetna increased \$234 million during the three months ended September 30, 2017 compared to the corresponding period in 2016 primarily due to the increase in adjusted earnings described below and lower transaction and integration-related costs in 2017 compared to 2016.

Adjusted earnings increased \$80 million during the three months ended September 30, 2017 compared to the corresponding period in 2016 primarily due to continued strong performance in our Health Care segment.

Total revenue decreased \$787 million during the three months ended September 30, 2017 compared to the corresponding period in 2016. The decrease was primarily due to lower premiums in our Health Care segment, including lower membership in our ACA compliant individual and small group products, and the temporary suspension of the HIF in 2017.

Our effective tax rate was 33.4 percent and 44.4 percent for the three months ended September 30, 2017 and 2016, respectively. The decrease in our effective tax rate for the three months ended September 30, 2017 compared to the corresponding period in 2016 was primarily due to the temporary suspension of the non-deductible HIF in 2017 and anticipated incremental tax benefits related to certain costs associated with the Humana transaction incurred in 2017.

Commentary - Nine Months Ended September 30, 2017 vs 2016

Net income attributable to Aetna decreased \$472 million during the nine months ended September 30, 2017 compared to the corresponding period in 2016 primarily due to the nine months ended September 30, 2017 reflecting costs associated with the termination of the Merger Agreement, partially offset by the increase in adjusted earnings described below.

Adjusted earnings increased \$559 million during the nine months ended September 30, 2017 compared to the corresponding period in 2016 primarily due to continued strong performance in our Health Care segment. Total revenue decreased \$1.7 billion during the nine months ended September 30, 2017 compared to the corresponding period in 2016. The decrease was primarily due to lower premiums in our Health Care segment, including lower membership in our ACA compliant individual and small group products, and the temporary suspension of the HIF in 2017.

Our effective tax rate was 33.0 percent and 42.7 percent for the nine months ended September 30, 2017 and 2016, respectively. The decrease in our effective tax rate for the nine months ended September 30, 2017 compared to the corresponding period in 2016 was primarily due to the temporary suspension of the non-deductible HIF in 2017, the deduction of transaction related costs in 2017 and increased tax benefits for share based compensation.

Total medical membership at September 30, 2017 decreased 956 thousand compared to September 30, 2016, primarily reflecting declines in our ACA compliant individual and small group and Medicaid products. The decrease was partially offset by increases in our Commercial ASC, International Commercial Insured and Medicare Insured products. Refer to “Health Care - Membership” below in this MD&A for further information on our medical membership.

Cash flow from operations decreased \$2.4 billion during the nine months ended September 30, 2017 compared to the corresponding period in 2016. During 2017, cash payments associated with the termination of the Merger Agreement were largely offset by an advance payment for Medicare premium receipts in September 2017. The remaining decrease was primarily due to the timing of collection of receivables and a decrease in our health care and insurance liabilities primarily due to lower membership and changes in business mix, primarily related to the decline in our Individual Commercial product membership and the increase in our Medicare product membership.

2018 Outlook

In 2018, we project the following challenges will impact our total revenue:

- The sale of our domestic group life insurance, group disability insurance and absence management businesses;
- Our previously disclosed Medicaid contract exits;
- Our exit from individual Commercial products; and
- Our continued repositioning of our ACA-compliant small group Commercial products.

In addition to the total revenue challenges described above which we project will pressure our ability to grow net income and adjusted earnings in 2018, we project earnings growth also will be pressured by the timing of revenue and expense recognition related to the reintroduction of the industry wide, nondeductible HIF in 2018. We also expect that reintroduction to produce incremental experience rating pressure in our large group insured products.

We also see the following opportunities in 2018:

- Our projected above-industry growth in individual Medicare Advantage products and strong growth in group Medicare Advantage products;
- The full year impact of 2017 capital deployment actions and the potential to deploy additional capital to improve earnings per share growth;
- The reduction of losses from exiting individual Commercial products in 2018; and
- Our ability to achieve expense efficiencies as we continue to simplify our processes and drive for best-in-class business performance.

Divestiture of Group Life Insurance, Group Disability Insurance, and Absence Management Businesses

On October 22, 2017, we entered into a definitive agreement to sell a substantial portion of our Group Insurance business segment consisting of our domestic group life insurance, group disability insurance and absence management businesses to Hartford Life and Accident Insurance Company (“HLAIC”) for cash consideration of \$1.45 billion. The transaction is being accomplished through an indemnity reinsurance arrangement, under which HLAIC will contractually assume certain of our policyholder liabilities and obligations, although we will remain directly obligated to policyholders. Assets related to and supporting the life and disability insurance policies will be transferred to a trust established by HLAIC for our benefit, and we will record a reinsurance receivable from HLAIC. The transaction is expected to result in an after-tax gain of approximately \$900 million, a significant portion of which will be deferred and amortized into earnings as we recover amounts due from the reinsurer over a period estimated to be approximately 30 years. The amount of the gain will depend on the actual amount of assets transferred and liabilities contractually assumed from us at the closing date.

The transaction is expected to close in early November 2017, subject to customary closing conditions. Following the closing, we expect excess capital resulting from the transaction to be released from our subsidiaries over time.

Terminated Acquisition of Humana and Terminated Divestiture to Molina

On July 2, 2015, we entered into a definitive agreement (the “Merger Agreement”) to acquire Humana Inc. (“Humana”). On July 21, 2016, the U.S. Department of Justice (the “DOJ”) and certain state attorneys general filed a civil complaint in the U.S. District Court for the District of Columbia (the “District Court”) against us and Humana charging that our acquisition of Humana (the “Humana Transaction”) would violate Section 7 of the Clayton Antitrust Act, and seeking a permanent injunction to prevent Aetna from acquiring Humana. On January 23, 2017, the District Court granted the DOJ’s request to enjoin the Humana Transaction.

On February 14, 2017, Aetna and Humana entered into a mutual termination agreement (the “Termination Agreement”) pursuant to which the parties thereto (collectively, the “Parties”) agreed to terminate the Merger Agreement, including all schedules and exhibits thereto, and all ancillary agreements contemplated thereby, entered pursuant thereto or entered in connection therewith (other than certain confidentiality agreements) (collectively with the Merger Agreement, the “Transaction Documents”), effective immediately as of February 14, 2017 (the “Termination Date”). Under the Termination Agreement, Aetna agreed to pay Humana the Regulatory Termination Fee (as defined in the Merger Agreement) of \$1.0 billion in cash in full satisfaction of any amounts required to be paid by Aetna under the Merger Agreement. The Parties also agreed to release each other from any and all liability, claims, rights, actions, causes of action, suits, liens, obligations, accounts, debts, demands, agreements, promises, liabilities, controversies, costs, charges, damages, expenses and fees, however arising, in connection with, arising out of or related to the Transaction Documents, the transactions contemplated therein or thereby or certain related matters. We paid Humana the Regulatory Termination Fee on February 16, 2017 and funded that payment with the proceeds of the 2016 senior notes (as defined below).

In June 2016, we issued \$13.0 billion of senior notes to partially fund the Humana Transaction (collectively, the “2016 senior notes”). In accordance with the terms of the 2016 senior notes, on February 14, 2017, we issued a notice of redemption for \$10.2 billion aggregate principal amount of certain of the 2016 senior notes (collectively, the “Special Mandatory Redemption Notes”) at a redemption price equal to 101% of the aggregate principal amount of those notes plus accrued and unpaid interest. We redeemed the Special Mandatory Redemption Notes on March 16, 2017, and we funded the redemption with the proceeds of the 2016 senior notes. As a result of the redemption of the Special Mandatory Redemption Notes, we recognized on a pretax basis in our net income during the nine months ended September 30, 2017 a loss on early extinguishment of long-term debt of \$192 million and a realized capital loss for the remaining unamortized effective portion of the related hedge loss of \$323 million that was previously recorded in accumulated other comprehensive income.

In order to address the DOJ’s perceived competitive concerns regarding Medicare Advantage relating to the Humana Transaction, on August 2, 2016, we entered into a definitive agreement (the “Aetna APA”) to sell for cash to Molina Healthcare, Inc. (“Molina”) certain of our Medicare Advantage assets. On February 14, 2017, Aetna and Molina entered into a Termination Agreement (the “APA Termination Agreement”) pursuant to which Aetna terminated the Aetna APA, including all schedules and exhibits thereto, and all ancillary agreements contemplated thereby or entered pursuant thereto. Under the APA Termination Agreement, Aetna agreed to pay Molina in cash (a) a termination fee of \$53 million and (b) approximately 70% of Molina’s transaction costs. We paid Molina the termination fee on February 16, 2017 and the applicable transaction costs of \$7 million on February 27, 2017 and recorded the expense in general and administrative expenses. The payments were funded with the proceeds of the 2016 senior notes.

Refer to Notes 3 and 9, respectively, for additional information on the Humana Transaction.

Health Care Reform

The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (as amended, collectively, the “ACA”) has made broad-based changes to the U.S. health care system. We anticipate continued efforts in 2017 and beyond to modify, repeal or replace the ACA, and the future of the ACA is uncertain. We expect aspects of the ACA and/or their implementation or enforcement and uncertainty about the future of the ACA to continue to significantly impact our business operations and operating results, including our pricing, our medical benefit ratios (“MBRs”) and the geographies in which our products are available. For example, the ongoing litigation over payment of the ACA’s cost sharing subsidies; the practical implications of the President’s January 2017 executive order giving the regulatory agencies that enforce the ACA the authority to interpret regulations issued under the ACA in a way that limits fiscal burdens on states and financial or regulatory burdens on individuals, providers, health insurers and others remain unclear; and our individual Commercial product exit strategy and/or uncertainty about the future of the ACA may lead to increased utilization of medical and/or other covered services in our individual Commercial products.

The ACA has presented us with business opportunities, but also with significant financial and regulatory challenges. Most of the ACA’s key components were phased in during or prior to 2014, and the ACA’s temporary Reinsurance and Risk Corridor programs expired at the end of 2016. The effects of existing provisions of the ACA are reflected in our operating results. If the ACA is not amended, repealed or replaced, certain of its components will continue to be phased in until 2020.

If the industry-wide \$14.3 billion 2018 HIF (as currently enacted) is not repealed or suspended, we may not be able to include all of our portion of the 2018 HIF in our premium rates beginning with 2017 medical customer renewals that have member months in 2018, particularly following the temporary suspension of the HIF in 2017.

In October 2017, the federal government announced that CMS will curtail payments related to the Cost-Sharing Subsidy program. While the details regarding implementation of this new policy are not yet finalized, and it is the subject of pending litigation, we do not anticipate a material impact to our financial statements as a result of this action.

The federal and state governments also continue to enact and seriously consider many other broad-based legislative and regulatory proposals that have had a material impact on or could materially impact various aspects of the health care and related benefits system. We cannot predict whether pending or future federal or state legislative or regulatory activity or court proceedings, including Federal budget negotiations and future U.S. Congressional appropriations, will change various aspects of the health care and related benefits system or the ACA or the implementation and/or enforcement of the ACA or the impact those changes will have on our business operations or operating results, but the effects could be materially adverse.

For additional information on the ACA, refer to the “Overview - Health Care Reform,” “Outlook for 2017,” and “Regulatory Environment” sections in Part II, Item 7 of our 2016 Annual Report and “Risk Factors” in Part I, Item 1A of our 2016 Annual Report.

Medicare Update

On April 3, 2017, CMS issued its final notice detailing final 2018 Medicare Advantage benchmark payment rates (the “Final Notice”). Overall, we project the benchmark rates in the Final Notice will increase funding for our Medicare Advantage business by less than one percent in 2018 compared to 2017.

The ACA ties a portion of each Medicare Advantage plan’s reimbursement to the plan’s “star ratings.” Beginning in 2015, plans must have a star rating of four or higher (out of five) to qualify for bonus payments. CMS released our 2018 star ratings in October 2017. Our 2018 star ratings will be used to determine which of our Medicare Advantage plans have

ratings of four stars or higher and qualify for bonus payments in 2019. Based on our membership at September 1, 2017, 87% of our Medicare Advantage members were in plans with 2018 star ratings of at least 4.0 stars, compared to 91% of our Medicare Advantage members being in plans with 2017 star ratings of at least 4.0 stars based on our membership at September 1, 2016.

Management Update

Heather Dixon has been appointed Vice President, Controller and Chief Accounting Officer of Aetna effective November 1, 2017. Ms. Dixon will succeed Sharon A. Virag when Ms. Virag leaves the Company effective November 1, 2017.

Segment Results and Use of Non-GAAP Measures in this Document

The following discussion of operating results is presented based on our reportable segments in accordance with the accounting guidance for segment reporting and is consistent with our segment disclosure included in Note 16. Our operations are conducted in three business segments: Health Care, Group Insurance and Large Case Pensions. Our Corporate Financing segment is not a business segment; it is added to our business segments to reconcile our segment reporting to our consolidated results. The Corporate Financing segment includes transaction and integration-related costs, income taxes, interest expense on our outstanding debt and the financing components of our pension and other postretirement employee benefit plans (“OPEB”) expense (the service cost and prior service cost components of this expense are allocated to our business segments).

Adjusted earnings and pre-tax adjusted earnings discussed in this quarterly report exclude from net income attributable to Aetna and income before income taxes attributable to Aetna reported in accordance with GAAP net realized capital gains or losses, amortization of other acquired intangible assets and other items, if any, that neither relate to the ordinary course of our business nor reflect our underlying business performance. Although the excluded items may recur, we believe excluding them from income before income taxes attributable to Aetna and net income attributable to Aetna to arrive at pre-tax adjusted earnings and adjusted earnings provides a more useful comparison of our underlying business performance from period to period. Net realized capital gains and losses arise from various types of transactions, primarily in the course of managing a portfolio of assets that support the payment of liabilities. Amortization of other acquired intangible assets relates to our acquisition activities. These transactions and amortization do not directly relate to the underwriting or servicing of products for our customers and are not directly related to the core performance of our business operations. Pre-tax adjusted earnings is the measure reported to our chief executive officer for purposes of assessing business segment financial performance and making operating decisions, such as the allocation of resources among our business segments. In each business segment discussion in this MD&A, we provide a table that reconciles income before income taxes attributable to Aetna to pre-tax adjusted earnings. Each table details the net realized capital gains or losses, amortization of other acquired intangible assets and any other items excluded from income before income taxes attributable to Aetna, and the footnotes to each table describe the nature of each other item and the reason we believe it is appropriate to exclude that item from income before income taxes attributable to Aetna. Non-GAAP financial measures we disclose, such as pre-tax adjusted earnings and adjusted earnings, should not be considered a substitute for, or superior to, financial measures determined or calculated in accordance with GAAP.

HEALTH CARE

Health Care consists of medical, pharmacy benefit management services, dental, behavioral health and vision plans offered on both an Insured basis (where we assume all or a majority of the risk for medical and dental care costs) and an employer-funded basis (where the plan sponsor under an administrative services contract (“ASC”) assumes all or a majority of this risk) and emerging businesses products and services that complement and enhance our medical products. We also offer Medicare and Medicaid products and services and other medical products, such as medical management and data analytics services, medical stop loss insurance, workers’ compensation administrative services and products that provide access to our provider networks in select geographies. We separately track premiums and health care costs for Government businesses (which represent our combined Medicare and Medicaid products). All other medical, dental and other Health Care products are referred to as Commercial.

Edgar Filing: AETNA INC /PA/ - Form 10-Q

Operating Summary for the Three and Nine Months Ended September 30, 2017 and 2016:

(Millions)	Three Months Ended September 30,		Nine Months Ended September 30,		Change Three Months Ended September 30, 2017 vs 2016		Change Nine Months Ended September 30, 2017 vs 2016	
	2017	2016	2017	2016	\$	%	\$	%
Premiums:								
Commercial	\$6,043	\$6,952	\$18,419	\$20,967	\$(909)	(13)%	\$(2,548)	(12)%
Government	6,667	6,573	20,733	19,656	94	1%	1,077	5%
Total premiums	12,710	13,525	39,152	40,623	(815)	(6)%	(1,471)	(4)%
Fees and other revenue	1,417	1,425	4,322	4,309	(8)	(1)%	13	—%
Net investment income	111	105	339	333	6	6%	6	2%
Net realized capital gains	26	26	34	51	—	—%	(17)	(33)%
Total revenue	14,264	15,081	43,847	45,316	(817)	(5)%	(1,469)	(3)%
Health care costs:								
Commercial	4,917	5,829	14,688	17,128	(912)	(16)%	(2,440)	(14)%
Government	5,495	5,263	17,217	16,044	232	4%	1,173	7%
Total health care costs	10,412	11,092	31,905	33,172	(680)	(6)%	(1,267)	(4)%
Operating expenses:								
Selling expenses	366	377	1,116	1,150	(11)	(3)%	(34)	(3)%
General and administrative expenses	2,149	2,281	6,485	6,836	(132)	(6)%	(351)	(5)%
Total operating expenses	2,515	2,658	7,601	7,986	(143)	(5)%	(385)	(5)%
Amortization of other acquired intangible assets	58	61	176	187	(3)	(5)%	(11)	(6)%
Total benefits and expenses	12,985	13,811	39,682	41,345	(826)	(6)%	(1,663)	(4)%
Income before income taxes including non-controlling interests	1,279	1,270	4,165	3,971	9	1%	194	5%
Less: Income (loss) before income taxes attributable to non-controlling interests	14	(9)	(7)	(4)	23	(256)%	(3)	75%
Income (loss) before income taxes attributable to Aetna for Health Care	\$1,265	\$1,279	\$4,172	\$3,975	\$(14)	(1)%	\$197	5%

We calculate our medical benefit ratio MBRs by dividing health care costs by health care premiums. For the three and nine months ended September 30, 2017 and 2016, our Commercial, Government and Total Health Care MBRs were:

	Three Months Ended September 30,		Nine Months Ended September 30,		Change Three Months Ended September 30, 2017 vs 2016		Change Nine Months Ended September 30, 2017 vs 2016	
	2017	2016	2017	2016	basis points	basis points		
Commercial	81.4 %	83.8 %	79.7 %	81.7 %	(240)	(200)		
Government	82.4 %	80.1 %	83.0 %	81.6 %	230	140		

Total Health Care 81.9 % 82.0 % 81.5 % 81.7 % (10) (20)

The table presented below reconciles income before income taxes to pre-tax adjusted earnings ⁽¹⁾ for our Health Care segment for the three and nine months ended September 30, 2017 and 2016:

(Millions)	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Income before income taxes (GAAP measure)	\$1,279	\$1,270	\$4,165	\$3,971
Less: Income (loss) before income taxes attributable to non-controlling interests (GAAP measure)	14	(9)	(7)	(4)
Income before income taxes attributable to Aetna for Health Care (GAAP measure)	1,265	1,279	4,172	3,975
Penn Treaty-related guaranty fund assessments	—	—	231	—
Amortization of other acquired intangible assets	58	61	176	187
Net realized capital gains	(26)	(26)	(34)	(51)
Pre-tax adjusted earnings for Health Care	\$1,297	\$1,314	\$4,545	\$4,111

(1) Pre-tax adjusted earnings excludes net realized capital gains and losses, amortization of other acquired intangible assets and the other item described in the reconciliation in Note 16.

Commentary - Three Months Ended September 30, 2017 vs 2016

Income before income taxes attributable to Aetna for Health Care and pre-tax adjusted earnings for Health Care remained relatively consistent for the three months ended September 30, 2017 compared to the corresponding period in 2016. The third quarter of 2017 reflects continued strong performance across our core Health Care businesses and reduced losses in our individual Commercial products, which offset the negative impact of the temporary suspension of the HIF in 2017.

Commercial premiums decreased \$909 million for the three months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to lower membership in our ACA compliant individual and small group products and the temporary suspension of the HIF in 2017, partially offset by higher premium yields.

Our Commercial MBR decreased 240 basis points for the three months ended September 30, 2017 compared to the corresponding period in 2016. The decrease was primarily due to reduced losses in our individual Commercial products and improved performance across our core Commercial business, partially offset by the unfavorable impact of the temporary suspension of the HIF in 2017.

Government premiums increased \$94 million for the three months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to membership growth in our Medicare products and higher premium yields, partially offset by membership declines in our Medicaid products and the temporary suspension of the HIF in 2017.

Our Government MBR increased 230 basis points for the three months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to the unfavorable impact of the temporary suspension of the HIF in 2017.

General and administrative expenses decreased by \$132 million primarily due to the temporary suspension of the HIF in 2017 and the continued execution of our expense management initiatives, largely offset by targeted investment spending on our growth initiatives, which we expect to continue during the remainder of 2017.

Commentary - Nine Months Ended September 30, 2017 vs 2016

Income before income taxes attributable to Aetna for Health Care increased \$197 million during the nine months ended September 30, 2017 compared to the corresponding period in 2016. The increase was primarily due to the increase in pre-tax adjusted earnings described below, partially offset by the nine months ended September 30, 2017 reflecting a \$231 million pre-tax expense related to estimated future guaranty fund assessments as a result of Penn Treaty Network America Insurance Company and one of its subsidiaries (collectively, "Penn Treaty") being placed in

liquidation in March 2017.

Pre-tax adjusted earnings for Health Care increased \$434 million for the nine months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to continued strong performance across our core Health Care businesses and reduced losses in our individual Commercial products, which more than offset the negative impact of the temporary suspension of the HIF in 2017.

Page 47

Commercial premiums decreased \$2.5 billion for the nine months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to lower membership in our ACA compliant individual and small group products and the temporary suspension of the HIF in 2017, partially offset by higher premium yields.

Our Commercial MBR decreased 200 basis points for the nine months ended September 30, 2017 compared to the corresponding period in 2016. The decrease was primarily due to reduced losses in our individual Commercial products and improved performance across our core Commercial business, partially offset by the unfavorable impact of the temporary suspension of the HIF in 2017.

Government premiums increased \$1.1 billion for the nine months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to membership growth in our Medicare products and higher premium yields, partially offset by the temporary suspension of the HIF in 2017 and membership declines in our Medicaid products.

Our Government MBR increased 140 basis points for the nine months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to the unfavorable impact of the temporary suspension of the HIF in 2017, partially offset by improved performance in our Medicaid products.

General and administrative expenses decreased by \$351 million primarily due to the temporary suspension of the HIF in 2017 and the continued execution of our expense management initiatives, largely offset by the expense recorded during the nine months ended September 30, 2017 for estimated future guaranty fund assessments related to Penn Treaty and targeted investment spending on our growth initiatives, which we expect to continue during the remainder of 2017.

Membership

Health Care's membership at September 30, 2017 and 2016 was:

(Thousands)	2017		2016		Change				
	Insured	ASC	Total	Insured	ASC	Total	Insured	ASC	Total
Medical:									
Commercial	4,584	13,470	18,054	5,596	13,064	18,660	(1,012)	406	(606)
Medicare Advantage	1,467	—	1,467	1,364	—	1,364	103	—	103
Medicare Supplement	733	—	733	667	—	667	66	—	66
Medicaid ⁽¹⁾	1,311	600	1,911	1,629	801	2,430	(318)	(201)	(519)
Total Medical Membership	8,095	14,070	22,165	9,256	13,865	23,121	(1,161)	205	(956)

Dental:

Total Dental Membership	5,538	7,930	13,468	5,940	8,393	14,333	(402)	(463)	(865)
-------------------------	-------	-------	--------	-------	-------	--------	-------	-------	-------

Pharmacy:

Commercial			7,994			9,610			(1,616)
Medicare PDP (stand-alone)			2,074			2,031			43
Medicare Advantage PDP			1,124			952			172
Medicaid ⁽¹⁾			2,493			2,719			(226)
Total Pharmacy Benefit Management Services Membership			13,685			15,312			(1,627)

⁽¹⁾ Medicaid membership includes members who are dually-eligible for both Medicare and Medicaid.

Commentary

Total medical membership at September 30, 2017 decreased 956 thousand members compared to September 30, 2016, primarily reflecting declines in our ACA compliant individual and small group and Medicaid products. The decrease was partially offset by increases in our Commercial ASC, International Commercial Insured and Medicare Insured products.

- Total dental membership at September 30, 2017 decreased 865 thousand members compared to September 30, 2016 due to declines in both our dental Insured and ASC products.

Total pharmacy benefit management services membership at September 30, 2017 decreased 1.6 million members compared to September 30, 2016, primarily reflecting declines in our Commercial business primarily attributable to our ACA compliant individual and small group products and declines in our Medicaid products.

GROUP INSURANCE

Group Insurance primarily includes group life insurance and group disability products. Group life insurance products are offered on an Insured basis. Group disability products are offered to employers on both an Insured and an ASC basis. Group Insurance also includes long-term care products that were offered primarily on an Insured basis. We no longer solicit or accept new long-term care customers.

Operating Summary for the Three and Nine Months Ended September 30, 2017 and 2016:

(Millions)	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2017		Change Three Months Ended September 30, 2017 vs 2016		Change Nine Months Ended September 30, 2017 vs 2016	
	2017	2016	2017	2016	\$	%	\$	%
Premiums:								
Life	\$294	\$285	\$871	\$856	\$9	3 %	\$15	2 %
Disability	248	241	719	715	7	3 %	4	1 %
Long-term care	10	11	32	33	(1)	(9) %	(1)	(3) %
Total premiums	552	537	1,622	1,604	15	3 %	18	1 %
Fees and other revenue	24	27	76	79	(3)	(11) %	(3)	(4) %
Net investment income	55	52	179	172	3	6 %	7	4 %
Net realized capital gains	19	5	36	25	14	280 %	11	44 %
Total revenue	650	621	1,913	1,880	29	5 %	33	2 %
Current and future benefits	478	474	1,411	1,394	4	1 %	17	1 %
Operating expenses:								
Selling expenses	35	31	108	95	4	13 %	13	14 %
General and administrative expenses	84	89	249	262	(5)	(6) %	(13)	(5) %
Total operating expenses	119	120	357	357	(1)	(1) %	—	— %
Total benefits and expenses	597	594	1,768	1,751	3	1 %	17	1 %
Income before income taxes attributable to Aetna for Group Insurance	\$53	\$27	\$145	\$129	\$26	96 %	\$16	12 %

We calculate our group benefit ratio by dividing current and future benefits by total premiums. Our group benefit ratios were:

Three Months Ended September 30, 2017	Nine Months Ended September 30, 2017	Change	
		Three Months Ended September 30, 2017 vs 2016	Nine Months Ended September 30, 2017 vs 2016

Edgar Filing: AETNA INC /PA/ - Form 10-Q

				vs	2016
				2016	
	2017	2016	2017	2016	basis basis
					points points
Group benefit ratio	86.6 %	88.3 %	87.0 %	86.9 %	(170) 10

The table presented below reconciles income before income taxes attributable to Aetna to pre-tax adjusted earnings ⁽¹⁾ for the three and nine months ended September 30, 2017 and 2016 for our Group Insurance segment:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	2017	2016	2017	2016
Income before income taxes attributable to Aetna for Group Insurance (GAAP measure)	\$53	\$27	\$145	\$129
Net realized capital gains	(19)	(5)	(36)	(25)
Pre-tax adjusted earnings for Group Insurance	\$34	\$22	\$109	\$104

⁽¹⁾ Pre-tax adjusted earnings excludes net realized capital gains and losses.

Commentary - Three Months Ended September 30, 2017 vs 2016

Total revenue increased \$29 million for the three months ended September 30, 2017 compared to the corresponding period in 2016 primarily due to higher premiums in our life and disability products and higher net realized capital gains in the three months ended September 30, 2017 compared to 2016.

Income before income taxes attributable to Aetna for Group Insurance increased \$26 million for the three months ended September 30, 2017 compared to the corresponding period in 2016. Pre-tax adjusted earnings for Group Insurance increased \$12 million for the three months ended September 30, 2017 compared to the corresponding period in 2016. Income before income taxes and pre-tax adjusted earnings increased primarily due to higher underwriting margins in our disability products, partially offset by lower underwriting margins in our life products. The increase in income before taxes also reflects higher net realized capital gains in the three months ended September 30, 2017 compared to 2016.

Our group benefit ratio decreased 170 basis points for the three months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to higher underwriting margins in our disability products, partially offset by lower underwriting margins in our life products.

Commentary - Nine Months Ended September 30, 2017 vs 2016

Total revenue increased \$33 million for the nine months ended September 30, 2017 compared to the corresponding period in 2016 primarily due to higher premiums in our life products and higher net realized capital gains in the nine months ended September 30, 2017 compared to 2016.

Income before income taxes attributable to Aetna for Group Insurance increased \$16 million for the nine months ended September 30, 2017 compared to the corresponding period in 2016. Pre-tax adjusted earnings for Group Insurance increased \$5 million for the nine months ended September 30, 2017 compared to the corresponding period in 2016. Income before income taxes and pre-tax adjusted earnings increased primarily due to higher underwriting margins in our disability products, partially offset by lower underwriting margins in our life products. The increase in income before income taxes also reflects higher net realized capital gains in the nine months ended September 30, 2017 compared to 2016.

Our group benefit ratio increased 10 basis points for the nine months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to lower underwriting margins in our life products, substantially offset by higher underwriting margins in our disability products.

LARGE CASE PENSIONS

Large Case Pensions manages a variety of retirement products (including pension and annuity products) primarily for tax-qualified pension plans. These products provide a variety of funding and benefit payment distribution options and other services. The Large Case Pensions segment includes certain discontinued products.

Operating Summary for the Three and Nine Months Ended September 30, 2017 and 2016:

(Millions)	Three Months Ended September 30,		Nine Months Ended September 30,		Change Three Months Ended September 30, 2017 vs 2016		Nine Months Ended September 30, 2017 vs 2016	
	2017	2016	2017	2016	\$	%	\$	%
Premiums	\$ 10	\$ 12	\$ 36	\$ 32	\$(2)	(17)%	\$ 4	13 %
Net investment income	67	53	201	171	14	26 %	30	18 %
Other revenue	2	2	6	7	—	— %	(1)	(14)%
Net realized capital gains	1	3	4	9	(2)	(67)%	(5)	(56)%
Total revenue	80	70	247	219	10	14 %	28	13 %
Current and future benefits	70	61	221	195	9	15 %	26	13 %
General and administrative expenses	4	3	9	9	1	33 %	—	— %
Reduction of reserve for anticipated future losses on discontinued products	—	—	(109)	(128)	—	— %	19	(15)%
Total benefits and expenses	74	64	121	76	10	16 %	45	59 %
Income before income tax expense including non-controlling interests	6	6	126	143	—	— %	(17)	(12)%
Less: Income (loss) before income taxes attributable to non-controlling interests	—	—	1	(1)	—	— %	2	(200)%
Income before income taxes attributable to Aetna for Large Care Pensions	\$ 6	\$ 6	\$ 125	\$ 144	\$—	— %	\$(19)	(13)%

The table presented below reconciles income before income taxes to pre-tax adjusted earnings ⁽¹⁾ for the three and nine months ended September 30, 2017 and 2016 for our Large Case Pensions segment:

(Millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Income before income taxes for Large Case Pensions (GAAP measure)	\$ 6	\$ 6	\$ 126	\$ 143
Less: Income (loss) before income taxes attributable to non-controlling interests (GAAP measure)	—	—	1	(1)
Income before income taxes attributable to Aetna for Large Case Pensions (GAAP measure)	6	6	125	144
Reduction of reserve for anticipated future losses on discontinued products	—	—	(109)	(128)
Net realized capital gains	(1)	(3)	(4)	(9)
Pre-tax adjusted earnings for Large Case Pensions	\$ 5	\$ 3	\$ 12	\$ 7

- (1) Pre-tax adjusted earnings excludes net realized capital gains and losses and the other item described in the reconciliation in Note 16.

Commentary - Three Months Ended September 30, 2017 vs 2016

Total revenue increased \$10 million for the three months ended September 30, 2017 compared to the corresponding period in 2016 primarily due to higher net investment income.

Income before income taxes attributable to Aetna for Large Care Pensions and pre-tax adjusted earnings both remained relatively flat for the three months ended September 30, 2017 compared to the corresponding period in 2016.

Commentary - Nine Months Ended September 30, 2017 vs 2016

Total revenue increased by \$28 million for the nine months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to higher net investment income.

Income before income taxes attributable to Aetna for Large Case Pensions decreased by \$19 million for the nine months ended September 30, 2017 compared to the corresponding period in 2016 primarily due to a larger reduction of our reserve for anticipated future losses on discontinued products in 2016 compared to 2017.

Pre-tax adjusted earnings for Large Case Pensions increased by \$5 million for the nine months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to favorable mortality experience and higher net investment income in the non-experience-rated business.

Discontinued Products

Prior to 1993, we sold single-premium annuities (“SPAs”) and guaranteed investment contracts (“GICs”), primarily to employer sponsored pension plans. In 1993, we discontinued selling these products to Large Case Pensions customers, and now we refer to these products as discontinued products. In November 2016, the last outstanding GIC matured. We discontinued selling these products because they were generating losses for us, and we projected that they would continue to generate losses over their life (which is currently greater than 30 years); so we established a reserve for anticipated future losses at the time of discontinuance.

The operating summary for Large Case Pensions above includes revenues and expenses related to our discontinued products, with the exception of net realized capital gains and losses which are recorded as part of current and future benefits. Since we established a reserve for anticipated future losses on discontinued products, as long as our expected future losses remain consistent with prior projections, the results of our discontinued products are applied against the reserve and do not impact net income attributable to Aetna. If actual or expected future losses are greater than we currently estimate, we may increase the reserve, which could adversely impact net income attributable to Aetna. If actual or expected future losses are less than we currently estimate, we may decrease the reserve, which could favorably impact net income attributable to Aetna. In those cases, we disclose such adjustment separately in the operating summary. Management reviews the adequacy of the discontinued products reserve quarterly. As a result of this review, we released \$71 million (\$109 million pretax) and \$84 million (\$128 million pretax) of the reserve in the nine months ended September 30, 2017 and 2016, respectively. The reserve release during the nine months ended September 30, 2017 was primarily due to favorable mortality experience compared to assumptions we previously made in estimating the reserve. In addition, the reserve release in the nine months ended September 30, 2017 and 2016 also reflects favorable retirement experience as well as favorable investment performance compared to assumptions we previously made in estimating the reserve. The current reserve reflects management’s best estimate of anticipated future losses, and is included in future policy benefits on our Balance Sheets.

Refer to Note 17 for additional information on the activity in the reserve for anticipated future losses on discontinued products during the three and nine months ended September 30, 2017 and 2016.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows

We meet our operating cash requirements by maintaining liquidity in our investment portfolio, using overall cash flows from premiums, fees and other revenue, deposits and income received on investments, issuing commercial paper, entering into repurchase agreements and obtaining cash advances from the Federal Home Loan Bank of Boston (“FHLBB”) from time to time. We monitor the duration of our investment portfolio of highly marketable debt securities and mortgage loans, and execute purchases and sales of these investments with the objective of having adequate funds available to satisfy our maturing liabilities. Overall cash flows are used primarily for claim and benefit payments, operating expenses, share and debt repurchases, repayment of debt, acquisitions, contract withdrawals and shareholder dividends. We have committed short-term borrowing capacity of \$2.0 billion through a revolving credit facility agreement that expires in March 2021.

Presented below is a condensed Statement of Cash Flows for the nine months ended September 30, 2017 and 2016. We present net cash flows used for operating activities and net cash flows provided by investing activities separately for our Large Case Pensions segment because changes in the insurance reserves for the Large Case Pensions segment (which are reported as cash used for operating activities) are funded from the sale of investments (which are reported as cash provided by investing activities). Refer to the Consolidated Statements of Cash Flows for additional information.

(Millions)	Nine Months Ended		Change	
	September 30, 2017	2016	\$	%
Cash flows from operating activities				
Health Care and Group Insurance	\$2,420	\$4,807	\$(2,387)	(50)%
Large Case Pensions	(196)	(186)	(10)	5%
Net cash provided by operating activities	2,224	4,621	(2,397)	(52)%
Cash flows from investing activities				
Health Care and Group Insurance	478	(514)	992	(193)%
Large Case Pensions	191	188	3	2%
Net cash provided by (used for) investing activities	669	(326)	995	(305)%
Net cash (used for) provided by financing activities	(14,961)	12,247	(27,208)	(222)%
Net (decrease) increase in cash and cash equivalents	\$(12,068)	\$16,542	\$(28,610)	(173)%

Commentary

Cash flows provided by operating activities for Health Care and Group Insurance decreased \$2.4 billion during the nine months ended September 30, 2017 compared to the corresponding period in 2016. During 2017, cash payments associated with the termination of the Merger Agreement were largely offset by an advance payment for Medicare premium receipts in September 2017. The remaining decrease was primarily due to the timing of collection of receivables and a decrease in our health care and insurance liabilities primarily due to lower membership and changes in business mix, primarily related to the decline in our Individual Commercial product membership and the increase in our Medicare product membership.

Cash flows provided by investing activities increased \$995 million for the nine months ended September 30, 2017 compared to the corresponding period in 2016, primarily due to net sales and maturities of investments for the nine months ended September 30, 2017 compared with net purchases of investments for the nine months ended September 30, 2016.

Cash flows used for financing activities were \$15.0 billion for the nine months ended September 30, 2017 compared with cash flows provided by financing activities of \$12.2 billion for the nine months ended September 30, 2016. The activity for the nine months ended September 30, 2017 reflects the repayment of long-term debt (including the \$10.2 billion principal amount Special Mandatory Redemption Notes), share repurchases, the issuance of long-term debt and dividends paid to shareholders. The activity for the nine months ended September 30, 2016 reflects the issuance of long-term debt, net payment on interest rate derivatives and dividends paid to shareholders.

Refer to Notes 9 and 11 for more information about debt issuances, debt repayments, share repurchases and dividend payments.

Termination of Merger Agreement and Aetna APA

As a result of the termination of the Merger Agreement, we paid Humana the applicable \$1.0 billion Regulatory Termination Fee on February 16, 2017. As a result of the APA Termination Agreement, we paid Molina the applicable termination fee of \$53 million on February 16, 2017 and paid Molina the applicable transaction costs of \$7 million on February 27, 2017. We funded these payments with the proceeds of the 2016 senior notes.

2016 Senior Notes

In June 2016, we issued \$13 billion of 2016 senior notes. In accordance with the terms of the 2016 senior notes, on February 14, 2017, following the termination of the Merger Agreement, we issued a notice of redemption for the entire \$10.2 billion aggregate principal amount of the Special Mandatory Redemption Notes at a redemption price equal to 101% of the aggregate principal amount of those notes plus accrued and unpaid interest. We redeemed the

Special Mandatory Redemption Notes on March 16, 2017, and we funded the redemption with the proceeds of the 2016 senior notes. As a result of the redemption, we recognized on a pretax basis in our net income a loss on early extinguishment of long-term debt of \$192 million and a realized capital loss for the remaining unamortized effective portion of the related hedge loss of \$323 million that was previously recorded in accumulated other comprehensive income. Refer to Notes 3 and 9 for additional information on these transactions.

2017 Senior Notes

In August 2017, we issued \$1.0 billion of 3.875% senior notes due 2047. We intend to use the net proceeds of this offering to repay a portion of our 1.5% senior notes due in November 2017, repay a portion of our floating rate senior notes due in December 2017 and for general corporate purposes.

Other Liquidity Information

From time to time, we use short-term commercial paper borrowings, repurchase agreements and cash advances from the FHLBB to address timing differences between cash receipts and disbursements. At both September 30, 2017 and December 31, 2016, we did not have any commercial paper outstanding or outstanding advances from the FHLBB. The maximum amount of commercial paper borrowings outstanding during the nine months ended September 30, 2017 was approximately \$850 million.

Our total debt to consolidated capitalization ratio (calculated as the sum of all short- and long-term debt outstanding (“total debt”) divided by the sum of total Aetna shareholders’ equity plus total debt) was 39.5 percent at September 30, 2017. Our total debt to consolidated capitalization ratio at September 30, 2017 reflects the issuance of \$1.0 billion aggregate principal amount of senior notes during the third quarter of 2017 to pre-fund debt maturities of approximately \$1.0 billion coming due in the fourth quarter of 2017. We continually monitor existing and alternative financing sources to support our capital and liquidity needs, including, but not limited to, debt issuance, preferred or common stock issuance, reinsurance and pledging or selling of assets.

Interest expense was \$90 million and \$349 million for the three and nine months ended September 30, 2017, respectively and \$189 million and \$414 million for the three and nine months ended September 30, 2016, respectively. The decrease in interest expense during the three and nine months ended September 30, 2017 compared to 2016 is primarily due to a lower long-term debt balance during 2017 compared to 2016 due to the repayment of certain of our long-term debt subsequent to September 30, 2016, partially offset by additional interest expense associated with the issuance of \$1.0 billion of senior notes in August 2017.

Refer to Notes 9 and 11 for information on our FHLBB membership and our stock-based compensation awards granted during 2017, respectively.

The State of Illinois has experienced budget difficulties which have contributed to the state being delinquent in paying certain of our premiums and fees. At September 30, 2017, the total amount due to Aetna was approximately \$828 million. In July 2017, the State of Illinois passed a budget. Given the state’s progress towards obtaining funding, a federal judge’s ruling that prioritizes Medicaid payments and the federal government’s match of a percentage of payments made by the state to managed care organizations under the state’s Medicaid program, we continue to believe the amounts due to us are collectible.

Contractual Obligations

The following table summarizes certain estimated future obligations by period under certain of our contractual obligations at September 30, 2017. The table below does not include all future obligations by period; it only includes those future obligations that have changed materially from those presented in our 2016 Annual Report as a result of the redemption of the \$10.2 billion aggregate principal amount of the Special Mandatory Redemption Notes, the redemption of the \$750 million aggregate principal amount of the 2020 Notes in March 2017 and the issuance of \$1.0 billion aggregate principal amount of senior notes due 2047 in August 2017. We believe that funds from future operating cash flows, together with cash, investments and other funds available under the Facility; from the FHLBB; and from public or private financing sources, will be sufficient to meet our existing commitments as well as our liquidity needs associated with future operations, including our strategic growth initiatives.

(Millions)	2017	2018-2019	2020-2021	Thereafter	Total
------------	------	-----------	-----------	------------	-------

Long-term debt obligations, including interest \$1,152 \$ 2,061 \$ 1,736 \$ 10,510 \$15,459

Form 10-Q Table of Contents

CRITICAL ACCOUNTING ESTIMATES

Refer to “Critical Accounting Estimates” in our 2016 Annual Report for information on accounting policies that we consider critical in preparing our consolidated financial statements. These policies include significant estimates we make using information available at the time the estimates are made. However, these estimates could change materially if different information or assumptions were used, and these estimates may not ultimately reflect the actual amounts that occur.

REGULATORY ENVIRONMENT

Except as described in the “Health Care Reform” section of the MD&A, there were no material changes in the regulation of our business since December 31, 2016. Refer to the “Regulatory Environment” section in our 2016 Annual Report for information on the regulation of our business.

FORWARD-LOOKING INFORMATION

Certain information in this MD&A is forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to uncertainties that are outside our control and could cause actual future results to differ materially from those statements. You should not place undue reliance on forward-looking statements, and we disclaim any intention or obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our earnings and financial position are exposed to interest rate risk, credit quality risk and market valuation risk.

For a discussion of these risks, refer to Item 7A “Quantitative and Qualitative Disclosures About Market Risk” included in our 2016 Annual Report on form 10-K. The market risk information below does not include all market risks; it only includes the market risks that have changed materially from those presented in our 2016 Annual Report as a result of the redemption of the \$10.2 billion aggregate principal amount of the Special Mandatory Redemption Notes, the redemption of the \$750 million aggregate principal amount of the 2020 Notes in March 2017 and the issuance of \$1.0 billion aggregate principal amount of senior notes due 2047 in August 2017.

Evaluation of Market Risks

We regularly evaluate our risk from market-sensitive instruments by examining, among other things, levels of or changes in interest rates (short-term or long-term), duration, prepayment rates, equity markets or credit ratings/spreads. We also regularly evaluate the appropriateness of investments relative to our management-approved investment guidelines (and operate within those guidelines) and the business objectives of our portfolios.

On a quarterly basis, we review the impact of hypothetical net losses in our investment portfolio on our consolidated near-term financial position, operating results and cash flows assuming the occurrence of certain reasonably possible changes in near-term market rates and prices. Interest rate changes (whether resulting from changes in treasury yields or credit spreads or other factors) represent the most material risk exposure category for us. In March 2017, following the termination of the Merger Agreement, we redeemed \$10.2 billion aggregate principal amount of the Special Mandatory Redemption Notes and also redeemed \$750 million aggregate principal amount of the 2020 Notes. In August 2017, we issued \$1.0 billion of 3.875% senior notes due 2047. We have estimated the impact on the fair value of our market sensitive instruments based on the net present value of cash flows using a representative set of likely future interest rate scenarios. The assumptions used were as follows: an immediate increase of 100 basis points in interest rates (which we believe represents a moderately adverse scenario and is approximately equal to the historical annual volatility of interest rate movements for our intermediate-term available-for-sale debt securities) and an

immediate decrease of 15% in prices for domestic equity securities.

Assuming an immediate 100 basis point increase in interest rates and immediate decrease of 15% in the prices for domestic equity securities, the theoretical decline in the fair values of our market sensitive instruments at September 30, 2017 is as follows:

The fair value of our long-term debt would decline by \$541 million (\$832 million pretax). Changes in the fair value of our long-term debt do not impact our financial position or operating results.

The theoretical reduction in the fair value of our investment securities partially offset by the theoretical reduction in the fair value of our interest rate sensitive liabilities would result in a net decline in fair value of \$300 million (\$462 million pretax) related to our continuing non-experience-rated products. Reductions in the fair value of our investment

Form 10-Q Table of Contents

securities would be reflected as an unrealized loss in equity, as we classify these securities as available for sale. We do not record our liabilities at fair value.

Based on our overall exposure to interest rate risk and equity price risk, we believe that these changes in market rates and prices would not materially affect our consolidated near-term financial position, operating results or cash flows at September 30, 2017.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain disclosure controls and procedures, which are designed to ensure that information that we are required to disclose in the reports we file or submit under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

An evaluation of the effectiveness of our disclosure controls and procedures as of September 30, 2017 was conducted under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures as of September 30, 2017 were designed to ensure that material information relating to Aetna Inc. and its consolidated subsidiaries would be made known to the Chief Executive Officer and Chief Financial Officer by others within those entities, particularly during the periods when periodic reports under the Exchange Act are being prepared and were effective. Refer to the Certifications by our Chief Executive Officer and Chief Financial Officer filed as Exhibits 31.1 and 31.2 to this Quarterly Report on Form 10-Q.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting identified in connection with the evaluation of such control that occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

The information contained in Note 15 of Condensed Notes to Consolidated Financial Statements is incorporated herein by reference.

Item 1A. Risk Factors

Except as disclosed in MD&A “Overview - Health Care Reform” in this Quarterly Report, there have been no material changes to the “Risk Factors” disclosed in Part I, Item 1A of our 2016 Annual Report. Those risk factors could adversely affect our business, financial condition and operating results as well as the market price for our common shares.

Form 10-Q Table of Contents

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information about our monthly share repurchases, all of which were purchased as part of a publicly-announced program, for the three months ended September 30, 2017:

Issuer Purchases of Equity Securities

(Millions, except per share amounts)	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
July 1, 2017 - July 31, 2017	—	\$—	—	\$ 1,783
August 1, 2017 - August 31, 2017 ⁽¹⁾	4.8	147.17	4.8	1,446
September 1, 2017 - September 30, 2017	1.3	160.85	1.3	1,238
Total	6.1	\$ 150.06	6.1	N/A

On February 22, 2017, we entered into accelerated share repurchase (“ASR”) agreements with two unrelated third party financial institutions to repurchase an aggregate of \$3.3 billion of our common shares. Under the terms of the ASR agreements, we made an approximately \$1.7 billion payment to each unrelated third party financial institution on February 22, 2017 and received from each of them an initial delivery of approximately 10.4 million of our ⁽¹⁾common shares on the same day, which represented approximately 80 percent of the total common shares expected to be repurchased under the ASR agreements based on the closing price of \$126.34 per share on the day before we entered into the ASR agreements. In August 2017, we settled the ASR agreements and received approximately 2.7 million of our common shares based on the volume-weighted average share price of our common shares during the term of the applicable transaction, less a discount. The average price of our common shares repurchased under the ASR agreements was \$140.09 per share.

The information contained in Note 11 of Condensed Notes to Consolidated Financial Statements is incorporated herein by reference.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

None.

Form 10-Q Table of Contents

Item 6. Exhibits

Exhibits to this Form 10-Q are as follows:

- 4 Instruments defining the rights of security holders, including indentures
 - 4.1 Supplemental Indenture dated as of August 10, 2017 between Aetna Inc. and U.S. Bank National Association, as successor-in-interest to State Street Bank and Trust Company, as trustee, establishing and designating the 2017 Senior Notes, incorporated herein by reference to Exhibit 4.1 to Aetna Inc.'s Form 8-K filed on August 10, 2017.
- 11 Statement re: computation of per share earnings
 - 11.1 "Computation of per share earnings" is incorporated herein by reference to Note 13 of Condensed Notes to Consolidated Financial Statements in this Form 10-Q.
- 12 Statements re: computation of ratios
 - 12.1 Computation of ratio of earnings to fixed charges.
- 15 Letter re: unaudited interim financial information
 - 15.1 Letter from KPMG LLP acknowledging awareness of the use of a report dated October 31, 2017 related to their review of interim financial information.
- 31 Rule 13a-14(a)/15d-14(a) Certifications
 - 31.1 Certification.
 - 31.2 Certification.
- 32 Section 1350 Certifications
 - 32.1 Certification.
 - 32.2 Certification.
- 101 XBRL Documents
 - 101.INS XBRL Instance Document.
 - 101.SCH XBRL Taxonomy Extension Schema.
 - 101.CAL XBRL Taxonomy Extension Calculation Linkbase.
 - 101.DEF XBRL Taxonomy Extension Definition Linkbase.
 - 101.LAB XBRL Taxonomy Extension Label Linkbase.
 - 101.PRE XBRL Taxonomy Extension Presentation Linkbase.

* Management contract or compensatory plan or arrangement.

Page 58

Form 10-Q Table of Contents

INDEX TO EXHIBITS

Exhibit Number	Filing Description	Method
12	Statements re: computation of ratios	
12.1	<u>Computation of ratio of earnings to fixed charges.</u>	Electronic
15	Letter re: unaudited interim financial information	
15.1	<u>Letter from KPMG LLP acknowledging awareness of the use of a report dated October 31, 2017 related to their review of interim financial information.</u>	Electronic
31	Rule 13a-14(a)/15d-14(a) Certifications	
31.1	<u>Certification.</u>	Electronic
31.2	<u>Certification.</u>	Electronic
32	Section 1350 Certifications	
32.1	<u>Certification.</u>	Electronic
32.2	<u>Certification.</u>	Electronic
101	XBRL Documents	
101.INS	XBRL Instance Document.	Electronic
101.SCH	XBRL Taxonomy Extension Schema.	Electronic
101.CAL	XBRL Taxonomy Extension Calculation Linkbase.	Electronic
101.DEF	XBRL Taxonomy Extension Definition Linkbase.	Electronic
101.LAB	XBRL Taxonomy Extension Label Linkbase.	Electronic
101.PRE	XBRL Taxonomy Extension Presentation Linkbase.	Electronic

Form 10-Q Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Aetna Inc.
Registrant

Date: October 31, 2017 By/s/ Sharon A. Virag
Sharon A. Virag
Vice President, Controller and
Chief Accounting Officer

Page 60