SUPPLEMENTAL REPORT TO THE PENNSYLVANIA INSURANCE DEPARTMENT CONCERNING THE APPLICATIONS OF BLUE CROSS PLANS FOR THE APPROVAL OF RESERVES AND SURPLUS

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October 29, 2004

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Supplemental Report

I. Introduction

This Supplemental Report responds to comments submitted to the Pennsylvania Insurance Department by Applicants and Commentators subsequent to the submission of my main report on September 23, 2004.[1] It also provides additional detail on certain points previously addressed. Except as required for clarity, I try not to duplicate my initial report (IMR) in the text found below. I hereby re-adopt and incorporate my main report by reference.[2]

II. The Applicants Have Still Not Presented Their Statutory Surpluses on a Consolidated Enterprise Basis in This Proceeding.

The Applicants are the parent companies of four fully integrated holding companies. The subsidiaries, depicted in Schedule Y of each Applicant's Annual Statement, are largely, but not entirely, insuring entities. The subsidiaries are licensed to sell a range of insurance products including but not limited to HMO, life, property, casualty and dental care. The insurance subsidiaries are domiciled in Pennsylvania and more than a dozen other states from California to Delaware. With minor exception, the insuring subsidiaries are exclusively owned and legally controlled by the four parent companies. Within their respective holding company groups, the

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[1] Except as otherwise indicated, references will be to the reports issued by Capital BlueCross (CBC) dated October 8, 2004; Independence Blue Cross (IBC) dated October 4, 2004; Highmark Inc. (Highmark) dated October 8, 2004; Milliman Co. (Milliman) dated October 8, 2004; Sherlock Co. (Sherlock) dated October 8, 2004, the Pennsylvania Medical Society (PMS) dated September 24, 2004, and IMR Health Economics (IMR) dated September 23, 2004.

[2] The following summary of key facts and opinions regarding minimum and maximum surplus levels (as set forth in my main report) were substantially un-rebutted by the Applicants.

1. A Parent Company Only financial format provides an incomplete and potentially misleading picture of capital adequacy (Page 3);
2. A Consolidated Company format is the only way for the Department to obtain a comprehensive and adequate picture of the applicants' financial strength (Page 2);
3. An individualized consideration of inter-company financial relationships and financial flows would greatly assist the Department analyze surplus requirements (Page 3);
4. The Department's authority for approving surpluses is grounded in its obligation to disapprove rates which are excessive, inadequate or unfairly discriminatory (Page 7);
5. The combined surplus reported by the Plans in their applications was $3.96 billion as of 12-31-03 (Page 7);
6. No Plan has documented the assumptions, data or methods underpinning the proposed 375% ACL threshold (lower bound) surplus level (Pages 6-7);
7. The Plans have proposed the following upper bound surplus levels: IBC, 25% of claims and expenses (equivalent to 865% ACL); Highmark, 650-950% ACL; NEPA, 750-850% ACL; CBC, no recommendation (Page 7);
8. Proposed upper bound targets would exceed current levels by 50% (Page 8);
9. Applicants' Surplus has grown steadily over the period 1990-2003 notwithstanding substantial annual and cumulative multi-year losses (Page 8);
10. Significant information relating to surplus targets (e.g. RBC Reports, business plans, risk assessment models) has not been made available to the public. Nor does the Department have all the information it would need to properly evaluate surplus targets (Page 10);
11. Standby authority for PID to temporarily increase lower bound surplus levels could offer additional protection (Page 13);
12. High premiums driven by excessive levels of surplus adversely affect policyholders and the public in various ways (Page 15).

parents and subsidiaries make available to each other a considerable range of business services. They also engage in numerous intra-group financial transactions. Among them, the insuring entities supply one another administrative and marketing support, entry to new geographic and product markets (e.g. through access to existing insurance company licenses), real estate and facilities, capital, credit and financial guarantees, reinsurance, tax allocation and asset management.

The holding company structure is integral to each Applicant's core business strategy.[3] For instance, the integration of for-profit subsidiaries into not-for-profit controlled holding companies provides the nonprofit entities access to equity capital that would not otherwise be available.[4] Business diversification into non-health related lines also lowers enterprise-wide risk and opens new markets. At the same time, however, operation of a multi-product firm makes it possible (and often advantageous) for the firm to adopt strategic cost-allocation and pricing policies (e.g. cross-subsidization) which may negatively affect market competition and unfairly discriminate against one class of policyholders over another. For these reasons, external review under the auspices of the Insurance Department is of singular importance.

In view of the fully integrated business structure and financial importance of the subsidiaries to the holding company (and vice versa), it is my opinion that the combined surpluses of the parents and subsidiaries should be evaluated against their consolidated liabilities; in effect, there should be symmetry between the way surpluses and liabilities are reported. It is only in this way that the PID will be able to make a meaningful evaluation of capital adequacy.

Applicants assert that they have presented their statutory surpluses on a consolidated basis in this proceeding.[5] I respectfully disagree.

Based on my reading of the applications filed in this proceeding, a thorough review of the annual statements filed by the applicants (parent companies) and each of their subsidiaries, and all of the reports submitted in this docket, I conclude that the Applicants have still not presented their statutory surpluses on a consolidated enterprise-wide basis in this case. I will discuss this more fully in the next section.

Suffice it to say, the question of financial presentation constitutes a central issue in this proceeding: one that must be joined directly if the Department is to properly regulate Plan surplus in the public interest. As a method for dealing with this and the myriad of other complex issues presented in this matter, I would reference my earlier suggestion that the Department notice contested case hearings offering full intervener status, informational transparency and procedural safeguards.

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[3] In my initial report, I referred to the phenomenon of "creeping conversion" and provided data on the proportion of each Applicant's assets invested in its subsidiaries. I would underscore that point now.

[4] I disagree with the Sherlock Report which states, "We believe that the level of surplus is a strategy to overcome their competitive disadvantage in lack of access to external capital sources." at 9. This loses sight of the impact of the holding company structure on the nonprofit parent's access to capital.

[5] Highmark at 5 and CBC at 15. However, IBC at 9 says that its Annual Statement reflects the "entire surplus available to [it] from all its subsidiaries" (which, of course, is different from claiming that its consolidated surplus is presented, in full, in this Application.)

III. The Plans Have Disregarded Over $2.3 Billion in Surplus on the Books of their Subsidiaries in This Proceeding.

The Applicants have reported less than two-thirds (2/3) of their combined surpluses for purposes of this proceeding. They have claimed surpluses totaling $3,956 million (on parent only basis) but have not shown another $2,319 million of surpluses reported separately on the books of their subsidiaries.[6] See Table 1. By far, the Plan which manifests the greatest subsidiary involvement is IBC with 60% of its combined surplus held almost entirely by three carriers-- AmeriHealth HMO ($448 million), Keystone East ($399 million) and QCC Insurance ($357 million). Together these three held almost 50% more surplus than IBC, the parent company.

Table 1. Surplus of Parent Companies, Insurance Subsidiaries and Consolidated Enterprises
($ Millions)

COMPANY	Reported Surplus of Parent Co.	UnreportedSurplus of Insurance Subsidiaries	Consolidated Surplus	Parents' Surplus as Percent of Consolidated
Highmark	$2194	$701	$2895	.76
IBC	841	1282	2123	.40
NEPA	405	68	473	.86
CBC	516	268	784	.66
All Applicants	3956	2319	6275	.63

To be absolutely clear, let me underscore that I am not in any way suggesting that the Applicants have misstated their statutory surplus in their Annual Statements. What I am saying, however, is that all of the Applicants have taken the position, for purposes of this proceeding, that the Parent Company's surplus, standing alone, must be measured against the consolidated liabilities (claims and expenses) of the holding company. Accordingly, that is precisely what they have illustrated in their Applications.

To illustrate: in a table purporting to present "The *REAL* numbers," IBC calculates that the Parent Company's surplus of $841 million provides sufficient coverage for only 41 days of IBC's claims and expenses (which it reports as being $7.4 billion).[7] IBC concludes that 41 days of surplus is highly inadequate and proposes an increase. My analysis suggests that IBC's

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[6] All data are drawn from the Annual Statements (Year Ending 12/31/03) filed with the Pennsylvania Insurance Department.

[7] IBC at 9.

presentation is highly flawed and misleading and severely understates the amount of surplus IBC has to cover its risks. In point of fact, on a consolidated enterprise basis, IBC and its subsidiaries held accumulated surplus totaling $2.1 billion (12/31/2003) against claims and expenses of $7.4 billion. Doing the arithmetic, on a combined enterprise basis, IBC and its subsidiaries had 103 days of claims' coverage – fully 2.5 times the amount of protection they alleged.

By way of explanation, IBC stated–without further elaboration-- that the surplus on the books of its subsidiaries was not *available* for purposes of meeting the liabilities of the entire holding company.[8] In contrast, however, their figures show that surplus of the parent company was fully committed to the needs of the combined enterprise.

The result, at a *micro* level, is to shift some costs from one group of policyholders to another within the holding company structure. At a more *macro* level, the net effect may be to cross-subsidize products in the more competitive lines of business (e.g. large group managed care) at the expense of lines in which the Blues enjoy more significant market power (e.g. non-group indemnity products).[9] Another aspect of this asymmetry is that policyholders enrolled in the Parent Company would presumably be responsible for funding additional surplus to support policyholders enrolled in the subsidiaries via the rate structure.

This raises a fundamental policy question often encountered in cases of unfair rate discrimination: is it fair to impose costs on one class of subscribers to benefit another class without any provision for reciprocity? Or, correspondingly, to offer selective benefits to one category of policyholders at the expense of another.

Several specific transactions can be cited for illustration: According to PID's Examination of Highmark Inc. (as of 12/31/01), Highmark contributed $55 million in cash into Keystone West's surplus in 1998 – ostensibly in furtherance of its charitable obligations. Highmark guaranteed all of Keystone West's financial and contractual obligations thereby relieving KW of the cost of reinsurance. These transactions presumably imposed a cost on Highmark and its subscribers and created a benefit for KW and its subscribers. Was there reciprocity? The factual question posed is whether KW's surplus is available to meet the obligations of Highmark (the parent corporation) and the other subsidiaries. Or, like IBC, is subsidiary surplus presumed to be "unavailable" to the parent company?

In another transaction, Capital Advantage Insurance Company, a CBC subsidiary, issued $325 million in debt (surplus debentures) to CBC, paying the parent corporation at below-market interest rates (4.8% in 2002 and 3.25% in 2003). Indeed, in 2003, Capital Advantage made no interest payments at all to CBC.[10] In effect, the parent company, CBC, made funds available to CAIC at concessionary rates that could have generated higher returns to CBC subscribers if invested elsewhere. Followed to its logical conclusion, higher investment income on CBC's

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[8] *Ibid*. And note that IBC, the parent company, is legally in control of the subsidiaries so that the question of the "availability" of surplus is arguably within its ambit.

[9] The concern with distortions brought about by market structure has also been put forward by the Pennsylvania Medical Society.

[10] Capital Advantage Insurance Company, 2003 Annual Statement.

portfolio could have stabilized premiums for CBC subscribers but was foregone in deference to CAIC.

IV. **The Current Surplus Levels Held by Applicants are Excessive on a Consolidated Enterprise Basis.**

To reiterate, the relevant presentation of surplus adequacy in a holding company structure calls for a comparison of the combined surplus of the parent and its subsidiaries with relevant measures of the holding company's consolidated liability risk.[11]

For reasons more fully stated in my main report, it is my opinion that Risk Based Capital provides a reasonable framework for evaluating the adequacy of an insurer's surplus relative to the risks it bears. I continue to believe that applying and evaluating RBC measures on a consolidated enterprise basis, represents an appropriate way of proceeding in this case. I would therefore renew the suggestions, previously put forward, for establishing what is in my opinion a fair and effective implementation procedure.

As an interim measure of capital adequacy (and given the data currently at hand) I provide an analysis based on two alternative metrics which have been suggested by participants in this proceeding.[12]

In Tables 2A and 2B I compare the results of two formats. In both tables, the criterion of capital adequacy is the ratio of surplus to the number of days of claims and expenses:[13] Table 2A illustrates IBC's proposed format–namely the ratio of the Parent Company's surplus to the Consolidated Company's Claims and Expenses. Table 2B, reflects the format I believe to be more appropriate-- the ratio of the Consolidated Company's surplus to the Consolidated Company's Claims and Expenses.

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[11] I pause here to recall that the original notice in this docket asked Applicants to suggest both lower and upper bounds for surplus. In my first report, I followed suit. Despite my best efforts to state recommendations clearly and unambiguously, some of the Applicants misread or misstated key points. To clarify: first, my suggestion of a 200% (or possibly higher, standby) level was proposed as a lower bound or threshold value. It was never proposed as an "optimal" level as suggested. My rationale was that the 200% level has been adopted by the Commonwealth and the NAIC and has remained in force for a long period of time; if the 200% level had been deemed inadequate, it could have been revised upward. It was not. Second, significant changes in the business environment have diminished rather than increased risk. Therefore, the 200% threshold probably offers a greater degree of protection, now, than it did when it was initially adopted. Third, the 375% lower bound standard adopted by the BCBS Association has not been described, analyzed or otherwise supported in this record. Therefore, it is unreviewable. I note that the PMS report is also critical of the purported BCBSA role as a quasi-government actor. See, PMS at 12.

[12] I would prefer that the Department analyze and evaluate a variety of surplus adequacy criteria including Risk-Based Capital. There seems to be a professional consensus that no single measure works perfectly so it stands to reason that useful insights can be gleaned from multiple measures.

[13] The ratio of surplus-to-claims and expenses has been endorsed both by IBC and PMS.

Table 2A. IBC's Proposed Surplus:Claims and Expenses Presentation
($ Millions)

Holding Company	Parent Company's Surplus	Monthly CONSOLIDATED Claims + Expenses	# Days of Claims and Expenses Covered by Parent's Surplus
Highmark	$2194	$657	100
IBC	841	620	41
NEPA	405	50	243
CBC	516	152	102

Table 2B. Surplus:Claims and Expenses--Consolidated Company Format
($ Millions)

Holding Company	Consolidated Company's Surplus	Monthly CONSOLIDATED Claims + Expenses	# Days of Claims and Expenses Covered by Consolidated Surplus
Highmark	$2895	657	132
IBC	2123	620	103
NEPA	473	50	284
CBC	783	152	155

It is clear from this comparison that by taking subsidiary surplus into account, each Applicant's financial position would be substantially improved. IBC's surplus:claims coverage would increase by 150%; Highmark's by 32%; NEPA's by 17% and CBC's by52%.

In its report, PMS proposes that the Applicants' statutory surplus be benchmarked as a multiple of surplus levels held by other insurers in Pennsylvania.[14] Taking that approach, PMS suggests that a range of 53-62 days of claims and expenses would be reasonable.

While I have not independently validated the data reported in the PMS report (specifically in Table 1) and am not, therefore, in any position to comment on the specific surplus-to-claims recommendations made therein, I would draw the Department's attention to the substantial differences between the range suggested by PMS (53-62 days) and the range reflected in Table 2B, above (103-284 days).

[14] PMS at 17.

An alternative measure of capital adequacy (suggested by IBC) is the ratio of surplus-to-net premium income. Tables 3A and 3B calculate these values on a Parent-Only Surplus Basis (IBC) and a Consolidated Enterprise Surplus Basis (my proposal).

Table 3A. IBC's Proposed Net Premium Presentation
($ Millions)

Holding Company	Parent Company's Surplus	Net Premium	Surplus as Percentage of Net Premium
Highmark	$2194	$8260	.27
IBC	841	8022	.10
NEPA	405	598	.68
CBC	516	1761	.29

Table 3B. Surplus to Net Premium: Consolidated Basis
($ Millions)

Holding Company	Consolidated Company's Surplus	Consolidated Company's Net Premium	Surplus as Percentage of Net Premium
Highmark	$2895	$8260	.35
IBC	2123	8022	.26
NEPA	473	598	.79
CBC	783	1761	.44

As with the previous comparison, each Applicant's surplus adequacy improves when considered on an integrated, consolidated basis.

Once again, although I would not favor using surplus-to-net premium as the exclusive criterion for evaluating surplus adequacy, I would point out that one Applicant in this proceeding (IBC) has proposed a minimum ratio of 0.25%. As Table 3B shows, all of the Applicants exceed that value–some by very substantial amounts.

V. The Surplus Levels (Upper Limit) Proposed by Applicants Are Excessive and Unreasonable

In my initial report, I estimated the amount of surplus each Applicant proposed as an upper bound and expressed it as a RBC ratio.[15] The calculation was reflected on a Parent Only basis. In Table 4, the Applicants' upper bound proposals are presented as both ratios of consolidated surplus-to-days of claims and expenses and as a percentage of consolidated net premium.[16]

Table 4. Proposed Surpluses on a Days of Claims and Net Premium Basis
($ Millions)

COMPANY	Current Consolidated Surplus	Proposed Consolidated Surplus	Days of Claims and Expenses Covered by Proposed Surplus	Consolidated Surplus as Percent of Net Premium
Highmark	$2895	$3932	180	0.48
IBC	2123	3143	152	0.39
NEPA	473	410	244	0.68
CBC	783	783	155	0.44

Referring once more to the criteria proposed in this proceeding by PMS (surplus equal to 53-62 days of claims and expenses) and IBC (surplus equal to at least 0.25% of net premium), Table 4 clearly exhibits the growing magnitude of the disparities (e.g. as compared with Tables 2B and 3B).[17]

With these data as a backdrop, I would like to address a general point raised by some Applicants and consultants, to wit, the purpose of surplus is far more than protection against the underwriting cycle ("surplus is not only about risk"). Applicants have suggested, for example that there is also a "vitality surplus," a litigation surplus, a competitive reaction surplus, a growth and development surplus and a surplus for regulatory delays among others.

One of the big problems with all of the above is that they are virtually open-ended and have not been subject to any form of external, critical scrutiny based on transparent business submissions. If surplus for example, is to be accumulated for business growth and development, then one would want to critically assess the Applicant's business plans, pro-formas and other relevant documents and probably examine key personnel within the company. As much as

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[15] Kirsch Report at 7-8.

[16] Without further information, I do not believe it is possible to compute a valid risk based capital ratio on a consolidated enterprise basis. Among many considerations, the mix of business complicates such a calculus.

[17] I cite the PMS and IBC criteria merely as independent reference points introduced into this proceeding. I do not in any way take a position on their validity, desirability or other aspect of them.

anything, these plans and projections are typically based on a foundation of subjective assumptions, proxy measures and similar factors with the results being highly sensitive to the assumptions and values chosen.

And although the Applicants may have submitted certain business documents (such as business plans and projections, financial models, risk-based capital reports, etc.) to the PID, these documents have not been shared with outside parties nor exposed to the kind of independent scrutiny which, in my opinion, is most useful for a comprehensive analysis. Nor has there been any opportunity to examine the applicants' staff or consultants in a meaningful way in order to understand the critical assumptions, data and methodological details underlying their findings and proposals.[18] In my opinion, this underscores the importance of having the PID convene formal contested-case hearings in which the necessary data would be shared and tested, independently, by interveners, witnesses could be examined on the record, a comprehensive record would be compiled and the applicants could protect their legitimate commercial interests through application of well-recognized confidentiality procedures.

VI. Conclusion

Based on my review of the record compiled in this proceeding together with additional document research, I conclude that (1) the Applicants are all parents in integrated holding company structures, (2) proper evaluation and regulation, by the Department, of the Applicants' surplus levels (minimum and maximum) calls for a filing and analysis of financial data on a consolidated enterprise basis, (3) financial data have not been presented on a consolidated enterprise basis for purposes of this proceeding, (4) the current filings (combined) fail to reflect $2.3 billion in statutory surplus in the hands of insuring entity subsidiaries, (5) using measures and criteria suggested by applicants and commentators involved in this matter and generally accepted by experts in the field, statutory surpluses levels of all of the Applicants, analyzed on a consolidated enterprise basis, are excessive, (6) excess surpluses adversely impact policyholders and the public, (7) on a consolidated basis, there is an uneven distribution of surplus burden between policyholders in the parent companies and policyholders in the subsidiaries, and (8) this proceeding as currently structured is not an adequate substitute for contested case hearings.

Respectfully Submitted,

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October 29, 2004

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[18] While Milliman at 16 indicated that it had run models comparable to those I suggested in my main report and expressed some willingness to share information, informally, on an "actuary-to-actuary" basis, it stopped well short of undertaking to expose its methods, assumptions and data to formal public scrutiny in the context of a contested case hearing. Or, to test models that explicitly incorporated the parameters and variables proposed in my report. I submit that anything less than a fully independent, on the record examination of the models, data, assumptions, etc. is bound to be unsatisfactory.