

Health Care Service Corp. (d/b/a Blue Cross & Blue Shield of Illinois, New Mexico, Oklahoma, and Texas)

Primary Credit Analysts:

Joseph Marinucci
New York
(1) 212-438-2012
joseph_marinucci@
standardandpoors.com

Secondary Credit Analysts:

Shellie Stoddard
New York
(1) 212-438-7244
shellie_stoddard@
standardandpoors.com



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RATING A+/Positive/— (STRONG)

An insurer rated 'A' has STRONG financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

HOLDING COMPANY

HCSC Group

DOMICILE

Illinois

LICENSED

Ill., Okla., N.M, Texas

Company Contact

Health Care Service Corp.
300 East Randolph Street
Chicago, IL 60601-5099
Tel.: (1) 312-653-6000
Treasurer: Brian Andrew Kennedy

Major Rating Factors

Strengths:

- Strong competitive position.
- Strong operating performance.
- Very strong capitalization.

Weaknesses:

- Earnings profile less diversified relative to peers.
- Limited geographic underwriting scope.

Rationale

The insurer financial strength rating on Health Care Service Corp. (HCSC), which does business as Blue Cross & Blue Shield of Illinois, Texas, Oklahoma, and New Mexico reflects the company's strong and improving competitive position, strengthened earnings profile, and enhanced level of capitalization. Offsetting factors include a relatively short history of sustained earnings at its current level relative to its peer group, and geographic concentration.

HCSC has developed strong franchises through the leverage of the Blue Brand in its core markets by means of its well-developed distribution channels, long-standing provider relationships, and competitive servicing capabilities. As of March 31, 2006, HCSC provided health insurance and related services to about 11 million members, a growth rate of more than 15% since 2004 (excluding BlueCard Host members). The consolidation with Blue Cross Blue Shield of Oklahoma (BCBSOK) in 2005 (465,000 members) has further enhanced HCSC's franchise in that health care market and is a new market for organic growth. In each of its primary markets, HCSC has established itself as the leading provider of health insurance coverage by developing a meaningful presence across key market segments. Standard & Poor's Ratings Services believes that HCSC's business profile has improved significantly in connection with the sustained development of its national account business, which has been a significant contributor to member growth in the past several years.

HCSC's earnings adequacy ratio (EAR), as measured by Standard & Poor's model, was 535% for the five-year period ended Dec. 31, 2005, which is considered strong overall relative to the rating. Consolidated operating performance has steadily improved in the past five years from marginal to very strong due to a disciplined pricing strategy, effective medical cost management, and a turnaround in the Texas health maintenance organization (HMO) marketplace. Pretax income was \$1.3 billion (9.8% ROR) for 2005 and \$327 million (8.9% ROR) through the first quarter of 2006.

HCSC's capital adequacy ratio (CAR), based on Standard & Poor's model, was 355% at year-end 2005, which is considered very strong and improved compared with the prior year ratio, which was 278%. In 2005, surplus grew by about \$1.2 billion or 38% to \$4.3 billion from \$3.1 billion mainly due to improved statutory net income results. Beginning year surplus was restated and increased by \$0.2 billion to account for the merger with BCBSOK.

Most of HCSC's insurance contracts are aligned with customers that reside in two generally competitive state markets: Illinois and Texas. HCSC's at-risk member base is about 28% of total membership and generates more than 80% of revenue. Its large base of customers, overall, enhances provider contracting and boosts operational efficiencies. Because of the at-risk concentrations, HCSC's insured customer base is somewhat less diversified geographically compared with its peers. Such a concentration of insured members potentially exposes the company in a more significant way to adverse developments on the legislative, regulatory, and economic fronts.

Outlook

The outlook is positive and reflects the fact that HCSC's financial performance in 2005 materially exceeded our expectations. The successful execution of its growth strategy and returns objectives has enhanced its competitive position, produced very strong operating results and strengthened its capitalization. The rating could be raised one notch if HCSC continues its successful strategy and if its recently improved business and financial profile are further enhanced and/or maintained. The outlook could be revised to stable if its growth strategy were to produce material business risk for the company and its profitability or capital adequacy were to

materially erode. Also, if the company were to make an acquisition that significantly altered its capital structure then this could have a negative impact to the ratings.

Standard & Poor's expects HCSC enrollment on a same-store basis to grow by 6%-8% and be 11.2 million-11.4 million members in 2006. Consolidated pretax income is expected to be \$1.1 billion-\$1.2 billion (about 9% ROR), which is considered very strong. The five-year average pretax ROR is expected to be 8%-9%. If HCSC meets our expectations for profitability, interest coverage is expected to exceed 40x and debt leverage will be less than 10% on an adjusted net worth basis. Surplus growth of 15%-25% is expected, and capital adequacy is expected to be 350%-375%, which is considered very strong relative to the rating.

Competitive Position: Strong Franchise Through BCBS Brand

HCSC has developed a strong franchise through the leverage of the Blue Brand in its core markets by means of its well-developed distribution channels, long-standing provider relationships, and competitive servicing capabilities. Through March 2006, HCSC enrollment increased by more than 15% compared with year-end 2004, resulting in membership of about 11 million. In each of its core markets, HCSC is the leading provider of insurance coverage and maintains strong market positions. Based on an estimate of the insured commercial market, the company's market share positions are Illinois, 42%; Texas, 26%; New Mexico, 29%, and Oklahoma, 20%.

Table 1

Health Care Service Corp./Selected Statistics					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	2005	2004	2003	2002	2001
Enrollment (000s) - from statutory statement	10,561.5	9,526.2	8,765.3	7,976.0	7,554.0
Premiums earned	11,713.9	6,991.3	6,249.8	5,509.8	4,571.1
Net underwriting gain/loss	1,168.1	990.3	785.0	370.0	343.9
Net income/loss	1,145.6	994.7	624.6	245.9	387.1
Pretax return on revenue (excluding realized capital gains/losses) (%)	11.3	12.5	10.5	6.0	6.8
Pretax return on revenue (including realized capital gains/losses) (%)	11.3	12.5	10.4	5.6	7.6
Total assets	7,770.4	5,886.8	4,939.4	4,161.0	3,593.2
Total adjusted capital	4,268.3	2,900.4	2,156.9	1,468.2	1,188.8

* 2005 numbers reflect consolidation with Blue Cross Blue Shield of Oklahoma.

Table 2

Health Care Service Corp./Business Statistics					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	2005	2004	2003	2002	2001
Enrollment (000s)	10,561.5	9,526.2	8,765.3	7,976.0	7,554.0
Year-over-year change (%)	10.9	8.7	9.9	5.6	9.0
Premiums earned	11,713.9	6,991.3	6,249.8	5,509.8	4,571.1
Year-over-year change (%)	67.6	11.9	13.4	20.5	19.8

* 2005 numbers reflect consolidation with Blue Cross Blue Shield of Oklahoma.

Historical

HCSC is a not-for-profit mutual legal reserve company that conducts business as Blue Cross Blue Shield of Illinois, Blue Cross Blue Shield of Texas, Blue Cross Blue Shield of Oklahoma, and Blue Cross Blue Shield of New Mexico. At year-end 2005, the company provided health insurance products and services to 10.6 million members (72% self-insured and 28% at-risk) in the private and public sectors.

The company is primarily a managed care organization, with more than 90% of its membership enrolled in managed care plans. A substantial portion of HCSC's health insurance business is transacted through the HCSC legal entity, which is also the parent to several downstream companies. HCSC markets its products and services primarily in Illinois, Texas, Oklahoma, New Mexico and nationally through affiliations with other BCBS plans as approved by the BCBSA. HCSC provides group and individual indemnity health insurance and managed care products such as HMOs, participating provider/preferred options (PPOs), point-of-service (POS) plans, and consumers-driven health plans (CDHP), as well as Medicare supplements coverage, dental, vision, and prescription drug products. HCSC also now provides Medicare Part D prescription and Medicare Advantage products in limited markets.

HCSC has built strong relationships with several national consulting organizations, general agents, producers and brokers to distribute its products. HCSC works closely with consulting firms to sell to larger groups and national accounts, which usually are the accounts with the highest customization of products. In the individual and small group markets, mostly general agents, producers, and independent brokers are utilized in each local market. Online quoting and enrollment capabilities have helped to improve growth in this highly competitive small group market segment.

In the fourth quarter of 2005, the merger between HCSC and Group Health Services of Oklahoma (GHS), which does business as Blue Cross Blue Shield of Oklahoma was completed. To realize the full potential of the merger, such as administrative cost per member, HCSC has begun integrating claims, customer service, and billing operations.

Prospective

Standard & Poor's expects HCSC to focus mainly on existing core market opportunities in 2006 and not to be involved with significant M&A deals that would result in material operational risk for the company during the next 12-18 months. Instead, Standard & Poor's expects the company's efforts to be directed at sustaining its already strong market positions in Illinois, Texas, Oklahoma, and New Mexico while pursuing organic national account growth opportunities. Organic member growth for 2006 is expected to be 6%-8%, exceeding 11.2 million members.

HCSC has eased away from its consolidator stance but acknowledges that merger opportunities with smaller nonprofit Blue plans will always be considered, which Standard & Poor's believes could result in at least some temporary disruption to ongoing operations depending on the magnitude of the deal. In the near term, Standard & Poor's believes that HCSC will rely more on targeted investments and additional Blues collaboration to drive competitive advantage.

Management And Corporate Strategy: Balanced Growth In Membership And Industry Consolidation

HCSC is successfully executing its intermediate strategy of maintaining a balanced growth in membership and earnings while enhancing brand positioning and product differentiation and providing financial support for its expansion through industry consolidation.

Operational management

HCSC's operational objective is to build on its financially sound, efficient, and competitively priced brand-management business that consolidates its negotiating power. Advanced IT and superior operations are included in this goal. The company's recent history has included several acquisitions. The primary objective of this strategy is to enhance the scale and cost efficiency needed to compete effectively with large national health care companies while remaining true to its mission as a not-for-profit Blue Cross Blue Shield carrier.

Financial management

Given the need to remain price-competitive, particularly in its national and large account segments, HCSC has adopted a policy of expense control that emphasizes improved efficiencies, enhanced technology and economies of scale. HCSC's management is committed to conservative financial management of the company. The company adheres to relatively conservative business, reserving, and underwriting practices while maintaining prudent risk-adjusted capitalization.

The company maintains a somewhat conservative level of debt, with a target maximum of 20% of total capital on an adjusted-net-worth basis, which makes provisions for various assets, including certain receivables, deferrals, goodwill and other intangibles. Standard & Poor's uses this valuation to compute and assess financial leverage and other balance-sheet-quality measures. On this basis, as of Dec. 31, 2005, debt leverage was 8.4%, and intangibles relative to adjusted net worth was about 5%, which Standard & Poor's views as very conservative.

The issuance of debt has historically improved the company's ability to fund strategic acquisitions and strengthen its working capital. The target capital structure would be exceeded only to finance a major acquisition—but with the intention of returning it to 20% in the intermediate term.

Accounting

HCSC is a nonprofit mutual legal reserve corporation and licensed health insurance company. The company does not produce GAAP financial data but instead uses accounting principles prescribed by the NAIC, which have been adopted by the State of Illinois Department of Insurance. Standard & Poor's considers HCSC's financial reporting to be reasonably conservative and transparent and we believe the company employs revenue recognition methods that are in the mainstream for its industry. HCSC does no off-balance-sheet financing, nor has it established any special-purpose entities for any reason. The company tends to set up reserves for various contingencies out of operating earnings and has established medical reserves for its core health plan at or above run-out for each of the past five years. Aside from certain balance sheet adjustments to make HCSC's financial condition more comparable (GAAP) with its peers, no other material accounting adjustments were made in connection with the analysis of HCSC's financial condition.

Operating Performance

The company's EAR, as measured by Standard & Poor's model, was 535% for the five-year period ended Dec. 31, 2005, which is considered very strong for the rating. Consolidated operating performance has improved during the most recent four-year period because of generally strong returns from the company's indemnity and PPO products and improved profitability in the Texas HMO marketplace. Standard & Poor's further believes that HCSC's earnings profile has been enhanced by the material amount of fee-based revenue and income generated from its major/national account business lines.

Table 3

<i>Health Care Service Corp./Operating Statistics</i>					
—Year ended Dec. 31—					
<i>(Mil. \$)</i>	<i>2005</i>	<i>2004</i>	<i>2003</i>	<i>2002</i>	<i>2001</i>
Total revenue	11,883.9	9,813.4	8,194.6	7,312.3	6,198.3
Net underwriting gain or loss	1,168.1	990.3	785.0	370.0	343.9
Pretax income (excluding realized capital gains or losses)	1,338.1	1,228.5	857.8	440.9	422.7
Pretax income (including realized capital gains or losses)	1338.4	1,230.6	855.5	406.0	474.1
Net income or loss	1,145.6	994.7	624.6	245.9	387.1
Pretax return on revenue (excluding realized capital gains or losses) (%)	11.3	12.5	10.5	6.0	6.8
Pretax return on revenue (including realized capital gains or losses) (%)	11.3	12.5	10.4	5.6	7.6
Earnings adequacy ratio (%)	535.0	493.5	328.0	260.0	103.0
Medical loss ratio (%)	81.5	78.4	78.5	79.3	80.9
Expense ratio (%)	8.5	3.6	6.6	10.3	8.5

* 2005 numbers reflect consolidation with Blue Cross Blue Shield of Oklahoma.

Historical

Premium revenue (excluding equivalents) increased 21% (\$2 billion) to \$11.8 billion at year-end 2005, compared with \$9.8 billion in the prior year. The increase was driven by member growth, merger with BCBS of Oklahoma, and rate increases. Pretax income and pretax ROR (as a percentage of premium revenue and self-funded account fees) for 2005 were \$1.3 billion and 9.8%, respectively, compared with \$1.2 billion and 10.9% in 2004. Interest coverage for year-end 2005, exceeded 45x, which is very conservative for the rating category.

Prospective

Standard & Poor's expects consolidated pretax income to be \$1.1 billion-\$1.2 billion (7.0%-8.0% ROR), which is considered very strong, and the five-year average pretax ROR is expected to be 7%-8%. Accordingly, the EAR for the five-year period ended Dec. 31, 2006, is expected to exceed 500%, which is considered very strong for the rating. Standard & Poor's expects profitability to be sustained by HCSC's core book of business in Illinois. If the company meets Standard & Poor's expectations for earnings, interest coverage would likely be 30x-35x.

Enterprise Risk Management

HCSC's ERM is adequate and reflects the conservative risk profile of the company. The company's product portfolio of health care products is not particularly complex. Its major risk is underwriting risks. The underwriting and pricing disciplines, and effective reinsurance strategy that management adheres to is evident by the strong financial performance and the capital strength that HCSC has achieved in the past five years. Its current system of monitoring claims and pricing trends are also considered to be adequate. Management is expected to dedicate the resources needed to maintain its operational capabilities to manage its risks.

Investments And Liquidity: Focus On Capital Preservation And Dependable Cash Flow

HCSC's investment portfolio is conservatively managed, with an investment philosophy that focuses on preservation of capital and dependable cash flow. HCSC's investment portfolio contains mostly a high credit quality fixed-income investment that provides strong liquidity. More than 95% of its fixed-income portfolio is in NAIC Class 1 securities with 65% maturing within one year. The plan has also had strong cash flow from operations in the past several years.

Table 4

<i>Health Care Service Corp./Investment Statistics</i>					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	2005	2004	2003	2002	2001
Net investment income	159.3	51.7	25.3	30.9	58.9
Net realized capital gain	0.3	2.1	(2.3)	(34.9)	51.5
Net investment gain	159.5	53.8	23.0	(4.0)	110.3
Net investment yield (excluding realized capital gains and losses) %	3.7	1.6	0.9	1.3	2.8
Net investment yield (including realized capital gains and losses) %	3.7	1.6	0.8	(0.2)	5.2
Total invested assets (excluding real estate)	5,093.9	3,612.9	3,030.4	2,462.2	2,176.8
<i>Portfolio composition</i>					
Cash and short-term investments (%)	39.0	52.8	46.0	35.9	27.5
Bonds (%)	41.4	25.9	24.7	28.4	30.8
Preferred stock (%)	0.0	0.0	0.7	0.9	1.1
Total common stock (%)	15.1	14.7	21.6	26.1	30.9
Unaffiliated common stock (%)	5.6	4.4	3.4	3.6	4.3
Real estate (%)	4.3	5.7	7.1	8.3	9.7
Other (%)	0.2	0.8	0.0	0.4	0.0

* 2005 numbers reflect consolidation with Blue Cross Blue Shield of Oklahoma.

Table 5

<i>Health Care Service Corp./Liquidity Statistics</i>					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	2005	2004	2003	2002	2001
Cash flow from operations	1,245.5	569.6	583.1	337.0	438.1
Cash and short-term investments	2,074.8	2,025.3	1,498.8	964.1	662.8
Total invested assets (excluding real estate/affiliated investments/other)	4,579.2	3,185.9	2,414.8	1,823.8	1,510.3
Unpaid claims liability	1,158.8	636.8	686.2	689.4	643.5

Table 5

Health Care Service Corp./Liquidity Statistics (cont. 'd)					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	2005	2004	2003	2002	2001
Quick liquidity ratio (%)	179.0	318.0	218.4	139.8	103.0
Cash flow from operation to unpaid claims (%)	107.5	89.4	85.0	48.9	68.1
Liquidity ratio (%)	250.0	200.3	193.1	172.2	153.0
Claims turnover (days)	44.3	42.4	51.0	57.6	63.5

* 2005 numbers reflect consolidation with Blue Cross Blue Shield of Oklahoma.

HCSC has very strong liquidity for the rating, as measured by a liquidity ratio, based on Standard & Poor's model, of 250% at year-end 2005. The company also maintains an untapped five-year \$300 million line of revolving credit with a consortium of banks, which will expire in November 2009.

Capitalization: Improved Statutory Net Income Grows Surplus

HCSC's CAR, based on Standard & Poor's model, was 355% for the year ended Dec. 31, 2005, which is considered extremely strong and is a significant improvement compared with the prior year. In 2005, surplus grew by about \$1.2 billion or 38% to \$4.3 billion from \$3.1 billion mainly due to improved statutory net income results and consolidation with BCBSOK.

Table 6

Health Care Service Corp./Capitalization Statistics					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	2005	2004	2003	2002	2001
Total assets	7,770.4	5,886.8	4,939.4	4,161.0	3,593.2
Total liabilities	3,502.1	2,994.0	2,798.5	2,700.2	2,412.3
Total adjusted capital	4,268.3	2,900.4	2,156.9	1,468.2	1,188.8
Total debt to capital (%)	8.6	12.1	15.6	21.4	25.2
Capital adequacy ratio (%)	355.0	277.6	203.7	144.9	136.0
Total equity assets to capital (%)	24.2	27.0	44.3	64.4	84.6

* 2005 numbers reflect consolidation with Blue Cross Blue Shield of Oklahoma.

Historical

Capital adequacy improved to 296% in 2004, which was materially above expectations and significantly improved from 204% in 2003. HCSC has reported significant growth in its statutory earnings in past few years, which have lead to the significant strengthening of its capitalization level.

Prospective

Standard & Poor's expects HCSC's consolidated capital adequacy to remain very strong for the rating category through year-end 2006 due to strong profitability and a sustained focus on fee-based business growth. Standard & Poor's expects HCSC's CAR to be 350%–375% by year-end 2006.

Financial Flexibility: Capital And Earnings Provide Strong Flexibility Despite Not-For-Profit Status

HCSC's significantly enhanced capital position and improved earnings strength provide it with strong financial and operating flexibility, which have permitted investments in business growth through acquisitions, strategic alliances, and the development of its managed care networks. Nevertheless, HCSC's financial flexibility is limited somewhat by its not-for-profit mutual legal reserve corporation status, which restricts access to the equity capital markets. Standard & Poor's does not expect the company to change its corporate structure over the near to intermediate term.

Its primary sources of funds consist of internally generated cash flow and its five-year, \$300 million credit facility, which expires in November 2009. Standard & Poor's expects that HCSC's capital needs will likely grow in the next several years but also believes that internally generated funds will be more than sufficient to meet the company's needs. Nonetheless, HCSC's strong financial profile and modest financial leverage would allow for relatively easy access to the debt capital markets if needed.

In 2001, the company issued \$400 million in 10-year senior unsecured notes by means of a 144A issuance. The majority of the proceeds were used to repay a commercial bank revolving credit facility. The debt obligation has the following repayment conditions and restrictions: The notes bear interest at a rate of 7.75% per annum, payable semiannually in arrears on June 15 and Dec. 15 of each year and will mature on June 15, 2011. As of Dec. 31, 2005, debt leverage (as a percentage of adjusted net worth) was less than 10%, and debt to EBITDA was 0.3x, which Standard & Poor's views considers conservative for the rating. Standard & Poor's does not expect these metrics to change over the next 12-18 months in a way that would pressure the company's financial profile.

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