

Financial Statements (Statutory Basis)

Health Care Service Corporation,
a Mutual Legal Reserve Company

*Years ended December 31, 2003 and 2002
with Report of Independent Auditors*

Health Care Service Corporation,
a Mutual Legal Reserve Company

Financial Statements (Statutory Basis)

Years ended December 31, 2003 and 2002

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Report of Independent Auditors

To the Board of Directors of
Health Care Service Corporation,
a Mutual Legal Reserve Company

We have audited the accompanying statutory-basis statements of admitted assets, liabilities and policyholders' surplus of Health Care Service Corporation, a Mutual Legal Reserve Company (the Corporation), as of December 31, 2003 and 2002, and the related statutory-basis statements of income and expenses, changes in policyholders' surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 2 to the financial statements, the Corporation presents its financial statements in conformity with accounting practices prescribed or permitted by the Illinois Insurance Department, which practices differ from accounting principles generally accepted in the United States. The variances between such practices and accounting principles generally accepted in the United States are described in Note 2. The effects on the financial statements of these variances are not reasonably determinable, but are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States, the financial position of the Corporation as of December 31, 2003 and 2002, or the results of its operations or its cash flow for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Corporation as of December 31, 2003 and 2002, and the results of its operations and its cash flow for the years then ended, in conformity with accounting practices prescribed or permitted by the Illinois Insurance Department.

Our audit was conducted for the purpose of forming an opinion on the statutory-basis financial statements taken as a whole. The accompanying schedule of selected financial data, summary investment schedule, and supplemental investment risks interrogatories are presented to comply with the NAIC Annual Statement Instructions and the NAIC Accounting Practices and Procedures Manual and is not a required part of the statutory-basis financial statements. Such information has been subjected to the auditing procedures applied in our audit of the statutory-basis financial statements and, in our opinion, is fairly stated in all material respects in relation to the statutory-basis financial statements taken as a whole.



February 27, 2004



**HEALTH CARE SERVICE CORPORATION,
A MUTUAL LEGAL RESERVE COMPANY**

**STATEMENTS OF ADMITTED ASSETS, LIABILITIES,
AND POLICYHOLDERS' SURPLUS (STATUTORY BASIS)
AS OF DECEMBER 31, 2003 AND 2002
(IN THOUSANDS OF DOLLARS)**

<u>ADMITTED ASSETS</u>	<u>2003</u>	<u>2002</u>
CASH AND INVESTED ASSETS:		
Cash and cash equivalents	\$ 501,751	\$ 540,638
Short-term investments, at amortized cost which approximates fair value	997,004	423,431
U.S. government and agency securities, at amortized cost (fair value: 2003 – \$301,723; 2002 – \$289,789)	294,116	279,554
Corporate and other bonds, at amortized cost (fair value: 2003 – \$529,341; 2002 – \$503,355)	510,799	483,004
Equity securities, at fair value (cost: 2003 – \$85,343; 2002 – \$87,605)	111,107	97,128
Investments in unconsolidated subsidiaries (Note 4)	615,560	627,076
Real estate, at cost, less accumulated depreciation of \$105,914 in 2003 and \$89,118 in 2002	229,859	221,585
Other invested assets	80	11,410
Total Cash and Invested Assets	3,260,276	2,683,826
RECEIVABLES:		
Premium business	121,562	175,759
Receivables related to uninsured customers	766,412	299,214
HMO business	0	7,558
Less: Allowance for doubtful accounts	(17,018)	(20,212)
Total Accident and Health Policy Receivables, net	870,956	462,319
Due from Federal Employees Program (Note 2)	352,930	319,465
Hospital receivables	212,251	474,938
Other	37,258	50,573
Total Receivables, net	1,473,395	1,307,295
DEFERRED TAX ASSETS (Note 12)	118,358	80,512
DATA PROCESSING EQUIPMENT , at cost, less accumulated depreciation of \$130,387 in 2003 and \$109,448 in 2002	42,424	38,080
GOODWILL AND INTANGIBLE ASSETS (Notes 9 & 18A)	44,902	51,284
TOTAL ADMITTED ASSETS	<u>\$4,939,355</u>	<u>\$4,160,997</u>

The accompanying notes to financial statements are an integral part of these statements.



**HEALTH CARE SERVICE CORPORATION,
A MUTUAL LEGAL RESERVE COMPANY**

**STATEMENTS OF ADMITTED ASSETS, LIABILITIES,
AND POLICYHOLDERS' SURPLUS (STATUTORY BASIS)
AS OF DECEMBER 31, 2003 AND 2002 (CONTINUED)
(IN THOUSANDS OF DOLLARS)**

<u>LIABILITIES AND POLICYHOLDERS' SURPLUS</u>	<u>2003</u>	<u>2002</u>
ACCIDENT AND HEALTH POLICY RESERVES:		
Policy and contract claims	\$ 686,224	\$ 690,505
Aggregate reserves	319,919	274,158
HMO policy and contract claims	<u>252,295</u>	<u>241,053</u>
Total Accident and Health Policy Reserves	1,258,438	1,205,716
Accrued liabilities	831,487	868,967
Long-term debt (Note 8)	399,906	399,766
Federal income tax liability	199,624	136,251
Liability for postretirement benefits other than pensions	80,385	71,581
Asset valuation reserve	16,056	7,402
Interest maintenance reserve	<u>12,623</u>	<u>10,536</u>
Total Liabilities	<u>2,798,519</u>	<u>2,700,219</u>
POLICYHOLDERS' SURPLUS	<u>2,140,836</u>	<u>1,460,778</u>
TOTAL LIABILITIES AND POLICYHOLDERS' SURPLUS	<u>\$4,939,355</u>	<u>\$4,160,997</u>

The accompanying notes to financial statements are an integral part of these statements.



HEALTH CARE SERVICE CORPORATION,
A MUTUAL LEGAL RESERVE COMPANY

STATEMENTS OF INCOME AND EXPENSES (STATUTORY BASIS)
FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002
(IN THOUSANDS OF DOLLARS)

	<u>2003</u>	<u>2002</u>
INCOME:		
Premium business	\$6,287,611	\$5,556,270
HMO business	1,869,122	1,715,268
Net investment income (Note 3)	27,965	32,936
Other income	5,675	7,870
Total Income	<u>8,190,373</u>	<u>7,312,344</u>
EXPENSES:		
Premium benefits	4,945,267	4,413,346
HMO benefits (Note 2)	1,680,310	1,518,711
Operating expenses, net of reimbursements (Note 16A)	412,520	671,371
Commission expenses	266,844	236,019
Other expenses	27,618	32,017
Total Expenses	<u>7,332,559</u>	<u>6,871,464</u>
NET GAIN FROM OPERATIONS BEFORE INCOME TAXES AND REALIZED CAPITAL LOSSES	857,814	440,880
Income tax expense (Note 12)	(230,938)	(160,049)
NET GAIN BEFORE REALIZED CAPITAL LOSSES	626,876	280,831
Net realized capital losses less federal income tax expense (benefit) of \$612 in 2003 and \$(7,539) in 2002	(2,308)	(34,900)
NET GAIN	<u><u>\$ 624,568</u></u>	<u><u>\$ 245,931</u></u>

The accompanying notes to financial statements are an integral part of these statements.



HEALTH CARE SERVICE CORPORATION,
A MUTUAL LEGAL RESERVE COMPANY

STATEMENTS OF CHANGES IN
POLICYHOLDERS' SURPLUS (STATUTORY BASIS)
FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002
(IN THOUSANDS OF DOLLARS)

	<u>2003</u>	<u>2002</u>
Policyholders' surplus at beginning of year	\$ 1,460,778	\$ 1,180,914
Net gain	624,568	245,931
Increase in nonadmitted assets	(189,287)	(112,378)
Net change in deferred tax (Note 12)	238,006	161,161
(Increase) decrease in asset valuation reserve	(8,654)	467
Net change in unrealized capital gains (losses)	12,947	(1,559)
Net increase in equity of unconsolidated subsidiaries	34,738	76,776
Increase in HMO restricted surplus fund	16	24
Goodwill amortization (Notes 4 and 18)	(32,276)	(90,558)
POLICYHOLDERS' SURPLUS AT END OF YEAR	<u><u>\$ 2,140,836</u></u>	<u><u>\$ 1,460,778</u></u>

The accompanying notes to financial statements are an integral part of these statements.



HEALTH CARE SERVICE CORPORATION,
A MUTUAL LEGAL RESERVE COMPANY

STATEMENTS OF CASH FLOW (STATUTORY BASIS)
FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002
(IN THOUSANDS OF DOLLARS)

	<u>2003</u>	<u>2002</u>
CASH FROM OPERATIONS:		
Premiums collected	\$6,309,224	\$5,481,160
HMO revenue collected	1,879,800	1,722,994
Net investment income received	79,201	77,344
Premium benefits paid	(4,926,287)	(4,354,100)
HMO benefits paid	(1,672,824)	(1,503,813)
Commissions and other expenses paid, net of reimbursements	(917,859)	(904,404)
Federal income taxes paid, net of refunds received	(167,565)	(175,359)
Net Cash Provided by Operations	<u>583,690</u>	<u>343,822</u>
CASH FROM INVESTMENTS:		
Proceeds (losses) from sale or maturity of -		
Bonds	656,709	629,999
Equity securities	46,084	33,322
Other invested assets	2,242	0
Net (loss) gain on short-term investments	(530)	9
Miscellaneous proceeds (losses)	11,330	(11,097)
Capital gains tax (paid) recovery	(612)	7,539
Total proceeds	<u>715,223</u>	<u>659,772</u>
Cost of investments acquired -		
Bonds	696,458	645,960
Equity securities	36,025	33,694
Real estate	27,312	4,824
Other invested assets	18,953	55
Total cost of investments acquired	<u>778,748</u>	<u>684,533</u>
Net Cash Used for Investments	<u>(63,525)</u>	<u>(24,761)</u>
CASH FROM FINANCING AND OTHER SOURCES, NET:		
Interest on long-term debt	(31,149)	(31,221)
Other sources, net	45,670	13,414
Net Cash Provided by (Used for) Financing and Other Sources	<u>14,521</u>	<u>(17,807)</u>
NET INCREASE IN CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS	534,686	301,254
CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS AT THE BEGINNING OF THE YEAR	<u>964,069</u>	<u>662,815</u>
CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS AT THE END OF THE YEAR	<u>\$1,498,755</u>	<u>\$ 964,069</u>

The accompanying notes to financial statements are an integral part of these statements.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis)
(In Thousands of Dollars)

December 31, 2003 and 2002

1. Organization

Health Care Service Corporation, a Mutual Legal Reserve Company, which does business as Blue Cross Blue Shield of Illinois, Blue Cross Blue Shield of Texas, and Blue Cross Blue Shield of New Mexico (the Corporation), operates under the provisions of Article III of the Illinois Insurance Code, which govern mutual legal reserve companies in Illinois. As required by these provisions, the Corporation must maintain policyholders' surplus of at least \$1,500.

The Corporation writes and administers health and dental insurance business throughout the states of Illinois, Texas, and New Mexico. The Corporation also offers insurance nationally through other Blue Cross Blue Shield plans.

2. Accounting Policies

Basis of Presentation

The accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Insurance Department (DOI), which practices differ from accounting principles generally accepted in the United States (GAAP).

The more significant variances from GAAP are:

- i. Certain assets, designated as "nonadmitted assets" (principally certain receivables, furniture, fixtures, office equipment, leasehold improvements, and nonoperating system software) are charged to policyholders' surplus.
- ii. An interest maintenance reserve, as prescribed by the National Association of Insurance Commissioners (NAIC), is established to defer recognition of net realized gains and losses on bonds due to changes in market interest rates, and to amortize these gains and losses into income over the remaining life of the bonds.
- iii. An asset valuation reserve, as prescribed by the NAIC, is established to stabilize policyholders' surplus when the market value of investments fluctuates.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

2. Accounting Policies (continued)

- iv. Changes in equity of unconsolidated subsidiaries and goodwill amortization expense related to the purchase of subsidiaries are reported as direct additions to or reductions from policyholders' surplus. The accounts and operations of the Corporation's subsidiaries are not consolidated with the accounts and operations of the Corporation as would be required under GAAP.
- v. Certain leases which are capitalized under GAAP are treated as operating leases under statutory accounting practices.
- vi. Pension expense and other postretirement benefit expense exclude nonvested employees.
- vii. Deferred tax assets and liabilities are recognized and deferred tax assets are admitted based on prescribed limitations. Changes in deferred tax assets and liabilities are recorded as a direct credit or charge to policyholders' surplus.
- viii. Investments are stated at values prescribed or permitted by the NAIC and, therefore, are not stated in accordance with GAAP.
- ix. The statements of cash flow are prepared in conformity with statutory accounting practices and, therefore, are not prepared in accordance with GAAP.
- x. For home office real estate, the NAIC requires an imputed rent calculation. The results of the imputed rent calculation are included in the Corporation's Statements of Income and Expenses as both additional investment income and additional operating expenses.
- xi. Administrative fees earned on Administrative Service Only and Administrative Services Contracts are shown as a reduction to operating expenses in the Corporation's Statements of Income and Expenses and therefore, are not stated in accordance with GAAP.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

2. Accounting Policies (continued)

The effects of the foregoing variances from GAAP on the accompanying statutory-basis financial statements have not been determined but are presumed to be material.

Use of Estimates

The preparation of financial statements of insurance companies requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed therein.

Permitted Accounting Practices

In 2002, the Corporation received written approval from the DOI to treat as admitted assets certain provider recoverables received within one or two months of the related claim payments for uninsured customers. Prescribed accounting methods normally would require that these provider recoverables be treated as nonadmitted assets to the extent that they cannot be offset against liabilities to the same provider. At December 31, 2002, this permitted practice increased policyholders' surplus by \$232,093. At December 31, 2003, all provider recoverables that are offset with amounts owed to the Corporation or are administered on behalf of uninsured plans are being admitted as a prescribed practice as approved by the DOI.

In 2002, the Corporation received written approval from the DOI to admit the intangible asset related to recording an additional minimum pension liability. This treatment resulted in an increase to policyholders' surplus of \$37,509 (see Note 9). Effective December 31, 2003, the Corporation adopted Statement of Statutory Accounting Principle (SSAP) No. 89, *Accounting for Pensions, a Replacement of SSAP No. 8*. In accordance with SSAP No. 89, the Corporation admitted the intangible asset related to the additional minimum pension liability as of December 31, 2003.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

2. Accounting Policies (continued)

There was no impact on the Corporation's net gain in 2002 as a result of practices permitted by the DOI. There were no permitted practices during 2003. A reconciliation of the Corporation's policyholders' surplus between the practices permitted by the DOI and the methods codified by the NAIC is shown below:

	December 31	
	2003	2002
Policyholders' surplus, as reported	\$2,140,836	\$1,460,778
State permitted practices:		
Hospital receivables	–	(232,093)
Intangible pension asset	–	(37,509)
Adjusted policyholders' surplus	\$2,140,836	\$1,191,176

Premium and HMO Business Income

Income from premium and HMO business is recorded on the accrual basis of accounting and is recognized as income during the period of coverage.

Administrative Services Contract (ASC)

ASC, which is also referred to as uninsured business under the NAIC Accounting Practices and Procedures Manual (codification), is business where the Corporation pays benefits on the behalf of employers using the Corporation's check stock. The Corporation receives an administrative fee for providing these services. Premium income and claim expenses are not included in the Corporation's financial statements. The administrative fees earned are reported as a reduction to operating expenses in the Corporation's Statements of Income and Expenses.

Administrative Services Only (ASO)

ASO, which is also referred to as uninsured business under codification, is business where the Corporation pays benefits on the behalf of employers using the employer's check stock. The Corporation receives an administrative fee for providing these services. Premium income and claim expenses are not included in the Corporation's financial statements. The administrative fees earned are reported as a reduction to operating expenses in the Corporation's Statements of Income and Expenses.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

2. Accounting Policies (continued)

Hospital Charge Recoveries

The Corporation contracts with various providers to provide medical services for customers. Hospital charge recoveries are netted against premium, ASC, and HMO benefits and are recorded on an incurred basis. Receivables related to the payment of claims by the Corporation are secured in that the Corporation can and does collect the majority of these amounts by offsetting payments to the providers with amounts owed to the Corporation. Consistent with prescribed accounting practices in 2003 and permitted accounting practices in 2002, certain hospital receivables have been included in the Corporation's Statements of Admitted Assets, Liabilities, and Policyholders' Surplus as admitted assets. These receivables are reported as hospital receivables. Additionally, a portion of these receivables result from claims paid by the Corporation on behalf of its uninsured customers. In 2003, these receivables are reported in the Corporation's Statements of Admitted Assets, Liabilities, and Policyholders' Surplus as receivables related to uninsured customers and in 2002 as hospital receivables.

Pharmacy Rebate Receivable

The Corporation contracts with a Pharmacy Benefit Manager (PBM) for the administration of pharmaceutical drug claims. Pharmacy Rebate Receivables are based on the PBM's estimate of the actual amounts due to the Corporation and an estimated amount calculated by the Corporation. The Corporation's estimated amount is based on the claims processed by the PBM in the prior quarter multiplied by a contractual rate based on utilization.

The PBM contract calls for rebate payments to be paid within 180 days after the end of each quarter, as received by the PBM. The contract also provides for various guaranteed minimum payments to be paid to the Corporation based on plan design and volumes. Pharmacy Rebate Receivables are included in receivables related to uninsured customers and hospital receivables in the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus depending on the type of business.

Data Processing Equipment

The Corporation capitalizes the cost of data processing equipment, including operating system software. At December 31, 2003 and 2002, data processing equipment had an admitted asset balance of \$42,424 and \$38,080, respectively. Equipment is depreciated on a straight-line basis over the lesser of three years or its remaining useful life.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

2. Accounting Policies (continued)

Depreciation expense was \$36,334 and \$31,232 for 2003 and 2002, respectively. Nonoperating system software is depreciated on a straight-line basis over the lesser of five years or its remaining useful life, with the remaining undepreciated balance being nonadmitted.

The Corporation began capitalizing internally developed software in 2002. Development costs for internally developed software are capitalized if the total capitalizable internal and external development costs exceed or are expected to exceed \$2,500. Internally developed software is amortized on a straight-line basis over the lesser of five years or its remaining useful life. At December 31, 2003 and 2002, capitalized internally developed software was \$14,500 and \$3,525, respectively, with the balance being nonadmitted. There were no amortization costs in 2003 and 2002.

Furniture, Fixtures, Equipment, and Leasehold Improvements

The Corporation capitalizes the cost of furniture, fixtures, and equipment and depreciates it on a straight-line basis over a five-year life. Depreciation expense was \$31,644 and \$28,115 for 2003 and 2002, respectively. The Corporation also capitalizes the cost of leasehold improvements and amortizes that cost over the shorter of the life of the lease or the economic useful life. Amortization expense was \$11,777 and \$11,466 for 2003 and 2002, respectively. The remaining unamortized balances of furniture, fixtures, equipment, and leasehold improvements are nonadmitted.

Accident and Health Policy Reserves

The Corporation records policy and contract claims for premium and HMO benefits at the time covered services are provided. The liabilities are established based on management's estimate of the ultimate cost of settling all losses incurred, but unpaid, including those incurred but not reported to the Corporation. Although such amounts are based on estimates, management believes that the reserves are reasonable and adequate. These estimates are continually reviewed and, as adjustments to these liabilities become necessary, such adjustments are reflected in current operations. Changes in assumptions for such things as medical cost and legal actions, as well as changes in actual experience, could cause these estimates to change in the near term.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

2. Accounting Policies (continued)

Aggregate reserves represent reserves for unearned premium income and guaranteed-to-issue block loss reserves for small group premium business.

An estimate of future claim payments is not recorded for ASC or ASO claims.

Investments

Investments are stated at values prescribed or permitted by the NAIC. Accordingly, bonds are stated at amortized cost. Short-term investments, primarily commercial paper, are stated at amortized cost which approximates market value. Short-term investments with original maturities of three months or less are reported as cash and cash equivalents in the Corporation's Statements of Admitted Assets, Liabilities, and Policyholders' Surplus. Real estate occupied by the Corporation is stated at cost, less accumulated depreciation. Equity securities, comprised of common and preferred stocks, bond mutual funds, and money-market funds, are stated at fair value. Fair values are based on valuations as prescribed by the NAIC Securities Valuation Office. Amortization of bond premium and accretion of bond discount are recognized on a yield-basis method. Realized gains and losses are determined on a specific identification basis. Security transactions are accounted for on a trade-date basis, with any unsettled transactions recorded as due to or from investment broker and included in other invested assets and accrued liabilities in the Corporation's Statements of Admitted Assets, Liabilities, and Policyholders' Surplus. Impairments are recognized for investments where the decline in fair value is determined to be other-than-temporary. The investment is written down to fair value as the new cost basis, and the amount of the write-down is accounted for as a realized loss on the Corporation's Statements of Income and Expenses.

Investments in the Corporation's unconsolidated insurance and HMO subsidiaries are reported in the accompanying Statements of Admitted Assets, Liabilities, and Policyholders' Surplus based on their underlying statutory capital and surplus plus any related unamortized goodwill. Investments in the Corporation's unconsolidated non-insurance subsidiaries are reported in the accompanying Statements of Admitted Assets, Liabilities, and Policyholders' Surplus based on their underlying equity, adjusted to a statutory basis of accounting. Changes in investments in unconsolidated subsidiaries are recorded as a direct increase or decrease to policyholders' surplus. Goodwill amortization resulting from statutory purchases is recorded as a direct decrease to policyholders' surplus.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

2. Accounting Policies (continued)

Dividends received from unconsolidated subsidiaries are recorded as investment income in the Statements of Income and Expenses (see Note 4).

Real Estate

The Corporation's real estate primarily consists of the downtown Chicago headquarters and the corporate data center. The buildings and building components are being depreciated over their useful lives, which range from 7 to 40 years.

Under statutory accounting practices, insurance companies are required to calculate imputed rental income and rent expense for owner-occupied real estate. The method for calculating imputed rental income and expense is based on estimated current market value times rentable square feet. These imputed amounts are reported as investment income and operating expense in the Statements of Income and Expenses as if the Corporation had paid itself rent of \$29,162 and \$23,386 for 2003 and 2002, respectively.

Federal Employees Program

The Federal Employees Program (FEP) is a national contract between Blue Cross and Blue Shield plans (participating plans) and the U.S. Office of Personnel Management under which participating plans provide health coverage to U.S. Government employees. The contract is underwritten by the participating plans on a premium basis. The Corporation provides insurance coverage for FEP members in Illinois, Texas, and New Mexico. The Blue Cross and Blue Shield Association (the Association) acts as the agent for the various participating plans. In its capacity as agent, the Association coordinates billing, claims processing, and investment activity and reports the financial results to each participating plan.

The Corporation's share of revenue, expenses, assets, and liabilities under the FEP contract is reported in the Corporation's financial statements. Amounts due from FEP represent funds being held in a Letter of Credit Account maintained specifically for FEP benefits. As checks clear its bank account, the Corporation reimburses itself by drawing funds from the FEP Letter of Credit Account.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

2. Accounting Policies (continued)

HMO Benefits

The Corporation contracts with medical groups to provide medical and dental benefits to subscribers enrolled in its HMO programs. The Corporation pays fixed amounts per enrolled subscriber and incentives to the medical groups that provide these benefits. In addition, the Corporation also incurs claim expenses for subscribers enrolled in its HMO programs. Estimates of future claim and incentive payments are included in the HMO policy and contract claims liability.

Reclassifications

Certain amounts in the 2002 presentation have been reclassified to conform to the current year presentation.

3. Investments

The amortized cost and NAIC fair value of debt securities, primarily bonds and short-term investments, held by the Corporation at December 31, 2003 and 2002, are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
2003				
Short-term investments	\$ 997,004			\$ 997,004
U.S. government and agency securities	294,116	\$ 8,573	\$ (966)	301,723
Corporate bonds	510,799	19,628	(1,086)	529,341
Total	<u>\$1,801,919</u>	<u>\$28,201</u>	<u>\$(2,052)</u>	<u>\$1,828,068</u>
Due in one year or less	\$1,028,562			\$1,029,085
Due after one year through five years	404,996			416,413
Due after five years through ten years	232,875			242,402
Due after ten years	135,486			140,168
Total	<u>\$1,801,919</u>			<u>\$1,828,068</u>
2002				
Short-term investments	\$ 423,431			\$ 423,431
U.S. government and agency securities	279,554	\$10,253	\$ (18)	289,789
Corporate bonds	483,004	20,925	(574)	503,355
Total	<u>\$1,185,989</u>	<u>\$31,178</u>	<u>\$(592)</u>	<u>\$1,216,575</u>

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

3. Investments (continued)

Proceeds from sales and maturities of investments in debt securities during 2003 and 2002 were \$656,709 and \$629,999, respectively. Gross gains of \$8,698 and gross losses of \$2,754 were realized on those sales in 2003. Gross gains of \$9,850 and gross losses of \$3,922 were realized on those sales in 2002. At December 31, 2003, there were gross unrealized gains of \$197,943 and gross unrealized losses of \$634,722 for equity securities, including investments in unconsolidated subsidiaries. During 2003, proceeds from sales of equity securities were \$46,084. Gross gains of \$3,449 and gross losses of \$2,671 were realized on those sales. At December 31, 2002, there were gross unrealized gains of \$171,655 and gross unrealized losses of \$619,864 for equity securities, including investments in unconsolidated subsidiaries. During 2002, proceeds from sales of equity securities were \$33,322. Gross gains of \$386 and gross losses of \$5,216 were realized on those sales. In 2003, the Corporation recognized other-than-temporary impairment losses in affiliated equity securities of \$2,000 related to its investment in MedConnect, LLC (MedConnect). As a result, the Corporation's carrying value in MedConnect is zero as of December 31, 2003. In 2002, the Corporation recognized other-than-temporary impairment losses in affiliated equity securities of \$20,000 for Third Coast Holding Company (see Note 16B) and \$5,500 for HealthCare Benefits, Inc. In addition, the Corporation recognized other-than-temporary impairment losses in unaffiliated equity securities of \$1,700 in 2003 and \$3,300 in 2002. The Corporation includes other-than-temporary impairments in net realized capital gains and losses in the Statement of Income and Expenses.

At December 31, 2003 and 2002, the Corporation had net investment income of \$27,965 and \$32,936. This includes expenses of \$63,006 and \$61,529 for 2003 and 2002, respectively. Investment expense for 2003 and 2002 is comprised of real estate depreciation expense of \$16,537 and \$16,710, respectively, investment expenses of \$5,127 and \$4,501, respectively, real estate expenses of \$10,193 and \$9,097, respectively, and interest expense of \$31,149 and \$31,221, respectively.

The Corporation does not engage in any off-balance-sheet, derivative, or hedging activities. There are no significant industry or other concentrations.

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

4. Investments in Unconsolidated Subsidiaries

The Corporation's total investment in unconsolidated subsidiaries was \$615,560 and \$627,076 at December 31, 2003 and 2002, respectively.

Life Subsidiaries

The principal life insurance subsidiaries of the Corporation are Fort Dearborn Life Insurance Company (FDL), Medical Life Insurance Company (MLI), Omaha Life Insurance Company (Omaha Life), and Colorado Bankers Life Insurance Company (CBL). Effective December 31, 2003, FDL acquired Omaha Life from Blue Cross and Blue Shield of Nebraska for \$4,300. The Corporation is carrying its investment in life insurance companies at their underlying statutory net worth. The combined financial statements of these life insurance companies are shown below.

Condensed Consolidated Statements of Admitted Assets, Liabilities,
and Capital and Surplus

	December 31	
	2003	2002
Cash and short-term investments	\$ 43,949	\$ 45,027
Investments	1,483,937	1,248,827
Premiums receivable	28,682	28,140
Other assets	40,300	38,024
Total assets	\$1,596,868	\$1,360,018
Policy reserves	\$ 727,852	\$ 680,537
Policy and contract claims	71,867	67,086
Other liabilities	462,128	294,457
Minority interest	12,000	12,000
Capital and surplus	323,021	305,938
Total liabilities and capital and surplus	\$1,596,868	\$1,360,018

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

4. Investments in Unconsolidated Subsidiaries (continued)

Condensed Consolidated Statements of Operations

	Year ended December 31	
	2003	2002
Premium income	\$730,633	\$700,832
Other income	67,589	63,666
Total income	798,222	764,498
Policy benefits	495,083	452,556
Operating expenses	277,410	288,806
Total expenses	772,493	741,362
Net income before income taxes	25,729	23,136
Income tax expense	(12,426)	(11,846)
Net income	\$ 13,303	\$ 11,290

HMO Subsidiaries

In 2000, the Corporation purchased NYLCare Health Plans of the Southwest, Inc. and NYLCare Health Plans of the Gulf Coast, Inc. for \$420,038. The names of these HMOs were subsequently changed in 2000 to Southwest Texas HMO, Inc. and Texas Gulf Coast HMO, Inc., respectively. This purchase resulted in goodwill of \$357,011. Of this amount, \$123,884 is being amortized by the Corporation over 10 years. Pursuant to permission from the DOI, the remaining \$233,127 was allowed as an admitted asset but was amortized over a three year period ending March 31, 2003. Goodwill amortization totaling \$31,816 in 2003 and \$90,097 in 2002 was recorded as a direct charge to policyholders' surplus. Total unamortized goodwill of \$77,427 and \$109,243 at December 31, 2003 and 2002, respectively, is included in investments in unconsolidated subsidiaries on the Statement of Admitted Assets, Liabilities, and Policyholders' Surplus. In 2001, Texas Gulf Coast HMO, Inc. was merged into Southwest Texas HMO, Inc. with Southwest Texas HMO, Inc. being the surviving entity. The remaining unamortized goodwill of \$77,427 will be written off as a charge to surplus on January 1, 2004, due to the merger of Southwest Texas HMO, Inc. into the Corporation (see Note 19).

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

4. Investments in Unconsolidated Subsidiaries (continued)

Below are the December 31, 2003 and 2002, condensed financial statements of Southwest Texas HMO, Inc. (Southwest Texas).

Condensed Statements of Admitted Assets, Liabilities, and Capital and Surplus

	2003	2002
Cash and short-term investments	\$108,219	\$115,082
Investments	94,854	95,416
Premiums receivable	40,562	119,631
Other assets	38,791	27,181
Total assets	\$282,426	\$357,310
Claims payable	\$ 91,511	\$166,116
Other liabilities	26,519	36,140
Capital and surplus	164,396	155,054
Total liabilities and capital and surplus	\$282,426	\$357,310

Condensed Statements of Operations

	Year ended December 31	
	2003	2002
Premium income	\$939,867	\$1,341,983
Other income	10,606	7,572
Total income	950,473	1,349,555
Claim expenses	835,023	1,131,449
Operating expenses	143,101	169,288
Total expenses	978,124	1,300,737
Net (loss) income before income taxes	(27,651)	48,818
Income tax benefit	17,077	6,373
Net (loss) income	\$ (10,574)	\$ 55,191

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

4. Investments in Unconsolidated Subsidiaries (continued)

Included in the above Condensed Statements of Admitted Assets, Liabilities, and Capital and Surplus as of December 31, 2003 and 2002, is a premium deficiency reserve of \$20,831 and \$35,296, respectively, related to certain commercial and Medicaid group contracts. During 2003, this premium deficiency reserve decreased by \$14,465. The premium deficiency reserve will continue to be released over the remaining term of the contracts as actual medical costs are incurred.

Below is a listing of directly or indirectly owned subsidiaries not included in the life insurance and HMO subsidiary information disclosed above as of December 31, 2003:

Medical Life Insurance Agency	HealthCare Benefits, Inc.
Dental Network of America, Inc.	Third Coast Holding Company
HCSC Purchasing, LLC	Third Coast Insurance Company
Preferred Financial Corporation	MedConnect
Industry Savings Plan, Inc.	HMO New Mexico, Inc.
HCSC Insurance Services Company	BCI HMO, Inc.
HCSA, Inc.	THIN, Inc.
Hallmark Services Corporation	Arizona California Texas International, Inc.

The Corporation made a capital contribution to HealthCare Benefits, Inc. in 2002 for \$1,000. No capital contributions were made during 2003. BCI HMO, Inc. (BCI) paid a \$900 and \$1,000 cash dividend to the Corporation in 2003 and 2002, respectively. The operations of these subsidiaries are insignificant.

5. Pharmacy Rebate Receivable

The total pharmacy rebate receivable at December 31, 2003 and 2002, was \$54,709 and \$62,977, respectively. Of this amount, \$32,969 and \$26,732 was nonadmitted for 2003 and 2002, respectively. The net admitted asset of \$21,740 and \$36,245 at December 31, 2003 and 2002, respectively, is included in receivables related to uninsured customers and hospital receivables in the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus depending on the type of business. The confirmed receivable owed to the Corporation was zero in 2003 and \$29,000 in 2002. The remaining \$54,709 and \$33,977 receivable from 2003 and 2002, respectively, was estimated by the

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

5. Pharmacy Rebate Receivable (continued)

Corporation. In 2003 and 2002, the Corporation collected pharmacy rebates of \$100,026 and \$45,649, respectively. The chart below contains further detail regarding pharmacy rebate receivables for the years 2003 and 2002.

Quarter	Estimated Pharmacy Rebates as Reported on Financial Statements	Pharmacy Rebates as Invoiced/ Confirmed	Actual Rebates Collected Within 90 Days of Invoicing Confirmation	Actual Rebates Collected Within 91 to 180 Days of Invoicing/ Confirmation	Actual Rebates Collected More Than 180 Days After Invoicing/ Confirmation
<i>(In Millions of Dollars)</i>					
12/31/2003	\$55	\$ –	\$ –	\$ –	\$ –
9/30/2003	43	–	–	–	–
6/30/2003	44	–	–	18	21
3/31/2003	71	–	–	19	53
12/31/2002	63	29	–	20	43
9/30/2002	43	24	–	–	45
6/30/2002	38	–	–	–	34
3/31/2002	36	–	–	–	37
12/31/2001	36	15	14	19	2

6. ASO and ASC Business

The Corporation provides certain claim administration services for its uninsured customers through ASO or ASC arrangements. The net gain or loss from operations related to these contracts for the years ending December 31, 2003 and 2002, is shown in the charts below:

	ASO	
	2003	2002
Net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses	\$ (12,437)	\$ (31,359)
Total net other income or expenses (including interest paid or received from customers)	–	–
Net loss from operations	<u>\$ (12,437)</u>	<u>\$ (31,359)</u>
Total claim payment volume	<u>\$1,403,074</u>	<u>\$1,290,631</u>

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

6. ASO and ASC Business (continued)

	ASC	
	2003	2002
Gross reimbursement for medical cost incurred	\$10,508,672	\$7,812,587
Gross administrative fees accrued	853,020	559,218
Gross expenses incurred (claims and administrative)	11,119,408	8,354,922
Net gain from operations	<u>\$ 242,284</u>	<u>\$ 16,883</u>

7. Unpaid Claims and Claim Adjustment Expenses

The Corporation accrues liabilities for unpaid claims and claim adjustment expenses for insured HMO and non-HMO benefits. These liabilities represent the estimated ultimate cost of settling claims relating to insured events that have occurred on or before December 31. The estimated liability includes amounts that will be required for future payments of: (a) claims that have been reported to the insurer; (b) claims related to insured events that have occurred, but that have not been reported to the insurer as of year-end; and (c) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees and costs to record, process, and adjust claims, and provisions for unpaid claim adjustment expenses are included in accrued liabilities in the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus.

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows:

	2003	2002
Balance at January 1	\$ 954,876	\$ 920,080
Incurred expenses related to:		
Current year	6,931,169	6,178,150
Prior years	(87,535)	(125,512)
Total incurred	<u>6,843,634</u>	<u>6,052,638</u>
Paid expenses related to:		
Current year	5,997,862	5,257,706
Prior years	826,232	760,136
Total paid	<u>6,824,094</u>	<u>6,017,842</u>
Balance at December 31	<u>\$ 974,416</u>	<u>\$ 954,876</u>

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

7. Unpaid Claims and Claim Adjustment Expenses (continued)

Reserves for incurred claims and claim adjustment expenses attributable to insured events of prior years are periodically updated. These updates are generally the result of ongoing analysis of recent loss development trends. Original estimates are increased (decreased) as additional information becomes known regarding individual claims.

The Corporation took into account estimated anticipated salvage and subrogation in its determination of the liability for unpaid claims and reduced such liability by \$382,315 and \$335,882 as of December 31, 2003 and 2002, respectively.

As of December 31, 2003 and 2002, the Corporation had liabilities of \$4,927 and \$4,231, respectively, related to premium deficiency reserves, which is included in the Statements of Admitted Assets, Liabilities and Policyholders' Surplus. The Corporation did not consider anticipated investment income when calculating its premium deficiency reserves.

8. Long-Term Debt

In 2001, the Corporation issued \$400,000 in debt, pursuant to Rule 144A under the Securities Act of 1933. The notes bear interest at a rate of 7.75% per annum, payable semiannually in arrears on June 15 and December 15 of each year. The notes mature on June 15, 2011. The notes may be redeemed prior to maturity for an amount calculated to preserve the purchase yield of the holders for the duration of the notes. At December 31, 2003 and 2002, the carrying value of the debt obligation including discount accretion was \$399,906 and \$399,766, respectively.

The Corporation has a \$90,000 five-year revolving facility (Revolving Facility). The facility commitment fee on the Revolving Facility is 0.125%. The interest rate is based on the Corporation's credit rating at the time of the draw and the amount of the draw. There is no outstanding balance for the Revolving Facility as of December 31, 2003 and 2002. The Corporation is in compliance with its debt covenants on the Revolving Facility at December 31, 2003.

9. Pension Plans and Other Employee Benefits

The Corporation provides its employees noncontributory defined benefit pension plans, defined contribution plans and a retiree health and life benefit plan.

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

9. Pension Plans and Other Employee Benefits (continued)

Noncontributory Defined Benefit Pension Plans

The Corporation offers two noncontributory defined benefit pension plans, covering the majority of eligible employees. One plan covers the majority of the Corporation's employees, as well as a smaller number of employees situated in the life insurance subsidiaries of FDL and MLI. The other plan covers the majority of the Chicago-based "represented" (union) employees of the Corporation located in Illinois. Retirement benefits are primarily a function of the number of years of service and the level of compensation. The current provisions of the plans require one year of service for eligibility and five years of service for vesting. The Corporation's policy is to fund the plans on a current basis to the extent that the contribution is deductible under existing tax regulations. The Corporation estimates the contribution to the plans to be between \$56,000 and \$71,000 in 2004. At December 31, 2003, 64% of the plans assets were invested in equity securities and 36% of the plans assets were invested in debt securities.

Retiree Health and Life Benefit Plan

The Corporation offers a health and life benefit plan to eligible retired employees. Previously, the Corporation provided these benefits under three separate provisions. The majority of employees are eligible for postretirement benefits if they are at least 55 years old and have at least 10 years of service when they terminate. These benefits are subject to deductibles, co-payment provisions, coordination with Medicare and other coverages, and other limitations. Covered employees pay for a percentage of their own health benefit coverage and a higher percentage of their covered dependent health care coverage based on a schedule of age and years of service prior to retirement. The Corporation pays the cost of life insurance coverage provided. Certain assets are held in a welfare benefit (VEBA) trust. The Corporation did not make any contributions to the VEBA in 2003 or 2002. The Corporation paid the current cost of retiree health claims and life premiums directly from corporate assets during 2003 and 2002. The Corporation reserves the right to amend or change the provisions related to existing or future retirees at any time.

Estimates and Assumptions Used to Determine Benefit Obligations and Costs

The preparation of financial statements in conformity with accounting practices prescribed or permitted by the DOI requires various estimates and assumptions that affect the reporting of net periodic benefit cost, plan assets, and plan obligations at the date of the financial statements. Significant estimates that relate to the calculation of benefit plan

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

9. Pension Plans and Other Employee Benefits (continued)

obligations are the discount rate and expected long-term rate of return on plan assets. The discount rate used to determine the present value of the plan benefit obligations as of December 31 is based upon published investment grade, long-term corporate bond yields. The expected long-term rate of return on the plan assets is based on an analysis of expected plan assets and recent economic conditions.

The following actuarial assumptions were used at December 31 in determining the reported plan benefit obligations and net periodic benefit costs:

	<u>Pension benefits</u>		<u>Other benefits</u>	
	2003	2002	2003	2002
Discount rate	6.25%	6.75%	6.25%	6.75%
Expected long-term rate of return on plan assets	8.00%	8.00%	5.00%	5.00%
Rate of compensation increase	4.50%-6.00%	4.50%-6.00%	4.50%-6.00%	5.50%-6.00%

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

9. Pension Plans and Other Employee Benefits (continued)

The following table provides a reconciliation of the changes in the plans' benefit obligations and fair value of plan assets and a statement of the plans' funded status for 2003 and 2002.

	Pension benefits		Other benefits	
At December 31	2003	2002	2003	2002
<i>Reconciliation of benefit obligation</i>				
Obligation at beginning of year	\$ 538,948	\$ 504,242	\$ 129,592	\$ 112,766
Service cost	23,656	20,281	14,841	9,369
Interest cost	36,936	33,227	9,559	7,830
Plan amendments	3,898	8,214	(229)	(27,468)
Actuarial loss (gain)	45,949	(1,250)	28,293	34,341
Benefit payments and adjustments	(26,331)	(25,766)	(10,707)	(7,246)
Obligation at December 31	\$ 623,056	\$ 538,948	\$ 171,349	\$ 129,592
<i>Reconciliation of fair value of plan assets</i>				
Fair value of plan assets at beginning of year	\$ 327,128	\$ 353,839	\$ 39,864	\$ 45,580
Actual return on plan assets	61,361	(35,249)	6,616	(5,716)
Employer contributions	57,000	34,304	10,707	7,246
Benefit payments and adjustments	(26,331)	(25,766)	(10,707)	(7,246)
Fair value of plan assets at December 31	\$ 419,158	\$ 327,128	\$ 46,480	\$ 39,864
<i>Funded status</i>				
Funded status at December 31	\$(203,898)	\$(211,820)	\$(124,869)	\$(89,728)
Unrecognized prior service cost (credit)	13,591	10,956	(16,334)	(20,570)
Unrecognized net loss	131,400	127,593	57,929	36,093
Unrecognized transition obligation	77,447	82,429	-	-
Prepaid asset	18,540	9,158	-	-
Minimum pension liability adjustment	(29,596)	(37,509)	-	-
Accrued benefit cost	\$ (11,056)	\$ (28,351)	\$ (83,274)	\$ (74,205)
Benefit obligation for nonvested employees	\$ 21,341	\$ 19,567	\$ 126,453	\$ 115,949

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

9. Pension Plans and Other Employee Benefits (continued)

The accumulated pension benefit obligation (APBO) was \$430,214 and \$355,479 at December 31, 2003 and 2002, respectively.

The following table provides the components of net periodic benefit cost for the plans for 2003 and 2002.

Years Ended December 31	Pension Benefits		Other Benefits	
	2003	2002	2003	2002
<i>Plan costs</i>				
Service cost	\$23,656	\$20,281	\$14,841	\$ 9,369
Interest cost	36,936	33,227	9,559	7,830
Expected return on plan assets	(27,121)	(28,633)	(1,993)	(2,279)
Amortization of unrecognized transition obligation	4,982	4,982	—	—
Amortization of prior service cost (credit)	1,262	272	(4,465)	(4,465)
Amortization of net loss	7,902	23	1,834	1,664
Net periodic benefit cost	\$47,617	\$30,152	\$19,776	\$12,119

Prior service costs are amortized on a fixed, straight-line basis over the average expected future service of active plan participants based on their full eligibility age. Gains and losses are amortized to the extent they exceed 10% of the greater of plan assets or the APBO over the average expected future service to retirement age of active participants.

For measurement purposes, an 11% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2003. The initial rate was 12% in 2002 and is assumed to decrease gradually each year to a rate of 5.0% for 2010 and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1.0% change in assumed health care cost trend rates would have the following effects.

	1% Increase	1% Decrease
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	\$ 3,736	\$ (3,067)
Effect on the health care component of the accumulated postretirement benefit obligation	22,543	(18,798)

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

9. Pension Plans and Other Employee Benefits (continued)

At December 31, 2003, and 2002, the Corporation recorded a net intangible pension asset of \$29,596 and \$37,509, respectively, related to the establishment of an accumulated minimum pension liability. A minimum pension liability is required when the APBO exceeds plan assets and accrued pension liabilities. As disclosed in Note 2, the DOI permitted the Corporation to admit the intangible pension asset at December 31, 2002. The Corporation admitted the intangible asset at December 31, 2003, under the provisions of SSAP No. 89.

The Corporation's allocated portion of accrued retiree costs at December 31, 2003 and 2002, was \$80,385 and \$71,581, respectively, with the remaining \$2,889 and \$2,624, respectively, allocated to FDL and MLI.

The Corporation's investment policy is to employ a suitable combination of investment risk and rate of return to support the plan's emerging obligations. The Corporation uses a long-term approach to obtain a stable level of return based upon a diversified portfolio.

The *Medicare Prescription Drug, Improvement and Modernization Act of 2003* (the Act) became effective December 8, 2003. The Act expanded Medicare to include, for the first time, coverage for prescription drugs. The Corporation expects that this legislation will eventually reduce the Corporation's cost for the benefit programs it sponsors. Due to the uncertainties related to this legislation and the related accounting impacts, the Corporation has elected to defer financial recognition of this legislation until the accounting issues are resolved by the NAIC. This deferral election is allowed by the NAIC.

Defined Contribution Plans

The Corporation has a thrift plan for Illinois division union employees and a 401(k) plan for Illinois, Texas, and New Mexico divisions' salaried employees. These plans cover substantially all employees who have completed one year of service. Participants may elect to contribute a portion of their salary, which will be matched in part by the Corporation. The total expense incurred by the Corporation related to matching employee contributions was \$10,853 in 2003 and \$9,818 in 2002.

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

10. Interest Maintenance Reserve and Asset Valuation Reserve

The NAIC requires companies to record an interest maintenance reserve (IMR) and asset valuation reserve (AVR).

A summary of IMR activity in 2003 and 2002 follows:

	2003	2002
Beginning balance	\$10,536	\$ 7,805
Net realized gains on bonds sold during the year	5,944	5,928
Less: Federal income tax expense	(1,189)	(1,186)
Net realized gains to be amortized	15,291	12,547
Amortization income in the current year	2,668	2,011
Ending balance	\$12,623	\$10,536

The \$2,668 and \$2,011 in amortization income in 2003 and 2002, respectively, are included in investment income in the Statements of Income and Expenses.

The AVR is designed to provide a standardized reserve process for realized and unrealized gains and losses due to the default and equity risks associated with invested assets. The Corporation increased this reserve \$8,654 in 2003, with a corresponding decrease to policyholders' surplus. In 2002, AVR decreased by \$467 with a corresponding increase to policyholders' surplus.

11. Leases

Leases are primarily for data processing equipment with remaining lease terms of one to five years, and for office space with remaining lease terms of one to eleven years. Rental expense for 2003 and 2002 was approximately \$79,100 and \$75,900, respectively.

Future minimum lease payments as of December 31, 2003, are as follows:

2004	\$ 42,962
2005	35,032
2006	29,608
2007	26,146
2008	14,069
Subsequent to 2008	65,700
Total minimum lease payments	\$213,517

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

12. Income Taxes

The Corporation files a consolidated federal income tax return with all of its majority-owned subsidiaries (see Note 4) except for CBL, which files separately.

The method of allocation between the companies is subject to a written agreement, which sets forth the manner in which the total combined federal income tax is allocated to each entity which is a party to the agreement.

The components of the net deferred tax asset recognized in the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus are as follows:

	December 31	
	2003	2002
Total of all gross deferred tax assets	\$1,081,340	\$833,606
Total of all deferred tax liabilities	(16,928)	(7,200)
Net deferred tax asset	1,064,412	826,406
Deferred tax asset nonadmitted	946,054	745,894
Net admitted deferred tax asset	\$ 118,358	\$ 80,512
Increase in nonadmitted deferred tax asset		
	\$ 200,160	\$141,858

The provisions for incurred taxes on earnings for the years ended December 31 are:

	2003	2002
Federal income tax	\$230,938	\$160,049
Federal income tax expense (recovery) on net capital losses	612	(7,539)
Current income taxes incurred	\$231,550	\$152,510

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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

12. Income Taxes (continued)

The tax effects of the change in temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

	<u>2003</u>	<u>2002</u>
Deferred tax assets		
Accrued vacation liability	\$ 110	\$ (4,310)
Allowance for doubtful accounts	(8)	4,753
Fixed assets	13,358	(2,601)
Postretirement benefits liability	3,081	1,576
Deferred compensation liability	5,051	(1,570)
Salvage and subrogation recoverable	4,092	14,058
Nonadmitted assets	(16,323)	25,337
Net operating loss carryforwards/tax credits	182,125	75,167
Contingent liabilities	44,360	54,909
Other	11,888	(5,145)
Total change in deferred tax assets	<u>247,734</u>	162,174
Change in nonadmitted deferred tax assets	<u>(200,160)</u>	(141,858)
Change in admitted deferred tax assets	<u>47,574</u>	20,316
Deferred tax liabilities		
Unrealized capital gains	5,211	(544)
Accrued market discount	(56)	(174)
Pension	4,576	1,730
Other	(3)	1
Total change in deferred tax liabilities	<u>9,728</u>	1,013
Change in net admitted deferred tax asset	<u>\$ 37,846</u>	\$ 19,303

The change in net deferred taxes is comprised of the following:

	December 31		
	<u>2003</u>	<u>2002</u>	<u>Change</u>
Total of all gross deferred tax assets	\$1,081,340	\$833,606	\$247,734
Total of all deferred tax liabilities	(16,928)	(7,200)	(9,728)
Net deferred tax asset	<u>\$1,064,412</u>	<u>\$826,406</u>	238,006
Change in unrealized capital gains			5,211
Change in net deferred income taxes			<u>\$243,217</u>

Health Care Service Corporation,
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Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

12. Income Taxes (continued)

The provision for federal income taxes incurred is different from that which would be obtained by applying the statutory federal income tax rate to net gain from operations before income taxes and realized capital losses. The significant items causing this difference for 2003 and 2002 are as follows:

	Effective Tax Rate Percentage	
	2003	2002
Provision computed at statutory rate	35.0%	35.0%
Special deductions/alternative minimum tax	(34.8)	(26.3)
Change in nonadmitted assets	1.9	(6.3)
Change in fixed assets	(1.6)	1.2
Other	(1.9)	(5.6)
Total	(1.4)	(2.0)
Federal income taxes incurred	27.0	37.9
Change in net deferred income taxes	(28.4)	(39.9)
Total statutory income taxes	(1.4)%	(2.0)%

At December 31, 2003, the Corporation had \$604,161 tax effected operating loss and tax credit carryforwards, originating in 1988 through 2003, of which \$7,430 will expire in 2003 and \$57,461 will expire generally between years 2010 and 2020 if unused.

The amount of federal income taxes incurred in the current year and the preceding year which are available for recoupment in the event of future net losses are:

2003	\$198,898
2002	97,685
Total	\$296,583

13. Direct Premium Written by a Third-Party Administrator

Total premiums written by a third-party administrator in 2003 and 2002 were \$327,388 and \$318,139. This business was written by Hallmark Services Corporation (Hallmark). Hallmark is a wholly owned subsidiary of the Corporation. Hallmark has authority to underwrite and sell individual and group health insurance on behalf of the Corporation. Hallmark also bills premiums, but amounts are remitted directly to the Corporation.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

14. Retrospectively Rated Contracts

The Corporation estimates accrued retrospective premium adjustments for its group health insurance business using the Corporation's underwriting rules and experience rating practices.

The amount of net premiums written by the Corporation at December 31, 2003 and 2002, that are subject to retrospective rating features was \$107,200 and \$89,100, respectively. This represents 2.3% and 2.1%, respectively, of the premiums written for group health. No other net premiums written by the Corporation are subject to retrospective rating features.

15. Legal Actions

The Corporation entered into a merger agreement with Blue Cross Blue Shield of Texas, Inc. (BCBSTX) in 1995. In 1996, the Attorney General of the State of Texas (Attorney General) filed a declaratory judgment action and contingent request for temporary and permanent injunction, to determine whether a proposed merger of BCBSTX and the Corporation should be permitted under various provisions of the laws of Texas. In 1998, the court rejected the lawsuit and ruled in favor of BCBSTX. Pursuant to a settlement agreement, the Corporation has committed to contribute \$10,000 over five years to the Texas Healthy Kids Corporation. The Corporation has paid and expensed \$10,000, consistent with the agreement, toward this judgment. Also, pursuant to the settlement agreement, the Attorney General has agreed to limit its appeal of this matter to the issue regarding the status of BCBSTX as a charity or a charitable trust. On July 30, 2003, the Third District Court of Appeals affirmed the trial court's judgment that BCBSTX was not a common-law charity. On January 14, 2004, the Attorney General appealed this case to the Texas Supreme Court. The effect of the Attorney General's appeal of this matter on the Corporation's financial statements cannot be determined at this time. However, if the Attorney General prevails on this appeal, the Corporation would be required to pay \$340,000 plus 5% interest over a period of 20 years to a charitable trust designated by the Attorney General.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

15. Legal Actions

In December 2002, the Circuit Court of Cook County entered an Agreed Order, Final Judgment, Consent Decree and Settlement Agreement, which resolved all claims of the Illinois Attorney General that the Corporation was or is a charity and/or holds charitable assets as a result of its incorporation under the Illinois Non-Profit Health Care Service Plan Act and subsequent conversion to a mutual insurance company on December 20, 1982. The settlement agreement required that the Corporation pay \$124,600 to the Illinois Children's Healthcare Foundation. The settlement was included in operating expenses, net of reimbursements, in the Statements of Income and Expenses as of December 31, 2002. The liability was included in accrued liabilities on the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus as of December 31, 2002. The liability was paid in February 2003.

In addition, the Corporation is a defendant in legal actions arising from normal business activities. Management believes, after consultation with legal counsel, that the ultimate liability, to the extent not provided for, will not materially affect the Corporation's financial position or results of operations.

16. Related Party Transactions

A. The Corporation has administrative agreements with nearly all of its subsidiaries whereby the Corporation may provide any combination of management, administrative, marketing, or claims processing functions. Amounts billed under these agreements, based on actual costs incurred, were \$154,505 and \$173,196 in 2003 and 2002, respectively. These amounts are netted against operating expenses in the Corporation's Statements of Income and Expenses.

At December 31, 2003 and 2002, the Corporation has receivables of \$5,389 and \$6,009, and payables of \$19,347 and \$15,988, respectively, from its subsidiaries.

B. The Corporation indirectly owns 100% of Third Coast Insurance Company (TCIC). The Corporation has agreed, under certain circumstances, to purchase surplus notes that may be issued by TCIC up to \$30,000 to maintain an appropriate level of statutory net worth. In 1997, the Corporation purchased and nonadmitted \$10,000 in surplus notes issued by TCIC. In 2001, the Corporation invested an additional \$3,000 through Third Coast Holding Company (TCHC) to TCIC, leaving a remaining commitment of \$17,000. As of December 31, 2002, TCIC has transferred all

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

16. Related Party Transactions (continued)

remaining risks associated with its workers' compensation business to third parties. TCIC is currently in the process of paying claims on runoff business. Therefore, in 2002, the Corporation recognized an impairment loss of \$10,000 in TCIC surplus notes which is included in realized gains and losses in the Statements of Income and Expenses.

- C. The Corporation has guaranteed that it will cover all uncovered expenses of Southwest Texas in the event Southwest Texas cannot fulfill its requirements. The Corporation has not accrued for any losses related to this guaranty. At December 31, 2003, Southwest Texas had a statutory capital and surplus of \$164,396.
- D. The Corporation, for a nominal fee, has guaranteed the payment of claim-related expenses of BCI in the event that BCI becomes insolvent as determined by the DOI. At December 31, 2003, BCI had a statutory capital and surplus of \$9,093. The Corporation has not accrued for any losses related to this guaranty.
- E. CBL has \$12,000 in outstanding voting preferred stock, which is owned by two unaffiliated companies. The Corporation has a guaranty repurchase agreement, which requires the Corporation to purchase the preferred stock from the two unaffiliated companies if CBL does not purchase it.
- F. In 2003, Nichold Company, a wholly owned subsidiary, was dissolved. A realized loss of \$495 was recorded upon its dissolution.

17. Risk-Based Capital

The NAIC has imposed regulatory risk-based capital (RBC) requirements on life and health insurance enterprises, including the Corporation. The RBC calculation serves as a benchmark for the regulation of life and health insurance enterprises' solvency by state insurance regulators. At December 31, 2003, the Corporation's total adjusted capital is in compliance with the regulatory RBC requirements.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Thousands of Dollars)

18. Other Items

- A. In 2001, the Corporation completed an assumption reinsurance agreement with Blue Cross Blue Shield of New Mexico (BCBSNM). In addition, the Corporation purchased 100% of the stock of New Mexico HMO, Inc. (NMHMO) as part of this transaction. The purchase of the NMHMO is reported as a statutory purchase.

The Corporation paid \$50,662 to acquire the business of BCBSNM and to purchase NMHMO. This transaction resulted in total goodwill of approximately \$28,000. Of the total goodwill, approximately \$23,800 related to assumption of the business of BCBSNM. This goodwill is being amortized to operations as operating expense over seven years, from July 1, 2001 through June 30, 2008. The remaining goodwill of approximately \$4,600 is related to the purchase of NMHMO and is being amortized as part of goodwill amortization directly to policyholders' surplus over a period of ten years.

Total unamortized goodwill at December 31, 2003 and 2002, was \$18,760 and \$22,622, respectively, \$15,306 and \$18,707, respectively, due to assumption reinsurance and \$3,454 and \$3,915, respectively, for the purchase of NMHMO. Of this amount \$8,847 was non-admitted at December 31, 2002. All unamortized goodwill is being admitted at December 31, 2003.

- B. The Corporation performs claims processing services for Indian Health Service. Revenue from the Corporation's Indian Health Service contract for December 31, 2003 and 2002 was \$0 in both years for medical and hospital-related services and \$5,789 and \$4,839, respectively, for administrative expenses. The Corporation recorded receivables from Indian Health Service of \$1,927 and \$1,409 for December 31, 2003 and 2002, respectively.

19. Subsequent Events

Effective January 1, 2004, the Corporation merged with Southwest Texas, its Texas based, wholly owned HMO subsidiary. This merger was approved by both the DOI and Texas Department of Insurance. As part of this merger, the Corporation assumed the assets, liabilities, and contracts of Southwest Texas. As a result of this statutory merger, the Corporation is required to write off the remaining statutory goodwill amount of \$77,427 related to its purchase of the NYLCare Health Plans.

In March 2004, the Corporation purchased a 49% interest in Prime Therapeutics, Inc. (PTI) for approximately \$44,000. PTI is a PBM. HCSC expects to transfer its pharmacy benefits functions to PTI in 2005.

Other Financial Information

Health Care Service Corporation,
a Mutual Legal Reserve Company

Selected Financial Data
(In Thousands of Dollars)

Year ended December 31, 2003

	2003
Investment income earned:	
U.S. government bonds	\$ 3,704
Other bonds (unaffiliated)	35,822
Preferred stocks (unaffiliated)	—
Common stocks (unaffiliated)	1,581
Common stocks of affiliates	900
Real estate	30,657
Cash and short-term investments	12,962
Other investment income	211
Investment income allocated from FEP	2,466
Amortization of interest maintenance reserve	2,668
Gross investment income	90,971
Less:	
Investment expenses	5,127
Real estate expenses	10,193
Interest expense	31,149
Depreciation on real estate	16,537
Net investment income	\$ 27,965
Real estate owned – Book value less encumbrances	\$229,859
Bonds and stocks of parents, subsidiaries, and affiliates – Book/ adjusted carrying value:	
Bonds	\$ —
Preferred stocks	23,000
Common stocks	592,560
Total	\$615,560

Health Care Service Corporation,
a Mutual Legal Reserve Company

Selected Financial Data (continued)
(In Thousands of Dollars)

Year ended December 31, 2003

Bonds and short-term investments by class and maturity:	
Bond by maturity – Statement value:	
Due within one year or less	\$1,028,562
Over 1 year through 5 years	404,996
Over 5 years through 10 years	232,875
Over 10 years	135,486
Total by maturity	<u>\$1,801,919</u>
Bonds by class – Statement value:	
Class 1	\$1,714,476
Class 2	87,443
Class 3	–
Class 4	–
Class 5	–
Class 6	–
Total by class	<u>\$1,801,919</u>
Total bonds publicly traded	\$1,801,919
Total bonds privately traded	–
Total bonds	<u>\$1,801,919</u>
Preferred stocks – Book/adjusted carrying value	\$ 23,000
Common stocks – Fair value	\$ 703,667
Short-term investments – Book/adjusted carrying value	\$ 997,004
Cash on deposit	\$ (28,621)

Health Care Service Corporation,
a Mutual Legal Reserve Company

Selected Financial Data (continued)
(In Thousands of Dollars)

Year ended December 31, 2003

Accident and health insurance – Premiums in force (premium business only):	
Group	\$5,001,651
Individual	1,663,408
Claim payments in 2003 by incurred year (premium business only):	
Group accident and health:	
2003	\$3,393,371
2002	437,604
2001 and prior	798
Individual accident and health:	
2003	\$ 926,175
2002	152,938
2001 and prior	(212)

**ANNUAL STATEMENT FOR THE YEAR 2003 OF THE Health Care Service Corporation,
an Mutual Legal Reserve Company**

SUMMARY INVESTMENT SCHEDULE

Investment Categories	Gross Investment Holdings		Admitted Assets as Reported in the Annual Statement	
	1	2	3	4
	Amount	Percentage	Amount	Percentage
1. Bonds:				
1.1 U.S. Treasury securities	75,861,352	2.327	75,861,352	2.327
1.2 U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
1.21 Issued by U.S. government agencies		0.000		0.000
1.22 Issued by U.S. government sponsored agencies	134,975,312	4.140	134,975,312	4.140
1.3 Foreign government (including Canada, excluding mortgaged-backed securities)	5,214,305	0.160	5,214,305	0.160
1.4 Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
1.41 States, territories and possessions general obligations		0.000		0.000
1.42 Political subdivisions of states, territories and possessions and political subdivisions general obligations		0.000		0.000
1.43 Revenue and assessment obligations		0.000		0.000
1.44 Industrial development and similar obligations		0.000		0.000
1.5 Mortgage-backed securities (includes residential and commercial MBS):				
1.51 Pass-through securities:				
1.511 Guaranteed by GNMA	13,189,175	0.405	13,189,175	0.405
1.512 Issued by FNMA and FHLMC	64,876,135	1.990	64,876,135	1.990
1.513 Privately issued	87,914,047	2.697	87,914,047	2.697
1.52 CMOs and REMICs:				
1.521 Issued by FNMA and FHLMC		0.000		0.000
1.522 Privately issued and collateralized by MBS issued or guaranteed by GNMA, FNMA, or FHLMC		0.000		0.000
1.523 All other privately issued		0.000		0.000
2. Other debt and other fixed income securities (excluding short-term):				
2.1 Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	422,884,811	12.971	422,884,811	12.971
2.2 Unaffiliated foreign securities		0.000		0.000
2.3 Affiliated securities		0.000		0.000
3. Equity interests:				
3.1 Investments in mutual funds	37,438,558	1.148	37,438,558	1.148
3.2 Preferred stocks:				
3.21 Affiliated	23,000,000	0.705	23,000,000	0.705
3.22 Unaffiliated		0.000		0.000
3.3 Publicly traded equity securities (excluding preferred stocks):				
3.31 Affiliated		0.000		0.000
3.32 Unaffiliated	52,120,828	1.599	52,120,828	1.599
3.4 Other equity securities:				
3.41 Affiliated	592,559,956	18.175	592,559,956	18.175
3.42 Unaffiliated	21,547,874	0.661	21,547,874	0.661
3.5 Other equity interests including tangible personal property under lease:				
3.51 Affiliated		0.000		0.000
3.52 Unaffiliated		0.000		0.000
4. Mortgage loans:				
4.1 Construction and land development		0.000		0.000
4.2 Agricultural		0.000		0.000
4.3 Single family residential properties		0.000		0.000
4.4 Multifamily residential properties		0.000		0.000
4.5 Commercial loans		0.000		0.000
5. Real estate investments				
5.1 Property occupied by the company	229,858,615	7.050	229,858,615	7.050
5.2 Property held for the production of income (includes \$ _____ of property acquired in satisfaction of debt)		0.000		0.000
5.3 Property held for sale (\$ _____ including property acquired in satisfaction of debt)		0.000		0.000
6. Policy loans		0.000		0.000
7. Receivables for securities	80,310	0.002	80,310	0.002
8. Cash and short-term investments	1,498,754,889	45.970	1,498,754,889	45.970
9. Other invested assets		0.000		0.000
10. Total Invested Assets	3,260,276,167	100.000	3,260,276,167	100.000

**SUPPLEMENTAL EXHIBIT FOR THE YEAR 2003 OF THE Health Care Service Corporation,
an Mutual Legal Reserve Company**

SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES

Due April 1
FOR THE YEAR ENDED DECEMBER 31, 2003

Of The (Name) Health Care Service Corporation, a Mutual Legal Reserve Company
 Address (City, State, and Zip Code) Chicago, IL 60601-5099
 NAIC Group Code 0917 NAIC Company Code 70670 Employer's ID Number 36-1236610

The Investment Risks Interrogatories are to be filed by April 1. They are also to be included with the Audited Statutory Financial Statements.

Answer the following interrogatories by stating the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments as shown on the Summary Investment Schedule. All reporting entities must answer interrogatories 1, 2, 3, 4, 11 and, if applicable, 20 through 24. Answer each of interrogatories 5 through 19 (except 11) only if the reporting entity's aggregate holding in the gross investment category addressed in that interrogatory equals or exceeds 2.5% of the reporting entity's total admitted assets. For Life, Health, and Fraternal blanks, responses are to exclude Separate Accounts. For Property and Casualty blank, responses are to exclude Protected Cell Accounts.

1. State the reporting entity's total admitted assets as reported on Page 2 of this annual statement. \$ 4,939,355,480
2. State by investment category the 10 largest exposures to a single issuer/borrower/investment, excluding U.S. government, U.S. government agency securities and those U.S. government money market funds listed in the Appendix to the SVO Purposes and Procedures manual as exempt, property occupied by the company and policy loans.

	1	2	3	
	Investment Category	Amount	Percentage of Total Admitted Assets	
2.01	Other Equity Securities - Affiliated	\$ 311,841,059	6.3	%
2.02	Other Equity Securities - Affiliated	\$ 218,823,300	4.4	%
2.03	General Electric Capital Corp.	\$ 120,763,015	2.4	%
2.04	Citigroup, Inc.	\$ 96,062,893	1.9	%
2.05	Household Finance Corp.	\$ 87,317,717	1.8	%
2.06	Institutional Government Money Market Fund	\$ 43,748,833	0.9	%
2.07	Maximillan Capital	\$ 39,837,392	0.8	%
2.08	DFA Fixed Income	\$ 37,210,751	0.8	%
2.09	Preferred Stocks - Affiliated	\$ 23,000,000	0.5	%
2.10	Other Equity Securities - Affiliated	\$ 17,638,554	0.4	%

3. State the amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating.

	Bonds	1	2		Preferred Stocks	3	4		
3.01	NAIC-1	\$ 1,714,476,004	34.7	%	3.07	P/RP-1	\$ 23,000,000	0.5	%
3.02	NAIC-2	\$ 87,442,988	1.8	%	3.08	P/RP-2		0.0	%
3.03	NAIC-3		0.0	%	3.09	P/RP-3		0.0	%
3.04	NAIC-4		0.0	%	3.10	P/RP-4		0.0	%
3.05	NAIC-5		0.0	%	3.11	P/RP-5		0.0	%
3.06	NAIC-6		0.0	%	3.12	P/RP-6		0.0	%

**SUPPLEMENTAL EXHIBIT FOR THE YEAR 2003 OF THE Health Care Service Corporation,
an Mutual Legal Reserve Company**

SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES (cont.)

4. State the amounts and percentages of the reporting entity's total admitted assets held in foreign investments (regardless of whether there is any foreign currency exposure) and unhedged foreign currency exposure (defined as the statement value of investments denominated in foreign currencies which are not hedged by financial instruments qualifying for hedge accounting as specified in SSAP No. 31 – *Derivative Instruments* and SSAP No. 68 – *Derivative Instruments*), including (4.01) foreign-currency-denominated investments of \$ _____; _____ 0.0% (4.02) supporting insurance liabilities denominated in that same foreign currency of \$ \$0.0% and excluding (4.03) Canadian investments and currency exposure of \$0.0%

Assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatories 5 – 10. (4.04)

Yes [] No [X]

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:
6. Two largest foreign investment exposures to a single country, categorized by NAIC sovereign rating:

	1	2
7. Aggregate unhedged foreign currency exposure	\$ _____	0.0 %

8. Aggregate unhedged foreign currency exposure categorized by the country's NAIC sovereign rating:
9. Two largest unhedged foreign currency exposures to a single country, categorized by the country's NAIC sovereign rating:
10. List the 10 largest non-sovereign (i.e. non-governmental) foreign issues:

11. State the amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure, including Canadian-currency-denominated investments of (11.01) \$ _____ 0.0% _____ supporting Canadian-denominated insurance liabilities of (11.02) \$ _____

Assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 12. (11.03)

Yes [X] No []

12. Aggregate Canadian investment exposure.
13. State the aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions (defined as investments having restrictions that prevent investments from being sold within 90 days).

Assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 13.

Yes [X] No []

14. State the aggregate amounts and percentages of admitted assets held in the largest 10 equity interests (including investments in the shares of mutual funds, preferred stocks, publicly traded equity securities, and other equity securities, and excluding money market and bond mutual funds listed in the Appendix to the SVO Purposes and Procedures Manual as exempt or Class 1).

Assets held in equity interests less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 14.

Yes [] No [X]

	1 Investment Category		2 Amount		3 Percentage of Total Admitted Assets	
14.01	Other Equity – Affiliated _____	\$ _____	311,841,059	_____	6.3	%
14.02	Other Equity – Affiliated _____	\$ _____	218,823,300	_____	4.4	%
14.03	DFA Fixed Income _____	\$ _____	37,210,751	_____	0.8	%
14.04	Preferred Stocks – Affiliated _____	\$ _____	23,000,000	_____	0.5	%
14.05	Other Equity – Affiliated _____	\$ _____	17,638,554	_____	0.4	%
14.06	Other Equity – Affiliated _____	\$ _____	13,041,309	_____	0.3	%
14.07	Other Equity – Affiliated _____	\$ _____	10,832,967	_____	0.2	%
14.08	BCS Financial Corp _____	\$ _____	10,536,448	_____	0.2	%
14.09	Other Equity – Affiliated _____	\$ _____	9,143,472	_____	0.2	%
14.10	Triwest Healthcare Alliance Co. _____	\$ _____	6,445,701	_____	0.1	%

**SUPPLEMENTAL EXHIBIT FOR THE YEAR 2003 OF THE Health Care Service Corporation,
an Mutual Legal Reserve Company**

SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES (cont.)

15. State the amounts and percentages of the entity's total admitted assets held in nonaffiliated, privately placed equities (included in other equity securities) and excluding securities eligible for sale under Securities Exchange Commission (SEC) Rule 144a or SEC Rule 144 without volume restrictions.

Assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 15. Yes No

16. State the aggregate amounts and percentages of the reporting entity's total admitted assets held in general partnership interests (included in other equity securities).

Assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 16. Yes No

17. With respect to mortgage loans reported in Schedule B, state the amounts and percentages of the reporting entity's total admitted assets held.

Mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatories 17 and 18. Yes No

18. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date:

19. State the amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A, excluding property occupied by the company.

Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A are less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 19. Yes No

20. State the amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

		At Year-End		At End of Each Quarter		
		1	2	1 st Quarter	2 nd Quarter	3 rd Quarter
		<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
20.01	Securities Lending (Do Not Include Assets Held as Collateral for Such Transactions) _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
20.02	Repurchase Agreements _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
20.03	Reverse Repurchase Agreements _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
20.04	Dollar Repurchase Agreements _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
20.05	Dollar Reverse Repurchase Agreements _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____

21. State the amounts and percentages indicated below for warrants not attached to other financial instruments, options, caps, and floors:

		Owned		Written	
		1	2	3	4
		<u> </u>	<u> </u>	<u> </u>	<u> </u>
21.01	Hedging _____	\$ _____	_____ 0.0 %	\$ _____	_____ 0.0 %
21.02	Income Generation _____	\$ _____	_____ 0.0 %	\$ _____	_____ 0.0 %
21.03	Other _____	\$ _____	_____ 0.0 %	\$ _____	_____ 0.0 %

22. State the amounts and percentages indicated below of potential exposure (defined as the amount determined in accordance with the NAIC Annual Statement Instructions) for collars, swaps, and forwards:

		At Year-End		At End of Each Quarter		
		1	2	1 st Quarter	2 nd Quarter	3 rd Quarter
		<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
22.01	Hedging _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
22.02	Income Generation _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
22.03	Replications _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
22.04	Other _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____

**SUPPLEMENTAL EXHIBIT FOR THE YEAR 2003 OF THE Health Care Service Corporation,
an Mutual Legal Reserve Company**

SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES (cont.)

23. State the amounts and percentages indicated below of potential exposure (defined as the amount determined in accordance with the NAIC Annual Statement Instructions) for futures contracts:

		At Year-End		At End of Each Quarter		
		1	2	1 st Quarter 3	2 nd Quarter 4	3 rd Quarter 5
23.01	Hedging _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
23.02	Income Generation _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
23.03	Replications _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____
23.04	Other _____	\$ _____	_____ 0.0 %	\$ _____	\$ _____	\$ _____

24. State the amounts and percentages of the 10 largest investments included in the Write-ins for Invested Assets category included on the Summary Investment Schedule.

	1	2	3
24.01	_____	\$ _____	_____ 0.0 %
24.02	_____	\$ _____	_____ 0.0 %
24.03	_____	\$ _____	_____ 0.0 %
24.04	_____	\$ _____	_____ 0.0 %
24.05	_____	\$ _____	_____ 0.0 %
24.06	_____	\$ _____	_____ 0.0 %
24.07	_____	\$ _____	_____ 0.0 %
24.08	_____	\$ _____	_____ 0.0 %
24.09	_____	\$ _____	_____ 0.0 %
24.10	_____	\$ _____	_____ 0.0 %