

Financial Statements (Statutory Basis)
and Other Financial Information

Health Care Service Corporation,
a Mutual Legal Reserve Company

Years ended December 31, 2004 and 2003

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a Mutual Legal Reserve Company

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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, 2004 and 2003, 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Corporation's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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 Department of Financial and Professional Regulation – Division of Insurance, 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, 2004 and 2003, 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, 2004 and 2003, 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 Department of Financial and Professional Regulation – Division of Insurance.

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, are fairly stated in all material respects in relation to the statutory-basis financial statements taken as a whole.

Ernst + Young LLP

February 25, 2005



HEALTH CARE SERVICE CORPORATION,
A MUTUAL LEGAL RESERVE COMPANY

STATEMENTS OF ADMITTED ASSETS, LIABILITIES,
AND POLICYHOLDERS' SURPLUS (STATUTORY BASIS)
AS OF DECEMBER 31, 2004 AND 2003
(IN MILLIONS OF DOLLARS)

<u>ADMITTED ASSETS</u>	<u>2004</u>	<u>2003</u>
CASH AND INVESTED ASSETS:		
Cash and cash equivalents	\$ 335.7	\$ 608.7
Short-term investments, at amortized cost which approximates fair value	1,689.6	998.2
U.S. government and agency securities, at amortized cost (fair value: 2004 – \$398.7; 2003 – \$346.6)	391.1	337.4
Corporate and other bonds, at amortized cost (fair value: 2004 – \$615.8; 2003 – \$583.8)	601.5	562.4
Equity securities, at fair value (cost: 2004 – \$142.8; 2003 – \$85.3)	167.9	111.1
Investments in unconsolidated subsidiaries (Note 4)	395.2	373.7
Real estate, at cost, less accumulated depreciation of \$120.1 in 2004 and \$105.9 in 2003	219.9	229.9
Other invested assets	31.8	0.1
Total Cash and Invested Assets	3,832.7	3,221.5
RECEIVABLES:		
Premium and HMO business	133.8	158.3
Receivables related to uninsured customers	1,109.6	768.2
Less: Allowance for doubtful accounts	(26.1)	(21.5)
Total Accident and Health Policy Receivables, net	1,217.3	905.0
Due from Federal Employees Program (Note 2)	396.0	352.9
Health care receivables	215.6	214.3
Other	34.6	41.4
Total Receivables, net	1,863.5	1,513.6
DEFERRED TAX ASSETS (Note 12)	136.4	132.6
DATA PROCESSING EQUIPMENT , at cost, less accumulated depreciation of \$137.4 in 2004 and \$130.4 in 2003	40.6	42.4
GOODWILL AND INTANGIBLE ASSETS (Notes 9 & 19A)	13.6	44.9
TOTAL ADMITTED ASSETS	\$5,886.8	\$4,955.0

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, 2004 AND 2003 (CONTINUED)
(IN MILLIONS OF DOLLARS)

<u>LIABILITIES AND POLICYHOLDERS' SURPLUS</u>	<u>2004</u>	<u>2003</u>
ACCIDENT AND HEALTH POLICY RESERVES:		
Policy and contract claims	\$ 636.8	\$ 686.2
Aggregate reserves	365.0	320.7
HMO policy and contract claims	325.3	341.0
Total Accident and Health Policy Reserves	1,327.1	1,347.9
Operating expense liabilities, including commissions	248.9	212.8
Employee benefits payable	236.6	224.1
Other accrued liabilities	564.1	479.6
Long-term debt (Note 8)	400.0	399.9
Federal income tax liability	198.7	198.6
Interest maintenance reserve	11.0	12.6
Asset valuation reserve	7.6	16.1
Total Liabilities	2,994.0	2,891.6
POLICYHOLDERS' SURPLUS	2,892.8	2,063.4
TOTAL LIABILITIES AND POLICYHOLDERS' SURPLUS	\$5,886.8	\$4,955.0

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, 2004 AND 2003
(IN MILLIONS OF DOLLARS)**

	<u>2004</u>	<u>2003</u>
INCOME:		
Premium business	\$7,042.6	\$6,287.6
HMO business	2,704.2	2,809.0
Net investment income (Note 3)	54.6	34.3
Other income	7.8	9.5
Total Income	<u>9,809.2</u>	<u>9,140.4</u>
EXPENSES:		
Premium benefits	5,529.3	4,923.1
HMO benefits (Note 2)	2,319.1	2,514.8
Operating expenses, net of reimbursements (Notes 6, 16A, & 19B)	416.0	573.9
Commission expenses	301.6	276.6
Other expenses	14.7	22.2
Total Expenses	<u>8,580.7</u>	<u>8,310.6</u>
NET GAIN FROM OPERATIONS BEFORE INCOME TAXES AND REALIZED CAPITAL GAINS (LOSSES)	1,228.5	829.8
Income tax expense (Note 12)	(235.9)	(213.9)
NET GAIN BEFORE REALIZED CAPITAL GAINS (LOSSES)	992.6	615.9
Net realized capital gains (losses) less federal income tax expense (benefit) of \$1.9 in 2004 and \$(0.5) in 2003	2.1	(1.9)
NET GAIN	<u>\$ 994.7</u>	<u>\$ 614.0</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, 2004 AND 2003
(IN MILLIONS OF DOLLARS)

	<u>2004</u>	<u>2003</u>
Policyholders' surplus at beginning of year	\$2,063.4	\$1,351.5
Net gain	994.7	614.0
Increase in nonadmitted assets	(399.9)	(170.1)
Net change in deferred tax (Note 12)	218.5	238.8
Decrease (increase) in asset valuation reserve	8.5	(8.7)
Net change in unrealized capital (losses) gains	(0.7)	12.9
Net increase in equity of unconsolidated subsidiaries	17.0	25.4
Goodwill amortization (Notes 18 and 19)	(8.7)	(0.4)
	<hr/>	<hr/>
POLICYHOLDERS' SURPLUS AT END OF YEAR	<u>\$2,892.8</u>	<u>\$2,063.4</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, 2004 AND 2003
(IN MILLIONS OF DOLLARS)

	<u>2004</u>	<u>2003</u>
CASH FROM OPERATIONS:		
Premiums collected	\$7,099.2	\$6,309.3
HMO revenue collected	2,632.6	2,895.8
Net investment income received	99.8	85.8
Premium benefits paid	(5,528.4)	(4,904.2)
HMO benefits paid	(2,351.3)	(2,582.2)
Commissions and other expenses paid, net of reimbursements	(1,164.5)	(1,079.0)
Federal income taxes paid, net of refunds received	(235.8)	(148.7)
Net Cash Provided by Operations	<u>551.6</u>	<u>576.8</u>
CASH FROM INVESTMENTS:		
Proceeds (losses) from sale or maturity of -		
Bonds	273.8	699.0
Equity securities	72.1	46.1
Other invested assets	1.5	2.2
Net loss on short-term investments	(1.0)	(0.5)
Miscellaneous proceeds	0.1	11.3
Capital gains tax paid	(0.8)	(0.6)
Total proceeds	<u>345.7</u>	<u>757.5</u>
Cost of investments acquired -		
Bonds	369.8	738.1
Equity securities	127.9	36.0
Real estate	7.0	27.3
Other invested assets	45.4	19.0
Total cost of investments acquired	<u>550.1</u>	<u>820.4</u>
Net Cash Used for Investments	<u>(204.4)</u>	<u>(62.9)</u>
CASH FROM FINANCING AND OTHER SOURCES, NET:		
Interest on long-term debt	(32.0)	(31.1)
Other sources, net	103.2	44.9
Net Cash Provided by Financing and Other Sources	<u>71.2</u>	<u>13.8</u>
NET INCREASE IN CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS	418.4	527.7
CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS AT THE BEGINNING OF THE YEAR	<u>1,606.9</u>	<u>1,079.2</u>
CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS AT THE END OF THE YEAR	<u>\$2,025.3</u>	<u>\$1,606.9</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 Millions of Dollars)

December 31, 2004 and 2003

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.

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

Effective January 1, 2004, the Corporation completed a statutory merger with its wholly owned subsidiary, Southwest Texas HMO, Inc. The 2003 financial statements have been restated to reflect the merger (see Note 18).

2. Accounting Policies

Basis of Presentation

The accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance (DOI), which practices differ from accounting principles generally accepted in the United States (GAAP). The Corporation did not have any permitted practices in 2004 or 2003.

The more significant variances from GAAP are:

- i. Certain assets, designated as “nonadmitted assets” (principally certain receivables, deferred tax assets, furniture, fixtures, office equipment, leasehold improvements, and nonoperating system software) are charged to policyholders’ surplus.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

- 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.
- 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.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

- xii. 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.

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.

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.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

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.

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, 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 health care receivables. Additionally, a portion of these receivables result from claims paid by the Corporation on behalf of its uninsured customers. These receivables are reported in the Corporation's Statements of Admitted Assets, Liabilities, and Policyholders' Surplus as receivables related to uninsured customers.

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.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

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 health care 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, 2004 and 2003, data processing equipment had an admitted asset balance of \$40.6 and \$42.4, respectively. Equipment is depreciated on a straight-line basis over the lesser of three years or its remaining useful life. 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. Depreciation expense for data processing equipment and nonoperating system software was \$25.8 and \$36.3 for 2004 and 2003, respectively.

The Corporation began capitalizing internally developed software in 2003. Development costs for internally developed software are capitalized if the total capitalizable internal and external development costs exceed or are expected to exceed \$2.5. Once operational, internally developed software is amortized on a straight-line basis over the lesser of five years or its remaining useful life. At December 31, 2004 and 2003, capitalized internally developed software was \$21.0 and \$14.5, respectively, with the balance being nonadmitted. There were no amortization costs in 2004 and 2003.

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 \$33.5 and \$31.6 for 2004 and 2003, 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 \$10.7 and \$11.8 for 2004 and 2003, respectively. The remaining unamortized balances of furniture, fixtures, equipment, and leasehold improvements are nonadmitted.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

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, as well as changes in actual experience, could cause these estimates to change in the near term.

Aggregate reserves represent reserves for unearned premium income.

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. Single class mortgage-backed/asset-backed securities are stated at either amortized cost or the lower of amortized cost or fair market value. The retrospective adjustment method is used to value all mortgage-backed/asset-backed securities. Prepayment assumptions for single class mortgage-backed/asset-backed securities were obtained from broker dealer survey values or internal estimates. Short-term investments with original maturities of three months or less are reported as cash and cash equivalents. 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.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

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. Investments in the Corporation's unconsolidated noninsurance 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.

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 \$30.8 and \$29.2 for 2004 and 2003, 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.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

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.

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.

Effect of New Accounting Pronouncements

Effective in 2003, Statement of Statutory Accounting Principles (SSAP) No. 85, *Claim Adjustment Expenses, Amendments to SSAP No. 55 – Unpaid Claims, Losses and Loss Adjustment Expenses*, was adopted by the NAIC. This accounting principle requires health insurance companies to report cost containment expenses as a component of operating expenses. The Corporation previously reported certain expenses paid to unrelated entities that resulted in lower claims expense as a component of premium or HMO benefits expense. As a result of the adoption of SSAP No. 85, the Corporation now reports these costs as operating expenses. These costs are amounts paid to Blue Cross and Blue Shield plans for access to their provider networks and contracts. The cost to the Corporation was approximately \$31.7 and \$28.1 for 2004 and 2003, respectively. The effect of this change in accounting classification is properly recorded in the Statements of Income and Expenses and did not change the overall net gain reported for the years ended December 31, 2004 and 2003.

Reclassifications

Certain amounts in the 2003 presentation have been reclassified to conform to the current-year presentation.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

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, 2004 and 2003, are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
2004				
Short-term investments	\$1,689.6			\$1,689.6
U.S. government and agency securities	391.1	\$ 8.8	\$(1.2)	398.7
Corporate and other bonds	601.5	15.8	(1.5)	615.8
	<u>\$2,682.2</u>	<u>\$24.6</u>	<u>\$(2.7)</u>	<u>\$2,704.1</u>
Due in one year or less	\$1,755.5			\$1,756.0
Due after one year through five years	484.6			494.4
Due after five years through ten years	233.8			239.2
Due after ten years	208.3			214.5
	<u>\$2,682.2</u>			<u>\$2,704.1</u>
2003				
Short-term investments	\$ 998.2			\$ 998.2
U.S. government and agency securities	337.4	\$10.3	\$(1.1)	346.6
Corporate and other bonds	562.4	22.6	(1.2)	583.8
	<u>\$1,898.0</u>	<u>\$32.9</u>	<u>\$(2.3)</u>	<u>\$1,928.6</u>

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

3. Investments (continued)

Proceeds from sales and maturities of investments in debt securities during 2004 and 2003 were \$273.9 and \$699.0, respectively. Gross gains of \$2.5 and gross losses of \$0.9 were realized on those sales in 2004. Gross gains of \$9.2 and gross losses of \$2.8 were realized on those sales in 2003. At December 31, 2004, there were gross unrealized gains of \$215.8 and gross unrealized losses of \$19.4 for equity securities, including investments in unconsolidated subsidiaries. During 2004, proceeds from sales of equity securities were \$72.2. Gross gains of \$10.9 and gross losses of \$4.7 were realized on those sales. At December 31, 2003, there were gross unrealized gains of \$197.9 and gross unrealized losses of \$21.5 for equity securities, including investments in unconsolidated subsidiaries. During 2003, proceeds from sales of equity securities were \$46.1. Gross gains of \$3.5 and gross losses of \$2.7 were realized on those sales. In 2004, the Corporation recognized other-than-temporary impairment losses in affiliated equity securities of \$3.6 related to its investment in RealMed Corporation (RealMed). As a result, the Corporation's carrying value in RealMed is zero as of December 31, 2004. In 2003, the Corporation recognized other-than-temporary impairment losses in affiliated equity securities of \$2.0 for MedConnect, LLC (MedConnect). As a result, the Corporation's carrying value in MedConnect is zero. In addition, the Corporation recognized no other-than-temporary impairment losses in debt or unaffiliated equity securities in 2004 and \$0 and \$1.7, respectively, in 2003. The Corporation includes other-than-temporary impairments in net realized capital gains and losses in the Statements of Income and Expenses.

At December 31, 2004 and 2003, the Corporation had net investment income of \$54.6 and \$34.3. This includes expenses of \$62.1 and \$63.0 for 2004 and 2003, respectively. Investment expense for 2004 and 2003 is comprised of real estate depreciation expenses of \$15.1 and \$16.5, respectively, investment expenses of \$5.6 and \$5.1, respectively, real estate expenses of \$9.4 and \$10.2, respectively, and interest expenses of \$32.0 and \$31.2, 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,
a Mutual Legal Reserve Company

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

4. Investments in Unconsolidated Subsidiaries

The Corporation's total investment in unconsolidated subsidiaries was \$395.2 and \$373.7 at December 31, 2004 and 2003, respectively.

Life Subsidiaries

As of December 31, 2004, the principal life insurance subsidiaries of the Corporation are Fort Dearborn Life Insurance Company (FDL) and Colorado Bankers Life Insurance Company (CBL). Effective December 31, 2003, FDL acquired Omaha Life from Blue Cross and Blue Shield of Nebraska for \$4.3. On May 31, 2004, Omaha Life Insurance Company was merged into FDL. In addition, Medical Life Insurance Company, a wholly owned subsidiary of FDL, was merged into FDL as of December 31, 2004. The Corporation is carrying its investment in life insurance companies at their underlying statutory capital and surplus. 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	
	2004	2003
Cash and short-term investments	\$ 48.5	\$ 44.0
Investments	1,587.3	1,483.7
Premiums receivable	32.2	28.7
Other assets	42.3	40.2
Total assets	\$1,710.3	\$1,596.6
Policy reserves	\$ 742.5	\$ 729.0
Policy and contract claims	93.8	70.7
Other liabilities	528.3	461.9
Minority interest	—	12.0
Capital and surplus	345.7	323.0
Total liabilities and capital and surplus	\$1,710.3	\$1,596.6

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

4. Investments in Unconsolidated Subsidiaries (continued)

Condensed Consolidated Statements of Operations

	Year ended December 31	
	2004	2003
Premium income	\$764.8	\$730.6
Other income	69.6	67.6
Total income	834.4	798.2
Policy benefits	633.7	495.1
Operating expenses	165.1	277.4
Total expenses	798.8	772.5
Net income before income taxes	35.6	25.7
Income tax expense	(8.6)	(11.9)
Net income	\$ 27.0	\$ 13.8

Below is a listing of directly or indirectly owned subsidiaries not included in the life insurance information disclosed above as of December 31, 2004:

Combined Services, LLC	RealMed
Dental Network of America, Inc.	Third Coast Insurance Company
HCSC Purchasing, LLC	MedConnect
Preferred Financial Corporation	HMO New Mexico, Inc.
Industry Savings Plan, Inc.	BCI HMO, Inc.
HCSC Insurance Services Company	THIN, Inc.
Hallmark Services Corporation	Arizona California Texas International, Inc.
Prime Therapeutics, LLC	

In 2004, the Corporation made a capital contribution to Hallmark Services Corporation of \$3.0, HCSC Insurance Services Company of \$5.0, and RealMed of \$3.6. No capital contributions were made during 2003. BCI HMO, Inc. (BCI) paid a \$0.9 cash dividend to the Corporation in both 2004 and 2003.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

5. Pharmacy Rebate Receivable

The total pharmacy rebate receivable at December 31, 2004 and 2003, was \$60.4 and \$54.7, respectively. Of this amount, \$32.9 and \$29.7 was nonadmitted for 2004 and 2003, respectively. The net admitted asset of \$27.5 and \$25.0 at December 31, 2004 and 2003, respectively, is included in receivables related to uninsured customers and health care 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 2004 and 2003, respectively.

In 2004 and 2003, the Corporation collected pharmacy rebates of \$108.1 and \$100.0, respectively. The chart below contains further detail regarding pharmacy rebate receivables for the years 2004 and 2003.

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
12/31/2004	\$27.5	\$ –	\$ –	\$ –	\$ –
9/30/2004	25.1	–	–	–	–
6/30/2004	25.3	–	–	23.8	–
3/31/2004	26.0	–	–	23.2	–
12/31/2003	25.0	–	–	27.6	0.4
9/30/2003	25.0	–	–	23.0	0.4
6/30/2003	23.5	–	–	20.2	1.4
3/31/2003	25.4	–	–	20.4	2.0
12/31/2002	22.8	–	–	–	23.2

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

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, 2004 and 2003, is shown in the charts below:

	ASO	
	2004	2003
Net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses	\$ (9.2)	\$ (12.4)
Total net other income or expenses (including interest paid or received from customers)	—	—
Net loss from operations	\$ (9.2)	\$ (12.4)
 Total claim payment volume	 \$ 1,106.7	 \$ 1,403.1
	ASC	
	2004	2003
Gross reimbursement for medical cost incurred	\$11,429.0	\$10,650.8
Gross administrative fees accrued	1,093.3	862.5
Gross expenses incurred (claims and administrative)	(12,142.2)	(11,277.7)
Net gain from operations	\$ 380.1	\$ 235.6

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. Provisions for unpaid claim adjustment expenses are included in operating expense liabilities, including commissions, in the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

7. Unpaid Claims and Claim Adjustment Expenses (continued)

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

	2004	2003
Balance at January 1	\$1,048.9	\$1,091.4
Incurred expenses related to:		
Current year	8,331.2	7,874.5
Prior years	(82.5)	(125.1)
Total incurred	8,248.7	7,749.4
Paid expenses related to:		
Current year	7,357.4	6,871.5
Prior years	927.3	920.4
Total paid	8,284.7	7,791.9
Balance at December 31	\$1,012.9	\$1,048.9

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 \$367.5 and \$414.6 as of December 31, 2004 and 2003, respectively.

As of December 31, 2003, the Corporation had a liability of \$25.7 related to premium deficiency reserves, which was included in the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus. There were no premium deficiency reserves recorded as of December 31, 2004. Premium deficiency reserves decreased \$25.7 and \$15.2 in 2004 and 2003, respectively. The Corporation did not consider anticipated investment income when calculating its premium deficiency reserves.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

8. Long-Term Debt

In 2001, the Corporation issued \$400.0 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, 2004 and 2003, the carrying value of the debt obligation including discount accretion was \$400.0 and \$399.9, respectively.

The Corporation had a \$90.0 line of revolving credit under a credit agreement with a consortium of banks, led by JP Morgan Chase Bank, N.A. There were no funds drawn or outstanding under the agreement, and the agreement was terminated on November 30, 2004. On that date, the Corporation completed a new, five-year, \$300.0 credit facility with a group of eight major U.S. banks led by Bank of America, N.A. During 2004, there were no funds drawn or outstanding on the new credit facility.

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.

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 nonunion employees, as well as a smaller number of employees of FDL. The other plan covers the majority of the Chicago-based 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 that its contributions to the plans will be between \$40.0 and \$78.0 in 2005. At December 31, 2004, 63% of the plans' assets were invested in equity securities, and 37% of the plans' assets were invested in debt securities.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

9. Pension Plans and Other Employee Benefits (continued)

Retiree Health and Life Benefit Plan

The Corporation offers a health and life benefit plan to eligible retired employees. 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 2004 or 2003. The Corporation paid the current cost of retiree health claims and life premiums directly from corporate assets during 2004 and 2003. 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 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:

	<u>Pension benefits</u>		<u>Other benefits</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Discount rate	6.00%	6.25%	6.00%	6.25%
Expected long-term rate of return on plan assets	8.00%	8.00%	5.00%	5.00%
Rate of compensation increase	5.00%-5.50%	4.50%-6.00%	5.50%	4.50%-6.00%

Health Care Service Corporation,
a Mutual Legal Reserve Company

Notes to Financial Statements (Statutory Basis) (continued)
(In Millions 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 2004 and 2003.

	<u>Pension benefits</u>		<u>Other benefits</u>	
	2004	2003	2004	2003
At December 31				
<i>Reconciliation of benefit obligation</i>				
Obligation at beginning of year	\$ 623.1	\$ 538.9	\$ 171.4	\$ 129.6
Service cost	26.4	23.7	17.3	14.8
Interest cost	38.8	36.9	10.8	9.6
Plan amendments	0.3	3.9	–	(0.2)
Actuarial loss	44.8	46.0	2.2	28.3
Benefit payments and adjustments	(36.8)	(26.3)	(9.9)	(10.7)
Obligation at December 31	\$ 696.6	\$ 623.1	\$ 191.8	\$ 171.4
<i>Reconciliation of fair value of plan assets</i>				
Fair value of plan assets at beginning of year	\$ 419.2	\$ 327.1	\$ 46.5	\$ 39.9
Actual return on plan assets	42.8	61.4	4.8	6.6
Employer contributions	60.0	57.0	9.9	10.7
Benefit payments and adjustments	(36.8)	(26.3)	(9.9)	(10.7)
Fair value of plan assets at December 31	\$ 485.2	\$ 419.2	\$ 51.3	\$ 46.5
<i>Funded status</i>				
Funded status at December 31	\$(211.4)	\$(203.9)	\$(140.5)	\$(124.9)
Unrecognized prior service cost (credit)	12.5	13.6	(11.8)	(16.3)
Unrecognized net loss	160.4	131.4	55.3	57.9
Unrecognized transition obligation	72.4	77.4	–	–
Prepaid asset	33.9	18.5	(97.0)	(83.3)
Minimum pension liability adjustment	(45.7)	(29.6)	–	–
Accrued benefit cost	\$ (11.8)	\$ (11.1)	\$ (97.0)	\$ (83.3)
Benefit obligation for nonvested employees	\$ 14.4	\$ 21.3	\$ 144.1	\$ 126.5

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

9. Pension Plans and Other Employee Benefits (continued)

The accumulated pension benefit obligation (APBO) was \$497.0 and \$430.3 at December 31, 2004 and 2003, respectively.

The following table provides the components of net periodic benefit cost for the plans for 2004 and 2003.

Years Ended December 31	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	2004	2003	2004	2003
<i>Plan costs</i>				
Service cost	\$ 26.4	\$ 23.7	\$17.3	\$14.8
Interest cost	38.8	36.9	10.8	9.6
Expected return on plan assets	(34.3)	(27.1)	(2.4)	(2.0)
Amortization of unrecognized transition obligation	5.0	5.0	-	-
Amortization of prior service cost (credit)	1.1	1.3	(4.5)	(4.4)
Amortization of net loss	7.4	7.9	2.4	1.8
Net periodic benefit cost	\$44.4	\$47.7	\$23.6	\$19.8

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, a 10.25% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2004. The initial rate was 11.0% in 2003 and is assumed to decrease gradually each year to a rate of 5.0% for 2010 and remain at that level thereafter.

Assumptions in 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	\$ 4.4	\$ (3.6)
Effect on the health care component of the accumulated postretirement benefit obligation	\$24.9	\$(20.8)

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

9. Pension Plans and Other Employee Benefits (continued)

At December 31, 2004, and 2003, the Corporation recorded a net intangible pension asset of \$11.8 and \$29.6, 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. The prepaid pension asset of \$33.9 was nonadmitted in 2004. In 2003, the prepaid pension asset of \$18.5 was admitted as a component of the \$29.6 intangible assets noted above.

The Corporation's allocated portion of accrued retiree costs at December 31, 2004 and 2003, was \$93.8 and \$80.4, respectively, with the remaining \$3.2 and \$2.9, respectively, allocated to FDL.

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. Due to the uncertainties related to this legislation and the related accounting impacts, the Corporation elected to defer the financial impact of this legislation on its retiree health benefit valuation during 2003. Effective July 2004, the Corporation elected to recognize the financial impact of this legislation. Due to this adoption, the Corporation will recognize a reduction in its benefit obligation of \$19.1 due to expected cash subsidies from Medicare for post-65 drug coverage. The reduction in obligations due to the subsidy is reflected as an unrecognized net gain to the plan. This gain was reflected in net periodic benefit cost for the first time in 2004, and net periodic cost was reduced by \$2.1 for 2004. The Corporation's actuaries have determined that our prescription drug plan provides a benefit that is at least actuarially equivalent to the Medicare prescription drug plan.

Defined-Contribution Plans

The Corporation has a thrift plan for Illinois union employees and a 401(k) plan for Illinois, Texas, and New Mexico 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 \$12.2 in 2004 and \$10.9 in 2003.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

9. Pension Plans and Other Employee Benefits (continued)

The Corporation also provides both a nonqualified deferred compensation plan for officers and managers and a nonqualified benefit restoration plan for certain highly compensated employees limited in their qualified defined benefit by IRS rules.

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 2004 and 2003 follows:

	<u>2004</u>	<u>2003</u>
Beginning balance	\$12.6	\$10.5
Net realized gains on bonds sold during the year	1.6	5.9
Less: Federal income tax expense	(0.3)	(1.1)
Net realized gains to be amortized	13.9	15.3
Amortization income in the current year	2.9	2.7
Ending balance	<u>\$11.0</u>	<u>\$12.6</u>

The \$2.9 and \$2.7 in amortization income in 2004 and 2003, respectively, is included as net 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 decreased this reserve \$8.5 in 2004, with a corresponding increase to policyholders' surplus. In 2003, AVR increased by \$8.7 with a corresponding decrease to policyholders' surplus.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

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 2004 and 2003 was approximately \$89.3 and \$79.1, respectively.

Future minimum lease payments as of December 31, 2004, are as follows:

2005	\$ 48.7
2006	35.5
2007	29.4
2008	14.9
2009	14.1
Subsequent to 2010	77.5
Total minimum lease payments	<u>\$220.1</u>

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	
	2004	2003
Gross deferred tax assets	\$1,601.1	\$1,378.1
Gross deferred tax liabilities	(21.4)	(16.9)
Net deferred tax asset	1,579.7	1,361.2
Deferred tax asset nonadmitted	1,443.3	1,228.6
Net admitted deferred tax asset	\$ 136.4	\$ 132.6
Increase in nonadmitted deferred tax asset	\$ 214.7	\$ 191.1

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

12. Income Taxes (continued)

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

	2004	2003
Federal income tax	\$235.9	\$213.9
Federal income tax expense (benefit) on net capital gains	1.9	(0.5)
Current income taxes incurred	\$237.8	\$213.4

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:

	2004	2003
Deferred tax assets		
Various employee benefit liabilities	\$ 2.3	\$ 8.2
Allowance for doubtful accounts	5.3	-
Premium deficiency liability	(7.3)	(5.1)
Unamortized goodwill	(6.0)	(6.0)
Fixed assets	(8.9)	13.4
Salvage and subrogation recoverable	(31.7)	4.1
Nonadmitted assets	15.4	(16.3)
Net operating loss carryforwards/tax credits	243.1	199.9
Contingent liabilities	22.5	44.0
Other	(11.7)	6.3
Total change in deferred tax assets	223.0	248.5
Change in nonadmitted deferred tax assets	(214.7)	(191.1)
Change in admitted deferred tax assets	8.3	57.4
Deferred tax liabilities		
Unrealized capital gains	(0.9)	5.2
Pension	5.2	4.5
Other	0.2	-
Total change in deferred tax liabilities	4.5	9.7
Change in net admitted deferred tax asset	\$ 3.8	\$ 47.7

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

12. Income Taxes (continued)

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

	December 31		Change
	2004	2003	
Gross deferred tax assets	\$1,601.1	\$1,378.1	\$223.0
Gross deferred tax liabilities	(21.4)	(16.9)	(4.5)
Net deferred tax asset	\$1,579.7	\$1,361.2	218.5
Change in unrealized capital gains			(0.9)
Change in net deferred income taxes			\$217.6

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 2004 and 2003 are as follows:

	Effective Tax Rate Percentage	
	2004	2003
Provision computed at statutory rate	35.0%	35.0%
Special deductions/alternative minimum tax	(36.8)	(36.0)
Intercompany tax settlements	-	(1.4)
Change in nonadmitted assets	(0.9)	2.4
Change in fixed assets	0.4	(1.6)
Other	3.8	(2.0)
Total	1.5	(3.6)
Federal income taxes incurred	19.2	25.8
Change in net deferred income taxes	(17.7)	(29.4)
Total statutory income taxes	1.5%	(3.6)%

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

12. Income Taxes (continued)

At December 31, 2004, the Corporation had \$1,045.7 tax-effected operating loss and tax credit carryforwards, originating in 1995 through 2004, of which \$255.9 will expire, if unused, in years 2010 and after.

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:

2004	\$269.5
2003	168.7
	<hr/>
	\$438.2
	<hr/>

13. Direct Premium Written by a Third-Party Administrator

Total premiums written by a third-party administrator in 2004 and 2003 were \$529.2 and \$327.4. 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.

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, 2004 and 2003, that are subject to retrospective rating features was \$138.2 and \$107.2, respectively. This represents 2.6% and 2.3%, respectively, of the premiums written for group health. No other net premiums written by the Corporation are subject to retrospective rating features.

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

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 the 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 committed to contribute \$10.0 over five years to the Texas Healthy Kids Corporation. The Corporation has paid and expensed \$10.0, consistent with the agreement. Also, pursuant to the settlement agreement, the Attorney General 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 Texas Attorney General's request for appeal was denied, which finally disposes of this case with no additional liability to the Corporation.

Thomas et al. v. Health Care Service Corporation No. 03-21296, United States District Court for the Southern District of Florida, Miami Division (Thomas); The putative class is a nationwide class of "all medical doctors, who, from May 21, 1993, to the date of certification, provided services to any patient insured by or who was a member or beneficiary of any plan administered by any defendant." The defendants are the Blue Cross Blue Shield Association and nearly all Blue Cross Blue Shield Plans. The legal theory is RICO only: (1) conspiracy to violate 18 U.S.C. §§ 1962 (a) and (c); and (2) aiding and abetting violations of §§ 1962 (a) and (c). The specific claims are: (1) untimely payment of claims resulting from built-in delays caused by intentional understaffing and unnecessary documentation requirements; (2) underpayment or denial of claims by manipulation of coding practices: down-coding, bundling, and refusal to recognize modifiers; (3) manipulation of the capitation setting process "so as to undermine its actuarial basis and further deprive doctors of payments;" (4) denial of coverage for medically necessary services on purely economic grounds; and (5) fraudulent concealment using inadequate Explanations of Benefits. The relief sought is: (1) injunctive relief enjoining future RICO violations and declaring their invalidity; (2) judgment for joint and several treble damages and treble interest caused by predicate acts and RICO violations; (3) injunctive relief prohibiting automated processing techniques that use improper cost-based criteria; (4) and attorneys' fees. Class certification discovery is nearly complete and merits discovery is about to begin.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

15. Legal Actions (continued)

Solomon et al. v. Health Care Service Corporation et. al. No. 03-22935 United States District Court for the Southern District of Florida, Miami Division; This case is essentially the same as *Thomas*, as discussed above, except that the putative class consists of podiatrists, psychologists, chiropractors, physical therapists, optometrists, opticians, social workers, nurse practitioners, acupuncturists, and other allied health professionals. The court has placed this case on a coordinated track with the *Thomas* case.

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 \$55.6 and \$35.4 in 2004 and 2003, respectively. These amounts are netted against operating expenses in the Corporation's Statements of Income and Expenses.

At December 31, 2004 and 2003, the Corporation has receivables of \$9.3 and \$5.4, and payables of \$2.8 and \$3.5, respectively, from its subsidiaries.

B. The Corporation 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 \$30.0 to maintain an appropriate level of statutory net worth. In 1997, the Corporation purchased and nonadmitted \$10.0 in surplus notes issued by TCIC. In 2001, the Corporation invested an additional \$3.0 in TCIC, leaving a remaining commitment of \$17.0. In 2002, TCIC transferred all remaining risks associated with its workers' compensation business to third parties. TCIC is currently in the process of paying claims on runoff business. In 2002, the Corporation recognized an impairment loss of \$10.0 in TCIC surplus notes.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

16. Related Party Transactions (continued)

- C. 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, 2004, BCI had statutory capital and surplus of \$8.3. The Corporation has not accrued for any losses related to this guaranty.

The Corporation sold 49% of its interest in BCI HMO, Inc. to another entity in December 2004.

- D. In 2004, HCSA, Inc., Health Care Benefits, Inc., and Third Coast Holding Company, wholly owned subsidiaries of the Corporation, were dissolved. Realized gains of \$1.3 and losses of \$2.7 were recorded upon dissolution. In 2003, Nichold Company, a wholly owned subsidiary, was dissolved. A realized loss of \$0.5 was recorded upon its dissolution.
- E. The Corporation has guaranteed the payment of claim-related expenses of HMO New Mexico, Inc. (NMHMO) as required by section 59A-46-13(F) of the New Mexico Insurance Code. At December 31, 2004, NMHMO had statutory capital and surplus of \$13.0. The Corporation has not accrued for any losses related to this guarantee.

17. Risk-Based Capital

The DOI 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, 2004, 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 Millions of Dollars)

18. Statutory Merger

In 2000, the Corporation purchased NYLCare Health Plans of the Southwest, Inc. and NYLCare Health Plans of the Gulf Coast, Inc. for \$420.0. The names of these HMOs were subsequently changed in 2000 to Southwest Texas HMO, Inc. and Texas Gulf Coast HMO, Inc., respectively. In 2001, Texas Gulf Coast HMO, Inc. was merged into Southwest Texas HMO, Inc. with Southwest Texas HMO, Inc. (Southwest) being the surviving entity. This purchase resulted in goodwill of \$357.0. Of this amount, \$123.9 was being amortized by the Corporation over 10 years. Pursuant to permission from the DOI, the remaining \$233.1 was allowed as an admitted asset but was amortized over a three-year period ending March 31, 2003. Prior to the statutory merger discussed below, goodwill amortization totaling \$31.8 was recorded in 2003 as a direct charge to policyholders' surplus, and total unamortized goodwill of \$77.4 was included in investments in unconsolidated subsidiaries on the Statement of Admitted Assets, Liabilities, and Policyholders' Surplus as of December 31, 2003.

Effective January 1, 2004, Southwest merged into the Corporation with the Corporation assuming the assets, liabilities, and contracts of Southwest. This statutory merger was approved by both the DOI and the Texas Department of Insurance. Under statutory accounting, the Corporation is required to restate the prior year's financial statements as if the merger had taken place at the beginning of 2003. Also, the Corporation is required to write off all goodwill related to its investment in Southwest as a charge to policyholders' surplus. As a result, the Corporation has restated the 2003 financial statements on a merged basis effective January 1, 2003. The Corporation charged the full \$109.2 of unamortized goodwill remaining at year-end 2002 as a direct reduction to policyholders' surplus. The \$109.2 consists of \$31.8 in goodwill which had been amortized in 2003 plus \$77.4 million of unamortized goodwill remaining as of year-end 2003.

The 2003 data of the previously separate companies has been restated on a combined basis. The condensed separate company and condensed combined company statutory information as of December 31, 2003, and results of operations for the year then ended are presented below. Intercompany balances have been eliminated.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

18. Statutory Merger (continued)

Condensed Combined Statements of Admitted Assets, Liabilities,
and Capital and Surplus as of December 31, 2003

	Reclassifications and			
	Corporation	Southwest	Eliminations	Combined
Cash and short-term investments	\$1,498.7	\$108.2	\$ –	\$1,606.9
Investments	1,761.5	94.9	(241.8)	1,614.6
Premiums receivable	871.0	42.2	(8.2)	905.0
Other assets	808.1	37.1	(16.7)	828.5
Total admitted assets	<u>\$4,939.3</u>	<u>\$282.4</u>	<u>\$(266.7)</u>	<u>\$4,955.0</u>
Claims payable	\$ 938.5	\$ 88.7	\$ –	\$1,027.2
Other liabilities	1,460.1	29.3	(24.9)	1,464.5
Long-term debt	399.9	–	–	399.9
Total liabilities	<u>2,798.5</u>	<u>\$118.0</u>	<u>(24.9)</u>	<u>\$2,891.6</u>
Capital and surplus	2,140.8	164.4	(241.8)*	2,063.4
Total liabilities and capital and surplus	<u>\$4,939.3</u>	<u>\$282.4</u>	<u>\$(266.7)</u>	<u>\$4,955.0</u>

*Includes write-off of \$109.2 related Southwest goodwill.

Condensed Combined Statements of Income and Expenses
for the year ended December 31, 2003

	Reclassifications and			
	Corporation	Southwest	Eliminations	Combined
Premium income	\$8,156.7	\$939.9	\$ –	\$9,096.6
Other income	6.0	10.3	5.3	21.6
Total income	<u>8,162.7</u>	<u>950.2</u>	<u>5.3</u>	<u>9,118.2</u>
Policy benefits	6,625.6	835.0	(22.7)	7,437.9
Operating expenses	679.4	143.1	28.0	850.5
Total expenses	<u>7,305.0</u>	<u>978.1</u>	<u>5.3</u>	<u>8,288.4</u>
Gain (loss) from operations before income taxes and net realized capital losses	857.7	(27.9)	–	829.8
Income tax expense (benefit)	230.9	(17.0)	–	213.9
Net income (loss) before realized capital loss	626.8	(10.9)	–	615.9
Net realized capital losses	(2.3)	0.4	–	(1.9)
Net gain (loss)	<u>\$ 624.5</u>	<u>\$ (10.5)</u>	<u>\$ –</u>	<u>\$ 614.0</u>

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

19. 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 NMHMO as part of this transaction. The purchase of the NMHMO was reported as a statutory purchase.

The Corporation paid \$50.7 to acquire the business of BCBSNM and to purchase NMHMO. This transaction resulted in total goodwill of approximately \$28.4. Of the total goodwill, approximately \$23.8 related to assumption of the business of BCBSNM. This goodwill was being amortized to operations as operating expense over seven years, from July 1, 2001 through June 30, 2008. The remaining goodwill of approximately \$4.6 is related to the purchase of NMHMO and was being amortized as part of goodwill amortization directly to policyholders' surplus over a period of ten years.

Total unamortized goodwill at December 31, 2003, was \$18.8, of which \$15.3 is due to assumption reinsurance and \$3.5 for the purchase of NMHMO. All remaining unamortized goodwill was admitted at December 31, 2003. As of December 31, 2004, the remaining \$11.9 in goodwill related to the BCBSNM assumption reinsurance was deemed impaired and expensed to operating expenses in 2004. In addition, the remaining \$3.0 in goodwill related to the investment in NMHMO was deemed impaired and written off in 2004.

- B. The Corporation performs claims processing services for Indian Health Service. Revenue from the Corporation's Indian Health Service contract for December 31, 2004 and 2003, was \$0 in both years for medical and hospital-related services and \$7.4 and \$5.8, respectively, for administrative expenses. The Corporation recorded receivables from Indian Health Service of \$1.2 and \$1.9 for December 31, 2004 and 2003, respectively.
- C. The Corporation purchased a 49% interest in Prime Therapeutics, LLC (Prime) in 2004 for approximately \$44.1. Prime is a PBM that is owned by several Blue Cross Blue Shield Plans. The purchase resulted in statutory goodwill of approximately \$5.3. The full amount of the goodwill was written off at the time of purchase. The Corporation's investment in Prime is included in other invested assets on the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus as of December 31, 2004.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

19. Other Items (continued)

- D. In 2004, the Corporation entered into merger discussions with Group Health Services of Oklahoma, Inc., which does business as Blue Cross Blue Shield of Oklahoma. This merger is subject to regulatory approvals as well as the approval of the Boards of Directors and the policyholders of both companies. The legal structure of the proposed transaction has not been finalized.

Other Financial Information

Health Care Service Corporation,
a Mutual Legal Reserve Company

Selected Financial Data
(In Millions of Dollars)

Year ended December 31, 2004

	2004
Investment income earned:	
U.S. government bonds	\$ 5.2
Other bonds (unaffiliated)	39.5
Preferred stocks (unaffiliated)	—
Common stocks (unaffiliated)	3.2
Common stocks of affiliates	0.9
Real estate	32.7
Cash and short-term investments	27.4
Other investment income	0.1
Investment income allocated from FEP	4.8
Amortization of interest maintenance reserve	2.9
Gross investment income	116.7
Less:	
Investment expenses	5.6
Real estate expenses	9.4
Interest expense	32.0
Depreciation on real estate	15.1
Net investment income	\$ 54.6
Real estate owned – Book value less encumbrances	\$ 219.9
Bonds and stocks of parents, subsidiaries, and affiliates – Book/adjusted carrying value:	
Bonds	\$ —
Preferred stocks	—
Common stocks	395.2
	\$ 395.2

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

Year ended December 31, 2004

Bonds and short-term investments by class and maturity:	
Bond by maturity – Statement value:	
Due within one year or less	\$1,755.5
Over 1 year through 5 years	484.6
Over 5 years through 10 years	233.8
Over 10 years	208.3
Total by maturity	<u>\$2,682.2</u>
Bonds by class – Statement value:	
Class 1	\$2,584.1
Class 2	98.1
Class 3	–
Class 4	–
Class 5	–
Class 6	–
Total by class	<u>\$2,682.2</u>
Total bonds publicly traded	\$2,682.2
Total bonds privately traded	–
Total bonds	<u>\$2,682.2</u>
Preferred stocks – Book/adjusted carrying value	\$ –
Common stocks – Fair value	\$ 563.1
Short-term investments – Book/adjusted carrying value	\$1,689.6
Cash on deposit	\$ (218.2)
Other long-term invested assets	\$ 31.8

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

Year ended December 31, 2004

Accident and health insurance – Premiums in force (premium business only):	
Group	\$5,897.0
Individual	1,547.7
Claim payments in 2004 by incurred year (premium business only):	
Group accident and health:	
2004	\$3,878.3
2003	501.0
2002 and prior	(3.9)
Individual accident and health:	
2004	\$1,024.2
2003	132.4
2002 and prior	(0.9)

**ANNUAL STATEMENT FOR THE YEAR 2004 OF THE Health Care Service Corporation,
a Mutual Legal Reserve Company
(In Millions of Dollars)**

SUMMARY INVESTMENT SCHEDULE

Investment Categories	Gross Investment Holdings		Admitted Assets as Reported in the Annual Statement	
	1 Amount	2 Percentage	3 Amount	4 Percentage
1. Bonds:				
1.1 U.S. Treasury securities.....	131.5	3.431	131.5	3.431
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	0.000	0.000
1.22 Issued by U.S. government sponsored agencies.....	157.2	4.102	157.2	4.102
1.3 Foreign government (including Canada, excluding mortgaged-backed securities).....	4.6	0.120	4.6	0.120
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	0.000	0.000
1.42 Political subdivisions of states, territories and possessions and political subdivisions general obligations.....	0.000	0.000	0.000	0.000
1.43 Revenue and assessment obligations.....	0.000	0.000	0.000	0.000
1.44 Industrial development and similar obligations.....	0.000	0.000	0.000	0.000
1.5 Mortgage-backed securities (includes residential and commercial MBS):				
1.51 Pass-through securities:				
1.511 Guaranteed by GNMA.....	21.3	0.556	21.3	0.556
1.512 Issued by FNMA and FHLMC.....	76.5	1.996	76.5	1.996
1.513 All other.....	109.5	2.857	109.5	2.857
1.52 CMOs and REMICs:				
1.521 Issued or guaranteed by GNMA, FNMA and FHLMC or VA.....	0.000	0.000	0.000	0.000
1.522 Issued by non-U.S. Government issuers and collateralized by mortgage-backed securities issued or guaranteed by agencies shown in Line 1.521.....	0.000	0.000	0.000	0.000
1.523 All other.....	0.000	0.000	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).....	492.0	12.837	492.0	12.837
2.2 Unaffiliated foreign securities.....	0.000	0.000	0.000	0.000
2.3 Affiliated securities.....	0.000	0.000	0.000	0.000
3. Equity interests:				
3.1 Investments in mutual funds.....	88.9	2.319	88.9	2.319
3.2 Preferred stocks:				
3.21 Affiliated.....	0.000	0.000	0.000	0.000
3.22 Unaffiliated.....	0.000	0.000	0.000	0.000
3.3 Publicly traded equity securities (excluding preferred stocks):				
3.31 Affiliated.....	0.000	0.000	0.000	0.000
3.32 Unaffiliated.....	56.5	1.474	56.5	1.474
3.4 Other equity securities:				
3.41 Affiliated.....	395.2	10.311	395.2	10.311
3.42 Unaffiliated.....	22.5	0.587	22.5	0.587
3.5 Other equity interests including tangible personal property under lease:				
3.51 Affiliated.....	0.000	0.000	0.000	0.000
3.52 Unaffiliated.....	0.000	0.000	0.000	0.000
4. Mortgage loans:				
4.1 Construction and land development.....	0.000	0.000	0.000	0.000
4.2 Agricultural.....	0.000	0.000	0.000	0.000
4.3 Single family residential properties.....	0.000	0.000	0.000	0.000
4.4 Multifamily residential properties.....	0.000	0.000	0.000	0.000
4.5 Commercial loans.....	0.000	0.000	0.000	0.000
4.6 Mezzanine real estate loans.....	0.000	0.000	0.000	0.000
5. Real estate investments				
5.1 Property occupied by the company.....	219.9	5.737	219.9	5.737
5.2 Property held for the production of income (includes \$_____of property acquired in satisfaction of debt).....	0.000	0.000	0.000	0.000
5.3 Property held for sale (\$_____including property acquired in satisfaction of debt).....	0.000	0.000	0.000	0.000
6. Policy loans.....	0.000	0.000	0.000	0.000
7. Receivables for securities.....	0.000	0.000	0.000	0.000
8. Cash and short-term investments.....	2,025.3	52.843	2,025.3	52.843
9. Other invested assets.....	31.8	0.830	31.8	0.830
10. Total Invested Assets	3,832.7	100.000	3,832.7	100.000

**SUPPLEMENTAL EXHIBIT FOR THE YEAR 2004 OF THE Health Care Service Corporation,
a Mutual Legal Reserve Company**

SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES

Due April 1
FOR THE YEAR ENDED DECEMBER 31, 2004
(IN MILLIONS OF DOLLARS)

Of The 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.

1. Reporting entity's total admitted assets as reported on Page 2 of the annual statement. _____ \$ 5,886.8
2. Ten largest exposures to a single issuer/borrower/investment.

	1	2	3	4	
	Issuer	Description of Exposure	Amount	Percentage of Total Admitted Assets	
2.01	Fort Dearborn Life Insurance Company	Other Equity Securities Affiliated	\$ 331.8	5.6	%
2.02	GE Capital Corp	Unaffil.Dom.Debt/Unaffil.Pub Traded Eq/	\$ 98.7	1.7	%
2.03	Prudential Funding Corp	Unaffil.Dom.Debt/Unaffil.Pub Traded Eq/S	\$ 80.5	1.4	%
2.04	Citigroup, Inc.	Unaffil.Dom.Debt/Cash & Short Term	\$ 70.0	1.2	%
2.05	Edison Asset Securitization	Unaffil.Dom.Debt/Cash & Short Term	\$ 66.4	1.1	%
2.06	UBS Finance Corp	Cash & Short Term	\$ 54.6	0.9	%
2.07	Household Finance Corp	Unaffil.Dom.Debt/Cash & Short Term	\$ 53.4	0.9	%
2.08	Van-Guard Mid Cap	Investments in Mutual Funds	\$ 51.1	0.9	%
2.09	Three Crown Funding	Cash & Short Term	\$ 49.6	0.8	%
2.10	Sigma Finance Inc.	Cash & Short Term	\$ 48.0	0.8	%

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

	Bonds		Preferred Stocks		
	1	2	3	4	
3.01	NAIC-1	\$ 2,584.2	43.9 %	3.07 P/RP-1	\$ 0.0 %
3.02	NAIC-2	\$ 98.1	1.7 %	3.08 P/RP-2	\$ 0.0 %
3.03	NAIC-3	\$ 0	0.0 %	3.09 P/RP-3	\$ 0.0 %
3.04	NAIC-4	\$ 0	0.0 %	3.10 P/RP-4	\$ 0.0 %
3.05	NAIC-5	\$ 0	0.0 %	3.11 P/RP-5	\$ 0.0 %
3.06	NAIC-6	\$ 0	0.0 %	3.12 P/RP-6	\$ 0.0 %

4. Assets held in Foreign Investments:

- 4.01 Are assets held in Foreign investments less than 2.5% of the reporting entity's total admitted assets: Yes [X] No []
- 4.02 Total admitted assets held in foreign investments: \$ 4.6 0.1 %
- 4.03 Foreign-currency-denominated investments \$ 0.0 0.0 %
- 4.04 Insurance liabilities denominated in that same foreign currency: \$ 0.0 0.0 %

If response to 4.01 above is yes, responses are not required for interrogatories 5 – 10.

**SUPPLEMENTAL EXHIBIT FOR THE YEAR 2004 OF THE Health Care Service Corporation,
a Mutual Legal Reserve Company**

SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES (cont.)
(In Millions of Dollars)

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:
6. Two largest foreign investment exposures in 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. Ten largest non-sovereign (i.e. non-governmental) foreign issues:
11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure.
- 11.01 Are Assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets? Yes [X] No []
If response to 11.01 is yes, detail is not required for the remainder of Interrogatory 11
12. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions.
- 12.01 Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets?..... Yes [X] No []
If response to 12.01 is yes, responses are not required for the remainder of interrogatory 12.
13. Amounts and percentages of admitted assets held in the largest 10 equity interests:
- 13.01 Are assets held in equity interests less than 2.5% of the reporting entity's total admitted assets..... Yes [] No [X]
If response to 13.01 above is yes, responses are not required for the remainder of Interrogatory 13.

	1	2	3	
	Investment Category	Amount	Percentage of Total Admitted Assets	
13.02	Fort Dearborn Life Ins. Co. _____	\$331.8	.....5.6	%
13.03	VanGuard Mid-Cap _____	\$51.1	.....0.9	%
13.04	DFA Fixed Income Portfolio _____	\$37.5	.....0.6	%
13.05	Prime Therapeutic Inc. _____	\$31.8	.....0.5	%
13.06	HCSC Insurance Services _____	\$18.0	.....0.3	%
13.07	Preferred Financial Corp _____	\$13.5	.....0.2	%
13.08	HMO New Mexico, Inc. _____	\$13.0	.....0.2	%
13.09	BCS Financial Corp _____	\$10.6	.....0.2	%
13.10	Triwest Healthcare All. _____	\$7.0	.....0.1	%
13.11	Dental Network of America _____	\$6.5	.....0.1	%

**SUPPLEMENTAL EXHIBIT FOR THE YEAR 2004 OF THE Health Care Service Corporation,
a Mutual Legal Reserve Company**

SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES (cont.)
(In Millions of Dollars)

14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities:
 14.01 Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets?..... Yes [X] No []
 If response to 14.01 above is yes, responses are not required for the remainder of Interrogatory 14.
15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests:
 15.01 Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets?..... Yes [X] No []
 If response to 15.01 is yes, responses are not required for the remainder of Interrogatory 15.
16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans:
 16.01 Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?..... Yes [X] No []
 If response to 16.01 above is yes, responses are not required for the remainder of Interrogatory 16 and Interrogatory 17.
17. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate:
 17.01 Are assets held in real estate reported in less than 2.5% of the reporting entity's total admitted assets, excluding property occupied by the company?..... Yes [X] No []
 If response to 17.01 above is yes, responses are not required for the remainder of interrogatory 18.

18. 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>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>
18.01	Securities Lending (Do Not Include Assets Held as Collateral for Such Transactions)	\$.....	.....0.0 %	\$.....	\$.....	\$.....
18.02	Repurchase Agreements	\$.....	.....0.0 %	\$.....	\$.....	\$.....
18.03	Reverse Repurchase Agreements	\$.....	.....0.0 %	\$.....	\$.....	\$.....
18.04	Dollar Repurchase Agreements	\$.....	.....0.0 %	\$.....	\$.....	\$.....
18.05	Dollar Reverse Repurchase Agreements	\$.....	.....0.0 %	\$.....	\$.....	\$.....

19. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps, and floors:

		Owned		Written	
		1	2	3	4
		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>
19.01	Hedging	\$.....	.....0.0 %	\$.....	.....0.0 %
19.02	Income Generation	\$.....	.....0.0 %	\$.....	.....0.0 %
19.03	Other	\$.....	.....0.0 %	\$.....	.....0.0 %

20. Amounts and percentages of the reporting entity's total admitted assets of potential exposure 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>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>
20.01	Hedging	\$.....	.....0.0 %	\$.....	\$.....	\$.....
20.02	Income Generation	\$.....	.....0.0 %	\$.....	\$.....	\$.....
20.03	Replications	\$.....	.....0.0 %	\$.....	\$.....	\$.....
20.04	Other	\$.....	.....0.0 %	\$.....	\$.....	\$.....

**SUPPLEMENTAL EXHIBIT FOR THE YEAR 2004 OF THE Health Care Service Corporation,
a Mutual Legal Reserve Company**

SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES (cont.)
(In Millions of Dollars)

21. Amounts and percentages of the reporting entity's total admitted assets of potential exposure 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
21.01	Hedging	\$.....	.....0.0 %	\$.....	\$.....	\$.....
21.02	Income Generation	\$.....	.....0.0 %	\$.....	\$.....	\$.....
21.03	Replications	\$.....	.....0.0 %	\$.....	\$.....	\$.....
21.04	Other	\$.....	.....0.0 %	\$.....	\$.....	\$.....