

Financial Statements (Statutory Basis)
Health Care Service Corporation,
a Mutual Legal Reserve Company
Years Ended December 31, 2005 and 2004

Health Care Service Corporation,
a Mutual Legal Reserve Company

Financial Statements (Statutory Basis)

Years Ended December 31, 2005 and 2004

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Report of Independent Auditors

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

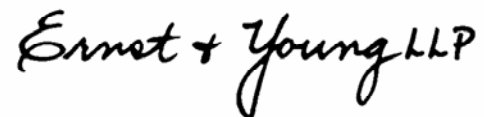
We have audited the accompanying statutory-basis balance sheets of Health Care Service Corporation, a Mutual Legal Reserve Company (the Corporation), as of December 31, 2005 and 2004, and the related statutory-basis statements of revenues and expenses, changes in policyholders' surplus, and cash flow 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, 2005 and 2004, 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, 2005 and 2004, 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.



February 24, 2006

Health Care Service Corporation,
a Mutual Legal Reserve Company

Balance Sheets – Statutory Basis
(In Millions of Dollars)

	December 31	
	2005	2004
Admitted Assets		
Cash and invested assets:		
Cash and cash equivalents	\$ 808.8	\$ 357.3
Short-term investments	1,266.0	1,689.6
Bonds	2,204.9	1,135.2
Common stocks:		
Affiliates	505.8	450.4
Non-affiliates	297.0	203.9
Real estate	228.8	235.9
Other invested assets	11.4	31.7
Total cash and invested assets	<u>5,322.7</u>	<u>4,104.0</u>
Uncollected premiums	94.8	124.5
Deferred Federal Employee Program premiums	587.6	547.0
Amounts receivable related to uninsured plans	1,232.7	1,100.7
Health care receivables	266.6	218.5
Electronic data processing equipment	32.0	44.8
Accrued investment income	30.8	20.2
Receivables from subsidiaries	10.1	9.0
Federal income taxes recoverable	–	3.2
Net deferred tax asset	153.2	138.8
Other admitted assets	39.9	48.8
Total admitted assets	<u><u>\$ 7,770.4</u></u>	<u><u>\$ 6,359.5</u></u>

See accompanying notes.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Balance Sheets – Statutory Basis (continued)
(In Millions of Dollars)

	December 31	
	2005	2004
Liabilities and Policyholders' Surplus		
Liabilities:		
Policy and contract liabilities:		
Claims unpaid	\$ 1,073.7	\$ 993.7
Accrued medical incentives	85.1	67.2
Unpaid claims adjustment expenses	307.0	229.1
Accident and health policy reserves	566.0	495.5
Premiums received in advance	78.9	39.3
Total policy and contract liabilities	2,110.7	1,824.8
General expenses due and accrued	293.9	298.3
Federal income tax liability	130.7	198.7
Amounts withheld or retained for account of others	64.5	23.6
Long-term debt, including interest payable	400.2	400.1
Payable for securities	32.2	–
Liabilities related to uninsured plans	32.5	15.0
Other liabilities	437.4	497.9
Total liabilities	3,502.1	3,258.4
Policyholders' surplus:		
Surplus note	18.0	18.0
Unassigned surplus	4,250.3	3,083.1
Total policyholders' surplus	4,268.3	3,101.1
Total liabilities and policyholders' surplus	\$ 7,770.4	\$ 6,359.5

See accompanying notes.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Statements of Revenues and Expenses – Statutory Basis
(In Millions of Dollars)

	Years Ended December 31	
	2005	2004
Premiums earned	\$ 11,713.9	\$ 10,629.1
Benefit expenses	9,528.0	8,595.2
Margin	2,185.9	2,033.9
Claims adjustment expenses, net	433.5	341.4
General and administrative expenses	571.0	492.8
Increase (decrease) in premium deficiency reserves	13.3	(25.7)
	1,017.8	808.5
Net underwriting gain	1,168.1	1,225.4
Net investment income	159.3	55.0
Net realized investment gain	0.3	6.8
Other income, net	10.7	10.8
	170.3	72.6
Net income before federal income taxes	1,338.4	1,298.0
Federal income tax expense	192.8	248.6
Net income	\$ 1,145.6	\$ 1,049.4

See accompanying notes.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Statements of Changes in Policyholders' Surplus – Statutory Basis
(In Millions of Dollars)

	Years Ended December 31	
	2005	2004
Policyholders' surplus, beginning of year	\$ 3,101.1	\$ 2,221.4
Net income	1,145.6	1,049.4
Net change in unrealized capital gains (including investment in unconsolidated subsidiaries)	(10.4)	14.7
Increase in net deferred tax asset	348.9	212.4
Increase in nonadmitted assets	(300.5)	(402.9)
Cumulative effect of changes in accounting principles	(8.0)	–
Other	(8.4)	6.1
Change in policyholders' surplus	1,167.2	879.7
Policyholders' surplus, end of year	\$ 4,268.3	\$ 3,101.1

See accompanying notes.

Health Care Service Corporation,
a Mutual Legal Reserve Company

Statements of Cash Flow – Statutory Basis
(In Millions of Dollars)

	Years Ended December 31	
	2005	2004
Operating Activities		
Premiums collected	\$ 11,800.2	\$ 10,675.6
Claims paid	(9,467.4)	(8,650.2)
Commissions and expenses paid	(1,030.3)	(1,279.9)
Investment income received, net	189.3	104.7
Other income, net	14.3	13.7
Federal income taxes paid	(260.7)	(241.3)
Net cash provided by operating activities	1,245.4	622.6
Investing Activities		
Proceeds from investments sold or matured:		
Bonds	1,339.6	316.8
Common stocks	96.7	85.5
Real estate	5.1	1.5
Other uses	(0.8)	(0.9)
Total investment proceeds	1,440.6	402.9
Cost of investments acquired:		
Bonds	2,421.8	450.4
Common stocks	232.3	155.5
Real estate	8.5	7.7
Other	(32.1)	45.3
Total investments acquired	2,630.5	658.9
Net cash used in investing activities	(1,189.9)	(256.0)
Financing and Miscellaneous Activities		
Interest on long-term debt	(31.4)	(32.0)
Other cash provided	3.8	87.2
Net cash (used in) provided by financing and miscellaneous activities	(27.6)	55.2
Net increase in cash, cash equivalents, and short-term investments	27.9	421.8
Cash, cash equivalents, and short-term investments:		
Beginning of year	2,046.9	1,625.1
End of year	\$ 2,074.8	\$ 2,046.9

See accompanying notes.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

December 31, 2005 and 2004

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, Blue Cross Blue Shield of New Mexico and Blue Cross Blue Shield of Oklahoma (the Corporation), operates under the provisions of Article III of the Illinois Insurance Code, which govern mutual legal reserve companies in Illinois.

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

Effective November 1, 2005, the Corporation completed a statutory merger with Group Health Service of Oklahoma, Inc. (GHS), which did business as Blue Cross Blue Shield of Oklahoma. The 2004 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). These practices differ from accounting principles generally accepted in the United States (GAAP). The Corporation did not have any permitted practices in 2005 or 2004.

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 excluded from the accompanying balance sheet and are charged directly to policyholders’ surplus. Under GAAP, these assets are included in the balance sheets.

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. 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.
- iii. Certain leases which are capitalized under GAAP are treated as operating leases under statutory accounting practices.
- iv. Pension expense and other postretirement benefit expense exclude nonvested employees.
- v. 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.
- vi. Investments are stated at values prescribed or permitted by the National Association of Insurance Commissioners (NAIC) and, therefore, are not stated in accordance with GAAP.
- vii. Surplus notes are reported as policyholders' surplus rather than as liabilities.
- viii. Under GAAP, real estate used for operational purposes is included in property and equipment, whereas under statutory accounting practices, real estate is included in invested assets.
- ix. 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 Revenues and Expenses as both additional investment income and additional operating expenses.
- x. The statements of cash flow are prepared in conformity with statutory accounting practices and, therefore, are not prepared in accordance with GAAP.

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 Revenues 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.

Insurance Premiums

Insurance premiums are recorded on the accrual basis of accounting and are recognized as income during the period of coverage.

Administrative Services Contracts (ASC)

ASC, which is also referred to as uninsured business under the NAIC Accounting Practices and Procedures Manual (the Manual), 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 Revenues 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 the Manual, 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 Revenues and Expenses.

Policy and Claims Reserves

Claims and claims adjustment expenses on insured policies represents management's best estimate of the ultimate net cost to process and pay all reported and unreported claims incurred through December 31. The Corporation does not discount claims and claims adjustment expenses. 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.

Accident and health policy reserves represent reserves for unearned premium income, liability for experience rating refunds, and additional policy reserves.

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

Health Care Receivables

The Corporation contracts with various providers to provide medical services for customers. Health care receivables are netted against insured and ASC benefits and are recorded on an incurred basis. Health care 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 claim payments to these providers with amounts owed to the Corporation. Consistent with prescribed accounting practices, certain health care receivables have been included in the

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

2. Accounting Policies (continued)

Corporation's Balance Sheets as admitted assets. The portion of these receivables related to insured plans 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 Balance Sheets as amounts receivable related to uninsured plans.

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 current PBM contract calls for rebate payments to be paid within 120 days from 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 amounts receivable related to uninsured plans and health care receivables in the Balance Sheets depending on the type of business.

Electronic Data Processing Equipment

The Corporation capitalizes the cost of electronic data processing equipment, including operating system software. At December 31, 2005 and 2004, data processing equipment had an admitted asset balance of \$32.0 and \$44.8, 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 electronic data processing equipment and nonoperating system software was \$28.6 and \$27.6 for 2005 and 2004, respectively.

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 capitalizes internally developed software. 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, 2005 and 2004, capitalized internally developed software was \$25.5 and \$26.0, respectively, with the balances being nonadmitted. Accumulated depreciation was \$7.6 and \$1.9 for 2005 and 2004, respectively.

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 \$36.3 and \$34.0 for 2005 and 2004, 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 \$11.4 and \$11.3 for 2005 and 2004, respectively. The remaining unamortized balances of furniture, fixtures, equipment, and leasehold improvements are nonadmitted.

Investments

Investments are stated at values prescribed or permitted by the NAIC. Accordingly, bonds are stated at amortized cost. Short-term investments with original maturities of three months or less are reported as cash and cash equivalents. Short-term investments, primarily commercial paper, are those investments that when purchased have a maturity of less than one year and are stated at amortized cost which approximates fair value. Amortization of bond premium and accretion of bond discount are recognized on a yield-basis method. Single class mortgage-backed/asset-backed securities are stated at either amortized cost or the lower of amortized cost or fair 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. Real estate occupied by the Corporation is stated at cost, less accumulated depreciation. Common stocks of nonaffiliates, comprised of common stocks, bond mutual funds, and money-market funds, and preferred stocks are stated at fair value. Fair values are based on valuations as prescribed by the NAIC Securities

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued) (continued)

Valuation Office. 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 due from investment broker and included in other invested assets and payable for securities in the Balance Sheets. 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 Revenues and Expenses.

Investments in the Corporation's unconsolidated insurance and HMO subsidiaries are reported in the accompanying Balance Sheets as common stocks affiliates based on their underlying statutory capital and surplus. Investments in the Corporation's unconsolidated noninsurance subsidiaries are reported in the accompanying Balance Sheets 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.

Dividends received from unconsolidated subsidiaries are recorded as investment income in the Statements of Revenues 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 both investment income and operating expense in the Statements of Revenues and Expenses as if the Corporation had paid itself rent of \$35.2 and \$35.1 in 2005 and 2004, respectively.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

Federal Employees Program

The Federal Employees Program (FEP) is a national contract between Blue Cross 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 an insured basis. The Corporation provides insurance coverage for FEP members in Illinois, Texas, New Mexico, and Oklahoma. 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. Deferred FEP premiums 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.

Effect of Accounting Changes

Effective in 2005, the Corporation began filing the NAIC Health Statement with the DOI rather than the Life and Accident and Health Statement. This change was granted by the DOI. The effect of this change resulted in an increase to policyholders' surplus of \$18.6 as of January 1, 2004 related to the elimination of the interest maintenance reserve and asset valuation reserve.

Effective January 1, 2005, Statement of Statutory Accounting Principles (SSAP) No. 88, *Investment in Subsidiary, Controlled, and Affiliated Entities, a Replacement of SSAP 46*, was adopted by the Corporation. SSAP No. 88 provides statutory accounting guidance for investment in subsidiary, controlled, and affiliated entities. The Corporation reported a decrease in policyholders' surplus of \$8.0 related to its investment in noninsurance subsidiaries as a result of adopting SSAP No. 88.

Health Care Service Corporation,
a Mutual Legal Reserve Company

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

2. Accounting Policies (continued)

Due to the merger with the Corporation, GHS reduced their January 1, 2004, policyholders' surplus by \$17.0. This change resulted from the discontinuance of permitted practice exceptions previously utilized by GHS, as well as to conform GHS accounting practices to the Corporation's accounting practices.

Reclassifications

Certain amounts in the 2004 presentation have been reclassified to conform to the current-year presentation.

3. Investments

The amortized cost and NAIC fair value of bonds held by the Corporation at December 31, 2005 and 2004, are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
2005				
U.S. government and agency securities	\$1,257.3	\$ 3.8	\$(16.3)	\$1,244.8
Corporate and other bonds	947.6	8.3	(11.7)	944.2
	\$2,204.9	\$12.1	\$(28.0)	\$2,189.0
Due in one year or less	\$ 161.3			\$ 160.4
Due after one year through five years	1,062.2			1,054.8
Due after five years through ten years	479.6			473.9
Due after ten years	501.8			499.9
	\$2,204.9			\$2,189.0
2004				
U.S. government and agency securities	\$ 533.7	\$ 8.7	\$ (2.1)	\$ 540.3
Corporate and other bonds	601.5	15.8	(1.5)	615.8
	\$1,135.2	\$24.5	\$(3.6)	\$1,156.1

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 bonds during 2005 and 2004 were \$1,339.6 and \$316.8, respectively. Gross gains of \$4.5 and gross losses of \$10.8 were realized on those sales in 2005. Gross gains of \$2.5 and gross losses of \$0.9 were realized on those sales in 2004. At December 31, 2005, there were gross unrealized gains of \$241.5 and gross unrealized losses of \$38.3 for common stocks, including investments in unconsolidated subsidiaries. During 2005, proceeds from sales of common stocks were \$96.7. Gross gains of \$10.7 and gross losses of \$2.6 were realized on those sales. At December 31, 2004, there were gross unrealized gains of \$218.3 and gross unrealized losses of \$19.4 for common stocks, including investments in unconsolidated subsidiaries. During 2004, proceeds from sales of common stocks were \$85.5. Gross gains of \$12.8 and gross losses of \$4.7 were realized on those sales.

In 2005 and 2004, the Corporation recognized other-than-temporary impairment losses in affiliated common and preferred stocks of \$1.4 and \$3.6, respectively, related primarily to its investment in RealMed Corporation (RealMed). The Corporation's carrying value in RealMed is zero as of December 31, 2005 and 2004. The Corporation includes other-than-temporary impairments in net realized investment gain in the Statements of Revenue and Expenses.

At December 31, 2005 and 2004, the Corporation had net investment income of \$159.3 and \$55.0. This amount is net of investment expenses of \$60.6 and \$68.5 for 2005 and 2004, respectively. Investment expense for 2005 and 2004 is comprised of real estate depreciation expenses of \$9.5 and \$15.1, respectively, investment expenses of \$9.4 and \$11.1 respectively, real estate expenses of \$9.1 and \$9.3, respectively, and interest expenses of \$32.6 and \$33.0, 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 Millions of Dollars)

4. Investments in Unconsolidated Subsidiaries

Life Subsidiaries

As of December 31, 2005, the principal life insurance subsidiary of the Corporation is Fort Dearborn Life Insurance Company (FDL). On May 31, 2004, Omaha Life Insurance Company (Omaha Life), a wholly owned subsidiary of FDL, 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 FDL at FDL's underlying statutory capital and surplus. The condensed financial statements of FDL are shown below.

FDL Condensed Balance Sheets (Statutory Basis)

	December 31	
	2005	2004
Cash and short-term investments	\$ 34.5	\$ 45.4
Investments	1,071.6	1,054.4
Premiums receivable	25.9	26.4
Other assets	31.1	37.7
Separate accounts	518.2	431.4
Total assets	\$1,681.3	\$1,595.3
Policy reserves	\$ 645.9	\$ 648.0
Policy and contract claims	65.7	91.8
Other liabilities	103.5	94.7
Separate accounts	519.1	429.1
Capital and surplus	347.1	331.7
Total liabilities and capital and surplus	\$1,681.3	\$1,595.3

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)

FDL Condensed Statements of Operations (Statutory Basis)

	Years Ended December 31	
	2005	2004
Premium income	\$738.9	\$727.3
Other income	63.2	63.3
Total income	802.1	790.6
Policy benefits	552.8	611.2
Operating expenses	204.7	146.7
Total expenses	757.5	757.9
Net income before income taxes	44.6	32.7
Income tax expense	11.3	8.1
Net income	\$ 33.3	\$ 24.6

In addition to FDL, below is a listing of directly or indirectly owned subsidiaries as of December 31, 2005:

Combined Services, LLC	HMO New Mexico, Inc.
Dental Network of America, Inc.	BCI HMO, Inc.
HCSC Purchasing, LLC	THIN, Inc.
Preferred Financial Corporation	Arizona California Texas International, Inc.
Colorado Bankers Life Insurance Company	GHS Holding Company
Industry Savings Plan, Inc.	GHS Property and Casualty Insurance Company
HCSC Insurance Services Company	GHS General Insurance Agency
Hallmark Services Corporation	GHS HMO Inc., d/b/a BlueLincs HMO
Prime Therapeutics, LLC	GHS Fire Insurance Company
RealMed	BHO, Inc.
Third Coast Insurance Company	Member Service Life Insurance Company
MedConnect, LLC	

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

4. Investments in Unconsolidated Subsidiaries (continued)

In 2005, the Corporation made capital contributions of \$15.6 in Third Coast Insurance Company. Third Coast Insurance Company then paid in full \$10.0 in surplus notes held by the Corporation as well as \$5.6 in accrued interest due to the Corporation. This transaction was approved in advance by the DOI.

In 2005, the Corporation made capital contributions of \$2.5 in Hallmark Services Corporation and \$1.3 in RealMed. In 2004, the Corporation made capital contributions of \$3.0 in Hallmark Services Corporation, \$5.0 in HCSC Insurance Services Company (HISC) and \$3.6 in RealMed.

In January 2006, the Corporation made capital contributions of \$30.0 in HISC. Pursuant to SSAP No. 72, *Surplus and Quasi-reorganizations*, and with the prior approval of the DOI, the Corporation reported this transaction as an investment in HISC in the Corporation's financial statements as of December 31, 2005. The \$30.0 investment is included in affiliates common stocks with a corresponding \$30.0 liability in payable for securities.

In 2005, FDL paid the Corporation a cash dividend of \$10.0. BCI HMO, Inc. (BCI) paid the Corporation a cash dividend of \$0.4 and \$0.9 in 2005 and 2004, respectively.

5. Pharmacy Rebate Receivable

The total pharmacy rebate receivable at December 31, 2005 and 2004, was \$70.7 and \$61.3, respectively. Of this amount, \$38.0 and \$32.9 was nonadmitted for 2005 and 2004, respectively. The net admitted asset of \$32.7 and \$28.4 at December 31, 2005 and 2004, respectively, is included in amounts receivable related to uninsured plans and health care receivables in the Balance Sheets depending on the type of business. The confirmed receivable owed to the Corporation was zero in 2005 and 2004, respectively.

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

5. Pharmacy Rebate Receivable (continued)

In 2005 and 2004, the Corporation collected pharmacy rebates of \$125.4 and \$109.1, respectively. The chart below contains further detail regarding pharmacy rebate receivables for the years 2005 and 2004.

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
12/31/2005	\$32.7	\$ -	\$ -	\$ -	\$ -
9/30/2005	32.8	-	-	-	-
6/30/2005	32.4	-	-	26.9	-
3/31/2005	31.1	-	-	22.9	8.2
12/31/2004	28.4	-	-	0.6	26.5
9/30/2004	26.7	-	-	-	25.1
6/30/2004	26.9	-	-	24.4	4.7
3/31/2004	27.4	-	-	23.6	3.8
12/31/2003	26.1	-	-	26.9	2.8

Health Care Service Corporation,
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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, 2005 and 2004 is shown below:

	ASO	
	2005	2004
Net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses	\$ (0.4)	\$ (12.2)
Total net other income or expenses (including interest paid or received from customers)	—	—
Net loss from operations	\$ (0.4)	\$ (12.2)
 Total claim payment volume	 \$ 553.2	 \$ 1,353.4
	ASC	
	2005	2004
Gross reimbursement for medical cost incurred	\$14,313.0	\$11,460.2
Gross administrative fees accrued	1,673.0	1,095.3
Gross expenses incurred (claims and administrative)	(15,411.4)	(12,177.2)
Net gain from operations	\$ 574.6	\$ 378.3

7. Unpaid Claims and Claim Adjustment Expenses

The Corporation accrues liabilities for unpaid claims and claim adjustment expenses. 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.

Health Care Service Corporation,
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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:

	2005	2004
Balance at January 1	\$ 1,114.2	\$1,178.0
Incurred expenses related to:		
Current year	10,515.6	9,170.3
Prior years	(108.5)	(128.4)
Total incurred	10,407.1	9,041.9
Paid expenses related to:		
Current year	9,323.3	8,097.0
Prior years	981.2	1,008.7
Total paid	10,304.5	9,105.7
Balance at December 31	\$ 1,216.8	\$1,114.2

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 or 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 \$621.9 and \$580.3 as of December 31, 2005 and 2004, respectively.

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

7. Unpaid Claims and Claim Adjustment Expenses (continued)

As of December 31, 2005, the Corporation had a liability of \$13.3 related to premium deficiency reserves, which is included on the Balance Sheets in accident and health policy reserves. There were no premium deficiency reserves recorded as of December 31, 2004. The Corporation did not consider anticipated investment income when calculating its premium deficiency reserves.

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. 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, 2005 and 2004, the carrying value of the debt obligation including discount accretion was \$398.8 and \$398.7, 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 2005 and 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 three qualified defined-benefit pension plans, covering the majority of eligible employees. One plan covers the majority of the Corporation's nonunion employees in Illinois, Texas, and New Mexico, and the employees of FDL. In 2005, the plan also covers Combined Services, LLC (CSLLC), whose pension benefits were transitioned from a former plan, and the employees of Dental Network of America (DNOA). The second plan covers the

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

9. Pension Plans and Other Employee Benefits (continued)

majority of the Chicago based union employees of the Corporation. The third plan was adopted during 2005 as a result of the merger between the Corporation and GHS. This plan covers all eligible employees located in Oklahoma. 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 \$50.0 and \$90.0 in 2006. At December 31, 2005 and 2004, 63% of the plans' assets were invested in equity securities, and 37% of the plans' assets were invested in debt securities.

Retiree Health and Life Benefit Plan

The Corporation provides certain health care (including prescription drug coverage meeting qualifications under the Medicare act) and life insurance benefits for eligible retired employees. Employees located in Illinois, Texas, and New Mexico, and employees of FDL are covered by this policy. CSLLC employees are not covered by a postretirement health benefit plan. The Corporation sponsors a similar policy for Oklahoma employees as a result of its merger with GHS in 2005. 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 employment. These benefits are subject to deductibles, co-payment provisions, coordination with Medicare and other coverages, and 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 2005 or 2004. The Corporation paid the current cost of retiree health claims and life premiums directly from corporate assets during 2005 and 2004. The Corporation reserves the right to amend or change the provisions related to existing or future retirees at any time.

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

9. Pension Plans and Other Employee Benefits (continued)

Estimates and Assumptions Used to Determine Benefit Obligations and Costs

The preparation of financial statements in conformity with statutory accounting practices 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 and net periodic benefit costs for the majority of employees:

	Pension Benefits		Other Benefits	
	2005	2004	2005	2004
Discount rate	5.75%	6.00%	5.75%	6.00%
Rate of compensation increase	5.50%	5.50%	5.50%	5.50%
Expected long-term rate of return on plan assets	8.00%	8.00%	5.00%	5.00%

Health Care Service Corporation,
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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 market value of plans' assets and a statement of the plans' funded status for 2005 and 2004.

	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	2005	2004	2005	2004
At December 31				
<i>Reconciliation of benefit obligation</i>				
Obligation at beginning of year	\$ 811.5	\$ 721.7	\$ 211.7	\$ 189.4
Service cost	44.0	33.6	19.8	19.3
Interest cost	47.1	44.8	11.8	11.9
Actuarial loss	24.5	50.1	8.9	1.8
Benefits paid	(48.2)	(42.1)	(12.2)	(10.7)
Plan amendments	-	0.8	-	-
Business combinations	-	2.6	-	-
Obligation at December 31	\$ 878.9	\$ 811.5	\$ 240.0	\$ 211.7
<i>Reconciliation of fair value of plan assets</i>				
Fair value of plan assets at beginning of year	\$ 572.7	\$ 480.2	\$ 51.3	\$ 46.5
Actual return on plan assets	42.3	50.7	3.4	4.8
Employer contributions	85.5	82.0	12.2	10.7
Benefit payments	(48.2)	(42.1)	(12.2)	(10.7)
Business combinations	0.3	1.9	-	-
Fair value of plan assets at December 31	\$ 652.6	\$ 572.7	\$ 54.7	\$ 51.3
<i>Funded status</i>				
Funded status at December 31	\$(226.3)	\$(238.8)	\$(185.3)	\$(160.4)
Unrecognized prior service cost (credit)	16.0	17.8	(7.0)	(11.5)
Unrecognized net loss	207.5	188.6	66.7	60.2
Unrecognized transition obligation	70.1	75.2	1.2	1.4
Prepaid asset (accrued liability)	67.3	42.8	(124.4)	(110.3)
Minimum pension liability adjustment	(68.9)	(54.6)	-	-
Accrued benefit cost	\$ (1.6)	\$ (11.8)	\$ (124.4)	\$(110.3)
Benefit obligation for nonvested employees	\$ 20.3	\$ 18.6	\$ 188.7	\$ 166.3

The accumulated pension benefit obligation (APBO) was \$654.2 and \$584.5 at December 31, 2005 and 2004, respectively.

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

9. Pension Plans and Other Employee Benefits (continued)

The following table provides the components of net periodic benefit cost for the plans for 2005 and 2004.

Years Ended December 31	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	2005	2004	2005	2004
<i>Plan costs</i>				
Service cost	\$44.0	\$33.6	\$19.8	\$19.3
Interest cost	47.1	44.8	11.8	11.9
Expected return on plan assets	(47.2)	(39.7)	(2.6)	(2.4)
Amortization of unrecognized transition obligation	5.1	5.1	0.2	0.2
Amortization of prior service cost (credit)	1.8	1.7	(4.5)	(4.4)
Amortization of net loss	10.2	9.1	1.6	2.5
Net periodic benefit cost	\$61.0	\$54.6	\$26.3	\$27.1

Net periodic benefit costs in 2005 include allocations to FDL and CSLLC of \$1.6.

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, for the Illinois, Texas, and New Mexico employee plan, a 9.25% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2005. It is assumed that the rate will decrease gradually each year to a rate of 5.0% for 2010 and remain at that level thereafter. The Oklahoma plan used a 10% rate for 2005 grading down to 5.0% by 2011.

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

9. Pension Plans and Other Employee Benefits (continued)

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	\$ 4.7	\$ (3.9)
Effect on the health care component of the accumulated postretirement benefit obligation	\$30.8	\$(25.7)

At December 31, 2005 and 2004, the Corporation recorded and admitted a net intangible pension asset of \$1.6 and \$11.8, 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 liability. The prepaid pension asset of \$67.3 and \$42.8 as of December 31, 2005 and 2004, respectively, were nonadmitted.

The Corporation's allocated portion of accrued retiree costs at December 31, 2005 and 2004 was \$120.4 and \$107.1, respectively, with the remaining \$4.0 and \$3.2, 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 coverage for prescription drugs. The Corporation expects that this legislation will eventually reduce the Corporation's costs for a portion of the benefit programs it sponsors. The Corporation elected to recognize the financial impact of this legislation in its statutory postretirement benefit valuation effective July 2004. The Corporation has applied for and has been initially approved to claim a subsidy related to the Act. Due to this adoption, the Corporation recognized 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

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

9. Pension Plans and Other Employee Benefits (continued)

was reflected in net periodic benefit cost for the first time in 2004, and net periodic benefit cost was reduced by \$2.1 for 2004. The accrued cost without the Medicare savings reflected at December 31, 2005 is estimated to have been \$130.5. 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.

Expected retiree healthcare benefit payments during 2006 are projected to approximate \$12.0; during 2006-2009 are projected to approximate a range from \$13.0 to \$18.0 per year; and for the five-year period ending 2014 may approximate an average of \$23.0 per year. The possible expected Medicare subsidy is estimated to be \$0.7 in 2006; during 2007-2009 the subsidy may range from \$0.8 to \$1.2 per year; and for the five-year period ending 2014 may approximate \$1.8 per year.

Defined-Contribution Plans

The Corporation currently sponsors three defined contribution 401(k) plans covering the majority of its employees. The first plan covers the Illinois, Texas, and New Mexico nonunion employees, as well as the FDL and CSLLC employees. The second plan covers union employees. The third plan covers Oklahoma employees. The 401(k) plan allows immediate eligibility and automatic enrollment. 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 \$15.0 in 2005 and \$13.7 in 2004.

The Corporation also provides a nonqualified deferred compensation plan for a select group of employees and a nonqualified excess benefit plan (nonqualified pension benefit restoration plan) for certain highly compensated employees limited in their qualified defined benefit by IRS rules. During 2005 the Corporation assumed certain previous GHS plans of a similar nature with very limited participation.

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

10. Leases

Leases are primarily for electronic data-processing equipment with remaining lease terms of one to five years and for office space with remaining lease terms of one to sixteen years. Rental expense for 2005 and 2004 was approximately \$118.0 and \$90.9, respectively.

Future minimum lease payments as of December 31, 2005, are as follows:

2006	\$ 62.4
2007	52.2
2008	29.5
2009	21.3
2010	13.5
Subsequent to 2010	<u>77.7</u>
Total minimum lease payments	<u><u>\$256.6</u></u>

11. Income Taxes

The Corporation files a consolidated federal income tax return with its subsidiaries other than BCI and Colorado Bankers Life Insurance Company, which file separately.

The method of allocation between the companies is subject to a written agreement approved by the Corporation's Board of Directors, 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.

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

11. Income Taxes (continued)

The components of the net deferred tax asset recognized in the Balance Sheets are as follows:

	December 31	
	2005	2004
Gross deferred tax assets	\$1,969.0	\$1,611.7
Gross deferred tax liabilities	(34.3)	(25.9)
Net deferred tax asset	1,934.7	1,585.8
Deferred tax asset nonadmitted	1,781.5	1,447.0
Net admitted deferred tax asset	\$ 153.2	\$ 138.8
Increase in nonadmitted deferred tax asset	\$ 334.5	\$ 214.7

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

	2005		2004	
Federal income tax	\$192.8		\$247.1	
Federal income tax expense on net capital gains	-		1.5	
Current income taxes incurred	\$192.8		\$248.6	

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

11. 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:

	2005	2004
Deferred tax assets		
Accrued vacation liability	\$ 0.7	\$ —
Allowance for doubtful accounts	(12.5)	5.1
Unamortized goodwill	(3.9)	(5.8)
Fixed assets	0.7	(11.3)
Postretirement benefits liability	8.7	1.9
Salvage and subrogation recoverable	83.2	(3.9)
Deferred compensation liability	10.9	(31.7)
Nonadmitted assets	(1.1)	15.5
Net operating loss carryforwards/tax credits	257.0	243.1
Contingent liabilities	(0.2)	22.5
Other	13.8	(11.1)
Total change in deferred tax assets	357.3	224.3
Change in nonadmitted deferred tax assets	(334.5)	(214.7)
Change in admitted deferred tax assets	22.8	9.6
Deferred tax liabilities		
Unrealized capital gains	(0.6)	(1.5)
Accrued market discount	0.2	0.1
Pension	12.2	5.2
Other	(3.4)	(0.4)
Total change in deferred tax liabilities	8.4	3.4
Change in net admitted deferred tax asset	\$ 14.4	\$ 6.2

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

11. Income Taxes (continued)

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

	December 31		Change
	2005	2004	
Gross deferred tax assets	\$1,969.0	\$1,611.7	\$357.3
Gross deferred tax liabilities	(34.3)	(25.9)	(8.4)
Net deferred tax asset	\$1,934.7	\$1,585.8	\$348.9
Change in unrealized capital gains			(0.3)
Change in net deferred income taxes			<u>\$348.6</u>

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 income before income taxes. The significant items causing this difference for 2005 and 2004 are as follows:

	Effective Tax Rate Percentage	
	2005	2004
Provision computed at statutory rate	35.0%	35.0%
Special deductions/alternative minimum tax	(34.3)	(30.1)
Change in nonadmitted assets	(6.2)	(0.5)
Other	(6.1)	(1.5)
Total	(11.6)	2.9
Federal income taxes incurred	14.4	19.2
Change in net deferred income taxes	(26.0)	(16.3)
Total statutory income taxes	(11.6)%	2.9%

At December 31, 2005, the Corporation had \$1,302.7 tax-effected operating loss and tax credit carryforwards, originating in 1995 through 2005, of which \$250.2 will expire, if unused, in years 2010 and after.

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

11. Income Taxes (continued)

The amounts 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:

2005	\$278.1
2004	258.4
Total	<u>\$536.5</u>

12. Direct Premium Written by a Third-Party Administrator

Total premiums written by third-party administrators in 2005 and 2004 were \$710.9 and \$529.2, respectively. This business was written by Hallmark Services Corporation (Hallmark). The Corporation owns 100% of Hallmark. 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.

13. 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, 2005 and 2004, that are subject to retrospective rating features was \$186.6 and \$138.2, respectively. This represents 1.6% and 1.4%, respectively, of the premiums written for group health. No other net premiums written by the Corporation are subject to retrospective rating features.

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

14. Legal Actions

Greg Abbott, Attorney General of Texas v. Blue Cross Blue Shield of Texas, Inc. et al. No. 03-0821; In the Supreme Court of Texas in connection with the merger between the Corporation and Blue Cross Blue Shield of Texas, Inc. (BCBSTX), the Texas Attorney General filed suit alleging that, because BCBSTX was a charity under Texas law, the merger constituted a breach of BCBSTX's duty to hold its assets in charitable trust for the benefit of the people of Texas. On September 18, 1998, the District Court of Travis County Texas rendered final judgment for the Corporation. It held that BCBSTX was not a charity, that the merger could proceed, and that BCBSTX had not violated any of its fiduciary duties to the people of the State of Texas. Pursuant to a settlement agreement, the Corporation committed to contribute \$10.0 over the period from 1998 to 2002 to the Texas Healthy Kids Corporation. The full amount of this contribution was expensed in 1998. Concurrent with the final judgment, the parties entered into an agreement, which provides that the Texas Attorney General will appeal the finding that BCBSTX was not a charity. In the event the Texas Attorney General prevails on this appeal, the Corporation will pay \$340.0 plus 5% interest over 20 years to a charitable trust designated by the Attorney General. 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 Texas Attorney General appealed this case to the Texas Supreme Court. The Texas Attorney General's request for appeal was denied. On May 27, 2005, the Texas Attorney General utilized a rare Texas legal procedure known as a Bill of Review and filed a new suit in the state court in Austin, Texas against BCBSTX and the Corporation. The 'Bill of Review' requests the court set aside all the judgments previously rendered by the Texas district court and appellate courts in the Corporation's favor regarding the merger of BCBSTX and the Corporation. The Corporation believes that the newly-filed lawsuit is entirely without merit. BCBSTX and the Corporation filed its Special Exceptions and Answer, the Attorney General filed a responsive pleading and a hearing was held on the special exceptions. The court has not yet ruled regarding this matter.

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

14. Legal Actions (continued)

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.

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.

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

15. 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 \$73.0 and \$65.2 in 2005 and 2004, respectively. These amounts are netted against general and administrative expenses in the Corporation's Statements of Revenues and Expenses.

At December 31, 2005 and 2004, the Corporation has receivables of \$10.1 and \$9.0 and payables of \$1.2 and \$1.3, respectively, from its subsidiaries.

- B. Pursuant to an excess insolvency reinsurance agreement, the Corporation guarantees payment of all claims for covered services of BCI subscribers in the event of BCI's insolvency, as determined by the DOI. The Corporation sold 49% of its interest in BCI to another entity in December 2004.
- C. The Corporation guarantees the payment of the claim-related expenses of HMO New Mexico, Inc. as required by the New Mexico Insurance Code.
- D. The Corporation has committed to the DOI that it will make additional financial contributions into Third Coast Insurance Company (TCIC) to insure that TCIC capital and surplus meets or exceeds Company Action Level Risk Based Capital requirements imposed by Illinois statute.
- E. As a result of the merger with GHS, the Corporation is a party to an agreement to guarantee payment of authorized and covered health claims in the event of the insolvency or cessation of business of GHS HMO, Inc., d/b/a BlueLincs HMO (BlueLincs).
- F. In connection with the merger with GHS, GHS transferred to HISC its contract with the Centers for Medicare and Medicaid Services to become a Medicare Prescription Drug Program Sponsor and guaranteed payment of all liabilities and the obligations assumed by HISC. As a result of the merger, the Corporation is now the guarantor.

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

15. Related-Party Transactions (continued)

- G. The Corporation has guaranteed to the full extent of its assets all the contractual and financial obligations of the following health subsidiaries in order for the subsidiary to be licensed by the Blue Cross and Blue Shield Association: BlueLincs, effective November 1, 2005; HISC, effective June 30, 2003; HMO New Mexico, Inc., effective August 3, 2000; and BCI.
- H. In connection with the February 2, 2005 application to offer Medicare Advantage PPO programs in certain areas of Texas and all of New Mexico, HISC represented to the Centers for Medicare and Medicaid Services that HISC will be funded by the Corporation as needed to meet Illinois state Risk-Based Capital requirements.

The Corporation has not committed any reserves to cover the above agreements and commitments.

16. Surplus Notes

As a result of its merger with GHS, the Corporation assumed a surplus note issued to GHS for \$18.0 on October 29, 2003. Interest on the note accrues at LIBOR plus 3.95%, adjusted quarterly. At December 31, 2005, the accrued interest is \$0.2. Interest is payable on a quarterly basis subject to prior approval by the Oklahoma Insurance Commissioner. Interest payments made during 2005 were approximately \$1.0. At the sole discretion of the Corporation, the note may be paid in full after five years, subject to approval of the Oklahoma Insurance Commissioner. All unpaid principal and interest is due in 30 years at maturity of the note.

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, 2005, the Corporation's total adjusted capital is in compliance with the regulatory RBC requirements.

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

18. Statutory Merger

Effective January 1, 2004, Southwest Texas HMO, Inc. (Southwest), a wholly owned subsidiary, was 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.

Effective November 1, 2005, the Corporation merged with GHS, which did business as Blue Cross Blue Shield of Oklahoma. This transaction was accounted for as a statutory merger and was approved by both the DOI and Oklahoma Department of Insurance. As a result of this merger, as required under statutory accounting practices, the Corporation restated the prior year's financial statements as if the merger had taken place at the beginning of 2004.

The 2004 data of the previously separate companies has been restated on a combined basis. The condensed separate company and condensed combined company statutory information for the year ended December 31, 2004, and results of operations for the year then ended are presented below.

Condensed Balance Sheets as of December 31, 2004

	<u>Corporation</u>	<u>GHS</u>	<u>Adjustments</u>	<u>Combined</u>
Cash and short-term investments	\$2,025.3	\$ 21.6	\$ –	\$2,046.9
Investments	1,807.4	263.4	(13.7)	2,057.1
Premiums receivable	507.0	33.6	130.9	671.5
Other assets	1,547.1	199.2	(162.3)	1,584.0
Total admitted assets	<u>\$5,886.8</u>	<u>\$517.8</u>	<u>\$ (45.1)</u>	<u>\$6,359.5</u>
Claims and medical incentives payable	\$ 962.1	\$ 98.8	\$ –	\$1,060.9
Other liabilities	1,614.6	205.8	(23.0)	1,797.4
Long-term debt	400.1	–	–	400.1
Total liabilities	<u>2,976.8</u>	<u>304.6</u>	<u>(23.0)</u>	<u>3,258.4</u>
Policyholders' surplus	2,911.4	211.8	(22.1)	3,101.1
Total liabilities and capital and surplus	<u>\$5,888.2</u>	<u>\$516.4</u>	<u>\$ (45.1)</u>	<u>\$6,359.5</u>

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

18. Statutory Merger (continued)

Condensed Statements of Revenues and Expenses
for the Year Ended December 31, 2004

	<u>Corporation</u>	<u>GHS</u>	<u>Adjustments</u>	<u>Combined</u>
Premiums earned	\$9,691.7	\$937.4	\$ –	\$10,629.1
Benefit expenses	7,823.5	771.7	–	8,595.2
	<u>1,868.2</u>	<u>165.7</u>	<u>–</u>	<u>2,033.9</u>
Administrative expenses	716.5	117.7	–	834.2
Decrease in premium deficiency reserves	(25.7)	–	–	(25.7)
Net underwriting gain	<u>1,177.4</u>	<u>48.0</u>	<u>–</u>	<u>1,225.4</u>
Other income	52.4	20.2	–	72.6
Net income before federal income taxes	<u>1,229.8</u>	<u>68.2</u>	<u>–</u>	<u>1,298.0</u>
Federal income taxes	236.8	11.8	–	248.6
Net income	<u>\$ 993.0</u>	<u>\$ 56.4</u>	<u>\$ –</u>	<u>\$ 1,049.4</u>

19. Other Items

- A. The Corporation performs claims processing services for Indian Health Service. Revenue from the Corporation's Indian Health Service contract for the year ended December 31, 2005 and 2004 was \$8.2 and \$7.4, respectively. The Corporation recorded receivables from Indian Health Service of \$1.3 and \$1.2 at December 31, 2005 and 2004, respectively.
- B. The Corporation acts in an agency capacity for the United States government in disbursing government funds for health insurance for the aged under the Social Security Act (Medicare Part A) and is reimbursed for administrative costs associated with operating the program. Medicare Part A benefits of \$1.5 billion and \$1.3 billion in 2005 and 2004, respectively, are not included in the accompanying statutory-basis financial statements. Administrative expense reimbursements of \$6.8 and \$6.0 for 2005 and 2004, respectively, have been deducted from general and administrative expenses.

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

19. Other Items (continued)

Claim amounts and administrative expenses paid by the Corporation under the Medicare program are subject to audit and possible adjustments by the government. Adjustments, if any, that may result from audits of subsequent years are not expected to have a material adverse effect on the Corporation's statutory-basis financial position, results of operations, or cash flow.

20. Subsequent Events

In January 2006, pursuant to permission from the DOI, the Corporation converted \$18.0 in surplus notes to debt. As a result, the Corporation's statutory policyholders' surplus was reduced by \$18.0 and the Corporation's liabilities increased by \$18.0.