

RatingsDirect®

Research Update:

Health Care Service Corp. 'AA-' Ratings Affirmed After Insurance Criteria Change; The Outlook Is Stable

Primary Credit Analyst:

Deep Banerjee, New York (1) 212-438-5646; shiladitya.banerjee@standardandpoors.com

Secondary Contact:

James Sung, New York (1) 212-438-2115; james.sung@standardandpoors.com

Research Contributor:

Caitlin Weir, New York (1) 212-438-5669; caitlin.weir@standardandpoors.com

Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

Research Update:

Health Care Service Corp. 'AA-' Ratings Affirmed After Insurance Criteria Change; The Outlook Is Stable

Overview

- Following a review under our revised insurance criteria, we are affirming our 'AA-' counterparty and financial strength ratings on Health Care Service Corp. (HCSC).
- The ratings reflect HCSC's very strong business and extremely strong financial profiles, based on its strong market share and extremely strong capital and earnings.
- The stable outlook reflects our expectation that HCSC will maintain its extremely strong capitalization, very strong competitive position in its core markets, and positive operating performance.

Rating Action

On June 24, 2013, Standard & Poor's Ratings Services affirmed its 'AA-' long-term counterparty and financial strength ratings on Health Care Service Corp. (d/b/a Blue Cross Blue Shield of Illinois, New Mexico, Oklahoma and Texas). We are also affirming our 'AA-' rating on the company's \$500 million senior unsecured debt. The outlook is stable.

Rationale

The rating on HCSC reflects our view of the company's very strong business risk profile (BRP) and extremely strong financial risk profile (FRP). This BRP/FRP combination results in an anchor of 'aa', which we adjust by one notch to 'aa-', reflecting our view that, although we view HCSC's competitive position to be very strong, the company has less product diversity than higher-rated peers.

The BRP reflects a low industry and country risk score and the company's very strong competitive position. Our view of the FRP is based on HCSC's extremely strong capital and earnings, intermediate risk position, and adequate financial flexibility.

HCSC operates within the U.S. health insurance market and, as such, faces low industry and country risk. Our view of low country risk stems from the stable economic growth prospects, sophisticated financial systems, and strong payment culture in the U.S. The U.S. health insurance sector's stable profitability, intermediate product risk, high operational barriers to entry, and regulatory

framework support our view of low industry risk. Overall, we expect the U.S. health sector's credit quality to be strong, with limited potential for change in the next 24 months. But key potential risks to the sector include a sluggish economic recovery, unanticipated increases in healthcare costs, or any unforeseen adverse effects from the Affordable Care Act to the risk profile of health insurers.

We view the company's competitive position as very strong. HCSC has established itself as the leading provider of health insurance in each of its primary markets through its well-developed distribution channels, long-standing provider relationships, and competitive servicing capabilities. HCSC provides health insurance and related services to about 13.2 million members (excluding Blue Card) as of year-end 2012. It reported about \$21 billion in annual insurance premiums in 2012, making it the fourth-largest insurer in the U.S. In terms of membership, HCSC has leading market positions in all four of its core states (Illinois, Texas, Oklahoma, and New Mexico) along with some national presence through its partnerships with other Blue plans (Blue Card), national administrative services only (ASO) accounts, and ancillary businesses through wholly owned subsidiary Dearborn National Life Insurance Co. (DNL). About 90% of its membership base is commercially insured, with roughly 60% self-funded or ASO-type contracts. HCSC's geographic diversity is an advantage versus other single-state BlueCross BlueShield plans, but the company is less diverse compared with national for-profit competitors which have a larger presence in noncommercial health insurance lines of business. Nonetheless, HCSC's market share is significantly larger in its chosen markets, supporting our view of the company's very strong competitive position.

HCSC has extremely strong capital and earnings, in our view, which we expect, as per our base-case forecast, to continue in the coming year or two. In 2012, statutory capital increased by 7% to \$9.6 billion. The company had regulatory risk based capital (RBC) of more than 600% at year-end 2012. As per our insurance capital model, the company's consolidated (including DNL) capital remains redundant at the 'AAA' level. HCSC has maintained its capital strength over several years due to prudent capital management, strong retained earnings, and relatively low-risk product profile.

HCSC's 2012 operating performance was in line with our expectations, with statutory return on revenue (ROR), excluding realized capital gains and losses, of 5.3% compared with 7.8% in 2011. Although this is slightly below similarly rated peers, we don't consider this dip in profitability to be a negative ratings factor since HCSC's capitalization and liquidity offset any relative downside risk in its earnings profile. On a five-year average, ROR averaged 6% and we anticipate the company to generate annual RORs (excluding net realized gains and losses, and one-time strategic investments) of around 5%-6% for full-year 2013.

In our view, HCSC's risk position reflects intermediate risk, which indicates our view that the company has average volatility risk for this sector and no material risk-concentrations. HCSC's investment portfolio is fairly

diversified with high-quality assets, and no significant sector or obligor concentrations. As of year-end 2012, 88% of its fixed-income portfolio was in National Assn. of Insurance Commissioners (NAIC) Class 1 securities, with 47% maturing within one year and less than 1% speculative grade. HCSC carefully manages the portfolio in line with its investment philosophy that focuses on preservation of capital and dependable cash flow. The company also does not have any material employee-benefit obligations that would cause any long-term strain on capital.

HCSC has adequate financial flexibility, in our view, since it funds its minimal capital needs with internally generated cash flow and excess capital. HCSC's modest debt leverage of less than 10% and strong balance sheet leaves adequate cushion in case the company needs to access the debt markets. In January 2011, the company offered \$500 million in 10-year unsecured notes through a 144A issuance. It used the proceeds to prefund previously issued unsecured notes that matured in June 2011.

We regard the company's enterprise risk management (ERM) and management and governance practices as consistent with the ratings. Our assessment of HCSC's ERM is adequate. A higher share of nonrisk membership lowers exposure to unanticipated volatility in medical cost trends. DNL has relatively small effect on the group's risk profile given its size. As of year-end 2012, DNL held \$413 million of statutory capital compared with \$9.6 billion at HCSC. A key improvement in HCSC's ERM program over the past year has been the development of formal risk appetite and tolerance statements. HCSC has enhanced its risk controls and monitoring systems for its investment portfolio. This recent enhancement provides for better investment analytics, real-time monitoring, and more-comprehensive understanding of risk-reward tradeoffs. The company continues to dedicate resources to manage its risks while establishing a mature, sustainable ERM process.

HCSC's management and governance is satisfactory, in our opinion. This reflects our positive view of management's expertise and depth as well as its ability to implement the company's strategy while maintaining appropriate risk tolerances. Management has also been proactive over the past few years by making key strategic investments to improve the company's competitive position and operational efficiencies as it gets ready for the implementation of U.S. health care reform. Since 2008, HCSC has made several small acquisitions, including Academic HealthPlans (individual student market), TMG Health Solutions (BPO services for government programs), and MEDecision (information exchange capabilities), all showcasing management's vision and knowledge of the changing U.S. health insurance marketplace. In 2012, the company announced its alliance with Blue Cross Blue Shield of Montana (BCBSMT), which will provide additional geographic diversity to the company's business profile.

We view HCSC's liquidity as exceptional, underpinned by a positive liquidity ratio of more than 220% as per our liquidity analysis, limited confidence sensitive liabilities, and no ratings triggers. The company has more than enough liquid assets to cover its short-term liabilities. As of year-end 2012, it reported \$2.8 billion in cash and short-term assets on its balance sheet.

Outlook

The stable outlook reflects our expectation that HCSC will maintain capital adequacy consistently at the 'AAA' level as per our insurance capital model, sustain its very strong competitive position and favorable operating performance.

Although unlikely in the next 12-24 months, we could lower the ratings if the company's pretax ROR falls to less than 4% on a sustained basis or capitalization deteriorates below the 'AA' level as per our insurance capital model. Conversely, we could consider raising the ratings if HCSC successfully bolsters its business profile by profitably diversifying into new markets and product lines.

Ratings Score Snapshot

Financial Strength Rating	AA-/Stable
BRP/FRP Anchor	aa
Business Risk Profile	Very Strong
IICRA	Low Risk
Competitive Position	Very Strong
Financial Risk Profile	Extremely Strong
Capital & Earnings	Extremely Strong
Risk Position	Intermediate Risk
Financial Flexibility	Adequate
Modifiers	0
ERM and Management	0
Enterprise Risk Management	Adequate
Management & Governance	Satisfactory
Holistic Analysis	0
Liquidity	Exceptional
Support	0
Group Support	0
Government Support	0

Related Criteria And Research

- Insurance Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- Group Rating Methodology, May 7, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Ratings Affirmed

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

Counterparty Credit Rating

Local Currency

AA-/Stable/--

Financial Strength Rating

Local Currency

AA-/Stable/--

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

Senior Unsecured

AA-

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.

Copyright © 2013 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.