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Research Update:

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

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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-

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