

Rating Health Insurance Companies

The purpose of this report is to provide transparency regarding A.M. Best Co.'s criteria for assigning financial strength ratings (FSR) to health insurance carriers, including traditional life/health insurance companies, health maintenance organizations (HMOs) and Blue Cross and Blue Shield plans. This methodology also updates A.M. Best's previously published health-care rating methodology to reflect changes in the marketplace.

The constantly changing operating environment and the unstable, escalating rate of inflation for health-care costs make it difficult for carriers to anticipate the medical cost factor in the pricing of policies that will be in effect for 12 months. The resulting volatility of earnings, combined with the thin capitalization that is characteristic of many health insurers, creates a fertile environment for financial impairment. More vulnerable are small health carriers with product and geographic concentrations and a lack of resources necessary for innovative responses to changes in the environment. As a result of these factors, the demand for financial strength ratings on these companies has increased.

Health Insurer Rating Criteria

An A.M. Best financial strength rating is an opinion about an insurer's financial strength and its ability to meet ongoing obligations to policyholders. The assigned rating is derived from an in-depth evaluation of a company's balance-sheet strength, operating performance and business profile, compared with A.M. Best's quantitative and qualitative standards. The required analysis reflects all sources of risk to which the health insurer is exposed. The entire group, including all of the rated entity's affiliates and their internal relationships, is considered. For the noninsurance

subsidiaries, A.M. Best performs a detailed, internal analysis of their risk profile and the resulting effect on rated entities within the group.

An important component of the evaluation process requires an interactive exchange of information, both public and confidential, with the insurer's management. Once assigned, ratings are re-evaluated continually for changes that might arise during the year or in conjunction with A.M. Best's ongoing dialogue with company management.

A.M. Best's criteria for analyzing health insurance carriers are broadly similar to those for life insurers. Key differences are the focus on benchmarks, ratios and qualitative factors relevant to the health-care operating environment. This report primarily details those elements of the rating analysis that are different for health insurers. For more detailed information on A.M. Best's criteria for life/health insurance companies, visit www.ambest.com/ratings.

Balance-Sheet Strength

In determining a company's ability to meet its current and ongoing obligations to policyholders, the most important area to evaluate is its balance-sheet strength. A critical measure of balance-sheet strength is the adequacy of a health insurer's capital and surplus to support its financial and operating practices. The net required capital to support these practices and the company's other risk exposures—primarily related to product mix and underwriting—is evaluated by Best's Capital Adequacy Ratio (BCAR). Other considerations in assessing balance-sheet strength are reserves, reinsurance and asset quality.

Capital Adequacy

A.M. Best believes all minimum state regulatory requirements for capital and surplus are too low. An A.M. Best Secure rating—(Very Good) B+ and higher—calls for substantially higher amounts of capital

This report was written by Ken Frino, vice president with the life/health division of A.M. Best Co.



than what is assessed under the Managed Care Organization Risk Based Capital (MCOBRC) company action level, as promulgated by the National Association of Insurance Commissioners.

While A.M. Best's analysis of capital adequacy begins with a BCAR assessment at each operating insurer, several other quantitative factors play significant roles in the rating, including:

- NAIC RBC
- Current and Overall Liquidity
- Underwriting leverage (net premiums written to capital and surplus).
- Equity per member per month (capital and surplus to member months). This measures the amount of capital and surplus spread over the membership base.
- Asset leverage (total liabilities to total assets).
- Amount of Debt or Surplus Notes
- Changes in Reserves

Quantitative models for capital measurement, however, are essentially static. They indicate capital adequacy at a fixed point in time, given the business risk typical for the lines of business offered that year. For this reason, A.M. Best makes a qualitative assessment of the risks related to the local market and regulatory conditions, risks unique to the company, or future risks that could develop as various conditions change.

External Capital Support

Another consideration in the assessment of capital adequacy is capital available from external sources, such as borrowings from the capital markets and private sources or contributions from an affiliate. The amounts that must be repaid to a lender—whether a parent or a third-party—aren't automatically considered permanent capital, although a regulator's permission might be required before payments are made. Capital composed of retained earnings or paid-in amounts is considered superior to capital that includes subsidiary borrowings.

Although a health insurance carrier might be thinly capitalized, it might be a subsidiary of a well-capitalized, national or multiregional holding company encompassing numerous HMOs and insurance companies. Holding companies and their associated capital structures can have a significant

impact on the overall financial strength of an insurance company subsidiary: They can provide subsidiaries with various levels of financial flexibility, including capital infusions. Conversely, debt and other securities, typically obligations of a holding company, can reduce a corporation's financial flexibility, depending on the magnitude of those obligations, and place significant dividend demands on a subsidiary, limiting growth of its surplus.

A.M. Best recognizes that efficient capital management at such organizations calls for maintaining most of the capital at the holding-company level, from which support can be disbursed downstream to an operating entity. To determine whether a rating is secure, A.M. Best measures both the willingness and the ability of the parent to provide support. The level of capital at the operating entity, however, remains

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For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.



The Insurance Information Source

important.

A.M. Best prefers that the holding company provide explicit support in the form of a minimum amount of capital to be maintained at the entity and the parent's commitment to provide cash infusions if the subsidiary generates losses. However, willingness to provide support also may be indicated through discussions with management, preferably backed with evidence of a history of support.

A.M. Best assesses the parent's ability to provide support based on its financial resources, such as the availability of cash and liquid assets and the sources and uses of funds at the holding company. To perform this assessment, A.M. Best looks at the parent's financial leverage and financial flexibility, using the ratio of total debt to total capital and coverage compared with the maximum for a rating category.

A.M. Best makes its evaluation of financial leverage based on the level to which the company manages, rather than the level at the time of the rating action. In addition, the level of coverage is deemed important. Companies in the Secure rating categories typically are expected to have coverage in excess of three times. Financial flexibility is evaluated based on the availability of funds from external sources, such as those obtained from the issuance of public and private debt, equity, and surplus notes and trust-preferred securities.

Cash flow available to the holding company from within the group depends primarily on the dividend-paying capacity of, and certain corporate service fees from, regulated and unregulated subsidiaries. Dividend capacity, in turn, depends on the organizational structure, recognizing that a generally flat structure is preferable to a stacked structure. The presence of profitable, nonregulated subsidiaries is viewed positively, as there are no limitations on the amount of dividends that may be sent upstream.

Expected uses of funds are for debt service, corporate expenses, capital infusions to subsidiaries and capital expenditures. A significant excess of funds may be channeled into a stock-repurchase program. A.M. Best views stock-repurchase programs cautiously. The volatility of the health insurance industry requires holding a prudent

quantity of funds for unexpected, adverse developments, although how much isn't determined easily and would be based on each organization's risk characteristics at the time of the rating.

Reserves

Reserve levels also are given considerable attention as another risk exposure on the balance sheet. A.M. Best reviews historical reserve development and current reserve margin above any third-party estimate. A.M. Best also evaluates a company's policy for the desired level of margin and premium stabilization funds and whether these percentages are maintained consistently.

Asset Quality and Reinsurance

Other considered balance-sheet exposures are investment asset policy; actual asset quality measured by exposure of surplus to risky assets; asset diversity; parent-company equity exposure to intangibles; quality of intangibles and off-balance-sheet exposures and commitments such as guarantees; pending litigation; and the funding status of a defined-benefit plan. An important aspect of asset quality is liquidity because of the short-tailed nature of health liabilities. A.M. Best, therefore, takes a negative view of investments in illiquid assets such as investment real estate, mortgages, certain private placements and securities with certain structures. Further, companies with above-average investments in unaffiliated common or preferred stocks will be viewed negatively.

A.M. Best also examines a company's reinsurance program to determine whether its retained risk is commensurate with the size of its capital level.

Operating Performance

Operating performance is a major contributor to capital growth or erosion. When evaluating operating performance, A.M. Best analyzes the stability and sustainability of a company's sources of earnings in relation to its product mix. The degree of volatility in a company's earnings and the impact this could have on capitalization and balance-sheet strength is of particular interest.

Operating performance is measured by the trends in growth of earnings, return on revenue and return on equity. Other important

considerations are medical loss ratios and administrative cost ratios. A.M. Best examines the source and sustainability of earnings from operations by business segment. The mix is examined for diversity by product, market segment and geographic region.

Earnings from the commercial segment generally are considered the most stable because of the company's ability to control pricing. Earnings from government sources are deemed the most volatile. The government imposes controls over premium levels and lengthy notification requirements for exiting the business, raising the potential for greater losses. Eventually, exits from these businesses reduce membership, thereby increasing unit administrative costs for the remaining business.

The drivers of profitability in commercial lines are premium growth in concert with medical-cost inflation and growth of enrollment. Pricing is a significant area of concern. Underestimating medical-cost trends can prove costly, while appropriate pricing shelters the company from adverse selection and furthers sustainability of earnings.

In the assessment of the sustainability of earnings, A.M. Best examines the company's:

- Commitment to pricing discipline;
- Presence and power of competitors;
- Regulatory mandates and price controls;
- Amount of product differentiation;
- Effectiveness of the company's controls over rising claims costs through cost shifting and disease management;
- Persistency of the business; and
- Administrative expense management, although A.M. Best deems as necessary those expenditures for technological development that enhance administrative efficiency, speed claims payment, improve service and meet mandatory requirements. The unit costs of these expenses, however, can be reduced greatly by building economies of scale.

A key aspect of an organization's operations is how effectively it manages and anticipates medical-cost trends. A.M. Best probes into the various components of health-care expenses that drive changes in the medical loss ratio, including, but not limited to, inpatient and outpatient utilization patterns; new technologies; medical-

cost inflation; trends in provider reimbursement rates; and pharmacy costs, recognizing that local market conditions affect these factors.

A.M. Best also examines earnings from investments. A.M. Best expects a company's investment strategy to focus on liquidity and asset quality, rather than on generating high income. Greater reliance on operating earnings, rather than investment income, is viewed positively.

While earnings are important, the strength of operating cash flow and its growth trend are critical for timely payment of claims. These are indicators of a company's claims-paying ability, which depends on superior liquidity as health-care claims are generally a short-tailed liability. Generally, a company that is rated at A- (Excellent) or above is expected to demonstrate the ability to generate strong and increasing operating cash flow.

Business Profile

Business profile is an important component of A.M. Best's rating evaluation, and the strength of a company's business profile becomes an even greater consideration at the higher rating levels. The factors that comprise an insurer's business profile drive current and future operating performance and, in turn, affect long-term financial strength and the company's ability to meet its obligations to policyholders.

Business profile is influenced by the degree of risk inherent in the company's mix of business, its competitive market position and the depth and experience of its management. Lack of size or growth aren't considered negative rating factors unless A.M. Best believes these issues have a negative influence on the company's prospective operating performance and balance-sheet strength.

Operating Environment and Marketplace

A.M. Best evaluates the advantages and constraints of the company's operating environment, such as the maturity or growth of the marketplace, regulatory constraints and the strength and number of competitors present or that have exited the region.

A.M. Best acknowledges that insuring

health care is a local business and that the carrier's market dominance in a state or even in part of a state can be an advantage. In this respect, a small, niche company can succeed by differentiating its provider network and products or by operating in rural areas where managed care is more accepted and where multiregional companies typically don't operate.

A lack of geographic diversity, however, can make a company's business vulnerable to the regulatory constraints of the region; pressure from local competitors with less stringent pricing discipline; the local economy; and exclusion from growth opportunities elsewhere in the country. A.M. Best assesses these factors to determine the strength of the rated entity's market presence.

Growth Trends

A.M. Best examines the company's strategy for growth and whether it focuses on acquisition or internal growth. The diversity and size of a company's enrollment base are important, because these factors can provide carriers with significant leverage when negotiating with providers for the discounts that can have a positive impact on operating performance and balance-sheet strength.

Growth is measured in terms of membership and revenue. Because membership drives premiums, a company's growth trend in enrollment, as compared with its competitors, is important. Furthermore, the growth trend must be sustainable. Below-average growth indicates a loss of market share, while too-rapid growth signals a potential for mispricing and future impairment of capital adequacy. Growth is deemed balanced when it mitigates event risk and improves diversity of products, in addition to raising earnings. A decline in membership, especially when part of a retrenchment strategy to enhance profitability, isn't necessarily viewed as a negative, particularly if a sound strategy for future growth is in place and growth can be expected to resume within one or two years.

In evaluating national and multiregional companies, A.M. Best assesses the proportion of organic growth to growth through acquisition. Organic growth generally is

viewed as superior. However, a good track record of acquisitions followed by successful integration and strong organic growth at the acquired entities is viewed positively. The strategic fit of the acquisition is critical—particularly its contribution to brand identity, product and geographic diversity or distribution—not merely its contribution to earnings.

Business and Product Diversity

A.M. Best looks at whether the company is an innovator of products or a follower and how close it comes to meeting customers' needs, as well as the strength of each business segment and its contribution to the enterprise.

The health insurance business generally is segmented between commercial and governmental payers. Within commercial lines are managed care, preferred provider organizations (PPOs), full-risk and administrative services only (ASO) plans, which are segmented further as large and small groups and individual plans. Government payers include Medicare and senior-population-related plans, Medicaid and the military. The dominance of large-group business over small-group and government premium payers is viewed positively, but profit margins are narrower. Individual, small and midsize group businesses are considered more volatile, as they are subject to greater regulatory oversight and restrictions and lower retention rates but generally produce lower medical-cost ratios.

A.M. Best carefully examines a carrier's management of any shifts in its mix of business, such as from managed care to PPO or full risk to ASO. The company's position either behind or ahead of any industrywide shifts toward choice of products and flexibility in payment of premiums can be a critical factor driving future earnings.

Provider Relationships

Important factors in A.M. Best's assessment of provider relationships are the density of the network, particularly the inclusion of major hospital systems; the degree of risk sharing—full risk, shared risk, capitated or mixed; and the balance of negotiating power between the company and providers, as well as the stability of the network.

A.M. Best also assesses the impact of any shift in risk sharing between the carrier and providers, and the ability of the company to sustain profitability during the shift through monitoring of claims costs. The stability of the provider network can be disrupted if carriers overreach with their negotiating power or if medical-malpractice insurance costs are excessive. An exodus of providers from a network or state under these pressures could prompt patients to seek out-of-network care, thereby significantly raising claims costs above pricing assumptions and reducing profits.

Distribution

Market presence can be influenced significantly by the carrier's distribution channels. A.M. Best evaluates how a company serves the needs of its distribution system, especially if a small company faces large, powerful, low-cost competitors. A.M. Best evaluates the strength of the carrier's distribution channels—independent and/or career or employee distribution—

and its use of group discretionary trusts and affiliations with other insurers for marketing complementary products.

Not-for-Profit Organizations

The difference in the evaluation of not-for-profit and for-profit entities isn't significant. Generally, not-for-profit companies aren't acquisition oriented, which eliminates one type of risk. Not-for-profit earnings might be lower, although this isn't viewed as a negative as long as capital grows adequately for the company's businesses. However, regulatory pressures can be stronger on these companies, limiting the prospects for expanding their capital. A.M. Best also recognizes the ability of small companies and not-for-profits to improve their financial flexibility through pooling, whereby separate entities aggregate their debt issuances into a pool, and the various "tranches"—or investment classes—are sold to investors as surplus or trust-preferred securities.



The Insurance Information Source

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A.M. Best Company

Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
<http://www.ambest.com>

A.M. Best Europe Ltd.

12 Arthur Street, 6th Floor
London, UK EC4R 9AB
Phone: (44-20)-7626-6264
Fax: (44-20)-7626-6265
www.ambest.co.uk

A.M. Best Asia-Pacific Ltd.

Unit 5707 Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Phone: (852)-2827-3400
Fax: (852)-2824-1833
www.ambest.com.hk