A.M. BEST

METHODOLOGY FEBRUARY 2007

Assigning Public Data Ratings To Health Insurance Companies

The purpose of this report is to provide transparency regarding A.M. Best Co.'s criteria for assigning Public Data Ratings (PDRs) to health insurance companies, including health maintenance organizations (HMOs), Blue Cross and Blue Shield plans and Delta Dental Plans.

The constantly changing operating environment and the unstable, escalating rate of inflation for health-care costs make it difficult for companies 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 insurance companies, creates a fertile environment for financial impairment. More vulnerable are small health insurance companies 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 Insurance Company Rating Criteria

A PDR is an A.M. Best opinion of the financial strength of an insurer. They are expressed using the same rating scale and definitions as A.M. Best's interactive ratings of long-term financial strength but have a 'pd' rating modifier applied to ensure the user is aware of the more limited information basis for the rating. The assignment of Best's Public Data Ratings ('pd' subscript) also incorporates analysis of balance-sheet strength, operating performance and business profile. However, the analysis does not generally involve interaction with company management. Other public documents and disclosures may be used as part of the analytical process for assigning PDRs.

In contrast, an interactive A.M. Best rating is produced at the request of a health insurance company. The rating process includes detailed interviews of senior management and, typically, access to nonpublic data and other information. Analysis on issues that typically would have limited distribution in the public domain plays a significant part in the interactive rating analysis (e.g. detailed information on management strategy, earnings forecasts, reinsurance protections, reserving methodology).

Best's Rating Model

The Health PDR model utilizes the statutory data of an insurance company that are filed with its state regulator. The model is the primary source for the quantitative analysis used in assigning PDRs, and it evaluates the five most recent years of a company's financial performance. A.M. Best will not assign PDRs to companies with less than three years of data.

Similar to Best's interactive rating analysis, the Health PDR model has three distinct sections: balance-sheet strength, operating performance and business profile. The model assigns the following weights to those sections:

Balance-Sheet Strength	**60%**
Operating Performance	**30%**
Business Profile	**10%**

A.M. Best's database has approximately 500 health insurance companies, both interactive and PDR companies. By utilizing A.M. Best's database, selected statutory financial data and ratios are loaded in the base PDR model to determine industry benchmarks. In addition to the base PDR model, A.M. Best creates four PDR models for the following business segments: Medical HMOs; Dental and Vision HMOs; Blue Cross Blue Shield organizations; and Delta Dental plans. The companies are combined in these groups to ensure similarities in business type. Based on the business type of an individual company, its calculated ratios and data are benchmarked to its peer group to determine a base financial strength rating.

This report was written by Ken Frino, vice president, and Jason Hopper, staff analyst, in the Life/Health division of A.M. Best Co.

Balance-Sheet Strength — Ratios and Tests

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—are evaluated by Best's Capital Adequacy Ratio (BCAR). The BCAR holds 25% of the weight for the balance sheet. This stresses the importance for a company's capital position to support its operations and unexpected risks. Other ratios used to evaluate the balance-sheet strength of companies are equity per member per month (PMPM), overall liquidity, surplus notes to capital and premiums to underwriting leverage. Other important considerations in assessing balance-sheet strength are operating cash flows, reserves, reinsurance and asset quality.

Best's Capital Adequacy Ratio (BCAR)

A.M. Best believes all minimum state regulatory requirements for capital and surplus are too low. An A.M. Best Secure rating— B+ (Good) and higher—calls for substantially higher amounts of capital than what is assessed under the Managed Care Organization Risk Based Capital (MCORBC) company action level, as promulgated by the National Association of Insurance Commissioners. For Secure rating consideration, BCAR needs to be 110% or greater. 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 or % over CAL: The Company Action Level (CAL) RBC is the product of 2.0 and its Authorized Control Level RBC, or the number determined by the RBC formula.

Overall Liquidity (16.7%)*: This ratio measures the proportion of total liabilities covered by a company's total assets to reflect a company's ability to meet its maturing obligations.

Underwriting leverage (net premiums written to capital and surplus) (16.7%)*: This test measures the leverage associated with the level of premiums compared with the total capital and surplus of the company. This test measures the company's exposure to pricing errors in its current book of business.

Equity per member per month (capital and surplus to member months) (25%)*: This test measures the amount of capital and surplus spread over a company's membership base.

Average Days Claims Payable: The ratio of claims payable to total health expenses per year in days (365).

Diversification of Invested Assets: The quality and diversification of invested assets is evaluated to assess the risk of default and the potential impact on surplus if the sale of these assets occurred unexpectedly. The better the liquidity, diversification and/or quality of the assets, the less uncertainty there is in the value to be realized upon the sale and the lesser the likelihood of default. Particular attention is paid to large, single investments that exceed 10% of a company's total capital.

* Percentages in ( ) represents weights in the model.

A.M. Best Co.

Methodology

February 2007

PUBLISHER, PRESIDENT AND CHAIRMAN
Arthur Snyder

EXECUTIVE VICE PRESIDENT/CHIEF OPERATING OFFICER
Arthur Snyder III

EXECUTIVE VICE PRESIDENT/CHIEF RATING OFFICER
Larry G. Mayewski

EXECUTIVE VICE PRESIDENT/CHIEF INFORMATION OFFICER
Paul C. Tinnirello

GROUP VICE PRESIDENTS
Manfred Nowacki, Life/Health
Matthew Mosher, Property/Casualty

PRODUCTION
Thomas Dawson IV, Associate Editor
Angel Negron, Designer

Copies are available through Customer Service: (908) 439-2200, Ext. 5577. The report is also available online at *www.ambest.com/ratings/methodology.html.*

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

The Insurance Information Source

Affiliated Investments to Capital (16.7%)*: Affiliated investments (including home office property) as a percentage of capital and surplus funds.

Debt or Surplus Notes to Capital (16.7%)*: The ratio of the company's total debt to its total capital and surplus. In this ratio, debt is defined as loans and notes payable on both a current and a long-term basis, as well as surplus notes.

Changes in Capital and Surplus: The annual percentage change in the sum of current year capital and surplus, plus voluntary investment reserves, over the prior year's sum.

Operating Cash Flows: The cash generated from the operations of a company, generally defined as revenues less all operating expenses.

Operating Performance

The model measures operating performance by the trends in growth of earnings, return on revenue, changes to the medical loss ratio and administrative cost ratio. Operating performance is a major contributor to capital growth or erosion.

A key aspect of an organization's operations is how effectively it manages and anticipates medical-cost trends. The model analyzes the following tests and ratios, evenly distributing the weight to each:

Net Change in Premium PMPM to Health-Care Expense PMPM (15%)*: The annual percentage change in premium revenue per member over the annual percentage change in health-care expenses per member.

Underwriting PMPM (15%)*: This test measures a company's underwriting gain spread over its membership base.

Return on Revenue (14%)*: Net income as a percentage of total revenue. This ratio measures post-tax earnings in relation to total funds provided from operations.

Change in Utilization (Days per 1,000) (14%)*: Total days per 1,000 members. This represents a) the total days incurred for the total membership, divided by b) the total membership's current-year member months divided by 12, c) multiplied by 1,000. The utilization ratios taken into consideration include hospital and commercial days, along with the change in Medicare and Medicaid days.

Medical Loss Ratio Trends: Cost ratio of total benefits used compared with health premiums earned. This shows the amount of the premium revenues actually spent on paying for medical services.

Administrative Ratio Trends: Costs associated with the overall management and operations of the company that are not directly related to providing medical services. This is taken as a percentage of net premium income to determine the amount of premium income spent on administrative expenses.

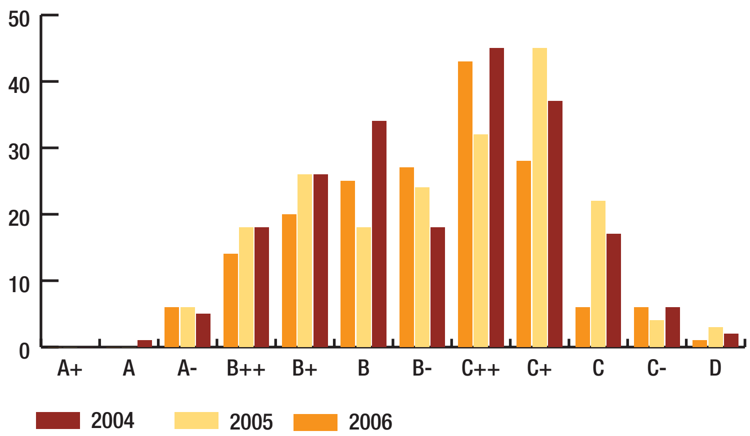
Business Profile

In the interactive rating process, 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. However, business profile carries the lowest weighting in the model because of the lack of insight A.M Best has of the companies' business strategies. With no interaction with management of PDR companies, it is more difficult to supplement their financials. What differentiates companies is the strength of their business profile, which typically translates into defensible competitive advantages. The model analyzes the business mix as well as the historical membership and revenue growth trends. The model is not a predictive tool used to determine the company's future growth trends and business mix. Further, 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. Each of the following four tests and ratios hold an equal weight allocation of 25% for the business profile. 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. The optimal score requires membership and annual revenue growth rates no greater than 15% with a diversified business mix. The following factors are considered in the model:

* Percentages in ( ) represents weights in the model.

- Growth in members (25%)*
- Percent of membership-noncommercial (25%)*
- Growth in Revenue (25%)*
- Percent of Revenue-noncommercial (25%)*

Final Ratings — 3-Year Comparison



Source: A.M. Best Co.

Rating Distributions

The graph at left lays out the three-year trend in distribution of Best's Financial Strength Public Data Ratings. A.M. Best wants to reiterate that the PDR model is used to calculate a base rating for the companies. The base rating may be modified following an analysis of other selected financial data and ratios. For example, a review of the notes to the statutory financial statements and other materials made public by such companies, including audited financial statements, annual reports and information made available on the organization's Web site, may result in a different rating conclusion. The final rating may prove to be more conservative because of the lack of insight of operations and business strategies the company may be implementing.

* Percentages in ( ) represents weights in the model.

A.M. Best Company
Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
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)-7-626-6265
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