REPORT OF THE
STATE CORPORATION COMMISSION ON

The Review of The Blue Cross/Blue Shield Plans' Administrative Expenses, Reserves and Investments in Subsidiaries and Affiliates

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

House Document No. 32

COMMONWEALTH OF VIRGINIA
RICHMOND
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COMMONWEALTH OF VIRGINIA

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STATE CORPORATION COMMISSION

January 29, 1988

TO: The Honorable Gerald L. Baliles
Governor of Virginia
and
The General Assembly of Virginia

The report contained herein is pursuant to House Joint Resolution No. 284 of the 1987 Session of the General Assembly of Virginia.

This report represents the response of the State Corporation Commission to the legislative directive to conduct a review of the Blues' administrative expenses, reserves, and investments.

Respectfully submitted,

Preston C. Shannon
Commissioner

Thomas P. Harwood, Jr.

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Commissioner

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EXECUTIVE SUMMARY

The 1987 General Assembly requested in House Joint Resolution 284 that the State Corporation Commission conduct a review of the Blue Cross/Blue Shield plans operating in Virginia regarding the following criteria for operational efficiency, including, where appropriate, comparisons with commercial health insurers and Blue Cross/Blue Shield plans in other states:

A. the percentage of subscriber premiums devoted to administrative expense;

B. the adequacy, inadequacy or excessiveness of reserves; and

C. whether the amount of the Blue Cross/Blue Shield Plans' investment in subsidiaries and affiliates poses any undue risk for Blue Cross/Blue Shield subscribers.

In addition, the Commission was requested to make a determination based on its review of the above-referenced criteria as to whether Blue Cross/Blue Shield subscribers are exposed to unreasonable expense or undue risk. The Commission was instructed to report its findings to the 1988 General Assembly and, in the event that the Commission recommended further study, the report was to set forth the proposed study objectives and research design as well as the estimated cost of such further study.

After examining the methodology necessary to conduct this study and in recognition of the time requirements and current internal staffing capability, the State Corporation Commission contracted with Technical Associates, Incorporated to conduct an operational review of the performance and diversification of the two Blue Cross/Blue Shield plans for the period 1984 to 1986. These were the years in which diversification activities had been most prominent. Technical Associates was requested to present its findings to the Commission for consideration as part of the Commission's report.

The study was conducted under the direction of the State Corporation Commission's Bureau of Insurance. The two Blue Cross/Blue Shield plans cooperated in providing extensive information necessary to conduct this study. The results of the research of Technical Associates are found in Section II of this report.

The original report was presented by Technical Associates to the Commission in October, 1987. The original report covered data and analysis through the end of 1986. The Commission, upon reading the original report, became concerned that performance trends of underwriting and administrative expenses and reserve levels were deteriorating. In view of these concerns, the Commission requested that Technical Associates update the report through the end of the third quarter of 1987 (September 30, 1987). This update would provide the Commission and the General Assembly with more current information about the Blue Cross/Blue Shield plans. The results of the updated report are found in Section III of this report.

After analyzing the original and updated reports prepared by Technical Associates, the Commission concurs with the factual findings contained in those reports.

With respect to the specific criteria for review set forth in House Joint Resolution 284, the Commission's findings are as follows:

A. The percentage of subscriber premiums devoted to administrative expense.

1. Blue Cross/Blue Shield plans experience significantly lower expense ratios than commercial accident and health insurers.

2. The expense ratios for Blue Cross/Blue Shield plans in Virginia as well as in other states have worsened during the period of study.

3. Blue Cross/Blue Shield plans in Virginia perform similarly to their counterparts in other states. Blue Cross/Blue Shield of Virginia consistently had a more favorable expense ratio than the average for other states' plans during the entire period of study. Blue Cross/Blue Shield of the National Capital Area, however, consistently had a less favorable expense ratio than the average for other states' plans during the entire period of study.

4. The Blue Cross/Blue Shield Plan of the National Capital Area's claims adjustment and administrative expense components of total expenses are well in excess of similar ratios for the Blue Cross/Blue Shield Plan of Virginia and for Blue Cross/Blue Shield plans of other states.

B. The adequacy, inadequacy or excessiveness of reserves.

1. The average number of surplus reserve days for commercial accident and health insurers and Blue Cross/Blue Shield plans in other states is in the same range.

2. Blue Cross/Blue Shield plans in Virginia have a considerably lower number of surplus reserve days than the average for commercial accident and health insurers and Blue Cross/Blue Shield plans in other states.

3. The Blue Cross/Blue Shield Plan of Virginia's number of surplus reserve days declined considerably during the period of study but is still above the 30 day minimum reserve requirement established by the Commission. The number of surplus reserve days went from 66.3 in 1984 to 45.3 through September, 1987 rising as high as 74.6 in 1985.

4. The Blue Cross/Blue Shield Plan of the National Capital Area's surplus reserve days declined significantly during the period of study. The number of surplus reserve days went from 71.4 in 1984 to 26.6 through September, 1987 rising as high as 73.4 in 1985. This is 3.4 days below the 30 day minimum reserve requirement established by the Commission.

The Commission is concerned that the reserves for this Plan may no longer be adequate.

5. The Commission has concern about the potential adequacy of reserves for both Blue Cross/Blue Shield plans in Virginia based on declining trends in performance during the period of study.

   A primary indicator of performance for purposes of this study is the underwriting ratio. This underwriting ratio combines the loss ratio and the expense ratio. The ratio does not take into account investment income. A ratio in excess of 100% indicates that, to the extent not offset by investment income, a plan is losing money and its number of surplus reserve days will decrease.

   Both plans have experienced a deterioration in the underwriting ratio which has continued throughout the entire period of study. Through September, 1987 the Blue Cross/Blue Shield Plan of Virginia had a 105.5% underwriting ratio and the comparable ratio for the Blue Cross/Blue Shield Plan of the National Capital Area was 106.6%. This performance, coupled with the continuous decline in the number of surplus reserve days is the focus of the Commission's concern regarding the potential adequacy of reserves for the plans in Virginia.

C. Whether the amount of the Blue Cross/Blue Shield Plans' investment in subsidiaries and affiliates poses any undue risk for Blue Cross/Blue Shield subscribers.

Blue Cross/Blue Shield of Virginia subscribers lost at least $14.3 million in reserve level protection due to investments in affiliates. This figure is based on the fact that the Plan received only $21.7 million for the $36 million it reported it invested in for-profit subsidiaries of Consolidated Healthcare, Inc. Reserves have also been affected to some degree by the substitution of $21.7 million in Consolidated Healthcare, Inc. preferred stock for high grade securities whose dividends are dependent on the flow of funds from Blue Cross/Blue Shield of Virginia.

It is reasonable to conclude that diversification has posed risk for subscribers of the Blue Cross/Blue Shield Plan of Virginia and that such risk actually resulted in losses. At the same time, the risk of diversification was not so significant that it seriously undermined the performance of Blue Cross/Blue Shield of Virginia or jeopardized the interests of subscribers.

For the future, the risk resulting from diversification will continue to prevail for subscribers of Blue Cross/Blue Shield of Virginia. The extent of that risk will depend on a host of factors such as the growth in diversification activities, the performance of affiliates, and the performance of Blue Cross/Blue Shield of Virginia.

With respect to the Blue Cross/Blue Shield Plan of the National Capital Area, this Plan lost $16.2 million due to diversification activities. This figure is based on the combined equity position of the subsidiaries in 1986 (negative $13 million), coupled with the initial investment in subsidiaries of $3.3 million. In addition, the Plan has guaranteed more than $20 million of the lines of credit of its subsidiaries, and was owed more than $9 million by its subsidiaries at mid-year 1987.

The main difference between the two Blue Cross/Blue Shield plans operating in Virginia is the number of surplus reserve days available to absorb losses in the performance of the Plans or their affiliates or subsidiaries. The Blue Cross/Blue Shield Plan of Virginia's number of surplus reserve days stood at 66.3 in 1984, 74.6 in 1985 and lowered to 51.8 in 1986 and 45.3 through September, 1987. The figure for the Blue Cross/Blue Shield Plan of the National Capital Area was 71.4 in 1984, 73.4 in 1985, but down to 40.4 in 1986 and further down to 26.6 through September, 1987. Further, losses in subsidiary operations rose during the period of study. The combination of the deterioration in the number of surplus reserve days, increasing underwriting ratios, increasing expense ratios, and subsidiary operations losses has caused the Commission concern about the risk posed to subscribers of the Blue Cross/Blue Shield Plan of the National Capital Area because of diversification.

Conclusions and Recommendations

Based on its review of the criteria established in House Joint Resolution 284, it is the Commission's opinion that the Blue Cross/Blue Shield Plan of Virginia's subscribers are not, at this time, exposed to unreasonable expense or undue risk. While diversification has posed risk to subscribers of this Plan, the risk of diversification has not been so significant as to seriously undermine the Plan's performance or jeopardize the interests of subscribers.

The Commission is concerned, however, that subscribers of the Blue Cross/Blue Shield Plan of the National Capital Area are exposed to a higher level of expense than the Blue Cross/Blue Shield Plan of Virginia and Blue Cross/Blue Shield plans in other states. Further, the combination of the deterioration in the number of surplus reserve days, increasing underwriting ratios, increasing expense ratios, and subsidiary operations' losses has caused the Commission concern about the risk posed to subscribers of the Blue Cross/Blue Shield Plan of the National Capital Area because of diversification.

The Commission recommends to the General Assembly that it be granted authority to raise the minimum contingency reserve requirement to greater than 30 days for any plan if the Commission determines that stronger financial protection is needed for subscribers. The Code currently states that the minimum contingency reserve requirement shall not exceed 30 days. The Commission's recommendation would provide for a minimum contingency reserve of at least 30 days but no more than 60 days. This recommendation is made in the interest of affording subscribers stronger financial safeguards, to protect subscribers, to promote solvency and to provide a financial safety net should the Plan become insolvent.

The Commission is currently conducting a financial examination of the Blue Cross/Blue Shield Plan of Virginia and will conduct a financial examination of the Blue Cross/Blue Shield Plan of the National Capital Area in 1988. The Commission will closely monitor the financial condition of both plans throughout 1988 to insure solvency and provide adequate protection for subscribers. The monitoring of both plans will include a careful evaluation of the relationship between each plan and its subsidiaries and affiliates.

GENERAL ASSEMBLY OF VIRGINIA - 1987 SESSION

HOUSE JOINT RESOLUTION NO. 284

Requesting the State Corporation Commission to conduct a review of the Blue administrative expenses, reserves and investments.

Agreed to by the House of Delegates, February 27, 1987
Agreed to by the Senate, February 27, 1987

WHEREAS, the premium income from Blue Cross and Blue Shield plans is taxed in a manner different from that of other health insurers; and

WHEREAS, in exchange for this difference in tax treatment, the Blues are required to provide community services and to offer comprehensive health care coverage at reasonable rates to any individual regardless of health history; and

WHEREAS, the reasonableness of rates is dependent to a great extent on the ability of the Blues to keep administrative costs to a reasonable level; and

WHEREAS, an analysis of the Blues' administrative expenses, reserves and investments may be necessary to ensure the Blues are operating in an efficient manner; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the State Corporation Commission is requested to conduct, in cooperation with the Blue Cross plans, a review of the following criteria for operational efficiency, including, where appropriate, comparisons with commercial health insurers and Blue Cross plans in other states:

a. The percentage of subscriber premiums devoted to administrative expense;

b. The adequacy, inadequacy or excessiveness of reserves; and

c. Whether the amount of the Blue Cross plans' investment in subsidiaries and affiliates poses any undue risk for Blue Cross subscribers; and, be it

RESOLVED FURTHER, That the Commission shall make a determination based on its review of the above-referenced criteria as to whether Blue Cross subscribers are exposed to unreasonable expense or undue risk. The Commission shall report its findings to the 1988 General Assembly and, in the event that the Commission recommends further study the report shall set forth the proposed study objectives and research design as well as the estimated cost of such further study.

SECTION I

REPORT OF THE STATE CORPORATION COMMISSION

INTRODUCTION

The 1987 General Assembly requested in House Joint Resolution 284 that the State Corporation Commission conduct a review of the Blue Cross/Blue Shield plans operating in Virginia regarding the following criteria for operational efficiency, including, where appropriate, comparisons with commercial health insurers and Blue Cross/Blue Shield plans in other states:

A. the percentage of subscriber premiums devoted to administrative expense;

B. the adequacy, inadequacy or excessiveness of reserves; and

C. whether the amount of the Blue Cross/Blue Shield Plans' investment in subsidiaries and affiliates poses any undue risk for Blue Cross/Blue Shield subscribers.

In addition, the Commission was requested to make a determination based on its review of the above-referenced criteria as to whether Blue Cross/Blue Shield subscribers are exposed to unreasonable expense or undue risk. The Commission was instructed to report its findings to the 1988 General Assembly and, in the event that the Commission recommended further study, the report was to set forth the proposed study objectives and research design as well as the estimated cost of such further study.

The cooperation of both the Blue Cross/Blue Shield Plan of Virginia and the Blue Cross/Blue Shield Plan of the National Capital Area with the study was requested. The latter Plan is licensed with the Commission as Group Hospitalization and Medical Services, Inc., but their trade name is the Blue Cross/Blue Shield Plan of the National Capital Area. They will be referred to by their trade name in this report.

The primary concern of the General Assembly appears to be the extent of risk and unreasonable expense to which subscribers have been exposed because of the diversification, corporate realignment and financial reorganization of the two Blue Cross/Blue Shield plans operating in Virginia.

There have been concerns raised over the unique and preferential tax treatment enjoyed by the Blue Cross/Blue Shield plans in providing health care in Virginia, and that there is in fact little, if any, threat to the two Plans posed by the increasingly competitive health care environment. Some legislators and regulators have questioned the increased risk imposed on Blue Cross/Blue Shield subscribers because of the diversification efforts.

On the other hand, the two Blue Cross/Blue Shield Plans have maintained that diversification is necessary in order to survive and retain market share in the highly competitive health care industry, as well as attempt to contain the cost of health care delivery, reduce the cost of providing health insurance and extend business activity into related health care fields. In addition, there is the possibility that the Blue

Cross/Blue Shield plans around the country will follow the banking industry trend of expansion through mergers and acquisitions into major regional health services plans.

After examining the methodology necessary to conduct this study and in recognition of the time requirements and current internal staffing capabilities, the State Corporation Commission contracted with Technical Associates, Incorporated to conduct an operational review of the performance and diversification of the two Blue Cross/Blue Shield plans for the period 1984 to 1986. These were the years in which diversification activities had been most prominent. Technical Associates was requested to present its findings to the Commission for consideration as part of the Commission's report.

The study was conducted under the direction and control of the State Corporation Commission's Bureau of Insurance. The two Blue Cross/Blue Shield plans cooperated in providing extensive information necessary to conduct this study. The results of the research of Technical Associates are found in Section II of this report.

The original report prepared by Technical Associates focused on two major areas:

1. An analysis of the operating performance of the two Blue Cross/Blue Shield plans measured in terms of their expense and reserve experience relative to that of Blue Cross/Blue Shield plans in other states and major commercial accident and health insurers in Virginia; and

2. An analysis of the extent of involvement in diversification by the two Blue Cross/Blue Shield plans measured in terms of changing corporate structures and integration, intracorporate investments, and transactions among affiliates.

The performance data of the two Blue Cross/Blue Shield plans was compared to the performance of the 50 largest commercial accident and health insurers writing business in Virginia as measured by premiums earned, as well as the performance of Blue Cross/Blue Shield plans in other states where information could be obtained in a complete and timely manner.

This study analyzed financial data utilizing Statutory Accounting Principles (SAP) as opposed to Generally Accepted Accounting Principles (GAAP). Historically, SAP has been oriented to the needs of regulatory officials, whereas GAAP has been oriented to the needs of investors and management. The main objective of SAP statements is to provide proof or assurance of solvency, as compared to the profitability or going concern value goal of GAAP statements. Thus, SAP involves statutory and/or administrative regulations governing the composition of assets, the maintenance of required minimal capital, surplus funds over and above contracted liabilities, and certain additional statutory reserves. SAP attempts to recognize the theory that insurance companies must be held accountable to the general public in a way similar to that in which a fiduciary is held accountable to beneficiaries before the courts. Accordingly, SAP presents the financial position of a firm from a liquidation perspective, rather than as a going concern under GAAP. SAP views a company's financial position very conservatively. For these reasons, the Commission analyzed financial data utilizing Statutory Accounting Principles.

The original report was presented to the Commission in October, 1987. The original report covered data and analysis through the end of 1986. The Commission, upon reading the original report, became concerned that performance trends of underwriting and administrative expenses and reserve levels were deteriorating. In view of these concerns, the Commission requested that Technical Associates update the report through the end of the third quarter of 1987 (September 30, 1987). This update would provide the Commission and the General Assembly with more current information about the Blue Cross/Blue Shield plans. The results of the updated report are found in Section III of this report.

After analyzing the original and updated reports prepared by Technical Associates, the Commission concurs with the factual findings contained in those reports.

FINANCIAL REGULATORY REQUIREMENTS FOR THE PROTECTION OF SUBSCRIBERS

Pursuant to its authority under § 38.2-4208, the Commission required that the Blue Cross/Blue Shield Plan of Virginia be subject to minimum contingency reserve requirements and membership in the Virginia Life, Accident and Sickness Insurance Guaranty Association in 1983. The Commission has just placed the Blue Cross/Blue Shield Plan of the National Capital Area under these requirements for all subscriber contracts issued or renewed on and after February 1, 1988. These requirements were established to promote the solvency of a plan and to protect subscribers in the event a Blue Cross/Blue Shield plan becomes insolvent.

Minimum contingency reserve requirements are set forth in § 38.2-4208. The minimum level of contingency reserves shall not exceed 30 days of anticipated operating expenses and claims receipts computed as the Commission requires. The Commission has established 30 days to be the minimum level of contingency reserves.

The purpose of the Guaranty Association is to protect subscribers, and certain other parties, against failure by a plan or insurer to fulfill its contractual obligations due to the impairment or insolvency of a plan or insurer issuing the policies or contracts. The Association guarantees the payment of benefits and continuation of coverages and assesses members of the Guaranty Association to provide funds to pay for the benefits guaranteed. The aggregate liability of the Association for any one insured shall not exceed $100,000 in cash values or $300,000 for all benefits.

The minimum contingency reserve requirement and membership in the Virginia Life, Accident and Sickness Insurance Guaranty Association provide financial regulatory protection to subscribers.

FINDINGS OF THE COMMISSION

With respect to the specific criteria for review set forth in House Joint Resolution 284, the Commission's findings are as follows:

A. The percentage of subscriber premiums devoted to administrative expense.

The following data compares the underwriting and expense experience of the Blue Cross/Blue Shield plans operating in Virginia to Blue Cross/Blue Shield plans operating in other states and commercial accident and health insurers for the periods 1984, 1985, 1986, and September, 1987.

Expense Ratios

	September 1987	**1986**	**1985**	**1984**
BC/BS of Virginia	9.7%	9.0%	8.6%	6.3%
BC/BS Of National Capital Area	13.2%	13.4%	11.4%	9.9%
BC/BS of Other States	11.1%	11.7%	10.3%	9.5%
Commercial Accident & Health Insurers	N/A	34.1%	37.6%	33.7%

Based on the above data, the following observations can be made:

1. Blue Cross/Blue Shield plans experience significantly lower expense ratios than commercial accident and health insurers.

   Commercial accident and health insurers' expense ratios average about 35%. This compares to 9% for the Blue Cross/Blue Shield Plan of Virginia and 13.4% for the Blue Cross/Blue Shield Plán of the National Capitol Area and 11.7% for Blue Cross/Blue Shield Plans in other states in 1986.

2. The expense ratios for Blue Cross/Blue Shield plans in Virginia as well as in other states have worsened during the period of study.

   Blue Cross/Blue Shield of Virginia's expense ratio went from 6.3% in 1984 to 9.7% through September, 1987. Blue Cross/Blue Shield of the National Capital Area's expense ratios went from 9.9% to 13.2% during the same period, rising to as high as 13.4% in 1986. Blue Cross/Blue Shield plans of other states' average expense ratio went from 9.5% to 11.1%, rising to as high as 11.7% in 1986.

3. Blue Cross/Blue Shield plans in Virginia perform similarly to their counterparts in other states.

   Through September, 1987, the expense ratio for Blue Cross/Blue Shield plans of other states averaged 11.1%. Blue Cross/Blue Shield of Virginia was under that average with 9.7% and has consistently had a more favorable expense ratio than the average for other states' plans during the entire period of study. Blue Cross/Blue Shield of the National Capital Area, however, was above the 11.1% average for other states' plans with 13.2% through September, 1987, and has consistently had a less favorable expense ratio than the average for other states' plans during the entire period of study.

4. The Blue Cross/Blue Shield Plan of the National Capital Area's claims adjustment and administrative expense components of total expenses are well in excess of similar ratios for the Blue Cross/Blue Shield Plan of Virginia and for Blue Cross/Blue Shield plans of other states.

   The figures in the following table compare claims adjustment, administrative and solicitation expenses of the Blue Cross/Blue Shield Plan of the National Capital Area with that of Blue Cross/Blue Shield of Virginia and Blue Cross/Blue Shield plans of other states.

	1986	**1985**	**1984**
BC/BS Of National Capital Area:			
Claim Adj. Exp. Ratio	7.0%	5.3%	4.1%
Adm. Exp. Ratio	5.2%	4.9%	4.8%
Solicitation Exp. Ratio	1.2%	1.1%	0.9%
BC/BS Other States:			
Claim Adj. Exp. Ratio	4.7%	3.9%	4.0%
Adm. Exp. Ratio	3.5%	3.2%	3.0%
Solicitation Exp. Ratio	1.8%	1.7%	2.0%
BC/BS of Virginia:			
Claim Adj. Exp. Ratio	3.7%	4.0%	2.4%
Adm. Exp. Ratio	3.6%	2.9%	2.8%
Solicitation Exp. Ratio	1.4%	1.3%	0.7%

   The Blue Cross/Blue Shield Plan of the National Capital Area's claims adjustment expense ratio of 7% and administrative expense ratio of 5.2% are well in excess of similar ratios for the Blue Cross/Blue Shield Plan of Virginia (3.7%, 3.6% respectively) and for Blue Cross/Blue Shield plans of other states (4.7%, 3.5% respectively). Only in the solicitation expense ratio does the National Capital Area Plan compare well with the other plans.

B. The adequacy, inadequacy or excessiveness of reserves.

Reserves provide protection for policyholders and subscribers. The larger a commercial insurer's or plan's number of surplus reserve days, the greater its financial strength relative to its underwriting experience and the greater its protection afforded subscribers or policyholders.

The figures in the table below present a comparison of surplus reserve days for the entities included in the operational review:

Surplus Reserve Days

	September 1987	**1986**	**1985**	**1984**
BC/BS of Virginia	45.3	51.8	74.6	66.3
BC/BS Of National Capital Area	26.6	40.4	73.4	71.4
BC/BS of Other States	57.4	80.2	85.1	73.2
BC/BS of Southwest VA*	--	--	18	46
Commercial Accident & Health Insurers	N/A	87	63	93

*This plan was merged into BC/BS of Virginia in 1986.

The following observations and conclusions can be made:

1. The average number of surplus reserve days for commercial accident and health insurers and Blue Cross/Blue Shield plans in other states is in the same range.

2. Blue Cross/Blue Shield plans in Virginia have a considerably lower number of surplus reserve days than the average for commercial accident and health insurers and Blue Cross/Blue Shield plans in other states.

3. The Blue Cross/Blue Shield Plan of Virginia's number of surplus reserve days declined considerably during the period of study but is still above the 30 day minimum reserve requirement established by the Commission. The number of surplus reserve days went from 66.3 in 1984 to 45.3 through September, 1987 rising as high as 74.6 in 1985.

4. The Blue Cross/Blue Shield Plan of the National Capital Area's surplus reserve days declined significantly during the period of study. The number of surplus reserve days went from 71.4 in 1984 to 26.6 through September, 1987 rising as high as 73.4 in 1985. This is 3.4 days below the

30 day minimum reserve requirement established by the Commission. The Commission is concerned that the reserves for this Plan may no longer be adequate.

5. The Commission has concern about the potential adequacy of reserves for both Blue Cross/Blue Shield plans in Virginia based on declining trends in performance during the period of study.

   A primary indicator of performance for purposes of this study is the underwriting ratio. This ratio combines the loss ratio and the expense ratio. The underwriting ratio does not take into account investment income. A ratio in excess of 100% indicates that, to the extent not offset by investment income, a plan is losing money and its number of surplus reserve days will decrease. The following table compares the underwriting ratios for the entities studied.

	September 1987	**1986**	**1985**	**1984**
BC/BS of Virginia	105.5%	102.0%	100.0%	97.3%
BC/BS Of National Capital Area	106.6%	105.6%	98.6%	97.0%
BC/BS of Other States	106.5%	103.9%	99.8%	97.2%
Commercial Accident & Health Insurers	N/A	99.6%	101.8%	98.4%

   This deterioration in the underwriting ratio has continued throughout the entire period of study. This performance, coupled with the continuous decline in the number of surplus reserve days is the focus of the Commission's concern regarding the potential adequacy of reserves for the plans in Virginia.

C. Whether the amount of the Blue Cross/Blue Shield Plans' investment in subsidiaries and affiliates poses any undue risk for Blue Cross/Blue Shield subscribers.

In Section II of this study, Technical Associates indicates that Blue Cross/Blue Shield of Virginia subscribers lost at least $14.3 million in reserve level protection due to investments in affiliates. This figure is based on the fact that the Plan received only $21.7 million for the $36 million it reported it invested in for-profit subsidiaries of Consolidated Healthcare, Inc. Reserves have also been affected to some degree by the substitution of $21.7 million in Consolidated Healthcare, Inc. preferred stock for high grade securities whose dividends are dependent on the flow of funds from Blue Cross/Blue Shield of Virginia.

The Commission concurs with the Section II findings that it is reasonable to conclude that diversification has posed risk for subscribers of the Blue Cross/Blue

Shield Plan of Virginia and that such risk actually resulted in losses. At the same time, the risk of diversification was not so significant that it seriously undermined the performance of Blue Cross/Blue Shield of Virginia or jeopardized the interests of subscribers.

For the future, the risk resulting from diversification will continue to prevail for subscribers of Blue Cross/Blue Shield of Virginia. The extent of that risk will depend on a host of factors such as the growth in diversification activities, the performance of affiliates, and the performance of Blue Cross/Blue Shield of Virginia. The Commission cannot measure or predict the extent to which the Blue Cross/Blue Shield Plan of Virginia was able to remain competitive in the health care field in the Commonwealth because of diversification.

With respect to the Blue Cross/Blue Shield Plan of the National Capital Area, Section II of this study indicates that this Plan lost $16.2 million due to diversification activities. This figure is based on the combined equity position of the subsidiaries in 1986 (negative $13 million), coupled with the initial investment in subsidiaries of $3.3 million. In addition, the Plan has guaranteed more than $20 million of the lines of credit of its subsidiaries, and was owed more than $9 million by its subsidiaries at mid-year 1987.

The main difference between the two Blue Cross/Blue Shield Plans operating in Virginia is the number of surplus reserve days available to absorb losses in the performance of the Plans or their affiliates or subsidiaries. The Blue Cross/Blue Shield Plan of Virginia's number of surplus reserve days stood at 66.3 in 1984, 74.6 in 1985 and lowered to 51.8 in 1986 and 45.3 through September, 1987. The comparable figure for the Blue Cross/Blue Shield Plan of the National Capital Area was 71.4 in 1984, 73.4 in 1985, but down to 40.4 in 1986 and further down to 26.6 through September, 1987. Further, losses in subsidiary operations rose during the period of study. The combination of the deterioration in the number of surplus reserve days, increasing underwriting ratios, increasing expense ratios, and subsidiary operations' losses has caused the Commission concern about the risk posed to subscribers of the Blue Cross/Blue Shield Plan of the National Capital Area because of diversification.

CONCLUSIONS AND RECOMMENDATIONS

Based on its review of the criteria established in House Joint Resolution 284, it is the Commission's opinion that the Blue Cross/Blue Shield Plan of Virginia's subscribers are not, at this time, exposed to unreasonable expense or undue risk. While diversification has posed risk to subscribers of this Plan, the risk of diversification has not been so significant as to seriously undermine the Plan's performance or jeopardize the interests of subscribers.

The Commission is concerned, however, that subscribers of the Blue Cross/Blue Shield Plan of the National Capital Area are exposed to a higher level of expense than the Blue Cross/Blue Shield Plan of Virginia and Blue Cross/Blue Shield plans in other states. Further, the combination of the deterioration in the number of surplus reserve days, increasing underwriting ratios, increasing expense ratios, and subsidiary operations' losses has caused the Commission concern about the risk posed to subscribers of the Blue Cross/Blue Shield Plan of the National Capital Area because of diversification.

The Commission recommends to the General Assembly that it be granted authority to raise the minimum contingency reserve requirement to greater than 30 days for any plan if the Commission determines that stronger financial protection is needed for subscribers. The Code currently states that the minimum contingency reserve requirement shall not exceed 30 days. The Commission's recommendation would provide for a minimum contingency reserve of at least 30 days but no more than 60 days. This recommendation is made in the interest of affording subscribers stronger financial safeguards, to protect subscribers, to promote solvency and to provide a financial safety net should the Plan become insolvent.

The Commission is currently conducting a financial examination of the Blue Cross/Blue Shield Plan of Virginia and will conduct a financial examination of the Blue Cross/Blue Shield Plan of the National Capital Area in 1988. The Commission will closely monitor the financial condition of both plans throughout 1988 to insure solvency and provide adequate protection for subscribers. The monitoring of both plans will include a careful evaluation of the relationship between each plan and its subsidiaries and affiliates.

SECTION II

PERFORMANCE AND DIVERSIFICATION OF THE BLUE CROSS/BLUE SHIELD PLANS IN VIRGINIA: AN OPERATIONAL REVIEW - 1984 - 86

PERFORMANCE AND DIVERSIFICATION
OF THE BLUE CROSS/BLUE SHIELD
PLANS IN VIRGINIA:

AN OPERATIONAL REVIEW
1984-86

PREPARED FOR
BUREAU OF INSURANCE
VIRGINIA STATE CORPORATION COMMISSION

PREPARED BY
TECHNICAL ASSOCIATES, INCORPORATED

OCTOBER, 1987

EXECUTIVE SUMMARY

Background and Purpose

Diversification, corporate realignment, and financial reorganization have caused continuing concern over the appropriate role of BC/BS Plans in providing A&H insurance, particularly as that role relates to the interests of subscribers. In Virginia, such concern intensified when the Roanoke Plan experienced a severe financial crisis that led to its demise as an independent entity. This combination of events prompted the 1987 Virginia General Assembly to call for a study of the relationship between the diversification activities and the A&H insurance performance of BC/BS Plans operating in the Commonwealth.

Under directions from the Bureau, the Consultant has conducted an operational review of Virginia's two BC/BS Plans for the period 1984 to 1986, years in which diversification activities have been most prominent. The study focuses on two major areas of inquiry: (1) the operating performance of the two BC/BS Plans, measured in terms of their expense and reserve experience relative to that of BC/BS Plans in other states and major commercial A&H insurers in Virginia; and (2) the extent of involvement in diversification by the two BC/BS Plans, measured in terms of changing corporate structures, business integration, intracorporate investments, and transactions among affiliates. The ultimate objective of the study is to determine whether diversification exposes subscribers to unreasonable expense and/or undue risk, viewed historically and prospectively.

Findings and Conclusions

Based on the analyses conducted, the Consultant has found that the expense experience of Virginia's BC/BS Plans has been comparable to that of BC/BS Plans in other states over the study period 1984 to 1986. That is, expenses as percentages of subscriber premiums have been within the ranges realized by other BC/BS Plans. This has been generally true whether administrative, claim adjustment, soliciting, or total underwriting expenses are considered. Moreover, BC/BS Plans in the Commonwealth have distributed subscriber premiums in a manner similar to their counterparts elsewhere--roughly 90¢ out of every premium dollar has been redistributed to BC/BS Plan subscribers in the form of benefits, the balance being retained to cover expenses. This compares to an average distribution within the commercial A&H insurer group studied of approximately 65¢ in benefits and 35¢ in expenses. Over the 1984-86 period, accordingly, there is little evidence that subscribers were confronted with unreasonable expense as a result of diversification by Virginia's BC/BS Plans.

With respect to the question of reserve levels in the period studied, the two BC/BS Plans in the Commonwealth maintained positions comparable to BC/BS Plans elsewhere. However, the extent of comparability declined from 1984 to 1986. This occurred partially because underwriting expenses increased by a larger amount than subscriber premiums and partially because of losses sustained in diversification activities. For BC/BS of VA (Richmond Plan), the decline in reserve level was magnified by its merger with the financially troubled Roanoke Plan. Despite these difficulties, however, the reserve positions of Virginia's BC/BS Plans remained on par with their counterparts in other states. Thus, reserve levels in Virginia appear to have been neither inadequate nor excessive in the study period. The Consultant has concluded, accordingly, that subscribers in the Commonwealth were not exposed to undue risk as a result of diversification.

The above findings rest largely on the view that a comparison with BC/BS Plans in other states constitutes a meaningful test. That such a viewpoint is reasonable follows because other BC/BS Plans provide surrogates for alternatives available to the public. Since subscribers in the Commonwealth received BC/BS Plan insurance services under expense and reserve conditions comparable to those confronted by subscribers elsewhere, it appears that the interests of Virginia subscribers would not have been materially improved or worsened if services had been provided by BC/BS Plans which typically operate in other states. The logic of this perspective follows further from the fact that, as elsewhere, for their premium dollars than would have been the case had commercial carriers provided the A&H insurance.

Qualifying Observations

The conclusions reached by the Consultant in this study are subject to several qualifications. First of all, while the interests of subscribers do not appear to have been significantly undermined by diversification activities in the period 1984-86, this does not mean that subscribers were made better-off as a result of diversification. This is true because no analysis has been made of comparative changes in the price, type, and quality of A&H insurance provided during the study period, or the extent to which the characteristics of such measures would have been different in the absence of diversification.

At the same time, however, it is clear that the failure of the Roanoke Plan was partially attributable to diversification. It is also true that the Richmond Plan has lost some $14.4 million through the end of the study period due to diversification activities--the comparable figure for BC/BS of NCA is a loss of $16.3 million. Although these figures pale in comparison to the premium volumes and reserve levels of the two BC/BS Plans, such evidence suggests that the interests of subscribers may have been better served had there been no diversification.

Furthermore, as the present study was not designed to be either a financial or a management audit, no tests have been made by the Consultant as to the reasonableness of the flow of funds between Virginia's BC/BS Plans and their affiliates or subsidiaries. It is conceivable that such audit studies might reveal that diversification caused expenses to be borne by the BC/BS Plans that otherwise might not have been incurred. On the other hand, diversification may have resulted in underwriting expense savings for the Commonwealth's BC/BS Plans. Similarly, diversification may have enabled the two Virginia BC/BS Plans to retain business that otherwise might have been lost or even to attract new business. As the present study is an operational review and not an audit, these questions have not been addressed.

Implications For the Future

An additional qualification focuses on implications for the future. While the Consultant has concluded that the interests of subscribers were not seriously jeopardized in the past by diversification, this need not hold in years to come. To the extent that diversification activities intensify, that diversification activities continue to lose money, and that Virginia's BC/BS Plans go on guaranteeing the debt and/or performance of subsidiaries or affiliates, subscribers in the Commonwealth could be exposed to unreasonable expense and/or undue risk in the future. As a hypothetical illustration, if either one of the two Virginia BC/BS Plans had fully lost its investment in affiliates or subsidiaries and had become fully obligated for its commitments to affiliates or subsidiaries, the 1986 reserve level would have fallen well below the typical levels of BC/BS Plans in other states. This would have been of particular concern in the case of BC/BS of NCA, as its underwriting expenses rose sharply in 1986.

Another illustration rests in the fact that the viability of BC/BS Plan affiliates or subsidiaries remains heavily dependent on the A&H insurance operations of the BC/BS Plans. In the case of BC/BS of NCA, it has guaranteed more than $20 million of the credit lines of its subsidiaries. BC/BS of NCA also was owed more than $9 million by its subsidiaries at mid-year 1987. In the case of BC/BS of VA, the return it receives from its affiliates is dependent on how much it pays its affiliates for services rendered. In this regard, BC/BS of VA paid its affiliates a net of some $51 million in 1986. While these arrangements were governed by contractual agreements that seem "arms-length" in nature, the holding company of which BC/BS of VA is a part is structured such that the same executive management controls the parent and all affiliates.

In summary, BC/BS Plan diversification in the Commonwealth does not seem to have exposed subscribers to unreasonable expense and/or undue risk in the past. At the same time, however, Virginia's subscribers have not been freed from the potential that diversification could materially affect their interests in an adverse manner in the future.

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PERFORMANCE AND DIVERSIFICATION OF THE BLUE CROSS/BLUE SHIELD PLANS IN VIRGINIA: AN OPERATIONAL REVIEW

PART I: BACKGROUND AND INTRODUCTION

In early July of this year, Technical Associates, Incorporated ("Consultant") was retained by the Bureau of Insurance of the Virginia State Corporation Commission ("Bureau") to perform an operational review of the Blue Cross/Blue Shield ("BC/BS") Plans presently doing business in the Commonwealth, i.e., BC/BS of Virginia ("BC/BS of VA" or "Richmond Plan") and BC/BS of the National Capital Area ("BC/BS of NCA"). The study was commissioned to meet the requirements of the 1987 Virginia General Assembly, as specifically set forth in House Joint Resolution 284.

In addition to the financial collapse of BC/BS of Southwestern Virginia ("BC/BS of SW VA" or "Roanoke Plan"),the operational review was sparked by debate over the proper role of BC/BS Plans, particularly in relation to the interests of subscribers. On the one hand, the contention is made that because of structural change and increasing competition in the healthcare industry, the survival of BC/BS Plans is dependent on their ability to meet market challenges. Holders of this view claim that diversification into various sectors of the healthcare business improves the viability of BC/BS Plans. On the other hand is the position that BC/BS Plans hold a unique and protected role in the provision of accident and health ("A&H") insurance such that there is little threat posed by economic change. And further, while diversification may have beneficial aspects, the risks to subscribers greatly outweigh those potential benefits.

In conducting the study of the BC/BS Plans in the Commonwealth, the Bureau instructed the Consultant to analyze five criteria:

(1) the percentage of subscribers' premiums devoted to administrative expense;
(2) the amount of reserves;

(3) the adequacy, inadequacy, or excessiveness of reserves;
(4) the amount of investment by each Plan in its subsidiaries; and
(5) the degree of risk of these investments to each Plan's subscribers.

In addressing these five criteria, the Consultant was further instructed to make comparisons, where appropriate, among BC/BS Plans in Virginia, BC/BS Plans in other states, and commercial A&H insurers operating in Virginia during the period 1984-86. The major purpose of the study is to provide the Bureau with findings regarding the issue of whether subscribers of Virginia's BC/BS Plans have been exposed to unreasonable expense and/or undue risk as a result of diversification activities.

A. Structure of the Report

The report contains four parts and three appendices. This Part I surveys the methodological approach to the study, as well as discusses one main qualification.

Part II presents an analysis of the comparative performance of Virginia's BC/BS Plans, BC/BS Plans in other states, and the largest 50 commercial A&H insurers licensed to do business in the Commonwealth over the 1984-86 period. The analysis focuses on a number of expense and reserve ratios related to the provision of A&H insurance which are used as measures of comparative performance.

In Part III of the report, the diversification activities of BC/BS Plans in the Commonwealth are described in some detail, from their initial inception in the 1970's up to the current time. Analyses of corporate structures, transactions among affiliates, and the relationship between A&H insurance performance and diversification activities are presented.

Part IV summarizes the Consultant's conclusions regarding the impact of diversification on the interests of BC/BS Plan subscribers in Virginia. The discussion distinguishes between those findings which are relevant from an historical perspective and those which can be reached in the future only upon further study.

The three appendices to the report are separately bound because of their volume or because they contain information which has been provided to the Consultant on a confidential basis. Appendix A is a technical discussion of the methodology employed by the Consultant, particularly in relation to how certain data and conceptual problems were resolved. Appendix B contains the raw data, along with various statistical tabulations used in the comparative analysis of A&H insurance performance. Appendix C consists of an indexed set of all reports, studies, financial statements, newspaper articles, responses to information requests, and other materials used by the Consultant in conducting the study.

B. Methodological Approach

The operational review requested by the Bureau essentially consists of analyses in two issue areas. First is the question of the operating performance of the Virginia BC/BS Plans relative to that of commercial A&H insurers and other BC/BS Plans. Second is the question of whether the diversification activities of the Virginia BC/BS Plans have adversely impacted either their historical performance or their ability to continue providing quality insurance without imposing a high level of expense or risk on subscribers. The present study fully addresses the first issue area with only minor qualification. With regard to the second question, however, the operational review is subject to certain limitations. These are discussed later in the report and, as will be indicated, are particularly important in considering the impact of diversification on subscribers in the future.

1. Performance Data. For reasons discussed in Appendix A, comparisons of operating performance among different types of insurers (or among similar insurers with different structural and/or market characteristics) can be difficult and must be approached cautiously. With this potential problem in mind, the Consultant collected various performance data for the 1984-86 period with respect to the following two comparison groups:

(1) the 50 largest commercial A&H insurers in terms of the volume of business written in Virginia in 1985 as measured by A&H premiums earned; and

(2) as many BC/BS Plans in other states for which information could be obtained in a complete and timely manner from annual reports filed with state regulatory authorities.

Data for the first comparison group were gathered directly from annual reports filed with the Bureau, as was the case for the BC/BS Plans in Virginia. Operating performance data for BC/BS Plans in other jurisdictions were obtained through written and telephone requests made of state regulatory authorities. As noted in Appendix A, the success of this latter effort was hampered to some degree due to communication and retrieval problems, as well as to the differing regulatory structures under which BC/BS Plans operate across the country.

TABLE I-A
COMPARISON OF DATA COLLECTED FOR
COMMERCIAL A&H INSURERS AND BC/BS PLANS

	(1) COMMERCIAL A&H INSURERS	(2) BC/BS PLANS
(1) A&H Premiums Earned	yes	yes
(2) A&H Claims Incurred	yes	yes
(3) A&H Expenses Incurred	yes	yes
(a) claim adjustment	no	yes
(b) administrative	no	yes
(c) soliciting	no	yes
(4) A&H Taxes, Licenses & Fees Incurred	yes	yes
(5) A&H Underwriting Expense Incurred	yes	yes
(6) Total Premiums Earned	yes	no
(7) Total Assets	yes	yes
(8) Total Liabilities	yes	yes
(9) Capital & Surplus Ratio	yes	yes
(10) A&H Aggregate Reserves	yes	no
(11) Total Aggregate Reserves	yes	no

In Table I-A, an identification of the various categories of annual data collected for each of the sets of companies over the three year period 1984-86 is presented. Note first that with respect to premiums and expenses, an "earned" (or "incurred") standard was used instead of a "cash" basis, as the former better matches the flow of revenues and expenditures as recognized under generally accepted accounting principles ("GAAP") and statutory accounting practices ("SAP").

The term "no" in Column (1) of Table I-A designates instances where data were not collected for one of the sets of companies. To illustrate, data for claim adjustment, administrative, and soliciting expenses (as those categories are used by BC/BS Plans in reporting financial information to regulators) were not collected for commercial A&H insurers. This was true because such categories of data are not readily discernible from the annual reports filed by commercial companies with the Bureau. As noted in Appendix A, moreover, while approximations of the amounts in these expense categories could be calculated from reported data, the results of such an exercise would be suspect--particularly when used in a comparative analysis involving BC/BS Plans that record such amounts directly.

The "no" shown in Column (2) of Table I-A indicates situations either where the data are not needed or where the data are not reported. The former situation refers to total premiums earned for BC/BS Plans, as these data are the same as A&H premiums earned. The latter situation refers to A&H and total aggregate reserves, since these data are only reported by commercial insurers.

OPERATING PERFORMANCE MEASURES

	(1) COMMERCIAL A&H INSURERS	(2) BC/BS PLANS
(1) Loss Ratio	yes	yes
(2) Expense Ratio	yes	yes
(3) Underwriting Ratio	yes	yes
(4) Net of Tax Underwriting Ratio	yes	yes
(5) Claim Adjustment Expense Ratio	no	yes
(6) Administrative Expense Ratio	no	yes
(7) Soliciting Expense Ratio	no	yes
(8) Premiums Ratio	yes	no
(9) Surplus Reserve Ratio	yes	yes
(10) Surplus Reserve Days	yes	yes

Table I-B shows the A&H operating performance measures used in the comparative analysis, as calculated from the collected data. Each of these annual measures is defined and used as follows:

(1) loss ratio--calculated as claim losses incurred divided by premiums earned--used as a measure of the portion of premiums returned to policyholders in the form of insurance benefits;

(2) expense ratio--calculated as expenses incurred (excluding claims incurred) divided by premiums earned--used as a measure of the expense of providing insurance services;

(3) underwriting ratio--calculated as the sum of the loss and expense ratios--used as a measure of the profitability of insurance underwriting activities;

(4) net of tax underwriting ratio--calculated as total underwriting costs (i.e., claims and expenses incurred) less taxes (non-income) licenses, and fees incurred divided by premiums earned--used as a measure of underwriting profitability if taxes, licenses, and fees are disregarded;

(5) claim adjustment expense ratio--calculated as claim adjustment expenses incurred less applicable taxes, licenses, and fees divided by premiums earned--used as a measure of the costs incurred by BC/BS Plans in controlling the loss ratio treating taxes, licenses, and fees as costs which are essentially noncontrolable;

(6) administrative expense ratio--calculated as in (5) but with respect to administrative expenses incurred--used as a measure of the indirect (but controllable) expense experience of BC/BS Plans in providing insurance services;

(7) soliciting expense ratio--calculated as in (5) but with respect to soliciting expenses incurred--used as a measure of the net cost of generating BC/BS Plan insurance business;

(8) premiums ratio--calculated as A&H premiums earned to total premiums earned--used as a measure of the involvement of commercial insurers in the A&H business;

(9.1) surplus reserve ratio (commercial insurers)--calculated as

$$\frac{(AHAR/TAR)CS-(AHUE/12)}{(AHUE/12)},$$

where AHAR is A&H aggregate reserves, TAR is total aggregate reserves, CS is capital and surplus, and AHUE is A&H underwriting expense--used as a measure of the ability of insurers to meet A&H claims (and associated expenses) beyond the current liability and reserve amounts booked for such purposes;

(9.2) surplus reserve ratio (BC/BS Plans)--calculated as

$$\frac{(CS)-(AHUE/12)}{(AHUE/12)},$$

defined and used as in (9.1); and

(10) surplus reserve days--calculated as 30 days (1+ surplus reserve ratio)--used to place the ability referenced in (9.1) in terms of the number of days

A&H claims (and associated expenses) could be met beyond currently booked provisions.

Two points regarding the above measures should be noted at this juncture. First, since BC/BS Plans are frequently exempt from paying various types of taxes to which commercial insurers are subject, a net of tax underwriting ratio serves to recognize this difference in making comparisons between the two groups. Second, as the concept of reserves cannot be unambiguously applied across the companies studied, as discussed in Appendix A, the Consultant adopted the Bureau's definition of "contingency reserves" for BC/BS Plans in Virginia as a base standard for comparison purposes. This definition establishes a threshold reserve level at 30 days of annual underwriting cost or expense, i.e., AHUE/12.

Incidentally, the Bureau's definition of "contingency reserve" is comparable to one of the membership requirements of the National Blue Cross and Blue Shield Association. In this sense, the 30-day threshold can be regarded as a universal standard of reserve adequacy for BC/BS Plans. However, as noted above, the Consultant has used the 30-day standard as a benchmark for all A&H insurers to facilitate the comparative analysis.

For BC/BS Plans, the definition of "contingency reserves" is easily calculable and can be applied in a relatively straightforward manner. The relationship between CS (capital and surplus) and AHUE/12 provides a standardized measure of an insurer's ability to meet potential claims and expenses above those already accounted for on the books of a BC/BS Plan. The conversion of this difference into a surplus reserve ratio and surplus reserve days is equally easy and understandable.

For commercial insurers, the development and use of a standardized measure of reserves is more difficult. In large part, this is true because they write insurance other than A&H--primarily life. Accordingly, capital and surplus (CS) shown on the books of a commercial insurer reflects paid-in-capital and retained earnings attributable to at least two lines of business (A&H and life insurance) which have accumulated since the company began its existence. Accordingly, the separation of CS into A&H and life components for commercial insurers using the allocator (AHAR/TAR) is, to a degree, arbitrary. But as noted in Appendix A, the more accurate and appropriate approach would have involved a specialized analysis of each commercial company to trace the actual CS attributable to each line of business. In addition to the fact that such analyses are well beyond the scope of the operational review, the discussion later in the report indicates that the results of the allocation provide at least some meaningful insights.

2. Diversification Data. In addressing the second area of inquiry the Consultant collected data regarding the structure and operations of the two BC/BS Plans currently doing business in Virginia, as well as for BC/BS of SW VA. The data collection effort focused on the organizational, ownership, and financial relationships between Virginia's BC/BS Plans and their affiliates and/or subsidiaries.

With respect to BC/BS of VA, the structural analysis focuses on the periods 1973 to 1983 and post-1983. These periods correspond to either differing types of diversification or to the extent of diversification activities. Data as to the relationships and transactions between BC/BS of VA and its affiliates were collected for both periods, but concentrated on the years since 1983.

For BC/BS of NCA, the structural analysis similarly considered just two periods, before 1983 and 1983 and after. Again, focusing on the latter period, data were collected on such questions as contractual agreements, commitment contingencies, and the flow of funds between BC/BS of NCA and its subsidiaries.

C. Study Qualification

The analyses conducted (and findings reached) by the Consultant are subject to one major qualification, as reflected by the fact that the present study is only an operational review. That is, the present study must be distinguished from a management or a financial audit, where the relationship between BC/BS Plan diversification and performance would be more intensively and critically examined.

To illustrate, the Consultant has not tested the reasonableness of the flow of funds between Virginia's BC/BS Plans and their affiliates/subsidiaries. Nor has the Consultant examined the question of whether payments reflected actual services provided or the question of whether the actual services provided were needed. Similarly, no investigation has been made of the extent to which diversification helped BC/BS Plans in the Commonwealth to maintain market share or to attract new business.

Because of the findings reached by the Consultant with respect to the past relationship between diversification and performance, the above qualification is not a serious limitation of the present operational review. However, as discussed later in the report, this may not be true for the future relationship between BC/BS Plan diversification and performance in the Commonwealth.

PART II: COMPARATIVE ANALYSIS OF PERFORMANCE

The operating and reserve performance data used in the comparative analysis are presented in Appendix B of the report. The data are organized into two series: (B-1) which shows for each company and for each year in the study period the various performance ratios identified in Part I, as well as tabulations of the ratios for the two comparison groups in terms of means and standard deviations; and (B-2) which shows the raw data for each company used in the comparative analysis from which the ratios were calculated. The information contained in Appendix B is summarized in a number of tables presented at the conclusion of this Part II of the report.

In analyzing the performance ratios, some care must be exercised in any comparative interpretation. This is true not only because of the data comparability problems mentioned in Part I (detailed in Appendix A), but also because of the magnitudes of the figures underlying the ratios. For instance, in comparing two underwriting ratios (say 99% and 101%, hypothetically), the tendency is to conclude that there is not much difference between them. While this is clearly true in terms of statistical measurement, the difference could amount to millions of dollars in losses versus profits.

For example, the combined premiums earned for the two BC/BS Plans currently doing business in Virginia were $2.119 billion in 1986; i.e., $1.213 billion for BC/BS of VA and $0.906 billion for BC/BS of NCA. Applying the hypothetical underwriting ratios to the $2.119 billion figure produces a difference between a total underwriting loss of $21.2 million in one case (101%) and a total underwriting profit of $21.2 million in the other case (99%).

A. Operating Measures

There is a noticeable difference in the loss (claims) and expense experience of commercial A&H insurers and of BC/BS Plans, whether Virginia or other BC/BS Plans are considered. However, in terms of total underwriting costs (combined loss and expense), the difference is far less significant, although the data indicate much greater diversity among the commercial companies. This pattern holds both before and after tax (non-income) expenses are taken into account.

1. Underwriting Experience. The following data present a comparison of the underwriting experience of commercial A&H insurers and of BC/BS Plans in other states:

		1986	1985	1984
Commercial Insurers				
Loss Ratio:	Mean	65.5%	64.2%	64.7%
	SD	20.1%	16.7%	14.8%
Expense Ratio:	Mean	34.1%	37.6%	33.7%
	SD	--	--	--
Underwriting Ratio:				
	Mean	99.6%	101.8%	98.4%
	SD	19.1%	16.5%	10.7%
BS/BS Plans Other States				
Loss Ratio:	Mean	92.2%	89.5%	87.7%
	SD	6.4%	6.6%	7.3%
Expense Ratio:	Mean	11.7%	10.3%	9.5%
	SD	--	--	--
Underwriting Ratio:				
	Mean	103.9%	99.8%	97.2%
	SD	8.3%	8.0%	9.4%

Over the three years in the study period, the average loss and expense ratios of the commercial insurers have been in the neighborhood of 65% and 35%, respectively. In contrast, the comparable average figures for BC/BS Plans in other states are about 90% and 10%, although both have exhibited an upward trend over the 1984-1986 period. This trend is reflected in the fact that the average underwriting ratio for BC/BS Plans in other states was 97% in 1984, rising to 103% in 1986. But aside from this, it is reasonable to conclude that while the distribution of underwriting costs is much different for the two comparison groups, the total underwriting experience differs far less so.

At the same time, however, there is a much greater clustering of experience for the BC/BS Plans than for the commercial A&H insurers. In 1986, for example, the standard deviation ("SD") of the underwriting ratio for the commercial insurers was 19.1%. (Note: the SD's should be read in percentage points, e.g., 19.1% is really 19.1 percentage points.) Thus, about two-thirds of these companies had underwriting ratios in the range of 81% to 119%, i.e., 99.6% $\pm$ 19.1%. In contrast, the corresponding range for BC/BS Plans in other states was 96% to 112%.

The loss, expense, and underwriting experience of the two Virginia BC/BS Plans has been similar to their counterparts elsewhere. This was also true of BC/BS of SW VA until its financial troubles in 1985 and its subsequent merger into BC/BS of VA in 1986. In this regard, the data below for the Richmond Plan reflect its individual operations in 1984 and 1985, but its merged operations in 1986:

	1986	1985	1984
BC/BS of VA:			
Loss Ratio	93.0%	91.4%	91.0%
Expense Ratio	9.0%	8.6%	6.3%
Underwriting Ratio	102.0%	100.0%	97.3%
BC/BS of NCA:			
Loss Ratio	92.2%	87.2%	87.1%
Expense Ratio	13.4%	11.4%	9.9%
Underwriting Ratio	105.6%	98.6%	97.0%
BC/BS of SW VA:			
Loss Ratio	--	98.6%	91.1%
Expense Ratio	--	11.0%	8.4%
Underwriting Ratio	--	109.6%	99.5%

First of all, note that the underwriting ratio of nearly 110% for BC/BS of SW VA in 1985 meant that for every dollar of premiums earned, it was sustaining an underwriting loss of 10¢. As its earned premiums were approximately $229 million in 1985, BC/BS of SW VA had 1985 underwriting losses of about $23 million. As underwriting profits were very small in 1984 (i.e., an underwriting ratio of nearly 100%), the continuation of the downward trend (absent any investment or other income offsets) was a primary reason for BC/BS of SW VA's financial crisis and subsequent merger into BC/BS of VA in 1986.

Whether the merger caused a major change in the performance of BC/BS of VA is not readily apparent from the data above. This is true because the loss and expense ratios were rising before the merger, as was the case for BC/BS Plans in other states. But given the comparatively high loss and expense ratios of BC/BS of SW VA in 1985, the performance of BC/BS of VA in 1986 likely would have been better had there been no merger.

The performance of BC/BS of VA has been, however, comparable to that of BC/BS Plans in other states for each of the three years in the study period. Even trends are similar. Specifically, the loss, expense, and underwriting ratios of BC/BS of VA have been very close to the averages for BC/BS Plans in other states and each of the ratios has been rising. In 1984, for example, BC/BS of VA had an underwriting ratio of 97% in comparison to the average for BC/BS Plans elsewhere of 97%. By 1986, the underwriting ratios had risen to 102% and 104%, respectively.

For BC/BS of the NCA, the ratios show a similar trend but also display sharp increases in 1986. Between 1985 and 1986, the loss and expense ratios rose 5 and 2 percentage points, respectively, such that the 1986 underwriting ratio for BC/BS of NCA was nearly 106%. This is near the upper end of the SD range for the average of BC/BS Plans in other states. In large part, this is caused by the comparatively high 1986 expense ratio, since the 1986 loss ratio (92%) of BC/BS of NCA is very close to the average of its counterparts elsewhere.

Based on the comparison of operating performance measures, the following observations seem to be in order for the period 1984-86:

(1) commercial A&H insurers have experienced significantly lower loss ratios than BC/BS Plans;

(2) commercial A&H insurers have experienced significantly higher expense ratios than BC/BS Plans;

(3) the total underwriting experience of commercial A&H insurers and BC/BS Plans have not been much different, although even a small difference could have meant millions of dollars in losses or profits;

(4) the variability in loss, expense, and underwriting ratios has been considerably greater among commercial A&H insurers than among BC/BS Plans; and

(5) BC/BS Plans in Virginia have performed in a similar manner to their counterparts in other states, although the 1986 expense and underwriting ratios of BC/BS of NCA approached the high end of the average for the comparison group.

In terms of the objectives of the present study, what do these observations imply? First of all, in making any comparison between commercial A&H insurers and BC/BS Plans, it would seem that one must first recognize that they have operated in distinctly different manners. The fact that BC/BS Plans sustained claim losses of roughly 90¢ out of each premium dollar, as opposed to 65¢ for commercial insurers, suggests that a much larger portion of the cost of A&H insurance was returned to BC/BS subscribers in the form of benefits than was the case for those insured by commercial companies.

At the same time, since commercial A&H insurers have incurred expenses of about 35¢ out of every premium dollar, as compared to 10¢ for BC/BS Plans, this implies that either the latter were more efficient or that they put relatively little effort into assessing insurance risks and/or managing their operations. If the prices and qualities of the insurance provided by the two groups were the same, and if the characteristics of the insured populations were also the same, then one might logically draw the conclusion that BC/BS Plans were more efficient--at least in terms of delivering insurance benefits at relatively low cost to the public.

But there are unknowns, as are other dimensions to the question. No comparisons have been made of the prices and qualities of the insurance services provided. Moreover, the fact that the underwriting ratios are similar for the two comparison groups, i.e., ranging very close to 100% on average, suggests that there are no great losses or profits in the A&H insurance business--at least when viewed overall. While some companies sustain large losses or reap large profits, particularly within the commercial insurers group, the continuing tendency toward a 100% underwriting ratio implies that the public interest was being served.

Perhaps a more plausible explanation of the operating differences between the two groups rests in the purposes for which they were created. Generally, the BC/BS Plans were created as extensions of doctor and hospital groups to facilitate payment for health services rendered. As such services were generally provided on demand, even to those who might not be able to afford them, the formation of BC/BS Plans served to shift risk from healthcare providers to the general public. At the same time, the public benefitted in terms of greater healthcare access and a healthier population. Corresponding to this viewpoint, BC/BS Plans operated on a non-profit basis and were, accordingly, exempt from many of the taxes to which commercial A&H insurers were subject. (Note this has become less true as reflected by the fact that Virginia BC/BS Plans now pay a small portion of the premium taxes paid by commercial insurers and that the former are now subject to federal income taxes.)

Although numerous changes have occurred since the early formation of the BC/BS Plans, the loss, expense, and underwriting ratios suggest that they are continuing to operate in accordance with their initial purposes, at least to some degree. In fact, some would contend that the relatively high loss ratio and relatively low expense ratio clearly demonstrates the continuing commitment of the BC/BS Plans to remain as insurers of last resort. This is evidenced, the contention continues, by their open enrollment practices whereby even very high risk individuals are provided with insurance which is unavailable from commercial insurers. In light of the performance data considered in the operational review, this contention may have merit.

In contrast to BC/BS Plans whose only business is A&H insurance, most commercial insurers entered the A&H field as a complement to their already existing life insurance businesses, some perhaps on a "loss-leader" basis. For instance, of the top 50 commercial A&H insurers which comprise the comparison group used in the study, only four companies in 1986 can be considered as being total A&H

insurers measured as having 95% or more of total premiums earned attributable to A&H business. If this standard is reduced to 90%, then the number of total A&H insurers rises to seven companies. But the proposition that the companies comprising this subset comparison group are primarily engaged in health insurance and, therefore, operate their A&H businesses similarly to BC/BS Plans is not supported by the data.

No commercial A&H insurer in the comparison group sustained a loss ratio of 90% or more in any year in the study period. There were only nine instances with loss ratios of 85% or more. And, for companies whose A&H business comprised 75% or more of total premiums, the average loss ratios were 59% in 1986, 58% in 1985, and 56% in 1984. Thus, irrespective of the role that A&H plays in the total business of the commercial firms used in the comparison, the attendant loss ratio is significantly lower than that experienced by BC/BS Plans. On the other hand, the expense experience is much higher while the underwriting ratio of the commercial insurers is similar to that of BC/BS Plans.

The picture that emerges lends credence to the position that BC/BS Plans continue to operate with differing policies and practices than commercial insurers. That is, while insurance prices are generally held for all insurers to just cover claims and expenses, i.e., an underwriting ratio of 100%, BC/BS Plans return a much larger part of the premium dollar to subscribers in the form of A&H benefits. This may reflect a continuing "social consciousness", the role of insurer of last resort, the force of regulatory and legislative pressure, or a combination of influences. Nevertheless, on a per dollar of premium basis, the data support the view that BC/BS Plans deliver greater value to consumers and do so at lower cost.

Since the performance of the Virginia BC/BS Plans is comparable to their counterparts in other states, this conclusion is equally applicable to them. From an operating performance standpoint, therefore, diversification activities of the BC/BS Plans in Virginia do not appear to have noticeably affected their ability to provide quality insurance at a reasonable cost. This does not mean, however, that there has been no impact from diversification or that the impact might not be significant in the future.

In this regard, a question that arises is whether the operating performance of the BC/BS Plans in Virginia might not have been better in the absence of diversification. To illustrate, of the 49 BC/BS Plans in other states for which complete 1986 loss and expense data have been collected, 19 Plans had underwriting ratios less than 100%. For this subgroup of 19, the averages of the performance measures were: underwriting ratio of 97.3%; loss ratio of 88.8%; and expense ratio of 8.5%. Focusing on the 1986 expense ratio of the subgroup, this compares to 9.0% for BC/BS of VA and 13.4% for BC/BS of NCA. Thus, using the experience of the 19 BC/BS Plans in other states as a standard of efficiency, BC/BS of VA continues to compare favorably despite its diversification activities. The same cannot be said of BC/BS of NCA. But whether an absence of diversification would have altered these observations in any way remains to be seen.

As the diversification activities of Virginia's BC/BS Plans have largely occurred within the last several years, their long-term potential impacts are not readily measurable from a historical perspective. This is true because the dollar amounts involved in the Virginia BC/BS Plans diversification activities are small relative to A&H premium volume such that positive or negative impacts become discernible, to the extent they exist, only after they have accumulated over time. Moreover, the impact on A&H insurance operations depends not only on the ongoing relationships between Virginia BC/BS Plans and their affiliates, but also on the performance of the affiliates themselves.

2. Tax Effects. As BC/BS Plans are exempt from many of the taxes that commercial A&H insurers are required to pay, it is useful to consider how tax expenses impact the operating performances of the comparison groups. The taxes to which we refer are those unrelated to income, although commercial insurers are also subject to income taxes unlike BC/BS Plans (at least until recently). Specifically, the taxes in question consist of such expenses as licenses and fees, property taxes, premium receipt taxes, etc.

The table below shows the average 1986 expense ratios of the comparison groups including and excluding tax expenses:

	1986 Exp. Ratios (Incl. Tax)	1986 Exp. Ratios (Excl. Tax)
Commercial Insurers	34.1%	30.4%
BC/BS Plans Other States	11.8%	10.6%
BC/BS of VA	9.0%	8.7%
BC/BS of NCA	13.5%	13.3%

The data in the tables presented at the conclusion of Part II portray a similar picture for 1985 and 1984. Specifically, whereas the exclusion of taxes reduces the average 1986 expense ratio of commercial A&H insurers by roughly 4 percentage points, the corresponding 1986 reduction for BC/BS Plans in only about 1 percentage point or less.

If the comparison groups were placed on an equivalent tax expense basis, several different implications are suggested. If commercial A&H insurance were subject to the same tax expense burden as BC/BS Plans (i.e., reduced from 4 to 1 percentage point) and there was no change in the prices of insurance, there would continue to be merit in the position that BC/BS Plans deliver greater insurance value at lower cost per premium dollar than commercial insurers. This is true since the expense ratio for the latter would remain above 30% as compared to about 10% for BC/BS Plans. Moreover, with no change in prices, the underwriting ratio for commercial insurers would decline by 3 percentage points (to about 96%) resulting in a significant increase in profits.

On the other hand, if the tax expense burden on BC/BS Plans were to be increased to a level comparable to that imposed on commercial insurers and, again, there were no change in insurance prices, the expense ratios for BC/BS Plans would rise by about 3 percentage points. They still would appear to be relatively more efficient in terms of the expense of delivering A&H insurance benefits, but the magnitude of underwriting losses would increase if there were no offsetting measures taken to cut costs. In the case of BC/BS of NCA, such a rise in tax expense might jeopardize its financial status since its 1986 underwriting ratio would increase to nearly 109%. This means an underwriting loss of

9¢ on each dollar of premium earned--close to that of the Roanoke Plan during its financial crisis.

3. Expense Categories. In the method of reporting by BC/BS Plans, expenses are booked into three categories: claim adjustment, administrative, and soliciting. The table following shows a comparison of the corresponding expense ratios excluding taxes, licenses, and fees for BC/BS Plans in other states and in Virginia:

	1986	1985	1984
BC/BS Other States:			
Claim Adj. Exp. Ratio	4.7%	3.9%	4.0%
Adm. Exp. Ratio	3.5%	3.2%	3.0%
Solic. Exp. Ratio	1.8%	1.7%	2.0%
BC/BS of VA:			
Claim Adj. Exp. Ratio	3.7%	4.0%	2.4%
Adm. Exp. Ratio	3.6%	2.9%	2.8%
Solic. Exp. Ratio	1.4%	1.3%	0.7%
BC/BS of NCA:			
Claim Adj. Exp. Ratio	7.0%	5.3%	4.1%
Adm. Exp. Ratio	5.2%	4.9%	4.8%
Solic. Exp. Ratio	1.2%	1.1%	0.9%
BC/BS of SW VA:			
Claim Adj. Exp. Ratio	--	2.8%	1.6%
Adm. Exp. Ratio	--	4.9%	4.9%
Solic. Exp. Ratio	--	2.7%	1.5%

Except for the average soliciting expense of BC/BS Plans in other states, there has been a general increase in expense ratios for all BC/BS Plans. With respect to the soliciting category, BC/BS of NCA has had the lowest expense ratio over the three year study period. Regarding claim adjustment and administrative expenses, BC/BS of NCA is on the high side of the comparison groups, particularly in 1986. To illustrate, the 1986 SD's of the claim adjustment and administrative expense ratios (not shown above) for BC/BS Plans in other states were 2.4% and 1.5%, respectively. Thus, two-thirds of these organizations fell in the range of 2.3% to 7.1% for the claim adjustment ratio and 2.0% to 5.0% for the administrative expense ratio. These ranges compare to 7.0% and 5.2% for BC/BS of NCA in 1986--both were up, moreover, over 1985 levels. As 1986 is a major year of diversification by BC/BS of NCA, such activity may have had an impact on its expense ratios.

For BC/BS of VA, all of the three expense ratios were very close (well within the SD's) to those of the comparison group in other states. In fact, except for the claim adjustment expense ratio in 1985 and the administrative expense ratio in 1986, BC/BS of VA's ratios were less than the averages for the comparison group. This favorable performance was exhibited despite the merger of BC/BS of SW VA in 1986.

B. Reserve Measures

Insurance reserves provide protection for policyholders or subscribers against large losses of an insurer, whether such losses result from extraordinarily large claims or poor business practices. A case in point is BC/BS of SW VA, where large losses eroded reserves to the point that it confronted a severe financial crisis.

The measure of reserves used in this study is total assets less total liabilities, i.e., capital and surplus. This measure goes beyond any liabilities (or reserves treated as liabilities) on company books which might be recorded to meet known claim and expense obligations. Capital and surplus is a well-recognized standard of a company's financial strength. This is particularly true in the insurance industry where a substantial portion of total assets is held in the form of stocks and bonds. Moreover, the laws of most states require that these stocks and bonds be held in securities that are liquid with relatively high investment-grade ratings, e.g., U.S. Government Bonds.

In conducting the comparison of reserve levels, as measured by an insurer's capital and surplus position, the threshold standard used is 30 days of underwriting (combined loss and expense) costs. As a hypothetical example, if an insurer had $210 million in claim losses and $30 million in expenses, its total annual underwriting costs would be $240 million. Its threshold reserve standard would be calculated as $240 million ÷ 12, i.e., 30 days of annual underwriting costs or $20 million. This means that if the hypothetical insurer had capital and surplus of just $20 million, it would be able to sustain 30 days of losses and expenses with no inflow of premium revenue.

If, however, the hypothetical insurer had only $10 million in capital and surplus, it would have: (a) a surplus reserve ratio of ($10 million - $20 million) ÷ $20 million or <50%>; and (b) surplus reserve days of 1+<50%> X 30 days or 15 days. Capital and surplus of $30 million translates into a surplus reserve ratio of 50% and surplus reserve days of 45 days under the comparative performance standards used in thisstudy.

1. <u>Surplus Reserve Days</u>. In comparing reserve levels of various types of A&H insurers, the discussion will focus on the standard of surplus reserve days. As indicated above, the larger is surplus reserve days, the greater is the financial strength of the insurer relative to its underwriting experience and the greater is the protection afforded subscribers or policyholders. But it must be also recognized that as this reserve measure becomes very large, capital and surplus may be far in excess of the level necessary to provide adequate protection to the insured. In turn, this might mean that premium levels are too high relative to underwriting experience.

The table below presents a comparison of average surplus reserve days for the various categories of insurers being considered in the operational review:

	1986	1985	1984
Commercial Insurers:			
Mean	87	63	93
SD	139	82	258
BC/BS Plans Other States:			
Mean	80	85	73
SD	52	52	49
BC/BS of VA	52	75	66
BC/BS of NCA	40	73	71
BC/BS of SW VA	--	18	46

The average surplus reserve days for commercial A&H insurers and BC/BS Plans in other states are not significantly different, although the SD's (not shown above) suggest that the distributions within each comparison group are dissimilar. For example, an SD larger than the average (mean), such as is the case for commercial insurers in each year of the study period, indicates that the observations are not distributed in accordance with the bell-shaped statistical curve. That is, the distribution is skewed or takes some other form such that a range of predominance cannot be readily specified.

In 1986, for example, commercial insurers had a mean of 87 surplus reserve days with a SD of 139 days. This data cannot be interpreted to mean that two-thirds of the surplus reserve days observations fall in the range of 87± 139 or <52> days to 174 days, although they do suggest considerable variation. The data in Appendix B show that 1986 surplus reserve days for commercial A&H insurers ranged from 0.2 days to 764.5 days. The data further suggest that the distribution takes the uniform shape rather than the bell shape as the observations are equally divided with an upper range of 84.0 to 764.5 days, a middle range of 13.1 to 77.1 days, and a lower range of 0.2 to 13.0 days.

The fact that some commercial A&H insurers have extremely low surplus reserve days cannot be interpreted to mean that policyholders are poorly protected. This is true because (as noted earlier in the report and explored in Appendix A), capital and surplus is allocated to A&H and life insurance based on the relationship of A&H aggregate reserves to total aggregate reserves. Thus, an insurer could have a very low A&H surplus reserve days simply because it writes a relatively small amount of A&H business, and books, accordingly, a small amount of A&H aggregate reserves. Overall capital and surplus might be still large, however, which would serve to protect both A&H and life policyholders.

The data in Appendix B for commercial A&H insurers supports this viewpoint as the table below for 1986 portrays:

Surplus Reserve Days Grouping	Surplus Reserve Days	Premiums Ratio
Upper Third:		
Mean	221	88%
Range	84 to 765	70% to 100%
Middle Third:		
Mean	32	49%
Range	13 to 77	41% to 69%
Lower Third:		
Mean	7	15
Range	0 to 13	<73%> to 37%

As indicated, there is a positive relationship between surplus days and the premiums ratio. That is, the larger is the ratio of A&H busines to total busines, the larger is surplus reserve days. This means that the amount of A&H aggregate reserves booked by a commercial insurer is directly related to the amount of A&H insurance it writes. And, further, as the study allocates overall capital and surplus to A&H insurance based on A&H aggregate reserves, the use of surplus reserve days (as defined herein) appears to be a meaningful measure of reserve performance despite the data comparability problems noted earlier and detailed in Appendix A. This is true because when the bulk of a company's business is derived from one line of insurance, the reasonable conclusion can be drawn (at least tentatively) that its capital and surplus position is primarily attributable to that line of insurance.

In interpreting the premiums ratio data shown above, some explanation is in order for such figures as <73%>, i.e., the ratio of A&H premiums earned to total premiums earned is actually a negative 73%. This can occur, and there are several instances in the data of either a negative ratio or a positive ratio in excess of 100%, because of the re-insurance process as the following hypothetical demonstrates:

	A&H Insurance	Life Insurance	Total
(1) Premiums Earned on Direct Business	$100	$100	$200
(2) Premiums Earned on Reinsurance Bus. Assumed	$20	$50	$70
(3) Premiums Earned On Reinsurance Bus. Ceded	$130	$20	$150
(4) Total Premiums Earned: (1)+(2)-(3)	<$10>	$130	$120
(5) Premiums Ratio	<8.3%>	108.3%	100.0%

Thus, through the process of reinsurance whereby insurers trade-off insurance that they have directly written among themselves, premiums earned in a particular line of business can be negative or greater than its total business. In circumstances where such figures have resulted in the study, the Consultant neither attempted to verify the accuracy of the reported information nor excluded the corresponding company from the data set since reinsurance is a normal business practice in the industry. It does, however, produce statistical results which seem strange on their face.

The finding that there is a positive relationship between the A&H premiums ratio and A&H surplus days for commercial insurers is significant in conducting the comparative analyses with BC/BS Plans. This is so, first, because the underlying threshold reserve measure of 30 days of underwriting expense is a standard which has been adopted by the Bureau and is applicable to only BC/BS Plans. Nevertheless, the application of this standard to the two comparison groups results in similar surplus reserve days, e.g., in 1986, 87 days for commercial A&H insurers and 80 days for BC/BS Plans in other states.

Perhaps the surprise here is that the surplus reserve days for the latter is so close to that of the former and not significantly greater. That is, since surplus reserve days in 1986 averaged 221 days for commercial insurers whose A&H premiums ratios were 70% to 100%, why is the average surplus reserve days of BC/BS Plans in other states only 80 days when their average A&H premiums ratio is 100%? The answer might again rest in the differing business objectives and operating characteristics of the two types of insurers. That is, that commercial insurers have been continually able to transfer a much larger portion of the premium dollar to capital and surplus.

With respect to the reserve positions of BC/BS Plans, consider first BC/BS of SW VA. Before financial troubles caused its merger into BC/BS of VA, surplus reserve days for the Roanoke Plan fell from 46 days in 1984 to 18 days in 1985. The 46 days in 1984 was already much lower than the average of 73 days for BC/BS Plans in other states. The 18 days in 1985 for BC/BS of SW VA, therefore, might be regarded as sort of a "danger zone" in assessing the financial strength of BC/BS Plans generally. That is, when a BC/BS Plan continues to experience declines in surplus reserve days driving its position to, say 15 days and lower, concern over its financial viability should be exercised. The percentage distribution presented below shows how the BC/BS Plans in other states compare to this "danger zone" standard:

	1986	1985	1984
Less than 15 days	4/54 = 7.4%	5/54 = 9.3%	4/41 = 9.8%
15 to 30 days	6/54 = 11.1%	4/54 = 7.4%	5/41 = 12.2%
30 to 45 days	5/54 = 9.3%	3/54 = 5.6%	4/41/= 9.8%
Over 45 days	39/54 = 72.2%	42/54 = 77.8%	28/41 = 68.3%

Consistently, more than 68% in this comparison group have had surplus reserve days in excess of 45 days. And, only about 10% were within the zone where concern should be focused.

In 1985, both Virginia BC/BS Plans (aside from the Roanoke Plan) had surplus reserve days in excess of 70. By 1986, however, these had fallen to 52 days for BC/BS of VA and 40 days for BC/BS of NCA. The declines in surplus reserve days are attributable, at least in part, to the rise in underwriting ratios for both Virginia BC/BS Plans. That is, an underwriting ratio greater than 100% means that claims and/or expenses must be met out of capital and surplus. Despite these declines, however, the 1986 surplus reserve days are within the 1986 SD range of BC/BS Plans in other states, i.e., 80$\pm$ 52 days, although BC/BS of NCA is close to the lower level of the range. Its 1986 surplus reserve days position of 40 days also differs from the finding that more than 70% of BC/BS Plans in other states maintain their positions at 45 days or more. But the surplus reserve days of BC/BS of NCA is not at or near the "danger zone" exemplified by the experience of BC/BS of SW VA. Moreover, the reported data suggest that the reserve levels of the two Virginia BC/BS Plans are neither inadequate nor excessive when compared to BC/BS Plans in other states.

2. Diversification Influences. The capital and surplus of a BC/BS Plan represents (at any point in time) the accumulated amount of premium revenue and income earned on investments that it has been able to retain. That is, not paid out in expenses and/or claims. In the presence of diversification, the same interpretation is applicable, although its dimension is somewhat different.

The capital and surplus of an insurer, as well as its surplus reserve days, will rise when its underwriting ratio declines or its investment income increases. Diversification, through both tranactions with affiliates and investments in affiliates, can influence the underwriting ratio and investment income. Affiliate transactions impact on expenses incurred, while investments in affiliates impact on investment income. If the services provided by affiliates to BC/BS Plans are overly expensive or of inferior quality, this will adversely influence the underwriting ratio. If affiliates fail to earn adequate profits, this could adversely impact investment income. Moreover, if a BC/BS Plan has guaranteed the performance or indebtedness of an affiliate, failure by an affiliate could reduce the capital and surplus of a BC/BS Plan.

As noted earlier, the operational review does not address the question of whether amounts involved in transactions among affiliates are reasonable. It does attempt, however, to fully document those relationships which affect the expense experience of the Virginia BC/BS Plans. Moreover, the study does measure the extent to which the Virginia BC/BS Plans have invested in (directly or through guarantees) their affiliates.

As will be discussed in Part III of the report, BC/BS of VA has lost more than $14 million of its initial $36 million of investments in affiliates. Thus, absent these losses, the surplus reserve days of BC/BS of VA would be higher than that presently exhibited. At the same time, however, the merger of BC/BS of SW VA also took its toll on the surplus reserve days of the Richmond Plan. To illustrate, the combination of a rise in the underwriting ratio, the investment loss in affiliates, and the merger of the Roanoke Plan served to reduce the capital and surplus of BC/BS of VA from $178.3 million at the end of 1985 to $178.0 million at the end of 1986. Coincidentally, its underwriting costs rose from $859.9 million in 1985 to $1,237.6 million in 1986.

The major reason for the sharp decline in BC/BS of VA's surplus reserve days between 1985 and 1986 was, undoubtedly, the merger of BC/BS of SW VA. To illustrate, if BC/BS of VA had not sustained the $14 million investment loss in affiliates, its 1986 surplus reserve days would have been 55.3 days rather than 51.8 days. These figures compare to pre-merger (1985) surplus reserve days of 74.6 days.

If, by chance, BC/BS of VA had lost its remaining investment in affiliates of $22 million, its surplus reserve days would have been 45.4 days in 1986--still a favorable comparison with BC/BS Plans in other states. Thus, at this level of analysis, the diversification activities of BC/BS Plan of VA do not seem to have posed a threat to subscribers. But, as discussed in Part III, there are other potential losses associated with its affiliate relationships which could further lower the surplus reserve days of the Richmond Plan.

Part III also shows that BC/BS of NCA has a direct investment in affiliates of $3.3 million and has guaranteed $20.3 million of affiliate credit lines. If this commitment were to result in a total loss, the surplus reserve days of BC/BS of NCA would approach a point of some concern, although not into the "danger zone" referenced earlier. To illustrate, if BC/BS of NCA had lost $24 million in 1986 due to associations with affiliates, its surplus reserve days would have been 31.4 days rather than 40.4 days in 1986.

C. Historical Perspective

Based on the operating and reserve performance measures examined, as well as on the limited analysis of diversification activities, the tentative conclusion can be drawn that relationships with affilates did not seriously undermine the past ability of Virginia's BC/BS Plans to provide quality insurance at reasonable cost. In terms of the purposes of the operational review, this tentatively means that in comparison to other A&H insurers (particularly BC/BS Plans in other states), the two Virginia BC/BS Plans:

(1) have had adequate reserves, i.e., neither excess nor inadequate, although reserve levels have declined in a period which corresponds to the time that diversification activities have been most intense;

(2) have rendered insurance services with loss (claim), expense and underwriting ratios that can be regarded as reasonable, although these ratios have risen as diversification activities have intensified;

(3) have rendered insurance services with administrative expense ratios that can be regarded as reasonable, although they have also risen; and

(4) have not placed their subscribers at a high level of risk by their diversification activities.

The tentative nature of these conclusions must be re-emphasized. First of all, the findings relate to historical performance only, and therefore, say little about the future. Second, the study has yet to document and examine the complete nature of the diversification activities of the two Virginia BC/BS Plans. Finally, these tentative (as well as any final) conclusions will always be subject to certain qualifications and limitations of the operational review.

TABLE II-A
1986 COMPARISON OF ACCIDENT & HEALTH ("A&H") INSURANCE PERFORMANCE CHARACTERISTICS OF DIFFERENT TYPES OF INSURERS

A&H PERFORMANCE CHARACTERISTIC	(1) TOP 50 COMMER. INSURERS	(2) BC/BS PLANS OTHER STATES	(3) BC/BS PLAN OF VIRGINIA	(4) BC/BS PLAN OF THE NCA
(1) Loss Ratio 1/:				
Mean	65.53%	92.15%	92.96%	92.16%
Stand. Dev.	20.12%	6.39%	--	--
No. of Cos.	48	67	1	1
(2) Underwrit. Ratio 2/:				
Mean	99.56%	103.93%	102.01%	105.56%
Stand. Dev.	19.05%	8.28%	--	--
No. of Cos.	48	56	1	1
(3) Net of Tax Underwriting Ratio 3/:				
Mean	95.87%	102.76%	101.69%	105.47%
Stand. Dev.	18.96%	85.48%	--	--
No. of Cos.	48	49	1	1
(4) Claim Adj. Exp. Ratio 4/:				
Mean	NC	4.71%	3.72%	7.00%
Stand. Dev.	NC	2.44%	--	--
No. of Cos.	NC	49	1	1
(5) Adm. Exp. Ratio 5/:				
Mean	NC	3.46%	3.57%	5.15%
Stand. Dev.	NC	1.52%	--	--
No. of Cos.	NC	49	1	1
(6) Solic. Exp. Ratio 6/:				
Mean	NC	1.79%	1.44%	1.15%
Stand. Dev.	NC	1.65%	--	--
No. of Cos.	NC	49	1	1
(7) Premiums Ratio 7/:				
Mean	52.48%	100.00%	100.00%	100.00%
Stand. Dev.	33.06%	--	--	--
No. of Cos.	47		1	1

TABLE II-A
1986 COMPARISON OF ACCIDENT & HEALTH ("A&H") INSURANCE
PERFORMANCE CHARACTERISTICS OF DIFFERENT
TYPES OF INSURERS

A&H PERFORMANCE CHARACTERISTIC	(1) TOP 50 COMMER. INSURERS	(2) BC/BS PLANS OTHER STATES	(3) BC/BS PLAN OF VIRGINIA	(4) BC/BS PLAN OF THE NCA
(8) Surplus Reserve Ratio 8/:				
Mean	190.11%	167.17%	72.60%	34.70%
Stand. Dev.	461.80%	174.38%	--	--
No. of Cos.	48	54	1	1
(9) Surplus Res. Days 9/:				
Mean	87.03	80.15	51.77	40.41
Stand. Dev.	138.54	52.32	--	--
No. of Cos.	48	54	1	1

1/ Defined as A&H claims incurred divided by A&H premiums earned.
2/ Defined as total A&H underwriting expenses incurred divided by A&H premiums earned.
3/ Same as 2/ but excluding all A&H taxes but income tax from total A&H underwriting expenses.
4/ Defined as A&H claims adjustment expense incurred divided by A&H premiums earned.
5/ Defined as A&H administrative expense incurred divided by A&H premiums earned.
6/ Defined as A&H soliciting expenses incurred divided by A&H premiums earned.
7/ Defined as A&H premiums earned by total premiums earned.
8/ Defined as: (a) for Commercials, [(AHAR/TAR)CS]-AHUE/12] divided by (AHOE/12); (b) for BC/BS Plans, [CS-AHUE/12] X (AHUE/12); where AHAR is A&H aggregate reserves, TAR is total aggregate reserves, CS is capital & surplus, and AHUE is A&H underwriting expense.
9/ Defined as 30 days (1+SRR) where SRR is surplus reserve ratio.

NC means not calculable given the way data are reported.

TABLE II-B
1985 COMPARISON OF ACCIDENT & HEALTH ("A&H") INSURANCE
PERFORMANCE CHARACTERISTICS OF DIFFERENT
TYPES OF INSURERS

A&H PERFORMANCE CHARACTERISTIC	(1) TOP 50 COMMER. INSURERS	(2) BC/BS PLANS OTHER STATES	(3) BC/BS PLAN OF VIRGINIA	(4) BC/BS PLAN OF THE NCA	(5) BC/BS PLAN OF SW VA
(1) Loss Ratio1/:					
Mean	64.20%	89.51%	91.38%	87.20%	98.61%
Stand. Dev.	16.69%	6.59%	--	--	--
No. of Cos.	49	69	1	1	1
(2) Underwrit. Ratio2/:					
Mean	101.83%	99.77%	99.97%	98.61%	109.55%
Stand. Dev.	16.47%	8.02%	--	--	--
No. of Cos.	49	55	1	1	1
(3) Net of Tax Under-writing Ratio3/:					
Mean	97.74%	98.79%	99.59%	98.49%	109.08%
Stand. Dev.	13.93%	8.55%	--	--	--
No. of Cos.	49	47	1	1	1
(4) Claim Adj. Exp. Ratio4/:					
Mean	NC	3.89%	4.02%	5.31%	2.87%
Stand. Dev.	NC	2.05%	--	--	--
No. of Cos.	NC	47	1	1	1
(5) Adm. Exp. Ratio5/:					
Mean	NC	3.24%	2.86%	4.92%	4.94%
Stand. Dev.	NC	1.53%	--	--	--
No. of Cos.	NC	47	1	1	1
(6) Solic. Exp. Ratio6/:					
Mean	NC	1.67%	1.33%	1.06%	2.67%
Stand. Dev.	NC	1.45%	--	--	--
No. of Cos.	NC	47	1	1	1
(7) Premiums Ratio7/:					
Mean	58.48%	100.00%	100.00%	100.00%	100.00%
Stand. Dev.	34.71%	--	--	--	--
No. of Cos.	49		1	1	1

TABLE II-B
1985 COMPARISON OF ACCIDENT & HEALTH ("A&H") INSURANCE
PERFORMANCE CHARACTERISTICS OF DIFFERENT
TYPES OF INSURERS

A&H PERFORMANCE CHARACTERISTIC	(1) TOP 50 COMMER. INSURERS	(2) BC/BS PLANS OTHER STATES	(3) BC/BS PLAN OF VIRGINIA	(4) BC/BS PLAN OF THE NCA	(5) BC/BS PLAN OF SW VA
(8) Surplus Reserve Ratio 8/:					
Mean	109.80%	183.75%	148.80%	144.70%	<40.60%>
Stand. Dev.	272.58%	174.42%	--	--	--
No. of Cos.	49	54	1	1	1
(9) Surplus Res. Days 9/:					
Mean	62.94	85.13	74.63	73.42	17.82
Stand. Dev.	81.77	52.33	--	--	--
No. of Cos.	49	54	1	1	1

1/ Defined as A&H claims incurred divided by A&H premiums earned.
2/ Defined as total A&H underwriting expenses incurred divided by A&H premiums earned.
3/ Same as 2/ but excluding all A&H taxes but income tax from total A&H underwriting expenses.
4/ Defined as A&H claims adjustment expense incurred divided by A&H premiums earned.
5/ Defined as A&H administrative expense incurred divided by A&H premiums earned.
6/ Defined as A&H soliciting expenses incurred divided by A&H premiums earned.
7/ Defined as A&H premiums earned by total premiums earned.
8/ Defined as: (a) for Commercials, [(AHAR/TAR)CS]-AHUE/12] divided by (AHOE/12); (b) for BC/BS Plans, [CS-AHUE/12] X (AHUE/12); where AHAR is A&H aggregate reserves, TAR is total aggregate reserves, CS is capital & surplus, and AHUE is A&H underwriting expense.
9/ Defined as 30 days (1+SRR) where SRR is surplus reserve ratio.

NC means not calculable given the way data are reported.

TABLE II-C
1984 COMPARISON OF ACCIDENT & HEALTH ("A&H") INSURANCE
PERFORMANCE CHARACTERISTICS OF DIFFERENT
TYPES OF INSURERS

A&H PERFORMANCE CHARACTERISTIC	(1) TOP 50 COMMER. INSURERS	(2) BC/BS PLANS OTHER STATES	(3) BC/BS PLAN OF VIRGINIA	(4) BC/BS PLAN OF THE NCA	(5) BC/BS PLAN OF SW VA
(1) Loss Ratio1/:					
Mean	64.69%	87.65%	91.00%	87.14%	91.07%
Stand. Dev.	14.81%	7.30%	--	--	--
No. of Cos.	49	64	1	1	1
(2) Underwrit. Ratio2/:					
Mean	98.38%	97.19%	97.26%	96.98%	99.48%
Stand. Dev.	10.67%	9.45%	--	--	--
No. of Cos.	49	43	1	1	1
(3) Net of Tax Under-writing Ratio3/:					
Mean	95.00%	96.22%	96.90%	96.88%	99.06%
Stand. Dev.	9.84%	11.11%	--	--	--
No. of Cos.	49	26	1	1	1
(4) Claim Adj. Exp. Ratio4/:					
Mean	NC	3.96%	2.42%	4.08%	1.60%
Stand. Dev.	NC	1.96%	--	--	--
No. of Cos.	NC	26	1	1	1
(5) Adm. Exp. Ratio5/:					
Mean	NC	2.99%	2.75%	4.75%	4.86%
Stand. Dev.	NC	1.10%	--	--	--
No. of Cos.	NC	26	1	1	1
(6) Solic. Exp. Ratio6/:					
Mean	NC	2.00%	0.73%	0.91%	1.53%
Stand. Dev.	NC	1.26%	--	--	--
No. of Cos.	NC	26	1	1	1
(7) Premiums Ratio7/:					
Mean	61.47%	100.00%	100.00%	100.00%	100.00%
Stand. Dev.	45.51%	--	--	--	--
No. of Cos.	49		1	1	1

TABLE II-C
1984 COMPARISON OF ACCIDENT & HEALTH ("A&H") INSURANCE
PERFORMANCE CHARACTERISTICS OF DIFFERENT
TYPES OF INSURERS

A&H PERFORMANCE CHARACTERISTIC	(1) TOP 50 COMMER. INSURERS	(2) BC/BS PLANS OTHER STATES	(3) BC/BS PLAN OF VIRGINIA	(4) BC/BS PLAN OF THE NCA	(5) BC/BS PLAN OF SW VA
(8) Surplus Reserve Ratio 8/:					
Mean	210.53%	144.11%	121.00%	138.10%	52.80%
Stand. Dev.	859.93%	163.82%	--	--	--
No. of Cos.	49	41	1	1	1
(9) Surplus Res. Days 9/:					
Mean	93.16	73.23	66.29	71.43	45.84
Stand. Dev.	257.98	49.15	--	--	--
No. of Cos.	49	41	1	1	1

1/ Defined as A&H claims incurred divided by A&H premiums earned.
2/ Defined as total A&H underwriting expenses incurred divided by A&H premiums earned.
3/ Same as 2/ but excluding all A&H taxes but income tax from total A&H underwriting expenses.
4/ Defined as A&H claims adjustment expense incurred divided by A&H premiums earned.
5/ Defined as A&H administrative expense incurred divided by A&H premiums earned.
6/ Defined as A&H soliciting expenses incurred divided by A&H premiums earned.
7/ Defined as A&H premiums earned by total premiums earned.
8/ Defined as: (a) for Commercials, [(AHAR/TAR)CS]-AHUE/12] divided by (AHOE/12); (b) for BC/BS Plans, [CS-AHUE/12] X (AHUE/12); where AHAR is A&H aggregate reserves, TAR is total aggregate reserves, CS is capital & surplus, and AHUE is A&H underwriting expense.
9/ Defined as 30 days (1+SRR) where SRR is surplus reserve ratio.

NC means not calculable given the way data are reported.

PART III: ORGANIZATIONAL AND BUSINESS DIVERSIFICATION

The diversification efforts of the two BC/BS Plans currently operating in Virginia began to intensify in the early 1980's, especially since 1983. These activities have involved not only vertical integration, i.e., expansion into various lines of business within the healthcare and insurance industries, but significant organizational realignments as well. The rationale for the corporate restructuring rests in a belief that competitive forces will continue to grow, posing serious challenges to the long-term survival of BC/BS Plans.

There is little doubt that the character of the healthcare industry is becoming ever more competitive. While considerable debate remains as to whether such developments are beneficial to the general public, the fact that they are occurring is undisputed. As a means of meeting the challenges of the new and evolving characteristics of the healthcare industry, BC/BS Plans in Virginia (and elsewhere) have diversified and reorganized with the stated purpose of achieving several goals. These include maintaining and regaining market share in the A&H insurance business, containing the cost of healthcare delivery, reducing the cost of providing A&H insurance, and extending business activities into healthcare related fields. For virtually any other type of enterprise, such diversification likely would be perceived as being a necessary part of a prudent business policy. For BC/BS Plans, however, this viewpoint is dampened by concerns over the potential adverse impacts of diversification on subscribers, as well as over the future role of BC/BS Plans as A&H insurers of last resort.

At issue is the question of whether BC/BS Plan subscribers are made better-off or worse-off by diversification. And, if made worse off, how much so? As the funds used to finance restructuring and new ventures are ultimately traceable to A&H insurance premiums, some risk/return trade-offs are obviously posed for subscribers. Furthermore, unlike in a typical business where potential risks are weighed against potential rewards, the former tend to be of much greater concern because of the unique role that BC/BS

Plans have played in the delivery of A&H insurance to the general public. Thus, questions abound as to the appropriate relationship between subscribers and BC/BS Plans in the ever-changing environment of the healthcare industry.

This part of the report examines the diversification and restructuring activities of the BC/BS Plans in Virginia, particularly since 1983. It also attempts to fully document the interrelationships that presently exist between the Plans and their affiliates for the purposes of identifying the potential risks (and rewards) for subscribers. Where possible, the extent of the potential risks and rewards are measured, at least in a qualitative sense.

A. BC/BS of Virginia

Of the two BC/BS Plans currently operating in Virginia, BC/BS of VA (Richmond Plan) was the first to begin its diversification program. From initial efforts dating back to 1973, BC/BS of VA has evolved into what appears as an intricate organization consisting of some 15 business entities providing a wide array of healthcare and insurance related services. Much of the business structure, as well as transactions among affiliates, are governed by various agreements setting forth the terms of corporate associations. To at least some degree, the present organization of BC/BS of VA has been influenced by the merger of BC/BS of SW VA (Roanoke Plan) in early 1986, although the merger does not appear as the major impetus.

1. Corporate Structure. BC/BS of Virginia was chartered on October 14, 1935 under the name Richmond Hospital Service Association. Its name was changed to Virginia Hospital Service Association in 1944 and to Blue Cross of Virginia in 1968. Paralleling these developments, Associated Doctors of Virginia was chartered on October 21, 1944. Its name was subsequently changed to Virginia Medical Service Association in 1945 and to Blue Shield of Virginia in 1968.

Individual BC and BS Plans were initially developed in metropolitan areas throughout the Commonwealth (e.g., Norfolk, Newport News, Lynchburg, Winchester, Roanoke, and

Richmond) for the purpose of funding the healthcare delivery system during the Great Depression. In large part, they were created by healthcare provider groups where BC Plans were managed by hospitals and BS Plans were managed by doctors. Eventually, most of the various Plans in Virginia were consolidated into either the Roanoke Plan or the Richmond Plan. On March 31, 1982, BC/BS of VA became a single company when the Richmond Blue Cross and Blue Shield Plans were combined.

BC/BS Plans have traditionally functioned as non-profit organizations, as their stated purpose was simply to finance the delivery of healthcare services to the general public. Historically, they have been exempt from many federal and state taxes, although 1986 marked a change in public policy as BC/BS Plans became subject to federal income tax requirements, as well as to some premium tax requirements in Virginia.

The first subsidiary of BC/BS of VA was created in July of 1973 when the Richmond Plan incorporated Monticello Service Agency, Inc. ("Monticello") with an initial capital investment of $50,000. The stated purpose of forming Monticello was the protection of market share, where the Company was designed to act as an agent or broker for the marketing of individual and group life insurance, disability income insurance, and prepaid health and surgical insurance. Thus, the creation of Monticello reflected an early effort to compete with commercial insurers by offering specialized insurance products. For similar reasons, the Roanoke Plan established the Cardinal Agency ("Cardinal") in April 1975 at an initial capitalization of $1,000. Monticello and Cardinal represent the only apparent efforts by BC/BS of VA to diversify during the period 1973 to 1982.

The major movement towards diversification began in 1983. Over the three year period 1983 to 1985, six subsidiaries were formed or acquired by the Richmond Plan while the Roanoke Plan created or acquired three subsidiaries. Unfortunately, diversification did little to prevent and seems to have contributed to the financial crisis of the latter.

The Computer Company ("TCC"), originally founded as a private firm in July of 1968 to process claims under government insurance programs, was acquired by the Richmond Plan in April, 1983 at a reported cost of $8,771,005. This acquisition had several purposes including: (1) retention of State of Virginia accounts; (2) creation of a regional center to operate on a multi-state basis in servicing federal government accounts; (3) achieving a synergy of the Richmond Plan's A&H expertise and the technical systems expertise of TCC; and (4) integration of a highly specialized data processing center near the Richmond Plan's corporate headquarters. TCC operates primarily as a data processing firm, largely in the handling of Medicaid claims. It also provides some data processing services to commercial firms, some of which are health related. In addition to its headquarters in Richmond, it presently operates out of offices in ten other states.

The Health Management Corporation ("HMC") was formed by the Richmond Plan in June, 1983 with an initial investment of $150,000. HMC was designed to act as a consulting arm within the corporate structure of which BC/BS of VA is a part by providing marketing and administrative services to various affiliates. One of its main functions was to serve as manager of BC/BS of VA under a contractual agreement. HMC was also created to manage other affiliates such as VaHMO, Healthkeepers, Inc., and Monticello, as well as various healthcare administration, benefit, and promotion programs.

In April of 1984, the Richmond Plan formed the Virginia Health Maintenance Organization ("VaHMO"). This company was organized as an alternative healthcare delivery system to compete with health maintenance organizations (HMO's) and preferred provider organizations (PPO's) entering the Virginia market. VaHMO trades under the name of HMO-Plus and was originally financed at a cost of $250,000.

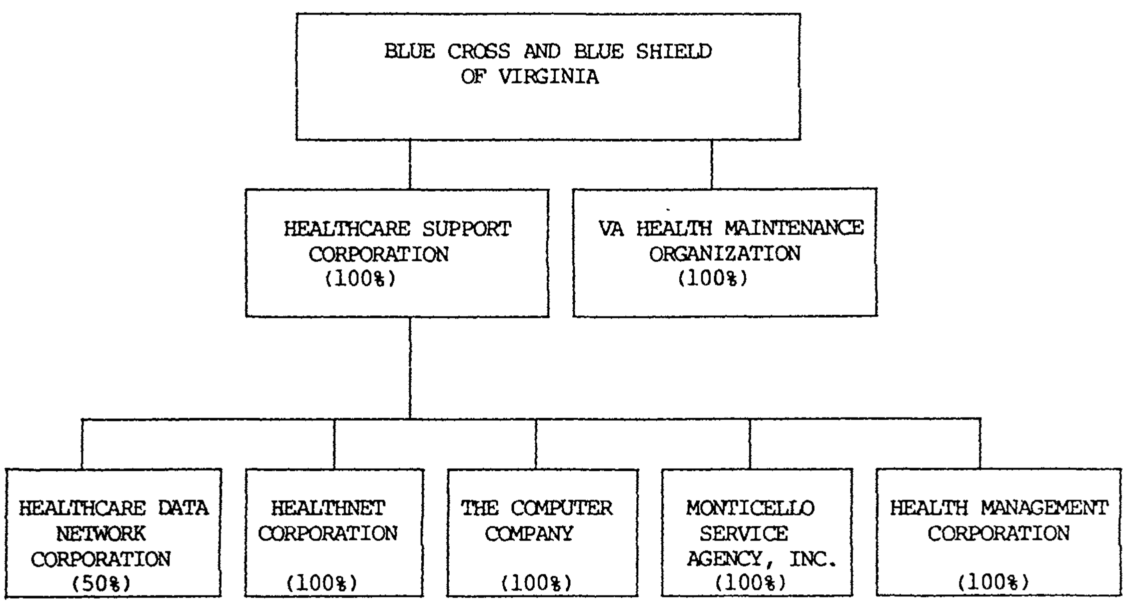
BC/BS of VA organized HealthNet Corporation ("HealthNet") in February of 1984 at a cost of $5,000,000. This company, formerly called Healthcare Information Network, Inc., was formed to facilitate the combined use of the data processing capabilities of the Richmond Plan and TCC. HealthNet was created to operate solely as an internal service company under a break-even financial target, i.e., providing data processing services to BC/BS of VA and TCC at cost. At the same time that HealthNet was created, the Richmond Plan also formed the Healthcare Support Corporation. This company was created to allow the for-profit subsidiaries of the Richmond Plan to file a consolidated tax return and, thereby, help minimize their consolidated income tax liability.

In July of 1985, the Richmond Plan participated in a joint venture (50% ownership interest at an initial cost of $290,695) known as Healthcare Data Network Corporation. The stated purpose of this organization was to develop the capability to transmit paperless claims between providers and insurance carriers. To date, this Company is still in a developmental phase.

As of the end of 1985 (i.e., prior to the BC/BS of SW VA merger), the Richmond Plan was structured as set forth in Chart III-A. As indicated, except for Healthcare Data Network Corp., all affiliates were 100% owned by the Richmond Plan on either a direct or indirect basis. The combined initial investment in subsidiaries was reported at $14,511,700. Moreover, at the close of 1985, no separate corporate distinctions were made between for-profit and non-profit entities.

CHART III-A

BLUE CROSS AND BLUE SHIELD OF VIRGINIA
PRE-MERGER ORGANIZATIONAL STRUCTURE

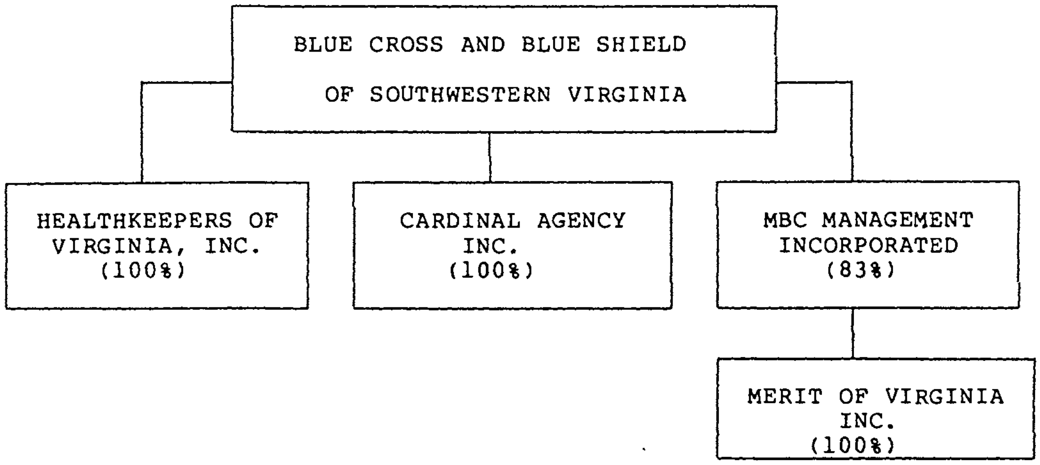


In addition to Cardinal, which had been created in 1975, the Roanoke Plan acquired a 67% interest in Merit of Virginia, Inc. ("Merit") in June of 1984. Operated as a marketing company, Merit served as the major sales arm of BC/BS of SW VA in the Tidewater region of the Commonwealth. The Roanoke Plan's initial 67% interest (and a subsequent additional 16% interest) in Merit came about through a guarantee of Merit's debt--more than $900,000. With the merger of the Roanoke Plan into BC/BS of VA in 1986, Merit was sold to its minority stockholder.

Healthkeepers of Virginia, Inc. ("Healthkeepers") was formed by the Roanoke Plan in April, 1985 at an initial capitalization of $1,000 for the purposes of operating and marketing a HMO program using the concept of experience as opposed to group rating. In the same month, the Roanoke Plan organized MBC Management, Inc. ("MBC") which was formed as a holding company to own Merit. However, neither MBC nor Healthkeepers ever became an active business entity within BC/BS of SW VA, although as early as 1984 the Roanoke Plan reported a contemplated commitment of as much as $1,000,000 of its reserves to Healthkeepers alone.

Chart III-B reflects the organizational structure of the Roanoke Plan as of year-end 1985. The initial investment in its subsidiaries is difficult to assess because of the unreported value of the guarantee of Merit's debt. In any event, it is clear that the Roanoke Plan was far less involved in diversification as compared to the Richmond Plan prior to the merger.

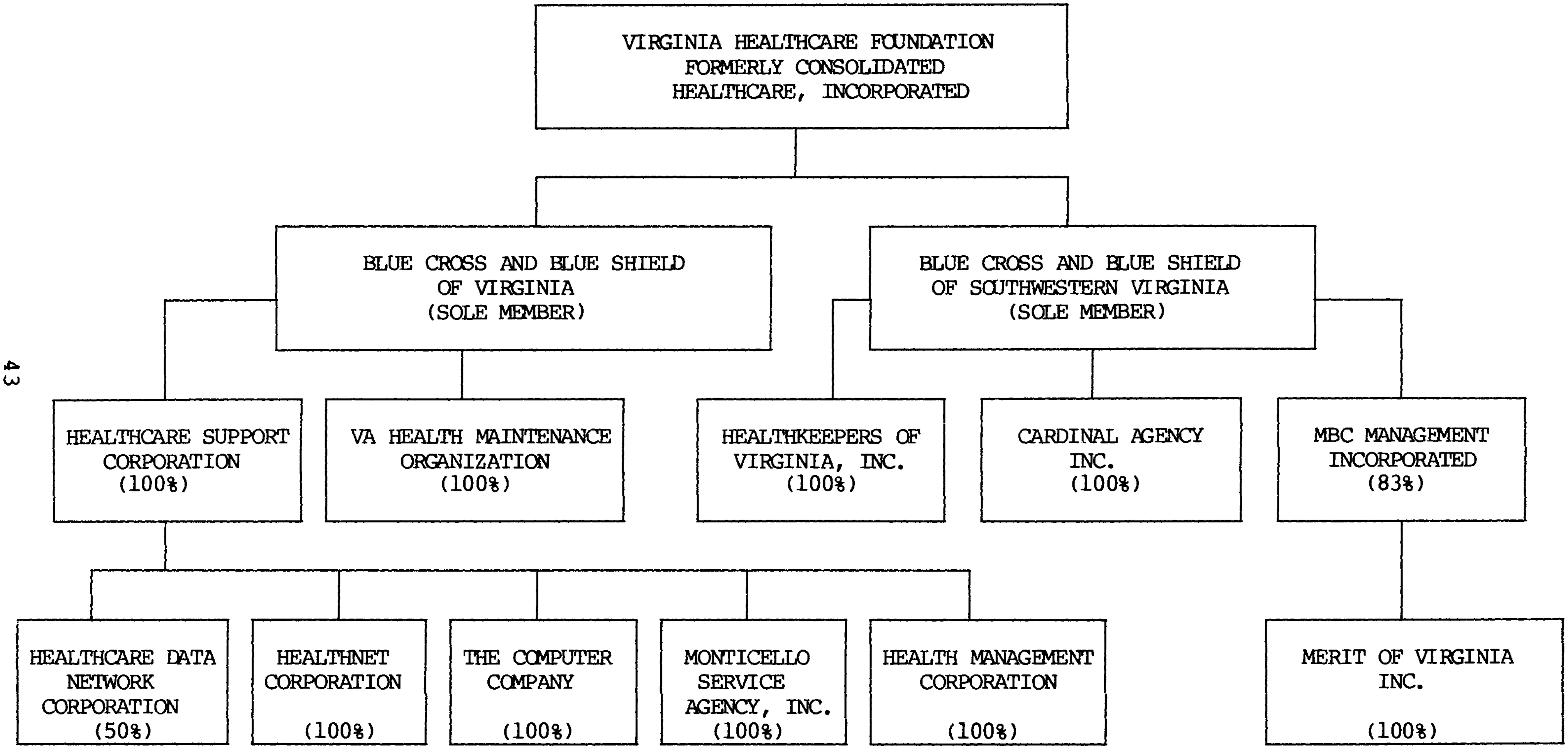
CHART III-B
BLUE CROSS AND BLUE SHIELD OF SOUTHWESTERN VIRGINIA
PRE-MERGER ORGANIZATIONAL STRUCTURE



By mid-1985, BC/BS of SW VA began experiencing severe financial troubles which prompted discussion about a potential merger with BC/BS of VA in order to prevent bankruptcy of the Roanoke Plan. In anticipation of this possibility and to fulfill other business objectives, the Richmond Plan created Consolidated Healthcare, Incorporated ("CHI") as a vehicle (a non-profit holding company) to corporately house the two BC/BS Plans on separate and distinct bases. The name of CHI was subsequently changed to Virginia Healthcare Foundation ("VHF"), although the former name was retained to serve as a for-profit entity under the umbrella of VHF at some point in the future. On February 12, 1986, the Richmond and Roanoke Plans were merged resulting in the temporary corporate structure shown in Chart III-C.

CHART III-C

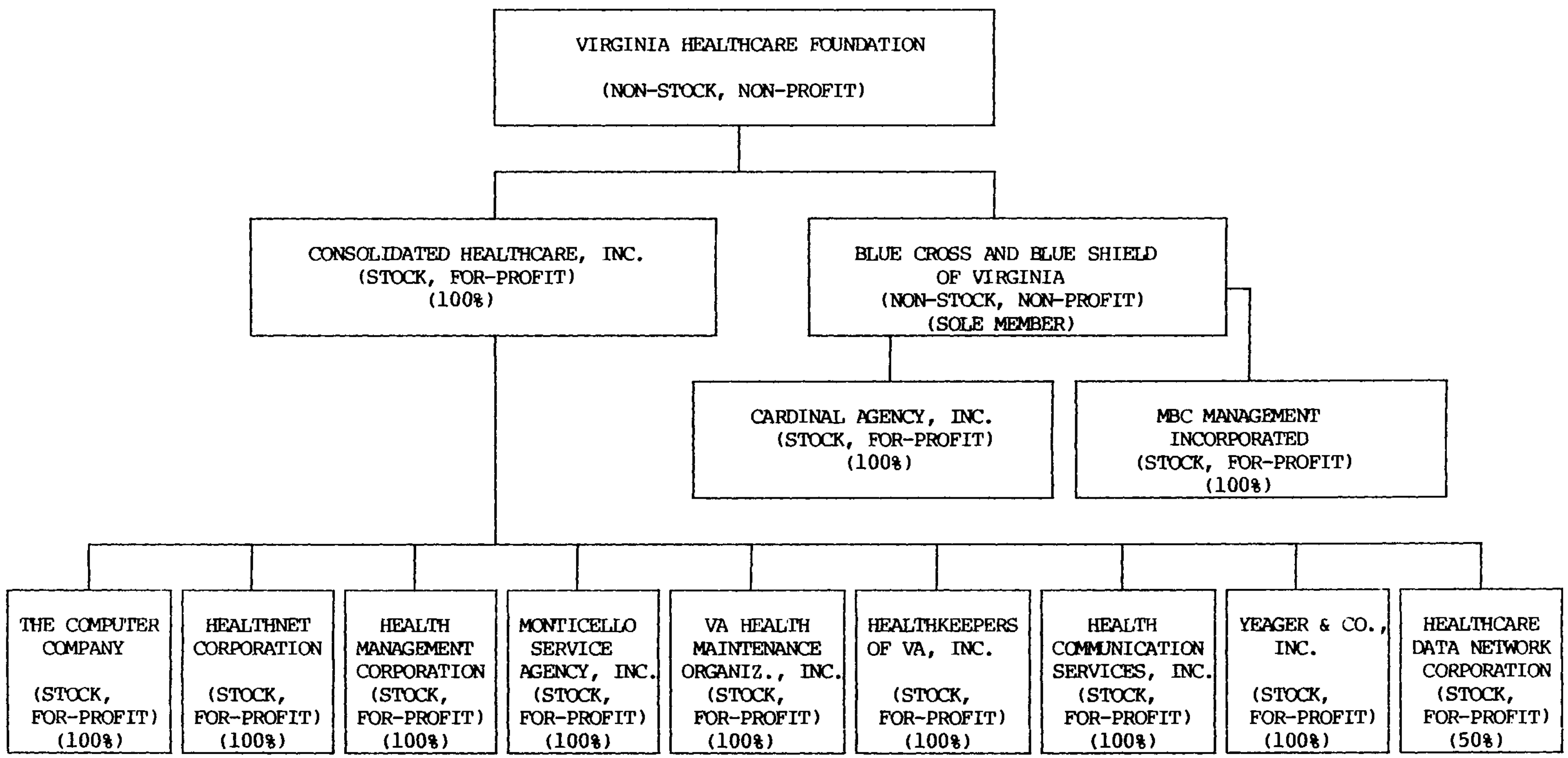
BLUE CROSS AND BLUE SHIELD OF VIRGINIA
CORPORATE STRUCTURE AFTER MERGER BUT BEFORE REORGANIZATION



As indicated in Chart III-C, except for VHF and its holding company status, the initial corporate structure of BC/BS of VA immediately after the merger was simply the amalgamation of the organizational structures of the Richmond and Roanoke Plans as they then existed. One significant difference was evident, however, doctors and hospitals were no longer member organizations of the BC/BS Plans, as VHF became the sole member. Thus, the resulting form of organization served to further distance the Richmond and Roanoke Plans from healthcare providers and, thereby, dealt with a long-standing complaint as to whether BC/BS Plans could serve the public interest while being so closely tied to healthcare providers. But simultaneously, the removal of healthcare providers as members enhanced management control.

In addition to the merger, other events were underway which would soon require changes in the structure in Chart III-C. A Virginia Supreme Court Decision (VALU Case) on January 17, 1986 upheld a State Corporation Commission finding that BC/BS Plans could not own life insurance agencies under the "similar or related" business criteria provisions of the Virginia Code which existed at that time. Moreover, the 1985 enabling legislation (Senate Bill No. 250) for the Chart III-A merger was not scheduled to become effective until July 1, 1986--long after the financial crisis of BC/BS of SW VA compelled that some form of a merger be consumated. Thus, the momentary corporate framework in Chart III-C quickly gave way to the reorganized structure in Chart III-D.

CHART III-D
BLUE CROSS AND BLUE SHIELD OF VIRGINIA
CORPORATE STRUCTURE AFTER MERGER AND REORGANIZATION

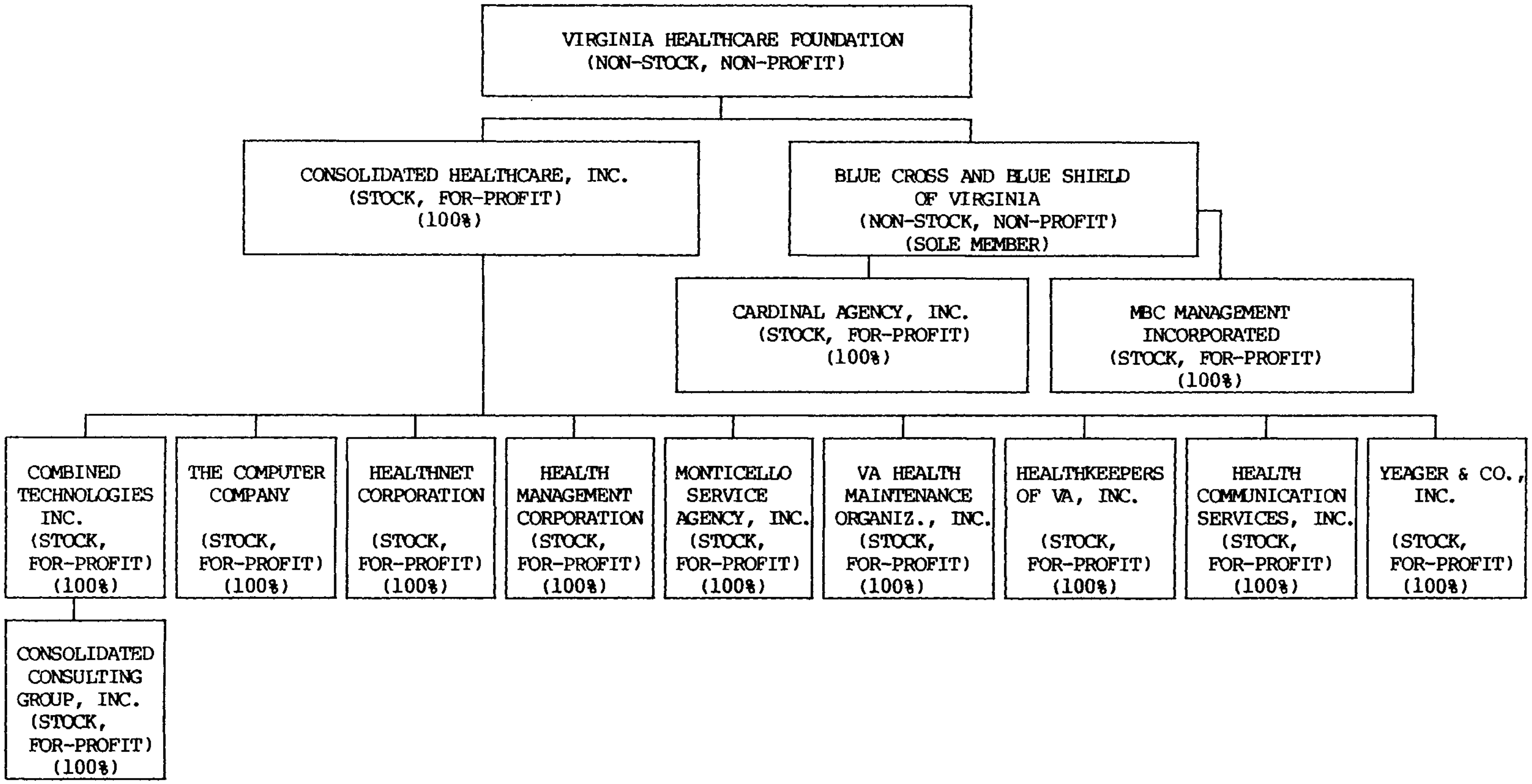


With the merger and subsequent reorganization, CHI was revitalized but as a 100% owned subsidiary of VHF responsible for all of the stock, for-profit subsidiaries that were actively operating. The Richmond and Roanoke Plans were combined into a single non-stock, non-profit company, i.e., BC/BS of VA. While Cardinal and MBC continued as direct subsidiaries of BC/BS of VA, they remained inactive (MBC) or were in the process of being dissolved (Cardinal). During the transition period, moreover, two additional affiliates were created.

Health Communication Services Incorporated ("HCS") was established in September of 1986 for the purposes of selling telecommunication links between insurers and health care providers and of developing a nationwide clearinghouse for the processing of insurance claims. Yeager & Company ("Yeager") was acquired in December of 1986 at an initial cost of $3,000,000 plus anticipated additional payments of $902,000 extending over a three year period. Yeager's primary business is the provision of third-party administrative services to organizations who choose to self-insure, particularly in the area of workers compensation.

As shown in Chart III-E, diversification activities of BC/BS of VA continued after the merger and structural reorganization. In comparing the structure in Chart III-E with that in Chart III-D, we see that Healthcare was no longer a subsidiary of CHI. While Healthcare does exist, it has ceased operations pending litigation with the other 50% stockholder. In its place, Combined Technologies, Inc. ("CTI") was created in the first quarter of 1987, along with its subsidiary Consolidated Consulting Group, Inc. ("CCG"). CTI was formed to provide specialized management services to CCG and TCC, as well as to act as liaison to various federal agencies. CCG was created to provide consulting services to BC/BS Plans elsewhere, the federal government, and industrial firms. CTI and CCG were formerly constituted as CHI's Washington, D.C. office.

CHART III-E
BLUE CROSS AND BLUE SHIELD OF VIRGINIA
MOST RECENT CORPORATE STRUCTURE



In addition to the creation of additional affiliates, the assets of Cardinal were sold to Monticello with the former continuing in the process of dissolution. MBC presently exists as a corporate entity, but on an inactive basis. Thus, as of the first half of 1987, Chart III-E reflects the evolution of a relatively simple BC/BS Plan corporate structure into a multi-dimensional and highly complex holding company.

2. Risk/Return Tradeoffs. From the standpoint of the risk posed by diversification to the subscribers of BC/BS of VA, perhaps the most significant event was the 1986 financial reorganization that accompanied the structural realignment. Specifically, in exchange for its common stock investments in various subsidiaries, BC/BS of VA received $21,650,000 of non-voting preferred stock in CHI, i.e., 216,500 shares at $100 par value. The preferred stock carries per share annual dividends (payable in semiannual installments) of $9.00 in 1986, $10.00 in 1987, $11.00 in 1988, $12.00 in 1980, $13.00 in 1990, and $15.00 thereafter. CHI is also required to begin redeeming the preferred stock in 1997 at an annual rate of 20% of the then outstanding shares. While this mandatory redemption will occur at the $100/share par value, CHI has a call option through 1990 to repurchase the preference shares but only at prices in excess of par.

The scheduled preferred dividend payments to BC/BS of VA by CHI translate into an approximate annual dividend rate of 13%. This might be viewed as a comparatively attractive rate, particularly in light of 1986 interest rates, and may have been considered as a form of future compensation for the fact that BC/BS of VA suffered losses on its investments in subsidiaries. That is, at the time that its equity interests were sold to CHI for approximately $21.6 million, BC/BS of VA reported an investment in subsidiaries of about $36 million. From the time diversification began and taking into account the merger of BC/BS of SW VA, a loss of about $14.4 million was sustained by BC/BS of VA due to its (and the Roanoke Plan's) diversified investments in subsidiaries.

In addition to the attractive dividend rate, the preferred stock relationship may have also served to reduce some of the risk of BC/BS of VA's involvement with its subsidiaries. Specifically, its financial interest became somewhat more secure because preferred stock dividends and principal would have to be paid before any distribution to common shareholders in the event of a CHI failure. Moreover, with the reorganization, CHI became a buffer between BC/BS of VA and its former subsidiaries. As noted later, however, the extent of the reduction in risk is questionable as the success of affiliates remains heavily dependent on the Richmond Plan.

Perhaps more important at this juncture is the question of whether BC/BS of VA was fairly compensated for its investments in subsidiaries. Two valuation studies were performed which indicated that $21.6 million in preferred stock with a 13% annual dividend rate was fair and reasonable given conditions which then existed. Taken on a combined basis, for example, the subsidiaries had never been profitable, losing some $10.6 million in 1984 and $5.1 million in 1985.

But at the same time, the Richmond Plan received only $21.6 million for the original $36 million invested in subsidiaries. Moreover, it is unlikely that such subsidiaries would ever have been created without the flow of funds from subscriber premiums. And, when one recognizes that losses are typical in the first few years of a new business, perhaps BC/BS of VA could have more than recouped its losses in the future had its equity interests in subsidiaries not been sold to CHI.

On the other hand, losses by subsidiaries could have continued indefinitely, further draining the reserves of BC/BS of VA. While potential rewards may have been present, downside risk and potential adverse impacts on subscribers were apparently given greater weight in determining the appropriate financial reorganization. Nevertheless, it is unclear whether subscribers will ever receive any net benefit from the diversification activities of BC/BS of VA, even though they largely financed the movement.

3. Nature of Integration. The history of diversification and structural realignments within BC/BS of VA paints an intricate picture of corporate development. To be sure, the merger of BC/BS of SW VA magnified the complexity, for it

necessitated taking on business entities which probably would not have been created. In addition, the unique historical role of BC/BS Plans as "quasi-public service" companies, i.e., subject to close scrutiny by both the General Assembly and State Corporation Commission, likely required meticulous adherence to legislative and regulatory requirements. And, as with any business embarking on an ambitious diversification program, the Richmond Plan confronted the uncertainties, if not the realities, of trial and error.

This latter fact (as well as the merger) probably explains what appear as duplications in the corporate structure, for several different subsidiaries seem to be engaged in very similar lines of business. To illustrate, TCC and HealthNet are both largely involved in data processing using some of the same resources, although the latter functions as an internal service company. HMC, Combined, and Consolidated all seem to be involved in various aspects of healthcare management consulting. More complete integration, however, may well be in BC/BS of VA's future plans, just as its present corporate structure has evolved over time with additions and deletions of business entities.

The organizational complexity is further reflected in a series of contracts and agreements governing relationships and transactions among affiliates, particularly those involving BC/BS of VA. These arrangements, moreover, are highly detailed to apparently provide some measure of "arms-length" protection for A&H insurance subscribers. This in turn, is probably the result of the regulatory and legislative scrutiny to which BC/BS of VA is subject. An illustration of such arrangements is found in the management services agreement between CHI and BC/BS of VA.

The agreement, covering the period February 12, 1985 to December 31, 1991, calls for CHI to provide BC/BS of VA with virtually all of the corporate, general, and administrative services that are typically necessary to operate a business. In addition to the requirement that BC/BS of VA make office space and other incidental assistance available (on a cost reimbursable basis), CHI is paid its fully allocated costs (direct labor, indirect labor, and corporate overhead charges) in rendering services plus a monthly management fee of 1% of the gross revenues of BC/BS of VA. The actual amount of the management fee is potentially limited, however, by the level of BC/BS of VA's contingency reserves, i.e., the fee is reduced (or even eliminated) if BC/BS of VA's reserves fall below 30 days underwriting expense--the Bureau's definition of contingency reserve. Under the terms of the agreement, furthermore, CHI can earn an additional 1% of BC/BS of VA's gross revenues if CHI "meets objective performance standards to be agreed upon by the parties".

There are also agreements between BC/BS of VA and HealthNet, HMO-Plus and BC/BS of VA, CHI and HMO-Plus, Healthkeepers and BC/BS of VA, HMC and BC/BS of VA, and TCC and BC/BS of VA. These agreements govern a wide array of services, equipment and facilities use, debt guarantees, and performance guarantees.

The corporate and financial structure of BC/BS of VA, as well as the agreements among affiliates, have not freed A&H insurance subscribers from the risk of diversification, although they have served to better define, manage, and constrain that risk. For instance, a portion of the funds which can flow to CHI from BC/BS of VA is a direct function of the contingency reserve position of the latter. Should CHI's management charges (above fully allocated costs) impinge on the contingency reserve of BC/BS of VA, contractual arrangements call for those fees to be commensurately reduced or eliminated. At the same time, BC/BS of VA no longer has equity ownership of its affiliates, but simply a preferred stock interest in CHI. Thus, BC/BS of VA not only no longer confronts the potential future equity commitments which frequently surround parent/subsidiary relationships, but it is also promised CHI preferred stock dividends at a relatively attractive rate of 13% annually.

But some risk to subscribers remains as a result of diversification. In addition to the possibility that CHI could default on its requirement to pay preferred stock dividends, BC/BS of VA continues as a guarantor of the debt and/or performance of some of its affiliates. With respect to both HMO-Plus and Healthkeepers, BC/BS of VA has guaranteed their performance, obligations, and solvency. The Richmond Plan also guarantees, to varying degrees, the performance of TCC on various government contracts by indemnifying the issuers of performance bonds against loss in the case of non-performance by TCC.

The 1986 audited financial statements of BC/BS of VA indicate that it is authorized to indemnify up to $25,000,000 in performance bonds related to Medicaid claim processing by TCC. The actual amount of indemnification was $13,052,000 at year-end 1986. The audited financial statements also acknowledge the Richmond Plan's guarantee of the performance of HMO-Plus and Healthkeepers, although the amount of the commitment is not disclosed.

4. <u>Management Control and Accountability</u>. Given the present holding company structure of which BC/BS of VA is a major part, ultimate management control and authority rests solely with VHF, a non-stock, non-profit Virginia corporation. As the sole member of the Richmond Plan, VHF elects the officers and directors of BC/BS of VA and has final approval power over virtually all corporate matters. VHF is also the sole stockholder of CHI, and consequently, has exclusive management control over the for-profit arm of the holding company system. CHI, moreover, is the major sister company of BC/BS of VA as reflected in the fact that the latter paid more than $45 million to CHI in 1986.

The President of VHF is also the President and Chief Executive Officer of CHI. The President of BC/BS of VA is also Senior Vice President of CHI. Several other members of the Board of Directors of VHF play prominent executive and/or director roles in the management of CHI, BC/BS of VA, and /or affiliated companies. In large part, accordingly, many of the same individuals oversee the operation of the Richmond Plan and its affiliates.

Unlike a holding company organized on a stock ownership basis, there is also the question of where ultimate corporate accountability rests within the structure of VHF. Perhaps (as in a private company) the absence of clear lines of accountability facilitates the development of diversification activities or even spin-offs, as there are no stockholders who might challenge management judgments. But since concern with the interests of subscribers is related to the issue of diversification, then one must query as to how subscribers are ultimately protected. Consider, for example, the question of who really owns VHF and its subsidiaries such as CHI and BC/BS of VA.

In the first instance, since VHF has no voting stock, no individual or set of individuals truly owns it although VHF is a "legal person" under the law. Moreover, as VHF is the only stockholder of CHI, the latter also is not owned by any identifiable individuals. The same is true for BC/BS of VA as VHF is its sole member. In essence, the holding company structure of which BC/BS of VA is a part is noticeably void of a separation between management and ownership despite the "public" nature of the Richmond Plan's business.

The absence of clear lines of corporate accountability poses potential risk for subscribers of BC/BS of VA. Transactions among affiliates which might fall prey to malfeasance or even misappropriation is not subject to the critical scrutiny that might otherwise prevail in alternative corporate forms. By the same token, there is no ultimate protection against poor management performance or outright efficiency as final control rests with management itself.

Of the risks posed by BC/BS of VA's diversification, the question of management accountability may be the most important. Such risk has not been significant in the past, if for no other reason than that the amount of funds placed at risk was comparatively small relative to the reserve position of the Richmond Plan. However, assuming diversification activities continue and amounts paid to CHI and affiliates by BC/BS of VA increase, management error could seriously threaten the interests of subscribers, particularly when some other management team may be in control in the future.

5. Financial Interrelationships. As the discussion earlier suggested, transactions between BC/BS of VA and its affiliates are both numerous and diverse. They consist of the provision of a multitude of services, largely to the Richmond Plan, as well as numerous debt and performance guarantees by BC/BS of VA. In large part, these transactions are governed by a series of contractual agreements.

The 1986 audited financial statements of BC/BS of VA indicate that it received $1,702,000 in preferred dividends from CHI and $2,967,000 from CHI and other affiliates for reimbursements of occupancy and other costs. Thus, the total received by BC/BS of VA from affiliates was $4,669,000 in 1986. In contrast, the Richmond Plan paid a total of $55,871,000 to affiliates 1986--a net outflow of $51,202,000. The payments made by BC/BS of VA consisted of $10,639,000 to CHI and affiliates for data processing services, $28,100,000 to CHI for cost reimbursements associated with management services provided,and $17,402,000 for service fees pursuant to the management contract between CHI and the Richmond Plan.

The net outflow of funds to affiliates in the amount of somewhat over $51 million seems large on its face. However, recall from Part II of the report that in comparison to BC/BS Plans in other states, BC/BS of VA has performed favorably in terms of its underwriting expense experience. Thus, when viewed in such a light, there is little reason to believe that the amounts being paid to affiliates are excessive. At the same time, the question remains as to whether the expenses inherent in such payments would have been lower in the absence of diversification.

The 1986 audited financial statements of CHI (and its for-profit subsidiaries) also indicate that without the management fees paid to it by the Richmond Plan, CHI would have lost money in 1986. To illustrate, CHI reported income before income taxes of $11.9 million in 1986. Without the $17.4 in management fees paid by BC/BS of VA, this figure would have been reduced to a negative $5.5 million. Thus, as they had in 1985 and 1984, the affiliates of BC/BS of VA sustained losses in 1986--at least with respect to non-affiliated transactions. The financial reorganization that subsequently accompanied the merger of BC/BS of SW VA appears to have freed subscribers of at least some of the risk associated with affiliate losses. But it is equally clear that the profitability of CHI is heavily dependent on the flow of funds from the Richmond Plan. At the present time, this dependence does not seem to have adversely impacted the underwriting performance of BC/BS of VA to any significant degree.

6. Implications for A&H Subscribers. In examining the relationship between diversification and the risk to subscribers, let us begin by considering a simple hypothetical example of the structure and purpose of a BC/BS Plan. Assume that a hypothetical BC/BS Plan has a revenue, expense, and reserve position as follows:

		AMOUNT	RATIO
(1)	Premium Income	$117 M	100.0%
(2)	Underwriting Expense	120 M	102.6%
(3)	Underwriting Income: (1)-(2)	<3 M>	<2.6%>
(4)	Investment Income	3 M	--
(5)	Net Income: (3)+(4)	0	--
(6)	Reserve	$30 M	--

As indicated, the hypothetical BC/BS Plan has premium income of $117 million and underwriting expense of $120 million, such that it sustains an underwriting loss of $3 million. This loss, however, is fully offset by the income earned (10% return) on its investment portfolio, where the latter is presumed to be exactly equal to its appropriate reserve level of $30 million. This reserve position, accumulated over the years when subscriber premiums were greater than underwriting costs, is equal to 90 days of underwriting expense, i.e., $120M/12 equals $10M or 30 days of underwriting expense, so $30M equals 90 days. If nothing were to happen in the economy, e.g., no growth, inflation, changes in interest rates, or changes in the incidence of accidents and illnesses, the hypothetical BC/BS Plan could continue as shown in perpetuity.

Suppose, however, the BC/BS Plan embarked on a diversification program requiring a capital commitment of $10 million. The funds for such an effort obviously would have to come from reserves either through a direct investment or through a guarantee of subsidiary debt. Assuming that subsidiaries were involved in ventures much more speculative than government bonds or high grade stocks, neither the direct or indirect investment could be reasonably counted as part of reserves. Thus, the reserve level of the hypothetical BC/BS Plan would decline from $30 million to $20 million or from, 90 to 60 days of underwriting expense. If 90 days is the appropriate reserve level to protect subscribers, something clearly must be done.

The decrease in reserves from $30 million to $20 million also means that investment income (at a 10% return) would decline from $3 million to $2 million. Thus, it may be necessary to take this impact into account. Given the hypothetical scenario, one recourse is to raise subscriber premiums such that the previous financial condition is restored. Such an increase may be of a gradual or an abrupt nature depending on the urgency of regaining the $30 million reserve level. In any event, if a definite reserve target is established and is to be maintained, the subscribers to the hypothetical BC/BS Plan may directly bear the risk of diversification by higher insurance premiums.

If there is no increase in premiums and the reserve target is allowed to decline, the risk of diversification is borne through the diminished ability of the hypothetical BC/BS Plan to meet its underwriting expenses. This is of little concern in the world posed in the hypothetical case, but could be cause for alarm under real circumstances. If, for example, there was 5% variance in the expected value of underwriting expenses such that they could reach $123 million instead of $117 million. An increase of this nature would further drive reserves, taking into account investment income impacts, to about $13 million or only 38 days of underwriting expenses.

In evaluating the impact of diversification on subscribers of BC/BS of VA, the extent to which such activities have led to increases (or even decreases) in premiums is unknown. This is true not only because the issue is beyond the scope of the operational review, but also because the impacts are clouded by the merger of BC/BS of SW VA. Nevertheless, as shown in Part II, BC/BS of VA has experienced an increase in its underwriting ratio and a decrease in its surplus reserve days over the period 1984 to 1986--a period of intensive diversification, corporate realignment, and financial reorganization. While the merger certainly was influential, the evidence also suggests that diversification may have adversely effected the performance of BC/BS of VA.

Recall that $36 million had been invested in affiliates by BC/BS of VA for which it received only $21.6 million in preferred stock of CHI. Recall further that the ability of CHI to meet its preferred stock obligations to BC/BS of VA is dependent on the performance of its subsidiaries and on the payments made by BC/BS of VA to CHI. In 1986, because the combined subsidiaries of CHI continued to sustain operating losses on non-affiliated operations, the preferred dividends paid by CHI to the Richmond Plan essentially came from fee payments made to BC/BS of VA to CHI. It is also true that BC/BS of VA continues to guarantee the performance and/or debt of some of its affiliates which are subsidiaries of CHI.

While diversification is likely to have had an adverse impact on subscribers, it is equally clear that such an impact has not seriously undermined the historical performance of BC/BS of VA. Rather, the Richmond Plan has continued to operate on par with BC/BS Plans in other states, even though it merged the financially troubled BC/BS of SW VA. From a historical perspective, accordingly, it is reasonable to conclude that diversification posed risk for subscribers and that such risk actually resulted in losses. At the same time, the risk of diversification was not so significant that it seriously undermined the performance of BC/BS of VA or jeopardized the interests of subscribers.

For the future, the risk of diversification will continue to prevail for subscribers of the Richmond Plan. The extent of that risk will depend on a host of factors such as the growth in diversification activities, the performance of affiliates, and the performance of BC/BS of VA itself. As a measure of the magnitude of the potential future risk, consider a worst case scenario in which the $21.6 million of CHI's preferred stock became worthless and BC/BS of VA became obligated for $25 million due to indemnification of the bonds related to the performance of affiliates. Such a worst case scenario would serve to reduce BC/BS of VA's 1986 capital and surplus by $46.6 million, from $178 million to $131.4 million. This reduced level compares to the Bureau's 1986 contingency reserve level of $103.1 million and, using the standard in Part II of the report, translates into 38 surplus reserve days. While this surplus reserve days is considerably less than the typical range of BC/BS Plans in other states, the figure is far above the "danger zone" reached by the Roanoke Plan prior to merger.

The magnitude of the impact of the worst case scenario could contract or expand as unpredictable events unfold in the future. Such a situation is further clouded by the corporate structure and attendant relationships of which BC/BS of VA is a major part. Specifically, the fact that the performance of CHI is largely dependent on the flow of funds from BC/BS of VA and the fact that clear lines of management accountability are not present, paint an uncertain future for subscribers. While the existence of agreements governing affiliate relationships and transactions moderates this concern as the agreements appear to be of an "arms-length" nature, the uncertainty is nevertheless present.

Would subscribers to BC/BS of VA be better-off without diversification? While some equivocation must also accompany the answer to this question, it would appear at this juncture in time that subscribers have benefited little from the diversification movement. Indeed, subscribers have lost at least $14.4 million in reserve level protection due to investments in BC/BS of VA affiliates. Reserves have also been undermined to some degree by the substitution of $21.6 million in CHI preferred stock for high grade securities-- preferred stock, moreover, whose dividends are dependent on the flow of funds from BC/BS of VA.

On the other hand, the extent to which diversification has helped BC/BS of VA to hold or regain market share is unknown. The same is true for the minimization of underwriting expenses. It may well be the case that without diversification, the current body of subscribers to the Richmond Plan would be confronting much higher premiums than they do presently.

B. BC/BS of the National Capital Area

The diversification program of BC/BS of NCA began somewhat later than that of the Richmond Plan. Within the last two years, however, BC/BS of NCA has aggressively expanded its scope of activity and lines of business. At the present time, its corporate structure also consists of some 15 business entities.

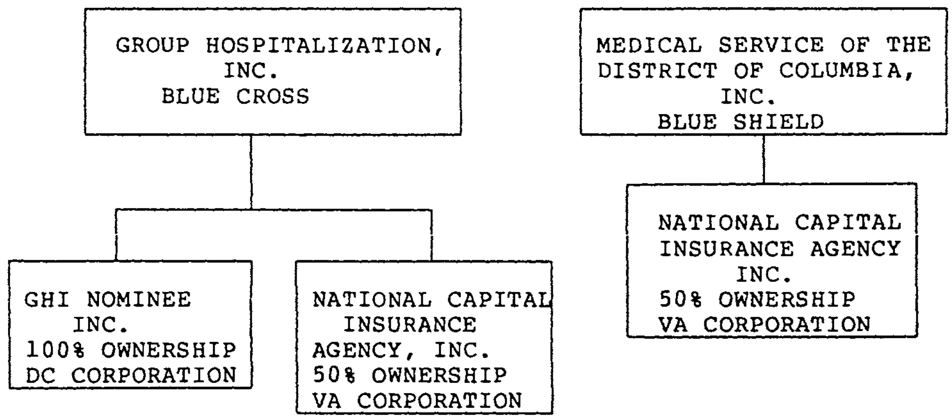
The legal form of BC/BS of NCA's corporate organization differs significantly from that of BC/BS of VA, as the former has a direct equity ownership in all of its subsidiaries--ranging from 50% to 100%. Thus, unlike the holding company of which the Richmond Plan is a part, BC/BS of NCA is the parent company. Its structure also differs because doctors and hospitals remain as members in contrast to the Richmond Plan whose only member is VHF. Aside from these differences, Virginia's two BC/BS Plans have similar involvements with respect to lines of business, intracorporate transactions, and the guarantee of the debt and/or performance of subsidiaries and affiliates.

1. Corporate Structure. Until 1985, BC/BS of NCA operated as two distinct businesses: Group Hospitalization and Medical Services, Inc. (the BC arm), and Medical Service of the District of Columbia, Inc. (the BS arm). Neither of these entities was apparently involved in diversification prior to 1978. Then, National Capital Insurance Agency, Inc. ("National") was formed with each of the BC and BS arms owning a 50% equity interest. With an initial investment of $50,000, National was formed to sell life insurance as well as accidental death and dismemberment coverage. National has subsequently received an additional $550,000 equity infusion from its parents and has had a $1 million line of credit guaranteed by BC/BS of NCA.

The other subsidiary created in the early years of diversification was GHI Nominee, Inc. ("GHI"). Formed in 1982 at an initial capital cost of $1,000 by the BC arm, this subsidiary was created to hold title to the land on which BC/BS of NCA's offices in the District of Columbia are located. The relationships among National, GHI, and their parents in the formative years of diversification are depicted in Chart III-F.

CHART III-F

BLUE CROSS AND BLUE SHIELD OF THE NATIONAL CAPITAL AREA
ORGANIZATIONAL STRUCTURE 1982



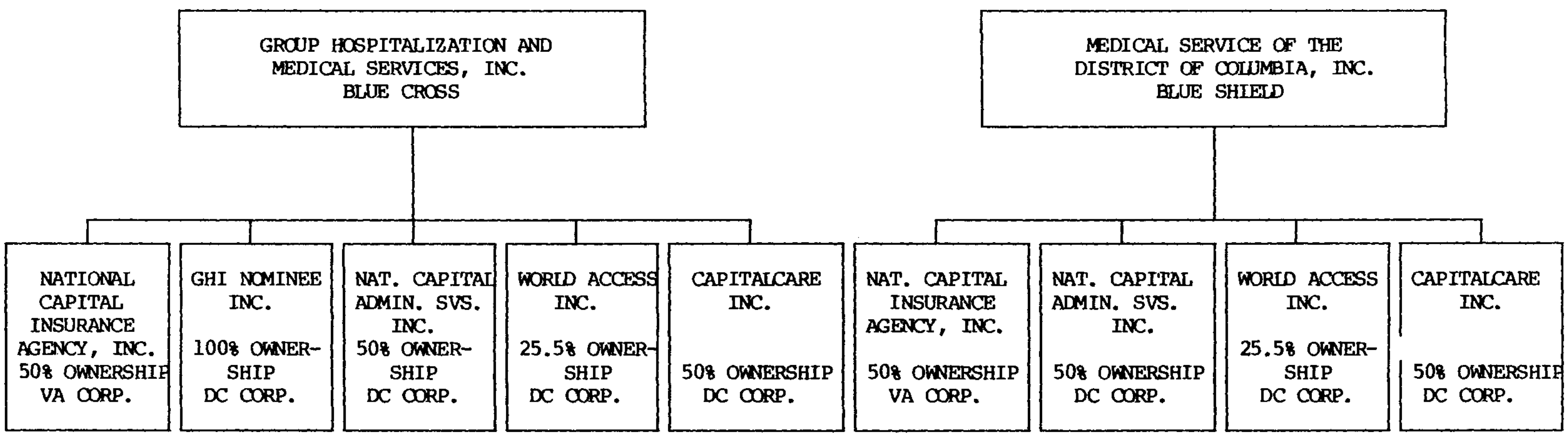
Beginning in 1983, diversification activities began to accelerate with the creation of World Access, Inc. ("World"). This subsidiary was formed to provide emergency medical transportation and medical assistance services for enrolled BC/BS subscribers traveling abroad. The initial investment in World for the BC and BS arms combined was $500,051, where the ownership share of each was 25.5%--a minority stockholder owns 49%. BC/BS of NCA presently acts as guarantor of a $3 million line of credit for World.

National Capital Administrative Services, Inc. ("NCAS") was also formed in 1983 to provide third party administrative services to employers which elect to self-fund their health care benefits program. The initial investment was $400,000, with the BC and BS arms each contributing 50%.

CapitalCare, Inc. ("CapitalCare") was formed by the BC and BS arms in 1984, each owning 50%. CapitalCare was designed to operate as a health maintenance organization and was created with an initial investment of $400,000. This subsidiary presently has a $9 million line of credit guaranteed by BC/BS of NCA. CapitalCare was the last diversification prior to the combination of the BC and BS arms in 1985. The organizational structure which then existed is shown in Chart III-G.

CHART III-G

BLUE CROSS AND BLUE SHIELD OF THE NATIONAL CAPITAL AREA
ORGANIZATIONAL STRUCTURE 1984



On January 2, 1985, the BC and BS arms (including their subsidiaries) were formally combined into a single corporate entity. That year also saw two additional subsidiaries created. Health Management Strategies International, Inc. ("HMSI") was formed to provide healthcare cost management services and hospital auditing services. The initial investment was $200,000, with a $2 million line of credit for HMSI subsequently being guaranteed by BC/BS of NCA.

At an initial cost of $25,000, International Health Benefits, Inc. was also formed in 1985 to provide internal administrative services to BC/BS of NCA's international operations.

During the first half of 1987, BC/BS of NCA formed several additional subsidiaries. Access America, Inc. ("Access") was organized with an initial 50% ownership interest investment of $400,000 accompanied by BC/BS of NCA acting as guarantor of a $2.8 million line of credit. Access markets worldwide medical services to travelers.

CapitalCare Administrative S^rvices, Inc. was formed with an initial investment of $25,000. This subsidiary provides administrative and health management services.

Professional Office Systems, Inc. was formed to market computer hardware and software to healthcare professionals. The initial investment was $400,000 and BC/BS of NCA acts as guarantor on a $2 million line of credit.

Protocol is a partnership formed to serve as an agent for BC/BS of NCA in making available preferred provider and managed healthcare products to the diplomatic and international community. The initial investment was $100,000 with a guaranteed $498,000 line of credit.

GHMSI Partnership, Inc. was formed with an initial investment of $25,000 and acts as a holding company for joint ventures.

GHMSI Companies, Inc. was formed via a transfer of stock and acts as a holding company for the stocks of wholly-owned subsidiaries.

Finally, Emtrust was organized in 1987 with an investment cost (50% interest) of $200,000. Emtrust conducts a general insurance agency business and provides administrative and other services to companies offering indemnity, prepaid health, and other insurance products.

The most recent (as of June 30, 1987) organizational structure of BC/BS of NCA is shown in Chart III-H. As indicated, BC/BS of NCA directly or indirectly owns at least 50% of each of its 14 subsidiary companies.

The total initial investment in subsidiaries was $2,726,051, with an additional equity infusion of $550,000. BC/BS of NCA has also guaranteed lines of credit for certain subsidiaries totaling $20,298,000. As of June 30, 1987, $14,481,000 was outstanding on these credit lines.

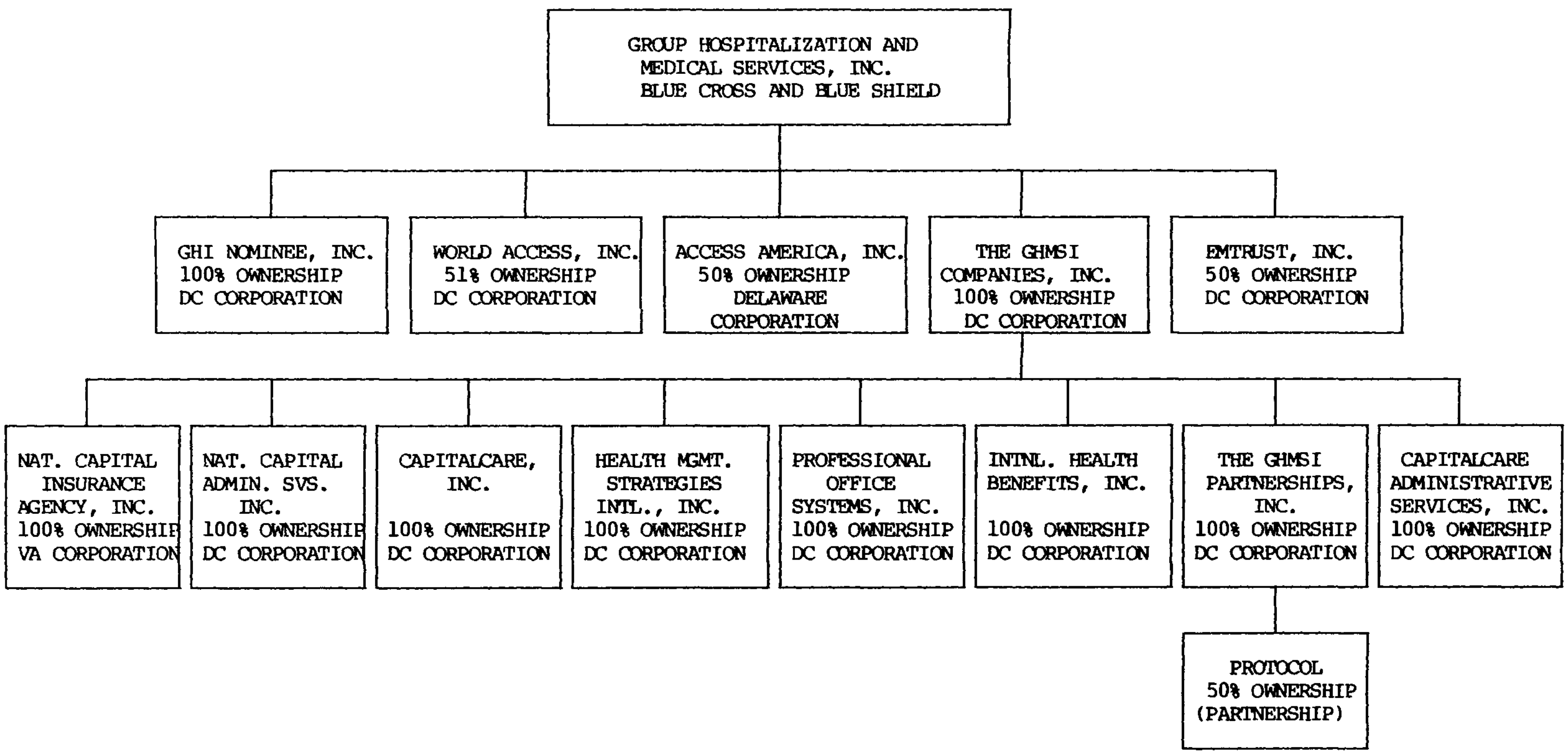
2. Risk/Return Tradeoffs. The risk posed by diversification to subscribers is represented by the equity investments and debt guarantees made by BC/BS of NCA on behalf of its subsidiaries. As indicated above, equity financing totals $3.3 million while debt guarantees total $20.3 million.

The diversification activities of BC/BS of NCA are of a comparatively recent origin. As such, it is not surprising that start-up costs and early operating losses tend to dominate the financial experience of subsidiaries. According to BC/BS of NCA's audited financial statements, the subsidiaries experienced combined losses of $5,422,000 in 1985 and $7,343,000 in 1986. In addition, the statements portray a 1986 combined negative equity position for the subsidiaries of $12,952,000. Such results strongly suggest that the diversification efforts of BC/BS of NCA have yet to produce any positive financial benefit for its A&H subscribers.

The extent to which the financial condition of subsidiaries will improve (or worsen) is a matter which is beyond the scope of this study. Results to date have not been

CHART III-H

BLUE CROSS AND BLUE SHIELD OF THE NATIONAL CAPITAL AREA
MOST RECENT ORGANIZATIONAL STRUCTURE



encouraging as the amount of loss due to subsidiary operations rose between 1985 and 1986. If this should continue, subscribers are likely to bear an increased burden in terms of reductions in A&H insurance reserves, if not an increase in premiums. On the other hand, should the activities of subsidiaries turn profitable, the converse could be true.

3. Nature of Integration. The corporate structure of BC/BS of NCA is much simpler than that of BC/BS of VA in one major respect. Specifically, BC/BS of NCA directly owns its interests in subsidiaries, whereas BC/BS of VA has only an affiliate interest due to the holding company structure of which it is a part. On the one hand, it might be said that subscribers have a more direct influence on the activities of subsidiaries under the corporate structure of BC/BS of NCA. At the same time, however, there is a more direct link between the performance of subsidiaries and the interests of subscribers such that there is a more limited insulation against risk.

Aside from this important structural difference, the nature of diversified activities are similar, except perhaps for BC/BS of NCA's involvement in ventures of an international character. There also appears to be duplication within the corporate framework, as several subsidiaries are involved in similar lines of business. Of course, as diversification is a comparatively recent phenomenon, the duplication may simply reflect a snapshot of a process yet to fully evolve. It is also true that redundancy may make it easier to close or spin-off a subsidiary.

4. Management Control and Accountability. As the owner of its subsidiaries, BC/BS of NCA is presumably in a position to exert direct management control over their operations. In turn, to the extent that subscribers can influence the parent company, they may have some indirect control over the activities of subsidiaries.

On the other hand, BC/BS of NCA is also a non-stock, non-profit corporation. As a result, the question is again posed as to where corporate accountability ultimately rests with respect to the operations of subsidiaries. While BC/BS of NCA similarly operates under a system whereby transactions among affiliates are governed by formal policies (although not to the contractual extent relied upon by BC/BS of VA), one must query as to how subscribers are ultimately protected against management inefficiency or imprudence.

The level of diversification does not appear to have resulted in a significant burden for subscribers, at least up to this point in time. This is true because subsidiary losses to date are comparatively small relative to the reserve position of BC/BS of NCA. By the same token, a continuation of diversification activities that produce losses and place increasing amounts at risk are sure to threaten the interests of subscribers, whether such events result from unanticipated market conditions or management error.

5. Financial Interrelationships. Transactions between BC/BS of NCA and its subsidiaries are numerous and involve substantial sums. They do not, however, approach the levels found in transactions between BC/BS of VA and its affiliates.

As of June 30, 1987, BC/BS of NCA was owed a net of $9,136,782 by its subsidiaries. From the perspective of BC/BS of NCA, this consisted of accounts receivable of $8,989,273, loans receivable of $900,000, and accounts payable of $752,491. The net amount of $9.1 million due from subsidiaries was in addition to the $20.3 million in line of credit guarantees and $3.3 million in equity investments made by BC/BS of NCA on behalf of its subsidiaries.

6. Implications for A&H Subscribers. Over the period 1984 to 1986, the diversification activities of BC/BS of NCA increased significantly. Losses in subsidiary operations also rose. Moreover, this was a period (as shown in Part II of the report) when BC/BS of NCA's underwriting ratio increased and its surplus reserve days declined. While the performance of BC/BS of NCA remained comparable to that of BC/BS Plans in other states, some deterioration was evident. The decline, however, was not so significant that it seriously jeopardized the interests of subscribers. For

example, its surplus reserve days was nowhere near the "danger zone" of the Roanoke Plan prior to its collapse.

At the same time, it is equally clear that subscribers did bear some risk during this period. To illustrate, the combined equity position of the subsidiaries stood at a negative $13 million in 1986. This, coupled with initial investments in subsidiaries of $3.3 million, means that the effective loss to subscribers was $16.3 million through 1986 as a result of BC/BS of NCA's diversification activities. Thus, without substantial evidence to the contrary, it also appears fair to say that subscribers would have been better-off without diversification.

As for the future, the performance of BC/BS of NCA and its subsidiaries will be subject to the same type of uncertain events that will impact the Richmond Plan. While forecasts of the future are beyond the scope of this operational review, it is again useful to consider a worst case scenario. If BC/BS of NCA were to lose the net amount of $9.1 million due from subsidiaries as of mid-1987 and were to become obligated for the $20.3 million in guaranteed lines of credit, its 1986 capital and surplus would decline from $107.3 to $77.9 million. This translates into 29.3 surplus reserve days which is lower than the Bureau's 30 day contingency reserve level--although BC/BS of NCA is not legally subject to that requirement. Nevertheless, under conditions where the reserve level was at or near such a hypothetical point, one might reasonably conclude that diversification had exposed subscribers to undue risks.

It is possible, however, that subsidiaries will soon turn profitable. And, further, that diversification has enabled BC/BS of NCA to retain business that it otherwise would have lost. But such a showing would have to be substantial in order to offset the evidence on diversification to date.

PART IV: SUMMARY AND FINDINGS

Focusing on the period 1983 to 1986, this operational review has considered a number of issues regarding the relationship between the diversification activities of Virginia's BC/BS Plans and their performance as A&H insurers. In large part, concerns as to whether such activities in the past served to seriously undermine the interests of subscribers have been alleviated. For the future, however, no such definitive statement can be made, for that will depend on events yet to unfold. Perhaps the uncertainty about the future relationship between diversification and performance is significant in and of itself, as it reflects the fact that risk will continue to confront subscribers to Virginia's BC/BS Plans. The nature and level of that risk, however, is presently indeterminable.

A. Overview of the Issues

BC/BS Plans in the Commonwealth have embarked on extensive programs of diversification. These programs, largely implemented since 1983, consist not only of vertical integration into healthcare and insurance related lines of business, but corporate realignments and financial reorganizations as well. With respect to both BC/BS Plans currently operating in Virginia, business structures that were once comparatively simple have been transformed into multi-tiered parent/subsidiary affiliations.

The diversification activities have sparked considerable debate as to the appropriate role of BC/BS Plans in the healthcare delivery and insurance industries. BC/BS Plans claim that diversification and corporate restructuring are necessary to meet competitive challenges inherent in the changing nature of the healthcare system. Countering are those who believe that the unique role of BC/BS Plans in providing A&H insurance is largely insulated from economic change. And, even in recognition of the beneficial aspects of diversification, the attendant risks to subscribers are too significant.

In the Commonwealth, concern over the various diversification issues has been heightened by the financial insolvency of BC/BS of SW VA in 1985. Prior to its financial crisis and subsequent 1986 merger into BC/BS of VA, the Roanoke Plan had begun a diversification program along with aggressive and highly competitive marketing strategies. Within a relatively short timespan, these policies appear to have contributed to the downfall of BC/BS of SW VA.

B. Study Directives

Public concern and the course of events prompted the 1987 Virginia General Assembly to pass House Joint Resolution 284. This legislative action called for the Bureau to conduct a study of the operating performance and diversification activities of the two BC/BS Plans currently doing business in the Commonwealth. To assist in meeting the study requirements of the General Assembly, the Bureau retained the Consultant to perform an operational review of BC/BS of VA and BC/BS of NCA.

In accordance with instructions from the Bureau, the Consultant has analyzed five criteria for each of the two BC/BS Plans:

(1) the percentage of subscribers' premiums devoted to administrative expense;
(2) the amount of reserves;
(3) the adequacy, inadequacy, or excessiveness of reserves;
(4) the amount of investment by each Plan in its subsidiaries; and
(5) the degree of risk of these investments to each Plan's subscribers.

In conducting the study, the Consultant was further instructed to compare, where appropriate, the operating and reserve performance of Virginia's BC/BS Plans with those of BC/BS Plans in other states and those of commercial A&H insurers licensed to do business in the Commonwealth. The ultimate purpose of the study is to determine whether subscribers are exposed to unreasonable expense or undue risk as a result of the diversification activities of Virginia's BC/BS Plans.

C. Scope and Limitations

The operational review conducted by the Consultant essentially consists of analyses in two areas. First is the question of how well (or how poorly) BC/BS Plans in Virginia have historically performed relative to other A&H insurers. A favorable showing in this regard, despite the extent or results of diversified activities, indicates that diversification has not significantly undermined the interests of subscribers.

The second question has three dimensions: (a) the extent to which subscribers have actually borne the risks of diversification; (b) whether subscribers would have been better-off without diversification; and (c) whether diversification in the future will pose an unreasonable expense or undue risk burden for subscribers.

The present study addresses each of the above issue areas, although with certain qualifications. The operational review performed by the Consultant is not a financial or a management audit, for the demands of those types of studies go well beyond the scope of the present effort. This distinction is important because intracorporate relationships within each of Virginia's BC/BS Plans consist of numerous transactions among affiliates involving substantial sums. The present study accepts the flow of funds among affiliates as they exist without questioning the necessity for the services provided or the accuracy and reasonableness of the amounts involved.

The operational review also has not investigated the question of whether diversification has enabled BC/BS Plans in the Commonwealth to maintain business they might otherwise have lost or to gain business they might otherwise not have attracted. This is also important since such positive benefits, to the extent they exist, would effectively serve to offset diversification losses.

D. Findings With Respect to BC/BS of VA

Of the two BC/BS Plans under study, the Richmond Plan has evolved into the most intricate corporate organization. BC/BS of VA now functions within a holding company structure, where for-profit affiliates are involved in data processing, workmen's compensation insurance, healthcare cost management, health maintenance organizations, and a variety of other lines of business. The merger of the Roanoke Plan in early 1986 clearly contributed to the complexity of the corporate structure, but it does not appear to have been the prime mover since diversification plans were underway prior to that time. Diversification into for-profit lines of business, however, has not yet proved to be profitable.

The holding company structure of which BC/BS of VA is a major part takes a unique form, as there are no definitive lines of ultimate management accountability. That is, the parent of the Richmond Plan (i.e., VHF, which operates on a non-stock, non-profit basis) has no stockholders or owners, but it and its management nevertheless completely control all for-profit and non-profit subsidiaries. Accordingly, as there is a noticeable absence of a separation between ownership and management, VHF functions more like a private than a public company. But at the same time, VHF is not privately owned.

The present holding company structure serves, however, to more clearly distinguish the Richmond Plan from its corporate affiliates. Within the VHF umbrella, CHI oversees all activities of for-profit subsidiaries. There are, moreover, a series of contractual agreements which govern transactions and the flow of funds among affiliates, particularly those which involve BC/BS of VA. These agreements are cast in an "arms-length" framework, although no tests have been made by the Consultant as to the reasonableness of the attendant dollar flows.

Despite the merger of the financially troubled Roanoke Plan, extensive diversification and restructuring, and the fact that VHF's for-profit subsidiaries have yet to be profitable, BC/BS of VA has performed in a comparable manner to other A&H insurers, particularly in relation to BC/BS Plans in other states. In fact, performance has been superior in some instances. Specifically, for the period 1984 to 1986, the Consultant has found with respect to the Richmond Plan that:

(1) its administrative expense as a percent of subscriber premiums has been equivalent to or lower than the average of BC/BS Plans in other states;

(2) its other expenses (i.e., claim adjustment and soliciting) as a percent of subscriber premiums has been equivalent to or lower than the average of BC/BS Plans in other states;

(3) its payment of benefits (claims or losses) on behalf of subscribers as a percentage of subscriber premiums has been equivalent to or higher than the average of BC/BS Plans in other states;

(4) its total underwriting costs (claims and expenses) as a percentage of subscriber premiums has been equivalent to or lower than the average of BC/BS Plans in other states; and

(5) its reserve level has been comparable (neither inadequate nor excessive) to that of BC/BS Plans in other states.

Based on these findings, it is fair to conclude that diversification has not adversely affected subscribers in a material manner in the past. This is true because subscribers to the Richmond Plan confronted the same expense and reserve conditions as their counterparts in other states. There are, however, several important aspects of this conclusion.

First, to the extent that some BC/BS Plans in other states are also involved in diversification, it might be claimed that the comparisons made by the Consultant are too biased to be useful. Analyses of the data indicate, however, no such significant degree of bias. This is true because underwriting costs of BC/BS Plans in other states have not only remained relatively stable (there has been some increase), but there is a comparatively small degree of variability of such costs within BC/BS Plans generally. Thus, with or without diversification, BC/BS Plans tend to be similar in many respects.

Second, in recognition of the fact that commercial A&H insurance is an alternative for subscribers, consider how the performance of commercial carriers compares to that of BC/BS Plans. While total underwriting costs as a percentage of subscriber premiums are not significantly different (i.e., roughly in the neighborhood of 100%), BC/BS Plans devote a considerably larger percentage of the premium dollar to the payment of benefits (about 90%). The comparable figure for commercial A&H insurers is about 65%. Accordingly, BC/BS subscribers appear to have received more benefits per dollar of premiums than they would have received with a commercial A&H policy. This is equally true for Richmond Plan subscribers.

Third, while the reserve level of the Richmond Plan can be viewed as comparable to that of BC/BS Plans in other states within a reasonable range, it has fallen over the study period to the point where the 1986 reserve level was about 65% of the average of other BC/BS Plans. The decline was primarily caused by the merger of BC/BS of SW VA, although losses sustained in diversification activities was also a contributing force. This is reflected in the fact that the reserve level of the Roanoke Plan in 1985 (just prior to the merger) was only about 21% of the average of other BC/BS Plans, as compared to more than 88% for the Richmond Plan. Diversification losses of about $14.4 million, as reflected in the sale of BC/BS of VA's $36 million investment in subsidiaries for $21.6 million in CHI preferred stock, further contributed to the decline in the reserves of the Richmond Plan. Nevertheless, the 1986 reserves of BC/BS of VA were far from the dangerously low level of the Roanoke Plan during its financial crisis.

Fourth, although it clearly cannot be said that subscribers to the Richmond Plan have borne unreasonable expense and/or undue risk, it also appears that they would have been better-off without diversification. The loss of $14.4 million, reflected in the transaction with its CHI affiliate, supports this inference. The demise of the Roanoke Plan, the costs of which are being borne by BC/BS of VA, was to some degree influenced by an attempt at diversification. And, while the structural and financial realignments under the umbrella of VHF have altered (if not reduced) the risk to subscribers, the potential for realizing the benefits of diversification have been virtually eliminated. This is true despite the fact that subscriber funds were used to fund the initial cost of diversification.

Finally, whether subscribers of BC/BS of VA might bear unreasonable expense or undue risk in the future as a result of diversification remains an open question. On the one hand, subscribers are better insulated from such a potential due to the present holding company structure of VHF. They are also afforded protection by the agreements governing transactions between BC/BS of VA and its affiliates. On the other hand, no tests of the reasonableness of the flow of funds to and from affiliates have been made. Moreover, the subsidiaries of CHI have continued to sustain losses such that CHI's ability to make preferred dividend payments to BC/BS of VA is heavily dependent on the management fees paid by BC/BS of VA to CHI.

The Consultant's equivocation about the future is perhaps more understandable if placed in an analogous context. In 1984 and even in much of 1985, few would have predicted that the Roanoke Plan was doomed to failure. Prospects, in fact, looked bright, as diversification and new marketing approaches portrayed an aggressive business posture. Events, however, held a different fate. This is not to suggest that BC/BS of VA might be subject to similar forces, but only that a careful assessment of the historical information considered in the operational review does not provide a clear insight into the future.

E. Findings With Respect to BC/BS of NCA

Unlike the Richmond Plan, BC/BS of NCA operates under a corporate structure whereby it has direct ownership of its subsidiaries, i.e., it has no affiliates such as those which exist in the holding company structure of which BC/BS of VA is a part. Nevertheless, BC/BS of NCA's diversification activities have paralleled those of BC/BS of VA and, similarly, have not yet proved to be profitable.

The direct ownership organizational framework has a potential disadvantage relative to a holding company structure in that the BC/BS Plan entity is not separately distinguishable and, therefore, has limited insulation from the activities of for-profit subsidiaries. Of course, depending on the true nature of intracorporate transactions, this difference simply may be one of form rather than substance.

Despite the fact that BC/BS of NCA's for-profit subsidiaries have not yet become profitable, it has performed in a manner comparable to other A&H insurers, particularly in relation to BC/BS Plans in other states. Specifically, for the period 1984 to 1986, the Consultant has found with respect to BC/BS of NCA that:

(1) its administrative expense as a percent of subscriber premiums has been on par with that of BC/BS Plans in other states, although on the high side of the comparison;

(2) its other expenses (i.e., claim adjustment and soliciting) as a percent of subscriber premiums has been on par with that of BC/BS Plans in other states, although on the high side of the comparison for claim adjustment and the low side of the comparison for soliciting;

(3) its payment of benefits (claims or losses) on behalf of subscribers as a percentage of subscriber premiums has been equivalent to the average of BC/BS Plans in other states;

(4) its total underwriting costs (claims and expenses) as a percentage of subscriber premiums has been equivalent to the average of BC/BS Plans in other states; and

(5) its reserve level has been on par (neither inadequate nor excessive) than than of BC/BS Plans in other states, although on the low side of the comparison, particularly in 1986.

Worthy of note here is the fact that BC/BS of NCA's expense levels showed rather sharp increases in 1986, while its reserve level declined in an equally sharp manner. Coincidentally, 1986 was a year when diversification activities began to accelerate. Nevertheless, the expense and reserve levels of BC/BS of NCA have remained within the range experienced by BC/BS in other states and have not approached the levels exhibited by the Roanoke Plan during its financial crisis.

The above findings lead the Consultant to conclude that diversification did not adversely effect BC/BS of NCA subscribers during the study period. The qualifications surrounding this conclusion, however, are the same as those discussed with respect to BC/BS of VA. They are, perhaps, even more relevant because the performance of BC/BS of NCA, as compared to BC/BS Plans in other states, was not as favorable as that of the Richmond Plan. In 1986, for example, BC/BS of NCA had an underwriting ratio of 106% as compared to 104% for BC/BS Plans in other states and 102% for the Richmond Plan. At the same time, it had 40 surplus reserve days in comparison to the 1986 levels of 52 for BC/BS of VA and 80 for BC/BS Plans in other states. Thus, a continuation or expansion of diversification losses could further worsen its comparative performance to the point where subscriber interests might be seriously threatened.

SECTION III

PERFORMANCE AND DIVERSIFICATION OF THE BLUE CROSS/BLUE SHIELD PLANS IN VIRGINIA: AN OPERATIONAL REVIEW - UPDATE THROUGH SEPTEMBER 30, 1987

PERFORMANCE AND DIVERSIFICATION OF THE BLUE CROSS/BLUE SHIELD PLANS IN VIRGINIA:

AN OPERATIONAL REVIEW UPDATE THROUGH SEPTEMBER 30, 1987

PREPARED FOR
BUREAU OF INSURANCE
VIRGINIA STATE CORPORATION COMMISSION

PREPARED BY
TECHNICAL ASSOCIATES, INCORPORATED

JANUARY, 1988

PERFORMANCE AND DIVERSIFICATION OF THE
BLUE CROSS/BLUE SHIELD PLANS IN VIRGINIA:
AN OPERATIONAL REVIEW
UPDATE THROUGH SEPTEMBER 30, 1987

I. INTRODUCTION

In October of 1987, Technical Associates, Incorporated ("Consultant") completed an operational review ("Initial Report") of Blue Cross/Blue Shield of Virginia ("BC/BS of VA") and Blue Cross/Blue Shield of the National Capital Area ("BC/BS of NCA") for the period 1984-86. The five-month study, conducted for the Virginia State Corporation Commission's ("Commission") Bureau of Insurance ("Bureau") pursuant to House Joint Resolution 284 of the 1987 Virginia General Assembly, focused on the expense, underwriting, and reserve performance of the two BC/BS Plans currently operating in the Commonwealth, particularly in relation to their diversification activities.

In its Initial Report to the Bureau, the Consultant found that the diversification activities of Virginia's BC/BS Plans had not exposed subscribers to unreasonable expense and/or undue risk in the 1984-86 historical period studied. At the same time, however, performance trends in terms of continuing diversification losses, rising underwriting expenses, and declining reserve levels were not encouraging. Accordingly, the Consultant concluded that its historical findings need not hold in years after 1986, especially in the case of BC/BS of NCA.[1]/

In view of the concerns raised by the Consultant and the fact that the performance data used in the Initial Report only covered through the end of 1986 due to the information available at the time the study was being conducted, the Commission determined that the Initial Report should be updated for the nine months ending September 30, 1987, i.e.,

1/ The Executive Summary and Part IV of the Initial Report discuss in detail the Consultant's findings.

3rd/Q-1987. The update would serve to provide both the Commission and the General Assembly with more current information in evaluating the performance and reserve positions of the Commonwealth's two BC/BS Plans. Subsequent to the Commission's determination in December of 1987, the Consultant began collecting the data necessary to update its Initial Report.

II. SCOPE AND LIMITATIONS

Because of severe time constraints (e.g., to allow for Commission review and to meet the 1988 session of the General Assembly), the Initial Report could not be updated in all respects. Consequently, decisions were made by the Consultant (with the Commission's concurrance) to update the most critical parts of the Initial Report to the extent possible. At first, this involved an update of the information in the Initial Report for Virginia's two BC/BS Plans through the 3rd/Q-1987. Given the pressures of time, it would have been impossible to collect the necessary information for commercial A&H insurers and BC/BS Plans in other states using the same procedures employed in preparing the Consultant's initial operational review.

However, when notified that an update of the Initial Report was being prepared, BC/BS of VA volunteered to collect as much 1987 information as possible regarding the performance of BC/BS Plans in other states. BC/BS of VA requested that an updated evaluation of the performance of Virginia's BC/BS Plans be made in relation to BC/BS Plan performance elsewhere, as was done in the Initial Report. Under the proviso that the necessary data would be collected quickly and provided to the Consultant within a certain time schedule, the Bureau accepted BC/BS of VA's request.

The information was gathered and provided to the Consultant in a timely manner by Coopers & Lybrand, the CPA firm which audits BC/BS of VA's financial statements. As the Consultant had experienced in preparing its Initial Report, it appears that Coopers & Lybrand had some difficulty in collecting information regarding the performance of BC/BS

Plans in other states[2]. This included: (1) some BC/BS Plans are not required to file quarterly statements with state insurance authorities or, for those who are subject to such a requirement, 3rd/Q-1987 filings had not yet been made or would not be released by state insurance authorities; (2) quarterly statements are filed by some BC/BS Plans with state insurance authorities on a generally accepted accounting principles ("GAAP") basis rather than on a statutory accounting principles ("SAP") basis; and (3) filed information, whether on a GAAP or SAP basis, was not complete relative to the data used in the Consultant's Initial Report, e.g., data regarding the payment of taxes, licenses, and fees, and data regarding the separation of expenses into claims adjustment, administrative, and soliciting often are not available on a quarterly basis.

It should also be noted that information reported to state insurance departments by BC/BS Plans on a quarterly (SAP) basis differs in a qualitative sense from that reported on an annual year-end (SAP) basis. This qualitative difference reflects the fact that as with most businesses, year-end financial statements provide the most definitive and accurate picture of financial operations and conditions. In contrast, quarterly statements tend to be based on less extensive analyses and greater use of estimates than is the case at year-end closings. In this limited sense, the BC/BS Plan performance data used in this update are not strictly comparable to that used in the Initial Report.

Because of the difficulties noted above, and in order to make the information used in this update as consistent as possible with that in the Initial Report, the Consultant has employed here a sample of 38 BC/BS Plans in other states for which Coopers & Lybrand collected data on a SAP basis. This includes 32 BC/BS Plans for which SAP information was obtained from state insurance authorities[3] and 6 BC/BS

2/ See Part I and Appendix A of the Initial Report for a discussion of a number of these difficulties.

3/ Coopers & Lybrand actually gathered data for 33 BC/BS Plans, but one was excluded (Rocky Mountain HMO) by the Consultant as the Company was not a BC/BS Plan.

Plans for which SAP information was obtained from the National Blue Cross and Blue Shield Association. Furthermore, the update focuses on loss ratios, expense ratios, underwriting ratios, and surplus reserve days.[4/]

III. COMPARATIVE PERFORMANCE MEASURES

Tables A and B, presented on the pages that follow (4a and 4b), show a comparison of various performance measures (SAP basis) for BC/BS Plans in Virginia and in other states over the period 1984 through 3rd/Q-1987. The information for 1984-86 is taken from the Consultant's Initial Report to the Bureau, while the information for the nine months ending September 30, 1987 is taken from the Appendix to this update.

The data for the two BC/BS Plans in the Commonwealth are the same in Tables A and B. The tables differ for BC/BS Plans in other states, however, in the following respect. Table A presents information as it was actually compiled by Coopers & Lybrand (through 3rd/Q-1987) or the Consultant (1984-86) despite the fact that: (1) some of the BC/BS Plans in other states are not present in the data sets in all of the four years; and (2) complete information was not available for every BC/BS Plan. Note in Table A, for example, that loss ratio data were available for 67 BC/BS Plans in 1986, but the comparable figure for underwriting ratio data is 56 BC/BS Plans. Accordingly, to test whether data collection difficulties created any bias in the comparative analysis, Table B presents performance measures (SAP basis) for 24 BC/BS Plans in other states for which complete data were gathered for all four years.

Focusing on the data through 3rd/Q-1987 in Table A, it is reasonable to conclude that underwriting losses continued in the BC/BS Plan insurance industry throughout the nation--a trend largely attributable to the payment of insurance benefits, suggesting a much greater incidence of claims and/or a considerable increase in the cost of hospital and medical care. For instance, from an average underwriting ratio of 103.9% in 1986 for BC/BS Plans in other states, the

4/ Part I of the Initial Report provides definitions of these terms.

TABLE A
COMPARISON OF PERFORMANCE MEASURES
BC/BS PLANS IN VIRGINIA AND IN OTHER STATES

		3RD/Q 1987	1986	1985	1984
BC/BS Plans Other States					
Loss Ratio:	Mean	95.4%	92.2%	89.5%	87.7%
	SD	4.7%	6.4%	6.6%	7.3%
	No.	38	67	69	64
Exp. Ratio:	Mean	11.1%	11.7%	10.3%	9.5%
	SD	--	--	--	--
	No.	--	--	--	--
Underwriting Ratio:	Mean	106.5%	103.9%	99.8%	97.2%
	SD	4.2%	8.3%	8.0%	9.4%
	No.	38	56	55	43
Surplus Reserve Days:	Mean	57.4	80.2	85.1	73.2
	SD	49.4	52.3	52.3	49.2
	No.	38	54	54	41
BC/BS of VA					
Loss Ratio:		95.8%	93.0%	91.4%	91.0%
Expense Ratio:		9.7%	9.0%	8.6%	6.3%
Underwriting Ratio:		105.5%	102.0%	100.0%	97.3%
Surplus Reserve Days:		45.3	51.8	74.6	66.3
BC/BS of NCA					
Loss Ratio:		93.4%	92.2%	87.2%	87.1%
Expense Ratio:		13.2%	13.4%	11.4%	9.9%
Underwriting Ratio:		106.6%	105.6%	98.6%	97.0%
Surplus Reserve Days:		26.6	40.4	73.4	71.4

TABLE B
COMPARISON OF PERFORMANCE MEASURES
BC/BS PLANS IN VIRGINIA AND IN 24 OTHER STATES

		3RD/Q 1987	1986	1985	1984
BC/BS Plans Other States					
Loss Ratio:	Mean	94.5%	91.1%	88.8%	86.8%
	SD	5.0%	4.8%	4.4%	5.9%
Exp. Ratio:	Mean	11.6%	11.6%	10.1%	8.9%
	SD	--	--	--	--
Underwriting Ratio:	Mean	106.0%	102.7%	98.9%	95.7%
	SD	4.5%	6.4%	4.2%	6.0%
Surplus Reserve Days:	Mean	67.4	78.9	80.6	71.6
	SD	54.0	54.2	58.9	54.0
BC/BS of VA					
Loss Ratio:		95.8%	93.0%	91.4%	91.0%
Expense Ratio:		9.7%	9.0%	8.6%	6.3%
Underwriting Ratio:		105.5%	102.0%	100.0%	97.3%
Surplus Reserve Days:		45.3	51.8	74.6	66.3
BC/BS of NCA					
Loss Ratio:		93.4%	92.2%	87.2%	87.1%
Expense Ratio:		13.2%	13.4%	11.4%	9.9%
Underwriting Ratio:		106.6%	105.6%	98.6%	97.0%
Surplus Reserve Days:		26.6	40.4	73.4	71.4

figure rose to 106.5% during the first nine months of 1987. This consisted of a small decline in the expense ratio (11.7% to 11.1%) but a large increase in the loss ratio (92.2% to 95.4%).

Similar trends were experienced for the two BC/BS Plans in the Commonwealth. The underwriting ratio of BC/BS of VA increased from 102.0% to 105.5%, while the comparable figures for BC/BS of NCA were 105.6% in 1986 and 106.6% by the 3rd/Q-1987. BC/BS of NCA was able to reduce somewhat its comparatively high expense ratio from 13.4% to 13.2%, but the increase in its loss ratio (92.2% to 93.4%) more than offset the small expense savings. BC/BS of VA experienced increases in both underwriting components, the loss ratio rising from 93.0% to 95.8% and the expense ratio rising from 9.0% to 9.7%.

The standard deviations (SD's) in Table A indicate that both BC/BS Plans in the Commonwealth had underwriting performances through 3rd/Q-1987 within the typical experiences of their counterparts elsewhere. For example, the average 1987 underwriting ratio of BC/BS Plans in other states was 106.5% with a SD of 4.2%, suggesting that about two-thirds of the companies had an underwriting experience in the range of 102.3% to 110.7%. This range compares to a 1987 underwriting ratio of 105.5% for BC/BS of VA and 106.6% for BC/BS of NCA.

An examination of the loss, expense, and underwriting ratios in Table B portrays a very similar picture. Thus, whether one looks at the BC/BS Plan industry on a random data collection basis (Table A) or on a consistent data collection basis (Table B), the findings appear to be the same. The underwriting ratios of BC/BS Plans continued to rise well above 100% in Virginia and elsewhere indicating mounting underwriting losses and an erosion of capital and surplus. This trend is highlighted by the fact that of the 38 BC/BS Plans in other states used for 1987, only two had underwriting ratios below (barely) 100% as shown in the Appendix.

The erosion of capital and surplus is exhibited in both Tables A and B. Surplus reserves in Table A fell from an average of 80.2 days in 1986 to 57.4 days as of the 3rd/Q-1987 for BC/BS Plans in other states. Declines were also experienced by the Commonwealth's BC/BS Plans--51.8 days to 45.3 days for BC/BS of VA and 40.4 days to 26.6 days for BC/BS of NCA. While these declines were not as dramatic as those (on average) of their counterparts elsewhere, they further eroded the protection afforded subscribers in the Commonwealth. This is particularly noticable in the case of BC/BS of NCA as its surplus reserve of 26.6 days fell below the Bureau's 30 day standard.[5]

While the 1987 performance of Virginia's BC/BS Plans has been comparable to their counterparts elsewhere, little comfort results from such a finding. The BC/BS Plan industry, nationally and in the Commonwealth, appears to be losing 6¢ on every dollar of A&H insurance business written. Absent offsetting increases in investment income, a continuation of such underwriting losses can only be sustained by those BC/BS Plans which have comparatively high reserve levels. As both BC/BS Plans in Virginia have surplus reserve days lower than the average of BC/BS Plans elsewhere (much lower in the case of BC/BS of NCA), a continuation of underwriting losses and declines in reserve levels is cause for concern.

IV. DIVERSIFICATION AND AFFILIATE RELATIONSHIPS

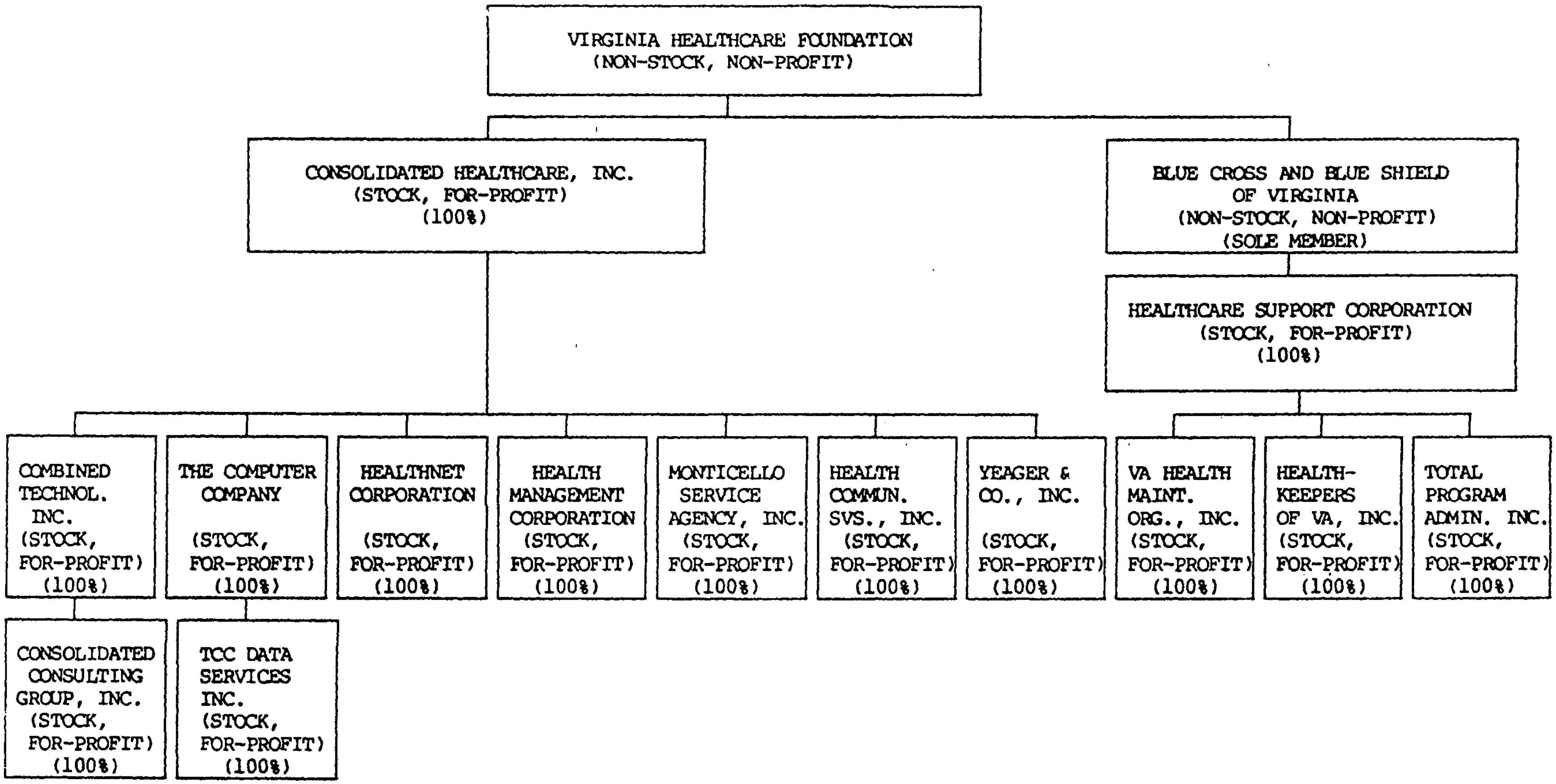
Diversification within the corporate structures of which Virginia's two BC/BS Plans are parts has continued since the Consultant's Initial Report was prepared. This has served not only to make corporate organizations even more intricate than they were just recently, but also to complicate the process of identifying relationships and transactions among affiliates and/or subsidiaries.

A. BC/BS of Virginia

There have been several changes in the corporate organization involving BC/BS of VA since the Consultant's Initial Report. The resulting new corporate structure is shown in Chart I on the following page 6a.

5/ As noted in the Consultant's Initial Report, this is also one of the membership standards of the National Blue Cross and Blue Shield Association.

CHART I
BLUE CROSS AND BLUE SHIELD OF VIRGINIA
MOST RECENT CORPORATE STRUCTURE



On July 16, 1987, direct ownership of Virginia Health Maintenance Organization, Inc. ("VaHMO") and Healthkeepers of Virginia, Inc. ("Healthkeepers") was transferred from Consolidated Healthcare, Inc. ("CHI") to BC/BS of VA. At the same time, MBC Management, Inc. was renamed Healthcare Support Corp. ("Healthcare") which, in turn, assumed control (within BC/BS of VA) of VaHMO, Healthkeepers, and a new subsidiary named Total Program Administrator, Inc. ("TPA") that was officially created on July 19, 1987. TPA, formed as a stock, for-profit corporation to process claims for self-insured businesses, had previously operated as a division of BC/BS of VA.

The transfer of VaHMO and Healthkeepers from CHI to BC/BS of VA and the creation of TPA under the umbrella of BC/BS of VA suggest somewhat of a redirection in management policy. In the Consultant's Initial Report, a trend was noted of placing for-profit subsidiaries under CHI leaving BC/BS of VA as the sole non-profit subsidiary of Virginia Healthcare Foundation ("VHF"). One factor causing the redirection appears to be that the National Blue Cross and Blue Shield Association has modified its annual licensing requirement with the affect that only HMO's directly owned and operated by BC/BS Plans can use the BC/BS logo.

As further indicated in Chart I, Cardinal Agency, Inc. is no longer part of the corporate structure of BC/BS of VA as it was legally terminated as a business entity on August 28, 1987. Additionally, along with the apparent redirection in management policy noted earlier, the corporate structure of VHF now seems to be evolving where subsidiaries directly involved in the provision of A&H business are placed under BC/BS of VA while other types of subsidiaries come under the umbrella of CHI.

The financial transaction which accompanied the 1987 transfer of VaHMO and Healthkeepers to BC/BS of VA consisted of Healthcare issuing some $4.8 million in preferred stock to CHI. This preferred stock carries the same terms as the $21.7 million of CHI's preferred stock held by BC/BS of VA. Accordingly, the financial aspects of the 1987 transfer of VaHMO and Healthkeepers might be viewed from an economic perspective as a reduction of BC/BS of VA's preferred stock investment in CHI from $21.7 million to $16.9 million.

At the time of preparing this update, complete information regarding financial transactions between BC/BS of VA and its subsidiaries and/or affiliates was unavailable due to the accounting cycles used within VHF.[6] Thus, the Consultant is only able to make at this juncture tentative statements relative to the performance of the affiliates and/or subsidiaries of BC/BS of VA, as well as to the role of affiliate payments from and to BC/BS of VA in that performance.

Because of the ownership transfer of VaHMO and Healthkeepers from CHI to BC/BS of VA, some difficulty is created in comparing diversification performance through 3rd/Q-1987 with that for 1986 in the Initial Report. This is true because CHI's financial data for 1st/Q and 2nd/Q-1987 include VaHMO and Healthkeepers while that for 3rd/Q-1987 do not. For purposes of the ensuing analysis, therefore, the Consultant has reconstructed CHI's financial performance assuming that VaHMO and Healthkeepers remained as CHI subsidiaries.

For the first nine months of 1987, CHI had pre-tax income of about $6.9 million. Combining the $3.0 million 3rd/Q-1987 (i.e., July through September) pre-tax loss of VaHMO and Healthkeepers with this figure, the diversification activities of BC/BS of VA produced a net pre-tax income of $3.9 million through the 3rd/Q-1987 ($6.9 million less $3.0 million). Thus, the reconstructed pre-tax income of CHI was $3.9 million for the first nine months of 1987 assuming continued ownership of VaHMO and Healthkeepers. As these two entities, however, sustained a pre-tax loss of $4.5 million through 3rd/Q-1987, the diversification activities of BC/BS of VA produced pre-tax income of $8.4 million for the first nine months of 1987 excluding VaHMO and Healthkeepers (i.e., $6.9 million pre-tax gain of CHI plus $1.5 million loss of

6/ Such information, as well as the debt and/or performance guarantees by BC/BS of VA, will be available sometime in the 1st/Q-1988.

VaHMO and Healthkeepers during the six month period in 1987 when they were owned by CHI).

The above reconstructed $3.9 million pre-tax income figure is used by the Consultant as the measure of the performance of BC/BS of VA's diversification activities for the first nine months of 1987. Incorporated in this figure is some $9.3 million that CHI received in management fees from BC/BS of VA. Thus, non-affiliated diversification activities sustained a pre-tax loss of $5.4 million through 3rd/Q-1987, i.e., $3.9 million less $9.3 million. On an annualized basis, this $3.9 million converts to a 1987 pre-tax loss of $7.2 million which is a $1.7 million increase over the $5.5 million 1986 loss in non-affiliated diversification activities shown in the Initial Report.

Thus, while corporate restructuring has continued within the organization of which BC/BS of VA is a part, it also appears that diversification is continuing to produce losses that are growing in magnitude. This, coupled with the underwriting losses experienced by BC/BS of VA through 3rd/Q-1987, does not present an encouraging financial picture for the future.

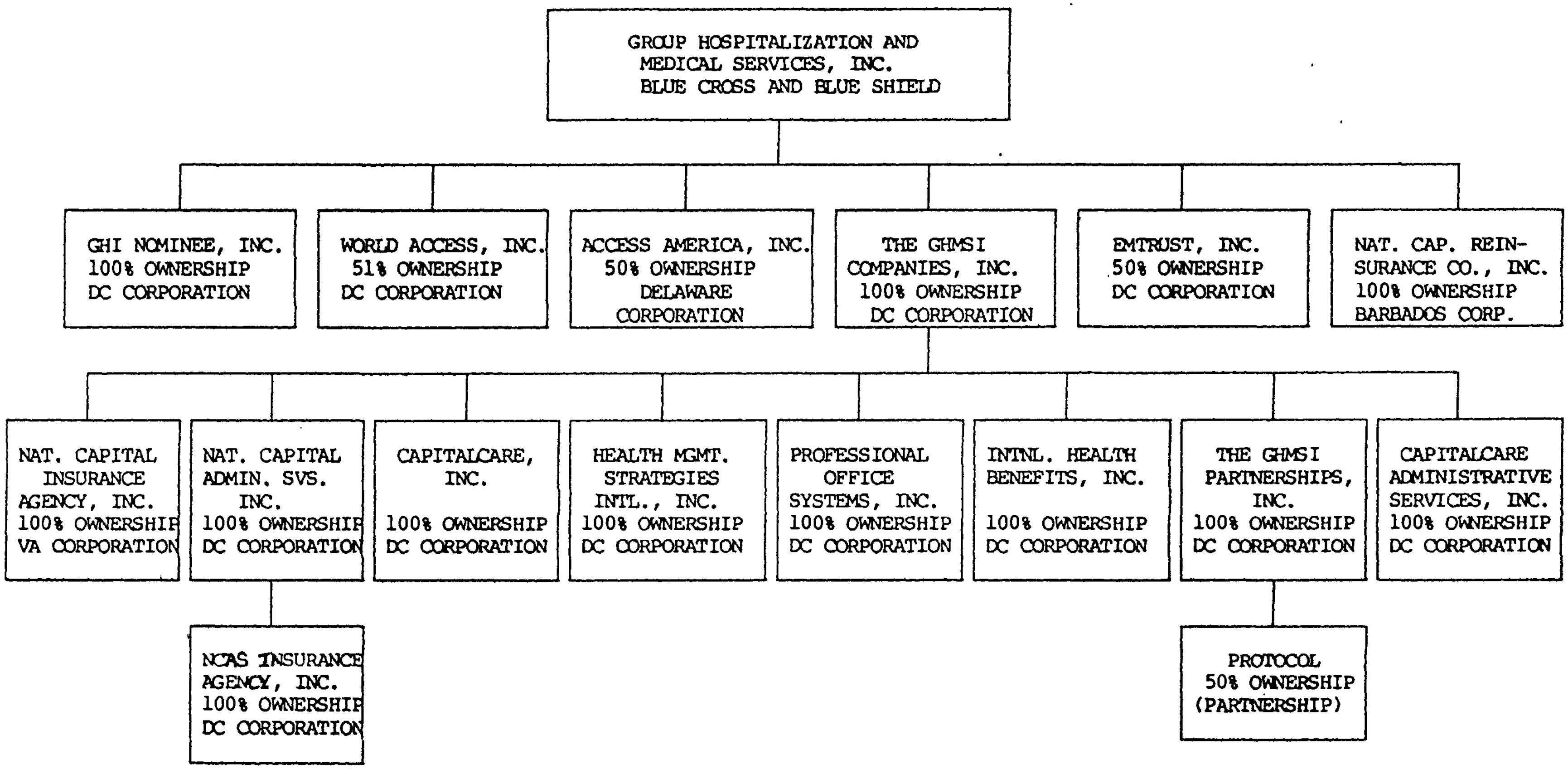
B. BC/BS of the National Capital Area

BC/BS of NCA has undergone two structural changes since the completion of the Initial Report of the Consultant. National Capital Reinsurance Company, Inc. was organized on July 6, 1987 with an initial capitalization of $200,000, while NCAS Insurance Agency, Inc. was created on December 8, 1987 with an initial investment of $1,000. This latter company is owned by National Capital Administrative Services, Inc. To date, neither of these two new entities have begun operation. The new corporate structure of BC/BS of NCA is shown in Chart II on the following page 9a.

During the first nine months of 1987, the subsidiaries of BC/BS of NCA lost about $5.6 million--an annual rate of some $7.5 million. Should this annual rate actually materialize for the year, accumulated losses from diversification will total about $23.8 million through 1987. This consists of the accumulated loss of $16.3 million as of 1986 as

CHART II

BLUE CROSS AND BLUE SHIELD OF THE NATIONAL CAPITAL AREA
MOST RECENT ORGANIZATIONAL STRUCTURE



indicated in the Initial Report plus an estimated $7.5 million loss for 1987.

At the same time that diversification losses have mounted, BC/BS of NCA has additionally invested a little over $0.2 million in new subsidiaries. This is coupled with the fact that as of the end of the 3rd/Q-1987, BC/BS of NCA had guaranteed $19.0 million of the debt of its subsidiaries and was owed a net amount of $7.5 million from its subsidiaries.

As appears to be the situation with BC/BS of VA, the diversification activities of BC/BS of NCA continue to be a drain on financial strength. The ongoing trend of these losses is of particular concern in the case of BC/BS of NCA as its surplus reserve days have already fallen below the 30 day "contingency reserve" standard previously established by the Bureau as a measure of reserve adequacy.

V. FINDINGS AND CONCLUSIONS

Unlike in its Initial Report to the Bureau, the Consultant is no longer able to say that the diversification activities of Virginia's BC/BS Plans have not exposed subscribers to unreasonable expense and/or undue risk. While the continuing decline in reserve levels is not solely attributable to diversification, losses from such activities have contributed to the worsening reserve positions of the two BC/BS Plans in the Commonwealth.

As in the Consultant's Initial Report, for example, consider worst case scenarios as contemplated under the SAP basis of reporting to the Bureau.[7] If BC/BS of VA were to lose totally its present investment in diversification activities (a net of some $16.9 million currently from an

7/ The SAP basis of reporting takes a policyholder's protection perspective, as compared to the going concern or stockholder approach under GAAP. To a substantial degree, SAP attempts to answer the question of the extent of protection currently afforded policyholders if an insurance company were to become bankrupt.

Moreover, the worst case scenarios herein cited cannot be viewed as extreme since the diversification activities of Virginia's BC/BS Plans continue to suffer financial losses.

economic perspective) and were to become liable for the $25 million of the authorized affiliate indemnification that existed in 1986, such events would reduce its 3rd/Q-1987 capital and surplus of $162.6 million by $41.9 million. This converts to a reduction in surplus reserves as of 3rd/Q-1987 from 45.3 days to 33.6 days.

For BC/BS of NCA, the worst case scenario may be even more alarming. If it were to become liable for the $19.0 million of subsidiary debt which BC/BS of NCA has guaranteed[8/], its 3rd/Q-1987 capital and surplus would fall from $73.8 million to $54.8 million. Concomitantly, surplus reserves would fall from 26.6 days to 19.8 days--a level close to that which Blue Cross/Blue Shield of Southwestern Virginia experienced (about 18 days) in 1985 prior to its merger with BC/BS of VA.

To be sure, the continuing rise in underwriting ratios has contributed significantly to the deterioration of the financial positions of the two BC/BS Plans currently operating in the Commonwealth. But at the same time, the magnitude of this deterioration has been influenced by diversification activities. Recall in this regard, for example, that through the 3rd/Q-1987, BC/BS of NCA has sustained an accumulated loss due to diversification in the amount of $21.9 million ($16.3 million through 1986 and $5.6 million in the first nine months of 1987). Given total underwriting expenses of $748.2 million through the first nine months of 1987, $21.9 million converts to 7.9 surplus reserve days. When surplus reserves are already at a comparatively low level (26.6 days in Table A), 7.9 days can be viewed as significant.

8/ Unlike in the Consultant's Initial Report (see page 67), the above worst case scenario does not take into account the net amount due from subsidiaries. This is appropriate as this amount is not viewed as an admitted asset in reports to the Bureau and, therefore, has already been taken into account in the determination of capital and surplus. In this regard, the net amount due from subsidiaries should not have been included in the worst case scenario posed in the Consultant's Initial Report.

In light of the continuing decline in reserve positions of Virginia's BC/BS Plans which has accompanied the growing losses of diversification, the Consultant has now concluded that diversification is beginning to impose a burden on subscribers. This is most apparent in the case of BC/BS of NCA, but less true for BC/BS of VA as its surplus reserve position remained above 30 days in the updated study period. In both cases, however, the burden of diversification will be magnified if underwriting and diversification losses continue in the future without offsetting investment income.

As in the Consultant's Initial Report, the above conclusions are subject to the qualification that no analyses have been conducted regarding whether subscribers have been made better-off or worse-off by diversification. For example, the Consultant has not investigated the reasonableness of transactions among affiliates or whether diversification allowed business to be retained that otherwise might have been lost.