Article Title: ARCHIVE | Criteria | Insurance | Health: Operational Analysis Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by an article titled "Non-Life Operational Analysis," which was published on March 19, 2009.) Standard & Poor's Ratings Services evaluation of operating performance focuses on how efficiently a health plan or health insurer implements its strategies, capitalizes on its strengths, and manages its weaknesses. Standard & Poor's believes healthy operating performance is vital to a health plan's long-term success, and internally generated earnings should be the primary source of capital growth for a health plan. Although the evaluation of earnings is driven primarily by quantitative factors, a number of qualitative aspects also play a role. In the case of HMOs and insurance companies that operate in different states or jurisdictions via wholly owned subsidiaries, Standard & Poor's looks at the overall consolidated operating performance rather than looking at the individual HMOs or subsidiaries. The overall analysis of HMOs' and health plans' operating performance also focuses on the areas that could significantly affect their operating performance: the ability to control market pricing, the ability to withstand competitive pricing pressures, and the ability to manage both medical and administrative costs. These three factors are increasingly influenced by a number of external marketplace elements. Operating performance evaluation is broken down into two sections. The first section is an analysis of underwriting performance. In the second section, Standard & Poor's assesses the company's overall performance, which incorporates the effect of investment returns and other revenues and expenses in addition to underwriting performance. The underwriting performance analysis looks at: Loss ratios for the total company and for major sectors or lines of business (individual, small group, large group, Medicare risk, etc.). Expense ratios. Combined ratios for the total company and for major sectors or lines of business. The effect of reserving and accounting practices on reported figures. The effect of one-time or nonrecurring charges on loss and expense ratios. Percent of business not at risk (e.g., administrative-services-only or cost-plus business). Premium rate increases for each major business segment. Analysis of underwriting results by studying loss ratios, expense ratios, and combined ratios provides a first impression of earnings strength. However, Standard & Poor's recognizes that different business mixes with different loss ratio expectations can often make superficial comparisons of combined ratios meaningless. Accordingly, a company's overall performance analysis focuses on: Diversity of earnings by business unit, sector, product line, and distribution channel. Stability/volatility of earnings. ROR, both before and after taxes. Standard & Poor's uses ROR as the main benchmark for evaluating overall profitability. In general, this measure gets beyond the impact on underwriting performance resulting from different business mixes because investment income is included as an additional source of earnings. The ROR calculation takes into account the impact of other, nonunderwriting factors, such as premium equivalents from nonunderwritten lines of business (e.g., self-insured blocks of business), debt interest expense on borrowings, and other expenses or revenues on earnings. ROR typically excludes realized capital gains/losses because Standard & Poor's believes that for many companies, realized capital gains are largely opportunistic, a function of economic and interest rate conditions. However, to the extent that companies can demonstrate a consistent strategy of realizing capital gains as part of a total investment and operating strategy, Standard & Poor's adjusts its analysis accordingly. Although many organizations use ROE as a performance benchmark, Standard & Poor's tends not to emphasize this ratio as a key indicator of operating results because it is influenced by the company's capital structure when debt is used. ROR is somewhat insulated from this effect. Earnings Adequacy Ratio In evaluating an insurer's financial strength, Standard & Poor's has long used earnings measurements as an important component of its analysis. Standard & Poor's earnings adequacy ratio for health plans uses ROR to measure operating performance, differentiating earnings targets by business line, given the risks associated with each product class. The measure is time weighted, encompassing five years of earnings performance to cover yearly fluctuations that could occur because of industry cyclicality, competitive pressures, repricing strategies, expense actions, and nonrecurring events. This benchmark ratio has associated standards of performance across all levels from weak ('B') to extremely strong ('AAA'). The ratio is the actual earnings divided by target or expected earnings at the 'BBB' level. The denominator of the ratio multiplies an earnings target for each of the company's business lines revenues or, in some cases, reserves. The earnings target used is a level considered adequate ('BBB') for the business line. The products of these business-line volumes multiplied by their earnings targets are then added together to produce a level of earnings that would be considered adequate for the company. With the broad range of managed care products today, Standard & Poor's has developed specific earnings model factors for the various health insurance and HMO products to better reflect the different earnings targets for these products. At its core, it is a risk-adjusted analysis of a company's earnings stream that reflects the health plans' underwriting risks, investment income, and capital needs. Standard & Poor's analysis recognizes comparative differences in capital invested in the products in terms of both acquisition costs and the risk-based capital that needs to be held to back these products. Although the risk-based capital requirements are lower with managed care products with greater risk-transfer elements, the acquisition and network maintenance costs of such products is greater, and the overall investment that is required to back these products increases with the level of managed care. Thus, Standard & Poor's earnings model targets for managed care products will be higher for products with greater degrees of managed care, as higher earnings levels are needed to recoup the higher initial investment. Standard & Poor's also looks at a version of the model that adjusts for the different levels of capital and realized gains among companies. The expected earnings on excess capital are the company-specific portfolio earned rate multiplied by the capital in excess of what is needed for a company capital ratio of 100%. Excess capital is equal to total adjusted capital minus the 'BBB' capital requirement. In some instances, a company may get an earnings credit if it is undercapitalized. This part of the analysis would also incorporate into actual earnings a seven-year rolling average of realized gains/losses. The numerator of the earnings adequacy ratio is the company's EBIT. The measure is calculated before interest expense because the intent is to evaluate the earnings performance of a health plan's operations irrespective of a company's choice of capital structure and tax status. If a company funds a foundation or other charity and books that as an expense, this charge may be backed out as an analytic adjustment if it is deemed to be voluntary or one-time in nature. Standard & Poor's prefers to use pretax consolidated GAAP earnings as its measure of operating performance for health plans and insurance companies. GAAP accounting tends to present a closer picture of the ongoing economic earnings capabilities of a company than statutory accounting. Statutory accounting is oriented more toward presenting a view of the company as if it were to be liquidated as of the statement date. Such differences in accounting treatment as the inclusion of deferred policy acquisition costs and use of more realistic reserving practices in GAAP accounting give a better picture of an insurer as an ongoing enterprise. Statutory earnings will be used in the model if GAAP or GAAP-like earnings are not available. Standard & Poor's will continue to use statutory accounting as its primary source of information for its balance-sheet-oriented models, such as Standard & Poor's capital adequacy model. The earnings adequacy model then compares the company's pretax earnings (excluding interest expense) to its earnings target. Companies considered to have adequate earnings capabilities will just cover their earnings target, while companies with stronger operational capabilities will have earnings that are some multiple of an adequate earnings target. The earnings adequacy model time-weights the earnings performance of a company over five years. Current years are more heavily weighted than other years. Standard & Poor's adds 20% of the most recent year's earnings adequacy ratio, 30% of the average of the past three years' ratios, and 50% of the average of the past five years' ratios to arrive at a time-weighted average of the company's earnings adequacy. Table 1 shows the calculation of the earnings adequacy ratio. The earnings targets that are multiplied against each line of business are levels that are considered adequate for that line of business. Consolidated GAAP EBIT (excluding realized gains and losses) is used in the numerator. The denominator is constructed by using GAAP revenue as the measure of line of business volumes to be multiplied against the earnings targets. If only statutory figures are available, statutory pretax, after policyholder dividend operating earnings are used in the numerator, and statutory revenues are used in the denominator. Table 2 shows the standards used to evaluate a company's earnings adequacy ratio for each level of operational performance. Table 1 Earnings Adequacy Ratio Calculation Numerator = GAAP EBIT (excluding realized gains/losses) Denominator = target earnings for each product line (derived by multiplying a target factor by the line's revenues or, in some cases, reserves) PRODUCT EARNINGS ADEQUACY RATIO FACTOR (%) MAJOR MEDICAL/HOSPITAL Traditional indemnity (premiums) 2.00 Retroactive experience-rated indemnity (premiums) 1.80 Contractual fee payments/bonus withholdings (premiums) 1.80 Capitation/salaried staff (premiums) 2.15 DENTAL Traditional indemnity (premiums) 2.00

Retroactive experience-rated indemnity (premiums) 1.80 Contractual fee payments/bonus withholdings (premiums) 1.80 Capitation/salaried staff (premiums) 2.15 Federal Employees Health Benefits Program/Champus (premiums) 0.50 Administrative services only (premium equivalents) 0.15 Stop-loss reinsurance (premiums) 1.40 Medicare supplement and other limited benefits (premiums) 1.50 Disability income and long-term care reserves 1.00 Disability income and long-term care (premiums) 1.75 Other not-at-risk health revenue (e.g., network rental) 3.00 Other revenue (e.g., revenue of nonhealth subsidiaries) 2.00 Excess capital Portfolio-specific (5% is used in the model) investment yield Conversions for GAAP figures: use GAAP pretax, preinterest operating income (excluding realized gains/losses) in the numerator. Excess capital is the value of statutory total adjusted capital held by the company minus the amount of capital deemed to be ‘BBB’ in the capital adequacy analysis. Note: All calculations are based on the use of average assets and average reserves for each year. GAAP total assets are adjusted to exclude the effects of FASB 115. EARNINGS ADEQUACY RATIO = NUMERATOR/DENOMINATOR, TIME-WEIGHTED AS FOLLOWS: 20% of the most recent year’s earnings adequacy ratio + 30% of the average of the past three years’ ratios + 50% of the average of the past five years’ ratios Table 2 Earnings Adequacy Ratio Standards CATEGORY EARNINGS ADEQUACY RATIO (%) Extremely Strong 250 and higher Very Strong 200-249 Strong 150-199 Good 100-149 Marginal 50-99 Weak Less than 50 In Standard & Poor's interactive rating process, analysts have the ability to adjust the raw data used in these models to reflect unique situations that might exist at particular companies. For example, to the extent that any particular year's earnings are considered out of the norm because of nonrecurring events, analysts have the ability to normalize the earnings used in the model. Likewise, the earnings targets applied to each line of business are considered adequate for the industry in aggregate. To the extent that a specific company's products are considered more or less risky, the analyst has the ability to adjust the target up or down. Given that the rating process is oriented toward taking a prospective view of a company's financial performance, Standard & Poor's analysts will often construct earnings adequacy ratios that include their projections of an insurer's earnings. Although a company's past performance is often a good indicator of its future, there are many instances where industry conditions or management's strategies are expected to significantly alter the earnings profile of a company. Related risks that the analysts will consider in evaluating financial strength are the investment risks, underwriting risks, and other business risks a company is taking to achieve its earnings. Companies that achieve high earnings because of a higher risk profile might be viewed as offering weaker financial security than the earnings adequacy ratio suggests. It is Standard & Poor's view that stronger companies will achieve high earnings through competitive advantages that they have established in the marketplace. These advantages should translate into favorable pricing or an expense advantage. The quality of earnings is also important. Companies with greater earnings diversification and stability are viewed more favorably than those with more concentrated profit streams. In the event of a shock, such as a pricing error on one specific case or class of business, a diversified health plan's or health insurer's overall earnings will be more resilient than one that is dependent on the success of one or two dominant lines. Standard & Poor's also considers the effect of different states' regulatory and tax regimes on both underlying and reported profitability. For example, strong/light regulation that has helped support or regulate industry pricing and benefited/hurt health plan profitability will be factored into Standard & Poor's view of operating performance.