Article Title: ARCHIVE | Criteria | Insurance | Health: Double Leverage In Health Insurance Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by "Holding Company Analysis," published on June 11, 2009.) Over the past several years, rapid consolidation in the managed care industry and unprecedented growth in Medicare and Medicaid programs have changed not only the business profile of many publicly held insurers, but the balance sheets as well. The many large mergers and acquisitions (M&A;) were funded by debt as well as equity shares, and very strong earnings supported share repurchase programs. The equity issuance and strong earnings enabled the industry balance sheets to remain relatively benign. However, earnings growth for managed care companies began to slow in 2007. Notwithstanding the consolidation that has reduced the competitive field within the industry, business prospects are narrowing. As a result, many managed care holding companies are taking on increasing levels of leverage (and double leverage), which is starting to tug credit quality down for both holding and operating companies. The capital requirements for health insurance companies are lower compared with other insurance sectors due to their short-term liability structure. Nearly all claims are paid within 90 days thanks to dramatic improvements in electronic submission and adjudication processes. Furthermore, many larger employers self-insure, and managed care firms provide a fee-based service arrangement whereby insurance risk is effectively eliminated. This type of health care financing arrangement lowers the health insurer's capital requirements and may also create a meaningful source of unregulated cash flow for the enterprise. Finally, capital adequacy and quality may not be a strategic priority because the purchasers of health insurance do not demand high financial strength ratings that are critical for monoline insurers, reinsurers, and asset accumulation sales. The relatively low capital adequacy ratios and low total adjusted capital levels held by health insurers leave them with less flexibility to carry the burden of double leverage created by their debt financed acquisitions and stock repurchases. Double leverage is the concept of holding company debt used to fund the operating company capital requirements. Double leverage will result regardless of whether a subsidiary is purchased with debt, debt is used to fund subsidiary growth, or whether the holding company is replacing equity capital with debt through share repurchases. The key to our concern on double leverage is that the holding company debt incurred must be serviced through operating company dividends, which are scrutinized by U.S. insurance regulators. Standard & Poor's Ratings Services considers holding company debt when making its assessment of operating company capital adequacy. Other aspects of our capital analysis include consolidated goodwill, hybrid equity, and the cash flow strength of both regulated and unregulated organizations. Cash flows have historically served to offset our qualitative concerns about large levels of goodwill (relative to equity) that the industry has accumulated through years of consolidation. The tolerance for double leverage is expressed as a percentage of consolidated GAAP capital, including goodwill that is not analytically or otherwise impaired. Standard & Poor's permits 20% of double leverage to be debt-funded, and up to 25% hybrid-funded, yielding a total holding company capital tolerance from double leverage of up to 45%. Maximum Tolerances For Double Leverage And/Or Hybrid Equity Use CASES WHERE ENFORCEMENT OF STRUCTURAL SUBORDINATION IS HIGH AND REGULATORS ALLOW HOLDING-COMPANY DEBT TO FUND OPERATING-COMPANY CAPITAL (E.G., U.S. AND BERMUDA) CATEGORY MAXIMUM TOLERANCE Total double leverage tolerance Up to 45% of capital* Debt-funded double leverage Up to 20% of capital* 'High equity content' hybrid tolerance (three-year mandatorily convertible) Up to 25% of capital* Sublimit 'intermediate equity content' hybrid tolerance Up to 15% of capital* 'Minimal equity content' hybrid tolerance 0% credit HYBRID RATIOS Standard & Poor's qualifying hybrid/[U.S. GAAP (consolidated) capital + total hybrid + total senior debt] DOUBLE LEVERAGE [Standard & Poor's qualifying hybrid + total senior debt + nonqualifying hybrid]/[U.S. GAAP (consolidated) capital + total hybrid + total senior debt] *The definition of 'capital' in regard to the maximum tolerance varies by region. In the U.S. and Bermuda, capital is defined as [U.S. GAAP consolidated equity + total hybrids + debt] with no adjustments to the reported numbers. Debt is defined to include unfunded pension and post retirement obligations but exclude operating lease adjustments. Amounts above our tolerances are deducted from statutory capital as an adjustment to our capital adequacy calculation. In the case of large debt levels, this formula can be very onerous and in some cases totally wipe out statutory capital levels overall. Double leverage is one of a variety of factors we look at to determine our overall assessment of capitalization. How We Factor

Double Leverage Into Ratings Health Insurance Criteria for Holding Company Analysis provides ratios used for evaluating holding companies and the assessment of goodwill. For many health insurers we may blend the criteria with the evaluation of U.S. Industrial financial ratios recognizing that nonregulated, noninsurance portions of a health insurers business can produce cash flow ratios that are generally stronger than insurance peers. In the following UnitedHealth Group Inc. (UNH; A-/Negative/A-2) example, double leverage adjustments exacerbate the mediocre capital structure and while not drive lower ratings, we do believe that successive acquisitions and a sustained share repurchase program could place undue burden on the consolidated operations in future years. On the positive side, we believe UNH's nonregulated cash flows are meaningful and provide substantial flexibility relative to servicing double leverage debt, yet these cash flows remain correlated to the regulated insurance model. Capitalization has not historically been a rating strength of UNH's credit profile. Large levels of debt issued and goodwill, acquired over a decade of M&A; activity, and the preference to move excess capital out of the regulated entities, to be used for growth or returned to share holders, has reduced UNH's capitalization. Nevertheless, the strong operating earnings lead to interest coverage that remains above insurance company 'A' rating levels, even in various prospective earnings scenarios. Given the diversity of revenues and considering the high level of potentially unregulated cash flow, we often compare U.S. Industrial financial ratios to evaluate the strength of UNH on a variety of cash metrics. We do not use these metrics to determine ratings, but they provide some guidance and perspective for firms with nonregulated cash flows. UNH has considerable liquidity because of cash flows that are not encumbered by legal entities and credit facilities the company has in place. Furthermore, the company's business profile is considered to be very strong, with geographic spread and scale that produces stable results. Results are not subject to catastrophe risk. The greatest threats to earnings are regulatory and legislative actions such as reduced funding of reimbursements to government programs. These risks are fairly remote for 2008 and 2009. UNH lifted its total debt leverage tolerance in 2007 to a 40% debt to capital ratio. Proceeds from debt issuance have since been used to fund share repurchases, primarily, as well as acquisitions and other general corporate needs. In response, we lowered UnitedHealth's counterparty and debt ratings one notch, from 'A' to 'A-', and indicated that if UnitedHealth were to increase its debt leverage further, we would strongly consider lowering the rating again. In April and July 2008, UNH announced it had experienced weakness in its enrollment growth and earnings. Standard & Poor's responded first with a negative outlook on the holding company. The interest coverage ratio was signaled as having increasing weight in the credit analysis. The negative pressure on the operating company is more remote due to its competitive strengths and earnings diversity flow from regulated and nonregulated sources. The Bottom Line For holding companies, taking on additional debt can be a double-edged sword. Debt can be used to lower the company's outstanding share count, which can improve earnings per share. A lower cost of capital, can improve the company's modeled enterprise valuation. But debt can also pressure the financial profile by impairing statutory capitalization and reducing financial flexibility. Other key metrics might also be weakened, including pretax income, EBITDA interest coverage, and ratios such as free operating cash flow to debt, discretionary cash flow to debt, and debt to EBITDA ratios. The more a health insurer's operating company's capital is supported by double leverage, the more negative pressure there is on the holding company counterparty credit rating or the financial strength rating on its operating company or both. If a holding company relies solely on operating company cash flow to fund debt repayment and growth slows, the debt's interest payments run the risk of not getting paid, which in essence, functions as a call on underlying statutory capital. A health insurance holding company that issues debt to repurchase shares puts itself at increased financial risk if it then relies upon operating company cash flow to service the debt, as are holding companies that acquire operating companies with debt that becomes serviced by the operating companies they acquire. The bottom line: leverage at the holding company level is leverage at the operating company level.