G. Mark Chaney
Executive Vice President
Chief Financial Officer

CareFirst BlueCross BlueShield
10455 Mill Run Circle
Owings Mills, MD 21117-4208
Tel. 410-998-5971
Fax 410-998-7810
E-mail: mark.chaney@carefirst.com

CareFirst BlueCross BlueShield

July 31, 2009

The Honorable Thomas E. Hampton
Commissioner
Department of Insurance, Securities & Banking
810 First Street, Suite 701
Washington, D.C. 20002

Dear Commissioner Hampton:

Attached please find the GHMSI report that in conjunction with our previous submission of the 2008 Milliman report, details the appropriate level of surplus necessary for the company to meet its: 1) statutory and corporate surplus requirements; 2) actuarially determined risk exposures; and 3) expected and unanticipated contingencies.

Please contact us with any questions or comments.

Best regards,

G. Mark Chaney

GMC:ss

GHMSI Reserves

I. BACKGROUND AND CONTEXT

This report is prepared in response to the requirement established by the Commissioner of the District of Columbia Department of Insurance, Securities, and Banking (DISB) in emergency and proposed regulations promulgated on July 10, 2009 (*See §4601.1).* The rules define the procedures for the September 10, 2009 hearing to review the reserves of hospital and medical services corporations (HMSC) and to determine whether the portion of the surplus attributable to the District is excessive. Group Hospitalization and Medical Services, Inc. (GHMSI), an affiliate of CareFirst Inc. is the only HMSC operating in the District of Columbia.

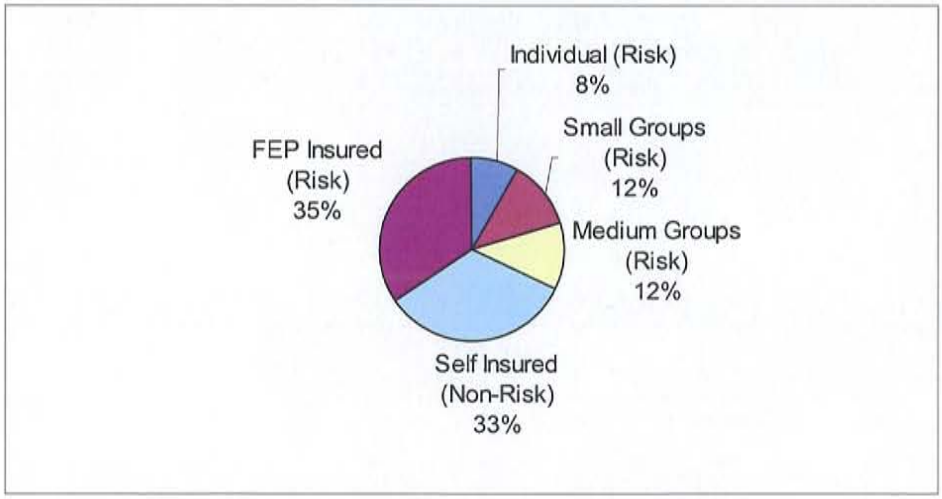
Before presenting the approach used by GHMSI to set reserves at appropriate levels, a brief outline of the key facts and circumstances is important in understanding the business context within which GHMSI operates and holds reserves.

Composition of GHMSI Membership

As established in its federal charter dating back to 1939, GHMSI operates as a not-for-profit health services plan for the benefit of its subscribers. In simple terms, GHMSI's subscriber base can be divided into three categories: [1] individuals and small/medium sized groups that buy health insurance products from the company where the risks are borne fully by the company; [2] self insured programs where the company serves as a health benefits administrator for a large group but bears certain performance, credit and business performance risks; and [3] the Federal Employee Health Plan (FEP), through which the company bears a portion of the insurance risk collectively assumed by all Blue Cross and Blue Shield Plans throughout the country.

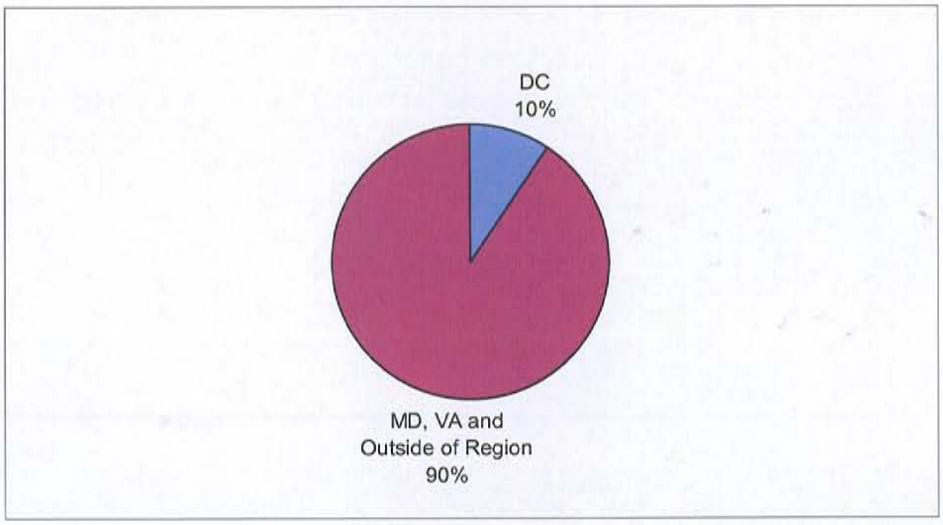
GHMSI's total enrollment of approximately 1,000,000 members is broken down as follows: 32% fully insured members; 33% self insured members and 35% insured FEP members. This is shown in more detail in Chart "A" below.

Chart A
GHMSI Enrollment



The overwhelming majority (approximately 90 percent) of all of GHMSI's membership resides outside of the District of Columbia. This is shown in Chart "B" below. These non-District residents contribute to GHMSI reserves through the coverage they have and the premiums paid by them or by their employers on their behalf. Regardless of where they live, all members served by GHMSI thus contribute substantially to GHMSI's reserves.

Chart B
GHMSI Members by Residence



Reserves

Insurance companies hold – and are *required* to hold – substantial sums in "reserve" to guard against anticipated risks (those the company can identify with reasonable certainty through actuarial and other analysis) and unanticipated risks (those the company is not able to anticipate, which fall into many categories). While the bulk of GHMSI's reserves are held to protect against the risks and contingencies associated with the insured business of the company, there are a number of other risks covered by reserves. A representative list of these major contingencies and risks against which GHMSI and all insurers must hold reserves includes the following:

- The adequacy of premium rates and protection against unforeseen trends or fluctuations in costs;
- The size of unpaid claim liabilities and the speed with which claims are presented for payment;
- Fluctuations in interest rates and portfolio asset values;
- The speed and certainty of subscriber payments, both individual and group;
- Unforeseen catastrophic events such as epidemics, natural disasters and acts of terrorism;
- Competitive changes in the health insurance market requiring new and/or different products, capabilities and services;

- Performance guarantees, especially from large, self insured groups, which have become far more common, complex and significant in terms of penalties for failure to perform; and;

- An unending stream of changes in government mandated requirements affecting all aspects of the business.

As a not-for-profit health services plan, GHMSI obtains the funds to build and hold reserves from a single source: the premiums paid by subscribers, whether directly or through their employer groups. GHMSI does not sell stock or count the excess of the market value of stock over tangible net worth as equity value to which the company can turn for capital should the need arise. The company has no stock.

The company accordingly builds reserves the only way it can – principally from the difference between what it collects in premiums and what it expends in claims and operating expenses to conduct its business. These amounts, built up over the years, are the company's only source of capital. Earnings on these reserves, which are conservatively invested on behalf of policyholders (approximately 80 percent of all investments are in the form of fixed income instruments), accumulate and add to reserves in normal economic times.

It is essential to understand that GHMSI's operating margins, meaning net income and underwriting gains, have historically been extremely small. Underwriting gains (the difference between premiums and total member claims and administrative expense) have averaged between less than 1 and 3 percent annually over many years. GHMSI's annual contributions to reserves (net income) have averaged between 1 and 4 percent, including investment income. This low margin is consistent with the company's not-for-profit mission and is much lower than for-profit company underwriting margins, which generally hover in the 6 to 10 percent range. These margins are subject to swings that are natural in the health insurance business. Historically, underwriting results of health insurers have been subject to trends in which multi-year underwriting loss periods are commonplace.

Long Term Build Up of Reserves

Given the small margins derived from underwriting risk and investment earnings, it takes the company years to build up reserves. But, as has been experienced in recent months and years, reserve levels painstakingly built up over long periods of time can decline precipitously when adverse financial market trends combine with adverse claim trends. Over the past decade, GHMSI reserve levels have fluctuated over 50 percent from high to low as the various factors influencing the reserves have been felt.

General Competitive Landscape

GHMSI operates in one of the most competitive health care marketplaces in the country. Virtually all of its competitors are multi-product line, multi-regional for profit insurers whose diversification, market value and ability to issue stock or debt are not dependent on this one region. Nor are their overall operating results dependent on a single line of business or earnings from this one region. The company's largest not-for-profit competitor is a national payer with diversification across most of the country.

In contrast, GHMSI is a one-product-line, one-region company with no diversification. If it were to run into capital shortages or other trouble with the risks it bears, the company has no ready source other than its reserves from which to draw. No government program provides a safety net or backup to the resources of the company. It must stand on its own. Its history includes at least one episode where its very existence was threatened and which required GHMSI to borrow $60 million from other Blue Plans. No government rescuer appeared in that hour of need.

In addition to these constraints, GHMSI faces a landscape in which health care is increasingly expensive, with the effect that an insurer's ability to ward off financial trouble through premium increases is greatly curtailed. Health care cost increases have reached the level where most individuals and employers are struggling to pay premiums. If GHMSI were to need to replenish reserves in a material way, it would have to add greater margins to its premium rates – further exacerbating the healthcare affordability problem and reducing the company's ability to compete. On the other hand a strong reserve position allows the Plan to sustain affordability by moderating otherwise required premium increases.

Moreover, the country may be entering an era of fundamental insurance and health care reform driven at the federal level which could change the landscape in fundamental ways – and could impose substantial new costs on insurers. One core idea in the reform debate illustrates this: there is widespread support for the proposal that all insurance companies would be required to issue policies without regard to the health status or pre-existing conditions of the prospective member. GHMSI strongly supports this idea. But, no one, including the company itself, knows the full impact or downstream consequences/risks of such a requirement. Certainly it could produce losses that would cut deeply into the reserves of GHMSI and other insurers nationwide.

The most fundamental objective of the company's management and Board is to serve GHMSI members. Especially in the current economic environment, being adequately reserved is perhaps the most important means to serving our members. It is the only way to assure that the promises the company makes to its members, their providers, and its vendors and partners can be met.

With the recent, unexpected collapse of financial institutions and insurers thought to be "invulnerable," it is imperative for anyone assessing the adequacy of reserves to guard against future adverse events and perform a cautious analysis.

Other Key Demands on Reserves

Insurance risks and contingencies are not the only demands to be accommodated by reserves. Three others are particularly noteworthy:

- Infrastructure upgrade: The costs of technology and systems to handle the ever greater complexity of the company's products and services must be funded from reserves since the company has no other source from which to fund these investments.
- Community health reinvestment and giving: Each year, the company, in keeping with the mission established by its Board, gives to a wide variety of worthy organizations engaged in activities that improve the general health of the community. This amounts to

millions of dollars annually. The only source of funds available to GHMSI for this giving: the company's reserves.

- Legislatively mandated losses: GHMSI is required by District law to offer products that produce known losses or that require the company to pay subsidies to help vulnerable populations gain better access to health care. These requirements are placed on GHMSI alone and apply to no other payer. The latest (and pending) framework set by the Council of the District of Columbia in draft legislation will produce losses of at least $12 million annually – and potentially much more. The source that supports these losses: GHMSI reserves, which must be constantly replenished through premiums if they are not to be materially diminished or depleted by these mandates alone.

II. SUMMARY OF MILLIMAN ANALYSIS

GHMSI Policy on Reserves

GHMSI seeks to hold only that amount of reserve that is reasonable and prudent to account for all of the various risks, contingencies and demands the company faces or may face. The Board of Directors of the company has adopted a formal policy position on this subject.

The essence of this policy is that the company strives to operate with reserve levels in an optimal range. If reserves are below or are heading below the bottom of the range, premium rate margins are increased to bring reserves back into the range. If reserves are too high or heading too high, rates are moderated or rate increases are delayed to bring the reserve level down. GHMSI generally evaluates its reserve levels on a three-year horizon in order to accommodate natural fluctuations in the business. Moderation is the key. Slow build up of margins when reserves are low is the goal in order to avoid large premium spikes.

The first step in determining reserve levels is to assure that they at least meet the National Association of Insurance Commissioners (NAIC) and Blue Cross and Blue Shield Association (BCBSA) minimum standards as defined in terms of a risk based capital (RBC) calculation. It is vital to understand that these levels are nothing more than emergency warning benchmarks, set so low that they would trigger monitoring or enforcement actions against the company if they were barely met. These levels are not viewed by the company, NAIC, BCBSA or by any regulator as reasonable, prudent or optimal levels. These standards represent levels to be avoided, not strived for.

It is also critical to note that neither the NAIC nor the BCBSA has established standards for what constitutes *too much* reserve. The entire focus of both organizations has been on the solvency of insurers and on establishing methodologies for ascertaining *minimum* solvency – not desired or optimal (much less "maximal") solvency.

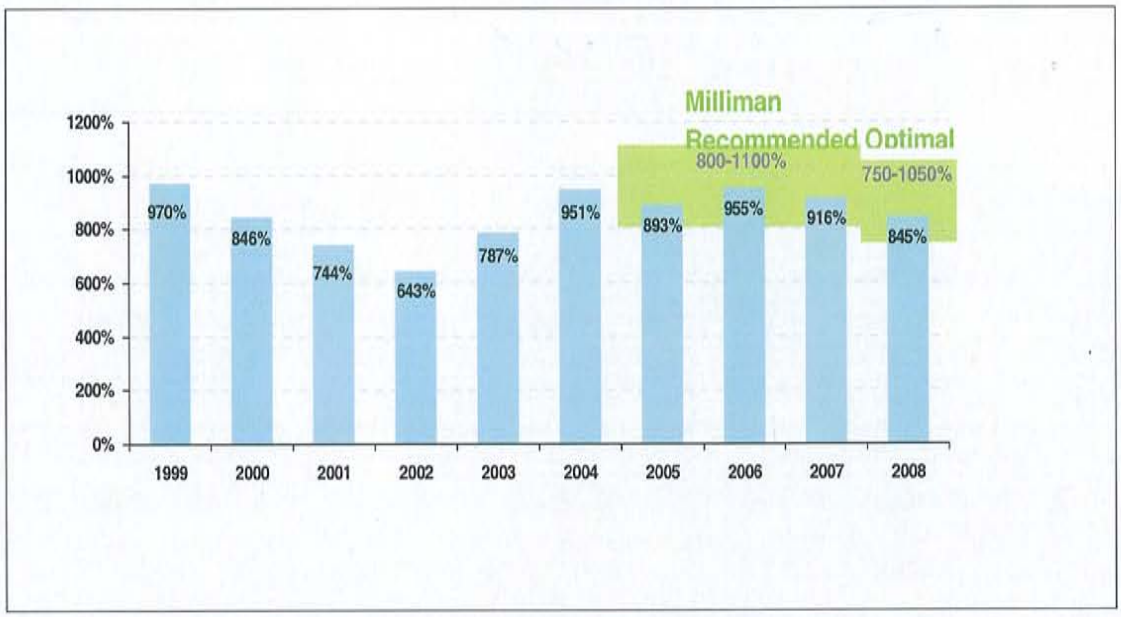
In the absence of clear standards and methodologies for determining an optimal reserve range, the GHMSI Board, beginning in 2005, sought outside expert actuarial advice. The company sought this advice not solely to assure that reserves stayed above the required minimums, but

with the notion of establishing an optimal range (floor and ceiling) that could provide the foundation for the policy framework described above.

To accomplish this, the company retained the services of Milliman, Inc., one of the nation's leading actuarial firms. Milliman developed an actuarial model, explained more fully below, that initially determined the company's optimal reserve level – given its various risks and demands over a multi-year period – to be between 800 and 1100 percent of RBC. A second review, completed in late 2008, placed the optimal range between 750 and 1050 percent of RBC.

Chart "C" shows GHMSI's reserve levels for each year in the last 10 years expressed as a percent of RBC. It also shows the ranges recommended by Milliman and GHMSI's position within those ranges. Importantly, Chart "C" demonstrates that, for at least a decade, GHMSI has never been above the RBC range recommended by Milliman.

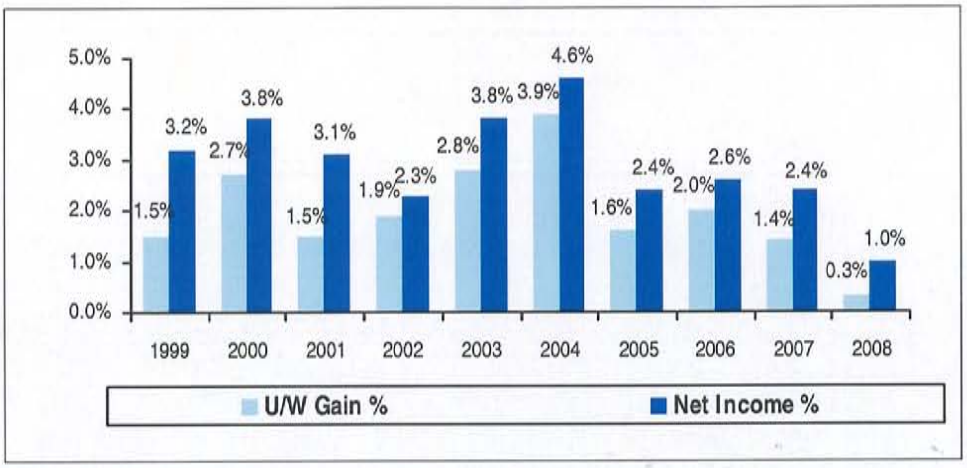
Chart C
GHMSI RBC Ratio



It also is quickly apparent that GHMSI has been in the lower half of the ranges throughout the decade except for a period early in the decade when it fell considerably below the floor of the ranges. It is equally apparent that GHMSI has been declining in its position in the range over the last several years. This reflects the generally poor condition of the economy and the financial markets as well as the continued strong upward climb of health care costs in this region. Nothing in the experience of the current year suggests a change in this position or trend.

Chart "D" shows GHMSI's underwriting margins during the last ten years as well as the total net income of the company after considering both underwriting results and investment returns. It is immediately clear that the company has constantly striven to manage its reserves consistent with its policy, increasing its margins in years when the reserve level fell below the minimum of the optimal range and reducing margins once reserves climbed back within that optimal range.

Chart D
GHMSI Margins



Due to concerns about premium levels in these difficult economic times and a desire to continue to maximize affordability, the company has not sought margin increases in the last several years and expects to operate with extremely thin margins in 2009. If the reserve drops below the floor of the optimal range, the company will have to reconsider the level of its margins. Should such a drop occur, any restoration to the optimal range would be attempted over a multi-year period in order to minimize rate fluctuations for premium-paying subscribers – either paying on their own or through group plans – the great majority of whom reside outside the District.

Reserve Range Methodology

In determining an optimal reserve range, Milliman essentially undertakes the following steps:

- examines GHMSI's historic performance to determine the range of underwriting performance and how it either conformed to or departed from rating assumptions;
- identifies and quantifies all key risks and contingencies that impact different aspects of the company's financial performance such as those mentioned previously in this document;
- employs an actuarial simulation model to determine the probability of different financial outcomes with different degrees and expressions of the key risks, both alone and in various combinations; and,
- compares and analyzes the simulation model results to actual historical results to develop a range of potential outcomes.

By necessity, this summary vastly oversimplifies the complex process and analysis undertaken by Milliman. Its actuaries consider the interaction of all of the above variables, their probability and degree of occurrence, as well as possible adverse impacts. The result is a range that provides the company with reasonable assurance that a single major catastrophic event, or the interconnected string of a number of less catastrophic events over a multi-year period, would not likely cause it to dip below Blue Cross and Blue Shield Association monitoring levels or, worse, to dip down to NAIC control levels.

This methodology, it should be emphasized, is not the simple "stacking up" of contingency reserves for a list of possible disasters (e.g., HIV, swine flu, etc.). Proper reserve levels cannot be rationally calculated in that way. Instead, Milliman follows proper actuarial practice by employing a sophisticated probabilistic and interactive model that is tested against historical results.

Further, the analysis is not focused solely on the risks inherent in medical underwriting, but considers all categories of risk, including business, asset, and financial-market risks. The last year alone illustrates how important these calculations are, as the adverse financial market and economic and health care trends all interacted simultaneously to cut into the company's reserves.

One cannot fully understand the models used by Milliman without substantial grounding in actuarial science, expertise and experience in the health field, and familiarity with GHMSI's business environment, history and market. As part of the DISB Commissioner's hearing and review process, Milliman as well as the financial management of the company stand ready to assist in interpretations, briefings and "guided tours" of the methodology and its implications for the Commissioner, his staff and any experts he chooses to assist him in evaluating the level of GHMSI's reserves.

The "Attributable" Issue

Into this already complicated picture must be inserted the complex task of ascertaining where the portion of GHMSI's reserves "attributable" to the District came from and how it is to be calculated.

The Medical Insurance Empowerment Amendment Act of 2008 (MIEAA) requires the Commissioner of DISB to analyze only that portion of the reserves that are "attributable to the District." The reserves of a multi-jurisdictional insurer such as GHMSI are fully and completely available to cover all the risks of the company regardless of the jurisdiction in which such risks may arise or the jurisdiction which, at any given time, may be said to most significantly contribute to those reserves.

Thus, any finding of excess limited to a portion of GHMSI's reserves is necessarily artificial and, if required to be expended, is probably in derogation of the rights and legitimate expectations of the other jurisdictions in which GHMSI operates and the non-resident policyholders for whose benefit and protection such reserves are held.

This unique reserves review requirement, recently established by District law, is by its nature complex, given that it inevitably entails determining what District sources built the reserves, and what District demands are placed on the "District-only" portion of the reserves. This calculus will be the subject of another report being prepared by GHMSI in preparation for the hearing scheduled for September 10, 2009.

For now, suffice it to say that while it may be possible to calculate surplus "attributable to the District," it is not possible, as a matter of sound actuarial practice, to calculate an appropriate RBC range for such a subset of the company's total surplus. As GHMSI's subsequent report will explain, RBC methodology is highly specified by the NAIC, is inextricably tied to the whole of

an insurance entity's investments and assets, and cannot be calculated on an arbitrary geographic subset of those assets.

III. Conclusion

GHMSI has built and maintains its reserves with great care, taking into account the various demands placed or likely to be placed on the company and the known and unknown risks in the future. It maintains these reserves within the bottom half of an optimal range based on outside expert actuarial review. GHMSI and its actuaries continually monitor reserves to ensure that they are funded sufficiently to meet the risks posed by and to this particular regional not-for-profit company, over and above the bare minimum standards imposed by NAIC and the national Blue Cross and Blue Shield Association. Maintenance of strong reserves is not in avoidance of, but is, in fact, critical to maintaining the company's ability to deliver on its community mission through infrastructure improvements, community giving and rate moderation that benefits subscribers.

July 31, 2009