July 11, 2013

Mr. Walter Smith, Esq.
The DC Appleseed Center for Law and Justice, Inc
1111 14th Street NW, Suite 510
Washington, DC 20005

RE: Group Hospitalization and Medical Services, Inc. ("GHMSI") Surplus

Dear Mr. Smith,

At your request, based on recent filings by Milliman (dated June 28, 2013) and GHMSI (dated July 1, 2013), I am providing some thoughts relative to each of those filings.

Milliman's June 28, 2013 Review

I previously wrote you (see previous correspondence including my letter of January 13, 2013) concerning the deficiencies of Milliman's prior approach to calculating needed surplus. Issues that I noted included:

1) Lack of transparency and justification in their construction of the "Loss Cycles" which drive their model;
2) Failure of their model to validate against GHMSI experience over the last 10-15 years;
3) Their handling of catastrophic events and unidentified growth and development within their model;
4) Their aggressively high premium growth for GHMSI assumption in the model which they applied to every scenario;
5) Their addition of inappropriate amounts of surplus for the already implemented aspects of the ACA;
6) Their speculation of additional amounts of surplus needed to address the impact of the ACA provisions that become effective 1/1/2014 and later; and
7) Their inappropriate use of confidence intervals relative to the BCBS Association monitoring threshold.

Milliman's June 28th filing does not do anything to address the above deficiencies of their previous modeling. In fact it indicates that no new modeling has yet been done or even requested of them by the company. The only thing their current review does do is provide mostly non-quantified thoughts about recent GHMSI financial information and the healthcare reform environment. The following are some high-level reactions to some of their thoughts:

a) Pricing margins

1) They note that actual underwriting margins were lower in 2012 than anticipated in their modeling due in part to a decision by GHMSI to limit the level of premium

increases in the individual line. To the extent that lower margins are due to a conscious decision by GHMSI management this should not impact modeling or future expectations.

2) They indicate that GHMSI filed premiums for 2014 which would generate non-FEP pricing margins of 2.8%. They indicate that the approved premiums were somewhat less and that reduced the expected margin to 1.8% BEFORE consideration of additional margins which might inure due to ACA risk programs. They also do not comment on why the premium filings were reduced – if the reduction was due to regulators having a different expectation for the future than the company, then the company's hoped for margin of 2.8% may still occur – again, before any additional margins from ACA risk programs.

b) **Annual Premium Growth** – Milliman acknowledges that GHMSI's reported premium growth rate in 2012 was 4.6% vs. 2.2% and 3.8% in the prior two years. This underscores the previous issue of premium growth in their model which was a much higher 9% and which was expected to occur in every future year.

c) **Health Care Reform Environment** – Milliman acknowledges that for the unimplemented portion of the ACA that much additional clarity has been given through the issuance of numerous regulations with regard to implementation. They also indicate that more uncertainty – particularly in regard to how purchasers will react - remains. While there is truth in these statements, Milliman fails to make any effort to quantify the likelihood or specifics of any potential impact upon GHMSI. Accordingly, their paper adds nothing to their previous speculation as to the directional impact of changes.

Finally, the particular risk Milliman notes here is "the potential for significant membership growth as the individual mandate takes effect in 2014." This statement is another mushy assertion lacking any quantitative facts or rigor to back it up. However, it should be noted first that individual business is a very small subset of GHMSI's current business and that a significant increase in that business might have an immaterial impact on the overall company. Secondly, it should be noted that it would take an enormous increase in individual business for the actual company growth rate to equal the 9% that Milliman has already assumed in their model.

GHMSI's July 1, 2013 Filing

GHMSI's filing begins by presenting some actual data that show their surplus has decreased in 2011 and 2012. An explanation for this is not given directly, but page 2 of the filing notes that GHMSI "voluntarily reduced rates substantially in 2011 and early 2012".

Much of the remainder of GHMSI's filing seems to argue that, despite these voluntarily reduced rates and therefore lower surplus than what would have accumulated, GHMSI's current surplus is more than adequate to protect policyholders. Here are a few thoughts on some of their points:

1) GHMSI presents a chart on page 4 that indicates that over the last five years Net Income has averaged 1.4% and Underwriting Gain has averaged 0.3%. It should be noted that this correlates with the chart on page 2 which shows that their surplus has increased over that same time period from 845% of RBC-ACL to 921%. This despite the following:

    a. The company voluntarily reduced rates (and thus margins) substantially in 2011 and 2012; and
    b. Milliman, the company's actuarial consultant, maintains[1] that an average pricing margin of at least 2.8% on non-FEP business is necessary to maintain a 900% RBC-ACL ratio.

2) On page 5 of their filing GHMSI indicates that for 2014 management intentionally chose "to set rates at the extreme lower end of potential increased morbidity." They then indicate that it is ***highly probable*** that the result will be "***significant losses*** on DC Exchange products that will materially impact GHMSI's statutory surplus." This is an interesting admission by the company and seems to indicate that a material reduction in statutory surplus from current levels would not be a problem for them, else why would they intentionally choose this strategy?

3) The company further argues on page 5 that if underwriting losses for 2014 and after materialize ***as expected*** it may take "multiple years to return underwriting levels to levels that no longer draw down surplus". This again seems to indicate not only a material reduction but also a sustained reduction in statutory surplus from current levels would not be a problem for them, else why would they intentionally choose this strategy?

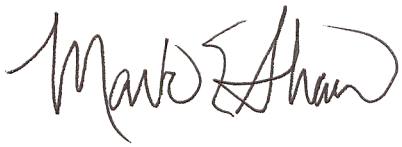
4) On page 6 of the GHMSI filing it states that "management and the Boards adopted optimal surplus ranges for GHMSI of… 1,000 to 1,300 percent PBC-ACL." It is curious why management would claim to adopt this target level of surplus and despite current surplus being materially lower than the adopted range (921% vs. the adopted minimum of 1000%), they admit to having intentionally chosen to pursue actions that will cause a material and sustained lowering of current surplus levels (see items 2 and 3 above). One might reasonably conclude that management does not really believe the optimal surplus range is really needed given their admitted strategy in this filing.

5) The GHMSI filing has many citations[2] referring to the uncertainties of the ACA and the potential to negatively impact the company. As discussed at our January meeting with CareFirst and Rector, and confirmed by CareFirst's Kenny Kan, CMS conducted a simulation of what may happen when the 2014 changes are implemented. The result for the Blues plan in the simulation was favorable – both increased revenues and profits. I am not aware of any credible modeling that would challenge that outcome. As a result, I do not believe that additional surplus for what is likely a positive event for the company is justifiable.

[1] See page 4 of the Milliman June 28, 2013 filing.
[2] For example, see section at the bottom of page 4 of the GHMSI filing entitled "Federal Health Care Reform Presents Significant New Uncertainties."

I am available to clarify or expound on any of the points made herein. As previously offered, I am also available to review the detailed Milliman model and data to make appropriate adjustments in order to produce a suitable surplus range for GHMSI. I again offer to sign an appropriate confidentiality agreement to facilitate that review.

Sincerely,



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