



**COMMONWEALTH OF MASSACHUSETTS**  
**OFFICE OF CONSUMER AFFAIRS AND BUSINESS**  
**REGULATION**

**Division of Insurance**

*Report on the Statutory Examination of*  
*Blue Cross and Blue Shield of Massachusetts, Inc.*

*Boston, Massachusetts*

*As of December 31, 2006*

**NAIC COMPANY CODE: 53228**

**EMPLOYERS ID NUMBER: 04-1045815**

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**COMMONWEALTH OF MASSACHUSETTS**  
**Office of Consumer Affairs and Business Regulation**  
**DIVISION OF INSURANCE**

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April 25, 2008

Honorable Alfred W. Gross, Chair  
Financial Condition (E) Committee, NAIC  
Commissioner  
Virginia Bureau of Insurance  
State Corporation Commission  
1300 East Main Street  
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The Honorable Nonnie S. Burnes  
Commissioner of Insurance  
Commonwealth of Massachusetts  
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Honorable Commissioners:

Pursuant to your instructions and in accordance with Massachusetts General Laws: Chapter 175, Section 4, Chapter 176A, Section 6, and Chapter 176B, Section 9, an examination has been made of the financial condition and affairs of

**Blue Cross and Blue Shield of Massachusetts, Inc.**

At its Main Administrative Office located at:

Landmark Center  
401 Park Drive  
Boston, MA 02215-3326

The following report thereon is respectfully submitted.

## **SCOPE OF EXAMINATION**

This statutory examination of Blue Cross and Blue Shield of Massachusetts, Inc., hereinafter referred to as “the Company,” “the Corporation,” “BCBSMA,” or “the Plan,” is as of December 31, 2006, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this statutory examination. KPMG LLP (KPMG) has applied certain agreed upon procedures to selected records and transactions of the Company.

The current examination was conducted at the direction of, and under the overall management and control of the examination staff of the Massachusetts Division of Insurance (the Division). The statutory examination was performed at the Company's main administrative office in Boston, Massachusetts. KPMG was engaged to perform certain agreed-upon procedures, which are in compliance with the *NAIC Financial Condition Examiners' Handbook*. KPMG's actuaries were involved in the performance of those procedures to the extent that such procedures related to the Company's reserves for unpaid claims and loss adjustment expenses and provider risk sharing settlements as of December 31, 2006. KPMG's Information Technology Advisory Services (ITAS) personnel were engaged to perform an Evaluation of Controls in Information Systems Questionnaire in a form substantially similar to the one established in the *NAIC Financial Condition Examiners' Handbook*. The ITAS Specialists performed examination procedures pertaining to the examination of the IT systems as outlined in the *NAIC Financial Condition Examiners' Handbook*. All procedures were performed under the management and control and general supervision of the examination staff of the Division.

The examination was conducted in accordance with standards and procedures established by the National Association of Insurance Commissioners (NAIC) Financial Condition (E) Committee and prescribed by the current *NAIC Financial Condition Examiners' Handbook*. The principal focus of the examination was 2006 activity; however, transactions both prior and subsequent thereto were reviewed as deemed appropriate.

In addition to a review of the financial condition of the Company, the examination included a review of the Company's business policies and practices, corporate records, provider contracts, reinsurance treaties, conflict of interest disclosure statements, fidelity bonds and other insurance, employees' pension and benefits plans, disaster recovery plan, and other pertinent matters to provide reasonable assurance that the Company was in compliance with applicable laws, rules and regulations. In planning and conducting the examination, consideration was given to the concepts of materiality and risk and examination efforts were directed accordingly.

In determining the scope of the statutory examination, after review and evaluation, the examination team placed reliance on certain workpapers provided by the Company's independent auditor, Ernst & Young LLP (E&Y). Wherever possible and wherever deemed appropriate and effective, E&Y's independent work product was used to define, support, document and expedite the overall examination process.

## **DESCRIPTION OF COMPANY**

### **History**

Blue Cross and Blue Shield of Massachusetts (BCBSMA) began as the Associated Hospital Service Corporation of Massachusetts in 1937. The Corporation aimed to spread the cost of hospital treatment among a large group of employed persons and, upon its opening, was the twenty-sixth plan of its kind in the United States, differing from others in its offering of statewide coverage. In 1939, the name Blue Cross was officially adopted by the American Hospital Association as the national symbol for the Hospital Service movement and in 1941, Blue Shield was established as a result of physician interest in the prepayment concept of financing health care.

Over the years “Blue Cross” and “Blue Shield of Massachusetts” continued to grow and adapt to the needs of consumers, offering ever-increasing comprehensive coverage. The two separate organizations merged to become Blue Cross and Blue Shield of Massachusetts, Inc. and continued as part of a national network of affiliated plans, the Blue Cross and Blue Shield Association.

## ***Blue Cross and Blue Shield of Massachusetts, Inc.***

In 1992, BCBSMA launched an insured Health Maintenance Organization (HMO) line of business branded as HMO Blue. The product reflected a change that was in line with the interests of the emerging market and represented a transition from traditional health insurance to managed care.

The Blue Cross Blue Shield of Massachusetts Foundation (BCBSF) was founded in 2001. The Foundation is committed to expanding high quality care access to the underserved in Massachusetts – in line with the original charter.

The Company is also the sole corporate member of The Health Care Assistance Foundation (HCAF). HCAF's mission is to promote the care of the elderly, disabled, and other persons who are experiencing financial hardships and to provide limited financial assistance for their care.

In 2003, BCBSF created the Massachusetts Medicaid Policy Institute (MMPI). MMPI is an independent and nonpartisan source for information and analysis of the Massachusetts Medicaid Program (often referred to as "MassHealth") and seeks to promote a broader understanding of the MassHealth program.

In January 2005, pursuant to a Master Reorganization Agreement (MRA), BCBSMA transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. (HMO Blue), a separately incorporated, and a wholly-owned subsidiary of BCBSMA. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed health maintenance organization. HMO Blue operates as a nonprofit, charitable organization and qualifies as a tax-exempt social welfare organization under Section 501 (c)(4) of the Internal Revenue Code.

Today, the Company provides coverage to approximately three million members in Massachusetts and has been recognized for standards of service excellence that are among the highest in the nation.

### **Capital and Surplus**

Capital and Surplus consists of capital contributed to the Company and the excess of revenues over expenses since inception. The total admitted assets, total liabilities and capital and surplus of the Company for the years ended 2004 through 2006 are shown in the following schedule.

<b><u>Year</u></b>	<b><u>Total Admitted Assets</u></b>	<b><u>Total Liabilities</u></b>	<b><u>Capital and Surplus</u></b>
2004	\$2,593,957,495	\$1,502,972,953	\$1,090,984,542
2005	\$1,604,631,720	\$1,139,264,392	\$465,367,328
2006	\$1,841,974,422	\$1,213,786,824	\$628,187,598

The decrease in Capital and Surplus from 2004 to 2005 is due to the \$696 million transfer from BCBSMA to HMO Blue.

## **MANAGEMENT**

### **Articles of Organization and By-Laws**

The name and purposes of the Corporation are set forth in the Articles of Organization. The Corporate By-Laws, the powers of the Corporation and of its members, directors and officers, and all matters concerning the conduct and regulation of the affairs of the Corporation are subject to the Articles of Organization.

### **Members and Membership**

The Company's By-Laws indicate the following regarding its corporate membership:

**Members** – In accordance with the Company’s Bylaws, the Annual Meeting of the members of the Company is to be held on the third Wednesday of March, or on such other day in March as shall be fixed each year by the directors, the chair of the board or the chief executive officer and stated in the notice of the meeting. The members also serve as the Board of Directors of the Company, which consists of no less than eleven and no more than 31 members. The purpose of the Annual meeting is the election of Directors and the transaction of such other business as may come before the meeting. The members shall also include persons having the qualifications required by any applicable law governing the composition of the Board of Directors.

Members and Directors of the Corporation shall be elected in accordance with Section 2 of Article II (Directors) of the Corporate By-Laws.

### **BOARD OF DIRECTORS**

The Bylaws specify that the business and affairs of the Company are controlled by a Board of Directors (the “Board”), the size of which is determined at each Annual Meeting of the members. Each Director must be a member of the Company. Directors are elected at the Annual Meeting and serve for three years or until a successor is duly elected and qualified.

The Rules of the Directors, in accordance with the Bylaws, specify that the Directors are to hold an annual meeting after the annual meeting of the members on the third Wednesday of March. The annual meeting of the directors is for the purpose of organization, election of the officers of the Company not elected by the members, establishment of committees of the Directors and the transaction of such other business as may properly come before the meeting. Special meetings of the Board may be called on notice by the Secretary upon request by the Chair of the Board, the Chief Executive Officer or two or more Directors.

At December 31, 2006, the Board was comprised of eighteen (18) directors, which was in compliance with the Company By-Laws. Directors duly elected and serving at December 31, 2006, and business affiliations, are as follows:

<b><u>Director</u></b>	<b><u>Principal Occupation</u></b>	<b><u>Tenure</u></b>
George R. Alcott III	President, Local 1301 Communication Workers of America	1 year
Brian M. Barefoot	President, Babson College	1 year
Peter W. Bertschmann	Former Vice President, Human Resources, New England Telephone	22 years
Samuel Cabot III	Chairman, Samuel Cabot, Inc.	13 years
Helen G. Drinan	Senior Vice President, Human Resources, Caritas Christi	12 years
Richard C. Garrison	Senior Vice President and Catalyst, Vertex Pharmaceuticals	8 years
Paul Guzzi	President and CEO, Greater Boston Chamber of Commerce	6 years
Robert J. Haynes	President, Massachusetts AFL-CIO	16 years
Marian L. Heard	President and CEO, Oxen Hill Partners	15 years
Philip W. Johnston	President, Philip W. Johnston Associates	9 years
Cleve L. Killingsworth, Jr.	President and CEO, Blue Cross and Blue Shield of Massachusetts	2 years
Gloria Cordes Larson	Partner and Co-Chair of the Government Practices Group, Foley Hoag LLP	1 year
William G. Lavelle, M.D.	Professor and Chairman, Department of Otolaryngology, University of Massachusetts Medical School	15 years
James H. Lunt	President and CEO, Rogers, Lunt & Bowlen Company	13 years
Ralph C. Martin II	Partner, Bingham McCutchen LLP	5 years



## *Blue Cross and Blue Shield of Massachusetts, Inc.*

Robert F. Meenan, M.D.	Dean, Boston University School of Public Health	3 years
William C. Van Faasen <sup>1</sup>	Chairman of the Board, Blue Cross and Blue Shield of Massachusetts	17 years
Benaree Wiley	Principal, The Wiley Group	3 years

### **Committees of the Board**

The Board may delegate such of its powers as it considers advisable, except those powers which by law, the Articles of Organization, or the By-Laws may not be so delegated, to such committees as the Board or the By-Laws may from time to time establish. All committees shall serve at the pleasure of the Board.

The current standing committees of the Board are as follows:

- **Audit Committee** – The Audit Committee provides assistance to the Board of Directors in fulfilling its oversight responsibilities with regard to the audit of the Company’s financial statements and the financial reporting process, the system of internal accounting and financial controls, the internal audit function, the annual independent audit of the Company’s financial statements, and the legal compliance and ethics programs of the Company. The Committee sets the overall “tone” for quality in financial reporting and control and management of risks, and deals with all matters affecting the auditing of the Company by internal and external auditors. The Audit Committee should be comprised of at least five independent Directors. At least one member should have depth of experience in financial work, and all members should have some degree of finance or accounting literacy. The Senior Vice President of Internal Audit and the independent auditor report directly to the Committee and administratively to the Chief Financial Officer.
- **Finance and Business Performance Committee** – The Finance and Business Performance Committee assists the Board in its oversight responsibility for the financial and business performance of the Company. It reviews key elements of the financial and business plan and also has oversight of the Company’s investment activity. The Finance and Business Performance Committee should have not less than five members. The Chair of the Board and CEO shall be an *ex officio* member without vote. The Chief Financial Officer shall be a regular, nonvoting participant. At least two-thirds must be independent Directors.
- **Human Resources Committee** - The Human Resources Committee provides assistance to the Board of Directors in its oversight responsibilities of the human assets of the Company. The Committee helps the Company in its efforts to produce sufficient leadership talent now and in the future, as well as sound practices for all associates. The Human Resources Committee shall be comprised exclusively of independent Directors.
- **Governance Committee** - The Governance Committee makes sure that skilled Directors are elected to the Board, that Board Committees have the necessary mix of content expertise and leadership, and that the Committees are addressing the appropriate strategic issues. With oversight of Board policy, the Governance Committee aligns the Board to its business purpose and defines the relationship between the Board, senior officers of the Company, the Company’s customers, and the community. The Governance Committee shall be comprised of not less than five or more than seven members, all of whom shall be independent Directors.
- **Health Care Delivery and Quality Committee** - The Health Care Delivery and Quality Committee provides assistance to the Board of Directors in its oversight responsibility for service to the Company’s members and coordinating the quality of health care delivery with providers. The Health Care Delivery and Quality Committee shall have a majority of independent Directors. The Chair of the Committee shall preferably be a physician or someone with a strong healthcare background.

### **OFFICERS**

The Corporate By-Laws require that the Corporation has as its officers a Chair of the Board, one or more Vice Chairs of the Board, a President, one or more Executive Vice Presidents, one or more Senior Vice Presidents, a Chief

<sup>1</sup> Mr. Van Faasen retired from the Board effective December 31, 2007. Mr. Killingsworth succeeded Mr. Van Faasen as Chairman of the Board.

## ***Blue Cross and Blue Shield of Massachusetts, Inc.***

Financial Officer, a Chief Actuary, a Chief Legal Officer, a Secretary, a Treasurer, one or more Assistant Secretaries, and one or more Assistant Treasurers. The Chair and each Vice Chair of the Board must also be Directors.

The Directors may elect or appoint from time to time such other officers with such powers and duties and for such terms, not exceeding three years, as the Directors may determine. The Directors have the authority to fix and determine the salaries and compensation of all officers.

All officers elected by the Board or members may be removed at any time for cause by vote of a majority of the Directors then in office, provided that an officer may be removed for cause only after a reasonable notice and opportunity to be heard before the Board. All officers elected by the Board may be removed at any time without cause by vote of a majority of the Directors then in office. Vacancies in any office, however occurring, may be filled by the Directors.

The powers granted by the By-Laws to any officer or officers of the Corporation shall be in addition to and not in limitation of any authority granted by vote of the Directors.

The Chair of the Board and each officer of the Corporation who is elected or appointed pursuant to the By-Laws must be annually sworn and their oaths entered on record in the books of the Corporation. The Secretary, the Treasurer, each Assistant Secretary and each Assistant Treasurer are covered by an existing fidelity bond.

The elected officers and their respective titles at December 31, 2006 were as follows:

<b><u>Officer</u></b>	<b><u>Elected Title</u></b>
Cleve L. Killingsworth, Jr.	President and Chief Executive Officer
William C. Van Faasen <sup>2</sup>	Chairman
Robert J. Haynes	Vice Chairman
Allen P. Maltz	Chief Financial Officer and Treasurer
Sandra L. Jesse	Executive Vice President, Chief Legal Officer and Assistant Secretary
Fredi Shonkoff	Senior Vice President and Secretary
Keith Renaldi	Senior Vice President and Assistant Treasurer
William T. Cushing, Jr.	Senior Vice President and Chief Audit Executive
Rina Vertes	Senior Vice President and Chief Actuary

## **CONFLICT OF INTEREST PROCEDURES**

The Company has adopted a conflict of interest policy statement. The Company has an established procedure for the disclosure to the Board of any material interest or affiliation on the part of any officer or director which is in or is likely to conflict with his/her official duties.

Each Director of the Board shall annually deliver to the Board, at or about the time of the Annual Meeting, a true and complete conflicts of interest statement (a "Conflicts Statement") in the form approved by the Board; provided that each person described above shall deliver only one Conflicts Statement regardless of the number of positions listed above that he or she holds. Each Director shall promptly update his or her most recent Conflicts Statement upon the occurrence of any event that makes the information contained in such Conflicts Statement no longer true or that would be required to be reported in such Conflicts Statement at the time it is delivered to the Board.

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<sup>2</sup> Mr. Van Faasen retired from the Board effective December 31, 2007. Mr. Killingsworth succeeded Mr. Van Faasen as Chairman of the Board.



***Blue Cross and Blue Shield of Massachusetts, Inc.***

The completed Conflict of Interest Disclosure Statements for Directors, Officers and Senior Managers for 2004, 2005 and 2006 were reviewed. No discrepancies were noted in the response to the General Interrogatories regarding conflicts of interest as reflected in the Company's December 31, 2006 Annual Statement.

**CORPORATE RECORDS**

**Articles of Incorporation and Bylaws**

Our review of the By-Laws indicated that they were amended effective December 14, 1993.

**Board of Directors Minutes**

The minutes of the Board and committee meetings for the period under statutory examination were read and indicated that all meetings were held in accordance with the Company By-Laws and the laws of the Commonwealth of Massachusetts. Activities of the committees were reported upon at various meetings of the Board.

**ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS AND PURCHASES OR SALES**

On January 1, 2005, pursuant to a Master Reorganization Agreement (MRA), BCBSMA transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to HMO Blue, a separately incorporated, wholly-controlled subsidiary of BCBSMA. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed Health Maintenance Organization.

The Company entered into a bilateral intercompany agreement with HMO Blue as a result of the MRA to settle any claims, fees, administrative cost expense allocation and pass-through cash and expenses paid by one company on behalf of the other company.

As a condition of granting an HMO license to HMO Blue, the Division required BCBSMA and HMO Blue to enter into an agreement with the Division granting the Division discretionary authority to require either company to issue a surplus note to the other company if either of the company's health risk-based capital (RBC) is more than seventy five percentage points higher than the other company's RBC. Under the terms of its license with Blue Cross and Blue Shield Association, BCBSMA has also entered into a unilateral agreement with HMO Blue to guarantee all current and future obligations of HMO Blue.

Under the MRA, both BCBSMA and HMO Blue have an undivided interest in what had been BCBSMA's property and equipment. The initial basis of the property and equipment were systematically allocated to each company at the date of the transaction. Ongoing depreciation expenses are charged to each company based on utilization.

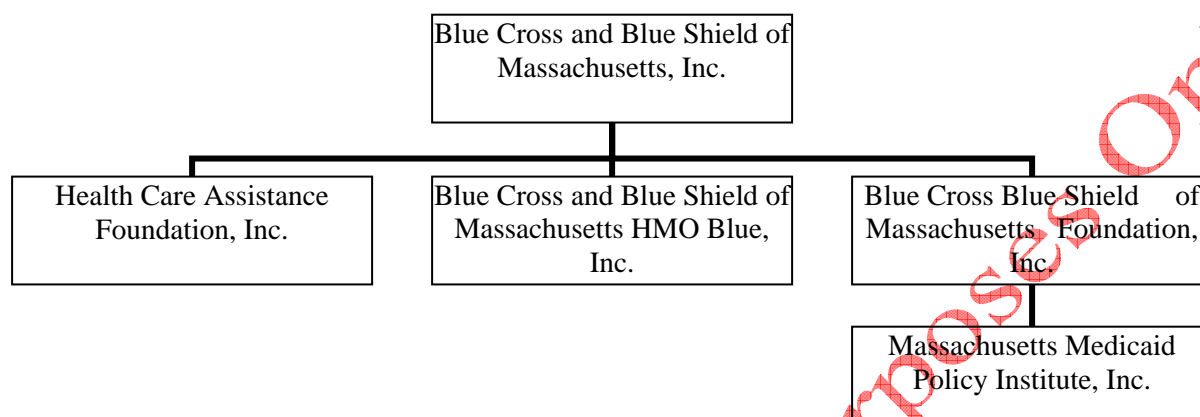
Under the MRA, existing employees (Associates) of the Companies are either concurrently employed by both BCBSMA and HMO Blue or solely employed by BCBSMA. Those individuals solely employed by BCBSMA include Senior Level Management. The compensation, benefits and administrative expenses of the concurrently employed Associates are charged to BCBSMA and HMO Blue in accordance with their provision of services to each company. With respect to individuals solely employed by BCBSMA, the pro rata portion of compensation, benefits and administrative expenses attributable to services provided to HMO Blue is charged to HMO Blue on an arm's length basis, including a mark-up. A common paymaster arrangement has been established for payroll and payroll related benefits. An agency arrangement has been established for payment of claims and operating expenses and receipt of funds. The Companies' pension and postretirement benefit plans continue to be sponsored by BCBSMA. BCBSMA charges HMO Blue, as a participating employer of benefit plans, a fee based on HMO Blue's allocated share of the benefit plans' expenses.

**MANAGEMENT CONTINUITY AND NATIONAL EMERGENCY**

The Company provides for the continuity of management and operations in the event of a catastrophe or national emergency in accordance with Massachusetts General Laws, Chapter 175 §§ 180M-180Q.

**AFFILIATED COMPANIES**

A summary of ownership and relationship of the Company and its operating subsidiaries and affiliated companies as of December 31, 2006 is illustrated below:



**RELATED PARTY TRANSACTIONS**

On January 1, 2005, pursuant to a Master Reorganization Agreement (MRA), BCBSMA transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to HMO Blue. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed HMO. BCBSMA entered into a bilateral intercompany agreement with HMO Blue as a result of the MRA to settle any claims, fees, administrative cost expense allocation and pass-through cash and expenses paid by one company on behalf of the other company.

BCBSMA's surplus as of December 31, 2004 was allocated between BCBSMA and HMO Blue, in accordance with the MRA, so that the post-reorganization risk-based capital (RBC) levels of the two entities were within 15 percentage points of each other. On April 1, 2005, in connection with the transfer of Blue Care 65 to HMO Blue, BCBSMA transferred surplus of \$60 million to HMO Blue so that the entities' RBC levels would remain within 15 percentage points of each other.

BCBSMA is the sole corporate member of two Foundations: the Health Care Assistance Foundation, Inc. (HCAF) and Blue Cross Blue Shield of Massachusetts Foundation (BCBSF). BCBSF is the sole corporate member of the Massachusetts Medicaid Policy Institute (MMPI). BCBSMA provided financial support of \$12.1 million and \$15.5 million in 2006 and 2005, respectively.

The Company had receivables from HMO Blue of \$70.8 million and \$75.7 million for the years ended 2006 and 2005, respectively. At December 31, 2006, the Company had payables to BCBSF and HCAF of \$10.3 million and \$29,000, respectively, and a receivable from MMPI of \$81,000. At December 31, 2005, the Company had payables to BCBSF and HCAF of \$12.7 million and \$29,000, respectively, and a receivable from MMPI of \$85,000.

BCBSMA and HMO Blue jointly entered into two \$100 million revolving credit agreements. Borrowings under these lines of credit bear interest on a floating interest rate basis. Each credit facility is unsecured and matured in June 2007 and August 2007. There were no amounts outstanding under either credit facility at December 31, 2006. The

## ***Blue Cross and Blue Shield of Massachusetts, Inc.***

Company continues to renew these lines annually. In addition, BCBSMA terminated a \$30 million revolving credit agreement in July 2006 which was set to expire in August 2006.

BCBSMA and HMO Blue jointly entered into a Tri-Party Agreement with Citizens Bank of Massachusetts (Citizens) and Perry South Shore Developer, LLC (the Developer) with respect to obligations of BCBSMA and HMO Blue pursuant to a Purchase and Sale Agreement with the Developer for the construction and development of a building and related improvements. The Tri-Party Agreement pledged assets of BCBSMA and HMO Blue in the amount of \$150 million to Citizens for the Developer's rights and interests under the Purchase and Sale Agreement. In September 2006, upon purchase of the building by BCBSMA and HMO Blue, the Tri-Party Agreement was terminated and the collateral was released.

### **FIDELITY BOND AND OTHER INSURANCE**

The Corporation maintains fidelity bond coverage with an authorized Massachusetts insurer. The aggregate limit of liability exceeds the NAIC suggested minimum.

In addition to the bond insurance, the Company has further protected its interests and properties by policies of insurance covering other insurable risks. Coverage is provided by insurers licensed in the Commonwealth of Massachusetts and was in force as of December 31, 2006.

### **PENSION AND INSURANCE PLANS**

All employees of BCBSMA are eligible to participate in the Retirement Income Trust Plan (RIT), which grants benefits to retired employees at various levels based on age and years of service. The Company also participates in two noncontributory retirement plans for eligible employees and sponsors a defined benefit plan covering medical, life and dental benefits.

Accumulated benefit obligations for fully and partially vested participants in the RIT were \$356.8 million and \$343.7 million at December 31, 2006 and 2005, respectively. Fair value of the plan assets for the RIT were \$451.9 million and \$420.8 million at December 31, 2006 and 2005, respectively. The net periodic benefit cost for 2006 and 2005 was \$14.0 million and \$6.3 million for the RIT and \$14.3 million and \$17.3 million for the post-retirement benefits plan, respectively.

Weighted-average assumptions used in the actuarial valuations of the benefit plans as of December 31, 2006 and 2005 are as follows:

	<b>Pension Benefits</b>		<b>Post-retirement Benefits</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Discount rate	5.90%	5.75%	5.75%	5.75%
Rate of compensation increase	4.50%	4.50%	N/A	N/A
Expected long-term rate of increase	8.00%	8.50%	8.00%	N/A

The Company has a non-pension post-retirement benefit plan. On December 31, 2006 and 2005, the Company's other benefits, included in its post-retirement plan, are medical, dental and life benefits for retired employees. The 401(h) account was instituted by BCBSMA in December 2003. There were no contributions made in 2006, and a contribution of \$9 million was made in December 2005. The accounting for the health insurance plans are based on the provisions of Statements of Statutory Accounting Principles (SSAP) No. 11. For measurement purposes, a 9.50% (pre-65) and 10.00% (post-65) annual rate of increase in the per capita cost of covered health care benefits was assumed for 2005. The rate was assumed to decrease gradually to 5.00% over 10 years and remain level thereafter.

Assumed healthcare cost trend rates have a significant effect on the amounts reported for the health care plans. A one percentage-point change in assumed health care cost trend rates would have the following effects (000's):

**Blue Cross and Blue Shield of Massachusetts, Inc.**

	<b>1 Percentage Point Increase</b>	<b>1 Percentage Point Decrease</b>
Effect on total of service and interest cost components	\$489	\$(462)
Effect on post-retirement benefit obligation	\$4,971	\$(4,698)

BCBSMA's pension benefit weighted average asset allocations at December 31, 2006 and 2005, by asset category are as follows:

<b>Asset category</b>	<b>Pension Benefits</b>		<b>Post-retirement Benefits</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Equity securities	59%	58%	59%	58%
Debt securities	21	25	21	25
Real Estate	6	5	6	5
Other	14	12	14	12
Total	100%	100%	100%	100%

The Company's portfolio is managed within ERISA guidelines to ensure adequate funding of the pension obligation and to maximize the returns. The asset allocation has to be structured to enable an 8.0% return target on the assets. The targets and ranges were established based on the results of an asset liability study which was done in 2003. The targets and ranges are 58% Equity target within a range of 50% - 65%, 22% for Debt with a range of 12% - 32%, 5% for Real Estate within a range of 2% - 8%, and 15% target for "Other assets". The Company considered the historical returns and future expectations for returns for each asset class, as well as target allocation of the portfolio to develop the expected long-term rate of return on assets assumption. This resulted in the selection of the 8.0% long-term rate of return on assets assumption.

BCBSMA's contributions for the fiscal year ending December 31, 2007 are expected to be \$20 million for its pension plan and \$9.4 million to its post-retirement benefit plan.

At December 31, 2006, the Company's projected benefit payments are as follows ('000's):

	<b>Pension Benefits</b>	<b>Other Benefits</b>	<b>Cash Flow from Medicare Subsidy</b>
2007	\$24,432	\$7,737	\$473
2008	26,329	8,065	521
2009	27,817	8,458	562
2010	29,287	8,805	608
2011	31,498	9,242	649
Next five years	179,737	50,166	3,865

BCBSMA also has a savings 401(k) plan for eligible employees. Under the employee savings plan, BCBSMA contributes an amount equal to 65% of employee contributions, up to a maximum of 6% of each employee's compensation, subject to pretax Internal Revenue Service limits. The Company's contribution for the 401(k) plan was \$3.4 million and \$3.6 million for 2006 and 2005, respectively. At December 31, 2006, the fair market value of these plan assets was \$281.6 million for BCBSMA and HMO Blue combined.

## **TERRITORY AND PLAN OF OPERATION**

### **Territory**

The Corporation is only licensed to transact business in the Commonwealth of Massachusetts.

## **Plan of Operations**

Blue Cross and Blue Shield of Massachusetts, Inc. is headquartered in Boston, MA.

## **PRODUCTS**

The Company offers the following insured products:

- **Blue Care Elect** — Blue Care Elect is a ‘non-gatekeeper’ type preferred provider organization (PPO) that includes two levels of benefits—a higher level of benefits for health care services furnished by preferred providers and a lower level of benefits for health services furnished by non-preferred providers. Blue Care Elect is subject to Massachusetts General Laws, Chapters 176I.
- **Indemnity Plans** — Indemnity plans are “traditional” plan options that provide full or partial compensation for hospital and/or physician and other professional health services. These plans, which are approved under Massachusetts General Laws, Chapters 176A and 176B, include the Blue Cross and Blue Shield Plan.
- **Point-of-Service Plans** — Point-of-service (dual certificate) plans are comprised of two separate health benefit plans: an HMO plan and an indemnity plan. The “in-network” portion is an HMO Blue plan offered by Blue Cross and Blue Shield of Massachusetts, HMO Blue Inc. that is licensed under Massachusetts General Laws, Chapter 176G. The “out-of-network” portion is an indemnity plan approved under Massachusetts General Laws, Chapters 176A and 176B. These plans include Blue Choice, Blue Choice New England and Access Blue Plus.
- **Nongroup Guaranteed Issue Preferred Provider Plans** — PPO Blue Direct and PPO Basic Blue Direct are nongroup guaranteed issue preferred provider plans in accordance with Massachusetts General Laws, Chapter 176M. (These plans are closed to new membership effective July 1, 2007.)
- **Medex Plans** — Medex plans are Medigap insurance programs that supplement benefits available under the Medicare Program (Part A and Part B only). Group Medex plans include Medex 3, Medex Silver and Medex Core. Direct-Billed Medex plans are offered to nongroup individuals and include Direct-Billed Medex Bronze and Direct-Billed Medex Core.
- **Medicare Prescription Drug Plans** — Medicare Prescription Drug Plans are Medicare Part D prescription plans. These plans include Blue Medicare RX Direct and Blue Medicare RX Group.
- **Dental Plans** — Dental plans are group insurance plans that provide full or partial compensation for dental care services. These plans include Dental Blue and Dental Blue PPO. These dental plans may include coverage for preventive, restorative, prosthodontic (tooth replacement), major restorative (crowns, inlays and onlays) and orthodontic services.

## **PROVIDER CONTRACTS**

The Company arranges for the provision of health care services to its subscribers and eligible dependents thereof through contracts with physician providers and other health care providers. Physician providers and such other organizations or individuals are and shall be deemed to be, for all purposes, independent contractors with the Company, and shall not be characterized as officers, employees or agents of the Company.

The agreements are in compliance with Massachusetts statutes and regulation 211 CMR § 52.



## **RESERVES**

KPMG Health Actuaries prepared independent estimates of the Unpaid Claim Liabilities (UCL) as of December 31, 2006 and prior periods. For December 31, 2006, completion factors for the projection of ultimate claims were developed using historical payment patterns and actuarial judgment. "Low" and "High" estimates were developed by subtracting the claims paid-to-date from the actuarial range of incurred estimates. As the BCBSMA business pays fairly quickly, the range of estimates for the December 31, 2006 UCL is narrow and the actuarial estimates are similar to BCBSMA's estimates with hindsight through June 30, 2007.

BCBSMA made a separate provision for Claim Adjustment Expenses (LAE/CAE) in 2006 and the resulting expense percentage levels used are within industry norms.

The Company's premium deficiency reserve calculation was reviewed and found to be reasonable. The calculation indicated that no premium deficiency reserves were required as of December 31, 2006.

## **REINSURANCE**

During 2006, the Company entered into a Specific Excess of Loss reinsurance agreement with ACE American Insurance Company, a Massachusetts licensed insurance company. The Company does not own in excess of 10%, nor directly or indirectly control this reinsurer. None of the Company's policies have been reinsured outside of the U.S. None of the Company's reinsurance agreements can be unilaterally cancelled except for nonpayment of premiums. There have been no terminated reinsurance policies as of December 31, 2006. The Company has not written off any reinsurance balances in 2006. The Company does not have any commutated reinsurance with other companies.

## **INCOME TAXES**

On January 1, 2005, BCBSMA transferred the operations of its health maintenance organization ("HMO") to HMO Blue in exchange for the assumption of the liabilities of the HMO. Prior to this restructuring, BCBSMA received opinion letters from outside counsel covering three issues; (1) that BCBSMA should not recognize taxable income or gain upon the transfer of assets to HMO Blue; (2) that the transfer would not constitute a material change of BCBSMA's business and BCBSMA would continue to qualify as an existing Blue Cross Blue Shield organization under Internal Revenue Code Section 833(c)(2); and (3) HMO Blue should be a tax exempt organization.

BCBSMA's December 31, 2006 provisions and rollforwards for federal income taxes were reviewed by KPMG. The Company booked two large adjustments to the current tax expense for a benefit of \$48.5 million. The two adjustments are related to the Company's settlement with the Internal Revenue Service of the fresh start intangible write-off. Based upon the assumptions and assertions by company management, the tax provisions for income tax appear reasonable.

## **ACCOUNTS AND RECORDS**

The books and records of the Company are audited annually by the independent certified public accounting firm of Ernst & Young LLP, in accordance with 211 CMR § 23. The CPA Firm issued an unqualified opinion on the December 31, 2006 audited financial statements. The Company is also subject to review by an internal audit department.

The internal control structure was discussed with management through questionnaires and through a review of the work performed by the Corporation's Independent Certified Public Accountants (Ernst & Young LLP). No material internal control weaknesses were noted in connection with the examination, nor were any such matters reported in the CPA Firm's filings with the Division.



***Blue Cross and Blue Shield of Massachusetts, Inc.***

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The NAIC provides a questionnaire covering the evaluation of the controls in the Information Systems environment. The questionnaire was completed by the Company and reviewed by KPMG's Information Technology Advisory Services (ITAS) team that evaluated the adequacy of the Information Systems controls. No material deficiencies were noted.

The Company uses an automated general ledger system. Trial balances were traced from the general ledger and supporting documents to the 2006 Annual Statement. No material exceptions were noted.

**COMMITMENTS AND CONTINGENCIES**

As a condition of granting an HMO license to HMO Blue, the Division required BCBSMA and HMO Blue to enter into an agreement with the Division granting the Division discretionary authority to require either company to issue a surplus note to the other company if either of the company's health risk-based capital (RBC) is more than seventy-five (75) percentage points higher than the other company's RBC. Under the terms of its license with Blue Cross and Blue Shield Association, BCBSMA has entered into a unilateral agreement with HMO Blue to guarantee all current and future financial obligations of HMO Blue.

**Lease Obligations**

The Company and HMO Blue jointly have a long-term operating lease agreement for approximately 500,000 square feet of office space for its corporate headquarters. The term of the lease is 15 years, commencing in May 2000, with an option to extend for one period of four years and eleven months.

The Company and HMO Blue jointly have entered into several other long-term non-cancelable operating lease agreements for office space that expire at various dates through 2010.

The Company and HMO Blue's office space rental expense for 2006 and 2005 was \$23.4 million and \$26.7 million, respectively.

In addition, the Companies have an agreement with an outside vendor to provide certain information technology services for substantially all of the Companies' business operations. The Companies minimum commitments under this agreement are approximately \$51.8 million per year.

***Blue Cross and Blue Shield of Massachusetts, Inc.***

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At December 31, 2006, the Companies minimum aggregate rental commitments are as follows (000's):

<b>Year ending December 31</b>	<b>Operating Lease</b>
2007	\$ 24,154
2008	19,009
2009	18,882
2010	19,654
2011	19,984
Balance through end of lease	\$ 55,119

Certain rental commitments have renewal options extending through the year 2007. Some of these renewals are subject to adjustments in future periods.

The Company has no sales-leaseback transactions at December 31, 2006.

**Legal Proceedings**

The Company is involved in pending and threatened litigation of the character incidental to its business or arising out of its insurance operations, and is from time to time involved as a party in various governmental and administrative proceedings. Management continues to monitor these matters, and believes the Company has accrued adequate reserves against potential liabilities.

For Information Purposes Only

**FINANCIAL STATEMENTS**

The Financial Statement section includes the following:

	<u>Page</u>
Statutory Statement of Assets, Liabilities and Capital & Surplus as of December 31, 2006	16
Statement of Revenue and Expenses for the Year Ended December 31, 2006	17
Capital & Surplus for the Year Ended December 31, 2006	18
Statement of Changes in Capital & Surplus for Three Years Ended December 31, 2006	19

The following financial statements are presented on the basis of accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance and by the National Association of Insurance Commissioners as of December 31, 2006.

For Information Purposes Only

**Blue Cross and Blue Shield of Massachusetts, Inc.**

**Blue Cross and Blue Shield of Massachusetts, Inc.  
Statutory Statement of Assets, Liabilities and Capital & Surplus  
As of December 31, 2006**

	<b>Annual Statement</b>	<b>Statutory Examination Adjustment</b>	<b>Per Statutory Examination</b>
<b><u>ASSETS</u></b>			
Bonds	\$ 443,415,753	\$ -	\$ 443,415,753
Stocks:			
Preferred stocks	\$ 2,991,818	-	\$ 2,991,818
Common stocks	153,631,129	-	153,631,129
Real estate:			
Properties occupied by the company	129,882,244	-	129,882,244
Cash, cash equivalents and short-term investments	62,165,705	-	62,165,705
Other invested assets	385,313,970	-	385,313,970
Receivable for securities	1,048,994	-	1,048,994
Subtotals, cash and invested assets	<u>1,178,449,613</u>	<u>-</u>	<u>1,178,449,613</u>
Investment income due and accrued	3,831,477	-	3,831,477
Premiums and considerations:			
Uncollected premiums and agents' balances in the course of collection	17,040,671	-	17,040,671
Accrued retrospective premiums	1,431,269	-	1,431,269
Amounts receivable relating to uninsured plans	400,670,207	-	400,670,207
Current federal and foreign income tax recoverable and interest thereon	48,402,216	-	48,402,216
Net deferred tax asset	10,735,041	-	10,735,041
Electronic data processing equipment and software	3,739,557	-	3,739,557
Receivables from parent, subsidiaries and affiliates	70,858,188	-	70,858,188
Health care and other amounts receivable	25,045,482	-	25,045,482
Other than invested assets	81,770,701	-	81,770,701
<b>Total Assets</b>	<u><u>\$1,841,974,422</u></u>	<u><u>\$ -</u></u>	<u><u>\$1,841,974,422</u></u>
<b><u>LIABILITIES</u></b>			
Claims unpaid	\$ 229,425,360	\$ -	\$ 229,425,360
Accrued medical incentive pool and bonus amounts	15,159,262	-	15,159,262
Unpaid claims adjustment expenses	11,144,425	-	11,144,425
Aggregate health policy reserves	30,731,247	-	30,731,247
Premiums received in advance	43,278,983	-	43,278,983
General expenses due or accrued	134,404,980	-	134,404,980
Current federal and foreign income tax payable and interest thereon	13,282,587	-	13,282,587
Ceded reinsurance premiums payable	6,300	-	6,300
Amounts withheld or retained for the account of others	407,669	-	407,669
Amounts due to parent, subsidiaries and affiliates	10,357,017	-	10,357,017
Payable for securities	15,593,889	-	15,593,889
Liability for amounts held under uninsured accident and health plans	391,458,158	-	391,458,158
Other Liabilities	318,536,947	-	318,536,947
<b>Total Liabilities</b>	<u><u>\$1,213,786,824</u></u>	<u><u>\$ -</u></u>	<u><u>\$1,213,786,824</u></u>
<b><u>CAPITAL AND SURPLUS</u></b>			
Unassigned funds (surplus)	628,187,598	-	628,187,598
<b>Total Capital and Surplus</b>	<u><u>\$ 628,187,598</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 628,187,598</u></u>
<b>Total Liabilities, Capital and Surplus</b>	<u><u>\$1,841,974,422</u></u>	<u><u>\$ -</u></u>	<u><u>\$1,841,974,422</u></u>

*Blue Cross and Blue Shield of Massachusetts, Inc.*

**Blue Cross and Blue Shield of Massachusetts, Inc.**

**Statement of Revenue and Expenses  
For the Year Ended December 31, 2006**

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
Member Months	7,248,432	-	7,248,432
Net premium income	\$2,097,001,311	\$ -	\$2,097,001,311
Change in unearned premium reserves and reserve for rate credits	455,595	-	455,595
Total revenues	2,097,456,906	-	2,097,456,906
Hospital and Medical:			
Hospital/medical benefits	1,298,233,512	-	1,298,233,512
Other professional services	126,888,379	-	126,888,379
Emergency room and out-of-area	21,338,404	-	21,338,404
Prescription drugs	341,048,464	-	341,048,464
Total medical and hospital	1,787,508,759	-	1,787,508,759
Claims adjustment expenses	141,355,415	-	141,355,415
General administrative expenses	110,423,884	-	110,423,884
Total underwriting deductions	2,039,288,058	-	2,039,288,058
Net underwriting gain	58,168,848	-	58,168,848
Net investment income earned	39,881,225	-	39,881,225
Net realized capital gains	10,424,172	-	10,424,172
Net investment gains	50,305,397	-	50,305,397
Other income (expense)	(2,373,792)	-	(2,373,792)
Net income after capital gains tax and before all other federal income taxes	106,100,453	-	106,100,453
Federal and foreign income taxes incurred	(51,149,506)	-	(51,149,506)
Net income	\$ 157,249,958	\$ -	\$ 157,249,958

***Blue Cross and Blue Shield of Massachusetts, Inc.***

**Blue Cross and Blue Shield of Massachusetts, Inc.**

**Capital & Surplus**

**For the Year Ended December 31, 2006**

	<b>Annual Statement</b>	<b>Statutory Examination Adjustment</b>	<b>Per Statutory Examination</b>
Capital and Surplus, December 31, 2005	\$ 465,367,328	\$ -	\$465,367,328
Net income or (loss)	157,249,958	-	157,249,958
Change in net unrealized capital gains and losses less capital gains tax	17,983,980	-	17,983,980
Change in net deferred income tax	306,908,533	-	306,908,533
Change in nonadmitted assets	(317,600,875)		(317,600,875)
Aggregate write-ins for gains (losses) in surplus	(1,721,326)		(1,721,326)
Net change in capital and surplus	162,820,270	-	162,820,270
Capital and Surplus, December 31, 2006	<u>\$ 628,187,598</u>	<u>\$ -</u>	<u>\$628,187,598</u>

For Information Purposes Only



**Blue Cross and Blue Shield of Massachusetts, Inc.  
Statement of Changes in Capital & Surplus  
For Three Year Period Ended December 31, 2006**

	<u>2004</u>	<u>2005</u>	<u>2006</u>
<b>Capital and Surplus, prior year</b>	<u>\$ 887,644,967</u>	<u>\$ 1,090,984,542</u>	<u>\$ 465,367,328</u>
Net income	242,761,698	127,722,543	157,249,958
Change in net unrealized capital gains (losses)	34,499,631	(11,722,106)	17,983,980
Change in net deferred income tax	11,400,563	(10,554,147)	306,908,533
Change in nonadmitted assets and related items	(85,853,686)	(40,380,806)	(317,600,875)
Change in surplus as a result of transfer	0	(696,378,632)	0
Change in surplus as a result of other write-ins	<u>531,369</u>	<u>5,695,934</u>	<u>(1,721,326)</u>
<b>Net change in capital and surplus for the year</b>	<u>203,339,575</u>	<u>(625,617,214)</u>	<u>162,820,270</u>
<b>Capital and Surplus, December 31, current year</b>	<u><u>\$ 1,090,984,542</u></u>	<u><u>\$ 465,367,328</u></u>	<u><u>\$ 628,187,598</u></u>

**ACKNOWLEDGMENT**

This is to certify that the undersigned is a duly qualified Certified Financial Examiner (CFE) and that, in conjunction with KPMG LLP, applied certain agreed-upon procedures to the accounting and corporate records of Blue Cross and Blue Shield of Massachusetts, Inc. in order for the Division of Insurance of the Commonwealth of Massachusetts to fulfill the Commonwealth's requirements regarding periodic Statutory Examinations of Massachusetts domiciled insurers.

The undersigned's participation in this Statutory Examination as the Examiner-in-Charge encompassed responsibility for the coordination and direction of the statutory examination performed which was in accordance with, and substantially complied with, those standards established by the Financial Condition (E) Committee of the NAIC and the *NAIC Financial Condition Examiners' Handbook*. This participation consisted of involvement in the planning (development, supervision and review of agreed upon procedures), administration, review of work papers and preparation of the statutory examination report.

The cooperation and assistance of the officers and employees of Blue Cross and Blue Shield of Massachusetts, Inc. extended to all examiners during the course of the examination is hereby acknowledged.

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John Turchi, CFE, CPCU  
Supervising Examiner & Examiner in Charge (EIC)  
Commonwealth of Massachusetts  
Division of Insurance  
Boston, MA

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