

Testimony Before The Pennsylvania Insurance Department
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Good morning, Commissioner, and thank you for convening this hearing and giving us the opportunity to address the issues you have raised.

In a few minutes, I will introduce John Foos, our CFO, who will address the specifics of those questions, as well as James Roberts from Ernst & Young. Mr. Roberts is an expert on health insurance company surplus levels.

And speaking of surplus,

I'm reminded of the morning when I picked up the Philadelphia Inquirer and saw an article on our allegedly "excessive" surplus. Now let me describe for you, Commissioner, the context in which I'm reading this attack on Independence Blue Cross:

- ◆ It's still early in the year, and we've been fielding hundreds of calls from employers and members who are really unhappy about another double-digit increase in premiums.
- ◆ We're negotiating every day with hospitals that demand huge increases in their reimbursements and threaten to terminate their contracts if we don't meet their expectations.
- ◆ We're getting attacked by legislators who claim we're covering too little, and by physicians who claim we're paying them too little.
- ◆ The whole health care cost system is about to implode, and I see this headline in The Inquirer:

“\$325 Million Surplus For Blue Cross”

Commissioner, I'll never forget the date of that article: March 29, 1991.

That's right, 1991 – over 11 years ago.

Way back then, during another time when medical costs were skyrocketing and no one seemed to have an answer, people were demanding to know why IBC had hundreds of millions of dollars in surplus.

Well, my answer now is the same one I had for The Inquirer in 1991. Quote: “If you look at the cycles through health care, many companies have gone to weak reserves, got hit with a bad cycle and serious trouble. Independence Blue Cross has to draw a balance, trying to keep rates reasonable, at the same time remaining financially stable.”

That statement was as true 11 years ago as it was this February when The Inquirer and its Editorial Board claimed that we had too much surplus and --

that **your department**, Commissioner, wasn't paying attention – which we all know is blatantly untrue.

Your department spends ample time with each insurance company, in:

- ◆ Market Conduct Examinations
- ◆ Quarterly reviews
- ◆ Tri-annual examinations
- ◆ Other audits of all kinds

Despite their earlier comments about our surplus and your Department, weeks later, and to their credit, the Inquirer Editorial Board decided, upon reflection, that our level of surplus was **NOT** excessive. I quote:

“Upon hearing reports of the surpluses, many health insurance subscribers who've been hit with recent rate increases were angry. They wondered why the surpluses had not instead been used for the purposes sought by the plaintiffs.

“But Independence Blue Cross now has provided an explanation of why its surplus represents **fiscal prudence**, not hoarding of revenues.”

And the Editorial added:

“No single region, no single insurer can wrestle the cost question to the ground. It's a national problem that will require national solutions.”

I'd like to tell you that Editorial put this matter to rest, Commissioner. But unfortunately, not enough people read it, because the bottom of Thursday's Editorial Page does not compare to the front page of the Sunday morning edition.

That front page article in February appeared after IBC had spent more than a year, meeting with legislators, providers, employers and customers to explain the incredible complexity of this present-day, health care cost crisis.

That one newspaper article sent the public discussion skidding over a cliff, with its overly-simplistic, dead-wrong explanation for the problem.

Make no mistake about it. This recent discussion started with a class action lawsuit that, in our case, totally misrepresented our level of surplus. What the lawsuit did was misinterpret the annual statement that IBC filed with the Insurance Department.

As you know, Commissioner, that particular statement directs us to record the total surplus for **ALL** of IBC's affiliates and subsidiaries, but **ONLY** the claims directly attributable to IBC's indemnity product – which these days accounts for just 10 percent of our business.

The Department directs us to file the claims for IBC's affiliates and subsidiaries **separately**.

Not understanding this, the attorneys stacked up IBC's entire **2000** surplus of **\$613 MILLION** against just **\$637 MILLION** in indemnity product claims and decided that Independence Blue Cross had enough surplus to cover almost a year's worth of claims for all of IBC's products.

Truth is, in total, IBC paid **\$6 BILLION** in claims that year. That surplus would cover claims – not for a year – but for a period of less than **SIX WEEKS**.

In fact, something like **37 DAYS** of claims.

As you can see, Commissioner, by misunderstanding the annual statement, the class action lawsuit **totally** misrepresented reality.

And as a result of these miscalculations, the story which followed and the ensuing discussion have misled the public on several issues.

Moreover, neither the lawsuit nor the stories nor the legislative debate to this point has ever cited **one single expert** on the issue of surplus. Why?

Because they would be hard-pressed to find an expert who – in good faith – would **ever** support the charge that a health insurance company with a surplus to cover less than 6 weeks of claims was over-surplused.

But you will hear today from a well-respected expert, someone intimately involved with the development of the Risk-Based Capital system. And he will be absolutely clear on this question.

The people of Pennsylvania are fortunate to have four healthy, well-managed Blue Cross Plans. Because insurance companies that get in trouble without adequate surpluses become problematic for everyone.

And if the Blue Cross Plans in Pennsylvania were to get into trouble, the problem would be even bigger.

Why?

Because publicly-traded insurance companies in need of capital have access to the markets for cash.

Pennsylvania's Blue Cross Plans don't.

And, as you know, Commissioner, publicly-traded insurance companies that get in trouble are covered by the state Guaranty Fund.

Pennsylvania's Blue Cross Plans aren't.

The fact is, Blue Cross Plans that get into trouble have only one place to turn – to the surplus they set aside to deal with the “unexpected.” And if those surplus funds run out, guess what doesn't get paid:

- ◆ Hospitals' claims don't get paid,
- ◆ Doctors' claims don't get paid,
- ◆ Customers' claims don't get paid.

All those promises broken.

And in the end, Commissioner, that's what IBC sells – a promise.

We promise our customers we will be there for them --- when they need us most.

We promise the hospitals and physicians in our network that we'll pay them for the services they deliver to our customers.

And we promise the employers who buy our products --- that we will offer access to quality health care ...

at the best price we can.

And we're very proud that more and more people in Southeastern Pennsylvania decide **every year** to take us up on that promise.

But the promise is only as sound as the company that makes it. I'm proud to say, Commissioner, that IBC – like the other Blue Cross plans in this state -- is a sound company.

But make no mistake, our surplus is essential to that financial stability.

Now, a lot of people have asked us to justify our surplus level against the requirements of the Insurance Department or against those of the Blue Cross Blue Shield Association. It's the Association that licenses us to use the Blue Cross, and gives our customers access to a worldwide health network.

Well, Commissioner, we **do** satisfy your department's minimum requirements, and we also satisfy those of the Blue Cross Blue Shield Association – which requires a much higher minimum level of surplus than the Commonwealth.

In fact, we've spent the past 12 years since I joined IBC doing exactly what I know the Insurance Department wants us to do – to build and maintain a healthy company for the benefit of our members.

To that end, IBC's surplus has grown **absolutely** in keeping with the standards for Risk-Based Capital set by the National Association of Insurance Commissioners – standards that became Pennsylvania law and have been overseen by your department.

You can look at our financial reports and see: IBC's Risk-Based Capital percentage has remained almost unchanged.

Our membership has grown.

Our claims have grown.

And appropriately,

Our surplus has grown.

And our RBC percentage is practically unchanged.

That means that every time we took on a new member, our surplus kept pace with that increased financial risk.

As our membership grew and our claims risk grew, our surplus grew – just as it is supposed to grow.

Or, put another way, every time we made a new promise, we put aside money so we could keep that promise.

That's sound and responsible business.

In fact, Commissioner, I want to assure IBC's members today that even if the requirements of the Insurance Department and the Blue Cross Blue Shield Association did not exist, IBC would still be determined to continue building its surplus –

Even beyond its current level.

Why?

Because every year, costs are going up.

In the past 13 months, for example, we've increased our physician fee schedule by nearly 15 percent. (And we are looking seriously at future increases.)

In fact, we raised the schedule by 7.5% in August 2001,

And we raised it by another 7.5% in April 2002

At an annualized cost of about \$200 million per year.

Also, in the past 12 months, we've negotiated new contracts with 22 area hospitals – all of whom received significantly higher rates of reimbursement.

In fact, over the past four years, we've nearly doubled our payments to hospitals – to about \$2 **BILLION** each year.

In other words, we are paying **more** claims and **more expensive** claims to members and providers. And if our surplus is to keep up with those claims, then it has to grow.

That's sound and responsible business.

Meanwhile, every year, our membership in Southeastern Pennsylvania is going up. And to us, when that happens, we hear from our most important critic – the marketplace.

And over the last 10 years, the marketplace has spoken loud and clear. It likes what we have to offer.

Their trust in us, especially when the threat of the unexpected has never been greater or more real, **demands** that we maintain appropriate levels of surplus.

You know, Commissioner, I knew our surplus was important before Sept. 11. Remember back then? When we thought of the “unexpected” in terms of ...

stock market crashes,

new and expensive technology

or severe recessions?

Now we know the “unexpected” can mean something very different.

Terrorism in our cities, anthrax in our mail.

And no health insurance company is more vulnerable to the financial crisis than one of those events would trigger than companies, like IBC, that primarily serve a single, large regional population.

The thousands of men and women who work tirelessly at IBC think about that every day. And it reminds us what that surplus is for.

We also think about the risk of doing business in the Philadelphia region, which has one of the highest rates of medical cost inflation in the nation.

We think about the risk associated with paying more than \$6.6 billion in claims last year – a risk that turns a 1% increase in utilization trends into \$66 million in additional claims that we would need to pay.

We think about all of those risks, Commissioner, and it reminds us what that surplus is for. And that IBC's surplus needs to grow.

But by how much? You asked what level of surplus would be appropriate.

The answer today, I will tell you, might not be the answer for tomorrow.

As you said in June, Commissioner, in your remarks to the state Senate Banking and Insurance Committee, "insurance is never a black and white issue."

That's why it has never been possible to establish a bright-line test for an appropriate level of surplus.

The one thing I do know, however, is what would **NOT** be appropriate.

The 200% RBC that has been **mischaracterized** in the media as the Insurance Department's "minimum" level is not – by any stretch of the imagination – an appropriate level of surplus.

And no one involved in the insurance industry ever intended it to be.

Certainly not the National Association of Insurance Commissioners, which developed the Risk-Based Capital calculation as one measure of a financially **WEAK** company.

In fact, NAIC officials regularly are asked to consider raising the 200% "weak company" level. Why?

Because experience has shown by the time a company's RBC drops to that level, it's too late to save the company. Is that an **appropriate** level?

Certainly **the Insurance Department** doesn't think companies should operate at the 200% RBC level. In fact, when a company gets down to that level, the Department initiates – and I quote the Insurance Department's guidelines – "an increasingly stringent level of regulatory response."

Actually, I am not sure what the value of the 200% RBC is to the Department. So far, its only use has allowed the media to reference a totally irrelevant **number** ... instead of **experts**.

As a result, a misled public has been taken on a very unproductive trip down a very blind alley.

It seems to me that any effort to set an appropriate level of surplus assumes a lot about the future of the health care industry and our world.

That's why I believe that rather than try to establish some arbitrary bright-line test for surplus, the Insurance Department should continue to do what it absolutely is in the best position to do and has done:

Work with individual insurance companies to determine, in each individual case, their appropriate level of surplus.

But there are people in this room who disagree. So let's cut to the bottom line.

Let's say we returned to our customers -- just those in our five-county area of Southeastern Pennsylvania -- all of the surplus that exceeds the Insurance Department's alarm level of 200% RBC?

What would that mean to Independence Blue Cross?

First, the Insurance Department would identify us as a company in trouble, and begin a process that could lead to takeover.

Then, we would no longer be a Blue Cross company. The Blue Cross Blue Shield Association would revoke our license, and our members would no longer have access to Blue Plan services anywhere in the world outside Southeastern Pennsylvania.

And our promise would be broken. Finished.

Is it worth it?

Commissioner, let me say that I absolutely understand why people are looking everywhere for relief during this health care crisis. A day doesn't pass when the complexity of this crisis doesn't visit my door.

But I've got to tell you that until the mythmakers stop misleading the public, the chances that we'll solve this crisis are miniscule. And the myths just never seem to stop.

Like: IBC doesn't pay taxes. There's a good myth. But let me set the record straight again.

In 2001, IBC paid **\$116 million** in federal, state and local **non**-payroll taxes. \$116 million -- \$40 million of it in premium taxes to the state.

How much of a premium tax break did we get?

About **\$6 million**.

And what did we do with that tax break? As you know, Commissioner, we spent it – in fact, we spent nearly three times that tax break. We spent it on our social mission.

Let me put that differently, Commissioner.

Except for that \$6 million premium tax break, IBC is taxed the same way as our publicly-traded competitors such as CIGNA, Aetna and United.

The primary difference between our tax structure and those companies' is this modest premium tax break -- \$6 million – for which we are expected to fulfill a social mission.

If you took that tax break away from IBC, we would then be paying exactly the same level of taxes as our publicly-traded competitors – with one big difference – we would still fulfill a social mission.

In fact, let me say right now that if the Insurance Department or the legislature or any other party decides to introduce legislation to take away that tax break, we at IBC would support it. And –

Unlike our publicly-traded competitors,

Our Board and our staff would still remain committed to our social mission.

- ◆ A social mission that started looking out for uninsured children long before any government got involved.
- ◆ A social mission that has helped Pennsylvania provide health insurance to more than 92 percent of the state's children – one of the best rates in the nation.
- ◆ A social mission that benefits hundreds of worthy causes every year.
- ◆ A social mission that helped us decide to stay in the Medicare + Choice business even as other insurers were pulling out.
- ◆ A social mission that allows anyone in Southeastern Pennsylvania to come to us at any time, in any state of health, and buy health insurance, that others, including our publicly-traded competitors, don't offer.

Finally, I'm reminded of another myth. This one says we are piling up a surplus in preparation for converting to a for-profit, publicly-traded company. No matter how many times I address this myth, it turns up again, stated as fact. Let me try one more time.

IBC is a not-for profit company that owns a number of for-profit entities. Keystone Health Plan East and QCC, the company through which we market our Personal Choice product, are for-profit companies. So are AmeriHealth Administrators, the company that provides services to self-insured group health plans, and AmeriHealth, which has operations in New Jersey, Delaware and elsewhere.

The establishment and growth of these companies has been critically important to IBC's financial health over the past decade. These companies have permitted IBC to compete against much larger, publicly-traded companies with much easier access to capital. But what sometimes seems to get lost in this discussion, Commissioner – what our critics cannot seem to comprehend – is that all of these for-profit companies have but one parent – one shareholder – and that is the not-for-profit Independence Blue Cross.

These companies are not publicly-traded. They do not have to address the profit expectations of multiple shareholders. They do not get managed quarter-to-quarter. They benefit just one entity – the not-for-profit Independence Blue Cross.

And it is to IBC that these entities – Keystone, QCC and the others – return the profits that permit IBC to successfully compete in today's very difficult health care marketplace ...

It is because of these for-profit companies that IBC can preserve its commitment to the social mission I described earlier, while delivering on the promise to give our customers access to quality health care at the best price we can.

Before we formed these for-profit companies, IBC was losing 100,000 customers a year – which created a drain on our remaining customers and hurt our ability to deliver on our social mission. Since investing in our for-profit companies, we've turned that situation around and added 1 million members in Southeastern Pennsylvania.

It is a structure that absolutely benefits our customers and our community.

That's why we have no plan to alter this structure. No intent to convert Independence Blue Cross to a for-profit plan.

Let me repeat that.

Independence Blue Cross has no plan to convert to a for-profit company.

Now before I introduce our CFO, John Foos, I would like to share a few excerpts from some letters addressed to the Commissioner concerning IBC's surplus.

These letters came from a variety of sectors – from providers and customers alike.

Four of the letters were written by leaders of some of the area's largest hospital systems. The University of Pennsylvania Health System, the Jefferson Health System, Catholic

Health East and the North Philadelphia Health System. Representing hospitals from throughout Southeastern Pennsylvania, these letters had one common message:

The success of our hospitals DEPENDS on a strong Independence Blue Cross.

Listen to a few quotes:

From Robert D. Martin, CEO of the University of Pennsylvania Health System, which includes the Hospital of the University of Pennsylvania, Pennsylvania Hospital, Phoenixville Hospital and Presbyterian Medical Center. Mr. Martin writes:

“We recently concluded a successful negotiation of our contract with IBC – a contract which provides for payments to our health system from IBC for the provision of medical care to patients who are members of Independence Blue Cross. At any moment in time, UPHS may have as much as \$75 million in accounts receivables from Independence Blue Cross. I would not like to see these receivables jeopardized because of a diminution in IBC’s ability to pay. The recent failure of Oaktree and its effects on my organization are vivid reminders of what can happen.”

“In my opinion, any action taken to arbitrarily diminish IBC’s reserves or reduce their financial strength will not be helpful to providers in southeastern Pennsylvania, including UPHS.”

From Joseph T. Sebastianelli, president and CEO of the Jefferson Health System, which includes Thomas Jefferson University Hospital, Albert Einstein Medical Center, Bryn Mawr Medical Center, Lankenau Hospital, Frankford Hospital, Methodist Hospital, Paoli Memorial Hospital, Magee Rehabilitation Hospital and Moss Rehabilitation Hospital. Mr. Sabastianelli writes:

“I do not believe the Insurance Department should use its regulatory authority to require a reduction, or freeze, in Blue Cross/Blue Shield Plan reserves in Pennsylvania. As the Department well knows, insurance reserves are cyclical and respond more to market conditions than regulatory considerations. By artificially reducing or controlling Blue Cross/Blue Shield rates through regulatory rather than market considerations, the Department will adversely affect the natural market fluctuations in rates and reserves. Moreover, since the Insurance Department is not proposing to require a reduction in the reserves of the Blue Plans’ competitors, a partial regulatory intervention in market dynamics can only skew the market even further.”

From George J. Walmsley III, President and CEO, and **Dominic Sabatini**, Board Chairman of North Philadelphia Health System, which includes Girard Medical Center and St. Joseph’s Hospital. They write:

“We strongly believe that the campaign to find relief by draining the surplus of Independence Blue Cross and Pennsylvania’s other Blue Cross Plans is misguided.”

“We encourage the Insurance Department to focus on assuring that insurers have adequate surplus, and resist any pressure to take precipitous action that could be damaging in the long-term.”

From Mark T. O’Neil, Jr., Executive Vice President of the Mid-Atlantic Division of Catholic Health East, which includes Mercy Fitzgerald Hospital, Mercy Hospital of Philadelphia, Mercy Suburban Hospital, Nazareth Hospital, St. Agnes Medical Center and St. Mary Medical Center. Mr. O’Neil writes:

“We must be very careful to safeguard against any ‘quick fix’ decisions that force IBC to reduce the reserve requirements, or pay providers less. A reduction may jeopardize the strength of the company and, importantly for us, the strength of the Mercy / IBC relationship.

“These are difficult times for all of us in the health care industry, as the cost crisis shows no sign of abating. There are many serious issues to confront in the months ahead, including financial relief for the challenges facing hospitals, doctors, insurers, employers and customers. The health care system is best served when insurers like IBC remain strong with sufficient reserves, allowing them to fulfill their role within the community to support its good health and its economic well-being.”

Some of the area’s largest labor unions also wrote letters. They emphasized that nothing is more important to their members than health care benefits. They, too, stressed the need for Independence Blue Cross to remain strong.

Listen to a few excerpts:

From Samuel J. Kenish, Administrator for the Health and Welfare Fund of Teamsters Local 830:

“I know that the primary purpose of an insurance company’s surplus is to serve as a “safety net,” having resources on hand to withstand unforeseen circumstances. Therefore, I am not in favor of any decision that would weaken IBC’s reserves, and which eventually could jeopardize the health and welfare of our members.”

From Patrick J. Eiding, president of the Philadelphia Council AFL-CIO, and **Patrick B. Gillespie**, Business Manager of Philadelphia Building Trades Council:

“We know first-hand about the spiraling costs of health care, and about the impact of those costs on the health insurance premiums. One of us, as a member of the Independence Blue Cross Board of Directors, knows first-hand about the challenges facing insurers who are trying to hold down those costs. But both of us also know how very important it is to our members to have health insurance that they can count on when they need it.”

“We urge the Insurance Department to keep those who misunderstand the importance of a strong surplus from weakening the financial strength of Independence Blue Cross. Such a move would not be in the best interests of our members.”

From Thomas J. Lamb, Administrator for Law Enforcement Health Benefits, Inc.:

“Our members value the security of their Blue Cross card, especially during a time of great need for themselves or for their family members. During this time of need, the Blue Cross reserve amounts mean nothing to them – but the continued security of Blue Cross does.”

And Charles P. Pizzi, president of the Greater Philadelphia Chamber of Commerce, which represents 6,000 businesses in the region, wrote: “The surplus of IBC assures employees that their coverage is in place and that they have little to fear about the financial viability of the insurer.”

Hopefully, Commissioner, I have been able to address some of the Department’s questions this morning. I especially hope that I have been able to reassure those who have been misled about this issue that Independence Blue Cross is **a financially strong, well-managed** company, focused on **servicing the needs of our customers** and **fulfilling our responsibility to our community**.

We are determined to be a part of the solution to the current health care crisis, Commissioner, and I believe that Independence Blue Cross is in a strong position to help find that solution.