

STATUTORY-BASIS FINANCIAL STATEMENTS

HCSC Insurance Services Company
(A Wholly Owned Subsidiary of Health Care Service Corporation, a
Mutual Legal Reserve Company)
Years Ended December 31, 2006 and 2005
With Report of Independent Auditors

S5715 PDP Illinois, New Mexico, and Texas
S5566 PDP Oklahoma
H3208 MA-PD New Mexico
H3709 MA-PD Oklahoma
H4531 MA-PD Texas

HCSC Insurance Services Company

Statutory-Basis Financial Statements

Years Ended December 31, 2006 and 2005

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Report of Independent Auditors

The Board of Directors and Stockholder
HCSC Insurance Services Company

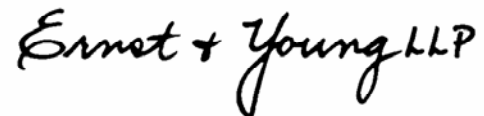
We have audited the accompanying statutory-basis balance sheets of HCSC Insurance Services Company (the Company) (a wholly owned subsidiary of Health Care Service Corporation, a Mutual Legal Reserve Company) as of December 31, 2006 and 2005, and the related statutory-basis statements of income and expenses and changes in capital and surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 2 to the financial statements, the Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance, which practices differ from accounting principles generally accepted in the United States. The variances between such practices and accounting principles generally accepted in the United States are described in Note 2. The effects on the financial statements of these variances are not reasonably determinable, but are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States, the financial position of the Company as of December 31, 2006 and 2005, or the results of its operations or its cash flow for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and 2005, and the results of its operations and its cash flow for the years then ended, in conformity with accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance.

A handwritten signature in black ink that reads 'Ernst + Young LLP'.

April 13, 2007

HCSC Insurance Services Company

Balance Sheets – Statutory Basis

	December 31	
	2006	2005
Assets		
Invested assets:		
Cash and cash equivalents	\$ 13,350,568	\$ 60,927
Short-term investments, at amortized cost which approximates fair value	1,492,287	117,827
U.S. government securities, at amortized cost	11,575,547	14,656,024
Total invested assets	26,418,402	14,834,778
Accrued investment income	80,547	90,273
Current federal income tax recoverable	–	4,034,205
Premium receivables	4,016,691	22,560
Amounts receivable related to uninsured plans	46,118,380	–
Healthcare and other receivables	28,915,598	533,334
Net deferred tax asset	559,262	78,377
Receivable from parent	12,647,715	30,000,000
Total assets	\$ 118,756,595	\$ 49,593,527
Liabilities and capital and surplus		
Liabilities:		
Contract life claims	\$ 2,836,000	\$ 879,000
Contract health claims and aggregate reserves	15,358,823	442,000
Payable to parent	–	6,609,525
General expenses due and accrued	22,391,600	10,919,534
Federal income taxes payable	1,757,221	–
Total liabilities	42,343,644	18,850,059
Capital and surplus:		
Common stock, \$5,000 par value, 500 shares authorized, issued, and outstanding	2,500,000	2,500,000
Additional paid-in capital	164,264,898	124,264,898
Accumulated deficit	(90,351,947)	(96,021,430)
Total capital and surplus	76,412,951	30,743,468
Total liabilities and capital and surplus	\$ 118,756,595	\$ 49,593,527

See accompanying notes.

HCSC Insurance Services Company

Statements of Income and Expenses and Changes in Capital and Surplus – Statutory Basis

	Year Ended December 31	
	2006	2005
Income		
Premiums earned	\$ 350,035,691	\$ 1,264,957
Net investment income	1,601,850	560,036
Other income	–	78,766
Total income	351,637,541	1,903,759
Expenses		
Benefits under life, accident and health policies	291,796,990	1,216,447
General and administrative expenses	54,051,317	22,188,663
Other expenses	–	79,037
Total expenses	345,848,307	23,484,147
Income (loss) from operations before federal income tax (expense) benefit	5,789,234	(21,580,388)
Federal income tax (expense) benefit	(212,416)	4,032,473
Net income (loss)	5,576,818	(17,547,915)
Other capital and surplus changes:		
Cumulative effect of changes in accounting principles	–	3,298
Change in net deferred tax	(3,745,238)	7,554,868
Change in nonadmitted assets	3,837,903	(7,481,083)
Contributed capital	40,000,000	30,000,000
Total other capital and surplus changes	40,092,665	30,077,083
Increase in capital and surplus	45,669,483	12,529,168
Capital and surplus, beginning of year	30,743,468	18,214,300
Capital and surplus, end of year	\$ 76,412,951	\$ 30,743,468

See accompanying notes.

HCSC Insurance Services Company

Statements of Cash Flow – Statutory Basis

	Year Ended December 31	
	2006	2005
Cash from operations		
Premiums received	\$ 346,895,300	\$ 1,242,396
Investment income received, net of investment expense	1,692,053	709,826
Federal income taxes refunded (paid)	5,578,985	(83,127)
Claims, commissions, and other expenses paid	(412,502,237)	(6,097,157)
Other income	–	78,766
Net cash used in operations	(58,335,899)	(4,149,296)
Cash from investments		
Proceeds from sale or maturity of bonds	3,000,000	2,860,000
Cost of investments acquired – bonds	–	(2,272,303)
Net cash provided by investments	3,000,000	587,697
Cash from financing		
Contributed capital	70,000,000	–
Net cash provided by financing	70,000,000	–
Net increase (decrease) in cash and cash equivalents and short-term investments	14,664,101	(3,561,599)
Cash and cash equivalents and short-term investments at beginning of year	178,754	3,740,353
Cash and cash equivalents and short-term investments at end of year	\$ 14,842,855	\$ 178,754

See accompanying notes.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements

Years Ended December 31, 2006 and 2005

1. Organization and Operation

HCSC Insurance Services Company (HISC or the Company) is a wholly owned subsidiary of Health Care Service Corporation, a Mutual Legal Reserve Company (HCSC), and is currently domiciled in Illinois. HISC is licensed to do business in 43 states and the District of Columbia.

Since 1997, the Company has maintained a coinsurance and servicing agreement (the Agreement) between the Company and Jefferson Pilot Financial (Jefferson Pilot) related to certain business written prior to 2001. Under this agreement, the Company cedes to Jefferson Pilot, on a 100% coinsurance basis, all risks, liabilities, and obligations arising under or relating to the Company's stop-loss group term life, accidental death and dismemberment, and conversion policies, and its discontinued fully insured major medical and student accident and health policies associated with prior policyholders. Activity recorded by Jefferson Pilot still includes run-out from prior policyholders.

In 2004, HISC entered into a reinsurance contract with Fort Dearborn Life Insurance Company (FDL), a wholly owned subsidiary of HCSC, to reinsure life claims for a specific group (see Note 6).

In 2005, HISC entered into an administrative contract with the State of New Mexico whereby HISC performs certain utilization review services for a contracted administrative fee.

In 2005, HISC also began offering the Medicare Advantage PPO (Part C) business in New Mexico and Oklahoma, as well as in certain counties in Texas. The Part C business in Oklahoma is written by HISC but administered, through a coinsurance agreement, by a local medical provider. Under this coinsurance agreement, risks and rewards are shared equally between HISC and the medical provider.

Beginning January 1, 2006, HISC formally began offering Medicare Drug (Part D) insurance coverage in Illinois, New Mexico, Oklahoma, and Texas under a contract with the Center for Medicare & Medicaid Services (CMS). The Part D business represents approximately 96% of HISC's 2006 premium revenue included in the statements of income and expenses and changes in capital and surplus.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

2. Significant Accounting Policies

Basis of Presentation

The accompanying financial statements have been prepared in conformity with practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance (Department), which practices differ from accounting principles generally accepted in the United States (GAAP).

The more significant variances from GAAP are:

Certain assets, designated as “nonadmitted assets” (principally certain receivables and deferred tax assets) are excluded from the accompanying balance sheets and are charged directly to capital and surplus. Under GAAP, these assets are included in the balance sheets.

Investments are stated at values prescribed or permitted by the NAIC and, therefore, are not stated in accordance with GAAP. GAAP requires that such securities be classified as held-to-maturity, trading, or available-for-sale. For GAAP, securities classified as held-to-maturity are carried at cost or amortized cost, and securities classified as trading or available-for-sale are carried at fair value with unrealized holding gains and losses reported in income for those securities classified as trading and as accumulated other comprehensive income, which is a separate component of stockholder’s equity, for those securities classified as available-for-sale.

Deferred tax assets and liabilities are recognized and deferred tax assets are admitted based on prescribed limitations. Changes in deferred tax assets and liabilities are recorded as a direct credit or charge to accumulated deficit.

Acquisition expenses, including commissions and other costs related to acquiring new and renewal business, are charged to operations as incurred rather than being deferred and amortized based on the premium-paying period of the related insurance policies or estimated gross profits as required by GAAP.

Premiums, commissions, expense reimbursements, benefits, and reserves related to reinsurance business are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Amounts applicable to

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

2. Significant Accounting Policies (continued)

reinsurance ceded for future policy benefits and claim liabilities have been reported as reductions of these items. Under GAAP, these items would be presented on a gross basis as compared to the statutory net presentation.

The cash flow statements are prepared in conformity with statutory accounting practices and, therefore, are not prepared in accordance with GAAP.

The effects of the foregoing variances from GAAP on the accompanying statutory-basis financial statements have not been determined but are presumed to be material.

Use of Estimates

The preparation of financial statements of insurance companies requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed therein.

Investments

Investments are stated at values prescribed or permitted by the NAIC. Accordingly, bonds are stated at amortized cost. Short-term investments are stated at cost or amortized cost, which approximates fair value. Investments with maturities of one year or less at the time of acquisition shall be considered short-term investments. Amortization of bond premium and accretion of bond discount are recognized on an effective yield-basis method. Realized gains and losses are determined on a specific identification basis. Impairments are recognized for investments where the decline in fair value is determined to be other-than-temporary. The investment is written down to fair value as the new cost basis, and the amount of the write-down is accounted for as a realized loss on the Company's statements of income and expenses and changes in capital and surplus.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash, certificates of deposit, and cash equivalents. Certificates of deposit included in cash are those in banks or other similar financial institutions with maturity dates within one year or less from the acquisition date. Cash equivalents are short-

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

2. Significant Accounting Policies (continued)

term highly liquid investments that are both: (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities of three months or less qualify under this definition.

Premium Business Income

Income from premium business is recorded on the accrual basis of accounting and is recognized as income during the period of coverage.

Medicare Part D Pharmacy Benefit Contract

There are six elements of payments received by the Company during the Part D plan year. These payment elements are as follows:

- CMS Premium – CMS pays a fixed monthly premium per member to the Company for the entire plan year.
- Member Premium – In addition to the CMS premium, each member pays a fixed monthly premium to the Company for the entire plan year.
- Low-Income Premium Subsidy – For qualifying low-income members, CMS pays some portion or all of the member's monthly premiums to the Company on the member's behalf.
- Catastrophic Reinsurance Subsidy – CMS pays the Company a cost reimbursement estimate monthly to fund the CMS obligation to pay approximately 80% of the costs incurred by individual members in excess of the individual annual out-of-pocket maximum of \$3,600. A settlement is made based on actual cost experience subsequent to the end of the plan of year.
- Low-Income Member Cost Sharing Subsidy – For qualifying low-income members, CMS pays on the member's behalf, some portion or all of a member's cost sharing amounts, such as deductibles and coinsurance. The cost sharing subsidy is funded by CMS through monthly payments to the Company. The Company administers and pays the subsidized portion of the claims on behalf of CMS, and a settlement payment is made between CMS and the Company based on actual claims experience, subsequent to the end of the plan year.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

2. Significant Accounting Policies (continued)

- **CMS Risk Share** – If the ultimate per member per month benefit costs of any Medicare Part D regional plan varies more than 2.5 percentage points above or below the level estimated in the original bid submitted by the Company and approved by CMS, there is a risk share settlement with CMS that is settled subsequent to the end of the plan year. The risk share adjustment, if any, is recorded as an adjustment to premium revenues and contract claims liabilities or other receivables.

The CMS Premium, the Member Premium, and the Low-Income Premium Subsidy represent payments for the Company's insurance risk coverage under the Part D program and therefore are recorded as premium revenues in the Company's statements of income and expenses and changes in capital and surplus. Premium revenues are recorded on the accrual basis of accounting and are recognized as income during the period of coverage. Premium payments received in advance of the coverage period are recorded on the Company's balance sheets as unearned premium.

The Catastrophic Reinsurance Subsidy and the Low-Income Member Cost Sharing Subsidies represent cost reimbursements under the Part D program. The Company is fully reimbursed by CMS for costs incurred for these contract elements and, accordingly, there is no insurance risk to the Company. Amounts received for these subsidies are not reflected as premium revenues, but rather are accounted for as deposits and, as such, are not included in the Company's statements of income and expenses and changes in capital and surplus. The Company had claims and claim reimbursements of \$195,622,508 related to the uninsured portion of the Part D business. No gain or loss was recorded.

Net pharmacy benefit costs and administrative costs are expensed as incurred and are recognized in benefits under life, accident and health policies expenses, and general and administrative expenses, respectively, in the Company's statements of income and expenses and changes in capital and surplus.

Pharmacy Rebate Receivable

The Company contracts with a Pharmacy Benefit Manager (PBM) for the administration of Part D pharmaceutical drug claims. Pharmacy rebate receivables are based on the PBM's estimate of the actual amounts due to the Company and an estimated amount calculated by the Company. The Company's estimated amount is based on the claims processed by the PBM in the

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

2. Significant Accounting Policies (continued)

prior quarter multiplied by a contractual rate based on utilization. Pharmacy rebate receivables are included in amounts receivable related to uninsured plans and healthcare and other receivables in the balance sheets depending on the type of business.

Policy and Contract Claims

Policy and contract claims represent the estimated ultimate net cost of all reported and unreported claims incurred and unpaid through December 31. The reserves for policy and contract claims are estimated using individual case-basis valuations and statistical analyses. These estimates are subject to the effects of trends in claim severity and frequency. Although considerable variability is inherent in such estimates, management believes that the reserves for policy and contract claims are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

Effect of Accounting Change

Effective in 2006, the Company began filing the NAIC Health Statement with the Department rather than the Life and Accident and Health Statement. This change was granted by the Department. The effect of this change resulted in an increase to capital and surplus of \$3,298 as of January 1, 2005, related to the elimination of the asset valuation reserve.

Reclassifications

Certain amounts in the 2005 presentation have been reclassified to conform to the current year presentation.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

3. Investments

The following table summarizes the amortized cost, unrealized gains and losses, and the NAIC fair value of investments in U.S. government securities at December 31, 2006 and 2005:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
2006				
U.S. government securities	\$ 11,575,547	\$ 22,389	\$ 256,917	\$ 11,341,019
Due in one year or less	\$ 3,992,210			\$ 3,944,760
Due 1 year – 5 years	7,453,832			7,244,364
Due 10 years – 20 years	129,505			151,895
	<u>\$ 11,575,547</u>	<u>\$ 22,389</u>	<u>\$ 256,917</u>	<u>\$ 11,341,019</u>
2005				
U.S. government securities	\$ 14,656,024	\$ 27,196	\$ 344,041	\$ 14,339,179

Proceeds from sales and maturities of investments in U.S. government securities during 2006 and 2005 were \$3,000,000 and \$2,860,000, respectively. There were no gross gains or losses in 2006 or 2005.

Major categories of net investment income are summarized as follows:

	Year Ended December 31	
	2006	2005
U.S. government securities	\$ 442,068	\$ 479,929
Short-term investments	1,160,552	80,886
Gross investment income	<u>1,602,620</u>	560,815
Investment expenses	770	779
Net investment income	<u>\$ 1,601,850</u>	<u>\$ 560,036</u>

At December 31, 2006 and 2005, investments with an amortized cost of \$1,700,160 and \$3,393,173, respectively, were on deposit with various states, as required.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

4. Pharmacy Rebate Receivable

The total pharmacy rebate receivable at December 31, 2006, was \$30 million. The total receivable was confirmed as owed and, as such, was treated as an admitted asset. There were no pharmacy rebates in 2005.

In 2006, the Company collected pharmacy rebates of \$24 million. The chart below contains further detail regarding pharmacy rebate receivables for 2006. Amounts in the chart are shown in millions of dollars.

Quarter	Estimated Pharmacy Rebates as Reported on Financial Statements	Pharmacy Rebates as Invoiced/Confirmed	Actual Rebates Collected Within 90 Days of Invoicing Confirmation	Actual Rebates Collected Within 91 to 180 Days of Invoicing/Confirmation	Actual Rebates Collected More Than 180 Days After Invoicing/Confirmation
12/31/2006	\$ 15	\$ 15	\$ —	\$ —	\$ —
09/30/2006	15	15	—	—	—
06/30/2006	14	14	—	14	—
03/31/2006	10	10	—	10	—

5. Income Taxes

The Company is included in the consolidated federal income tax return of HCSC and other eligible subsidiaries. The method of allocation between the companies is subject to a written agreement, which sets forth the manner in which the total combined federal income tax is allocated to each entity which is a party to the agreement.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

5. Income Taxes (continued)

The components of the net deferred tax assets and liabilities recognized in the balance sheets are as follows:

	December 31	
	2006	2005
Total of all gross deferred tax assets	\$ 4,305,225	\$ 7,855,772
Total of all deferred tax liabilities	(204,980)	(10,289)
Net deferred tax asset	4,100,245	7,845,483
Deferred tax asset nonadmitted	3,540,983	7,767,106
Net admitted deferred tax asset	\$ 559,262	\$ 78,377
	\$ (4,226,123)	\$ 7,481,083

The tax effects of the change in temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

	2006	2005
Deferred tax assets		
Net operating loss carryforwards	\$(3,612,756)	\$ 7,059,859
Unpaid losses	112,236	5,569
Administrative deficiency reserve	(179,457)	490,646
Other	129,430	6,672
Total change in deferred tax assets	(3,550,547)	7,562,746
Change in nonadmitted deferred tax assets	4,226,123	(7,481,083)
Change in admitted deferred tax assets	675,576	81,663
Deferred tax liabilities		
Accrued market discount	1,822	7,878
Salvage and subrogation	192,869	-
Total change in deferred tax liabilities	194,691	7,878
Change in net admitted deferred tax asset	\$ 480,885	\$ 73,785

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

5. Income Taxes (continued)

The change in net deferred taxes is comprised of the following:

	December 31		Change
	2006	2005	
Gross deferred tax assets	\$ 4,305,225	\$ 7,855,772	\$(3,550,547)
Gross deferred tax liabilities	(204,980)	(10,289)	(194,691)
Net deferred tax asset	\$ 4,100,245	\$ 7,845,483	\$ (3,745,238)
Change in unrealized capital gains			—
Change in net deferred income taxes			\$ (3,745,238)

The provision for federal income taxes incurred is different from that which would be obtained by applying the statutory federal income tax rate to gain from operations before provision for federal income tax. The significant items causing this difference are as follows:

	Effective Tax Rate Percentage	
	2006	2005
Provision computed at statutory rate	35.0%	(35.0)%
Utilization of net operating losses	35.7	—
Intercompany tax settlement	—	(18.7)
Other	(2.3)	—
Total	68.4%	(53.7)%
Federal income tax expense (benefit)	3.7%	(18.7)%
Change in net deferred income taxes	64.7	(35.0)
Total statutory income taxes	68.4%	(53.7)%

At December 31, 2006, the Company had \$10,672,962 in net operating loss carryforwards originating in 2003 through 2005 which expire, if unused, in years 2023 to 2025.

The amount of federal income taxes incurred in 2006 of \$1,757,196 is available for recoupment in the event of future net losses.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

6. Related-Party Transactions

The Company does not have any employees. HCSC provides management, administrative, and investment services and pays certain expenses on behalf of the Company. The senior management and officers of the Company also serve as senior management and officers of HCSC. Additionally, certain officers of HCSC also serve on the Board of Directors of the Company. Expenses allocated from HCSC to HISC were \$14,626,676 and \$12,763,903 in 2006 and 2005, respectively.

Effective September 1, 2004, the Company began offering reinsurance coverage to FDL for a specific group's life claims that exceed a predetermined amount. FDL ceded the Company \$852,776 and \$750,627 in premiums during 2006 and 2005, respectively, for this coverage. The Company's exposure to loss for this coverage is based on life claims paid by FDL. The Company incurred \$3,195,815 and \$718,000 in claims under this policy in 2006 and 2005, respectively.

In connection with the February 2, 2005, application to offer Part C programs in certain areas of Texas and all of New Mexico, HISC represented to the CMS that HISC will be funded by HCSC as needed to meet Illinois state Risk-Based Capital requirements.

HCSC has also paid various start-up costs associated with entering the Part C and Part D business on behalf of HISC, and has allocated these expenses to HISC. General administrative expenses in 2006 are primarily due to supporting the administration of the new Part D product.

7. Reinsurance

In the normal course of business, the Company cedes insurance in order to limit its exposure to loss on any single insured event by ceding risks to reinsurers under various types of contracts. To the extent that any reinsuring companies are unable to meet obligations under reinsurance agreements, the Company would be liable for the reinsured risk.

The effect of reinsurance with related parties and third parties on premiums written and earned in 2006 and 2005 is as follows:

	<u>2006</u>	<u>2005</u>
Direct and assumed premiums	\$ 351,830,585	\$ 1,264,957
Premiums ceded	(1,794,894)	—
Net premiums earned	<u>\$ 350,035,691</u>	<u>\$ 1,264,957</u>

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

7. Reinsurance (continued)

The effect of reinsurance with related parties and third parties on reserves at December 31, 2006 and 2005, is as follows:

	2006	2005
Direct and assumed:		
Policy reserves	\$ 312,407	\$ 303,657
Claim reserves	17,887,000	2,517,000
Amounts ceded	(858,407)	(1,499,657)
Net reserves	\$ 17,341,000	\$ 1,321,000

8. Unpaid Claims and Claims Adjustment Expenses

The Company accrues liabilities for unpaid claims and claim adjustment expenses for insured life and health claims. These liabilities represent the estimated ultimate cost of settling claims relating to insured events that occurred on or before December 31. The estimated liability includes amounts that will be required for future payments of: (a) claims that have been reported to the insurer; (b) claims related to insured events that have occurred, but that have not been reported to the insurer as of year-end; and (c) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees and costs to record, process, and adjust claims. Provisions for unpaid claim adjustment expenses are included in general expenses due and accrued in the balance sheets.

Activity in the liability for unpaid claims and claim adjustment expenses, net of reinsurance ceded, is summarized as follows:

	2006	2005
Balance at January 1	\$ 1,268,000	\$ 564,000
Incurred expenses related to:		
Current year	344,337,542	3,653,921
Prior years	(502,594)	(564,000)
Total incurred	343,834,948	3,089,921
Paid expenses related to:		
Current year	326,590,542	2,385,921
Prior years	544,406	-
Total paid	327,134,948	2,385,921
Balance at December 31	\$ 17,968,000	\$ 1,268,000

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

8. Unpaid Claims and Claims Adjustment Expenses (continued)

The provision for unpaid claims and claim adjustment expense related to prior underwriting years decreased by \$502,594 in 2006 principally due to favorable reserve development on the one small block of life contract claims.

9. Capital and Surplus

Under the applicable laws and regulations of the state of Illinois, the Company is required to maintain minimum capital and surplus of \$1,500,000. At December 31, 2006, the Company's capital and surplus was \$76,412,951.

The insurance departments of various states, including Illinois, impose risk-based capital (RBC) requirements on insurance enterprises. The RBC calculation serves as a benchmark for the regulation of insurance companies by state insurance regulators. The requirements apply various weighted factors to financial balances or activity levels based on their perceived degree of risk. The RBC guidelines define specific capital levels where regulatory intervention is required based on the ratio of the Company's actual total adjusted capital to control levels determined by the RBC formula. At December 31, 2006, the Company's total adjusted capital is in compliance with the regulatory RBC requirements.

The Company is subject to limitations on the payment of dividends to the stockholder. Generally, dividends during any year may not be paid without prior regulatory approval, in excess of the greater of: (a) 10% of statutory surplus as of the preceding December 31, or (b) the statutory gain from operations for the preceding year. The Company did not pay dividends in 2006 or 2005 and cannot pay a dividend in 2007 without special approval.

In January 2006, HCSC contributed \$30,000,000 of capital to HISC, continuing its support of the full implementation and rollout of the Part C and Part D businesses. In accordance with Statement of Statutory Accounting Principles 72, *Surplus and Quasireorganizations*, and with the approval of the Department, the \$30,000,000 of contributed capital was included in the balance sheets, as both receivable from parent and contributed capital as of December 31, 2005.

During 2006, HCSC made two additional capital contributions into HISC totaling \$40,000,000. These contributions were made to support the continued growth of the Part D business.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

10. Reconciliation to Statutory Filing

Information identified subsequent to the filing of the 2006 Annual Statement resulted in adjustments of the following account balances:

	Net Income	Capital and Surplus
Year ended December 31, 2006:		
Per annual statement	\$ 6,575,596	\$ 77,411,729
Adjustment to amounts receivable related to uninsured plans	547,002	547,002
Adjustment to healthcare and other receivables	(4,585,865)	(4,585,865)
Adjustment to contract health claims and aggregate reserves	2,550,000	2,550,000
Adjustment to federal income taxes payable	490,085	490,085
Per accompanying statutory-basis financial statements	\$ 5,576,818	\$ 76,412,951

There were no differences identified in the account balance reported in the 2005 Annual Statement and the accompanying statutory-basis financial statements.