

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, 2007 and 2006
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, 2007 and 2006

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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, 2007 and 2006, 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, 2007 and 2006, 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, 2007 and 2006, 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.

Ernst + Young LLP

April 18, 2008

HCSC Insurance Services Company

Balance Sheets – Statutory Basis

	December 31	
	2007	2006
Assets		
Invested assets:		
Cash and cash equivalents	\$ 6,807,122	\$ 13,350,568
Short-term investments, at amortized cost which approximates fair value	586,387	1,492,287
U.S. government securities, at amortized cost	7,496,592	11,575,547
Total invested assets	14,890,101	26,418,402
Accrued investment income	122,175	80,547
Premium receivables	2,413,400	4,016,691
Amounts receivable related to uninsured plans	123,396,520	46,118,380
Healthcare and other receivables	38,702,403	28,915,598
Net deferred tax asset	709,942	559,262
Receivable from parent	–	12,647,715
Total assets	\$ 180,234,541	\$ 118,756,595
Liabilities and capital and surplus		
Liabilities:		
Health claims	\$ 13,098,000	\$ 14,505,000
Health aggregate reserves	2,030,494	853,823
Contract life claims and aggregate reserves	878,000	2,836,000
Payable to parent	66,940,258	–
General expenses due and accrued	10,728,982	22,391,600
Reinsurance in unauthorized company	578,000	–
Federal income taxes payable	3,816,109	1,757,221
Total liabilities	98,069,843	42,343,644
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	164,264,898
Accumulated deficit	(84,600,200)	(90,351,947)
Total capital and surplus	82,164,698	76,412,951
Total liabilities and capital and surplus	\$ 180,234,541	\$ 118,756,595

See accompanying notes.

HCSC Insurance Services Company

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

	Year Ended December 31	
	2007	2006
Income		
Premiums earned	\$ 397,727,478	\$ 350,035,691
Net investment income	1,359,083	1,601,850
Other income	3,917	–
Total income	399,090,478	351,637,541
Expenses		
Benefits under life, accident, and health policies	323,964,663	291,796,990
General and administrative expenses	64,683,405	54,051,317
Total expenses	388,648,068	345,848,307
Income from operations before federal income tax expense	10,442,410	5,789,234
Federal income tax expense	(3,814,803)	(212,416)
Net income	6,627,607	5,576,818
Other capital and surplus changes:		
Change in net deferred tax	316,411	(3,745,238)
Change in nonadmitted assets	(614,271)	3,837,903
Change in unauthorized reinsurance	(578,000)	–
Contributed capital	–	40,000,000
Total other capital and surplus changes	(875,860)	40,092,665
Increase in capital and surplus	5,751,747	45,669,483
Capital and surplus, beginning of year	76,412,951	30,743,468
Capital and surplus, end of year	\$ 82,164,698	\$ 76,412,951

See accompanying notes.

HCSC Insurance Services Company

Statements of Cash Flow – Statutory Basis

	Year Ended December 31	
	2007	2006
Operating activities		
Premiums received	\$ 400,507,440	\$ 346,895,300
Investment income received, net of investment expense	1,396,410	1,692,053
Federal income taxes (paid) refunded	(1,755,894)	5,578,985
Claims, commissions, and other expenses paid	(411,601,219)	(412,502,237)
Other income	3,917	–
Net cash used in operations	(11,449,346)	(58,335,899)
Investing activities		
Proceeds from sale or maturity of bonds	4,000,000	3,000,000
Net cash provided by investments	4,000,000	3,000,000
Financing activities		
Contributed capital	–	70,000,000
Net cash provided by financing	–	70,000,000
Net (decrease) increase in cash and cash equivalents and short-term investments	(7,449,346)	14,664,101
Cash and cash equivalents and short-term investments at beginning of year	14,842,855	178,754
Cash and cash equivalents and short-term investments at end of year	\$ 7,393,509	\$ 14,842,855

See accompanying notes.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements

Years Ended December 31, 2007 and 2006

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 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 by an unrelated insurance company. The risks and rewards are shared equally between HISC and this insurance company under a coinsurance agreement.

In 2006, HISC entered into an administrative contract with the state of New Mexico whereby HISC performs certain utilization review services for a contracted administrative fee.

Beginning January 1, 2006, HISC also 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 94% and 96% of HISC's 2007 and 2006 net premium revenue included in the statutory-basis 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 (the 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 National Association of Insurance Commissioners (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 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.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

2. Significant Accounting Policies (continued)

Certain reinsurance credits are treated as unauthorized reinsurance. This occurs when the reinsurer is not licensed in the domiciliary state of the insurer and the insurer has not received an acceptable form of security from the reinsurer. Increases in unauthorized reinsurance credits are reported as direct reductions to capital and surplus.

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 statutory-basis 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 (continued)

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-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.

Net Premiums Earned

Income 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 \$3,850 and \$3,600 for 2007 and 2006, respectively. A settlement is made based on actual cost 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)

- **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.
- **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 statutory-basis 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 statutory-basis balance sheets as unearned premium.

The Catastrophic Reinsurance Subsidy and the Low-Income Member Cost Sharing Subsidy 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 statutory-basis statements of income and expenses and changes in capital and surplus. The Company had claims and claim reimbursements related to the uninsured portion of the Part D business of \$244,900,000 and \$195,600,000 for 2007 and 2006, respectively. 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 statutory-basis 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 (continued)

Pharmacy Rebate Receivable

The Company contracts with an affiliated 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. Pharmacy rebate receivables are included in amounts receivable related to uninsured plans and healthcare and other receivables in the statutory-basis 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.

Reclassifications

Certain amounts in the 2006 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, 2007 and 2006:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
2007				
U.S. government securities	\$ 7,496,592	\$ 41,211	\$ 18,581	\$ 7,519,222
Due in 1 year or less	\$ 7,043,447			\$ 7,030,386
Due 1 year – 5 years	323,969			331,932
Due 5 years – 10 years	129,176			156,904
	<u>\$ 7,496,592</u>	<u>\$ 41,211</u>	<u>\$ 18,581</u>	<u>\$ 7,519,222</u>
2006				
U.S. government securities	\$ 11,575,547	\$ 22,389	\$ 256,917	\$ 11,341,019

At December 31, 2007 and 2006, investments with an amortized cost of \$1,674,000 and \$1,700,100, respectively, were on deposit with various states, as required.

Major categories of net investment income are summarized as follows:

	Year Ended December 31	
	2007	2006
U.S. government securities	\$ 338,463	\$ 442,068
Short-term investments, cash, and cash equivalents	1,021,362	1,160,552
Gross investment income	<u>1,359,825</u>	1,602,620
Investment expenses	742	770
Net investment income	<u>\$ 1,359,083</u>	<u>\$ 1,601,850</u>

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

4. Pharmacy Rebate Receivable

The total pharmacy rebate receivable at December 31, 2007 and 2006, was \$36,500,000 and \$30,000,000, respectively. These receivables were confirmed by the PBM as owed, and as such, were treated as an admitted asset.

In 2007 and 2006, the Company collected pharmacy rebates of \$66,500,000 and \$23,800,000, respectively. The chart below contains further detail regarding pharmacy rebate receivables. 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
12/31/2007	\$ 18.4	\$ 18.4	\$ —	\$ —	\$ —
09/30/2007	18.1	18.1	—	—	—
06/30/2007	18.8	—	—	18.5	—
03/31/2007	16.9	—	—	16.9	—
12/31/2006	15.0	15.0	—	15.1	—
09/30/2006	15.0	15.0	—	14.7	—
06/30/2006	14.0	—	—	13.4	1.3
03/31/2006	10.0	—	—	10.4	—

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 statutory-basis balance sheets are as follows:

	December 31	
	2007	2006
Total of all gross deferred tax assets	\$ 4,634,054	\$ 4,305,225
Total of all deferred tax liabilities	(217,398)	(204,980)
Net deferred tax asset	4,416,656	4,100,245
Deferred tax asset nonadmitted	3,706,714	3,540,983
Net admitted deferred tax asset	\$ 709,942	\$ 559,262
	\$ 165,731	\$(4,226,123)

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:

	Year Ended December 31	
	2007	2006
Deferred tax assets		
Net operating loss carryforwards	\$ —	\$(3,612,756)
Unpaid losses	(16,410)	112,236
Administrative deficiency reserve	209,575	(179,457)
Nonadmitted assets	130,409	—
Other	5,255	129,430
Total change in deferred tax assets	328,829	(3,550,547)
Change in nonadmitted deferred tax assets	(165,731)	4,226,123
Change in admitted deferred tax assets	163,098	675,576
Deferred tax liabilities		
Accrued market discount	(3,551)	1,822
Subrogation	15,969	192,869
Total change in deferred tax liabilities	12,418	194,691
Change in net admitted deferred tax asset	\$ 150,680	\$ 480,885

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
	2007	2006	
Gross deferred tax assets	\$ 4,634,054	\$ 4,305,225	\$ 328,829
Gross deferred tax liabilities	(217,398)	(204,980)	(12,418)
Net deferred tax asset	\$ 4,416,656	\$ 4,100,245	316,411
Change in unrealized capital gains			–
Change in net deferred income taxes			\$ 316,411

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

	Effective Tax Rate Percentage	
	2007	2006
Provision computed at statutory rate	35.0%	35.0%
Utilization of net operating losses	–	35.7
Change in nonadmitted assets	(1.2)	–
Other	(0.3)	(2.3)
Total	33.5%	68.4%
Federal income tax	36.5%	3.7%
Change in net deferred income taxes	(3.0)	64.7
Total statutory income taxes	33.5%	68.4%

At December 31, 2007, the Company had \$10,673,000 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 2007 of \$3,816,000 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 \$19,834,000 and \$14,627,000 in 2007 and 2006, respectively.

The amount due to parent of \$66,940,000 is predominantly due to prescription drug claims paid by HCSC on behalf of HISC under an administrative agreement. These balances are generally settled within 90 days.

The Company offers reinsurance coverage to FDL for a specific group's life claims that exceed a predetermined amount. FDL ceded premiums to the Company of \$967,000 and \$853,000 in 2007 and 2006, respectively, for this coverage. The Company's exposure to loss for this coverage is based on life claims paid by FDL.

The contract life claim aggregate reserves related to the FDL group business are \$878,000 and \$2,836,000 at December 31, 2007 and 2006, respectively. The Company paid claims of \$1,205,000 and \$1,162,000 in 2007 and 2006, respectively. The contract life claims and aggregate reserves were reduced by \$1,958,000 in 2007 and were increased by \$1,957,000 in 2006.

In connection with the 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.

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.

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 premiums written and earned are as follows:

	Year Ended December 31	
	2007	2006
Direct and assumed premiums	\$403,045,926	\$351,830,585
Premiums ceded	(5,318,448)	(1,794,894)
Net premiums earned	<u>\$397,727,478</u>	<u>\$350,035,691</u>

The effect of reinsurance with related parties and third parties on reserves is as follows:

	December 31	
	2007	2006
Direct and assumed:		
Policy reserves	\$ 312,407	\$ 312,407
Claim reserves	14,726,000	17,887,000
Amounts ceded	(1,062,407)	(858,407)
Net reserves	<u>\$13,976,000</u>	<u>\$17,341,000</u>

8. Unpaid Claims and Claim 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 statutory-basis balance sheets.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

8. Unpaid Claims and Claim Adjustment Expenses (continued)

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

	2007	2006
Balance at January 1	\$ 17,968,000	\$ 1,268,000
Incurred expenses related to:		
Current year	399,696,229	344,337,542
Prior years	(16,160,476)	(502,594)
Total incurred	383,535,753	343,834,948
Paid expenses related to:		
Current year	385,285,411	326,590,542
Prior years	1,728,342	544,406
Total paid	387,013,753	327,134,948
Balance at December 31	\$ 14,490,000	\$ 17,968,000

The provision for unpaid claims and claim adjustment expense related to prior underwriting years decreased by approximately \$16,160,000 in 2007 principally due to a favorable adjustment made to the insured claims related to the 2006 annual Medicare Part D settlement with CMS.

The provision for unpaid claims and claim adjustment expense related to prior underwriting years decreased by \$503,000 in 2006 is principally due to favorable reserve development on the one small block of life contract claims.

At December 31, 2007 and 2006, the Company recorded contract health claims liability net of estimated anticipated pharmacy rebates of \$1,636,000 and \$926,000, respectively.

9. Capital and Surplus

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, 2007, the Company's total adjusted capital is in compliance with the regulatory RBC requirements.

HCSC Insurance Services Company

Notes to Statutory-Basis Financial Statements (continued)

9. Capital and Surplus (continued)

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 2007 or 2006.

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 statutory-basis 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.

10. Reconciliation to Statutory Filing

Information identified subsequent to the filing of the 2007 and 2006 Annual Statements resulted in adjustments of the following account balances:

	Net Income	Capital and Surplus
Year ended December 31, 2007:		
Per annual statement	\$ 5,628,829	\$ 82,164,698
Adjustment to amounts receivable related to uninsured plans	(547,002)	—
Adjustment to healthcare and other receivables	4,585,865	—
Adjustment to contract health claims and aggregate reserves	(2,550,000)	—
Adjustment to federal income taxes payable	(490,085)	—
Per accompanying statutory-basis financial statements	\$ 6,627,607	\$ 82,164,698
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