

**BEFORE THE COMMISSIONER OF INSURANCE
OF THE STATE OF KANSAS**

In the Matter of the Conversion and)
Acquisition of Blue Cross and Blue Shield)
of Kansas, Inc.)

Docket No. 3014-DM

**PREFILED DIRECT TESTIMONY OF
MICHAEL L. SMITH**

1 Q. Please state your name and your position with Anthem Blue Cross and Blue
2 Shield (“Anthem BCBS”).

3 A. My name is Mike Smith and I am Executive Vice President and Chief Financial
4 Officer of Anthem BCBS.

5 Q. What matters will you cover in your testimony?

6 A. I will provide a financial overview of Anthem BCBS; describe its capital
7 adequacy; and discuss the financial aspects of the proposed acquisition of Blue Cross and
8 Blue Shield of Kansas (“BCBSKS”).

9 Q. Please provide an overview of Anthem’s financial performance and condition.

10 A. Anthem currently operates Blue Cross and Blue Shield plans in Indiana, Ohio,
11 Kentucky, Colorado, Nevada, Connecticut, New Hampshire and Maine. Anthem is
12 among the largest Blue Cross Blue Shield organizations in the country, with substantial
13 market share in each of its core markets. In addition to its ranking among other Blue

1 Cross and Blue Shield licensees, Anthem is the fifth largest health benefits company in
2 the United States.

3 Anthem has recently completed a demutualization and executed an initial public
4 offering of its common stock. Anthem raised more than \$2.1 billion from this transaction
5 and in late December distributed more than \$3.8 billion in cash and common stock to its
6 eligible statutory members. Following these transactions, Anthem has more than
7 103,000,000 common shares outstanding with the aggregate market value of
8 approximately \$5.0 billion.

9 Anthem's 1999 and 2000 Consolidated Financial Statements were previously
10 filed as part of these proceedings. The financial statements show Anthem, for the period
11 ending September 30, 2001, with surplus at more than \$2.1 billion, based on Generally
12 Accepted Accounting Principles ("GAAP"). In addition to providing financial security
13 for our policyholders, our surplus provides the capital resources needed to invest in
14 information systems, health care technology and health management initiatives that will
15 further our position of leadership in our industry. Anthem intends to maintain a strong
16 surplus position post closing of the BCBSKS transaction. I will address the projected
17 adequacy of Anthem's surplus in more detail later in my testimony.

18 Anthem has established a trend of very strong operating results. For 1999,
19 Anthem's reported net income of \$44.9 million on \$6.3 billion in GAAP revenues. These
20 earnings were net of several non-recurring payments. These one-time payments were for
21 the settlement of charitable trust claims on our assets in Ohio, Connecticut and Kentucky
22 totaling \$71.8 million (after tax) and a payment of \$41.9 million following investigation
23 of Connecticut BCBS Medicare fiscal intermediary operations during periods that

1 preceded Anthem's 1997 merger with that company. The Company's income before
2 discontinued and unusual items for 1999 was \$152.0 million. In 2000, Anthem reported
3 net income of \$226.0 million on GAAP revenues of approximately \$8.8 billion. In
4 addition, for the period ending September 30, 2001, Anthem reported net income of
5 \$254.5 million on GAAP revenues of approximately \$7.8 billion. Much of this success is
6 attributable to operations which have been integrated into Anthem from previous
7 mergers, and economies gained from reaching scale in each of our regions.

8 Q. How does Anthem compare under risk based capital adequacy measures?

9 A. Anthem has consistently maintained statutory surplus well above industry
10 averages. Capital adequacy measures reflecting Anthem's strong capital position include
11 the Risk Based Capital formula, used by the National Association of Insurance
12 Commissioners ("NAIC") to measure the strength of an insurance company's surplus.

13 Details as to Anthem's total adjusted capital levels, as well as the corresponding
14 NAIC Risk Based Capital ("RBC") ratio were previously filed as part of this proceeding.
15 Anthem's total adjusted capital on a statutory basis has grown from \$1.3 billion in 1996
16 to \$1.9 billion as of December 31, 2000.

17 Anthem's RBC ratio has remained consistently above industry averages with
18 adjusted capital and surplus as a percentage of authorized control level growing from
19 548% of statutory requirements in 1996 to 646% as of December 31, 2000. As of June
20 30, 2001, Anthem's RBC ratio was 703% of authorized control level. All of Anthem's
21 insurance company subsidiaries are likewise strongly capitalized.

22 Q. What impact does Anthem's investment portfolio have on its financial strength?

1 A. Anthem's investment portfolio as of September 30, 2001 of nearly \$4.2 billion is a
2 significant symbol of Anthem's overall financial strength and operating success. Our
3 conservative, diversified investment approach seeks to preserve capital while yielding
4 adequate investment returns, consistent with insurance statutes and other regulatory
5 requirements. Anthem's investment policy stresses high quality instruments and prohibits
6 the use of derivative securities. As of September 30, 2001, approximately 98% of our
7 investment portfolio consists of investment grade securities. The size of our portfolio
8 allows for cost effective management utilizing outside professional money managers.
9 Total returns on our portfolios have exceeded benchmark performances, including the
10 Lehman Aggregate Bond Index, in each of the past several years, including 2000 and the
11 first nine months of 2001. As a strategy to further enhance the quality of the portfolio
12 and to minimize the effect of market volatility, the portfolio equity allocation was
13 reduced in 2001 from a high of approximately 13% to the current allocation of
14 approximately 4%. The cash proceeds from the sale of equities were invested in fixed
15 income securities of equivalent high quality to that of the original portfolio.

16 Q. What financial ratings does Anthem enjoy from financial rating organizations?

17 A. The financial community has long judged Anthem to be a strong company. The
18 insurance industry's most respected rating agencies continued to recognize our
19 financial strength in 2001. Fitch maintained their rating of our claims-paying ability as
20 A+, while Standard & Poor's gave our claims-paying ability its A rating. A.M. Best, a
21 leader among insurance rating agencies, affirmed our A- rating. Moody's has recently
22 upgraded our rating to A2. Anthem's consistently strong ratings over the years is
23 evidence of Anthem's commitment to our policyholders' security.

1 Our focus on growth and financial strength is integral to our strategic plan to
2 remain competitive. With size comes the ability to maximize efficiencies and to
3 withstand regional economic swings. For example, Anthem's size and flexibility allowed
4 our Kentucky subsidiary to stay in the individual market during that state's 1995-1998
5 experimentation with health care reform, a period during which all but one of the other
6 commercial carriers exited the market while Anthem persevered and worked with
7 governmental, consumer and industry representatives to produce necessary changes.

8 Q. What steps has Anthem taken to focus on its health insurance business?

9 A. During 1997 and 1998, we divested substantially all of our non-health holdings in
10 order to focus on our core health business. These transactions, which involved the sale of
11 more than 40% of Anthem's assets and revenues, were accomplished without any serious
12 disruption of our core insurance operations. With the completion of these efforts in 1998,
13 Anthem has focused on its future as a health benefits company, and one which is better
14 able to devote its resources to its health benefits business.

15 Q. What benefits will Anthem's financial strength and organization bring to Anthem
16 BCBS in Kansas?

17 A. Anthem Health Plans of Kansas will enjoy the strength of its parent company and
18 the entire Anthem family of successful health benefits operations. This ensures that
19 Anthem Health Plans of Kansas's operations will have adequate reserves to meet all
20 financial requirements under Kansas law.

21 Our focus on growth and financial strength is part of our strategic plan to remain
22 competitive in our industry. With size comes the ability to maximize efficiencies, spread
23 fixed costs over a larger enrollment, fund the development of innovative systems, and

1 capture savings that accrue from bargaining advantages in vendor selection and
2 procurement activities, such as telecommunications, software, equipment, etc.

3 Additionally, the transaction will afford the Kansas company access to many
4 other resources which are already in place at Anthem, including experienced management
5 and valuable relationships with highly respected outside parties, such as investment
6 managers.

7 Also, Anthem’s strategy is focused on the operation of business segments to
8 support the local plans in the states in which we operate. Assuming completion of this
9 transaction, BCBSKS would become part of our Anthem West region, which also
10 supports the Blue Cross and Blue Shield Plans in Colorado and Nevada. Each region
11 provides operational and administrative support to local operations, and delivers
12 significant economies of scale and operating efficiencies to our local/state operations.
13 For instance, “back office” operations such as claims processing, billing and enrollment
14 processing can be managed more efficiently, and common vendors and volume
15 purchasing can reduce costs for products and services such as procurement of technology,
16 equipment, supplies and printing. Information systems and support can also be
17 implemented and managed more efficiently. Savings are also expected in other areas that
18 will be administered or managed as shared services or corporate services. Those
19 functions include accounting, investment management, treasury and employee benefits
20 and payroll.

21 This approach demonstrated its effectiveness following the integration of
22 Anthem’s Indiana, Kentucky and Ohio operations to form Anthem Midwest.
23 Administrative expenses in Anthem Midwest now represent less than 17.4% of our

1 premium revenues; a much smaller percentage than those experienced by the three
2 Midwest state companies prior to their integration.

3 In addition, we have eleven (11) integration teams working diligently to plan the
4 integration of BCBSKS into Anthem West, Inc. While final plans are not available at
5 this date, we believe that by combining our companies and sharing best practices, we can
6 have a positive impact on BCBSKS's administrative costs, which will result in a positive
7 impact on premiums paid by customers.

8 As I previously stated, as of September 30, 2001, the surplus of Anthem was in
9 excess of \$2.1 billion on a GAAP basis, with total adjusted capital on a statutory basis in
10 excess of \$1.9 billion. In comparison, standing alone, BCBSKS's reserve for the
11 protection of policyholders at the end of 2000 was \$328.5 million on a GAAP basis and
12 \$230.5 million on a statutory basis. These figures make clear that the financial condition
13 of Anthem will not jeopardize the financial stability of BCBSKS or prejudice the
14 interests of its policyholders. On the contrary, the combination will significantly
15 strengthen the position of the Kansas company and thus benefit its policyholders.

16 Although Anthem has no formal capitalization policy, we typically maintain
17 subsidiary capitalization at least at 100-125% of Company Action Level Risk Based
18 Capital, or the applicable Blue Cross Blue Shield Association minimum standard,
19 whichever is greater. Anthem regularly monitors the statutory capitalization of its
20 subsidiaries against internal, NAIC, state, and Blue Cross Blue Shield Association
21 capitalization requirements. Included in the review are current capital needs as well as
22 known or anticipated changes. We also consider statutes and regulations in the
23 subsidiary state of domicile relative to dividend payments. Should surplus exceed current

1 and projected capital needs, a dividend will be considered in accordance with relevant
2 laws and regulations.

3 Q. Larry Glasscock already described the primary reasons for Anthem's
4 demutualization. Please provide additional detail as to why Anthem believes the
5 demutualization will increase its financial flexibility and enhance its ability to compete.

6 A. Let me begin by reiterating that Anthem has historically maintained a strong
7 capital base and that Anthem's current financial position is very strong. As Mr.
8 Glasscock mentioned, the decision to demutualize resulted from the Company's analysis
9 of the risks associated with continuing the mutual company structure and the need to be
10 positioned to respond to rapid changes in the health benefits industry.

11 Demutualization has provided Anthem with greater financial flexibility and
12 access to public capital markets. We now enjoy the ability to further strengthen our
13 capital position by selling stock. Many of our peers in the health benefits industry also
14 have this ability. This financial flexibility will allow Anthem and its subsidiaries to
15 expand existing business, develop new business opportunities, enhance our competitive
16 position in the health benefits industry, further improve service to customers and assure
17 our continued financial strength and stability. Also, the ability to provide stock-based
18 incentive compensation plans and other programs, in the same manner as many of
19 Anthem's competitors, will enhance Anthem's ability to attract and retain qualified
20 management and other personnel whose talent and dedication are essential to meeting
21 customers' needs and expectations.

22 Further, demutualization will not negatively impact the capitalization of Anthem.
23 In fact, the Plan of Conversion required Anthem, Inc., the new parent company, to make

1 all cash and stock payments to eligible statutory members and reimburse Anthem
2 Insurance for all demutualization costs and expenses out of the proceeds from the initial
3 public offering and other capital raising transactions. I am pleased to report that
4 Anthem's initial public offering was the largest ever for a health benefits company and
5 the twenty-second (22nd) largest initial public offering in the history of the New York
6 Stock Exchange. Net proceeds from Anthem's offerings were approximately \$2.1
7 billion.

8 As a stock insurance company, Anthem Insurance and its insurance and managed
9 care subsidiaries will remain subject to the same regulatory oversight that currently
10 prevails in the states in which we operate. As provided in the Plan of Conversion, the
11 paid-in capital and surplus of Anthem Insurance will continue to be at least the amount
12 required by the State of Indiana for a new domestic stock insurance company transacting
13 like kinds of insurance. The capital and surplus of Anthem's other insurance and
14 managed care subsidiaries will continue to be maintained at levels established by the laws
15 and regulations of the states where they operate.

16 Q. Please explain the differences in the administrative costs of Anthem and BCBSKS.

17 A. Anthem and BCBSKS calculate administrative costs differently. BCBSKS's
18 administrative expense ratio is approximately 9%. When calculated in the same manner,
19 Anthem's administrative expense ratio is 11.5%. This small difference is attributed to
20 mix of funding arrangements, size of ancillary business lines and investments in
21 technology and medical management programs. Anthem's administrative expense ratio
22 continues to decrease. Anthem has demonstrated an ability to reduce administrative costs
23 in partnerships formed with existing Blue Cross and Blue Shield companies. For

1 example, the administrative expense ratio of the Anthem East region (based on BCBSKS
2 classification) is 11.5% down from 14.9% in 1999. Similarly, the administrative expense
3 ratio of the Anthem West region (based on BCBSKS classification) is 13.7% down from
4 26.8% in 1999.

5 Q. Does this conclude your testimony?

6 A. Yes.

Respectfully submitted,

Michael L. Smith

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the foregoing was served upon counsel by depositing same in the United States Mail, first class postage prepaid, on this 17TH day of December 2001, properly addressed as follows:

Kathy Greenlee, Esq.
General Counsel
Kansas Insurance Department
420 S.W. 9th Street
Topeka, Kansas 66612-1678
(785) 296-3071
(785) 296-2283 Fax
COUNSEL FOR THE KANSAS DEPARTMENT OF INSURANCE

Patrick H. Cantilo, Esq.
CANTILO & BENNETT, L.L.P.
7501 C. North Capital of Texas Highway, Suite 200
Austin, Texas 78731
(512) 478-6000
(512) 404-6550 Fax
COUNSEL FOR THE KANSAS DEPARTMENT OF INSURANCE

Gary D. McCallister, Esq.
Gary D. McCallister & Associates, Ltd.
29 S. La Salle Street, Suite 1210
Chicago, Illinois 60603
(312) 345-0611
(312) 345-0612 Fax
COUNSEL FOR BLUE CROSS AND BLUE SHIELD OF KANSAS, INC.

James C. Scoville, Esq.
Debevoise & Plimpton
875 Third Avenue
New York, New York 10022
(212) 909-6655
(212) 909-6836 Fax
COUNSEL FOR BLUE CROSS AND BLUE SHIELD OF KANSAS, INC.

Doug Fauth, Esq.
Anthem Blue Cross and Blue Shield
120 Monument Circle
Indianapolis, Indiana 46204-4903

(317) 488-6259
(317) 488-6891 Fax
COUNSEL FOR ANTHEM BLUE CROSS AND BLUE SHIELD

Douglas S. Laird, Esq.
William W. Sneed
Polsinelli Shalton & Welte
555 Kansas Avenue, Suit 301
Topeka, Kansas 66603
(785) 233-1446
(785) 233-1939
COUNSEL FOR KANSAS MEDICAL SOCIETY

Charles R. Hay
GOODELL, STRATTON, EDMONDS & PALMER
515 South Kansas Avenue
Topeka, KS 66603-3999
COUNSEL FOR KANSAS HOSPITAL ASSOCIATION

Karen A. Eager, Esq.
LAW OFFICES OF THEODORE J. LICKTEIG
16 East 13th Street
Lawrence, KS 66044
COUNSEL FOR THE STATE NURSES ASSOCIATION
AND KANSAS ASSOCIATION OF THE MEDICALLY UNDERSERVED

Randall J. Forbes