

BEFORE THE COMMISSIONER OF INSURANCE OF THE STATE OF KANSAS

In the Matter of the Plan of Conversion of
BLUE CROSS AND BLUE SHIELD OF
KANSAS, INC.

Docket No. 3014-DM

WRITTEN STATEMENT OF DANIEL J. McCARTHY

I. Introduction

My name is Daniel J. McCarthy. I am a consulting actuary in the New York City office of Milliman USA, Consultants and Actuaries, formerly known as Milliman & Robertson, Inc. (“Milliman”). Milliman has served as actuarial advisor to Blue Cross Blue Shield of Kansas, Inc. (“BCBSKS” or the “Company”) in connection with BCBSKS’ Plan of Conversion, dated October 25, 2001. Under the Plan of Conversion, BCBSKS proposes to convert from a mutual life insurance company to a publicly traded stock life insurance company in a process known as demutualization.¹

II. Qualifications

I have been a consulting actuary at Milliman since 1972. From 1959 until I joined Milliman in 1972, I held various actuarial and management posts at The Equitable Life Assurance Society of the United States, including assignments in financial reporting, group insurance, and underwriting. I hold a Bachelor of Science degree in Mathematics from Fordham University.

¹ Capitalized terms used in this statement, unless otherwise defined herein, have the meanings set forth in the Plan of Conversion.

I am a Fellow by examination of the Society of Actuaries and have served as a member of its Board of Governors. I also am a Member of the American Academy of Actuaries and currently serve as its President and a member of its Board of Directors. In addition, from 1993 to 1998, I served on the Actuarial Standards Board. My testimony today is not given on behalf of any of the organizations that I have just mentioned, rather it is based on my work for Milliman on behalf of BCBSKS.

Since joining Milliman in 1972, I have directed a number of our firm's major consulting assignments for insurance companies, including assignments relating to product development, financial reporting, equitable treatment of policyholders, reinsurance, sale of companies or blocks of business, and other similar matters.

I am familiar with the actuarial issues and relevant literature relating to the conversion of mutual insurance companies to stock insurance companies. I also am familiar with the actuarial issues and literature relating to the formation and operations of closed blocks.

Milliman has been retained as an actuarial advisor by numerous insurers in connection with insurance company conversions. In particular, I have directed and participated in Milliman's work for each of the following insurance companies in connection with its demutualization:

- Union Mutual Life Insurance Company (1984-1986)
- Northwestern National Life Insurance Company (1988-1989)
- The Equitable Life Insurance Society of the United States (1989-1992)
- Guarantee Mutual Life Insurance Company (1993-1995)
- State Mutual Assurance Company of America (1993-1995)
- Standard Insurance Company (1998-1999)
- Anthem Blue Cross Blue Shield (2000-2001)

- Principal Life Insurance Company (2000-2001)
- Prudential Insurance Company of America (1999-2001)

I also directed and participated in Milliman's work for Principal Mutual Holding Company in connection with its demutualization, which was completed in 2001. In addition, I have directed and participated in Milliman's work in assignments for each of the following insurance companies in connection with its conversion from a mutual insurance company to a stock insurance company as part of a mutual holding company structure:

- Pacific Mutual Life Insurance Company (1996-1997)
- Minnesota Mutual Life Insurance Company (1998)
- National Life Insurance Company of Vermont (1998)
- Ohio National Life Insurance Company (1998)
- Principal Mutual Life Insurance Company (1998)
- Western & Southern Life Insurance Company (1999-2000)

In each case I provided actuarial opinions to the company's board of directors and testified at the public hearing on the company's plan of conversion.

Milliman has also been retained as an actuarial advisor by state insurance regulators in connection with insurance company conversions. I have directed and participated in Milliman's work in assignments by regulators in connection with the conversion of the following companies:

- American Mutual Life Insurance Company (1995), on behalf of the State of Iowa
- Maccabees Mutual Life Insurance Company (1988-1989), on behalf of the State of Michigan
- Metropolitan Life Insurance Company (2000), on behalf of the State of New York
- American Mutual Holding Company (2000), on behalf of the State of Iowa

- Canada Life, Sun Life and Manufacturers Life (1998-2000), on behalf of the State of Michigan

Milliman also served as staff to the Society of Actuaries Task Force on Mutual Life Insurance Company Conversion over the period 1984-1987. I directed our firm's activities in developing and testing concepts that related to the Task Force's work on closed block and policyholder equity issues.

I have also directed and participated in Milliman's work in connection with feasibility studies for mutual insurance companies considering conversion. In addition, I have directed and participated in Milliman's work in related matters such as the development of state legislation to implement either demutualization or the formation of mutual holding companies, including meetings with regulators and testimony before legislators.

III. Responsibilities in BCBSKS' Demutualization

I directed the work of Milliman in our assignment with BCBSKS developing and implementing the actuarial concepts and principles involved in the allocation of policyholder consideration under the Plan of Conversion. I provided an actuarial opinion, dated October 25, 2001, to BCBSKS' Board of Directors concerning the fairness of the allocation of consideration among Eligible Policyholders and the appropriateness of excluding a closed block provision under the Plan of Conversion. I understand that a copy of that opinion has been submitted to be made part of the record.

In all cases, I and other Milliman staff acting under my direction either derived the results on which my opinions rest or reviewed derivations carried out by BCBSKS employees. In all of this work, I have relied on information provided to me or to others at

Milliman by personnel of BCBSKS acting under the general direction of David J.

Hutchins, F.S.A., M.A.A.A., Chief Actuary of BCBSKS.

IV. Distribution of Consideration

The Plan provides for distribution to Eligible Policyholders of consideration comprised of a Special Distribution and the Purchase Price. In general, policyholders with coverage in force on October 25, 2001, the date that the BCBSKS Board of Directors adopted the Plan of Conversion, are eligible to receive consideration, which will consist of both a variable component and a fixed component. The amount of such consideration distributed to each Eligible Policyholder, which will be distributed in the form of cash, is expressed as that Eligible Policyholder's Proportionate Share of the total amount of consideration distributed to all Eligible Policyholders.

A. Allocation of Variable Component

The Variable Share of the distribution is the majority of the consideration to be distributed to Eligible Policyholders, comprising two-thirds of the total. Its allocation among the Eligible Policyholders is based on an "actuarial contribution method", which takes into account both historical contributions to surplus since BCBSKS became a mutual insurance company in mid - 1992 and anticipated future contributions to surplus. The actuarial contribution method is recognized in the actuarial literature as an appropriate allocation method. In particular, Actuarial Standard of Practice 37 ("ASOP 37"), entitled "Allocation of Policyholder Consideration in Mutual Life Insurance Company Demutualizations," is the most authoritative professional guidance available to actuaries on this subject. It states, in part, "The variable component of consideration

should be allocated on the basis of the actuarial contribution.” ASOP 37 defines “actuarial contribution,” in relevant part, to be “The contributions that a particular policy . . . has made to the company’s statutory surplus and asset valuation reserve, plus the present value of contributions that the same policy . . . is expected to make in the future.” This is consistent with the definition in the Plan.

As explained in my Statement of Opinion, the use of “actuarial contribution” as the principal basis underlying the allocation of consideration is appropriate. Moreover, within the Plan, the actuarial contribution method has been implemented in a reasonable manner, through the use of methods and assumptions that are reasonable and appropriate, consistent with relevant actuarial literature and, in particular, consistent with methods and assumptions prescribed or permitted by ASOP 37.

B. Allocation of Fixed Component

The distribution also takes into account, through the Fixed Share, the fact that Eligible Policyholders have membership rights that are independent of their actuarial contributions. In the aggregate, the Fixed Share accounts for one-third of the total amount of consideration to be distributed. For the Fixed Component, each Eligible Policyholder is allocated the same proportionate share of the consideration without regard to the actuarial contribution of the policy. This element of the allocation assures that each Eligible Policyholder will receive some distribution, and is consistent with overall concepts of equity.

C. Overview of Fixed and Variable Components

As noted, the Variable Share accounts for two-thirds of the distribution, and the Fixed Share accounts for one-third. In most other demutualizations that have taken place in the United States, the proportion of the total distribution that has been allocated through the fixed share has been smaller than in the Plan of Conversion proposed for BCBSKS. Typical proportions for the Fixed Share have ranged from approximately one-tenth to one-fourth of the distribution. In my opinion, it is appropriate in the case of the proposed Plan of Conversion, and consistent with the general guidance provided in ASOP 37, that the fixed share be larger in this instance than has historically been the case. The two principal reasons for my view, which are interconnected, are as follows:

1. Based on an estimate of the anticipated total amount of the distribution, the total of the actuarial contributions will be less than two-thirds of the amount distributed. Thus, even though the variable shares will account for only two-thirds of the total, each Eligible Policyholder's variable share is very likely to exceed the amount of that policyholders' actuarial contribution. This is consistent with the guidance provided by ASOP 37.

2. A significant portion of the amount to be distributed arises from surplus which arose prior to the conversion of BCBSKS to mutual insurer status in 1992. This surplus is not readily attributable to current policyholders and, in fact, arose primarily from surplus earned at an earlier time and investment return earned on that surplus over many years.

It is reasonable to reflect these facts by distributing a larger proportion of the distribution via the fixed share than would otherwise be the case.

D. The Purchase Price and the Escrow Fund.

A portion of the Purchase Price will be deposited in the Escrow Fund and distributed to Eligible Policyholders after satisfaction of certain liabilities and expenses to be borne by the Escrow Fund. Thus, the total amount and timing of funds to be distributed is not known with certainty. Nevertheless, the Plan of Conversion provides that each distribution will be allocated proportionately among the Eligible Policyholders using the same proportions, so the uncertainty as to the timing and amount of the distribution will have no effect on the proportion of the total that each Eligible Policyholder receives. I believe that this is a fair and equitable way to deal with the uncertainty of the Escrow Fund distribution.

V. Exclusion of a Closed Block

BCBSKS' Plan does not include a "closed block," which is an accounting device that some prior demutualizations have used to protect the continuation of the company's existing dividend practices. Section 40-4003(b) of the Kansas Conversion Law provides that, if a closed block is established, it will consist of "all of the participating individual policies of life insurance of the mutual life insurer in force on the effective date of the plan of conversion for which the insurer has an experience-based dividend scale payable in the year in which the plan is adopted." BCBSKS has no participating individual life insurance policies in force, nor has it ever issued any such policies. In addition, BCBSKS does not pay experience-based dividends on individual policies. Therefore, the

above-cited section is not applicable in this instance, and the concern addressed by a closed block — the continuation of a company’s policyholder dividend practices — is also not applicable. Thus, there is neither a statutory nor an equitable reason for BCBSKS to establish a closed block.

VI. Opinion

I have delivered an opinion to BCBSKS’ Board of Directors dated October 25, 2001. As more fully set forth in that opinion letter, and on the basis of the assumptions set forth therein, it is my opinion that:

- The principles, assumptions, methodologies, and formulas used to allocate consideration among the Eligible Policyholders of BCBSKS as set forth in Article VIII of the Plan of Conversion (including the Actuarial Contribution Memorandum, which is Exhibit A thereto) are reasonable and appropriate and consistent with the requirements of the Kansas Conversion Law.
- The Plan of Conversion’s exclusion of a special provision, such as a closed block, to preserve the dividend expectations of policyholders is fair and equitable and consistent with the Kansas Conversion Law.
- The Plan of Conversion’s allocation of consideration is fair and equitable to the Eligible Policyholders.

Daniel J. McCarthy

Dated: December 17, 2001
Sworn to before me this 17th day of December, 2001

Notary Public