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Bybee, Cressinda

From: Harbaugh, David L. [dharbaugh@morganlewis.com]
Sent: Thursday, March 06, 2014 2:46 PM
To: Bybee, Cressinda
Cc: Lucas, Yen; Daubert, Amy; Beaser, Lawrence; Gramlich, William; Davis, Steven (SDavis@STRADLEY.COM)
Subject: Form A Application Re: Independence Blue Cross Restructuring
Attachments: Letter to C Bybee March 6 2014.pdf; Supplemental Response to Request #5.pdf

Dear Ms. Bybee:

Attached for filing with the Department in the above matter is the Supplemental Response of Independence Blue Cross to Request No. 5 from the Department's November 27, 2013 requests for additional information, along with a cover letter for this filing. If there are any questions, please let me know.

With best regards,

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March 6, 2014

VIA EMAIL

Cressinda E. Bybee
Insurance Company Licensing Specialist
Pennsylvania Insurance Department
Company Licensing Division
Office of Corporate and Financial Regulation
13th Floor Strawberry Square
Harrisburg, PA 17120

Re: "Form A" Statement Regarding the Application of Independence Blue Cross to Restructure its Insurance Holding Company System

Dear Ms. Bybee:

Attached for filing with the Department in the above matter is the Supplemental Response of Independence Blue Cross to Request No. 5 from the Department's November 27, 2013 requests for additional information.

If you have any questions with respect to the foregoing, please let us know.

Sincerely,

David L. Harbaugh

BEFORE THE PENNSYLVANIA INSURANCE DEPARTMENT

In Re: "Form A" Statement Regarding the	:
Application of Independence Blue Cross	:
to Restructure its Insurance Holding	:
Company System	:

Response of Independence Blue Cross to Request No. 5 of the
Pennsylvania Insurance Department's November 27, 2013 Requests for Additional Information

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DATED: March 6, 2014

IBC provides this supplemental response to Request No. 5 from the Department's November 27, 2013 requests for additional information.

Explain in detail the risks and benefits of the proposed transaction, including how the proposed transaction is fair and reasonable, confers a benefit on IBC's policyholders and subscribers, and is in the public interest.

The reasons for and benefits of the transaction were set forth at length in the December 9, 2013 public submission. Additional specific benefits to all policyholders and the public at large are further evidenced by the following:

Structural Improvement

IBC's current structure consists of a nonprofit hospital plan corporation which is authorized to sell indemnity plans as the ultimate parent company of an insurance holding company system that includes for-profit insurance companies, health maintenance organizations, third-party administrators, Medicaid managed care organizations and a number of other affiliates engaged in other businesses related to health insurance and managed health care. Insurance and managed health care businesses are currently conducted in twenty-four states and the District of Columbia, serving more than 7.5 million people. Principal lines of business include traditional indemnity and modern managed care health insurance, HMO insurance, workers compensation insurance and Medicaid managed care programs. IBC's affiliates are not currently arranged by product line or geographic markets. A number of these operating companies are regulated insurers and HMOs arrayed in vertically "stacked" ownership chains.

IBC's book of traditional indemnity insurance business has contracted sharply with the introduction of more modern managed health care delivery systems such as HMOs and PPOs. Today, on a "standalone" (unconsolidated) basis, IBC's wholly owned managed care health insurance affiliates are significantly larger than the parent company's indemnity business in every relevant measure, including premium revenue, in-force subscriber counts and admitted assets.1

As a hospital plan corporation, IBC is subject to the Pennsylvania life insurance company investment rules. The regulated subsidiaries also are subject to the investment rules of their respective states of domicile. Further, IBC and all of its affiliates are subject to regulation under the Insurance Holding Company Act ("IHCA") both in Pennsylvania and also in the other states where regulated affiliates are domiciled. This structure requires complex and time-consuming regulatory compliance functions with respect to the many inter-company transactions that occur each month as funds are moved between and among IBC and its affiliates to meet daily cash flow requirements. Financial reporting of "stacked" insurers and HMOs located below IBC also is complex and could be made simpler and more easily understandable if those insurers and HMOs were not in a direct parent/subsidiary relationship. The objective of flattening and "unstacking" IBC and its regulated affiliates is a concept which historically has been supported by the Pennsylvania Insurance Department.

[1] Keystone Health Plan East, Inc. and QCC Insurance Company are the two best examples of this evolution in the IBC holding company system's mix of insurance products, lines of business and operations.

The current "stacked" structure also is not efficient in redeploying capital generated by IBC's operating companies to support and grow existing and new lines of managed care business. As a hospital plan corporation, IBC is subject to Pennsylvania's life insurance company investment rules, and these same rules apply to many of IBC's key operating subsidiaries, including QCC Insurance Company, Keystone Health Plan East, Inc., AmeriHealth HMO, Inc, and Vista Health Plan, Inc. All of these companies are also subject to the IHCA. This creates challenges and inefficiencies in moving earnings from one downstream regulated subsidiary up the ownership chain through other regulated affiliates before that capital can be redeployed as needed to support the operations and capital requirements of other regulated affiliates.

Solving these structural problems is a matter of importance to (i) IBC's insurance regulators, (ii) the insureds who are today served, or who in the future will be served, by IBC and its affiliates, (iii) promoting competitive conditions in the Pennsylvania health insurance market where IBC and its affiliates need to remain high quality and cost-effective competitors to the national, investor-owned insurers; and (iv) the Commonwealth of Pennsylvania which has a keen interest is assuring IBC's continued presence as a major employer and taxpayer. IBC and its affiliates have 7,149 employees in Pennsylvania and another 1,419 employees in other states. In 2012, IBC and its affiliates paid over $250 Million in taxes of which more than $200 Million consisted of Pennsylvania state and local taxes. IBC and its affiliates expect to pay over $500 Million in taxes in 2014, of which approximately $250 Million will consist of Pennsylvania state and local taxes.

The restructuring plan will reorganize and group IBC and its affiliates by product and geographic markets under a nonprofit holding company and a set of downstream holding companies, with the following benefits:

- Clear and direct lines of sight for insurance regulators in Pennsylvania and other states into regulated companies and lines of business.
- An enhanced ability to measure, manage and improve performance by geographic and product markets. "Unstacking" and flattening operating subsidiaries, and grouping operating subsidiaries by product and geographic markets will yield better metrics and enhanced transparency for the measurement and management of financial and operating results by the holding company system's regulators and managers.
- An enhanced ability to allocate and deploy capital to particular operating areas and lines of business, at the appropriate level of the holding company structure, which will better position the regulated affiliates to respond to the requirements of customers and regulators.
- "Unstacking" and flattening operating subsidiaries will remove illiquid subsidiary stocks from the balance sheets of those subsidiaries (and thereby assure that the assets reflected on those balance sheets will consist, in greater part, of liquid, investment grade securities). This will assure that the assets reflected on each regulated affiliate's balance sheet will be of the type, quality and liquidity needed to pay policyholder and subscriber claims.

Policyholder Protection

The restructuring plan will preserve the financial safety and soundness enjoyed today by the policyholders of IBC and its regulated affiliates. The pro forma financial projections included at Exhibit H to the Form A filing (filed with the Department as confidential information) demonstrate this point. The only change of any consequence is that the investments comprising the asset side of each regulated affiliate's balance sheet will no longer consist primarily of the ownership interests in illiquid "stacked" subsidiaries, but instead will be comprised in greater part of marketable investment grade securities.

Additional financial protection will be provided by parental guarantees. Effective upon closing and as a condition to receipt of its primary license from the Blue Cross and Blue Shield Association, HoldCo #1 will execute financial guarantees of customer obligations owed by IBC, Vista Health Plan, Inc. ("Vista") and Keystone Health Plan East, Inc. ("KHPE"). These guarantees will make all the assets of HoldCo #1 and all the assets of its direct and indirect subsidiaries available to support the solvency and claims payment obligations of IBC, Vista and KHPE.

Modernized Governance

The incumbent directors of IBC immediately prior to closing of the transaction will remain in office as directors of Independence Hospital Indemnity Plan, Inc. ("IHIP") and also will serve as the directors of HoldCo #1 and HoldCo #2 following closing. The incumbent principal officers of IBC immediately prior to closing of the Transaction will serve in the same capacities as the principal officers of IHIP, HoldCo #1 and HoldCo #2 following closing. There will be no change in the boards of directors or the officers of IBC's other operating affiliates as a result of the transaction.

Article VI of IBC's Articles of Incorporation ("IBC Articles") provides that the board of directors shall include several governmental appointees:

> The Governor of the Commonwealth of Pennsylvania, the Mayor of the City of Philadelphia, the President of the Philadelphia City Council, the Chairman of the County Council of Delaware County, Pennsylvania and the Chairman of the respective Boards of Commissioners of Bucks, Chester and Montgomery Counties, Pennsylvania shall each appoint one eligible person to the position of director of the corporation in such manner and for such terms as may be provided in the Bylaws.

This provision will continue without change under the Articles of Incorporation of IHIP ("IHIP Articles") because the provision was adopted in connection with IBC's historical operations as a regulated hospital plan corporation in its five-county service area of Southeastern Pennsylvania.

In order to effect a smooth transition to HoldCo #1 as the new parent company of the insurance holding company system, the appointed directors who today serve on IBC's board of directors will be named to HoldCo #1's board of directors for terms equal to the unexpired portion of their current terms of service on the IBC board. These same individuals will continue, in their appointed capacity, as IHIP directors.

The Articles of Incorporation of HoldCo #1 ("HoldCo Articles") will not provide for appointed directors. Instead, all of the directors will be drawn from nominees identified by the board's governance committee and will be elected by the full board.[2] This provision is consistent with modern corporate governance best practices. It will assure the board of directors has the flexibility and opportunity to recruit the best and most qualified candidates who will have the skill sets, expertise, background and experience needed to guide the varied insurance and managed care businesses of the holding company system. This provision also recognizes that the HoldCo #1 insurance holding company system will include (as the IBC system does today) insurance and managed care lines of business operating in a number of different jurisdictions and serving a number of different customer groups. Governance of operations in these different geographic and product markets, with the obligation to serve these different customer groups with high quality and low cost insurance and managed care coverage, requires a board comprised of the best and brightest candidates. As members leave the board and other qualified candidates are identified, the composition and size of the board will evolve with the hope and expectation that it will become a more efficient entity that can conduct its business in accordance with modern governance standards. At the same time, the appointed directors will continue to have an important governance presence for operations in IBC's five-county service area through their continuing presence on the IHIP board. This balance will best serve the present and future interests of all the customers served by IBC and its affiliates.

Article VI of the IBC Articles provides that a group of 300 or more "Subscribers" may submit one or more nominees for election to the board of directors. Article VII of the IBC Articles requires that a special meeting be called upon petition of 5% or more of the Subscribers to consider the removal of one or more IBC directors and that any one or more directors may be removed by majority vote of those Subscribers voting in person or by proxy. Article VII also provides that a group of 5% or more of the Subscribers may petition the board of directors to consider (i) the amendment of the articles or the adoption, amendment and repeal of the bylaws; (ii) a plan of sale, lease, or exchange of assets; (iii) a plan of merger, consolidation, division or conversion; or (iv) the voluntary dissolution of the corporation.

These provisions will continue without change under the IHIP Articles because they were adopted in connection with IBC's historical operations as a regulated hospital plan corporation in the five-county service area of Southeastern Pennsylvania. Comparable provisions will not be included in the HoldCo Articles for a number of reasons:

- These provisions are not typical governance provisions for a non-member, nonprofit corporation. Even for a "Blue" plan, they are outliers. IBC is the only "Blue" hospital or professional health service plan in Pennsylvania that has such provisions in its articles or bylaws. They are an anachronism and are fundamentally inconsistent with good governance "best practices."
- The customers served by IBC and its affiliates are located in diverse geographic markets and purchase very different products.[3] The customers purchase based on quality of service and price (and their status as customers can and does often change from year to year based on market pricing and product features available from competitors). There is the real potential for conflicts of interest among these customer groups who will each act

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2 Upon expiration of their current terms following closing under the Plan of Division, the appointed directors will be eligible to stand for re-election to the HoldCo # 1 board, subject to nomination by the board's governance committee.

3 Examples include traditional indemnity insurance, HMO products, PPO products, ASO products; TPA services, stop loss coverage, Medicaid managed care products, and behavioral health services.

(properly so) to protect their own economic interests as insurance consumers. They are not owners of the enterprise and have no equity stake or vested interest in, or ownership claim to, the holding company system.

These changes will produce a highly qualified HoldCo #1 Board that will be populated by the best and brightest candidates. These changes are a needed reform that will modernize the holding company system's governance and best enable the board of directors to manage and oversee HoldCo #1, IBC and their other regulated affiliates effectively, appropriately and responsibly in this challenging period of change in healthcare regulation.