

MIKE KREIDLER  
STATE INSURANCE COMMISSIONER



OFFICE OF  
INSURANCE COMMISSIONER

In the Matter of	)	No. G06-4
	)	
The Financial Examination of	)	FINDINGS, CONCLUSIONS,
<b>PACIFICARE OF WASHINGTON, INC.</b>	)	AND ORDER ADOPTING REPORT
	)	OF
	)	FINANCIAL EXAMINATION
A Registered Health Care		
Service Contractor.		

**BACKGROUND**

An examination of the financial condition of **PACIFICARE OF WASHINGTON, INC.** (the Company) as of December 31, 2002, was conducted by examiners of the Washington State Office of the Insurance Commissioner (OIC). The Company holds a Washington certificate of registration as a health care service contractor. This examination was conducted in compliance with the laws and regulations of the state of Washington and in accordance with the procedures promulgated by the National Association of Insurance Commissioners and the OIC.

The examination report with the findings and instructions was transmitted to the Company for its comments on September 21, 2005. The Company's response to the report is attached to this order only for the purpose of providing convenient review of the response.

The Commissioner or a designee has considered the report, the relevant portions of the examiners work papers, and submissions by the Company.

Subject to the right of the Company to demand a hearing pursuant to Chapters 48.04 and 34.05 RCW, the Commissioner adopts the following findings, conclusions, and order.

**FINDINGS**

Findings in Examination Report. The Commissioner adopts as findings the findings of the examiners as contained in pages 1 through 16 of the report.

**CONCLUSIONS**

It is appropriate and in accordance with law to adopt the attached examination report as the final report of the financial examination of **PACIFICARE OF WASHINGTON** and to order the Company to take the actions described in the Instructions section of the report. The Commissioner acknowledges that the Company may have implemented the

Instructions prior to the date of this order. The Instructions in the report are an appropriate response to the matters found in the examination.

### ORDER

The examination report as filed, attached hereto as Exhibit A, and incorporated by reference, is hereby ADOPTED as the final examination report.

The Company is ordered as follows, these being the Instructions contained in the examination report on pages 1-5.

1. The Company is ordered to comply with RCW 48.31C.060 and the requirements of Solicitation Permit No. 276 as required by RCW 48.06.180, pursuant to RCW 48.44.015, to obtain OIC's written approval of payments on surplus notes. Instruction 1, Examination Report, page 2.
2. The Company is ordered to correct all deficiencies relating to the safeguarding of securities and to execute a revised or amended custodial agreement pursuant to NAIC Annual Statement Instructions and the NAIC Accounting and Procedures Manual, as required by WAC 284-07-050(2). Adherence to the NAIC Financial Condition Examiners Handbook is included in this requirement. Instruction 2, Examination Report, page 4.
3. The Company is ordered to comply with RCW 48.12.070 and produce records, books and other information that are reasonably necessary to ascertain the financial condition of the Company. Instruction 3, Examination Report, page 4.
4. The Company is ordered to correctly classify all transactions as required by RCW 48.44.095, WAC 284-07-050, and the NAIC Annual Statement Instructions. Instruction 4, Examination Report, page 5.

IT IS FURTHER ORDERED THAT, the Company file with the Chief Examiner, within 90 days of the date of this order, a detailed report specifying how the Company has addressed each of the requirements of this order.

ENTERED at Olympia, Washington, this 13<sup>th</sup> day of February, 2006.



MIKE KREIDLER  
Insurance Commissioner

# PacifiCare®

January 18, 2006

RECEIVED  
JAN 20 2006  
INSURANCE COMMISSIONER  
COMPANY SUPERVISION

Mr. James T. Odiome, CPA, JD  
Deputy Insurance Commissioner  
State of Washington  
5000 Capitol Blvd.  
Tumwater, WA 98501

RE: Examination Report of PacifiCare of Washington  
As of December 31, 2002

Dear Mr. Odiome:

Enclosed please find for your consideration our responses to be included in the final Examination Report of PacifiCare of Washington.

Please feel free to contact me with any further questions or concerns regarding our responses.

Respectfully,



Susan L. Berkel  
Chief Financial Officer  
PacifiCare of Washington, Inc.

cc: Michael Montevideo  
Joanne Delvecchio  
Joyce Zacks  
John Burch  
Nicole Yu  
Jane Knous  
Peter Reynolds  
Judith D'Ambrosio

## SCOPE OF THE EXAMINATION

This examination covers the period January 1, 1997 through December 31, 2002 and comprises a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administrative Code (WAC), Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination that were noted during the examination.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

## INSTRUCTIONS

The examiners reviewed the Company's filed 2002 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as contained in the Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review.

### **1. Payment of Surplus Notes Require Prior Approval**

The Company made two payments to its parent company, PacifiCare Health Plan Administrators (PHPA) and subsequently asked for OIC's approval to reduce surplus notes. The terms of the surplus notes state that all payments to reduce the surplus notes shall be subject to prior written approval by OIC.

In December 2000, the Company transferred \$21,000,000 to PHPA. Subsequently, on April 10, 2001, OIC approved the cash transfer as a payment on surplus notes. On August 9, 2001, the Company transferred another \$24,000,000 to PHPA. Subsequently, on June 2, 2002 in a Form D filing, the Company requested approval of the transfer as a payment on surplus notes. OIC responded to the Form D filing in a letter dated July 2, 2002 asking for information as to how PCW was going to maintain capital at the 10% level of annualized premium in which the Company had agreed to in a letter dated September 14, 2000. OIC did not approve the reduction of the surplus note for the

second payment until December 15, 2004, by which time the Company supplied the requested information to OIC on its minimum surplus requirements.

The Company justified the payments without receiving prior approval based on its interpretation of the risk-based capital net worth requirements as provided under the Health Carrier Holding Company Act. The adoption of the Health Carrier Holding Company Act (Chapter 48.31C) did not alter or supersede the terms of the solicitation permit. The repayment of the surplus notes is governed by the terms of Solicitation Permit No. 276. According to the terms of the solicitation permit, the Company cannot make any payment on the surplus notes without the prior approval of the Commissioner.

The first and second payments by the Company to PHPA are in violation of Solicitation Permit No. 276 which requires OIC's permission for payment on the surplus notes. The second payment is also in violation of the Health Carrier Holding Company Act 48.31C.050(2) which requires the Company to notify the Commissioner in writing before entering certain specific transactions.

**The Company is instructed to comply with RCW 48.31C.060 and the requirements of Solicitation Permit No. 276 as required by RCW 48.06.180, pursuant to RCW 48.44.015.**

**PacifiCare of Washington (the "Company") RESPONSE:** *The Company would like to go on record that in a Form D filing dated December 4, 2004 submitted to James E. Tompkins, Assistant Deputy Commissioner, PacifiCare of Washington, Inc. formally requested approval to apply the \$24 million advance against the outstanding Subordinated Notes of \$43 million. In response to this filing, the Company received approval from the OIC to pay down the outstanding Subordinated Note. The Company would like to request that this finding be considered closed. The Company agrees to comply with RCW 48.31C.060.*

## **2. Custodial Agreement with Bank of New York Not in Compliance with NAIC's Annual Statement Instructions**

The OIC investment specialist reviewed the Custodial Agreement (Agreement) that PacifiCare of Washington, Inc. (PCW) executed with Bank of New York, Western Trust Company (BNY) to determine if the Agreement was in compliance with Part 1-General, Section IV. H - Custodial or Safekeeping Agreements of the FCEH.

The Company's response to the General Interrogatory 22.01 of its 2002 NAIC Annual statement incorrectly indicated that it complied with the FCEH since the Custodial Agreement with BNY did not comply with Part 1-General, Section IV. H - Custodial or Safekeeping Agreements of the FCEH. The OIC investment specialist determined that the agreement with BNY is not in compliance with pages I-73 - I-75 of the FCEH or with state statutes relating to the safeguarding of securities, as detailed below.

- The Agreement does not state that PacifiCare's certificated securities shall be held separate from all other securities or in fungible bulk.

- The Agreement does not state that PacifiCare's securities held in fungible bulk by BNY through a clearing corporation, or in the Federal Reserve book-entry system, shall be separately identified on BNY's books as being owned by PacifiCare.
- The Agreement does not allow PacifiCare's securities that are not held subject to deposit requirements to be withdrawable upon demand.
- Confirmation of all transfers by hard-copy or in electronic format is not expressly required by the Agreement.
- The Agreement does not require BNY to indemnify PacifiCare for the loss of PacifiCare's securities caused by BNY's negligence or dishonesty of its officers, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction.
- For the loss of securities which BNY is obligated to indemnify PacifiCare, BNY is not required to promptly replace the securities or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities.
- The Agreement does not require that in the event BNY gains entry in a clearing corporation through an agent [to include national bank, state bank, or trust company], there will be written agreement between BNY and the said agent, subjecting the agent to the same liability for loss of the securities as BNY.
- The Agreement does not require BNY to provide written notice to our office within three business days of PacifiCare's safekeeping account being terminated or all funds being withdrawn.
- The Agreement does not require BNY to allow an officer or employee of PacifiCare, or an independent accountant selected by PacifiCare and the OIC, to be entitled to examine BNY's records relating to the securities on the premises of BNY during regular business hours.
- The Agreement does not require BNY to send to PacifiCare all reports it receives from its outside auditor, from a clearing corporation, or the Federal Reserve book-entry system, which permit such reports to be redistributed, addressing the respective systems of internal control.
- To the extent that certain information maintained by BNY is relied upon by PacifiCare in preparation of its annual statement and supporting schedules, the Agreement does not require BNY to maintain records sufficient to determine and verify such information.
- The Agreement does not require BNY to provide appropriate affidavits with respect to PacifiCare's securities held by BNY, upon written request from a regulator or an authorized officer of PacifiCare.
- The Agreement does not require BNY to secure and maintain adequate insurance protection over PacifiCare's assets covered by the Agreement.

- The Agreement allows BNY to use depositories or subcustodians acceptable to them. The only acceptable depository is a custodian which meets the statutory qualifications of a qualified custodian. A qualified custodian is either a participating financial institution or clearing corporation. Statutory authority contemplates all depositories being qualified custodians.

**The Company is instructed to follow the NAIC's Annual Statement Instructions and the AP&P, as required by WAC 284-07-050(2). Adherence to the FCEH is included in these requirements, so the Company is instructed to correct all deficiencies noted above and to execute a revised or amended custodial agreement.**

**COMPANY RESPONSE:** *The Company has proposed amendments to our custody agreement and reviewed them with the OIC. As of January 19, 2006 the Company's representative and the OIC agreed to the proposed changes which address all of the concerns raised in the examination. An amendment to the custody agreement will be executed by January 31, 2006.*

### **3. The Incurred But Not Paid (IBNP) Model Does Not Reconcile to Company General Ledger**

For the review of Claims Unpaid liability for the year ending December 31, 2002, the information supplied to the OIC actuary was incorrect and included inappropriate costs in the Claims Unpaid liability account. In the review of the Claims Unpaid liability as of December 31, 2002, the OIC actuary reviewed paid data claims for the period January 1, 2000 through November 11, 2003 by lines of business to determine the consistency and quality of data. Paid claim amounts, as provided by the Company's actuaries, could not be reconciled to the Company's 2002 NAIC Annual Statement. It was determined late in the examination process that the paid claims information provided by the Company's actuaries included paid claims for both Oregon and Washington.

The general ledger was properly recording paid claims for each state but the actuarial database was overstating paid claims in Oregon's IBNP model and understating paid claims in Washington's IBNP model.

**The Company is instructed to comply with RCW 48.12.070 and produce records, books and other information that are reasonably necessary to ascertain the financial condition of the Company.**

**COMPANY RESPONSE:** *The correct paid claims files were used beginning in the fourth quarter of 2003, before the OIC financial examination began. A reconciliation process was implemented in the fourth quarter of 2003 to ensure that these data issues do not arise again. The reconciliation is performed on a monthly basis by the accounting staff to compare the paid claims per the IBNR model to the paid claims in the general ledger by state and by system. A rollforward of IBNR is also performed, which ensures that the general ledger activity is consistent with the IBNR model. Any*

*variances are investigated and addressed as appropriate. The Corporate Actuarial department also performs a reconciliation on a monthly basis to make sure paid claims within the model have not changed from month to month. The paid claims by process period from the current month's IBNR model are compared to the paid claims by process period from the prior month's IBNR model by state, by system, and by claim category, to ensure that paid claims do not change from month to month. Any variances are investigated and communicated to by the Actuarial Department to Finance.*

#### **4. Errors in NAIC Annual Statement Filings**

##### **a) Misclassification of Escheat Balance**

The Company incorrectly classified uncashed checks pending escheats to Washington State in the Company's 2002 NAIC Annual Statement as General Expenses Due or Accrued. Uncashed checks pending escheats for claims payments, capitation payments and provider services in the amount of \$121,533 should be recorded in the Liabilities, Capital and Surplus Statement as Aggregate Write-Ins for Other Liabilities.

RCW 48.43.097 and WAC 284-07-050(2) require annual statement forms to be in general form and context as approved by the NAIC. The 2002 NAIC Annual Statement Instructions requires checks pending escheats to be classified as Aggregate Write-ins for Other Liabilities. Since capital and surplus was not affected, no examination reclassification is recommended.

##### **b) Misclassification of expenses for Increase in Reserves for Accident and Health Contracts**

The Company incorrectly classified expenses for the Increase in Reserves for Accident and Health Contracts in the amount of \$1,304,000 as General and Administrative expenses and as Aggregate Write-ins for Medical and Hospital Expenses.

The 2002 NAIC Annual Statement Instructions require that expenses for accident and health contracts be recorded as an Increase in Reserves for Accident and Health Contracts. Since capital and surplus was not affected, no examination reclassification is recommended.

##### **c) Misclassification of Premium Taxes**

The Company incorrectly classified premium tax expense in the Underwriting and Investments Exhibit of its 2002 NAIC Annual Statement as State and Local Insurance taxes. Premium taxes should be recorded in the Underwriting and Investments Exhibit of the NAIC Annual Statement as State Premium Taxes. Total misclassification as of December 31, 2002 is \$3,600,000. Since capital and surplus was not affected, no examination reclassification is recommended.

#### **d) Claims Overpayment Receivables**

The Company incorrectly classified claims overpayment receivables in the amount of \$1,595,932 as Claims Unpaid in the Liability section of the Company's 2002 NAIC Annual Statement. Claims overpayment receivables should be reported as a Health Care Receivable in the asset section of the NAIC Annual Statement. Since capital and surplus was not affected, no examination reclassification is recommended.

**The Company is instructed to correctly classify all transactions as required by RCW 48.44.095, WAC 284-07-050, and the NAIC Annual Statement Instructions.**

**COMPANY RESPONSE: *The NAIC statements required for December 31, 2002 had been recently rolled out. The Company agrees that these misclassifications occurred. Beginning with the December 31, 2005 NAIC annual statements, the items noted above will be reported as required.***

#### **COMMENTS AND RECOMMENDATIONS**

No comments or recommendations were noted based on our examination.

#### **COMPANY PROFILE**

##### **Company History**

PCW obtained its Certificate of Registration in Washington State on March 6, 1986 as a Health Maintenance Organization (HMO). On February 28, 1994, PCW purchased Network Health Plan (NHP). NHP began operating in Washington State on June 20, 1986. Its Certificate of Registration is as a Health Care Service Contractor (HCSC). On June 30, 1994 PCW surrendered its HMO license and merged into PacifiCare of Oregon (PCO). On October 1, 1994, NHP changed its name to PacifiCare of Washington (PCW). PCW is owned 100% by PacifiCare Health Plan Administrators (PHPA) and PHPA is owned 100% by PacifiCare Health Systems, Inc. (PHS).

##### **Territory and Plan of Operation**

PCW is a health care service contractor that only conducts business in the state of Washington. Its primary operations include managed care products for employer groups and Medicare beneficiaries. The Medicare Plus Choice business segment contributes approximately 70% of the Company's revenues. PacifiCare capitates approximately 48% of its hospital contracts and 52% are shared risks. On the physician side, 78% of the contracts are capitated and 22% are shared risk. PHS is the ultimate parent for thirty-one affiliated companies which includes PCW. The majority of these companies are health,