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Fort Dearborn Life Insurance Co. And Fort Dearborn Life Insurance Co. of New York

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Fort Dearborn Life Insurance Co. And Fort Dearborn Life Insurance Co. of New York

Major Rating Factors

Strengths:

- Strategically important subsidiaries of Health Care Service Corp. (HCSC).
- Enhanced market presence in the group employee benefits market.
- Very strong capitalization.
- Very good earnings profile.

Weaknesses:

- Modest growth in the group employee benefits business.
- Operates within a highly competitive business environment in the group life and disability insurance benefit markets.

Operating Companies Covered By This Report

Financial Strength Rating

Local Currency

A+/Stable/--

Rationale

The insurer financial strength ratings on Fort Dearborn Life Insurance Co. and Fort Dearborn Life Insurance Co. of New York (FDLNY) reflect the benefits the companies (collectively referred to as FDL) derive from their status as strategically important subsidiaries of their parent, HCSC. The ratings are also based on FDL's enhanced market presence in the group employee benefits market, very strong capitalization, and very good earnings performance. Offsetting these positive factors are the challenges that FDL will continue to face in growing its business and expanding its distribution geographically in the highly competitive markets in which the company operates.

FDL benefits from HCSC's strong operational, marketing, and financial resources as well as the parent's commitment to maintaining high levels of capital strength in its operating subsidiaries. HCSC has demonstrated its commitment to support FDL by contributing capital to FDL for its growth initiatives in recent years. FDL adds an important dimension to HCSC's small group strategy and enables the parent to offer a more complete benefit package to its customers.

FDL's position in the employee benefits market is supported by its growth in the broker direct-distribution channel in recent years and the well-established distribution relationships the company has with its parent and the Blue Cross Blue Shield (BCBS) system. Management continues to leverage these relationships for growth and to develop a stronger distribution system for its broad array of group life and disability benefits products. Within two of its core products—group life and short-term disability, which are dominated by large multi-line life and health players—FDL has managed to sustain its growth. Selective acquisitions have also fueled growth.

FDL's risk-adjusted capitalization is extremely strong for the rating. Its statutory capital level has continually increased through good operating performance and a contribution of capital from HCSC. Total adjusted capital grew 4% to \$470 million in 2007 from \$451 million in 2006.

Operating performance has improved in the past three years as FDL continues to grow its business. The pretax statutory return on assets (ROA) for 2007 was 1.7% and has averaged 1.8% over the last five years. The company's

premium income from its core products has continued to grow both organically and through acquisition, with a double-digit five-year (2003-2007) compound annual growth rate of 20% in its group life business and 41% in its group accident and health line.

Offsetting these positive factors are the challenges FDL faces in growing its market position and expanding its distribution systems in the highly competitive group employee-benefits market. The top players in this market are large, multi-line public health and life companies. Price competition is intense, and margins are narrow. FDL's management has built a very strong distribution system for its products by growing its relationships in the broker-direct channel and working with HCSC and other BCBS plans. FDL has been expanding its distribution in the broker-direct channel, yet some concentration remains in FDL's in-force book of business. Distribution from HCSC remains meaningful and should continue to contribute to FDL's distribution and growth strategy.

Outlook

Standard & Poor's Ratings Services expects that FDL will likely maintain its very good position in the employee-benefits market by leveraging its distribution relationships to further diversify and expand the distribution of its products and to promote growth. In 2008, FDL should record new annualized premium of \$75 million-\$85 million, and we expect that this will improve in 2009 as the benefits of its expanding distribution emerge. Sales of annuities will likely be about \$350 million-\$400 million in 2008. We expect that FDL's capitalization will remain very strong for the rating.

We consider FDL to be a strategic holding of HCSC, and any rating actions we take on HCSC could similarly affect the FDL ratings.

Competitive Position: Expanded Distribution Has Helped Sustain Growth

FDL's competitive position is very good based on its well-established distribution relationships with HCSC, the BCBS system, and its growing broker-direct distribution channel. FDL's distribution system is expanding and becoming more diversified. FDL recorded new annualized premium of \$78 million in 2007. The company had net group life premium of \$512 million and net group accident and health premium of \$137 million.

Table 1

Fort Dearborn Life Insurance Co./Selected Statistics					
	—Year ended Dec. 31—				
(Mil. \$)	2007	2006	2005	2004	2003
Statutory earnings adequacy ratio (%)	141.0	137.3	140.5	111.2	92.9
Liquidity ratio (%)	315.0	316.1	284.7	273.4	234.0
Total assets (including separate accounts)	2,238.6	2,105.5	1,681.4	1,595.3	1,369.8
Total premiums and considerations	963.1	1,020.4	738.8	727.3	485.1
Adjusted pretax income	39.5	30.6	44.8	33.8	7.1
Total adjusted capital (including asset valuation reserve)	469.6	451.3	353.1	343.9	322.6

Table 2

Fort Dearborn Life Insurance Co./Business Statistics					
—Year ended Dec. 31—					
(Mil. \$)	2007	2006	2005	2004	2003
Total revenue	1,035.9	1,087.7	802.3	791.6	532.1
Total premiums and considerations	963.1	1,020.4	738.8	727.3	485.1
Premium revenue increase (%)	(5.6)	38.1	1.6	49.9	4.2
Deposits	10.9	6.9	11.3	2.8	2.9
Total premiums, considerations, and deposits	974.1	1,027.2	750.1	730.1	488.1
Premiums, consideration, and deposit revenue increase (%)	(5.2)	36.9	2.7	49.6	4.8
Net first-year premiums	0.7	0.2	0.7	0.6	0.6
Net first-year increase (%)	216.8	(66.2)	15.0	(3.5)	(12.3)
Net single premiums*	297.1	274.4	138.7	84.1	194.9
Net single increase (%)	8.3	97.8	64.9	(56.8)	3.9
Separate accounts assets	861.2	769.2	518.2	431.4	382.7
Increase in separate accounts assets (%)	12.0	48.4	20.1	12.7	72.2
Major lines					
Individual life	17.4	18.3	11.7	12.1	11.0
Individual annuities	297.1	274.4	138.7	84.1	194.9
Group life	511.6	499.2	412.0	400.5	243.4
Group accident and health	137.0	225.9	172.7	227.8	35.1
Individual accident and health	0.0	2.7	3.7	2.8	0.7
Deposits	10.9	6.9	11.3	2.8	2.9

*Excludes annuity and fund deposits for 2001 and later.

Management's strategic focus is on acquisitions and broadening its broker-direct distribution channel outside of the Blues system and in states where the BCBS relationship has changed. This should conserve FDL's premium and ensure future growth. In the last few years, FDL has opened many new group benefits sales offices with independent broker/agent relationships nationally. In addition, the acquisition of its New York subsidiary FDLNY, the 2006 acquisition of the life and disability business of HM Life Insurance Co., and the merger with Member Service Life have added distribution. FDLNY's lines of business are similar to those of FDL, except for New York state mandatory short-term disability. These and past mergers and acquisitions create opportunities for further expansion of FDL's distribution system and to expand FDL's presence geographically. In addition, product packaging and pricing strategies will play an increasing role in FDL's sales efforts as the market seeks a single carrier for multiple products for ease of administration.

FDL's core products are group term life as well as voluntary short-term and long-term disability. The company also offers preferred provider organization and voluntary dental products. FDL's growth strategy for its life insurance products includes enhanced supplemental life enrollment capabilities as well as the utilization of life claims settlement options for asset retention.

FDL also sells individual interest-sensitive, market-value-adjusted, and fixed indexed-annuity products. It distributes these products through regional banks and marketing organizations as well as being cross-sold with some of HCSC's products. FDL remains disciplined and targeted in its approach for the growth of its fixed-annuity product.

Prospective

We expect that management will continue to focus on expanding its distribution relationships geographically, both through new broker-direct relationships and targeted acquisitions. Distribution through HCSC will continue to play a major role in FDL's distribution and growth strategy. In 2008, new annualized premium will likely be \$75 million-\$85 million. Annuity product sales should improve to \$350 million-\$400 million.

Management And Corporate Strategy: Focus Has Been On Expanding Distribution Geographically

FDL's management has developed and implemented a strategy to diversify and expand its distribution geographically to fuel future growth in markets where a BCBS relationship has changed or no BCBS relationship exists. Standard & Poor's believes that strategy has been a success so far.

New business has been—and will continue to be—added through targeted expansion and additions. Growth will come from its broker-direct relationships, the purchase of additional blocks of business, and increased bundling and cross-selling of complementary FDL products into HCSC's and other BCBS Plans' customer bases.

Operational management

Standard & Poor's expects management's operational initiatives to focus on:

- Providing a competitive life, disability, dental, and annuity product portfolio.
- Strengthening and expanding its distribution networks.
- Enhancing its services and expanding its technological capabilities.
- Maintaining its strong level of capitalization.
- Growing its business with earnings that support that growth.

FDL and its affiliates manage their operations well, and management is aware that to maintain competitive pricing for its life products, it must have a competitive cost structure with strong technological capabilities. As such, it continues to focus on keeping expenses low and making improvements. FDL also benefits from its ability to leverage HCSC's technology to achieve a very good operational infrastructure.

To realize operational synergies and economies of scale, targeted acquisitions by FDL are usually merged into the company's operations. Standard & Poor's believes the successful execution of FDL's integration and consolidation strategies with its affiliates will enable it to compete effectively in its existing markets

Financial management

FDL is committed to maintaining a conservative financial management position in which it maintains very strong levels of capital, no debt on its balance sheet, and high-quality, very liquid assets in its investment portfolio. The company's reserving and underwriting policies are also conservative. It is committed to maintaining profitability in all product lines, though it has been challenged in achieving adequate levels of profitability in its disability products. HCSC has demonstrated a commitment to maintaining high levels of capital strength at FDL.

Enterprise Risk Management: Adequate For Company's Conservative Risk Profile

FDL's risk management is adequate and reflects the conservative risk profile of the company. The company's core insurance portfolio of group benefit products is not particularly complex. FDL's consistent financial performance

and capital strength demonstrate its underwriting and pricing discipline. Its major risk is underwriting risk. Risk management and product pricing in both its insurance and annuity lines of business to enhance product competitiveness will continue to be a focus of FDL. As a strategically important subsidiary of HCSC, FDL will continue to benefit from HCSC's strong operational, marketing, and financial resources and the parent's commitment to maintaining high levels of capital strength in its operating subsidiaries.

Accounting

FDL presents its financial statement on a statutory accounting basis. One of the most significant variances from GAAP reporting, which we considered in our qualitative analysis of FDL's earnings, was its annuity policy acquisitions cost and the treatment of gains on assets for the MVA portion of fixed annuities products that are recorded on the general ledger. The costs of acquiring its annuity policies are not deferred and then amortized; rather, FDL expenses them when they are incurred. This puts a strain on statutory earnings.

Operating Performance: Good, With Relatively Stable Financial Results

FDL's earnings profile is very good, with a pretax statutory ROA of 1.7% and a five-year average of 1.8%. Full-year results for 2007 showed adjusted pretax statutory operating income (excluding realized gains/loss) remaining stable at \$37.5 million. Contributing to 2007 performance were underwriting gains and investment income. FDL paid no dividend to HCSC in 2007.

Table 3

Fort Dearborn Life Insurance Co./Summary Operating Statistics					
	—Year ended Dec. 31—				
(Mil. \$)	2007	2006	2005	2004	2003
Adjusted pretax income	37.5	30.6	44.8	33.8	7.1
Net income	42.8	17.7	33.3	24.6	0.4
Statutory earnings adequacy ratio (%)	141.0	137.3	140.5	111.2	92.9
Return on revenue (%)	3.6	2.8	5.6	4.3	1.3
Return on assets (%)	1.7	1.6	2.7	2.3	0.6
Pretax statutory rate of return on capital (%)	10.9	9.9	17.1	12.7	2.2

Table 4

Fort Dearborn Life Insurance Co./Operating Statistics					
	—Year ended Dec. 31—				
(Mil. \$)	2007	2006	2005	2004	2003
General expenses	69.6	65.9	54.2	50.7	34.6
General expense ratio (%)	7.9	8.4	9.2	10.0	7.9
Expense ratio (%)	14.7	15.1	16.7	14.6	13.9
Unit expenses (in whole dollars)	74.7	62.1	77.0	64.9	53.0
General expenses as a percentage of total assets	3.1	3.1	3.2	3.2	2.5
Commission ratio (%)	4.6	4.4	4.2	4.5	4.6
Lapse ratio (ordinary only) (%)	17.0	24.2	12.2	16.2	14.5
Mortality ratio (%)	107.5	78.5	96.7	101.3	120.8

Table 4

Fort Dearborn Life Insurance Co./Operating Statistics(cont.)					
Investment spread (%)	2.7	2.8	2.7	2.9	2.0
Accident and health					
Loss ratio (%)	68.9	73.9	70.7	85.9	64.2
Expense ratio (%)	38.2	23.9	28.6	15.2	37.9
Combined ratio (%)	107.1	97.8	99.3	101.1	102.2

Historical

The first time the company paid a dividend to HCSC was in 2005, when it paid \$10 million in conjunction with a one-time favorable tax treatment.

Prospective

Standard & Poor's expects that FDL's earnings profile will continue to be positive through the continued expansion of its distribution systems and acquired blocks of business, the capital contribution from HCSC if a need were to arise, and continued management of overhead expense and administrative costs. We expect that statutory pretax income will remain stable at \$30 million-\$35 million in 2008. This reflects the company's commitment to invest in the growth of its distribution systems and its annuity business.

Investments And Liquidity: Very Strong Portfolio Provides Ample Liquidity

Standard & Poor's believes the credit quality of FDL's investment portfolio is very strong and that it provides more than adequate liquidity for the company's operating needs. The company's investment strategy is to optimize the return on funds while maintaining the security and liquidity necessary to meet long-term reserve requirements and short-term cash-flow needs. Moreover, in conjunction with FDL's asset/liability management procedures, it performs annual cash-flow testing (including stochastic testing) to review matching of assets and liabilities and profitability. This is to ensure that it maintains adequate liquidity levels under stress scenarios in each product line.

Table 5

Fort Dearborn Life Insurance Co./Investment Statistics					
(Mil. \$)	—Year ended Dec. 31—				
	2007	2006	2005	2004	2003
Net investment income	61.3	60.3	57.8	58.2	44.7
Total invested assets	1,317.2	1,272.0	1,112.9	1,109.4	951.5
Net realized capital gains	1.7	0.2	(0.2)	(1.1)	(0.4)
Asset risk to invested assets (%)	7.1	4.5	4.9	5.1	20.5
High-risk assets to total invested assets (%)	3.4	2.5	6.1	4.7	5.6
Net investment yield (%)	4.7	5.1	5.2	5.7	4.8
Five-year realized capital gains to invested assets (%)	(0.00)	(0.00)	(0.00)	0.01	0.00
Portfolio composition					
Cash, cash equivalents, and short-term investments (%)	3.8	3.7	3.1	4.1	1.6
Bonds (%)	81.1	82.1	78.2	76.8	64.7
Mortgage-backed securities (%)	12.1	13.1	17.6	18.0	17.7
Policy loans (%)	0.5	0.5	0.6	0.6	0.7

Table 5

Fort Dearborn Life Insurance Co./Investment Statistics(cont.)					
Stocks (%)	2.1	0.1	0.2	0.2	15.2
Other (%)	0.3	0.4	0.3	0.2	0.0

Table 6

Fort Dearborn Life Insurance Co./Liquidity And Reserves Statistics					
—Year ended Dec. 31—					
(Mil. \$)	2007	2006	2005	2004	2003
Allocation of reserves					
Individual life	15.8	16.1	17.7	17.9	18.6
Group life	0.6	0.6	0.4	0.3	0.2
Individual annuities	43.4	44.3	57.6	60.4	65.8
Accident and health	19.2	19.3	7.4	6.6	4.8
Other	21.0	19.7	16.9	14.7	10.6
Liquidity ratio (%)	N.A.	316.1	284.7	273.4	234.0
Liquid assets to total assets (%)	77.9	0.0	N.A.	N.A.	N.A.

N.A.—Not available.

FDL's liquidity ratio is extremely strong based on a stand-alone liquidity ratio of more than 300% at year-end 2007. The high credit quality of FDL's assets enhances liquidity. Assets consist primarily of U.S. Treasury securities and publicly traded, investment-grade corporate bonds.

The combined fixed-income portfolio accounted for more than 97% of the company's total investments of about \$2.2 billion at year-end 2007, of which about 95% were in NAIC Class 1 or 2 securities and Treasuries. Investments in equities and speculative-grade bonds are kept at less than 3%. External investment-management firms manage the majority of the portfolio and also perform asset/liability management functions. The company's principal asset/liability management objectives are to preserve capital and to evaluate crediting spreads to maximize returns within its conservative risk profile.

Prospective

Standard & Poor's does not expect any material changes to FDL's investment and asset/liability management strategies. FDL should continue to manage its portfolio conservatively and maintain its liquidity position at extremely strong levels in the near term.

Capitalization: Strong Risk-Adjusted Position Should Grow

FDL maintains an extremely strong level of capitalization for the rating level. FDL's statutory capital level has continually increased through operating earnings, capital contributions from HCSC, and mergers and acquisitions. Total adjusted capital grew 4% to \$470 million in 2007 from \$451 million in 2006.

Table 7

(Mil. \$)	—Year ended Dec. 31—				
	2007	2006	2005	2004	2003
Total assets	2,238.6	2,105.5	1,681.4	1,595.3	1,369.8
General account assets	1,377.4	1,336.3	1,163.2	1,163.9	987.2
Total liabilities (excluding separate accounts and asset valuation reserve)	899.9	897.1	809.2	822.3	673.3
Total adjusted capital (including asset valuation reserve)	469.6	451.3	353.1	343.9	322.6
Unrealized capital gains	(1.7)	(0.7)	0.5	(0.1)	11.4
Capital adequacy ratio (%)	262.1	272.9	252.2	240.7	172.4
Company action level to NAIC risk-based capital ratio (%)	416.6	387.8	368.9	350.5	346.7
Assets risk to total adjusted capital ratio (%)	20.0	12.7	15.6	16.6	60.7
High-risk assets to total adjusted capital ratio (%)	9.5	7.1	19.3	15.2	16.6
Surplus from operating earnings after dividends (%)	96.1	87.8	171.2	44.8	34.5
Stockholder dividends/net income	8.4	12.7	14.3	0.0	0.0
Net premiums to gross premiums (%)	96.0	96.6	96.7	97.0	97.6
Net reserves to gross reserves (%)*	82.1	82.5	87.7	88.1	93.1
Stockholders' dividends	0.0	0.0	10.0	0.0	0.0
Stockholders' dividends to net operating income (%)	0.0	0.0	29.9	0.0	0.0

*Includes annuity and fund deposits.

Mitigating this strength are the absolute size of FDL's capital position and the growth of its capital-intensive fixed-annuity business, which could subject the company to some volatility.

Prospective

It is likely that FDL's capitalization level will remain extremely strong for the rating.

Financial Flexibility: No Capital Needs On the Horizon

FDL's strong capital position and its relatively consistent earnings provide it with strong financial flexibility. If a capital need were to arise, the company could likely access additional financial resources through its parent company.

Ratings Detail (As Of August 1, 2008)*

Operating Companies Covered By This Report

Fort Dearborn Life Insurance Co.

Financial Strength Rating

Local Currency

A+/Stable/--

Counterparty Credit Rating

Local Currency

A+/Stable/--

Fort Dearborn Life Insurance Co. of New York

Financial Strength Rating

Local Currency

A+/Stable/--

Issuer Credit Rating

Local Currency

A+/Stable/--

Ratings Detail (As Of August 1, 2008)***(cont.)**

Related Entities

Health Care Service Corp. (d/b/a Blue Cross & Blue Shield of Illinois, New Mexico, Oklahoma, and Texas)

Financial Strength Rating

Local Currency

AA-/Stable/--

Issuer Credit Rating

Local Currency

AA-/Stable/--

Senior Unsecured (1 Issue)

AA-

Domicile

Illinois

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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