

**Banner Health**  
**Management's Discussion and Analysis of Results of Operations and Financial**  
**Position**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make assumptions and estimates that affect the amounts reported in the financial statements, including the notes thereto, and related disclosures of commitments and contingencies, if any. Management relies on historical experience and other assumptions believed to be reasonable under the circumstances in making its judgments and estimates. Actual results could differ materially from those estimates.

We recommend that you read this discussion together with our audited consolidated financial statements and related notes of Banner Health ("Banner") for the year ended December 31, 2016. The audited consolidated financial statements are available from the Municipal Securities Rulemaking Board (the "MSRB") on its Electronic Municipal Market Access ("EMMA") system, found at <http://emma.msrb.org>.

# Banner Health

## Management's Discussion and Analysis

### For The Quarter Ended March 31, 2017

#### Overview

Banner is one of the nation's largest nonprofit healthcare systems. Its stated mission is to "make a difference in people's lives through excellent patient care" and it seeks to achieve that mission through continuous improvement in clinical and service performance for the patients and members it serves. Headquartered in Phoenix, Arizona, Banner provides a broad range of healthcare and related services concentrated in three geographic areas: the Greater Phoenix metropolitan area, the Greater Tucson metropolitan area, and in northern and northeastern Colorado, with the remaining facilities located in small or rural communities in Wyoming, Nebraska, Arizona, Nevada, and California. Centralized corporate and other support services for these operations are provided from Banner's corporate offices in Phoenix, Arizona. In December, 2015, Banner exercised its right to terminate the Greater Fairbanks Community Hospital Foundation lease with one year advance notice. The termination was effective January 1, 2017. Prior year comparisons below have been adjusted to reflect only continuing operations.

#### Financial Performance

Banner Health generated operating income of \$68.0 million and net income of \$208.4 million for the quarter ended March 31, 2017, equating to operating and total margins of 3.5% and 9.9%, respectively. This performance represents a decline from the \$106.5 million operating income and 5.5% operating margin for the first quarter of 2016, but an improvement over the 2016 first quarter net loss of \$15.3 million net margin of -0.8%. Performance results include three significant elements:

- Strong "community delivery" system performance. Non-academic delivery system operations yielded \$106.3 million in operating income the equivalent of an 8.3% operating margin, largely unchanged from the 8.4% operating margin earned in the first quarter of 2016. Community delivery revenue increased 2.0% over the prior year, although patient encounters (inpatient admissions plus observation cases) were down slightly. A significant factor in the hospital volume decline was an unusually light flu season, particularly in Arizona.
- Unprofitable academic medicine delivery operations. The Academic Medicine Division, which include two medical centers and the faculty practice plan in Tucson Arizona, and a medical center and faculty practice plan in Phoenix, Arizona, experienced an overall net operating loss of \$23.8M compared to a loss of \$16.6M for the first quarter of 2016. Adjusted admissions, outpatient registration, and inpatient and outpatient surgery volumes reflect strong year-over-year growth and while revenue for the division grew 9.4% from first quarter 2016 to 2017, operating expenses outpaced revenue growth. This was driven by the short term impact of several physician clinic acquisitions and a more complex patient population, which has increased wages, benefits, and supply costs. The Division has very focused cost reduction efforts underway with expected improvements in the upcoming quarters.
- Unprofitable insurance operations. These operations include two Accountable Care Networks which take full risk from Medicare Advantage (MA) health plans and an Arizona Medicaid plan and its associated MA/D-SNP plan. These operations generated an operating loss of \$23.3 million on \$306.6 million in revenue, an operating margin of -7.6% which is a significant decline from the \$11.6 million in operating losses reported for the first quarter of 2016. The decrease in operating performance is largely attributable to increased losses on Banner Health Network's Medicare Advantage Plans. The largest of these plans, the BCBS Medicare Advantage Plan, was substantially modified through new contract terms in 2017 and the addition of a new provider network. Although the initial short-term impact of these changes is negative, the long-term potential of the

changes is expected to be positive and will improve the Plan's overall financial performance. BHN has initiated several performance improvement plans, which are expected to result in improvements in financial performance as the year progresses.

### Revenue, Volume and Operating Expense

Banner continues to see strong revenue growth, as revenue increased 5.1% from first quarter 2016 to first quarter 2017.

On a consolidated basis, acute and observation cases declined by 1,050 cases, or 1.2%. Emergency room visits of 262,433, declined 5.6% from 2016, and accounted for 66.9% of Banner's inpatient cases, up from 61.8% in the first quarter of 2016. Surgical volumes increased 0.4% and totaled 40,519. The outpatient percentage of these cases was essentially unchanged, at 62.7% in 2017 compared to 62.8% in 2016. Non-hospital volume growth was strong as a result of continued additions to medical group capacity and productivity increases. Clinic encounters grew 13.8% on a consolidated basis excluding prior year Alaska encounters.

Operating expenses totaled \$1.9 billion for the quarter with labor and supply costs comprising 55.6% and 18.5% of patient revenue, respectively, compared with 54.1% and 18.3% of net patient revenue for the same period in 2016. Banner has embarked on an aggressive cost reduction plan in order to meet its income expectations for 2017 and the early outcomes of these plans are showing net positive results after severance and other costs.

Financial support from the academic medical centers to the academic medical group increased by \$46.3 million from 2016 to 2017. This caused a shift in operating income from the obligated group (medical centers) to the non-obligated group (medical group). The accounting change was made to better reflect the integrated nature of the academic medical group with the medical centers, and to facilitate performance measurements required by the Academic Affiliation Agreement beginning two years after the UAHN acquisition, the second anniversary of which was February 27, 2017.

### Non-operating Performance

Non-operating performance improved over prior year, as both investment returns and interest rate swap movements were positive during the first quarter of 2017. Banner's \$4.2 billion consolidated investment portfolio generated an annualized return of 12.9% for the year, compared to an annualized loss of 4.2% earned for the same period in the prior year. Fixed interest rate swaps generated a mark-to-market gain of \$14.1 million for the quarter, however the required collateral posting increased slightly to \$106.9 million from \$101.7 million at the end of 2016.

### Capital Structure & Balance Sheet

Banner's financial position is shown in the table below:

	Quarter Ended March 31, 2017	Quarter Ended March 31, 2016	Year Ended December 31, 2016	Year Ended December 31, 2015
LT Debt to Capital	35.1%	37.6%	36.6%	38.0%
Days Cash on Hand	215	213	218	239
Cash to LT Debt	154%	146%	150%	151%
MADS Coverage	5.5	4.9	4.5	4.5

**Banner Health and Subsidiaries**

**Unaudited Financial Statements**

**As of March 31, 2017**

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## Banner Health and Subsidiaries

## Consolidated Balance Sheets

## Unaudited

(\$ in thousands)

	As of March 31, 2017				As of March 31, 2016			
	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated
<b>Assets</b>								
<b>Current assets:</b>								
Cash and cash equivalents	\$ 20,681	\$ 97,991	\$ -	\$ 118,672	\$ 18,716	\$ 62,746	\$ -	\$ 81,462
Short-term investments	113,618	75,488	-	189,106	166,149	75,174	-	241,323
Collateral held under securities lending program and repurchase agreements	345,615	-	-	345,615	318,954	-	-	318,954
Assets limited as to use	10,660	33,774	-	44,434	1,246	33,675	-	34,921
Patient receivables, net of allowance for doubtful accounts	756,953	86,617	(41,249)	802,321	786,059	90,592	(27,074)	849,577
Inventories	170,432	19,234	-	189,666	173,350	13,457	-	186,807
Estimated current portion of third-party payor settlements	507	-	-	507	-	-	-	-
Other receivables	242,465	39,955	(9,836)	272,584	95,999	48,190	(7,895)	136,294
Other, primarily prepaid expenses	155,939	(76,876)	-	79,063	69,076	4,342	(1)	73,417
Total current assets	1,816,870	276,183	(51,085)	2,041,968	1,629,549	328,176	(34,970)	1,922,755
<b>Assets limited as to use:</b>								
<b>Funds designated by:</b>								
Board of Directors	1,903,174	-	-	1,903,174	1,692,975	-	-	1,692,975
Lease agreements	1,895	-	-	1,895	3,107	-	-	3,107
<b>Funds held by trustees under:</b>								
Self-insurance funding arrangements	15,562	114,728	-	130,290	14,885	150,525	-	165,410
Other funds	193,205	898	-	194,103	245,773	885	-	246,658
Total assets limited as to use, less current portion	2,113,836	115,626	-	2,229,462	1,956,740	151,410	-	2,108,150
Assets held for sale	2,140	-	-	2,140	2,140	-	-	2,140
Property and equipment, net of depreciation	3,188,516	85,185	-	3,273,701	3,038,184	61,747	-	3,099,931
Leased hospital assets	232,809	-	-	232,809	249,282	-	-	249,282
<b>Other assets:</b>								
Long-term investments	1,965,657	29,378	-	1,995,035	1,970,594	29,284	-	1,999,878
Other	398,999	158,229	79,646	636,874	347,070	149,679	45,341	542,090
Total other assets	2,364,656	187,607	79,646	2,631,909	2,317,664	178,963	45,341	2,541,968
	<u>\$ 9,718,827</u>	<u>\$ 664,601</u>	<u>\$ 28,561</u>	<u>\$ 10,411,989</u>	<u>\$ 9,193,559</u>	<u>\$ 720,296</u>	<u>\$ 10,371</u>	<u>\$ 9,924,226</u>

## Banner Health and Subsidiaries

## Consolidated Balance Sheets

Unaudited

(\$ in thousands)

	As of March 31, 2017				As of March 31, 2016			
	Obligated Group	Obligated Non-Group	Eliminations	Banner Health Consolidated	Obligated Group	Obligated Non-Group	Eliminations	Banner Health Consolidated
<b>Liabilities and net assets</b>								
Current liabilities:								
Current portion of long-term debt	\$ 156,208	\$ -	\$ -	\$ 156,208	\$ 154,652	\$ 1,654	\$ (225)	\$ 156,081
Current portion of hospital lease obligations	23,785	-	-	23,785	22,719	-	-	22,719
Trade accounts payable	196,882	35,748	-	232,630	186,960	20,494	(1)	207,453
Payable under securities lending program and repurchase agreements	345,615	-	-	345,615	318,954	-	-	318,954
Estimated current portion of third-party payor settlements	-	-	-	-	461	1	-	462
Accrued expenses:								
Salaries and benefits	272,084	73,735	(6,384)	339,435	272,762	63,583	(6,167)	330,178
Claims payable	-	146,724	(43,650)	103,074	-	125,188	(23,960)	101,228
Other	171,014	70,241	(1,029)	240,226	134,287	69,727	(1,050)	202,964
Total current liabilities	1,165,588	326,448	(51,063)	1,440,973	1,090,795	280,647	(31,403)	1,340,039
Long-term debt, less current portion	2,737,425	-	-	2,737,425	2,745,965	-	-	2,745,965
Hospital lease obligation, less current portion	223,320	-	-	223,320	234,754	-	-	234,754
Estimated third-party payor settlements, less current portion	29,738	-	-	29,738	26,198	-	-	26,198
Estimated self-insurance liabilities, less current portion	74,518	98,662	(630)	172,550	58,175	122,467	(4,411)	176,231
Interest rate swaps	318,666	-	-	318,666	429,921	-	-	429,921
Other	214,293	5,598	-	219,891	229,745	5,483	-	235,228
Total liabilities	4,763,548	430,708	(51,693)	5,142,563	4,815,553	408,597	(35,814)	5,188,336
Net assets:								
Unrestricted	4,879,442	98,527	79,778	5,057,747	4,332,927	180,855	45,505	4,559,287
Temporarily restricted	75,837	103,137	-	178,974	45,079	98,324	-	143,403
Total Banner Health net assets	4,955,279	201,664	79,778	5,236,721	4,378,006	279,179	45,505	4,702,690
Noncontrolling interests - unrestricted	-	32,229	476	32,705	-	32,520	680	33,200
Total net assets	4,955,279	233,893	80,254	5,269,426	4,378,006	311,699	46,185	4,735,890
	\$ 9,718,827	\$ 664,601	\$ 28,561	\$ 10,411,989	\$ 9,193,559	\$ 720,296	\$ 10,371	\$ 9,924,226

Banner Health and Subsidiaries

Consolidated Income Statements

Unaudited

(\$ in thousands)

	For the Three Months Ending March 31, 2017				For the Three Months Ending March 31, 2016			
	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated
<b>Revenues:</b>								
Net patient service	\$ 1,517,215	\$ 258,497	\$ (121,235)	\$ 1,654,477	\$ 1,511,039	\$ 235,090	\$ (102,149)	\$ 1,643,980
Provision for doubtful accounts	63,570	11,191	-	74,761	56,268	8,813	-	65,081
Net patient service revenue, less provision for doubtful accounts	1,453,645	247,306	(121,235)	1,579,716	1,454,771	226,277	(102,149)	1,578,899
Medical insurance premiums	-	286,114	-	286,114	-	258,609	-	258,609
Other revenue	55,754	116,188	(85,616)	86,326	64,047	80,611	(50,906)	93,752
Total revenues	1,509,399	649,608	(206,851)	1,952,156	1,518,818	565,497	(153,055)	1,931,260
<b>Expenses:</b>								
Salaries and benefits	693,319	305,015	(46,286)	952,048	678,793	267,635	(30,264)	916,164
Supplies	268,231	48,406	-	316,637	266,849	42,327	-	309,176
Physician and professional fees	70,121	16,936	(38,839)	48,218	31,590	10,883	(4,322)	38,151
Depreciation and amortization	98,431	2,934	-	101,365	97,190	2,253	-	99,443
Interest	29,657	1,218	-	30,875	33,656	1,392	(199)	34,849
Medical claims costs, net of Banner claims	-	280,906	(88,431)	192,475	-	237,298	(77,873)	159,425
Other	243,716	31,863	(33,076)	242,503	248,638	59,300	(40,435)	267,503
Total expenses	1,403,475	687,278	(206,632)	1,884,121	1,356,716	621,088	(153,093)	1,824,711
Operating income (loss)	105,924	(37,670)	(219)	68,035	162,102	(55,591)	38	106,549
<b>Other income (losses):</b>								
Investment income-realized	23,533	735	-	24,268	3,376	134	(199)	3,311
Investment income (loss) - unrealized	79,422	1,376	-	80,798	(17,799)	(77)	-	(17,876)
Income (loss) from alternative investments	30,273	263	-	30,536	(28,658)	(549)	-	(29,207)
Investment income (loss)	133,228	2,374	-	135,602	(43,081)	(492)	(199)	(43,772)
Unrealized gain (loss) on interest rate swaps	14,115	-	-	14,115	(68,947)	-	-	(68,947)
Other	(2,301)	(693)	693	(2,301)	(1,916)	(163)	162	(1,917)
	145,042	1,681	693	147,416	(113,944)	(655)	(37)	(114,636)
Excess (deficiency) of revenues over expenses	250,966	(35,989)	474	215,451	48,158	(56,246)	1	(8,087)
Less excess of revenues over expenses attributable to noncontrolling interests	-	7,014	7	7,021	-	7,098	76	7,174
Excess (deficiency) of revenues over expenses attributable to Banner Health	250,966	(43,003)	467	208,430	48,158	(63,344)	(75)	(15,261)
Amortization of cumulative loss on interest rate swaps	57	-	-	57	57	-	-	57
Equity transfers	(45,828)	45,828	-	-	(79,075)	79,075	-	-
Other changes in net assets, primarily distributions of earnings	(43,596)	45,278	126	1,808	(90)	(4,136)	5,420	1,194
Increase (decrease) in unrestricted net assets	\$ 161,599	\$ 48,103	\$ 593	\$ 210,295	\$ (30,950)	\$ 11,595	\$ 5,345	\$ (14,010)

Banner Health and Subsidiaries  
Consolidated Statements of Changes in Net Assets

Unaudited

(\$ in thousands)

	For the Three Months Ending March 31, 2017				For the Three Months Ending March 31, 2016			
	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated
Unrestricted net assets:								
Excess (deficiency) of revenues over expenses attributable to Banner Health	\$ 250,966	\$ (43,003)	\$ 467	\$ 208,430	\$ 48,158	\$ (63,344)	\$ (75)	\$ (15,261)
Amortization of cumulative loss on interest rate swaps	57	-	-	57	57	-	-	57
Equity transfers	(45,828)	45,828	-	-	(79,075)	79,075	-	-
Other changes in net assets, primarily distributions of earnings	(43,596)	45,278	126	1,808	(90)	(4,136)	5,420	1,194
Increase (decrease) in unrestricted net assets	161,599	48,103	593	210,295	(30,950)	11,595	5,345	(14,010)
Temporarily restricted net assets:								
Contributions and other	1,548	1,987	-	3,535	3,965	2,258	-	6,223
Net unrealized gain (loss) on investments	4	543	-	547	18	(189)	-	(171)
Net assets released from restriction	(684)	(2,868)	-	(3,552)	(2,261)	(3,204)	-	(5,465)
Increase (decrease) in temporarily restricted net assets	868	(338)	-	530	1,722	(1,135)	-	587
Noncontrolling interests:								
Excess of revenues over expenses attributable to noncontrolling interests	-	7,014	7	7,021	-	7,098	76	7,174
Other changes, primarily distributions of earnings to noncontrolling interests	-	(4,900)	-	(4,900)	-	(4,900)	(157)	(5,057)
Increase (decrease) in noncontrolling interests	-	2,114	7	2,121	-	2,198	(81)	2,117
Increase (decrease) in net assets	162,467	49,879	600	212,946	(29,228)	12,658	5,264	(11,306)
Net assets, beginning of period	4,792,812	184,014	79,654	5,056,480	4,407,234	299,041	40,921	4,747,196
Net assets, end of period	\$ 4,955,279	\$ 233,893	\$ 80,254	\$ 5,269,426	\$ 4,378,006	\$ 311,699	\$ 46,185	\$ 4,735,890



Banner Health and Subsidiaries

Consolidated Statements of Cash Flows

Unaudited

(\$ in thousands)

	For the Three Months Ending March 31, 2017				For the Three Months Ending March 31, 2016			
	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated
<b>Operating activities:</b>								
Increase (decrease) in net assets	\$ 162,467	\$ 49,879	\$ 600	\$ 212,946	\$ (29,228)	\$ 12,658	\$ 5,264	\$ (11,306)
Adjustments to reconcile increase in net assets to net cash provided by (used in) operating activities:								
Depreciation and amortization	98,431	2,934	-	101,365	97,190	2,253	-	99,443
Decrease (increase) in investments designated as trading	91,072	1,540	-	92,612	250,552	5,430	-	255,982
Equity transfers	45,828	(45,828)	-	-	79,075	(79,075)	-	-
Net unrealized (gain) loss on interest rate swaps	(14,172)	-	-	(14,172)	68,890	-	-	68,890
(Gain) loss on sale of assets	(5)	-	-	(5)	3	-	-	3
Temporarily restricted contributions	(1,548)	(1,987)	-	(3,535)	(3,965)	(2,258)	-	(6,223)
Changes in operating elements, net of acquisitions:								
Patient receivables	(44,574)	(7,382)	2,388	(49,568)	(66,429)	(13,592)	8	(80,013)
Inventories and other current assets	(35,226)	5,581	4,334	(25,311)	26,341	2,919	(1,545)	27,715
Accounts payable and accrued expenses	(67,434)	(15,160)	(6,871)	(89,465)	(11,922)	(34,941)	4,980	(41,883)
Estimated third-party settlements	(1,626)	-	-	(1,626)	(818)	-	-	(818)
Estimated self-insurance liabilities	2,685	(188)	152	2,649	12,519	1,602	(3,444)	10,677
Other liabilities	5,259	(138)	-	5,121	(378)	52	-	(326)
Net cash provided by (used in) operating activities	241,157	(10,749)	603	231,011	421,830	(104,952)	5,263	322,141
<b>Investing activities:</b>								
Net purchases of property and equipment	(132,584)	(11,337)	-	(143,921)	(91,504)	5,128	-	(86,376)
(Increase) decrease in other assets	(11,409)	1,513	(603)	(10,499)	1,792	2,030	(5,337)	(1,515)
Net cash (used in) provided by investing activities	(143,993)	(9,824)	(603)	(154,420)	(89,712)	7,158	(5,337)	(87,891)
<b>Financing activities:</b>								
Proceeds from temporarily restricted contributions	1,548	1,987	-	3,535	3,965	2,258	-	6,223
Intercompany activity, including equity transfers	(45,923)	45,923	-	-	(88,993)	88,992	1	-
Payments of hospital lease obligations	(5,940)	-	-	(5,940)	1,214	-	-	1,214
Payments of long-term debt	(55,909)	(23)	-	(55,932)	(252,164)	(117)	73	(252,208)
Net cash (used in) provided by financing activities	(106,224)	47,887	-	(58,337)	(335,978)	91,133	74	(244,771)
Net (decrease) increase in cash and cash equivalents	(9,060)	27,314	-	18,254	(3,860)	(6,661)	-	(10,521)
Cash and cash equivalents at beginning of period	29,741	70,677	-	100,418	22,576	69,407	-	91,983
Cash and cash equivalents at end of period	\$ 20,681	\$ 97,991	\$ -	\$ 118,672	\$ 18,716	\$ 62,746	\$ -	\$ 81,462
<b>Noncash activities</b>								
Capital leases, primarily NCMC, Inc.	\$ 5,204	\$ -	\$ -	\$ 5,204	\$ 10,576	\$ -	\$ -	\$ 10,576

# Banner Health and Subsidiaries

## Notes to Consolidated Unaudited Financial Statements

March 31, 2017

### 1. Description of Business

Banner Health is a nonprofit corporation exempt from income taxes under Internal Revenue Code Section 501(c)(3) and applicable state income tax codes. Banner Health and its subsidiaries (Banner) own or lease hospitals, multi-specialty physician groups, clinics, nursing homes, clinical laboratories, ambulatory surgery centers, urgent care centers, home health agencies, a captive insurance company, foundations, an accountable health care organization, health insurance plans, and other health care-related organizations in six western states. Banner also holds an interest in several healthcare related organizations, including:

- A 51% controlling interest in Sonora Quest Laboratories (SQL); the financial results of SQL have been included in Banner's consolidated financial statements.
- A 50% noncontrolling interest in Veritage LLC (Veritage) which is accounted for under the equity method of accounting. Banner's share of Veritage LLC's net income has been recorded within other operating revenue.

### 2. Significant Accounting Policies

#### Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial reporting, applied on a basis substantially consistent with that of the 2016 audited financial statements of Banner. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2017 are not necessarily indicative of the results to be expected for the year ended December 31, 2017. For more information, refer to the audited consolidated financial statements and notes thereto as of and for the year ended December 31, 2016.

Subsequent events have been evaluated through May 22, 2017, the date of the issuance of the unaudited consolidated financial statements.

The separate details of the Obligated and Non-Obligated Group financial statements are presented for purposes of additional analysis and are not a required part of the consolidated financial statements.

#### Basis of Consolidation

The accompanying consolidated financial statements reflect the consolidated operations of all owned and leased operating units of Banner and its wholly owned subsidiaries.

Banner also holds a controlling interest in several joint ventures, the financial results of which are included in Banner's consolidated financial statements. Banner records the unrelated investors' ownership share of these joint ventures as noncontrolling interest. The noncontrolling interest balance as of March 31, 2017 and 2016 primarily relates to Quest's investment in SQL, in which Banner holds a 51% interest and Quest Diagnostics, Inc. holds the remaining 49% interest.

#### Short-Term Investments

Short-term investments primarily include debt securities with maturity dates of one year or less from the balance sheet date, US Treasury government obligations and actively traded equity securities. These investments are stated at fair value (Refer to Note 3).

## Banner Health and Subsidiaries

### Notes to Consolidated Unaudited Financial Statements

March 31, 2017

#### 2. Significant Accounting Policies (continued)

##### Investments

Banner invests in alternative investments, mainly hedge funds, through limited partnerships. Banner accounts for its ownership share in these alternative investments under the equity method based on the hedge funds' net asset value per share of the fund held by Banner. The hedge fund net asset value is provided to Banner by each of the hedge fund managers. The net asset value is determined based on the estimated fair value of each of the underlying investments held in the hedge fund. However, the hedge fund investment holdings may include investment in private investment funds whose values have been estimated by the hedge fund manager in the absence of readily ascertainable fair values. Due to the inherent uncertainty of these estimates, these values may differ from the values that would have been used had a ready market for these investments existed. Banner's share of the alternative investments' unrestricted realized and unrealized gains (losses) approximated \$30,536,000 and (\$29,207,000) for the three months ended March 31, 2017 and 2016, respectively. The restricted share of alternative investment realized and unrealized gains (losses) is approximately \$1,067,000 and (\$57,000) for the three months ended March 31, 2017 and 2016, respectively.

Banner uses derivative financial instruments in its investment portfolio to moderate changes in value due to fluctuations in the financial markets. Banner has not designated its derivatives related to marketable securities as hedged financial instruments. Banner offsets the fair value for various derivative instruments including forwards, interest rate swaps, currency swaps, options and other conditional or exchange contracts, if they are executed with the same counterparty under a master netting arrangement. Banner invests in a variety of derivative instruments through fixed income managers that have executed a master netting arrangement with each of its forward and future purchase and sale contracts, interest and credit swap agreements and option agreements, whereby the financial instruments are held by the same counterparty and are legally offset as the instrument is settled. Banner's derivative contracts in a net loss position were immaterial at March 31, 2017 and 2016 and were reported on the accompanying consolidated balance sheets on a net basis. As of March 31, 2017 and 2016, the gross derivative assets and liabilities held and netted together within the investment accounts amounted to assets of approximately \$501,888,000 and \$354,101,000 and liabilities of approximately \$496,310,000 and \$359,037,000, respectively. (See Note 3 for a more complete description of derivative assets and liabilities.)

Banner has entered into repurchase agreements amounting to approximately \$98,500,000 and \$125,900,000 as of March 31, 2017 and 2016, respectively, which are included in long-term investments on the accompanying consolidated balance sheets. In connection with the repurchase agreements, Banner has loaned cash to certain financial institutions in exchange for collateral. Collateral provided by the financial institutions amounted to approximately \$101,089,000 and \$129,790,000 as of March 31, 2017 and 2016, respectively, and is recorded in the unaudited consolidated balance sheets within collateral held under securities lending program and repurchase agreements as of March 31, 2017 and 2016.

Banner participates in securities lending transactions through its custodian whereby Banner lends a portion of its investments to various brokers in exchange for collateral for the securities loaned, usually on a short-term basis. Collateral provided by the brokers consists of cash and securities and is maintained at levels approximating 102% of the fair value of the securities on loan, adjusted for market fluctuations. Banner maintains effective control of the loaned securities through its custodian during the term of the arrangement in that they may be recalled at any time. Under the terms of the agreement, the borrower must return the same, or substantially the same, investments that were borrowed. The value of collateral held for loaned securities is reported in current assets as collateral held under securities lending program and repurchase agreements, and a corresponding obligation is reported in current

# Banner Health and Subsidiaries

## Notes to Consolidated Unaudited Financial Statements

March 31, 2017

### 2. Significant Accounting Policies (continued)

liabilities as a payable under securities lending program and repurchase agreements in the accompanying consolidated balance sheets. At March 31, 2017 and 2016, the fair value of the collateral provided on behalf of Banner was approximately \$244,526,000 and \$189,164,000, respectively. At March 31, 2017 and 2016, the fair market value of securities on loan was approximately \$237,104,000 and \$183,925,000, respectively, and is included in assets limited as to use on the accompanying consolidated balance sheets.

#### Premium Revenues and Claims Costs

Premium revenues and claims costs of BHN and the University Health Plans are as follows (in thousands):

	<u>3/31/2017</u>	<u>3/31/2016</u>
Net premium revenue	\$ 286,114	\$ 258,609
Net claims cost	192,475	159,425
BHN and University Health Plans elimination	98,588	89,875
Gross claims cost, including claims paid to Banner facilities and providers	<u>\$ 291,063</u>	<u>\$ 249,300</u>
Claims cost as a percent of premiums	101.7%	96.4%

#### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements.

Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are made in the areas of patient accounts receivable, accruals for settlements with third-party payors, risk pool and insurance settlements, medical claim liabilities, contingent liabilities, and accrued liabilities resulting from self-insurance programs. In the quarter ended March 31, 2017, Banner Health recognized \$5,769,000 in shared risk revenue for a change in estimate related to losses on a commercial insurance plan in 2016.

## Banner Health and Subsidiaries

### Notes to Consolidated Unaudited Financial Statements

March 31, 2017

#### **2. Significant Accounting Policies (continued)**

##### **Reclassifications**

Prior year amounts have been reclassified to conform to the current year presentation. Prior year third party settlements have been reclassified between current portion and non-current portion to conform to the 2016 audited and 2017 interim presentation.

#### **3. Fair Value of Financial Instruments**

Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, Banner utilizes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

**Level 1.** Pricing inputs into the determination of fair value are generally observable inputs such as quoted prices in active markets.

**Level 2.** Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities

**Level 3.** Pricing inputs are generally unobservable and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are therefore determined using factors that involve considerable judgment and interpretations, including but not limited to private and public comparables, third party appraisals, discounted cash flow models, and fund manager estimates.

Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

March 31, 2017

**3. Fair Value of Financial Instruments (continued)**

Assets and liabilities measured at fair value are based on one or more of three valuation techniques identified in the tables below. Where more than one technique is noted, individual assets or liabilities were valued using one or more of the noted techniques. The valuation techniques are as follows:

- (a) *Market approach.* Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- (b) *Cost approach.* Amount that would be required to replace the service capacity of an asset (replacement cost).
- (c) *Income approach.* Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option-pricing and excess earnings models).

Banner's investment in alternative investments, amounting to approximately \$1,223,304,000 and \$1,364,030,000 as of March 31, 2017 and 2016, respectively, are accounted for using the equity method of accounting. Accordingly, the alternative investments are omitted from the following schedule of financial instruments measured at fair value. Also, included in assets limited as to use are premium payments to be received from Banner's split dollar life insurance policies amounting to \$7,574,000 and \$12,702,000 as of March 31, 2017 and 2016, respectively, which are not measured at fair value. The decrease in split dollar receivables is due to the program winding down and policies being surrendered. Further decreases are expected over the next several years.

Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

March 31, 2017

3. Fair Value of Financial Instruments (continued)

	March 31, 2017 <i>(In Thousands)</i>	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b, c)
Cash and cash equivalents	\$ 370,807	\$ 322,057	\$ 48,750	\$ -	a
Collateral held under securities lending and repurchase agreement (primarily cash and debt securities)	345,615	244,526	101,089	-	a
Mutual funds:					a
Mutual funds – U.S. funds	900,684	900,684	-	-	a
Mutual funds – International	427,825	427,825	-	-	a
Total mutual funds	2,044,931	1,895,092	149,839	-	
Debt securities:					
U.S. Treasury/government obligations	345,175	-	345,175	-	a
Corporate bonds/Non-U.S. government bonds	228,770	-	228,770	-	a
Asset-backed securities	118,182	-	118,182	-	a
Commercial mortgage-backed securities	16,122	-	16,122	-	a
Non-government-backed collateralized mortgages	19,698	-	19,698	-	a
Government mortgage-backed securities	292,506	-	292,506	-	a
Government commercial backed	4,668	-	4,668	-	a
Total debt securities	\$ 1,025,121	\$ -	\$ 1,025,121	\$ -	
Repurchase agreements	\$ 98,505	\$ -	\$ 98,505	\$ -	a
Equity securities:					
U. S. equity securities	\$ 198,010	\$ 198,010	\$ -	\$ -	a
International equity securities	276,550	276,550	-	-	a
Total equity securities	474,560	474,560	-	-	a
Derivative securities					a
Future contracts	60,850	60,850	-	-	a
Forward contracts	423,379	-	423,379	-	a
Interest rate swap agreements	6,365	-	6,365	-	a
Net credit swaps	11,294	-	11,294	-	a
Subtotal derivative assets	\$ 501,888	\$ 60,850	\$ 441,038	\$ -	
Future contracts	(60,850)	(60,850)	-	-	a
Forward contracts	(426,272)	-	(426,272)	-	a
Interest rate swap agreements	(2,327)	-	(2,327)	-	a
Option agreements	(106)	-	(106)	-	a
Net credit swaps	(6,755)	-	(6,755)	-	a
Subtotal derivative liabilities	\$ (496,310)	\$ (60,850)	\$ (435,460)	\$ -	
Total fair value Investments	\$ 3,648,695	\$ 2,369,652	\$ 1,279,043	\$ -	
Short-term investments	189,106				
Collateral held under securities lending and repurchase agreements	345,615				
Assets limited as to use	2,273,896				
Long-term investments	1,995,035				
Other assets – Banner Foundation restricted funds	75,921				
Less: alternative investments	1,223,304				
Less: split dollar life insurance	7,574				
Total fair value investments	\$ 3,648,695				
Interest rate swaps	\$ (318,666)	\$ -	\$ (318,666)	\$ -	c

## Banner Health and Subsidiaries

## Notes to Consolidated Unaudited Financial Statements

March 31, 2017

## 3. Fair Value of Financial Instruments (continued)

	March 31, 2016 (In Thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b, c)
Cash and cash equivalents	\$ 414,607	\$ 395,203	\$ 19,404	\$ -	a
Collateral held under securities lending and repurchase agreement (primarily cash and debt securities)	318,954	189,165	129,789	-	a
Mutual funds:					a
Mutual funds – U.S. funds	1,118,354	1,118,354	-	-	a
Mutual funds – International	288,311	288,311	-	-	a
Total mutual funds	2,140,226	1,991,033	149,193	-	
Debt securities:					
U.S. Treasury/government obligations	260,276	-	260,276	-	a
Corporate bonds/Non-U.S. government bonds	143,484	-	143,484	-	a
Asset-backed securities	56,308	-	56,308	-	a
Commercial mortgage-backed securities	18,701	-	18,701	-	a
Non-government-backed collateralized mortgages	8,868	-	8,868	-	a
Government mortgage-backed securities	200,714	-	200,714	-	a
Government commercial backed	2,698	-	2,698	-	a
Total debt securities	\$ 691,049	\$ -	\$ 691,049	\$ -	
Repurchase agreements	\$ 125,905	\$ -	\$ 125,905	\$ -	a
Equity securities:					
U. S. equity securities	\$ 189,435	\$ 189,435	\$ -	\$ -	a
International equity securities	253,255	253,255	-	-	a
Total equity securities	442,690	442,690	-	-	a
Derivative securities					a
Future contracts	48,862	48,862	-	-	a
Forward contracts	300,842	-	300,842	-	a
Interest rate swap agreements	2,846	-	2,846	-	a
Net credit swaps	1,551	-	1,551	-	a
Subtotal derivative assets	\$ 354,101	\$ 48,862	\$ 305,239	\$ -	
Future contracts	(48,862)	(48,862)	-	-	a
Forward contracts	(302,808)	-	(302,808)	-	a
Interest rate swap agreements	(6,608)	-	(6,608)	-	a
Option agreements	(64)	-	(64)	-	a
Net credit swaps	(695)	-	(695)	-	a
Subtotal derivative liabilities	\$ (359,037)	\$ (48,862)	\$ (310,175)	\$ -	
Total Fair Value Investments	\$ 3,394,934	\$ 2,433,723	\$ 961,211	\$ -	
Short-term investments	241,323				
Collateral held under securities lending and repurchase agreements	318,954				
Assets limited as to use	2,143,071				
Long-term investments	1,999,878				
Other assets – Banner Foundation restricted funds	68,440				
Less: alternative investments	1,364,030				
Less: split dollar life insurance	12,702				
Total fair value investments	\$ 3,394,934				
Interest rate swaps	\$ (429,921)	\$ -	\$ (429,921)	\$ -	c



Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

March 31, 2017

**3. Fair Value of Financial Instruments (continued)**

Investment income (loss) consisted of the following for the three months ended March 31:

(\$ in thousands)

	<u>2017</u>	<u>2016</u>
Interest and dividend Income	\$ 11,111	\$ 15,985
Net realized gain (loss) on sales of investments	13,745	(7,080)
Gain (loss) from alternative investments	31,603	(29,264)
Net realized gain (loss) on sales of future contracts	640	(3,523)
Net realized gain (loss) on sales of interest rate swap agreements	238	(128)
Net realized gain on sales of option agreements	224	138
Net realized loss on sales of net credit swaps	(30)	(673)
Net unrealized gain (loss) on investments	78,390	(17,030)
Net unrealized gain (loss) on interest rate swap agreements	222	(2,573)
Net unrealized (loss) gain on option agreements	(4)	1,685
Net unrealized gain (loss) on net credit swaps	<u>2,412</u>	<u>(748)</u>
	138,551	(43,211)
Less: Investment income credited to other revenue, restricted funds, and capitalized bond project funds	<u>2,949</u>	<u>561</u>
Investment income (loss)	<u>\$ 135,602</u>	<u>\$ (43,772)</u>

**4. Interest Rate Swap Agreements**

Banner entered into multiple interest rate swaps that currently do not qualify for hedge accounting. For the three months ended March 31, 2017 and 2016, the mark-to-market adjustment resulted in an unrealized gain of \$14,115,000 and an unrealized loss of \$(68,947,000) respectively, recorded in excess of revenue over expenses. The net effect of the interest rate swaps, recorded in interest expense, was to increase the overall cost of borrowing for the three months ended March 31, 2017 and 2016, by \$10,114,000 and \$10,893,000, respectively.

Each of the interest rate swap agreements has collateral posting thresholds based on the counterparties' bond ratings. At the AA- rating level, Banner and its counterparties must post collateral when the mark-to-market adjustment exceeds between \$35,000,000 and \$75,000,000 depending on the counterparty. At March 31, 2017 and 2016, Banner had \$106,926,000 and \$146,368,000 of collateral outstanding with its counterparties, respectively. The fair value of the collateral is reported as other funds under the assets limited as to use category in the accompanying consolidated balance sheets.