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 Three and Nine Months Ended September 30, 2017

Overview

Banner is one of the nation's largest nonprofit healthcare systems, combining a portfolio of community hospital assets with a comprehensive academic medicine partnership (University of Arizona) and an Insurance Division operating under Banner Health Network. Its stated mission is "making health care easier, so life can be better" 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.

Performance for the Three Months Ended September 30, 2017

Banner generated operating income of $1.7 million and net income of $113.6 million for the quarter ended September 30, 2017, equating to operating and total margins of 0.1% and 5.7%, respectively. Included in income for the quarter is an $18.9 million accrual booked at Banner Health Network in anticipation of future losses under the Blue Advantage Plan (the Premium Deficiency Reserve ("PDR") accrual). The accrual covers anticipated losses from October, 2017 through December, 2018, and will be reversed to offset the losses as they occur. Third quarter operating income excluding the PDR accrual was $20.5 million and a 1.1% operating margin. This performance compares favorably to the $29.6 million operating loss and $59.5 million net income and -1.6% and 3.1% operating and total margins for the third quarter of 2016. Performance results include three significant elements:

- Strong "community delivery" system performance. Non-academic delivery system operations yielded $67.3 million in operating income, the equivalent of a 5.5% operating margin, up significantly from the 3.2% operating margin earned in the third quarter of 2016. Community delivery revenue increased 3.9% over the prior year on a 0.9% increase in acute patient encounters (inpatient acute admissions plus observation cases). The revenue increase exceeded the volume increase due to a change in the character of the encounters; acute inpatient admissions increased 4.7%, while observation cases decreased 5.1% from the third quarter of 2016. Effective cost control on a volume-adjusted basis, for both labor and non-labor costs, continues to be observed through the third quarter.

- Disappointing University Medicine delivery operations. The University Medicine Division, which includes two medical centers and the faculty practice plan in Tucson, and a medical center and faculty practice plan in Phoenix, lost $37.9 million from operations, compared to a $34.8 million loss for the third quarter of 2016. Operating margin declined slightly to (6.9%) from (6.8%) for the three months ended September 30, 2017 and 2016, respectively. Overall volumes reflect year-over-year growth in admissions and outpatient services, but inpatient surgery volume declined 3.1% from the third quarter of 2016. Operating revenue for the division grew 6.9% from third quarter 2016 to

2017, but operating expenses grew 7.0%, resulting in a decrease in operating income compared to prior year. Important to note is the improvement seen in the University-based faculty practice plan, Banner—University Medical Group (BUMG), highlighted by nearly a 4% year-over-year improvement in clinical productivity, as measured by worked RVU, and favorable revenue recognition from coding improvements and managed care contracts. University Medical Center (hospital) operations, particularly in Tucson, remain challenged, as we work to reduce the expense profile while building new programs.

- 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 $50.8 million on $296.4 million in revenue, an operating margin of (17.1%), down from the $45.3 million operating loss and (15.3%) operating margin reported for the third quarter of 2016. The decrease in operating performance is attributable to the PDR recorded by Banner Health Network, as mentioned above. Excluding the PDR, the health plans' operating loss for the third quarter of 2017 was $32.0 million, an operating margin of (10.8%), a notable improvement over the prior year. Management expects the PDR to unwind by FYE 2018.

Revenue, Volume and Operating Expense

Banner continues to see strong revenue growth, as revenue increased 6.3% from third quarter 2016 to third quarter 2017.

On a consolidated basis, acute and observation cases increased by 689 cases, but in a reversal of recent trends, observation cases decreased by 1,261, or 4.4% while acute inpatient admissions increased by 1,950 or 3.8%. Emergency room visits of 248,101 increased slightly from 2016, and accounted for 57.1% of Banner's inpatient cases, up from 55.4% in the second quarter of 2016. Surgical volumes decreased 1.6% and totaled 38,739. The inpatient percentage of these cases increased to 37.3% in the third quarter of 2017 compared to 36.2% in the same period a year ago. Non-hospital volume growth was strong as a result of continued additions to medical group capacity, the addition of Banner Urgent Care Services in November, 2016, and productivity increases. Clinic encounters grew 12.5% on a consolidated basis, excluding prior year Alaska encounters.

Operating expenses totaled $1.9 billion for the quarter with labor and supply costs comprising 57.1% and 19.1% of patient revenue, respectively, compared with 57.4% and 19.5% of net patient revenue for the same period in 2016. Management continues to observe effective expense control, both labor and non-labor, capitalizing on explicit cost reduction initiatives executed earlier in fiscal year 2017.

Non-operating Performance

Non-operating performance for the quarter was strong, with investment earnings of $116.3 million and mark-to-market gains of $3.8 million from interest rate swaps. Partially offsetting these gains were income taxes and other non-operating expenses of $2.4 million and income attributable to noncontrolling interest of $5.8 million.

Performance for the Nine Months Ended September 30, 2017

For the first nine months of 2017, Banner Health generated operating income of $191.2 million on revenue of $5.837 billion, compared to $170.5 million in operating income for the same period in 2016. Included in 2017 operating income is $22.1 million in one-time severance costs incurred to enable operational changes and future cost savings. Year to date net income through September, 2017 is $500.4 million, compared to $182.5 million net income in the prior year. The significant increase in net income is due to the combined effect of improved investment returns and favorable mark-to-market movement in interest rate swaps in 2017. This performance equates to operating and total margins of 3.3% and 8.1%, respectively, compared to 3.0% and 3.2% for the same period a year earlier. Operating EBITDA is strong at 10.0%, but declined slightly from 10.1% in the same period in 2016. Year-to-date results reflect strong delivery system performance and challenges in insurance operations, as reflected in the table below. It is important to note that Banner continues to deliver consistent operating returns year-over-year, while also continuing to invest both capital and operating expense into the University Division, including the addition of new physicians to expand services, and the Insurance Division to build membership and further access into Banner Health.

Summary of Operating Performance
For the Nine Months Ended September, 2017

($ in thousands)	Community Delivery	University Delivery	Insurance Operations [1]	Elims/ Other	Consolidated
Operating Revenue	$ 3,791,721	$ 1,740,036	$ 919,678	$ (614,510)	$ 5,836,925
Operating Expense	3,506,660	1,791,609	1,013,751	(666,301)	5,645,719
Operating Income	$ 285,061	$ (51,573)	$ (94,073)	$ 51,791	$ 191,206
Prior Year Operating Income *	$ 205,727	$ (52,684)	$ (55,703)	$ 73,173	$ 170,513
% Change in Operating Income	38.6%	2.1%	-68.9%	-29.2%	12.1%
* *Prior year Alaska operations in Other*					

[1] FYTD 2017 Insurance Division impacted by recognition of PDR provision of $19 million. Management expects the PDR to be fully unwound by FYE 2018.

Capital Structure & Balance Sheet

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

	Four quarters ended September 30, 2017	**Four quarters ended September 30, 2016**	**Year Ended December 31, 2016**	**Year Ended December 31, 2015**
LT Debt to Capital	33.3%	36.6%	36.6%	38.0%
Days Cash on Hand	221	216	218	239
Cash to LT Debt	162%	149%	150%	151%
MADS Coverage	5.1	4.6	4.5	4.5

Banner Health and Subsidiaries

Unaudited Financial Statements

As of September 30, 2017

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Banner Health and Subsidiaries

Consolidated Balance Sheets

Unaudited

($ in thousands)

	As of September 30, 2017				As of September 30, 2016			
	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated
Assets								
Current assets:								
Cash and cash equivalents	$ 20,482	$ 133,174	$ -	$ 153,656	$ 18,891	$ 74,000	$ -	$ 92,891
Short-term investments	200,073	75,782	-	275,855	174,233	75,304	-	249,537
Collateral held under securities lending program and repurchase agreements	372,504	-	-	372,504	285,578	-	-	285,578
Assets limited as to use	12,262	33,774	-	46,036	1,668	33,675	-	35,343
Patient receivables, net of allowance for doubtful accounts	704,783	81,059	(35,626)	750,216	733,549	76,993	(39,670)	770,872
Inventories	167,395	21,120	-	188,515	170,568	17,138	-	187,706
Other receivables	190,785	70,678	(5,278)	256,185	157,012	91,412	(5,872)	242,552
Other, primarily prepaid expenses	249,763	(187,708)	-	62,055	128,238	(59,155)	-	69,083
Total current assets	1,918,047	227,879	(40,904)	2,105,022	1,669,737	309,367	(45,542)	1,933,562
Assets limited as to use:								
Funds designated by:								
Board of Directors	2,024,247	-	-	2,024,247	1,795,574	-	-	1,795,574
Lease agreements	1,906	-	-	1,906	2,415	-	-	2,415
Funds held by trustees under:								
Self-insurance funding arrangements	16,119	115,582	-	131,701	15,347	154,942	-	170,289
Indenture agreements	-	-	-	-	-	-	-	-
Other funds	221,855	930	-	222,785	305,967	890	-	306,857
Total assets limited as to use, less current portion	2,264,127	116,512	-	2,380,639	2,119,303	155,832	-	2,275,135
Assets held for sale	2,140	-	-	2,140	2,140	-	-	2,140
Property and equipment, net of depreciation	3,315,323	94,203	-	3,409,526	3,094,798	65,366	-	3,160,164
Leased hospital assets	225,866	-	-	225,866	271,506	-	-	271,506
Other assets:								
Long-term investments	1,859,272	31,466	-	1,890,738	1,914,184	27,902	-	1,942,086
Other	482,112	164,302	74,851	721,265	340,707	152,571	55,085	548,363
Total other assets	2,341,384	195,768	74,851	2,612,003	2,254,891	180,473	55,085	2,490,449
	$ 10,066,887	$ 634,362	$ 33,947	$ 10,735,196	$ 9,412,375	$ 711,038	$ 9,543	$ 10,132,956

Banner Health and Subsidiaries

Consolidated Balance Sheets

Unaudited

($ in thousands)

	As of September 30, 2017				As of September 30, 2016			
	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated
Liabilities and net assets								
Current liabilities:								
Current portion of long-term debt	$ 214,013	$ -	$ -	$ 214,013	$ 154,529	$ 1,414	$ (76)	$ 155,867
Current portion of hospital lease obligations	23,785	-	-	23,785	22,719	-	-	22,719
Trade accounts payable	168,324	31,034	-	199,358	207,638	23,847	-	231,485
Payable under securities lending program and repurchase agreements	372,504	-	-	372,504	285,578	-	-	285,578
Estimated current portion of third-party payor settlements	5,206	513	-	5,719	3,607	-	-	3,607
Accrued expenses:				-				-
Salaries and benefits	294,504	71,290	(7,216)	358,578	237,745	67,340	(7,914)	297,171
Claims payable	-	168,223	(30,464)	137,759	-	144,750	(34,213)	110,537
Other	148,338	52,121	(3,143)	197,316	128,649	63,624	(3,091)	189,182
Total current liabilities	1,226,674	323,181	(40,823)	1,509,032	1,040,465	300,975	(45,294)	1,296,146
Long-term debt, less current portion	2,675,931	-	-	2,675,931	2,744,960	-	-	2,744,960
Hospital lease obligation, less current portion	218,861	-	-	218,861	258,120	-	-	258,120
Estimated third-party payor settlements, less current portion	31,128	-	-	31,128	24,144	-	-	24,144
Estimated self-insurance liabilities, less current portion	71,685	109,611	(684)	180,612	42,458	126,134	(940)	167,652
Interest rate swaps	323,819	-	-	323,819	467,779	-	-	467,779
Other	219,471	5,803	-	225,274	234,170	5,205	-	239,375
Total liabilities	4,767,569	438,595	(41,507)	5,164,657	4,812,096	432,314	(46,234)	5,198,176
Net assets:								
Unrestricted	5,223,906	53,107	75,036	5,352,049	4,552,545	150,964	55,273	4,758,782
Temporarily restricted	75,412	110,862	-	186,274	47,734	98,724	-	146,458
Total Banner Health net assets	5,299,318	163,969	75,036	5,538,323	4,600,279	249,688	55,273	4,905,240
Noncontrolling interests - unrestricted	-	31,798	418	32,216	-	29,036	504	29,540
Total net assets	5,299,318	195,767	75,454	5,570,539	4,600,279	278,724	55,777	4,934,780
	$ 10,066,887	$ 634,362	$ 33,947	$ 10,735,196	$ 9,412,375	$ 711,038	$ 9,543	$ 10,132,956

Banner Health and Subsidiaries

Consolidated Income Statements

Unaudited

($ in thousands)

	For the Nine Months Ending September 30, 2017				For the Nine Months Ending September 30, 2016			
	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated
Revenues:								
Net patient service	$ 4,555,395	$ 738,372	$ (348,973)	$ 4,944,794	$ 4,470,458	$ 693,995	$ (317,179)	$ 4,847,274
Provision for doubtful accounts	193,864	31,396	-	225,260	195,696	25,627	-	221,323
Net patient service revenue, less provision for doubtful accounts	4,361,531	706,976	(348,973)	4,719,534	4,274,762	668,368	(317,179)	4,625,951
Medical insurance premiums	-	855,252	-	855,252	-	804,012	-	804,012
Other revenue	166,875	324,416	(229,152)	262,139	174,856	275,009	(198,391)	251,474
Total revenues	4,528,406	1,886,644	(578,125)	5,836,925	4,449,618	1,747,389	(515,570)	5,681,437
Expenses:								
Salaries and benefits	2,080,154	885,204	(113,501)	2,851,857	2,055,049	818,274	(121,296)	2,752,027
Supplies	802,296	148,136	(3,326)	947,106	811,251	130,806	-	942,057
Physician and professional fees	185,274	47,308	(95,630)	136,952	99,930	31,424	(13,729)	117,625
Depreciation and amortization	297,491	9,049	-	306,540	292,729	7,123	-	299,852
Goodwill impairment	-	-	-	-	-	-	-	-
Interest	84,495	3,672	-	88,167	100,592	4,596	(931)	104,257
Medical claims costs, net of Banner claims	-	872,343	(266,184)	606,159	-	766,384	(230,154)	536,230
Other	707,791	99,678	(98,531)	708,938	716,964	192,029	(150,117)	758,876
Total expenses	4,157,501	2,065,390	(577,172)	5,645,719	4,076,515	1,950,636	(516,227)	5,510,924
Operating income (loss)	370,905	(178,746)	(953)	191,206	373,103	(203,247)	657	170,513
Other income (losses):								
Investment income-realized	96,494	2,264	-	98,758	53,977	628	(931)	53,674
Investment income - unrealized	163,698	3,021	-	166,719	58,586	2,123	-	60,709
Income (loss) from alternative investments	61,338	1,030	-	62,368	33,896	(528)	-	33,368
Investment income (loss)	321,530	6,315	-	327,845	146,459	2,223	(931)	147,751
Unrealized gain (loss) on interest rate swaps	8,849	-	-	8,849	(106,918)	-	-	(106,918)
Other	(6,800)	(4,948)	3,495	(8,253)	(7,901)	(4,475)	4,521	(7,855)
	323,579	1,367	3,495	328,441	31,640	(2,252)	3,590	32,978
Excess (deficiency) of revenues over expenses	694,484	(177,379)	2,542	519,647	404,743	(205,499)	4,247	203,491
Less excess of revenues over expenses attributable to noncontrolling interests	-	19,240	(27)	19,213	-	20,764	230	20,994
Excess (deficiency) of revenues over expenses attributable to Banner Health	694,484	(196,619)	2,569	500,434	404,743	(226,263)	4,017	182,497
Amortization of cumulative loss on interest rate swaps	170	-	-	170	170	-	-	170
Equity transfers	(149,249)	149,249	-	-	(219,342)	219,342	-	-
Other changes in net assets, primarily distributions of earnings	(39,342)	50,053	(6,718)	3,993	3,097	(11,375)	11,096	2,818
Increase (decrease) in unrestricted net assets	$ 506,063	$ 2,683	$ (4,149)	$ 504,597	$ 188,668	$ (18,296)	$ 15,113	$ 185,485

Banner Health and Subsidiaries

Consolidated Statements of Changes in Net Assets

Unaudited

($ in thousands)

	For the Nine Months Ending September 30, 2017				For the Nine Months Ending September 30, 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	$ 694,484	$ (196,619)	$ 2,569	$ 500,434	$ 404,743	$ (226,263)	$ 4,017	$ 182,497
Amortization of cumulative loss on interest rate swaps	170	-	-	170	170	-	-	170
Equity transfers	(149,249)	149,249	-	-	(219,342)	219,342	-	-
Other changes in net assets, primarily distributions of earnings	(39,342)	50,053	(6,718)	3,993	3,097	(11,375)	11,096	2,818
Increase (decrease) in unrestricted net assets	506,063	2,683	(4,149)	504,597	188,668	(18,296)	15,113	185,485
Temporarily restricted net assets:								
Contributions and other	4,174	15,897	-	20,071	8,128	6,736	-	14,864
Net unrealized gain on investments	6	1,284	-	1,290	19	150	-	169
Net assets released from restriction	(3,737)	(9,794)	-	(13,531)	(3,770)	(7,621)	-	(11,391)
Increase (decrease) in temporarily restricted net assets	443	7,387	-	7,830	4,377	(735)	-	3,642
Noncontrolling interests:								
Excess of revenues over expenses attributable to noncontrolling interests	-	19,240	(27)	19,213	-	20,764	230	20,994
Other changes, primarily distributions of earnings to noncontrolling interests	-	(17,557)	(24)	(17,581)	-	(22,050)	(487)	(22,537)
Increase (decrease) in noncontrolling interests	-	1,683	(51)	1,632	-	(1,286)	(257)	(1,543)
Increase (decrease) in net assets	506,506	11,753	(4,200)	514,059	193,045	(20,317)	14,856	187,584
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	$ 5,299,318	$ 195,767	$ 75,454	$ 5,570,539	$ 4,600,279	$ 278,724	$ 55,777	$ 4,934,780

Banner Health and Subsidiaries

Consolidated Statements of Cash Flows

Unaudited

($ in thousands)

	For the Nine Months Ending September 30, 2017				For the Nine Months Ending September 30, 2016			
	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated	Obligated Group	Non-Obligated Group	Eliminations	Banner Health Consolidated
Operating activities:								
Increase (decrease) in net assets	$ 506,506	$ 11,753	$ (4,200)	$ 514,059	$ 193,045	$ (20,317)	$ 14,856	$ 187,584
Adjustments to reconcile increase (decrease) in net assets to net cash provided by (used in) operating activities:								
Depreciation and amortization	297,491	9,049	-	306,540	292,729	7,123	-	299,852
(Increase) decrease in investments designated as trading	(40,891)	(1,728)	-	(42,619)	135,893	2,260	-	138,153
Equity transfers	149,249	(149,249)	-	-	219,342	(219,342)	-	-
Net unrealized (gain) loss on interest rate swaps	(9,019)	-	-	(9,019)	106,748	-	-	106,748
Gain on sale of assets	(21)	-	-	(21)	(192)	-	-	(192)
Temporarily restricted contributions	(4,174)	(15,897)	-	(20,071)	(8,128)	(6,736)	-	(14,864)
Changes in operating elements, net of acquisitions:								
Patient receivables	7,596	(1,824)	(3,235)	2,537	(16,280)	60	12,604	(3,616)
Inventories and other current assets	25,558	(16,087)	(224)	9,247	(29,841)	(40,611)	(3,568)	(74,020)
Accounts payable and accrued expenses	(96,248)	(18,940)	3,369	(111,819)	(34,898)	(16,852)	(9,060)	(60,810)
Estimated third-party settlements	5,477	513	-	5,990	274	(1)	-	273
Estimated self-insurance liabilities	(148)	10,761	98	10,711	(3,198)	5,269	27	2,098
Other liabilities	10,138	67	-	10,205	3,681	(226)	-	3,455
Net cash provided by (used in) operating activities	851,514	(171,582)	(4,192)	675,740	859,175	(289,373)	14,859	584,661
Investing activities:								
Net purchases of property and equipment	(442,580)	(26,308)	-	(468,888)	(300,824)	(11,572)	-	(312,396)
Acquisitions	-	-	-	-	(12,024)	947	-	(11,077)
(Increase) decrease in other assets	(95,499)	(4,722)	4,192	(96,029)	4,139	(531)	(15,081)	(11,473)
Net cash used in investing activities	(538,079)	(31,030)	4,192	(564,917)	(308,709)	(11,156)	(15,081)	(334,946)
Financing activities:								
Proceeds from temporarily restricted contributions	4,174	15,897	-	20,071	8,128	6,736	-	14,864
Intercompany activity, including equity transfers	(249,235)	249,235	-	-	(298,743)	298,743	-	-
Payments of hospital lease obligations	(18,035)	-	-	(18,035)	(10,245)	-	-	(10,245)
Payments of long-term debt	(59,598)	(23)	-	(59,621)	(253,291)	(357)	222	(253,426)
Net cash (used in) provided by financing activities	(322,694)	265,109	-	(57,585)	(554,151)	305,122	222	(248,807)
Net (decrease) increase in cash and cash equivalents	(9,259)	62,497	-	53,238	(3,685)	4,593	-	908
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	$ 20,482	$ 133,174	$ -	$ 153,656	$ 18,891	$ 74,000	$ -	$ 92,891
Noncash activities								
Capital leases NCMC, Inc. and Washakie Medical Center	$ 12,840	$ -	$ -	$ 12,840	$ 45,401	$ -	$ -	$ 45,401

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), the owner of MediSun, Inc., a Medicare Advantage plan doing business as Blue Advantage (Blue Advantage), 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.
- A 49% noncontrolling interest in Banner Health and Aetna Health Insurance Holding Company LLC (Aetna LLC) which is accounted for under the equity method of accounting. Banner's share of Aetna LLC's net income has been recorded within other operating revenue. In August, 2017 Banner provided its initial funding of $58,914,000 to Aetna LLC.

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 nine months ended September 30, 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 November 20, 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 September 30, 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.

2. Significant Accounting Policies (continued)

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).

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 approximated $62,368,000 and $33,368,000 for the nine months ended September 30, 2017 and 2016, respectively. The restricted share of alternative investment realized and unrealized gains is approximately $937,000 and $1,067,000 for the nine months ended September 30, 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 September 30, 2017 and 2016 and were reported on the accompanying consolidated balance sheets on a net basis. As of September 30, 2017 and 2016, the gross derivative assets and liabilities held and netted together within the investment accounts amounted to assets of approximately $503,014,000 and $427,189,000 and liabilities of approximately $497,699,000 and $434,326,000, respectively. (See Note 3 for a more complete description of derivative assets and liabilities.)

Banner has entered into repurchase agreements amounting to approximately $123,315,000 and $74,104,000 as of September 30, 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 $124,631,000 and $74,760,000 as of September 30, 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 September 30, 2017 and 2016.

2. Significant Accounting Policies (continued)

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 liabilities as a payable under securities lending program and repurchase agreements in the accompanying consolidated balance sheets. At September 30, 2017 and 2016, the fair value of the collateral provided on behalf of Banner was approximately $247,873,000 and $210,818,000, respectively. At September 30, 2017 and 2016, the fair market value of securities on loan was approximately $241,186,000 and $204,065,000, 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 Banner Health Network (BHN), an accountable care organization, and the University of Arizona Health Plans (University Health Plans) are as follows (in thousands):

	9/30/2017	9/30/2016
Net premium revenue	$ 855,252	$ 804,012
Net claims cost	606,159	536,230
Less: premium deficiency reserve	(27,098)	-
BHN and University Health Plans elimination	266,184	230,154
Gross claims cost, including claims paid to Banner facilities and providers	$ 845,245	$ 766,384
Claims cost as a percent of premiums	98.8%	95.3%

In June 2017, BHN recorded a premium deficiency reserve (PDR) of $8,246,000 for its risk-based provider network contract with Blue Advantage plan, for which BHN is paid on a percent of capitation basis. In September 2017, the PDR was increased to $27,098,000 as a result of Blue Advantage receiving notification from the Centers for Medicare and Medicaid Services that it's STAR rating was being adjusted, resulting in a reduction to the monthly member capitation payment to be received. The PDR is an accrual of anticipated future losses under the Blue Advantage contract. The Blue Advantage PDR, recorded as of September 30, 2017, represents the projected losses for the period from October 2017 through December 2018. As losses are incurred in future periods, the PDR accrual will be reversed against the recorded losses. The University Family Care plan, a Medicaid managed care plan and one of Banner's University Health Plans, also recorded a PDR as of September 30, 2017 amounting to $4,850,000 which is the remaining PDR initially recorded in 2016. Accordingly, the total PDR recorded as of September 30, 2017 amounted to $31,948,000.

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,

2. Significant Accounting Policies (continued)

contingent liabilities, and accrued liabilities resulting from self-insurance programs. In the nine months ended September 30, 2017 and 2016, BHN recorded prior plan year income of $12,006,000 and $25,511,000, respectively, related to the Medicare Pioneer ACO savings, which is recorded as an increase to other revenue. BHN also recognized an increase (decrease) to other operating revenue amounting to $10,724,000 and $(4,634,000) in 2017 and 2016 for adjustments to prior year risk sharing agreements. The 2017 adjustment is due to an actuarial adjustment in the loss projections by Blue Cross and Blue Shield of Arizona for a commercial risk-based provider network contract, including an anticipated reinsurance settlement. Net patient services revenue was increased by $17,541,000 and $22,494,000 in the first nine months of 2017 and 2016 for prior year third party settlements, and by $23,728,000 and $38,626,000 for changes in reimbursement for graduate medical education programs (GME). GME distribution amounts are not finalized until near the end of the fiscal year covered, so there are often changes in estimates relative to this program. Professional and general liability insurance expense decreased $10,000,000 and $17,500,000 in the first nine months of 2017 and 2016 due to actuarial adjustments.

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.

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).

3. Fair Value of Financial Instruments (continued)

Banner's investment in alternative investments, amounting to approximately $1,006,013,000 and $1,392,692,000 as of September 30, 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 $6,116,000 and $9,498,000 as of September 30, 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.

	September 30, 2017 (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	$ 274,538	$ 274,538	$ -	$ -	a
Commerical Paper	$ 35,380	$ -	$ 35,380	$ -	a
Collateral held under securities lending and repurchase agreement (primarily cash and debt securities)	$ 372,504	$ 247,872	$ 124,632	$ -	a
Mutual funds:					a
Mutual funds – U.S. funds	$ 1,127,064	$ 1,127,064	$ -	$ -	a
Mutual funds – International	767,457	767,457	$ -	$ -	a
Total mutual funds	$ 1,894,521	$ 1,894,521	$ -	$ -	
Debt securities:					
U.S. Treasury/government obligations	$ 291,698	$ -	$ 291,698	$ -	a
Corporate bonds/Non-U.S. government bonds	240,409	-	240,409	-	a
Asset-backed securities	137,041	-	137,041	-	a
Commercial mortgage-backed securities	10,584	-	10,584	-	a
Non-government-backed collateralized mortgages	21,836	-	21,836	-	a
Government mortgage-backed securities	348,948	-	348,948	-	a
Government commercial backed	10,060	-	10,060	-	a
Total debt securities	$ 1,060,576	$ -	$ 1,060,576	$ -	
Repurchase agreements	$ 123,315	$ -	$ 123,315	$ -	a
Equity securities:					
U. S. equity securities	$ 109,691	$ 109,691	$ -	$ -	a
International equity securities	153,796	153,796	$ -	$ -	a
Total equity securities	$ 263,487	$ 263,487	$ -	$ -	
Derivative securities					
Future contracts	$ 100,884	$ 100,884	$ -	$ -	a
Forward contracts	392,722	-	392,722	-	a
Interest rate swap agreements	3,382	-	3,382	-	a
Option agreements	29	-	29	-	a
Net credit swaps	5,997	-	5,997	-	a
Subtotal derivative assets	$ 503,014	$ 100,884	$ 402,130	$ -	
Future contracts	$ (100,884)	$ (100,884)	$ -	$ -	a
Forward contracts	(392,856	-	(392,856)	-	a
Interest rate swap agreements	(1,458)	-	(1,458)	-	a
Option agreements	(247)	-	(247)	-	a
Net credit swaps	(2,254)	-	(2,254)	-	a
Subtotal derivative liabilities	$ (497,699)	$ (100,884)	$ (396,815)	$ -	
Total fair value investments	$ 4,029,636	$ 2,680,418	$ 1,349,218	$ -	
Short-term investments	$ 275,855				
Collateral held under securities lending and repurchase agreements	372,504				
Assets limited as to use	2,426,675				
Long-term investments	1,890,738				
Other assets – Banner Foundation restricted funds	75,993				
Less: alternative investments	1,006,013				
Less: split dollar life insurance	6,116				
Total fair value investments	$ 4,029,636				
Interest rate swaps	$ (323,819)	$ -	$ (323,819)	$ -	c

3. Fair Value of Financial Instruments (continued)

	September 30, 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	$ 448,588	$ 448,588	$ -	$ -	a
Commercial Paper	$ 40,804	$ -	$ 40,804	$ -	
Collateral held under securities lending and repurchase agreement (primarily cash and debt securities)	$ 285,578	$ 285,578	$ -	$ -	a
Mutual funds:					
Mutual funds – U.S. funds	$ 929,993	$ 929,993	$ -	$ -	a
Mutual funds – International	474,108	474,108	-	-	a
Total mutual funds	$ 1,404,101	$ 1,404,101	$ -	$ -	
Debt securities:					
U.S. Treasury/government obligations	$ 198,137	$ -	198,137	$ -	a
Corporate bonds/Non-U.S. government bonds	149,121	-	149,121	-	a
Asset-backed securities	79,177	-	79,177	-	a
Commercial mortgage-backed securities	12,199	-	12,199	-	a
Non-government-backed collateralized mortgages	14,547	-	14,547	-	a
Government mortgage-backed securities	319,174	-	319,174	-	a
Government commercial backed	4,967	-	4,967	-	a
Total debt securities	$ 777,322	$ -	$ 777,322	$ -	
Repurchase agreements	$ 74,104	$ -	$ 74,104	$ -	a
Equity securities:					
U. S. equity securities	$ 180,325	$ 180,325	$ -	$ -	a
International equity securities	252,548	252,548	-	-	a
Total equity securities	$ 432,873	$ 432,873	$ -	$ -	
Derivative securities					
Future contracts	$ 28,244	$ 28,244	$ -	$ -	a
Forward contracts	394,171	-	394,171	-	a
Interest rate swap agreements	4,003	-	4,003	-	a
Net credit swaps	771	-	771	-	a
Subtotal derivative assets	$ 427,189	$ 28,244	$ 398,945	$ -	
Future contracts	$ (28,243)	$ (28,243)	$ -	$ -	a
Forward contracts	(397,298)	-	(397,298)	-	a
Interest rate swap agreements	(1,186)	-	(1,186)	-	a
Option agreements	(52)	-	(52)	-	a
Net credit swaps	(7,547)	-	(7,547)	-	a
Subtotal derivative liabilities	$ (434,326)	$ (28,243)	$ (406,083)	$ -	
Total Fair Value Investments	$ 3,456,233	$ 2,571,141	$ 885,092	$ -	a
Short-term investments	$ 249,537				
Collateral held under securities lending and repurchase agreements	285,578				
Assets limited as to use	2,310,478				
Long-term investments	1,942,086				
Other assets – Banner Foundation restricted funds	70,744				
Less: alternative investments	1,392,692				
Less: split dollar life insurance	9,498				
Total fair value investments	$ 3,456,233				
Interest rate swaps	$ (467,779)	$ -	$ (467,779)	$ -	c

3. Fair Value of Financial Instruments (continued)

Investment income consisted of the following for the nine months ended September 30:

($ in thousands)

	2017	2016
Interest and dividend Income	$ 38,958	$ 35,559
Net realized gain on sales of investments	64,897	23,122
Gain from alternative investments	63,305	34,435
Net realized gain (loss) on sales of future contracts	1,275	(2,515)
Net realized loss on sales of interest rate swap agreements	(4,123)	(402)
Net realized gain on sales of option agreements	616	474
Net realized gain on sales of net credit swaps	89	182
Net unrealized gain on investments	162,547	62,863
Net unrealized gain (loss) on interest rate swap agreements	2,887	(3,741)
Net unrealized (loss) gain on option agreements	(112)	47
Net unrealized gain on net credit swaps	2,500	1,761
	332,839	151,785
Less: Investment income credited to other revenue, restricted funds, and capitalized bond project funds	4,994	4,034
Investment income	$ 327,845	$ 147,751

4. Debt

Series 2017ABC

On September 28, Banner priced its $188,985,000 Series 2017A fixed-rate tax-exempt bonds. Additionally, it priced its $171,890,000 Series 2017BC five and seven year tax-exempt put bonds. The proceeds of the sale of the Series 2017ABC Bonds will be used together with other funds for the purpose of (i) financing and reimbursing the acquisition, construction, renovation, improvement, furnishing, and equipping of certain capital improvements on the campuses of certain of the health facilities and related facilities (including two patient towers at Banner — University Medical Center Phoenix and Banner — University Medical Center Tucson. The Series 2017A bonds are fixed-rate securities bearing interest at an annual rate ranging from 4.00% to 5.00% and are due in annual installments beginning in 2039 through 2041. The Series 2017B and C are put bonds bearing interest at an annual rate of 5.00% and due in annual installments beginning in 2047 through 2048, but are subject to a mandatory tender in 2022 and 2025, respectively, in connection with the redetermination of the interest rate to be borne by the bonds.

Series 2008H

On September 28, Banner reclassified the entire portion of series 2008H long-term debt, amounting to $57,940,000, to current debt. Security for the payment of the Series 2008H is provided for with a direct pay letter of credit with The Northern Trust Company. The direct pay letter of credit expires on September 28, 2018. Banner has not currently renewed the direct pay letter of credit. The debt has been reclassified to current because the expiration date is within one year.

5. Interest Rate Swap Agreements

Banner entered into multiple interest rate swaps that currently do not qualify for hedge accounting. For the nine months ended September 30, 2017 and 2016, the mark-to-market adjustment resulted in an unrealized gain of $8,849,000 and an unrealized loss of $(106,918,000) 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 nine months ended September 30, 2017 and 2016, by $28,525,000 and $32,510,000, 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 September 30, 2017 and 2016, Banner had $124,478,000 and $196,548,000 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.

6. Subsequent Events

On October 17, Banner priced its $100,000,000 Series 2017D variable rate demand tax-exempt bonds. The proceeds of the sale of the Series 2017D Bonds will be used together with other funds for the purpose of (i) financing and reimbursing the acquisition, construction, renovation, improvement, furnishing, and equipping of certain capital improvements on the campuses of certain of the health facilities and related facilities (including two patient towers at Banner — University Medical Center Phoenix and Banner — University Medical Center Tucson. The Series 2017D bonds are variable-rate demand securities and bear interest based on successive interest rate periods of seven days at an interest rate determined by a remarketing agent. The Series 2017D bonds are due in annual installments beginning in 2047 through 2048.

On October 18, Banner finalized the Series 2017ABCD bond transaction in which $500,000,000 in net bond proceeds were received.