# An Analysis

# of the

# Claims Payments and Performance

# of

# Physicians Insurance
# A Mutual Company

# 1995-2005

by

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## Executive Summary

This Report analyzes the claims payments and performance of Physicians Insurance ("Physicians") based on the Annual Statements it has filed with the Washington Office of Insurance Commissioner ("OIC") during the last 10 years and the additional statement it has filed covering the first half of 2005. According to those Statements, over the last ten years:

* Physicians' total claims payments in Washington declined by 19%;
* The number of claims Physicians paid in Washington declined by 23%;
* Physicians' surplus increased by 49%;
* Physicians' premiums increased by 99%.

In addition, its ten most recent Annual Statements indicate that Physicians has historically paid out 39% less on a given year's policies than it initially projected it would pay out.

## I. Methodology

Insurance companies must file comprehensive financial statements with state insurance departments by March 1 each year. Those statements, known as Annual Statements, include extensive financial data for the most recent calendar year, and summary data for each of the most recent five calendar years. In particular, an insurer's Annual Statement includes data on:

- the premium it collects;
- its claims payments and projected claims payments;
- its reserves—the amount it sets aside to pay projected future claims; and
- its surplus—the extra cushion held by the insurer in addition to the amount it sets aside to pay future claims.

Insurers also file quarterly statements with state insurance departments. The most recent quarterly statement Physicians has filed with the OIC updates its performance through June 30, 2005. This Report analyzes Physicians' performance based on data in its last ten Annual Statements and its most recent quarterly statement.

Although Physicians has written small amounts of business in Oregon, Alaska, Idaho and Montana, 97% of its business is Washington business. Physicians' Annual and quarterly statements break out premium and loss data by state. Those statements do not break out reserve and surplus data by state, but because substantially all of Physicians' business is Washington business, its company-wide reserves and surplus are almost completely attributable to its Washington business.

A. Written premiums vs. paid losses

One way to measure an insurer's performance is to compare "written premium" with "paid losses"--i.e., to compare the premium an insurer takes in in a given year with the claims it pays out in that same year. Such a comparison does not provide a complete picture of an insurer's performance, since claims paid out in a given year are typically covered by policies written in prior years. On the other hand, the trend over several years in an insurer's written premiums and paid losses, and in the amount of its average claim, are relevant indicators of the insurer's performance, of the excessiveness or inadequacy of the insurer's rates, and of the litigation environment. This Report shows these trends for Physicians' Washington business.

B. Earned premiums vs. projected losses

A second way to measure the performance of an insurance company is to compare the premiums it earns in a given year with the claims it projects it will pay in future years on policies in effect in that year.

Earned premium refers to the portion of the premium attributable to a particular period of coverage. For example, if a policy covering the period July 1, 2004 through June 30, 2005 costs $100, the insurance company writes $100 in premium but earns only $50 in premium for 2004, since only half of the coverage provided by that policy occurs in 2004. Because insurance companies continually write policies, earned premium and written premium typically do not differ greatly.

The claims an insurer projects it will ultimately pay that are covered by premiums earned in a given year are referred to by insurers as their "incurred losses" for that year. To the lay person the term "incurred losses" is misleading, since an insurer's "incurred losses" are not payments it has made but rather are estimates of the payments it projects it will make in the future. These estimated payments may never be made, and Physicians' Annual Statements reveal that it has historically posted "incurred loss" estimates that ultimately proved to be substantially overstated, as will be discussed in section IIC. Nevertheless, insurers and regulators typically use the incurred loss ratio--the ratio of an insurer's incurred loss estimates to its earned premium--as a measure of its profitability. Accordingly, this Report examines that ratio for Physicians' Washington business.

C. Reserve analysis

A third type of analysis based on the data in the Annual Statements is an analysis of the accuracy of an insurer's reserves, which are the amounts an insurer sets aside to pay its projected "incurred losses." Whether or not an insurer has reserved the correct amount for claims covered by policies in a given year--i.e., whether or not the insurer's "incurred loss" estimates are accurate--can not possibly be known until substantially all of those claims are actually paid, which for medical malpractice claims is approximately 10 years after the year the policy is written. The data in its current Annual Statement therefore does not permit us to determine how accurate Physicians' current reserve estimates are. Each of Physicians' Annual Statements does, however, permit us to determine how accurate its incurred loss estimate was for the policy year ten years earlier. This Report determines that amount for each of the ten most recent policy years with respect to which substantially all claims have now been paid.

D. Surplus analysis

Surplus is the extra cushion an insurance company accumulates over and above the amount it has set aside to pay its estimated future claims. A company increases its surplus to the extent that, after setting aside a sufficient amount to pay all projected future claims, it both earns a profit and declines to distribute that profit to its shareholders (in a stock company) or policyholders (in a mutual company). This Report analyzes the change in Physicians' surplus between 1995 and June 30, 2005.

## II. Findings

A. Written premiums vs. paid losses

Figure 1 sets forth Physicians' written premium and paid loss experience for each of the last ten years and the first half of 2005 for its Washington business. It indicates that during that period the total it paid in claims, its average claim payments, and the number of claims it paid all declined, while its premiums increased substantially.

## Figure 1

### Physicians Insurance
### Washington
### Written Premiums, Paid Losses, Number of Claims and Average Claim
### 1995 – June 30, 2005

| Year | Written Premium($) | Paid Losses($) | Paid Loss Ratio | # of Claims | Average Claim($) |
|---|---|---|---|---|---|
| 1995 | 44,848,558 | 41,549,220 | 92.6% | 210 | 197,853 |
| 1996* | n/a | n/a | n/a | n/a | n/a |
| 1997 | 46,463,585 | 45,339,443 | 97.6% | 198 | 228,987 |
| 1998 | 47,522,519 | 36,147,030 | 76.1% | 164 | 220,409 |
| 1999 | 49,149,768 | 34,884,508 | 71.0% | 228 | 153,002 |
| 2000 | 49,380,583 | 34,994,139 | 70.9% | 191 | 183,215 |
| 2001 | 56,173,923 | 37,948,264 | 67.6% | 230 | 164,992 |
| 2002 | 66,992,394 | 40,157,273 | 60.0% | 196 | 204,884 |
| 2003 | 85,715,864 | 43,236,019 | 50.4% | 201 | 215,105 |
| 2004 | 93,722,424 | 33,648,287 | 35.9% | 161 | 208,996 |
| 2005 1st half | 89,025,731 | 15,935,913 | ** | 85 | 187,481 |

* 1996 data was not available from the OIC.

** Because substantially more premium is written during the first half of the year than the latter half, the 17.9% paid loss ratio through June 30, 2005 can not fairly be extrapolated to year-end 2005.

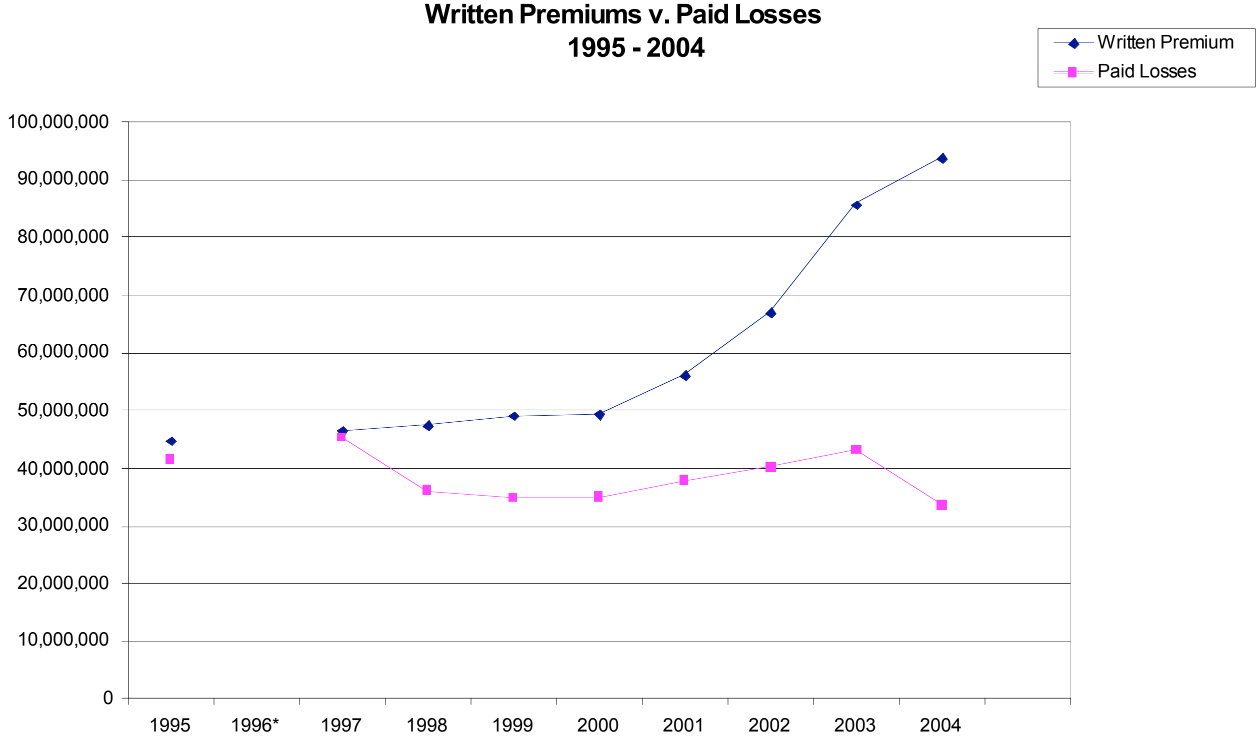
Source: 1995 and 1997-2004 Annual Statements and Q2 2005 Quarterly Statement, Supplement A to Schedule T. Supplement A to Schedule T was not included in the 1996 Annual Statement filed with the OIC.

Specifically, as Figure 1 indicates, between 1995 and 2004 Physicians' premiums increased by 99% -- from $44.8 million to $93.7 million – while the total it paid in claims decreased by 19%; the number of claims it paid decreased by 23%; and the size of its average paid claim increased by only 5.6%, or less than ½ of 1% per year—far less than the rate of inflation. Thus, in real terms Physicians' total claims payments, its number of paid claims, and its average paid claim have all decreased over the last ten years, while its premiums have doubled.

Moreover, as Figure 1 also indicates, based on first half 2005 data the favorable trends in Physicians' loss experience appear to be continuing: its total claims payments declined to $15,935,913, or $31,871,826 on an annualized basis; there was a negligible increase in the number of claims it paid; and its average paid claim fell to $187,481—5.2% less than its average paid claim of ten years ago, even without accounting for inflation.

Figure 2 graphically displays the sharp upward trend in Physicians' Washington written premium along with the countervailing trend in its total paid claims for Washington.

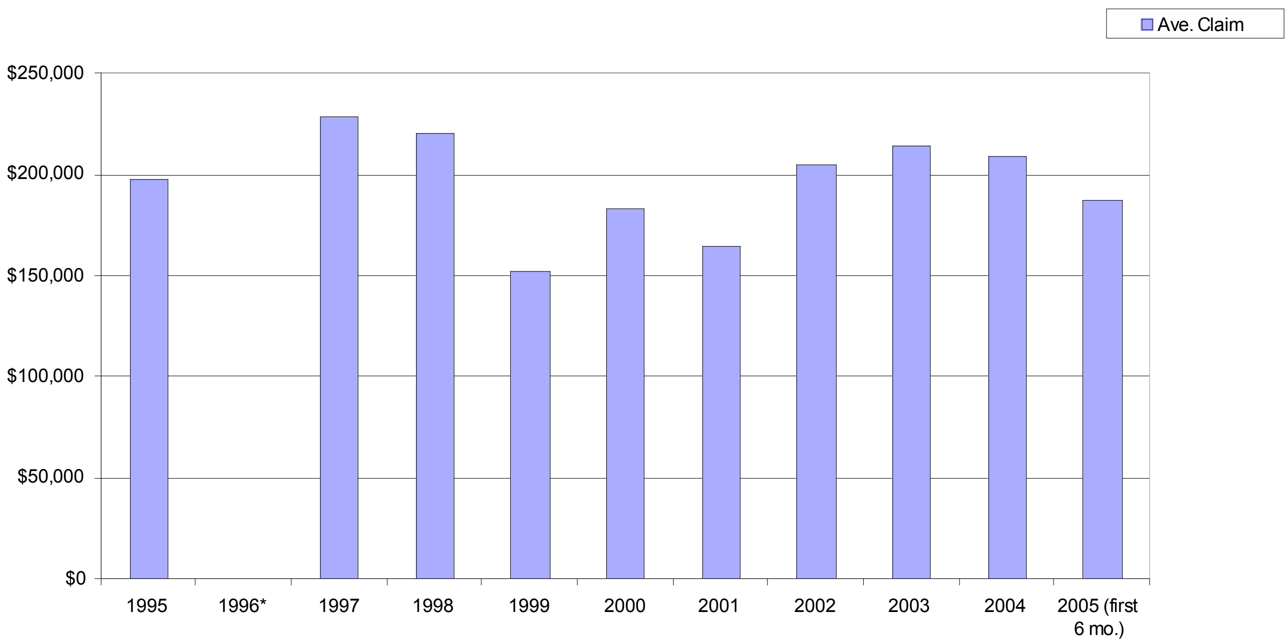
**Figure 2**
**Physicians Insurance**
**Washington**
**Written Premiums v. Paid Losses**
**1995 - 2004**




* Data not available

Figure 3 displays the trend from 1995 through June 30, 2005 in the size of Physicians' average paid claim in Washington.

**Figure 3**
**Physicians Insurance**
**Washington**
**Average Claim Size**
**1995 - June 30, 2005**

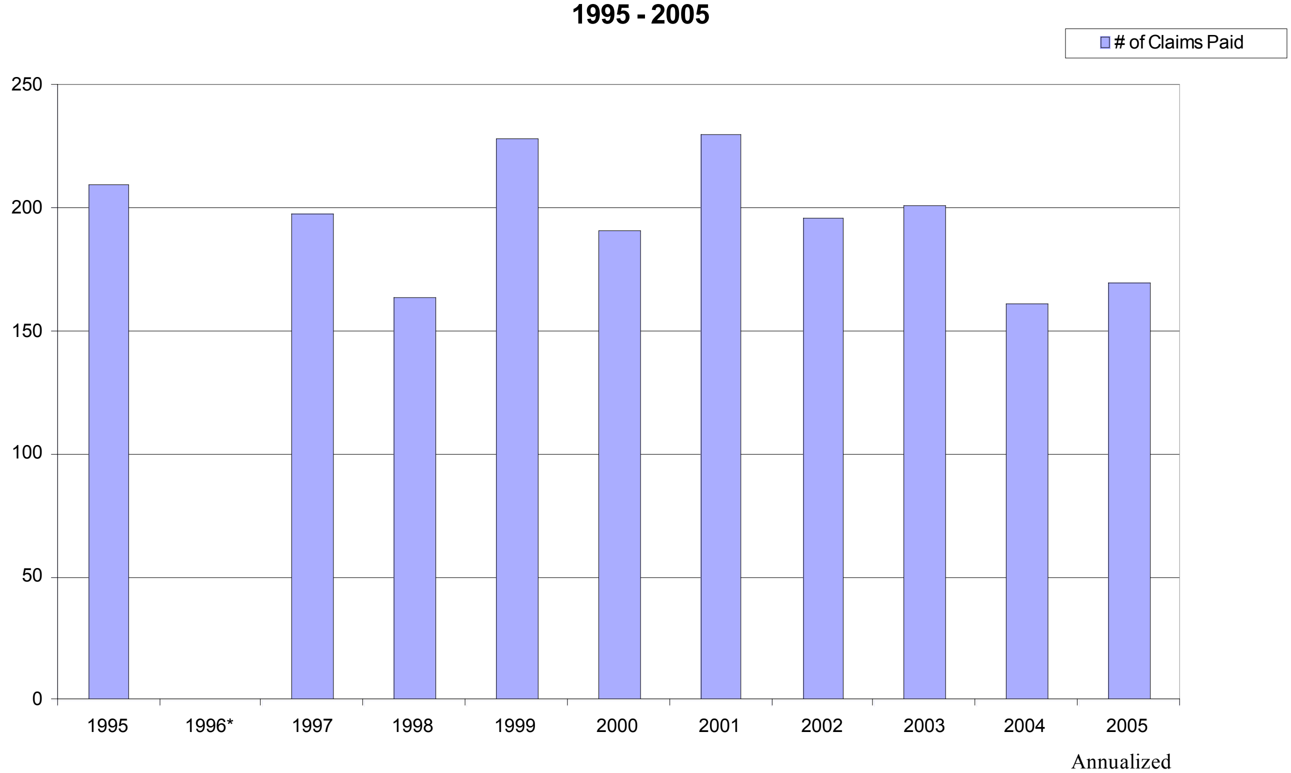



* Data not available

None of the above charts take inflation into account. When inflation is taken into account, the decline in Physicians' claims payments—both average and total—is even more significant.

Figure 4 graphically displays the number of Washington claims paid by Physicians each year since 1995.

**Figure 4**
**Washington**
**Number of Claims Paid**
**1995 - 2005**




* Data not available

B. Earned premiums vs. incurred losses

Figure 5 sets forth Physicians' earned premium and incurred loss experience since 1995. Notably, it indicates that between 1995 and 2004 Physicians' earned premiums increased by $48.6 million, even though its "incurred losses"--its estimated future claims payments--increased by only $16.7 million. As a result, Physicians' incurred loss ratio--the ratio between its projected claims payments and its earned premiums--declined sharply, from 60.4% in 1995, and from a high of 100.7% in 1997, to less than 50% in 2003 through the first half of 2005. As a result, during the past two and one-half years, Physicians earned more than $2 of premium for each dollar it projected it would pay out in claims.

**Figure 5**

**Physicians Insurance**
**Washington**
**Earned Premiums v. Incurred Losses**
**1995-June 30, 2005**

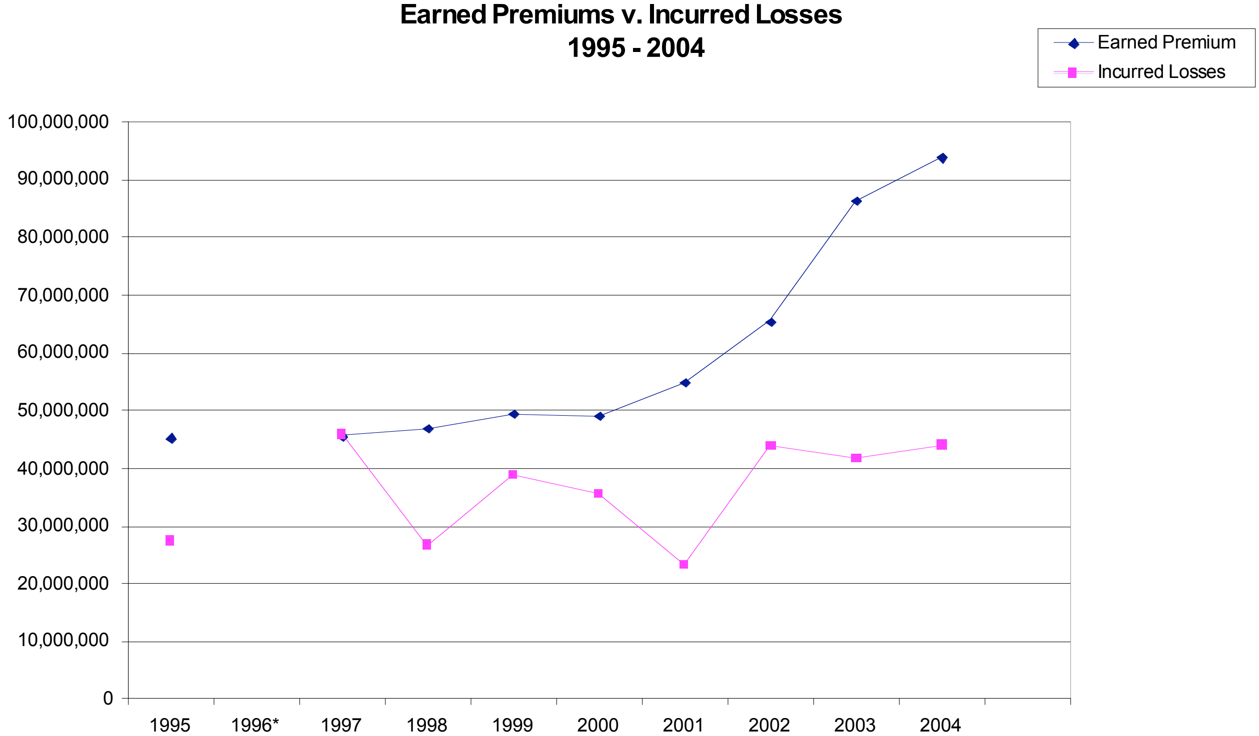
| Year | Earned Premiums | Incurred Losses | Ratio |
|---|---|---|---|
| 1995 | 45,270,612 | 27,358,584 | 60.4% |
| 1996* | n/a | n/a | n/a |
| 1997 | 45,643,381 | 45,950,087 | 100.7% |
| 1998 | 46,927,222 | 26,744,459 | 57.0% |
| 1999 | 49,466,807 | 38,802,235 | 78.4% |
| 2000 | 49,149,621 | 35,639,178 | 72.5% |
| 2001 | 54,888,605 | 23,323,653 | 42.5% |
| 2002 | 65,464,985 | 43,855,170 | 67.0% |
| 2003 | 86,406,898 | 41,688,297 | 48.3% |
| 2004 | 93,919,537 | 44,076,907 | 47.0% |
| 2005-1st half | 46,244,434 | 21,425,537 | 46.3% |

* 1996 data was not available from the OIC.

Source: 1995 and 1997-2004 Annual Statements and Q2 2005 Quarterly Statement, Supplement A to Schedule T. Supplement A to Schedule T was not included in the 1996 Annual Statement filed with the OIC.

Figure 6 graphically displays the trends in Physicians' earned premiums and incurred losses in Washington.

**Figure 6**
**Physicians Insurance**
**Washington**
**Earned Premiums v. Incurred Losses**
**1995 - 2004**




* Data not available

C. Reserve analysis

The extent to which Physicians' reserve estimates for prior years' policies have proved to be accurate is disclosed in Schedule P, Part 2F of its Annual Statement. That schedule sets out Physicians' initial estimate of its ultimate payments for claims covered by policies in effect in each of the nine years preceding the year for which the Annual Statement is filed, along with the revised estimate Physicians made in each succeeding year as to its ultimate payments for those claims.

As explained in section IB, an insurer's "incurred losses" are not actual losses but rather estimates of projected future payments which may or may not be made. Each year, as the insurer receives more information about the "incurred losses" it has estimated it will ultimately pay for claims covered by policies in effect in a previous year, it adjusts that estimate based on that information.

Because virtually all medical malpractice claims are paid within ten years, as explained in section IC, an insurer's estimate of its true liability for claims it estimates that it has incurred in a given year is substantially accurate after ten years. Whether Physicians’ current reserves are too low or too high can therefore not be definitively known until 2014. On the other hand, because at least nine years has now elapsed between each year prior to 1996 and the present, we can now determine the extent to which the reserves Physicians established for each prior year prior to 1996 have proved to be too low or too high.

Accordingly, Figure 7 compares Physicians’ initial estimate of its ultimate payments with its actual ultimate payments for claims covered by policies written in each year from 1986 through 1995--the ten most recent policy years for which Physicians’ actual ultimate payments are known. Figure 7 demonstrates that during that ten-year period, Physicians’ initial incurred loss estimate turned out to be overstated for each policy year; to be overstated by more than 27% in all but one year; and to be overstated by more than 60% in three years. In total, for the ten-year period 1986-1995, Physicians’ initial incurred loss estimates proved to be overstated by 38.7%.

**Figure 7**

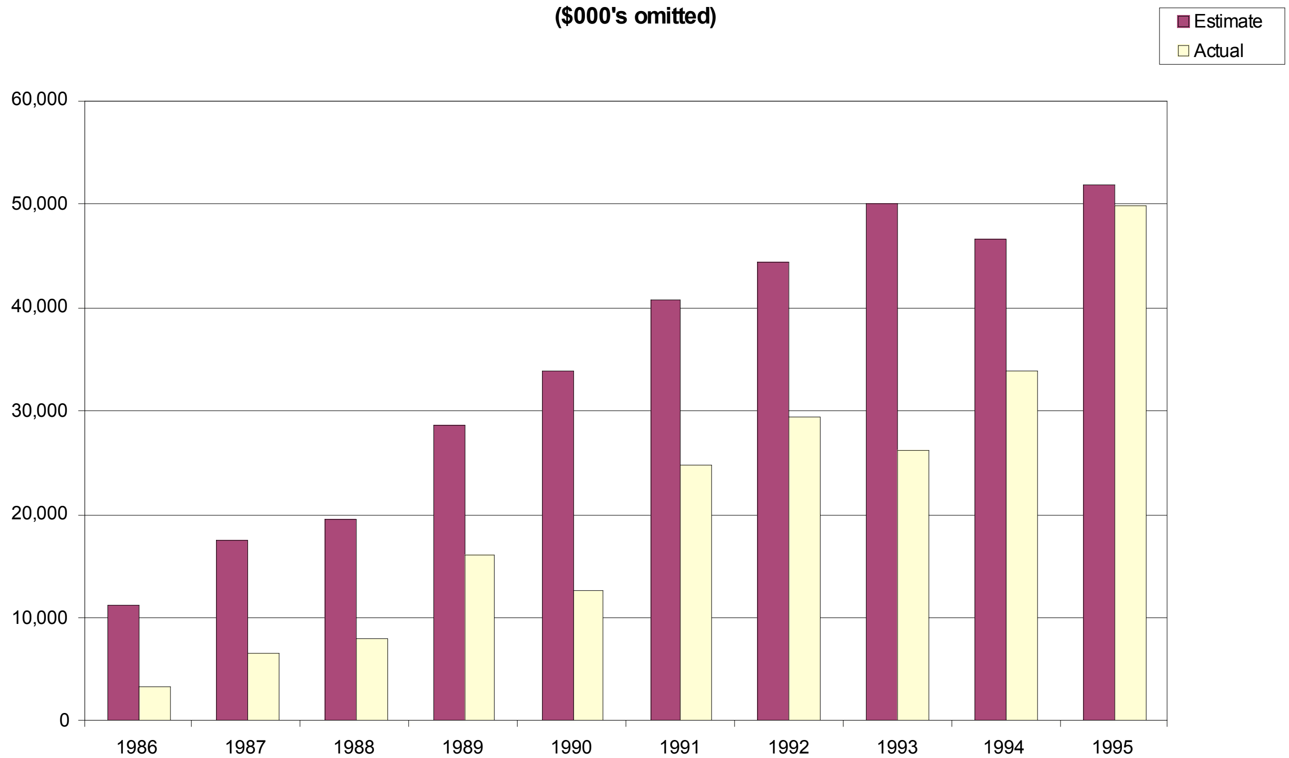
## Physicians Insurance – All States Combined
## Initial Incurred Loss Estimates vs. Incurred Losses Reported after 9 years
## (000's omitted)

| Policy Year | Initial Estimate of Incurred Loss For Policy Year | Reported Incurred Loss 9 Years Later for Year | Difference in Dollars | Difference in Percentage |
|---|---|---|---|---|
| 1986 | 11,245 | 3,446 | 7,799 | 69.4% |
| 1987 | 17,534 | 6,748 | 10,786 | 61.5% |
| 1988 | 19,668 | 8,072 | 11,596 | 59.0% |
| 1989 | 28,671 | 16,203 | 12,568 | 43.9% |
| 1990 | 33,972 | 12,712 | 21,260 | 62.6% |
| 1991 | 40,773 | 24,786 | 15,987 | 39.2% |
| 1992 | 44,518 | 29,563 | 14,955 | 33.6% |
| 1993 | 50,098 | 26,301 | 23,797 | 47.5% |
| 1994 | 46,735 | 33,991 | 12,744 | 27.3% |
| 1995 | 52,024 | 50,022 | 2,002 | 3.9% |
| Totals | 345,238 | 211,744 | 133,494 | 38.7% |

Source: 1995-2004 Annual Statements, Schedule P, Part 2F.

Figure 8 displays the data set out in Table 5 graphically:

**Figure 8**
**Physicians Insurance - All States Combined**
**Initial Incurred Loss Estimates vs. Actual Losses**
**($000's omitted)**




Another way to determine the accuracy of Physicians' reserves is by reading the Notes to Financial Statements section of its Annual Statement. For each of the last four years, insurers have been required to disclose in those Notes the extent to which they have adjusted their reserves. Insurers whose reserves have proved to be too low disclose the extent to which they have added to those reserves during the previous year; those whose reserves have proved to be too high disclose the extent to which they have reduced them.

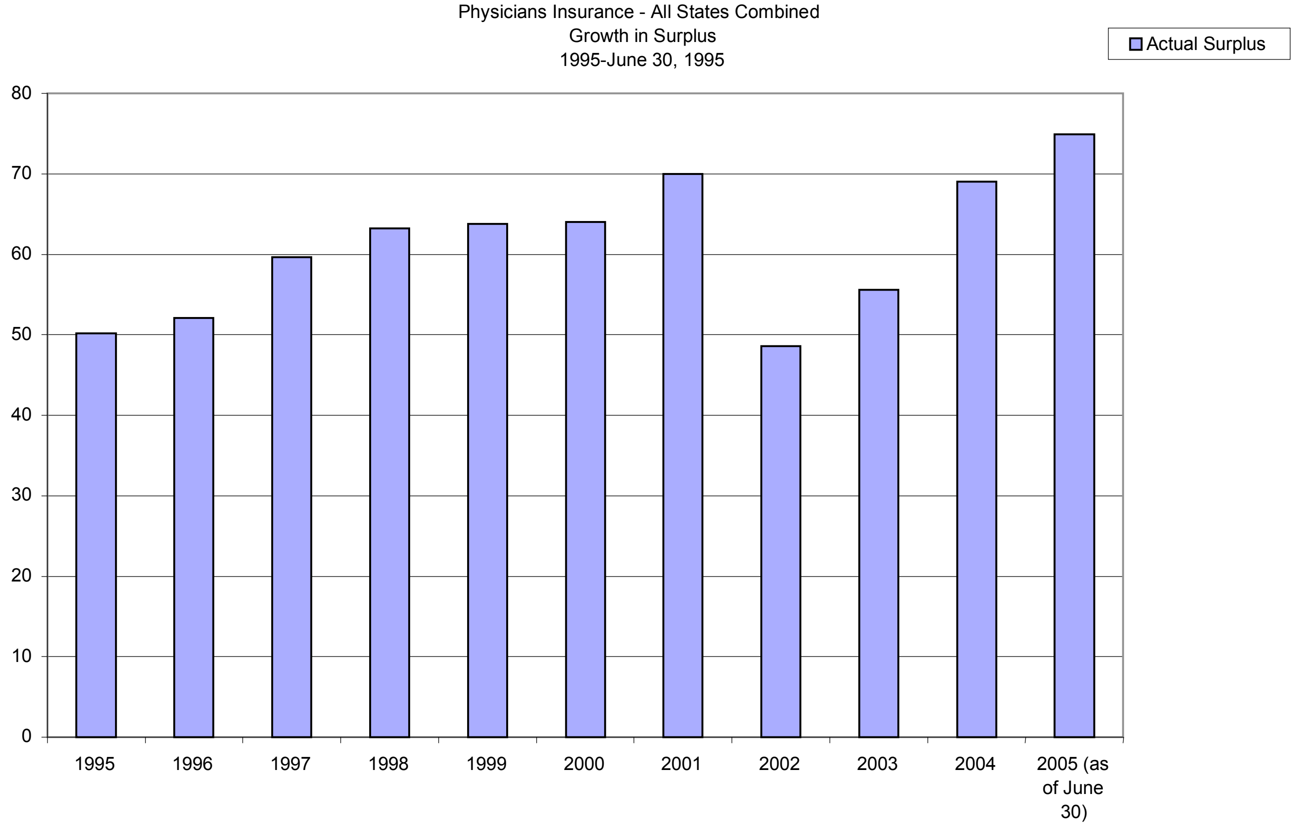
Notably, as indicated by the relevant Note from each of Physicians' last four Annual Statements, attached as Exhibits A-1 through A-4, for three of the last four years Physicians has acknowledged that its reserves for prior years were too high, and accordingly has reduced them. In 2001 it reduced its reserves for prior years by $12.7 million; in 2002 it reduced them by $10.1 million; and in 2004 it reduced them by $7.5 million, after having increased them in 2003 by $4.4 million.

During the past four years, therefore—the period during which the NAIC has required this disclosure in the Annual Statement—Physicians has decreased its reserves by a net of $25.9 million. By decreasing its reserves, and stating that it was doing so because of its "ongoing analysis of development trends," Physicians is acknowledging that the litigation environment today is more conservative than it assumed it would be when it initially set its reserves.

D. Surplus Analysis

Figure 9 sets forth Physicians' surplus—the extra cushion it has accumulated over and above the amount it has set aside to pay future claims—as of December 31 of each of the last ten years, and also as of June 30, 2005. It indicates that Physicians' surplus grew steadily from 1995 through 2001, declined in 2002, and grew steadily thereafter. Its current surplus of $74.9 million is its all-time high.

Figure 9
Physicians Insurance - All States Combined
Growth in Surplus
1995-June 30, 1995




Source: 1999 and 2004 Annual Statements, Five-Year Historical Data Pages.

The greater an insurer's surplus, the greater the protection for policyholders in case the amount the insurer has set aside to pay future claims turns out to be insufficient. As demonstrated in the previous section, however, Physicians has historically set aside to pay claims substantially more than it ultimately ended up paying out. Having a huge surplus is therefore less important for Physicians than it would be for a company that had traditionally understated its ultimate liabilities, rather than overstating them as Physicians has.

EXHIBIT A1

# NOTES TO FINANCIAL STATEMENTS

21. **EVENTS SUBSEQUENT**
None

22. **REINSURANCE**
Unsecured reinsurance recoverables in excess of 3% of surplus are:

| | | |
|---|---|---|
| AA-1126435 | DP Mann syndicate | $3,140,000 |
| AA-1127141 | Amlin syndicate | 2,684,000 |
| AA-1128001 | Amlin syndicate | 2,416,000 |
| AA-1340125 | Hannover Re | 3,680,000 |

All other – Not Applicable

23. **RETROSPECTIVELY RATED CONTRACTS & CONTRACTS SUBJECT TO REDETERMINATION**
Not applicable

24. **CHANGE IN INCURRED LOSSES AND LOSS ADJUSTMENT EXPENSES**
Incurred losses for prior years decreased by 12,714,023 in 2001 as a result of reestimation of unpaid losses and loss adjustments on the medical malpractice line. This decrease is generally the result of ongoing analysis of development trends. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

25. **INTERCOMPANY POOLING ARRANGEMENTS**
None

26. **STRUCTURED SETTLEMENTS**
A. None
B. None

27. **HIGH DEDUCTIBLES**
None

28. **DISCOUNTING OF LIABILITIES FOR UNPAID LOSSES OR UNPAID LOSS ADJUSTMENT EXPENSES**
None of the liabilities for unpaid losses or unpaid loss adjustment expenses are discounted.

29. **ASBESTOS/ENVIRONMENTAL RESERVES**
Not Applicable

30. **SUBSCRIBER SAVINGS ACCOUNTS**
Not Applicable

31. **FINANCIAL GUARANTY INSURANCE EXPOSURES**
Not Applicable

EXHIBIT A2

# NOTES TO FINANCIAL STATEMENTS

| | | | |
|---|---|---|---|
| AA-1126435 | | DP Mann syndicate | $2,232,000 |
| AA-1128791 | | Managing Agency Partners | 2,942,000 |
| AA-1128001 | | Amlin syndicate | 4,323,000 |
| AA-1340125 | | Hannover Re | 4,632,000 |
| AA-127141 | | JE Mumford (U/A) Ltd | 1,819,000 |
| 47-0698507 | | Odyssey America Reins. Corp | 2,093,000 |
| 13-5616275 | | Transatlantic Reins. Co. | 2,618,000 |
| | | | |
| | | | |

All other – Not Applicable

**23. RETROSPECTIVELY RATED CONTRACTS & CONTRACTS SUBJECT TO REDETERMINATION**
Not applicable

**24. CHANGE IN INCURRED LOSSES AND LOSS ADJUSTMENT EXPENSES**
Incurred losses for prior years decreased by 10,146,252 in 2002 as a result of reestimation of unpaid losses and loss adjustments on the medical malpractice line. This decrease is generally the result of ongoing analysis of development trends. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

**25. INTERCOMPANY POOLING ARRANGEMENTS**
None

**26. STRUCTURED SETTLEMENTS**
A. None
B. None

**27. HEALTH CARE RECEIVABLES**
Not Applicable

**28. PARTICIPATING POLICIES**
Not Applicable

**29. PREMIUM DEFICIENCY RESERVES**
None

**30. HIGH DEDUCTIBLES**
None

**31. DISCOUNTING OF LIABILITIES FOR UNPAID LOSSES OR UNPAID LOSS ADJUSTMENT EXPENSES**
None of the liabilities for unpaid losses or unpaid loss adjustment expenses are discounted.

**32. ASBESTOS/ENVIRONMENTAL RESERVES**
Not Applicable

# NOTES TO FINANCIAL STATEMENTS

EXHIBIT A3

All other – Not Applicable

**23. RETROSPECTIVELY RATED CONTRACTS & CONTRACTS SUBJECT TO REDETERMINATION**
Not applicable

**24. CHANGE IN INCURRED LOSSES AND LOSS ADJUSTMENT EXPENSES**
Incurred losses for prior years increased by $4,394,410 in 2003 as a result of reestimation of unpaid losses and loss adjustments on the medical malpractice line. This increase is generally the result of ongoing analysis of development trends. Original estimates are increased or decreased, as additional information becomes known regarding individual claims.

**25. INTERCOMPANY POOLING ARRANGEMENTS**
None

**26. STRUCTURED SETTLEMENTS**
A. None
B. None

**27. HEALTH CARE RECEIVABLES**
Not Applicable

**28. PARTICIPATING POLICIES**
Not Applicable

**29. PREMIUM DEFICIENCY RESERVES**
None

**30. HIGH DEDUCTIBLES**
None

**31. DISCOUNTING OF LIABILITIES FOR UNPAID LOSSES OR UNPAID LOSS ADJUSTMENT EXPENSES**
None of the liabilities for unpaid losses or unpaid loss adjustment expenses are discounted.

**32. ASBESTOS/ENVIRONMENTAL RESERVES**
Not Applicable

**33. SUBSCRIBER SAVINGS ACCOUNTS**
Not Applicable

**34. MUTIPLE PERIL CROP INSURANCE**
Not Applicable

## NOTES TO FINANCIAL STATEMENTS

EXHIBIT A4

| | | |
|---|---|---|
| AA-1128791 | Managing Agency Partners | $ 7,162,000 |
| AA-1128001 | Amlin syndicate | 3,305,000 |
| AA-1340125 | Hannover Re | 8,228,000 |
| AA-1128488 | ACE | 3,232,000 |
| 47-0698507 | Odyssey America Reins. Corp | 5,314,000 |
| 13-5616275 | Transatlantic Reins. Co. | 5,729,000 |
| | | |

All other – Not Applicable

**24. RETROSPECTIVELY RATED CONTRACTS & CONTRACTS SUBJECT TO REDETERMINATION**
Not applicable

**25. CHANGE IN INCURRED LOSSES AND LOSS ADJUSTMENT EXPENSES**
Incurred losses for prior years decreased by $7,473,035 in 2004 as a result of reestimation of unpaid losses and loss adjustments on the medical malpractice line. This increase is generally the result of ongoing analysis of development trends. Original estimates are increased or decreased, as additional information becomes known regarding individual claims.

**26. INTERCOMPANY POOLING ARRANGEMENTS**
None

**27. STRUCTURED SETTLEMENTS**
A. None
B. None

**28. HEALTH CARE RECEIVABLES**
Not Applicable

**29. PARTICIPATING POLICIES**
Not Applicable

**30. PREMIUM DEFICIENCY RESERVES**
None

**31. HIGH DEDUCTIBLES**
None

**32. DISCOUNTING OF LIABILITIES FOR UNPAID LOSSES OR UNPAID LOSS ADJUSTMENT EXPENSES**
None of the liabilities for unpaid losses or unpaid loss adjustment expenses are discounted.

**33. ASBESTOS/ENVIRONMENTAL RESERVES**
Not Applicable

**34. SUBSCRIBER SAVINGS ACCOUNTS**
Not Applicable

**35. MUTIPLE PERIL CROP INSURANCE**
Not Applicable