

REPORT OF EXAMINATION
OF THE
MEDICAL INSURANCE EXCHANGE
OF CALIFORNIA
AS OF
DECEMBER 31, 2016

Filed May 16, 2018

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San Francisco, California
May 3, 2018

Honorable Dave Jones
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

MEDICAL INSURANCE EXCHANGE OF CALIFORNIA

(hereinafter also referred to as the Exchange) at its home office located at 6250 Claremont Avenue, Oakland, California 94618.

SCOPE OF EXAMINATION

We have performed our multi-state examination of the Exchange. The previous examination of the Exchange was as of December 31, 2012. This examination covered the period from January 1, 2013 through December 31, 2016.

The examination was conducted in accordance with the National Association of Insurance Commissioners *Financial Condition Examiners Handbook (Handbook)*. The Handbook requires the planning and performance of the examination to evaluate the Exchange's financial condition, assess corporate governance, identify current and prospective risks, and evaluate system controls and procedures used to mitigate those risks. An examination also includes identifying and evaluating significant risks that could cause an insurer's surplus to be materially misstated both currently and prospectively.

All accounts and activities of the Exchange were considered in accordance with the risk-focused examination process. This may include assessing significant estimates made

by management and evaluating management's compliance with Statutory Accounting Principles. The examination does not attest to the fair presentation of the financial statements included herein. If, during the course of the examination, an adjustment is identified, the impact of such adjustment will be documented separately following the Exchange's financial statements.

This examination report includes findings of fact and general information about the Exchange and its financial condition. There might be other items identified during the examination that, due to their nature (e.g., subjective conclusions, proprietary information, etc.), were not included within the examination report, but separately communicated to other regulators and/or the Exchange.

COMPANY HISTORY

The Exchange is a reciprocal insurance exchange that was formed in 1975. The Exchange was licensed and began writing business in California on July 11, 1975. The Exchange was organized under the sponsorship of six medical societies of Northern California with surplus deposits from policyholders totaling \$5.1 million. All surplus deposits had been returned to its policyholders since December 31, 1987.

As of December 31, 2016, the Exchange has two wholly-owned subsidiary, MIEC Investment Company, Inc. (MIECICI) and Medical Underwriters of California (MUC). The Exchange's investment in MIECICI and MUC is valued at \$9.4 million and is entirely non-admitted. MIECICI was formed in 1994; and in 1995, began providing "corporate capital" limited liability underwriting capacity to selected underwriting syndicates at Lloyd's of London (Lloyd's). Effective January 1, 2005, the Exchange's board voted to discontinue MIECICI's underwriting activities by selling its underwriting capacity rights at the Lloyd's auctions in September 2004.

On September 1, 2013, the Exchange purchased 100% of the outstanding capital stock of MUC, its Attorney-In-Fact, from the Alameda-Contra Costa Medical Association for

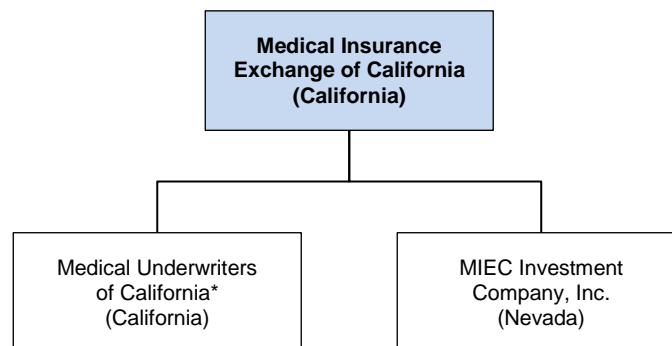
\$5.0 million. The California Department of Insurance (CDI) approved the transaction on August 2, 2013. As part of the transaction, the Exchange assumed sponsorship of a non-contributory defined benefit pension plan covering substantially all of MUC's employees. As of December 31, 2016, future obligations of the pension plan were valued at \$51.5 million, plan assets were valued at \$36.7 million, and the resulting underfunded pension liability carried was \$14.8 million.

As a reciprocal insurance exchange, the Exchange is owned by its policyholders. The Exchange has no employees and its affairs are administered by its Attorney-In-Fact, MUC, under an administrative services agreement.

On March 21, 2013, the Exchange's Board of Governors approved an amendment to its Rules and Regulations to allow for the removal of a Board member with cause by a simple majority or without cause by an eighty percent majority vote. The Exchange filed the amended Rules and Regulations with the CDI on April 16, 2013.

MANAGEMENT AND CONTROL

The Exchange is a member of an insurance holding company system. The following organizational chart depicts the relationship of the Exchange within the holding company system as of December 31, 2016 (all ownership is 100% unless otherwise indicated):



(*) Medical Underwriters of California is the attorney-in-fact for the Medical Insurance Exchange of California.

An eleven-member Board of Governors, who are elected for three year terms, oversees the business and affairs of the Exchange. Board terms are staggered among Board members; therefore, several board members are elected and/or re-elected annually. Each governor is a physician and a policyholder of the Exchange. There are no outside governors. As of December 31, 2016, the governors and principal officers were as follows:

Governors

| <u>Name and Location</u> | <u>Principal Business Affiliation</u> |
|---|---|
| Toni J. Brayer, MD Mill Valley, California | Physician Sutter Health |
| Ronald V. Dorn III, MD Boise, Idaho | Retired Physician |
| James O. Gemmer, MD Fairfield, California | Retired Physician |
| Scott A. Hoffinger, MD Moraga, California | Physician Stanford University School of Medicine |
| Robert J. Margolin, MD San Francisco, California | Self Employed Physician |
| Gary A. Okamoto, MD Honolulu, Hawaii | Physician AlohaCare |
| Lamont D. Paxton, MD San Leandro, California | Physician General Vascular Surgery Medical Group |
| Vinod K. Sawhney, MD San Leandro, California | Self Employed Physician |
| Cheryl A. Tanasovich, MD Greenbrae, California | Physician Greenbrae Dermatology |
| Steven R. Una, MD Castro Valley, California | Self Employed Physician |

Name and Location

Ann L. Vercoutere, MD
Greenbrae, California

Principal Business Affiliation

Physician
Veterans Administration

Principal Officers

| <u>Name</u> | <u>Title</u> |
|--------------------|--|
| Andrew F. J. Firth | President |
| Denis J. Dillon | Chief Financial Officer, Secretary and Treasurer |
| Anne M. Petrides | Vice President of Actuarial and Large Group Services |
| Janice M. Ginley | Vice President of Claims |
| Julie M. Nycum | Vice President of Underwriting |

Management Agreements

Administrative Services Agreement: Effective January 1, 2000, the Exchange entered into an Administrative Services Agreement (Agreement) with its attorney-in-fact, Medical Underwriters of California (MUC). Subject to supervision and direction by the Exchange's Board of Governors, MUC manages the daily operations of the Exchange and its subsidiaries on a cost reimbursement basis. MUC is responsible for the production, underwriting, reserving, and claims handling of insurance for the Exchange, as well as accounting, financial reporting, and providing adequate personnel and facilities to perform these services. The Agreement was last amended and approved by the California Department of Insurance (CDI) on September 22, 2010 pursuant to California Insurance Code (CIC) Section 1215.5(b)(4). It was noted that the Agreement was not appropriately disclosed in the Exchange's 2014, 2015, and 2016 Insurance Holding Company System Annual Registration Statement (Form B) pursuant to CIC Section 1215.4(b)(3). It is recommended that the Exchange appropriately disclose all management agreements in accordance with CIC Section 1215.4(b)(3). The total fees incurred by the Exchange in 2016 for services rendered under this Agreement were \$14,926,068.

Tax Allocation Agreement: The Exchange is party to a Tax Allocation Agreement (Agreement) dated May 26, 1996 with its subsidiaries, MIEC Investment Company, Inc. and MUC. The Agreement provides for the federal tax returns of the parties to be filed on a consolidated basis. Allocation is based on a separate company return basis with

current credit given to a company for net losses or tax credits to the extent losses and/or credits result in an actual reduction to the consolidated group's tax liability. The Agreement was last amended and approved by the CDI on March 5, 2014 pursuant to CIC Section 1215.5(b)(4). It was noted that the Agreement was not appropriately disclosed in the Exchange's 2014, 2015, and 2016 Form B, pursuant to CIC Section 1215.4(b)(3). It is recommended that the Exchange appropriately disclose all tax allocation agreements in accordance with CIC Section 1215.4(b)(3). The total taxes incurred by the Exchange in 2016 under this Agreement were \$23,620.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2016, the Exchange is licensed to transact liability insurance business in the states of Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington. Direct premiums written during 2016 totaled \$58.0 million. The majority of the business was written in California (44.5%) with the remaining 55.5% written in Alaska, Hawaii, Idaho, and Washington.

The Exchange generates its business from state, county, and specialty medical societies' sponsorship and trade journals, via direct solicitations and through the Exchange's website.

The Exchange specializes in underwriting medical professional liability and legal defense coverage for physicians, group practices, blood banks, acupuncturists, and clinics. Policies are written on a claims-made basis with a common renewal date of February 1st. No disability insurance has been written to date. Most policies written are issued on a claims-made basis at limits below \$5.0 million. However, the Exchange can issue policies with limits up to \$10.0 million that are subject to specific underwriting and reinsurance restrictions. "Tail" coverage is provided without additional premium in the event an individually insured physician dies, is permanently disabled, or retires from practice at age 55 or older and insured for at least five consecutive years. For cancellations or non-renewals, unlimited length "tail" coverage is contractually available

for additional premium.

The unearned premium reserves reported by the Exchange also include a reserve for death, disability, and retirement to fund future utilization of the free tail coverage.

All premiums are written through Medical Underwriters of California (MUC), the Exchange's Attorney-in-fact and exclusive managing general agent. MUC has the authority for binding, premium collection, claims adjustment, and claims payment. The Exchange retains underwriting authority for all policies issued under the Administrative Services Agreement.

REINSURANCE

Assumed

The Exchange has no current book of assumed business. The Exchange's assumed reinsurance is in runoff with the last treaty year effective 2013. Assumed amounts during the examination period were immaterial.

Ceded

The following chart summarizes the Exchange's principal ceded reinsurance program as of December 31, 2016:

| Line of Business and Type of Contract | Reinsurer's Name | Exchange's Retention | Reinsurer's Limit |
|--|--|--------------------------------------|--|
| <p>"Combined" Excess of Loss Covering:</p> <p>Per Risk - Policies up to \$5.0 million limit plus loss adjustment expenses,</p> <p>ECO/XPL - Loss in excess of policy limit, and</p> <p>Clash - More than one policy involved in one event.</p> | <p>Nine authorized reinsurers. Participation percentages vary by contract year.</p> | <p>\$2.0 million</p> | <p>\$4.0 million excess of \$2.0 million</p> |
| <p>Underlying Excess of Loss Covering:</p> <p>Ultimate Net Loss including LAE each and every loss and in the aggregate</p> | <p>Three authorized reinsurers. Participation percentages vary by contract year.</p> | <p>\$500 thousand</p> | <p>\$1.5 million excess of \$500 thousand</p> |
| <p>Catastrophe "Awards Made" Excess of Loss covering ECO/XPL</p> | <p>Eight authorized reinsurers. Participation percentages vary by contract year.</p> | <p>Section A: \$2.0 million</p> | <p>Section A: \$10.0 million excess of \$2.0 million</p> |
| | | <p>Section B: \$250 thousand</p> | <p>Section B: \$5.0 million excess of \$250 thousand</p> |
| <p><i>If a loss is recoverable under both sections of this contract, Section A will be deemed to respond.</i></p> | | | |

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2016

Underwriting and Investment Exhibit for the Year Ended December 31, 2016

Reconciliation of Surplus as Regards Policyholders from December 31, 2012
through December 31, 2016

Statement of Financial Condition
as of December 31, 2016

| <u>Assets</u> | <u>Ledger and Nonledger Assets</u> | <u>Assets Not Admitted</u> | <u>Net Admitted Assets</u> | <u>Notes</u> |
|--|--|--------------------------------|--------------------------------|--------------|
| Bonds | \$ 317,426,309 | \$ | \$ 317,426,309 | |
| Common stocks | 75,239,497 | 9,369,503 | 65,869,994 | |
| Real estate | 1,988,055 | | 1,988,055 | |
| Cash, cash equivalents and short-term investments | 7,276,035 | | 7,276,035 | |
| Investment income due and accrued | 1,967,802 | | 1,967,802 | |
| Premiums and agents' balances in course of collection | 169,949 | 63,506 | 106,443 | |
| Premiums, agents' balances and installments booked but deferred and not yet due | 3,118 | | 3,118 | |
| Funds held by or deposited with reinsured companies | 4,957 | | 4,957 | |
| Net deferred tax asset | 8,137,397 | 4,118,538 | 4,018,859 | |
| Guaranty funds receivable or on deposit | 12,663 | | 12,663 | |
| Aggregate write-ins for other than invested assets | <u>763,233</u> | <u>46,735</u> | <u>716,498</u> | |
| Total assets | <u>\$ 412,989,015</u> | <u>\$ 13,598,282</u> | <u>\$ 399,390,733</u> | |
| <u>Liabilities, Surplus and Other Funds</u> | | | | |
| Losses | | | \$ 87,386,980 | (1) |
| Loss adjustment expenses | | | 48,653,150 | (1) |
| Commissions payable, contingent commissions and other similar charges | | | 86,083 | |
| Other expenses | | | 817,938 | |
| Taxes, licenses and fees | | | 35,237 | |
| Current federal and foreign income tax | | | 983,343 | |
| Unearned premiums (including \$37,000,000 death, disability and retirement reserve) | | | 37,220,774 | (1) |
| Advance premiums | | | 7,730,767 | |
| Policyholders dividends declared and unpaid | | | 15,594,766 | |
| Ceded reinsurance premiums payable | | | 3,726,039 | |
| Amounts withheld or retained by company for account of others | | | 4,674,980 | |
| Payable to parent, subsidiaries and affiliates | | | 113,249 | |
| Aggregate write-ins for liabilities | | | <u>14,827,508</u> | |
| Total liabilities | | | 221,850,814 | |
| Unassigned funds (surplus) | | <u>\$ 177,539,919</u> | | |
| Surplus as regards policyholders | | | <u>177,539,919</u> | |
| Total liabilities, surplus and other funds | | | <u>\$ 399,390,733</u> | |

Underwriting and Investment Exhibit
for the Year Ended December 31, 2016

Statement of Income

Underwriting Income

| | | |
|--------------------------------------|------------------|-------------------|
| Premiums earned | | \$ 50,365,947 |
| Deductions: | | |
| Losses incurred | \$ 21,005,717 | |
| Loss adjustment expenses incurred | 20,820,838 | |
| Other underwriting expenses incurred | <u>8,874,614</u> | |
| Total underwriting deductions | | <u>50,701,169</u> |
| Net underwriting loss | | (335,222) |

Investment Income

| | | |
|------------------------------|------------------|------------|
| Net investment income earned | \$ 8,784,633 | |
| Net realized capital gain | <u>8,149,605</u> | |
| Net investment gain | | 16,934,238 |

Other Income

| | | |
|---|-------------------|---------------------|
| Net loss from agents' or premium balances charged off | \$ <u>(4,013)</u> | |
| Total other income | | <u>(4,013)</u> |
| Net income before dividends to policyholders, after capital gains tax and before federal and foreign income taxes | | 16,595,003 |
| Dividends to policyholders | | <u>12,000,000</u> |
| Net income after dividends to policyholders, after capital gains tax and before federal and foreign income taxes | | 4,595,003 |
| Federal and foreign income taxes incurred | | <u>(1,170,431)</u> |
| Net income | | <u>\$ 5,765,434</u> |

Capital and Surplus Account

| | | |
|---|---------------|-----------------------|
| Surplus as regards policyholders, December 31, 2015 | | \$ 173,676,018 |
| Net income | \$ 5,765,434 | |
| Change in net unrealized capital losses | (2,358,291) | |
| Change in net deferred income tax | (475,530) | |
| Change in nonadmitted assets | 847,822 | |
| Aggregate write-ins for gains in surplus | <u>84,466</u> | |
| Change in surplus as regards policyholders for the year | | <u>3,863,901</u> |
| Surplus as regards policyholders, December 31, 2016 | | <u>\$ 177,539,919</u> |

Reconciliation of Surplus as Regards Policyholders
from December 31, 2012 through December 31, 2016

| | | | |
|--|-----------------------------|----------------------------|-----------------------|
| Surplus as regards policyholders, December 31, 2012 | | | \$ 185,815,632 |
| | <u>Gain in Surplus</u> | <u>Loss in Surplus</u> | |
| Net income | \$ 11,227,978 | \$ | |
| Net unrealized capital losses | | 4,533,958 | |
| Change in net deferred income tax | 3,461,150 | | |
| Change in nonadmitted assets | | 12,182,393 | |
| Change in provision for reinsurance | 130,000 | | |
| Aggregate write-ins for gains and losses in surplus | <u> </u> | <u>6,378,490</u> | |
| Total gains and losses | <u>\$ 14,819,128</u> | <u>\$ 23,094,841</u> | |
| Net decrease in surplus as regards policyholders | | | <u>(8,275,713)</u> |
| Surplus as regards policyholders, December 31, 2016 | | | <u>\$ 177,539,919</u> |

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses, Loss Adjustment Expenses, and Unearned Premiums (Death, Disability and Retirement Reserve)

Based on an analysis by a Casualty Actuary from the California Department of Insurance, the Exchange's loss, loss adjustment expense, and unearned premiums (death, disability and retirement reserves) as of December 31, 2016 were found to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management Agreements (Page 6): It is recommended that the Exchange appropriately disclose all management and tax allocation agreements in accordance with California Insurance Code Section 1215.4(b)(3).

Previous Report of Examination

None.

ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Exchange's officers and employees during the course of this examination.

Respectfully submitted,

_____/S/_____

Allen Lau
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California

_____/S/_____

Kyo Chu, CFE
Senior Insurance Examiner, Supervisor
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