

STATE OF WASHINGTON  
OFFICE OF THE INSURANCE COMMISSIONER



FINANCIAL EXAMINATION  
OF  
PHYSICIANS INSURANCE A MUTUAL COMPANY  
SEATTLE, WASHINGTON

NAIC CODE 40738  
December 31, 2011

Order No. 13-159  
Physicians Insurance A Mutual Company  
Exhibit A

**SALUTATION**

Seattle, Washington  
April 1, 2013

The Honorable Mike Kreidler, Commissioner  
Washington State Office of the Insurance Commissioner (OIC)  
Insurance Building-Capitol Campus  
302 Sid Snyder Avenue SW, Suite 200  
Olympia, WA 98504

Dear Commissioner Kreidler:

In accordance with your instructions, and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

**Physicians Insurance A Mutual Company**

of

Seattle, Washington

hereinafter referred to as "PIAMC," or the "Company" at the location of its home office, 1301 Second Avenue, Suite 2700, Seattle, Washington 98101. This report is respectfully submitted showing the financial condition and related corporate matters of PIAMC as of December 31, 2011.

**CHIEF EXAMINER'S AFFIDAVIT**

I hereby certify I have read the attached Report of the Financial Examination of Physicians Insurance A Mutual Company of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 2011.



Patrick H. McNaughton  
Chief Examiner

5-9-13

Date

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## **SCOPE OF THE EXAMINATION**

This examination covers the period January 1, 2007 through December 31, 2011 and comprises a risk focused review of the books and records of the Company. The examination followed statutory requirements contained in the Washington Administrative Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination through the end of fieldwork on April 1, 2013.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following section of this report. In addition, the Company's Certified Public Accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

This examination was performed in compliance with the 2011 NAIC FCEH which requires the examiner to consider the Company's risk management process, corporate governance structure, and control environment. The examiners utilized the information obtained during the examination to assess the Company's overall potential risks both currently and on an on-going basis, to allow the examiners to focus on the Company's greatest areas of risk, and to provide assurance on the Company's financial statements as of the examination date.

## **INSTRUCTIONS**

The examiners reviewed the Company's filed 2011 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as outlined in the NAIC Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review:

### **1. Custodial Agreement**

PIAMC's custodial agreement with The Northern Trust Company did not contain several provisions which are required by RCW 48.13.480.

**The Company is instructed to execute a revised or amended custodial agreement that complies with RCW 48.13.480.**

### **2. Tax Allocation Agreement**

PIAMC is a party to the Tax Allocation Agreement, effective January 1, 1999, between PIAMC and all its subsidiaries at that time, including Northwest Dentists Insurance Company (NORDIC). However,

NORDIC should not be a party to the agreement since it was acquired by non-affiliated entities in 2007.

Also, Note No. 9 (F)(1) of the 2011 NAIC Annual Statement did not list Washington State Physicians Insurance Association, Inc., an inactive affiliate of PIAMC, as a party to the Tax Allocation Agreement.

**The Company is instructed to comply with RCW 48.05.250 and RCW 48.31B.025(2)(c) by amending the Tax Allocation Agreement, effective January 1, 1999, reflecting current participants.**

**Also, the Company is instructed to follow the NAIC Annual Statement Instructions and the AP&P, as required by WAC 284-07-050(2) by listing all Tax Allocation Agreement participants in Note No. 9 (F)(1) of the NAIC Annual Statement.**

### **3. Management and Service Agreement**

The Management and Service Agreement effective January 1, 2010 between PIAMC and a non-insurance company affiliate, Association Insurance Services, Inc. (AIS), was not filed on a Form D, Prior Notice of A Transaction, in accordance with RCW 48.31B.030(1)(b) and WAC 284-18-440.

The Management and Service Agreement between PIAMC and AIS was also not disclosed in PIAMC's most recent Form B, Insurance Holding Company System Annual Registration Statement, Item 5, in accordance with RCW 48.31B.025(2)(c)(v) and WAC 284-18-390.

**The Company is instructed to comply with RCW 48.31B.030(1)(b) by properly filing agreements subject to the Holding Company Regulation and with RCW 48.31B.025(2)(c)(v) and WAC 284-18-390 by reporting all intercompany agreements in the Company's annual registration statement, which includes the Management and Service Agreement between PIAMC and AIS.**

### **4. Reinsurance Intermediaries**

The Company did not annually obtain financial statements of its reinsurance intermediaries-brokers as required by RCW 48.94.025(3).

**The Company is instructed to comply with RCW 48.94.025(3) by annually obtaining a copy of statements of the financial condition of each reinsurance intermediary-broker with which it transacts business.**

## **COMMENTS AND RECOMMENDATIONS**

None

## COMPANY PROFILE

### **Company History**

The Company was incorporated and granted a certificate of authority by the OIC on December 22, 1981. The Washington State Medical Association sponsored the organization of the Company. PIAMC primarily provides comprehensive professional liability insurance to physicians.

### **Capitalization**

The Company was incorporated as a mutual insurance company owned by and operated in the interest of its members pursuant to Chapter 48.09 RCW. As a mutual insurer, there is no authorized or issued capital stock. RCW 48.09.100 requires a domestic mutual insurer to maintain surplus funds that represent the excess of its assets over its liabilities in an amount not less than stated in RCW 48.05.340 for the lines of business that it is authorized to transact. As of December 31, 2011, the Company exceeded the required capitalization requirements for the lines of business it transacts.

### **Territory and Plan of Operations**

The Company is authorized to transact multiple property and casualty lines of business in Alaska, California, Idaho, Montana, Oregon, Utah, Washington, and Wyoming. PIAMC also is authorized on a surplus lines basis in Arizona, Colorado, Hawaii, Nevada, and New Mexico. The Company specializes in writing medical malpractice insurance for physicians and surgeons. As of December 31, 2011, PIAMC insured 6,244 physicians.

### **Growth of Company**

The following reflects the Company's growth as reported in its filed NAIC Annual Statements for the five year period under examination:

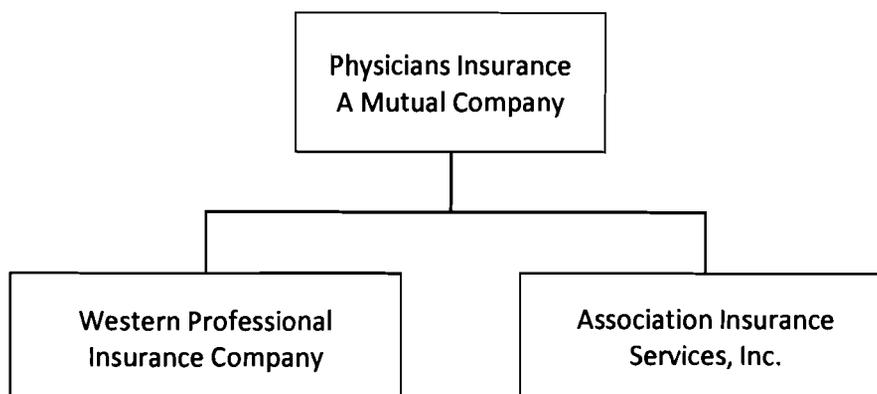
<u>Year</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital &amp; Surplus</u>		
2011	\$420,971,751	\$234,990,565	\$185,981,186		
2010	398,592,041	218,634,327	179,957,714		
2009	377,779,214	216,594,475	161,184,739		
2008	354,660,520	216,561,075	138,099,445		
2007	352,536,129	226,155,688	126,380,441		

<u>Year</u>	<u>Premium Earned</u>	<u>Net Underwriting Gain (Loss)</u>	<u>Net Investment Gain (Loss)</u>	<u>Net Income</u>
2011	\$70,370,781	\$ 1,000,069	\$14,460,800	\$8,429,262
2010	65,704,876	7,819,306	15,089,097	13,287,856
2009	70,577,910	12,861,716	14,162,229	16,534,159
2008	70,282,640	23,749,748	13,249,009	22,668,446
2007	78,287,526	26,856,622	18,936,404	33,514,290

## Affiliated Companies

The following abbreviated organization chart, taken from PIAMC's filed 2011 NAIC Annual Statement, shows the active affiliates:



## Intercompany Agreements

As of December 31, 2011, the Company had the following intercompany agreements:

- Tax Allocation Agreement, effective January 1, 1999. This agreement allows the filing of consolidated federal income tax returns for PIAMC, Western Professional Insurance Company (WPIC), AIS, PHYSIS Corporation, Washington State Physicians Insurance Association, Inc., and NORDIC. (See Instruction No. 2.)
- Management Agreement Including a Power of Attorney, dated June 23, 1998, and with Amendment Number 1 effective January 1, 2007, between WPIC and PIAMC.
- Management and Service Agreement between PIAMC and AIS, effective January 1, 2010. (See Instruction No. 3.)
- Quota Share Reinsurance Agreement, dated June 16, 1998, with Amendment Number 1 effective January 1, 2007, between WPIC and PIAMC.

## MANAGEMENT AND CONTROL

### Board of Directors (BOD)

Directors as of December 31, 2011:

James P. Campbell, MD	Chairman
David S. McClellan, MD	Vice Chairman
Thomas J. Curry	
Lloyd A. David	
John R. Huddleston, MD	
Chi-Dooh "Skip" Li, JD	
Grant E. McLaughlin, CPA	
Timothy L. Melhorn, MD	
Sheila Rege, MD	

Ralph A. Rossi, MD  
David A. Russian, MD  
Walter E. Skowronski  
Leslie A. Struxness, MD  
Brian P. Wicks, MD  
Josephine C. Young, MD

### **Officers**

Officers as of December 31, 2011:

Mary-Lou A. Misrahy	President and Chief Executive Officer
Rodney A. Pierson	Senior Vice President, Chief Financial Officer and Treasurer
Gary L. Morse	Senior Vice President, General Counsel and Secretary
Leslie I. Mallonee	Senior Vice President and Chief Information Officer
Richard L. Nauman	Senior Vice President, Underwriting
Alison L. Talbot	Senior Vice President, Human Resources and Administration
Terry B. Evans	Vice President, Information Technology
Eric M. Holm	Vice President, Claims
Claudette A. Kenmir	Vice President, Eastern Regional Office
Kristin L. Kenny	Vice President and Controller
Dennis R. Olson	Vice President, Risk Management

### **Conflict of Interest**

The Company requires the annual completion of a conflict of interest statement by officers, directors, and key employees. All are required to disclose to the corporate counsel relevant outside interests, memberships, associations, and affiliations. No exceptions were noted.

### **Fidelity Bond and Other Insurance**

The Company maintains financial institution bond coverage that meets the amount suggested by NAIC guidelines. Also, the Company is the named insured on corporate insurance coverages to cover risks in the normal course of business.

### **Officers', Employees', and Agents' Welfare and Pension Plans**

The Company has no defined benefit plan. All eligible employees are covered by a qualified 401(k) Retirement Investment Plan and Money Purchase Plan.

The Company has Management and Employee Annual Incentive Plans. Senior management, officers, and other key employees designated by the Compensation Committee are eligible to participate in the Management Annual Incentive Plan. All PIAMC employees are eligible to participate in the Employee Annual Incentive Plan.

## **CORPORATE RECORDS**

The Company's Articles of Incorporation, Bylaws, Certificates of Authority and meeting minutes of the BOD and its committees were reviewed for the period under examination. All BOD meetings were

conducted with a quorum present. Investment purchases, transfers, and disposals were ratified by the BOD and noted in the minutes.

The Company's Restated Bylaws were amended in 2011 to change the principal office location to its current address.

#### **UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES**

<b><u>Year</u></b>	<b><u>Losses</u></b>	<b><u>Loss Adjustment Expenses</u></b>
2011	\$137,731,080	\$58,975,630
2010	133,786,721	55,391,874
2009	125,688,051	60,309,168
2008	125,450,572	57,432,736
2007	128,815,341	61,092,450

As shown above, the reserves carried by the Company for unpaid losses and loss adjustment expenses were \$137,731,080 and \$58,975,630, respectively, as of December 31, 2011.

The OIC actuaries reviewed the unpaid losses and loss adjustment expenses for medical malpractice reserves, including other liability, of the Company and concluded that the reserves were within a range of reasonable estimates. The OIC actuaries also reviewed the stop-loss reserves and death, disability and retirement (DDR) reserves of the Company and concluded that these two reserves were reasonable. Therefore, the Company's reserves for losses and loss adjustment expenses, for stop-loss, and for DDR were accepted as reasonable and no adjustments were proposed to the amounts reported in the Company's 2011 NAIC Annual Statement.

#### **REINSURANCE**

The Company is a party to excess of loss and quota share reinsurance agreements with various retention amounts and limits. The Company is protected against a catastrophic loss for up to \$30 million.

The Company assumes all premiums and losses under an intercompany 100 percent quota share agreement with its affiliate, WPIC.

Reinsurance agreements were reviewed and found to be in compliance with Washington State reinsurance statutes. The reinsurers are properly classified in Schedule F of the 2011 NAIC Annual Statement. The Company has controls in place to monitor its reinsurance program including the financial condition of the reinsurers.

The Company's reinsurance arrangements are facilitated by two reinsurance intermediaries-brokers: BMS Group Ltd., and Guy Carpenter & Company, LLC. The Company's reinsurance intermediaries-brokers contracts are in compliance with provisions of RCW 48.94, Reinsurance Intermediary Act, except the Company did not annually obtain financial statements of its reinsurance intermediaries-brokers as required by RCW 48.94.025(3). (See Instruction No. 4.)

### **STATUTORY DEPOSITS**

The Company maintained the following statutory deposits as of December 31, 2011:

<u>State</u>	<u>Type</u>	<u>Book Value</u>	<u>Fair Value</u>
Washington	Bond	\$2,719,718	\$3,034,260

### **ACCOUNTING RECORDS AND INFORMATION SYSTEMS**

The Company maintains its accounting records on a Statutory Accounting Principles (SAP) basis and is audited annually by the certified public accounting firms of Deloitte & Touche LLP for years ended prior to December 31, 2010 and by Ernst & Young LLP subsequently. The Company received an unqualified opinion for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no significant weaknesses were noted.

The Company's Information Technology (IT) environment was reviewed during the planning and testing phase of the examination, focusing on the following Control Objectives for Information and related Technology (COBIT) Framework domains:

- Plan and Organize
- Acquire and Implement
- Deliver and Support
- Monitor and Evaluate

The IT system and controls were evaluated to gain an understanding of the IT general control risks and assess the effectiveness of these controls to determine if appropriate mitigating and internal controls have been implemented. Appropriate mitigating and internal controls have been implemented to reduce residual risk to appropriate levels. The Company has an effective Business Continuity Plan and Disaster Recovery Plan, which have been tested on a regular basis and includes the availability of an alternate site.

### **SUBSEQUENT EVENTS**

There were no material events impacting the Company between the examination date and the last day of our field work on April 1, 2013.

### **FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS**

All previous report instructions and recommendations were satisfactorily addressed.

## **FINANCIAL STATEMENTS**

The following financial statements show the financial condition of Physicians Insurance A Mutual Company as of December 31, 2011:

Assets, Liabilities, Surplus and Other Funds  
Statement of Income and Capital and Surplus Account  
Five Year Reconciliation of Surplus

**Physicians Insurance A Mutual Company**  
**Assets, Liabilities, Surplus and Other Funds**  
**December 31, 2011**

	<u>Balance Per Company</u>	<u>Examination Adjustments</u>	<u>Balance Per Examination</u>
<b>Assets</b>			
Bonds	\$344,754,513	\$0	\$344,754,513
Stocks:			
Common stocks	46,898,695		46,898,695
Cash and short-term investments	<u>17,833,493</u>		<u>17,833,493</u>
<b>Subtotals, cash and invested assets</b>	<b><u>409,486,701</u></b>	<b><u>0</u></b>	<b><u>409,486,701</u></b>
Investment income due and accrued	3,294,049		3,294,049
Premiums and considerations:			
Uncollected premiums and agents' balances in the course of collection	2,681,529		2,681,529
Accrued retrospective premiums	60,895		60,895
Amounts recoverable from reinsurers	1,110,011		1,110,011
Current federal and foreign income tax recoverable and interest thereon	1,241,206		1,241,206
Net deferred tax asset	2,628,192		2,628,192
Electronic data processing equipment and software	249,834		249,834
Receivables from parent, subsidiaries and affiliates	83,839		83,839
Aggregate write-ins for other than invested assets	<u>135,495</u>		<u>135,495</u>
<b>Total Assets</b>	<b><u>\$420,971,751</u></b>	<b><u>\$0</u></b>	<b><u>\$420,971,751</u></b>
<b>Liabilities, Surplus and Other Funds</b>			
Losses	\$137,731,080	\$0	\$137,731,080
Reinsurance payable on paid losses and loss adjustment expenses	22,690		22,690
Loss adjustment expenses	58,975,630		58,975,630
Other expenses	4,601,183		4,601,183
Taxes, licenses and fees	302,516		302,516
Unearned premiums	14,951,160		14,951,160
Advance premium	11,380,256		11,380,256
Ceded reinsurance premiums payable	6,585,256		6,585,256
Provision for reinsurance	250,779		250,779
Aggregate write-ins for liabilities	<u>190,015</u>		<u>190,015</u>
<b>Total Liabilities</b>	<b><u>234,990,565</u></b>	<b><u>0</u></b>	<b><u>234,990,565</u></b>
Unassigned funds (surplus)	<u>185,981,186</u>		<u>185,981,186</u>
<b>Surplus as regards policyholders</b>	<b><u>185,981,186</u></b>	<b><u>0</u></b>	<b><u>185,981,186</u></b>
<b>Total Liabilities, Surplus and Other Funds</b>	<b><u>\$420,971,751</u></b>	<b><u>\$0</u></b>	<b><u>\$420,971,751</u></b>

**Physicians Insurance A Mutual Company**  
**Statement of Income and Capital and Surplus Account**  
**For the Year Ended December 31, 2011**

	<u>Balance Per Company</u>	<u>Examination Adjustments</u>	<u>Balance Per Examination</u>
<b>Underwriting Income</b>			
Premiums earned	\$70,370,781	\$0	\$70,370,781
<b>Deductions</b>			
Losses incurred	29,698,266		29,698,266
Loss adjustment expenses incurred	28,466,208		28,466,208
Other underwriting expenses incurred	<u>11,206,238</u>		<u>11,206,238</u>
Total underwriting deductions	<u>69,370,712</u>	<u>0</u>	<u>69,370,712</u>
<b>Net underwriting gain or (loss)</b>	<b><u>1,000,069</u></b>	<b><u>0</u></b>	<b><u>1,000,069</u></b>
<b>Investment Income</b>			
Net investment income earned	13,338,762		13,338,762
Net realized capital gains or (losses)	<u>1,122,038</u>		<u>1,122,038</u>
<b>Net investment gain or (loss)</b>	<b><u>14,460,800</u></b>	<b><u>0</u></b>	<b><u>14,460,800</u></b>
<b>Other Income</b>			
Net gain or (loss) from agents' or premium balances charged off	1,629		1,629
Finance and service charges not included in premiums	485,080		485,080
Aggregate write-ins for miscellaneous income	<u>2,338</u>		<u>2,338</u>
<b>Total other income</b>	<b><u>489,047</u></b>	<b><u>0</u></b>	<b><u>489,047</u></b>
Net income, before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	15,949,916		15,949,916
Dividends to policyholders	<u>5,050,240</u>		<u>5,050,240</u>
<b>Net income</b>	<b><u>\$10,899,676</u></b>	<b><u>\$0</u></b>	<b><u>\$10,899,676</u></b>
Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	10,899,676		10,899,676
Federal and foreign income taxes incurred	<u>2,470,414</u>		<u>2,470,414</u>
<b>Net income</b>	<b><u>\$8,429,262</u></b>	<b><u>\$0</u></b>	<b><u>\$8,429,262</u></b>
<b>Capital and Surplus Account</b>			
<b>Surplus as regards policyholders, December 31 prior year</b>	<b><u>\$179,957,714</u></b>	<b><u>\$0</u></b>	<b><u>\$179,957,714</u></b>
<b>Gains and (losses) in surplus</b>			
Net income	8,429,262		8,429,262
Change in net unrealized capital gains or (losses)	(609,947)		(609,947)
Change in net deferred income tax	513,245		513,245
Change in nonadmitted assets	(2,058,309)		(2,058,309)
Change in provision for reinsurance	<u>(250,779)</u>		<u>(250,779)</u>
<b>Change in surplus as regards policyholders for the year</b>	<b><u>6,023,472</u></b>	<b><u>0</u></b>	<b><u>6,023,472</u></b>
<b>Surplus as regards policyholders, December 31 current year</b>	<b><u>\$185,981,186</u></b>	<b><u>\$0</u></b>	<b><u>\$185,981,186</u></b>

**Physicians Insurance A Mutual Company**  
**Five Year Reconciliation of Surplus**  
**For the Years Ended December 31,**

	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Capital and Surplus, December 31, prior year	<u>\$179,957,714</u>	<u>\$161,184,739</u>	<u>\$138,099,445</u>	<u>\$126,380,441</u>	<u>\$98,055,664</u>
Net income or (loss)	8,429,262	13,287,856	16,534,159	22,668,446	33,514,290
Change in net unrealized capital gains or (losses)	(609,947)	3,432,776	3,722,223	(6,929,263)	(4,494,654)
Changes in net deferred income tax	513,245	120,535	(930,763)	670,499	637,197
Change in nonadmitted assets	(2,058,309)	1,907,033	3,777,675	(4,744,522)	(1,424,437)
Change in provision for reinsurance	(250,779)	24,775	(18,000)	53,844	92,381
Change in surplus as regards policyholders for the	<u>6,023,472</u>	<u>18,772,975</u>	<u>23,085,294</u>	<u>11,719,004</u>	<u>28,324,777</u>
Capital and Surplus, December 31, current year	<u>\$185,981,186</u>	<u>\$179,957,714</u>	<u>\$161,184,739</u>	<u>\$138,099,445</u>	<u>\$126,380,441</u>

## **NOTES TO THE FINANCIAL STATEMENTS**

### **Special Consent**

The Company holds a special consent, issued by the state of Washington, with an effective date of January 1, 2011, and subsequently renewed effective January 1, 2012, that allows the Company to own and purchase mutual funds if certain statutory requirements have been met. PIAMC is allowed to acquire and hold a single entity's NAIC non-exempt listed mutual funds totaling not more than four percent of PIAMC's admitted assets. As of December 31, 2011, PIAMC's mutual fund investments represented 10.47 percent of its admitted assets. Three of PIAMC's mutual fund investments exceeded the one percent of assets limitation that would have been imposed by RCW 48.13.240(3) without the special consent.

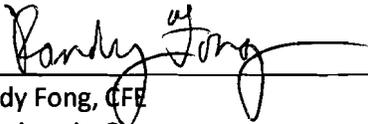
The Company has no additional special consents, permitted practices, or orders from the state of Washington.

**ACKNOWLEDGMENT**

Acknowledgment is hereby made of the cooperation extended to the examiners by the officers and employees of Physicians Insurance A Mutual Company and its affiliates during the course of this examination.

In addition to the undersigned, Michael V. Jordan, CPA, CFE, MHP, Assistant Chief Examiner; John Jacobson, AFE, CISA, AES, Automated Examination Specialist; Susan Campbell, CPA, FLMI, CFE, Reinsurance Specialist; D. Lee Barclay, FCAS, MAAA, Senior Actuary; Timothy F. Hays, CPA, JD, Investment Specialist; Eric Slavich, ACAS, MAAA, Actuary; Tarik Subbagh, MSBA, CPA, CFE, Property and Casualty Field Supervising Examiner; Edsel R. Dino, AFE, Financial Examiner; and James R. Gill, CPA, MBA, Financial Examiner; all from the Washington State Office of the Insurance Commissioner, participated in the examination and in the preparation of this report.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Randy Fong", is written over a horizontal line. The signature is cursive and extends to the right of the line.

Randy Fong, CFE  
Examiner-in-Charge  
State of Washington

