



Texas Medical Liability Trust and Subsidiary

CONSOLIDATED FINANCIAL STATEMENTS

Years Ended December 31, 2001 and 2000

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Board of Directors
Texas Medical Liability Trust and Subsidiary

Independent Auditor's Report

We have audited the accompanying consolidated balance sheet of Texas Medical Liability Trust and subsidiary as of December 31, 2001, and the related consolidated statements of operations, changes in policyholders' surplus and cash flows for the year then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Texas Medical Liability Trust and subsidiary as of December 31, 2000, were audited by other auditors whose report dated March 28, 2001, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2001 financial statements referred to above present fairly, in all material respects, the consolidated financial position of Texas Medical Liability Trust and Subsidiary at December 31, 2001 and the consolidated results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Cathoun & Co., LLP

Certified Public Accountants
November 8, 2002



Texas Medical
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**AUDITED
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Year Ended
December 31, 2001

CONSOLIDATED FINANCIAL STATEMENTS

	December 31,	
	2001	2000
	(In Thousands)	
Assets		
Securities, Available-for-Sale, at Fair Value:		
Fixed-Maturity Securities	\$ 181,580	\$ 184,444
Common Stocks	19,414	21,482
Cash and Cash Equivalents	11,961	12,472
Premiums Receivable	43,436	32,501
Accrued Interest Receivable	2,305	2,505
Reinsurance Recoverables:		
On Paid Losses	4,890	2,864
On Unpaid Losses and Loss Adjustment Expenses	40,742	26,202
Prepaid Reinsurance Premiums	8,726	5,935
Deferred Tax Asset	10,619	10,294
Cash Surrender Value of Key Man Life Insurance	2,588	2,588
Other	7,644	6,244
	<hr/>	<hr/>
Total Assets	\$ 333,905	\$ 307,531

LIABILITIES AND POLICYHOLDERS' SURPLUS

Liabilities

Reserves:		
Unpaid Losses and Loss Adjustment Expenses	\$ 217,675	\$ 170,510
Unearned Premiums	62,837	48,211
	<hr/>	<hr/>
	280,512	218,721
Revolving Line of Credit	10,500	-
Premiums received in advance	3,953	2,934
Accounts Payable and Accrued Expenses	5,034	5,296
Reinsurance Premiums Payable	11,000	14,921
	<hr/>	<hr/>
Total Liabilities	310,999	241,872
Policyholders' Surplus		
Contributed Surplus	11,221	10,538
Surplus Contributes Receivable	(488)	1
	<hr/>	<hr/>
	10,733	10,539
Accumulated Other Comprehensive Loss	(985)	(353)
Unassigned surplus	13,158	55,473
	<hr/>	<hr/>
Total Policyholders' Surplus	22,906	65,659
	<hr/>	<hr/>
Total Liabilities and Policyholders' Surplus	\$ 333,905	\$ 307,531

See notes to consolidated financial statements



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CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,	
	2001	2000
	(In Thousands)	
Premiums Earned, Net of Reinsurance	\$ 98,876	\$ 77,327
Investment Income, Net of Investment Expenses of \$299 in 2001 and \$392 in 2000.	12,762	13,461
Net Realized Gains (Losses) on securities available for sale	(2,292)	1,528
Other Revenue	1,980	1,513
Total Revenues	<u>111,326</u>	<u>93,829</u>
Losses and Expenses:		
Losses and Loss Adjustment Expenses	137,235	89,081
Other Underwriting Expenses	16,406	15,030
Total Operating Expenses	<u>153,641</u>	<u>104,111</u>
Loss Before Income Taxes	(42,315)	(10,282)
Income Tax Expense (Benefit)	–	(2,883)
Net Loss	<u>\$ (42,315)</u>	<u>\$ (7,399)</u>

See notes to consolidated financial statements



Texas Medical
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CONSOLIDATED STATEMENTS OF CHANGES IN POLICYHOLDERS' SURPLUS

(In Thousands)

	Contributed Surplus	Unassigned Surplus	Accumulated Other Comprehensive Income (Loss)	Total Policyholders' Surplus	Comprehensive Income
Balances at January 1, 2000	\$ 10,518	\$ 62,872	\$ (104)	\$ 73,286	\$ -
Other Comprehensive Income	-	-	(249)	(249)	(249)
Net Loss	-	(7,399)	-	(7,399)	(7,399)
Contributed Surplus, Net	21	-	-	21	-
Balances at December 31, 2000	10,539	55,473	(353)	65,659	<u>\$ (7,648)</u>
Other Comprehensive Income	-	-	(632)	(632)	(632)
Net Loss	-	(42,315)	-	(42,315)	(42,315)
Contributed Surplus, Net	194	-	-	194	-
Balances at December 31, 2001	<u>\$ 10,733</u>	<u>\$ 13,158</u>	<u>\$ (985)</u>	<u>\$ 22,906</u>	<u>\$ (42,947)</u>

See notes to consolidated financial statements



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CONSOLIDATED STATEMENTS OF CASH FLOW

	Year Ended December 31,	
	2001	2000
	(In Thousands)	
Operating Activities:		
Net Loss	\$ (42,315)	\$ (7,399)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	487	511
Net (accretion) amortization on securities	(198)	(150)
Deferred Income Taxes	(325)	(3,244)
Net Realized Gains	2,292	(1,528)
Change in Operating Assets and Liabilities:		
Premiums Receivable	(10,935)	(7,582)
Reinsurance Recoverables	(16,566)	792
Reserves	47,165	(1,782)
Reinsurance Premium Balances	(3,921)	(945)
Refundable Income Taxes	-	2,750
Other	11,509	9,606
Net Cash used in Operating Activities	(12,807)	(8,971)
Investing Activities:		
Purchases of securities	(50,139)	(51,938)
Proceeds from Disposals and Maturities of Securities	52,019	63,223
Purchases of Furniture and Equipment	(278)	(292)
Increase in Key Man Life Insurance	-	1,786
Net Cash Provided by Investing Activities	1,602	12,779
Financing Activity:		
Net borrowings under line of credit	10,500	-
Net Surplus Contributions	194	21
Cash Provided by Financing Activity	10,694	21
Change in Cash and Cash Equivalents	(511)	3,829
Cash and Cash Equivalents at Beginning of Year	12,472	8,643
Cash and Cash Equivalents at End of Year	\$ 11,961	\$ 12,472

See notes to consolidated financial statements



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Year Ended December 31, 2001

(Amounts in Thousands)

A. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Texas Medical Liability Trust (Trust) was formed in June 1978 to provide professional liability and office premises liability insurance coverage to eligible physicians who are members of the Texas Medical Association and who practice primarily in Texas. The Trust was organized under Article 21.49 – 4 of the Texas Insurance Code under the name “Texas Medical Association Health Care Liability Claim Trust” and began operations in 1979.

The Trust provides professional liability coverage to the ancillary staff of the Trust’s policyholders through its wholly-owned subsidiary, Texas Medical Insurance Company (TMIC), which was formed in 1995 as a state-regulated property/casualty insurance company.

Basis of Presentation

The consolidated financial statements include the accounts of the Trust and TMIC after elimination of all significant intercompany accounts.

The preparation of financial statements requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known which could impact the amounts reported and disclosed herein.

Premiums

Policies written are generally for a one-year term and premiums are recorded as earned on a pro rata basis over the life of the policy. Policies are written on both an occurrence and claims-made basis. Unearned premiums represent the portion of premiums written which are applicable to the unexpired terms of the policies in force.

Billings for calendar year premiums are rendered in advance of the premium year. Also, surplus deposits are received from physicians applying for coverage in advance of approval of their applications. Premiums and deposits collected in advance of the period covered are classified as premiums received in advance.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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A. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES – Continued

Unpaid Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses represent the estimated liability for claims reported through year end (case-basis) plus the estimated losses and loss adjustment expenses relating to incidents incurred but not yet reported. These amounts have been estimated by management and the Company's consulting actuaries based on available industry data and the Trust's actual experience and represent estimates of the ultimate cost of all losses incurred, but unpaid, through year end. However, the ultimate cost of settling claims may vary significantly from the estimated liability. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in current operations and are accounted for as changes in estimates.

Unpaid losses and loss adjustment expenses have been discounted using a 4% factor. The discount amount was approximately \$14,000 and \$10,000 at December 31, 2001 and 2000 respectively.

The Trust considers anticipated investment income in determining whether a premium deficiency exists on the unexpired terms of the policies in force. No such deficiency exists as of December 31, 2001.

Reinsurance

Amounts recoverable from reinsurers for unpaid losses and loss adjustment expenses and the amounts payable to reinsurers for reinsurance premiums are estimated in a manner consistent with the related liabilities associated with the reinsured policies. Consistent with the estimate of the unpaid loss and loss adjustment expenses, the reinsurance balances are discounted at a rate of 4%. The effect of this discounting decreased a portion of ceded premiums by approximately \$24 and \$292 at December 31, 2001 and 2000 respectively. Adjustments to the provisional reinsurance premiums are provided for in the ceded premiums.

Amounts paid to reinsurers under prospective, short-duration reinsurance contracts are recorded as prepaid reinsurance premiums which are recognized as the related premiums are earned.

Investments

Investments are categorized as available-for-sale. Accordingly, the investment portfolio is carried at fair value. Unrealized holding gains and losses on securities are reported in accumulated other comprehensive income (loss) net of income taxes and are classified as a separate component of policyholders' surplus.



Texas Medical
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Year Ended December 31, 2001

(Amounts in Thousands)

A. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES – Continued

Investments – Continued

The cost of fixed-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity, or in the case of loan-backed securities, over the estimated life of the security. Such amortization and interest earned are included in investment income. Realized gains and losses are included in net realized gains on investments. The cost of securities sold is based on the specific identification method.

Income Taxes

The Trust uses the liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Acquisition Costs

Acquisition costs are expensed as they are incurred; the financial statement effect of this method does not differ significantly from the effect of using the deferral method.

Cash Equivalents

Money market funds and commercial paper with initial maturities of less than three months are considered to be cash equivalents.

Disclosures about Fair Value of Financial Instruments

The fair value of financial instruments, as defined by generally accepted accounting principles, approximates the recorded book value of such instruments.

Accounting Changes

During 2001, the Trust and TMIC changed their method for recording investment transactions from the settlement date to the trade date. The cumulative effect of changes in accounting principles should be reported as an adjustment to unassigned surplus in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date, if the new accounting principle had been applied retroactively for all prior periods. This cumulative effect as of January 1, 2001, has no material effect on the financial statements.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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B. COMPREHENSIVE INCOME

In accordance with SFAS 130, *Reporting Comprehensive Income*, the Trust presents comprehensive income (loss) within the consolidated statements of changes in policyholders' surplus.

Components of other comprehensive income (loss) consist of the following:

	Year Ended December 31,	
	2001	2000
Unrealized losses on available-for-sale securities	\$ (957)	\$ (3,365)
Reclassification adjustment for realized net gains (losses) in net income	-	2,919
Income tax benefit	325	197
Other comprehensive loss	<u>\$ (632)</u>	<u>\$ (249)</u>

Accumulated other comprehensive income shown on the consolidated statements of changes in policyholders' surplus is solely comprised of unrealized gains (losses) from available-for-sale securities, net of tax of \$325 and \$(182) for the years ended December 31, 2001 and 2000, respectively.

C. SECURITIES

The amortized cost and fair value of the Trust's investments in fixed-maturity securities are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
At December 31, 2001:				
U.S. government and its agencies	\$ 11,281	\$ 478	\$ 23	\$ 11,736
Corporations	80,588	2,691	2,162	81,117
Loan-backed securities and collateralized mortgage obligations	86,858	2,219	350	88,727
	<u>\$ 178,727</u>	<u>\$ 5,388</u>	<u>\$ 2,535</u>	<u>\$ 181,580</u>
At December 31, 2000:				
U.S. government and its agencies	\$ 11,487	\$ 268	\$ 156	\$ 11,598
Corporations	88,270	1,082	1,053	88,299
Loan-backed securities and collateralized mortgage obligations	84,007	997	458	84,547
	<u>\$ 183,764</u>	<u>\$ 2,347</u>	<u>\$ 1,667</u>	<u>\$ 184,444</u>



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Texas Medical Liability Trust and Subsidiary

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C. SECURITIES – Continued

At December 31, the Trust’s investment in common stocks had a cost basis of \$23,759 and \$22,813 in 2001 and 2000, respectively. Gross unrealized gains and gross unrealized losses were \$756 and \$5,101 respectively in 2001 and, \$2,323 and \$3,537 respectively in 2000.

The fair values generally represent quoted market value prices for securities traded in the public marketplace or analytically determined valued using bid or closing prices for securities not traded in the public marketplace.

The amortized cost and estimated fair value of the fixed-maturity securities at December 31, 2001 are summarized, by stated maturity as follows:

	Amortized Cost	Estimated Fair Value
Years to maturity:		
One or less	\$ 6,699	\$6,916
After one through five	40,021	41,878
After five through ten	33,059	33,444
Loan-backed securities and collateralized mortgage obligations and other	98,948	99,342
Total	<u>\$ 178,727</u>	<u>\$ 181,580</u>

Actual maturities may differ from the contractual maturities in the foregoing table because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

Proceeds from the sales of available-for-sale securities were \$43,442 in 2001 and \$51,021 in 2000. Gross realized gains and gross realized losses on these sales were \$529 and \$2,869 respectively, during 2001, and \$5,221 and \$3,693, respectively, during 2000.

D. UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

The following table provides a reconciliation of the beginning and ending reserve balances for unpaid losses and loss adjustment expenses (LAE), net of reinsurance recoverables, for 2001 and 2000.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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Year Ended December 31, 2001

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D. UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES – Continued

	Year Ended December 31,	
	2001	2000
Reserve for unpaid losses and LAE, net of related reinsurance recoverables at beginning of year	\$ 144,308	\$ 146,324
Add provision for claims, net of reinsurance, occurring in:		
Current year	104,803	79,645
Prior years	32,432	9,436
Incurred losses during the current year, net of reinsurance	137,235	89,081
Deduct payments for claims, net of reinsurance, occurring in:		
Current year	202	745
Prior years	104,099	90,352
	104,301	91,097
Reserve for losses and LAE, net of related reinsurance recoverables, at end of year	177,242	144,308
Reinsurance recoverables on unpaid losses and LAE, at end of year	40,433	26,202
Reserve for unpaid losses and LAE, gross of reinsurance recoverables on unpaid losses, at end of year.	\$ 217,675	\$ 170,510

The foregoing reconciliation shows that the Trust's reserve for unpaid losses and LAE, net of related reinsurance recoverable, at December 31, 2001 and 2000, was increased by \$32,432 and \$9,436 for claims that had occurred on or prior to 2000 and 1999, respectively. During 2001, the Trust increased reserves due to higher than anticipated loss severity and frequency, which resulted in higher reserves for both current year and prior year reported claims. This change in management's estimate of claims resulted from plaintiff's attorney's response to recent changes in the procedure for filing lawsuits and the time period allowed for discovery in Texas. During 2000, the \$9,436 additional provision for claims occurring in prior years, is partially a continuation of the 1999 claim trends, and also reflects the inherent uncertainties in estimating medical malpractice reserves for unpaid losses and LAE.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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D. UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES – Continued

Medical malpractice claims have a very long development period. Historically, cases have taken years to be reported and, as a rule, take years to adjust, settle or litigate. With respect to the Trust’s estimates of reserves for unpaid losses and LAE, there is additional uncertainty related to the strength of case reserves and the effect of changes in the reinsurance of allocated loss adjustment expense (ALAE). Accordingly, should management’s assumptions as to case reserve redundancies or reinsurance recoverables differ from the actual closure of claims, reserves are likely to develop adversely. Loss and loss adjustment reserve estimates are reviewed regularly and adjusted, as appropriate.

E. REINSURANCE

The trust cedes certain risks to various reinsurers. These reinsurance arrangements allow management to control exposure to potential losses arising from large risks and provide additional capacity for growth. A significant portion of the reinsurance is effected under quota-share reinsurance contracts and, in some cases, stop-loss coverage.

Ceded premiums are charged to operations as a deduction from premiums written. The effects of reinsurance on premiums written and earned are as follows:

	2001 Premiums		2000 Premiums	
	Written	Earned	Written	Earned
Direct	\$ 130,380	\$ 115,753	\$ 101,051	\$ 91,233
Ceded	19,668	16,877	13,930	13,906
Net Premiums	<u>\$ 110,712</u>	<u>\$ 98,876</u>	<u>\$ 87,121</u>	<u>\$ 77,327</u>

The amounts deducted from losses and loss adjustment expenses in the income statements that relate to reinsurance were \$27,623 for 2001 and \$13,871 for 2000.

Reinsurance ceded contracts do not relieve the Trust from its obligations to policyholders. The Trust remains liable to its policyholders for the portion reinsured to the extent that any reinsurer does not meet the obligations assumed under the reinsurance agreements. To minimize its exposure to significant losses from reinsurer insolvencies, the Trust evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities or economic characteristics of the reinsurers.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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F. FEDERAL INCOME TAXES

Significant components of the provision for income tax expense (benefit) for the year ended December 31 were as follows:

	<u>2001</u>	<u>2000</u>
Current expense (benefit)	\$ -	\$ (17)
Deferred expense (benefit)	-	(2,866)
	<u>\$ -</u>	<u>\$ (2,883)</u>

No income tax refunds were received or taxes paid in 2001. The Trust received income tax refunds of \$2,795 during 2000.

Significant components of the Trust's deferred tax assets and liabilities were as follows as of December 31:

	<u>2001</u>	<u>2000</u>
Deferred Tax Assets:		
Loss Reserve Discounting	\$ 4,779	\$ 3,564
Unearned Premium Discounting	4,273	2,947
Net Operating Losses	16,662	6,983
Other	783	678
Total Deferred Tax Assets	26,497	14,172
Valuation Allowance for Deferred Tax Assets	(15,378)	(3,495)
Total Deferred Tax Assets, Net of Allowance	11,119	10,677
Deferred Tax Liabilities:		
Other	(500)	(383)
Total Deferred Tax Liabilities	(500)	(383)
Net Deferred Tax Asset	<u>\$ 10,619</u>	<u>\$ 10,294</u>

Under provisions of FASB Statement No. 109, the Trust is required to record a valuation allowance on a deferred tax asset, if it is more likely than not that the benefit will not be realized. At December 31, 2001, the Trust established a \$15,378 valuation allowance for the deferred tax asset, an \$11,883 increase from December 31, 2000. Management believes that it is more likely than not the net deferred tax asset recorded at December 31, 2001 will be realized from expected future taxable income.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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F. FEDERAL INCOME TAXES – Continued

At December 31, 2001, the Trust has taxable net operating loss carryforwards of \$49,000 which begins to expire in 2019 to offset against future federal taxable income.

The differences between the income tax benefit reported and the income tax benefit that would result from applying domestic federal statutory rates to pretax income in 2001 and 2000 resulted primarily from the effects of tax-exempt interest and changes in the valuation allowance.

G REVOLVING – LINE OF CREDIT

In January, 2001, the Trust entered into an agreement with a commercial lender which provides the Trust with a revolving credit facility of \$15,000 (\$10,500 outstanding at December 31, 2001 and no outstanding balance at December 31, 2000). The funds are available under the credit agreement may be used for general corporate purposes. The revolving credit facility expires on January 17, 2002. Under the revolving credit facility, the Trust granted liens with respect to equity interests in certain fixed maturity investments owned by the Trust.

Interest on borrowings under the credit agreement are determined, at the Company's option, based on the prime rate minus 2.35% or the LIBOR rate plus a margin of 0.7%. There is a commitment fee of .08% on the unused balance. At December 31, 2001 the prime rate was 4.75%.

Subsequent to year end, the line of credit was renewed for an additional year at substantially the same terms.

H. POLICYHOLDERS' SURPLUS

Eligible physicians desiring to purchase insurance through the Trust are required to purchase a Surplus Deposit Certificate. The Surplus Deposit Certificates are offered solely to provide surplus for the Trust and do not bear interest.



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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(Amounts in Thousands)

I. COMMITMENTS AND CONTINGENCIES

The Trust leases office facilities and certain equipment through agreements which expire through 2004. As of December 31, 2001, the future minimum lease payments under these agreements for the years ending December 31 are as follows:

2002	\$ 747
2003	747
2004	652
2005	-
Thereafter	-
Total	\$ 2,146

Total rent expense was \$1,222 for 2001 and \$1,208 for 2000.

The Trust is named as a defendant in various legal actions principally from claims made under insurance policies. Those actions are considered by the Trust in estimating the loss and loss adjustment expense reserves. The Trust's management believes that the resolution of those actions will not have a material adverse effect on the Trust's financial position or results of operations.

J. EMPLOYEE BENEFIT PLAN

The Trust sponsors a non-contributory, defined contribution employee benefit plan, which covers all employees who have completed one year of service. The Trust makes contributions to the Plan equal to 10% of participant's salaries. Such contributions are reduced by forfeitures of participants who leave the Plan before they become fully vested. Plan expense was \$1,161 for 2001 and \$980 for 2000.