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April 19, 2016

Mr. Alan Seeley, FCAS  
Chief Actuary  
New Mexico Office of Superintendent of Insurance  
PERA Building, 4<sup>th</sup> Floor  
1120 Paseo de Peralta  
Santa Fe. NM 87501

Re: 2015 Actuarial Analysis of the New Mexico Patient's Compensation Fund

Alan,

Enclosed are copies of our report analyzing a variety of issues related to the New Mexico Patient's Compensation Fund (PCF) as of December 31, 2015. This includes a review of the indicated unpaid claims liabilities, prospective surcharges, and the impact of potential coverage changes, as well as an industry class plan comparison.

Please give me a call at your earliest convenience so that we can discuss this report. We have enjoyed working with you on this assignment and look forward to presenting the results in Albuquerque.

Sincerely,

A handwritten signature in black ink that reads "Robert J. Walling III". The signature is written in a cursive, flowing style.

Robert J. Walling III, FCAS, MAAA  
Principal and Consulting Actuary

**2015 Actuarial Analysis of the  
New Mexico Patients Compensation Fund**

April 2016



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*Commitment Beyond Numbers*

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## Exhibits

# 2015 Actuarial Analysis of the New Mexico Patients Compensation Fund

## *Executive Summary*<sup>1</sup>

The New Mexico Patients Compensation Fund (PCF) serves a vital role in supporting the overall health of the medical professional liability insurance (MPLI) system in New Mexico. The PCF provides excess coverage that stabilizes the operating results of participating insurers and encourages competition which leads to greater availability and affordability of coverage. In New Mexico and other states, a competitive MPLI market tends to attract new physicians leading to greater access to care. The coverage provided by the PCF requires the use of an occurrence coverage form, preferred by healthcare providers, with limits that provide comprehensive coverage to ensure that injured patients receive appropriate compensation for their injuries. As a result, all stakeholders in the New Mexico healthcare system benefit in some way from a healthy PCF.

One way that the New Mexico Office of Superintendent of Insurance (OSI) ensures the ongoing health of the PCF is to conduct its mandatory biennial actuarial review. This review examines several aspects of the PCF including analyses of indicated reserves for unpaid losses, appropriate assessment surcharges for upcoming policy periods, the impact of potential legislative changes and an examination of the competitive landscape for MPLI in New Mexico and surrounding states.

Through a review of a number of both publicly available and proprietary data sources, Pinnacle has come to a number of key conclusions regarding a number of aspects of the PCF. The highlights of our findings regarding the various issues include:

### **Unpaid Claims Liabilities**

- Pinnacle estimates the amount of losses still to be paid for all claims occurring prior to December 31, 2015 to be approximately \$73.3 million on a nominal basis, \$66.4 million on a discounted basis using a 3.5% discount rate, and \$81.3 million when the discounted reserves reflect a risk margin to increase to the statistical confidence to 90%. These are all increases

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<sup>1</sup> Third parties receiving only this Executive Summary should recognize that the furnishing of this summary is not a substitute for their own due diligence and should place no reliance on this summary that would result in the creation of any duty or liability by Pinnacle to the third party. Pinnacle is available to answer any questions regarding the information contained in the Executive Summary.

from the values as of December 31, 2013 of \$61.8 million (nominal), \$56.4 million (discounted) and \$69.0 million (discounted at 90% confidence).

### **PCF Surplus/Deficit**

- The current PCF fund balance of approximately \$36.573 million as of December 31, 2015, when compared to Pinnacle's estimate of indicated nominal loss reserves of approximately \$73.339 million, suggests a Fund deficit position of \$36.766 million, or just over 100% of the current Fund balance.
- Reflecting reserves on a present value basis, using a 3.5% discount rate, results in a Fund deficit of approximately \$29.8 million.
- If discounted loss reserves are increased to the 90% confidence level, the resulting reserves indicate a \$44.7 million PCF surplus deficit.

### **Expected Surcharge Levels**

- Pinnacle's rate level indication suggests an increase of +18.1% on an expected value basis. If adjusted to a 90% level of statistical confidence an indicated increase of 46.8% results. Deterioration in loss ratios in more recent years and increased reported claims frequency would also support some form of increase in assessments.

### **Class Relativities/Experience Rating Plan**

- There is some evidence to suggest that a small number of classes could be considered for changes in class group assignment based on excess programs in Wisconsin, Indiana, and commercial MPLI carriers in NM. These recommendations should be provided to the Underwriting Committee for consideration.
- It would appear that the approach proposed by Pinnacle for hospital risks large enough to warrant an experience-rated large risk rating option appears to provide adequate regulatory controls that protect the overall solvency of the PCF as well as the interests of the healthcare providers currently insured by the PCF.

### **Impact of Potential Coverage Changes**

- If the damage cap were increased to \$1.0 million for non-medical damages and the coverage attachment point is unchanged, PCF layer losses are estimated to increase by between 8.9% and 14.9%. This is based on data from the states of Florida, Michigan, Texas and Virginia. This

model assumes no increase in expected medical professional claims frequency due to societal shifts resulting from the increased caps.

- Increasing the non-medical cap amount creates larger expected claims cost increases for the PCF, while introducing some assumption regarding increased frequency due to societal behaviors impacts both costs for primary insurers and the PCF.

## ***Background***

The PCF was established in 1976 to provide for the payment of claims in excess of a primary limit of \$100,000 per incident which was provided by private insurers. This resulted in the PCF providing coverage with a non-medical indemnity limit of \$400,000 per incident (to reach the state damage cap on non-medical damages), plus unlimited medical benefits. Effective July 1, 1991, the primary limit was increased to \$150,000 on new and renewal policies, thereby reducing the PCF's liability limit to \$350,000 non-medical indemnity, plus unlimited medical. The PCF's liability was further reduced to \$300,000 effective April 1, 1992 when the primary limit was increased to \$200,000. Most recently, an increase in the maximum non-medical indemnity amount to \$600,000 effective April 1, 1995 increased the PCF liability retention to \$400,000 non-medical indemnity, plus unlimited medical.

The unlimited medical feature of the New Mexico PCF presents significant risk for the PCF and additional variability in estimating the current liabilities and prospective rates. Since the detailed data available to estimate the unpaid claims liabilities and indicated surcharge levels only goes back to calendar year 2000, some adjustments are required to this data. These adjustments, as well as the methods and assumptions used to estimate indicated loss reserves and PCF surcharges are detailed later in the report and in the attached exhibits.

Pinnacle Actuarial Resources, Inc. (Pinnacle) has been retained by the New Mexico Office of Superintendent of Insurance (OSI) to conduct a comprehensive actuarial analysis of the New Mexico Patients Compensation Fund (PCF). This analysis will contain several components including evaluation of:

- the estimated ultimate liabilities for losses incurred by the New Mexico Patients Compensation Fund (PCF) as of December 31, 2015,
- recommend PCF assessment surcharges to fund the operations of the PCF for the effective dates of September 1, 2016 and 2017,
- proposed changes, if any, to the PCF class relativities and experience rating plan, and

- the potential impact on primary insurance costs and PCF surcharges of a variety of changes in both non-medical damage caps in the state and underlying coverage requirements for PCF coverage.

Pinnacle is an Illinois corporation that has been in property and casualty actuarial consulting since 1984. Our actuarial consultants make Pinnacle one of the largest property/casualty actuarial consulting firms in the U.S. We specialize in insurance pricing, loss reserving, alternative markets, legislative costing, market analysis and financial risk modeling.

Pinnacle has established a reputation as a provider of unbiased, independent, actuarially sound analyses and reports. This reputation is demonstrated in the variety of clients that have engaged us for projects similar to this one. Clients that have engaged Pinnacle in areas of medical professional liability including governmental insurance programs, legislative costing and market evaluation have included healthcare industry associations (e.g. American Medical Association, Oregon Medical Association, Medical Society of Virginia), insurance departments and governmental panels (e.g. Connecticut, Florida, Illinois, Indiana, Maine, Michigan, New York, Ohio, Oregon), and government insurance programs, (e.g. Florida Neurological Injury Compensation Association, New Mexico Patient Compensation Fund, New York Medical Indemnity Fund, Virginia Birth Related Neurological Injury Compensation Program, Wisconsin Patients Compensation Fund). Pinnacle may be unique in the breadth of parties involved in the medical professional liability insurance system that have engaged us.

### ***Data Sources***

Our analyses use a number of data sources. The data sources are categorized as follows:

1. PCF Financial Statement Data
2. Industry Rate Filings
3. Closed Claims Databases
4. PCF Claims Data

A brief description of the data sources utilized in each area along with a description of the key data elements and potential limitations of the data follows for each category.

### **PCF Financial Statement Data**

Unlike insurance companies who are required to provide extensive, detailed financial information annually that complies with a standardized format prescribed by the National Association of Insurance Commissioners (NAIC), most governmental insurance programs, such as the PCF, have much simpler financial reporting requirements.

Pinnacle was provided a single document, one page in length, related to and supporting the financial statements of the PCF. While its prior analyses monthly cash flows in and out of the PCF were provided dating back to 1996, including: surcharge collections, loss payments, interest earned, underwriting expenses and claims handling expenses; for this analysis we were provided only with calendar year 2014 and 2015 loss, expense and operating payments, surcharges as well as the total PCF funds. Calendar year 2014 information was valued as of December 31, 2014, while calendar year 2015 information was valued as of October 31, 2015, and no 2015 year surcharge value was available.

The material change in the type of data provided for analysis has an effect on the actuarial methods and assumptions used to project unpaid claim liabilities, making those projections subject to more uncertainty than if more detailed information were provided. Our findings may have been materially different had better loss data been available.

### **Industry Rate Filings**

Insurance company rate filings provide valuable insights into individual insurance company perceptions of prospective claim trends. Many of these filings include rigorous actuarial analyses of claim frequency, severity and pure premium trends. Due to data limitations, these trend analyses are often performed on countrywide data to increase statistical credibility. Pinnacle reviewed several publicly available filings for MPLI insurers and government insurance programs in New Mexico and other states to assess trends in the medical professional liability insurance (MPLI) marketplace and for MPLI excess insurance programs in particular. Pinnacle relied on this information without independent review or verification. However, given that information had been through regulatory scrutiny, we are comfortable that the information is appropriate for the limited role it plays in our analysis.

### **Closed Claims Databases**

A statewide closed claim database is a valuable data source available to legislators, policymakers and other stakeholders in the MPLI arena. Several states have created closed claim databases which are



used to effectively analyze medical professional liability claims trends, crisis conditions, costing proposed legislation and measuring the impact of proposed and recently implemented laws.

Many states, including Florida, Texas, Michigan, and Virginia have developed data reporting requirements based on the NAIC template from the mid-1970s. The data collected on closed medical professional liability claims includes information about the:

- health care provider (e.g. name, specialty, location county, zip code),
- injured patient (age, sex),
- claim incident (date, location, procedure, nature of complaint),
- claim process (report, lawsuit and settlement dates, attorney involvement, arbitration), and
- settlement values [paid indemnity (economic versus non-economic), loss adjustment expense, insurance limits].

For this study, Pinnacle compiled data from Florida, Michigan, Texas and Virginia into an electronic format. The data for each state was then tested for reasonableness and consistency and “scrubbed” to correct for typographical errors during data entry. Pinnacle’s analysis is then based on the modified databases. All data was trended to appropriate loss dates to reflect the impact of claims severity inflation. The use of these databases has enabled us to develop a range of estimated impacts of caps on non-medical damages at various levels which reflect some differing judicial systems and at the same time demonstrate a significant consistency in the estimated reductions in expected losses created by the caps. Ultimately, the Michigan data was not used as it had too few large losses for modeling the impacts under review.

The American Academy of Actuaries has provided guidance on the limitations of using closed claims databases. This guidance can be found at [www.actuary.org/pdf/casualty/medmal\\_042005.pdf](http://www.actuary.org/pdf/casualty/medmal_042005.pdf). Readers of this report are advised to be aware of these limitations. In spite of these cautions, closed claim databases such as those used in this analysis remain the most readily available source of large volumes of medical malpractice claims applicable for evaluating the impact of caps on non-economic damages and other legislative changes and are widely used and accepted.

These data sources represent states with a variety of different approaches to medical malpractice liability law. While none of the states have a current medical malpractice environment perfectly identical to the climate that exists in New Mexico, the consistency of the analysis results between the various states suggests that closed claim data are valid for the purpose of estimating the impact of non-economic damage caps. Examples of the differences between the states are Michigan’s mandatory medical review panels and Virginia’s Birth-Related Neurological Injury Fund. Another

example is Florida, whose judicial system tends to results in a larger than average number and proportion of high severity medical professional liability claims. The Florida data may somewhat overstate the impact of the damage caps due to its greater frequency and severity of large losses.

### **PCF Claims Data**

The enabling statute for the PCF (41-5-25) requires that the PCF surcharges be based on data obtained from New Mexico experience if available. Since Pinnacle began performing these studies for OSI, credible New Mexico loss data in the PCF layer has only been available on a calendar year basis which is not appropriate for reserving or ratemaking. As a result, prior analyses have relied on New Mexico data for losses limited to \$100,000 from the two major primary insurers in New Mexico that participate in the PCF.

Starting with our 2010 study, OSI has been able to provide detailed claim data for most claims paid since 2000. Most of this data had valid loss dates and payment dates as well. In addition, a table of open claims with loss date information was also provided. These databases enabled Pinnacle to develop a much more direct approach to estimating indicated loss reserves as well as prospective assessment surcharge levels. However, for the current analysis only calendar year 2014 and 2015 aggregate loss payments were provided. We have relied upon the individual claim data provided to us for prior analyses, supplemented with the calendar year data provided for the current analysis. We believe our methods and assumptions have made reasonable adjustments for these weaknesses in the data.

We understand that early in 2012, a group of approximately 69 claims associated with Dr. Frank Bryant and Gerald Champion Regional Medical Center were all settled. It appears this group of claims were all patients that had adverse results from spinal surgeries, most in the 2007-2009 period. It has been represented to us that the settlement is on the order of \$10 million. We have reflected this settlement across accident years 2007, 2008, and 2009.

## ***Discussion and Analysis***

### **Estimated Unpaid Claims Liabilities as of December 31, 2015**

Pinnacle estimates the amount of losses still to be paid for all claims occurring prior to December 31, 2015 to be approximately \$73.3 million on a nominal basis, \$66.4 million on a discounted basis using a 3.5% discount rate, and \$81.3 million when the discounted reserves reflect a risk margin to increase to the statistical confidence to 90%. These results are summarized in Exhibit 1. These amounts represent estimates of the losses that remain to be paid from the current fund balance if the PCF had ceased operations as of December 31, 2015. These are all increases from the values as of December 31, 2013 of \$61.8 million (nominal), \$56.4 million (discounted) and \$69.0 million (discounted at 90% confidence).

The present value as of December 31, 2015, assuming a 3.5% annual discount rate, of unpaid losses on claims occurring through December 31, 2015 is estimated as \$66.4 million. The \$29.8 million difference between the discounted losses and the estimated December 31, 2015 PCF Fund balance (\$36.6 million) represents the present value of the expected deficit between the currently available funds and the funds needed to meet all outstanding claim obligations as of December 31, 2015. The current PCF Fund balance is also \$36.8 million lower than the nominal reserve estimate. If discounted loss reserves are increased to the 90% confidence level, the resulting reserves indicate a \$44.7 million PCF surplus deficit.

### **Methodology**

Pinnacle's estimates of ultimate losses for the PCF were developed based on four actuarial methods. The methods used are paid loss development, expected loss ratio method, paid loss Bornhuetter-Ferguson (B-F) method, and average paid claim development (also known as a frequency and severity or counts and averages method). These methods are among the most commonly used methods and would be considered generally accepted actuarial methods. The calculations and assumptions underpinning these methods are documented in Exhibits 3 through 10.

The paid loss development method uses historical loss payment patterns to project actual payments to an ultimate settlement basis. Estimates of the percentage of additional development expected during a given interval between valuations (link ratios or age-to-age factors) based on historical development are used to estimate the expected amount of ultimate loss that is paid as of a given valuation. These factors "to ultimate" are applied to the latest paid loss data for each accident year to compute an estimate of ultimate losses. Estimates produced using this method are not affected by changes in case

reserve adequacy or open claim frequency that might have occurred during the review period. The inability to respond to the presence or absence of large outstanding claims is a significant weakness of this method. This method may also be susceptible to changes in claims settlement philosophy and/or payment speed. The results of the paid loss development method are summarized in Exhibit 4. The paid loss development triangles and selected age-to-age factors are shown in Exhibit 9. It is important to note, that loss payments for calendar years 2014 and 2015 were not provided by accident year, but only in aggregate. In order to use the paid development method, it was necessary to allocate the calendar year payments for the last two years to estimated accident years. We have done this based on the expected development patterns used in our December 31, 2013 analysis. This allocation is summarized in the appendix to the report.

The expected loss ratio method assumes that over the long run the ratio of ultimate losses to earned premiums, or in this case assessment surcharges, will remain stable. The long term loss ratio for the program is assumed to be 105.0% prior to 2000 and 130.0% for 2000 and subsequent based on the historical experience of the program, and reflects the significant losses paid in the last two years. The estimates of ultimate losses are computed as the assessments for each year times this long term average loss ratio. The results of this method are shown in Exhibit 3, Page 2. Participant surcharges for 2015 are also estimated.

The B-F method estimates ultimate losses using a combination of *a priori* expected losses and loss development techniques. If we define:

- A = Paid Losses
- B = Expected Percentage of Ultimate Losses Reported
- C = *a priori* Expected Losses, equal to historical assessments times long term loss ratio of 101.5% or 115% depending on the year

then the estimated ultimate losses using the B-F technique are:

$$A + [C \times (1 - B)].$$

B-F ultimate loss estimates have the advantage of stability. This is important for coverages with long periods of loss development like MPLI. This stability means the method's estimates do not over-react to short term or one-time changes in development patterns that do not impact long-term development expectations. They also do not overreact to the presence or absence of large losses early in the development of a portfolio of claims. Conversely, B-F estimates have the disadvantage of being slow

to respond to real changes in underlying loss development behavior. The *a priori* losses were based on the expected loss ratio method previously described. This method is summarized in Exhibit 3, Page 1.

The counts and averages method estimates ultimate losses by multiplying an estimate of the ultimate number of claims by a selected average cost per claim. The results of this method are contained in Exhibits 5 through 8 and summarized in Exhibit 5. The supporting development patterns are contained in Exhibit 10. It is important to note that the number of paid claim counts for calendar years 2014 and 2015 were not provided for this analysis, and in order to use the counts and averages method we have assumed claim counts to develop based on the expected development patterns used in our December 31, 2013 analysis.

The estimated number of claims has been selected based on three methods: a closed claim development method, a B-F method, and a frequency method looking at the long term ratio of claims closed with payment to assessment revenues. Similarly, average claim costs (severities) have been estimated using paid claim severity development and applying a smoothing approach to adjust for volatility between years.

These four methods are standard actuarial reserving techniques for estimating claim liabilities. Selected ultimate loss estimates for the PCF layer of coverage by year were then made based on the results of these four methods. These estimates rely heavily on the B-F method and frequency and severity method in the more recent years.

Exhibit 1, Page 3 contains a detailed comparison of the selected ultimate losses compared to the results of our previous study. Estimated ultimate losses for years 2006 and prior have all produced reductions since the last study, except for a small increase in 2003. Estimates for 2007 – 2013 have all resulted in material increases. Higher initial claims payments in calendar year 2014 and 2015 are driving these increases.

Because of the often significant delay between the occurrence of a PCF claim and its payment, a material discount to bring the ultimate claim payments to a present value reflecting the time value of money exists. Exhibit 1, Page 2 contains the analysis developing estimates of the PCF present value factors based on a 3.5% rate of return and the estimated PCF excess payment pattern. This analysis assumes claim payments are made mid-year on average.

The financial operations of the PCF are similar to a commercial insurer, however, one major difference is that the PCF does not maintain a large capital/surplus account. However, in any given year, the actual experience of the PCF can deviate widely from the expected experience. Also, unanticipated

changes in the social, legal or economic environments can adversely affect PCF experience. An insurer's capital/surplus can assist in withstanding such deviations in experience. By adding a margin for the risk of adverse deviation to indicated loss reserve (and also funding levels), the PCF can be protected in a similar manner.

There are various rules of thumb used in the insurance industry, and by state regulations, that specify the size of the required risk margin (surplus). One state, for example, requires a margin sufficient to assure that funds will be sufficient to meet all claims obligations under 90% of all claims scenarios on a discounted basis. While there are a number of methods for estimating a risk margin, a reasonable margin can be estimated via a simulation model.

We constructed a simulation model that randomly generated possible aggregate loss outcomes for each of the PCF's projected unpaid claims that will ultimately result in payments occurring prior to December 31, 2015. Each random outcome generated by a model is called a trial. A trial consists of simulating the individual and aggregate claim results for the PCF for the coming years. We generated 10,000 trials for each model and produced a distribution of aggregate PCF losses. We then compared the average outcome with the outcome at the 90th percentile to compute the risk margin for the 90% confidence level. Exhibit 1, Page 1 summarizes Pinnacle's selected ultimate losses and ultimate loss reserves as of December 31, 2015. These selected reserves are then adjusted for discounting at 3.5% annually and a risk margin to increase statistical confidence to the 90% level. A similar simulation model was created for the risk margin applied to the prospective rate level indication and a similar approach was used to develop the rate indication at the 90% confidence level.

### **PCF Surplus/Deficit**

The current PCF fund balance appears to be approximately \$36.6 million as of December 31, 2015. When compared to Pinnacle's estimate of indicated loss reserves of approximately \$73.3 million, this would suggest a Fund deficit position of \$36.8 million as of December 31, 2015. The indicated Fund position remains a deficit of approximately \$29.8 million when losses are considered on a discounted basis using a 3.5% discount rate.

However, it is imperative to understand that the application of discounting to unpaid claims liabilities strongly indicates the need to add an implicit or explicit risk margin. For example, section 5.5 of Actuarial Standard of Practice No. 20, promulgated by the Actuarial Standards Board of the entitled, "Discounting of Property and Casualty Loss and Loss Adjustment Expense Reserves" states that, "The

actuary should be aware that a discounted reserve is an inadequate estimate of economic value unless appropriate risk margins are included.”(Emphasis added.)

The standard allows both implicit margins (such as the nominal reserve estimate) and explicit margins (such as the 90% risk margin developed by Pinnacle). If discounted reserves are increased to the 90% confidence level, the resulting reserves of \$81.25 million indicate a \$44.68 million PCF surplus deficit.

### **Expected Surcharge Levels**

A table of current and recommended PCF surcharges by physician class is shown in Exhibit 11. Recommended surcharges were computed based on both an expected value basis and a 90% confidence level. The indicated percentage rate level changes are derived in Exhibit 12. Two approaches are presented: a single rate change that would remain in-force for a two year period, and two annual rate changes each year to achieve the overall rate level indication. On an expected value basis the indicated surcharge change is an increase of +18.1%, while at the 90% confidence level an indicated increase of 46.8% is indicated. Including the risk margin improves the likelihood that rates will be sufficient to cover all claims liabilities for the upcoming exposure year.

Investment income as an offset to the otherwise required revenue is recognized in both sets of rates using a 3.5% annual discount rate. Loss ratios were selected based on historical results and reflect recent loss ratio deterioration. The rates include provisions for other expenses, such as administration and medical/legal panels, as well as losses. However, since allocated loss adjustment expenses (ALAE) have historically been paid by the primary carrier, no ALAE provision is included in the PCF rates. Exhibit 13 shows selected ratios of expenses to either losses or surcharge revenues based on the PCF’s historical paid expenses and losses. There is also no provision for profit and contingencies in the rate level indications, other than the risk margin.

### **Class Relativities and Experience Rating Methodology**

#### *Class Relativities for Doctors and Other Practitioners*

Evaluating potential changes to classification relativities for PCFs, is quite difficult. This is due to the lack of credible data that exists at the class level of detail for large claims. New Mexico is no exception. Unfortunately, the lack of detailed claims data from the PCF did not allow evaluation of claims by physician specialty. Even if it had, the data would have been of limited usefulness due to the relatively low credibility of the small number of claims. Two alternative approaches are to examine changes in classification factors made by patient compensation funds in other states and changes in classification