

2002 Annual Report



for the care you give

MedAmerica
RISK RETENTION GROUP, INC
MUTUAL

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MedAmerica Mutual's *mission* is to provide the highest quality insurance products and services to our partners in the health care field and to promote excellence in their daily practices through the use of risk management tools and skills.

Dear MedAmerica Mutual Member:

The year 2002 saw the nation begin to recover from the tragic events of September 11th, 2001 that generated the largest losses in insurance industry history. For many medical professional liability insurers, reinsurance rates increased dramatically as reinsurers attempted to recoup losses. MedAmerica Mutual was fortunate to have had a reinsurance treaty in place that provided an element of financial stability throughout 2002.

The year experienced continued medical malpractice insurance turmoil. Prior years saw an industry trend of pricing products and services at inadequate rates; additionally, there was an increase in claims severity. Therefore, in California and across the United States, emergency medicine insurance premiums continued to dramatically trend upward as carriers priced products and services at more adequate rates. Many companies are no longer writing emergency medicine, as it is perceived as a high-risk specialty while others have exited the market due to insolvency.

MedAmerica Mutual's vision is to be regarded as the premier source for Emergency Medicine professional liability insurance products by continuing to deliver the highest levels of client services, patient safety strategies, and innovation.

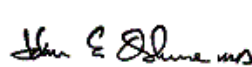
2002 MedAmerica Mutual Highlights

- Gloria H. Everett was retained as the Chief Executive Officer. Ms. Everett has over 25 years of experience in the medical malpractice industry including key leadership roles at TIG, Fireman's Fund, NORCAL Mutual, and Kaiser Permanente.
- MedAmerica Mutual continued to maintain solid financial strength through prudent operations.

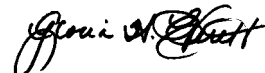
- A.M. Best reaffirmed MedAmerica Mutual's rating as B++. This is noteworthy in that MedAmerica Mutual remains one of the few California physician owned insurers that saw their financial strength improve during the course of the year.
- MedAmerica Mutual's reinsurance company still assumes a small quota share of ED professional liability insurance insured by another company.
- The Board of Directors implemented four new committees to strengthen the Board's ability to better govern the company. They are the Audit Committee, Compensation Committee, Governance Committee, and Nomination subcommittee.
- The Company funded several significant patient safety initiatives in 2001 that were completed in 2002. Projects launched and completed in 2002 include papers on vascular disasters and tPA for stroke patients and best practices on discharge instructions.

The Board of Directors and the management team valued the opportunity of serving you in 2002. As a physician owned company, we encourage our policyholders' questions and suggestions.

Sincerely,



John E. Osborne, MD
 Chairman & President



Gloria H. Everett
 Chief Executive Officer

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2002 and 2001

Admitted Assets	2002	2001
Cash investments:		
Cash and short-term investments	\$ 455,440	2,074,999
Debt securities	7,966,286	7,911,799
Common stock of subsidiaries	<u>2,010,562</u>	<u>1,967,867</u>
Total cash investments	10,432,288	11,954,665
Premiums receivable	167,908	195,090
Reinsurance balances recoverable	584,153	65,179
Deferred income tax, net	88,000	124,000
Equipment, net	15,047	29,408
Accrued investment income	137,060	130,043
Receivable from subsidiary	3,708	96,443
Other assets	<u>884,059</u>	<u>3,000</u>
Total admitted assets	<u>\$ 12,312,223</u>	<u>12,597,828</u>
Liabilities and Surplus		
Liabilities:		
Reserves:		
Losses	\$ 2,752,797	2,841,637
Loss adjustment expenses	<u>3,365,815</u>	<u>2,170,244</u>
Total reserves	6,118,612	5,011,881
Unearned premiums	214,358	241,801
Advanced premiums	—	1,125,857
Ceded reinsurance premiums payable	—	222,838
Accounts payable and accrued expenses	146,412	376,510
Federal income taxes	<u>195,000</u>	<u>294,037</u>
Total liabilities	<u>6,674,382</u>	<u>7,272,924</u>
Surplus:		
Contributed surplus	250,000	250,000
Unassigned surplus	<u>5,387,841</u>	<u>5,074,904</u>
Total surplus	<u>5,637,841</u>	<u>5,324,904</u>
Total liabilities and surplus	<u>\$ 12,312,223</u>	<u>12,597,828</u>

See accompanying notes to statutory financial statements.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Statutory Statements of Income

Years ended December 31, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Net underwriting income:		
Premiums earned	\$ 5,237,773	4,718,394
Losses and loss adjustment expenses	(4,056,059)	(3,288,209)
Other underwriting expenses	<u>(1,011,852)</u>	<u>(1,264,336)</u>
Net underwriting income	169,862	165,849
Net investment gains:		
Net investment income	408,413	342,901
Net realized capital gains	<u>892</u>	<u>31,006</u>
Net investment gains	409,305	373,907
Dividends to policyholders	<u>(173,433)</u>	<u>(23,549)</u>
Income before federal income taxes	405,734	516,207
Federal income taxes	<u>(141,191)</u>	<u>(301,000)</u>
Net income	<u>\$ 264,543</u>	<u>215,207</u>

See accompanying notes to statutory financial statements.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Statutory Statements of Changes in Surplus

Years ended December 31, 2002 and 2001

	<u>Contributed surplus</u>	<u>Unassigned surplus</u>	<u>Total surplus</u>
Balances at December 31, 2000	\$ 250,000	4,884,962	5,134,962
Net income	—	215,207	215,207
Increase in nonadmitted assets	—	(133,569)	(133,569)
Change in net unrealized losses	—	(112,696)	(112,696)
Change in net deferred income tax	—	166,000	166,000
Cumulative effect of change in accounting principle	<u>—</u>	<u>55,000</u>	<u>55,000</u>
Balances at December 31, 2001	250,000	5,074,904	5,324,904
Net income	—	264,543	264,543
Increase in nonadmitted assets	—	(109,864)	(109,864)
Change in net unrealized gains	—	71,258	71,258
Change in net deferred income tax	<u>—</u>	<u>87,000</u>	<u>87,000</u>
Balances at December 31, 2002	<u>\$ 250,000</u>	<u>5,387,841</u>	<u>5,637,841</u>

See accompanying notes to statutory financial statements.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Statutory Statements of Cash Flows

Years ended December 31, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Operations:		
Premiums collected, net of reinsurance	\$ 3,616,279	4,709,450
Losses and loss adjustment expenses paid	(3,468,302)	(541,929)
Underwriting expenses paid	(1,243,314)	(1,061,743)
Net investment income received	411,237	340,050
Dividends paid to policyholders	(161,625)	(23,549)
Federal income taxes paid	<u>(240,228)</u>	<u>(8,963)</u>
Net cash provided by (used in) operations	<u>(1,085,953)</u>	<u>3,413,316</u>
Investment activities:		
Proceeds from sales, maturities, or repayments of debt securities	<u>822,735</u>	<u>4,728,546</u>
Cost of investments acquired:		
Debt securities	(885,103)	(6,324,373)
Stocks	<u>—</u>	<u>(2,036,000)</u>
Total investments acquired	<u>(885,103)</u>	<u>(8,360,373)</u>
Net cash used in investment activities	<u>(62,368)</u>	<u>(3,631,827)</u>
Financing and miscellaneous activities:		
Net transfers from (to) affiliates	92,735	(96,443)
Other applications, net	<u>(563,973)</u>	<u>(87,023)</u>
Net cash used in financing and miscellaneous activities	<u>(471,238)</u>	<u>(183,466)</u>
Net decrease in cash and short-term investments	(1,619,559)	(401,977)
Cash and short-term investments:		
Beginning of year	<u>2,074,999</u>	<u>2,476,976</u>
End of year	\$ <u><u>455,440</u></u>	\$ <u><u>2,074,999</u></u>

See accompanying notes to statutory financial statements.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

NOTES TO STATUTORY FINANCIAL STATEMENTS

(1) Organization and Summary of Significant Accounting Policies

(a) *Organization and Description of Business*

MedAmerica Mutual Risk Retention Group, Inc. (Company) was incorporated under the laws of the state of Hawaii on December 26, 1991 and was formed as a captive insurance company as defined in Article 19 of Chapter 431 of the Hawaii Revised Statutes and the Liability Risk Retention Act of 1986, as amended. The Company is a mutual insurance company and is not authorized to issue shares of capital stock. The members of the Company are its policyholders.

The Company's wholly owned subsidiaries include MedAmerica Reinsurance Company, Inc. (MRC), MedAmerica Financial Services, Inc. (MAFS), and EMPAQ Purchasing Group (EMPAQ). MRC was capitalized on April 1, 2001 with \$2,000,000 of cash and securities and operates as a professional reinsurance company. MAFS was purchased on January 1, 1999 and is a licensed insurance brokerage company. MAFS was inactive during 2001, but began operating as an insurance management company in 2002. EMPAQ remains inactive.

The Company's principal activity is to provide medical malpractice insurance to emergency medicine practitioners in the state of California. The Company issues claims-made insurance policies primarily with limits of \$1 million/\$3 million for losses and no limit for allocated loss adjustment expenses such as legal defense costs. After reinsurance, the Company generally retains limits of up to \$250,000 for losses and allocated loss adjustment expense combined.

(b) *Basis of Presentation*

The accompanying statutory financial statements have been prepared in conformity with statutory accounting practices as prescribed or permitted by the Insurance Division of the Department of Commerce and Consumer Affairs of the State of Hawaii (Insurance Division), which vary in some respects from accounting practices generally accepted in the United States of America (GAAP).

The National Association of Insurance Commissioners (NAIC) has adopted the codification of Statutory Accounting Principles Project (Codification) as the NAIC supported basis of accounting. The Codification project was approved with the provision for commissioner discretion in the determination of appropriate statutory accounting for insurers. Such discretion will allow prescribed or permitted accounting practices that may differ from state to state. The state of Hawaii and, accordingly, the Company have adopted Codification effective January 1, 2001. The adoption of Codification increased unassigned surplus by \$55,000, primarily due to the establishment of deferred tax assets. The more significant differences between GAAP and statutory principles are as follows:

- (1) Market values of certain investments in bonds are based on values specified by the NAIC rather than on actual or estimated market values. Changes between cost and admitted asset investment amounts are credited and charged directly to unassigned surplus rather than to a separate surplus account.
- (2) Certain assets designated as "nonadmitted assets", principally certain short-term investments and deferred tax assets, are excluded from the accompanying statutory

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

statements of admitted assets, liabilities, and surplus and are charged directly to unassigned surplus.

- (3) Unearned premiums and the liability for losses and loss adjustment expenses are recorded net of ceded unearned reinsurance premiums and reinsurance recoverable on unpaid losses and loss adjustment expenses, respectively.
- (4) The accounts and operations of the Company and its subsidiaries are not consolidated as would be required under GAAP. The Company values its investment in an insurance subsidiary based on the underlying statutory equity, and the investment in noninsurance subsidiaries based on the underlying GAAP equity. The Company's share of undistributed earnings and losses of the subsidiaries are included in unrealized gains and losses in the statutory statements of changes in surplus.
- (5) Deferred income tax assets and liabilities are recognized with modifications for the realization criteria for deferred tax assets and the recording of the impact of changes in its deferred tax balances. Deferred tax assets are subject to an admissibility test and are admitted based on a defined formula. Changes in deferred tax assets and liabilities, including changes in tax rates are recognized as a separate component of gains and losses in unassigned surplus.
- (6) Acquisition costs, such as commissions, premium taxes, and other items, are charged to current operations as incurred, whereas related premium income is taken into earnings on a pro rata basis over the periods covered by the policies.
- (7) Cash and short-term investments in the statutory statements of cash flows represent cash balances and investments with initial maturities of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with initial maturities of three months or less.

The presentation methodology of the statutory statements of cash flows is not in conformity with GAAP. The statements also do not include a reconciliation of net income to net cash from operations.

- (8) The presentation methodology of the statutory statements of admitted assets, liabilities, and surplus is also not in conformity with GAAP in regard to the reporting of comprehensive income.
- (9) Accounting changes are recognized as a separate component of surplus rather than as a component of net income.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

(c) Investments

Debt securities, common stock of subsidiaries, and short-term investments are stated at values prescribed by the NAIC, as follows:

- (1) Bonds are generally stated at amortized cost using the level-yield basis. Bonds which do not qualify to be carried at amortized cost are stated at the NAIC value.
- (2) Common stock of insurance subsidiaries are reported based on the underlying statutory equity, and common stock of noninsurance subsidiaries are reported based on the underlying GAAP equity. The Company's share of undistributed earnings (losses) of the subsidiaries are reported in unassigned surplus.
- (3) Short-term investments are stated at amortized cost, which approximates fair value.
- (4) Mortgage-backed securities are carried at amortized cost or market value based on valuation procedures determined by the NAIC. The Company considers anticipated portfolio prepayments in the carrying value of mortgage-backed securities in accordance with policies adopted by the NAIC. Accordingly, the amortized cost for mortgage-backed securities are periodically adjusted retrospectively for such prepayment experience and other revisions on the underlying mortgage collateral.
- (5) Investment securities, for which a decline in the fair value is determined to be other than temporary, are stated at fair value with the write down accounted for as a realized loss. Realized capital gains and losses on sales of investment securities are determined using specific certificate identification.

(d) Premiums

Insurance premiums are earned pro rata over the period the insurance policy is in force. Premiums applicable to future periods are deferred in the accompanying statutory statements of admitted assets, liabilities, and surplus.

(e) Losses and Loss Adjustment Expenses

The liability for losses and loss adjustment expenses represent estimates of reported losses and loss adjustment expenses are based on target losses and loss adjustment expense ratios that management believes are reasonable and reflective of anticipated ultimate experience. The ultimate settlement of outstanding claims and estimated losses may vary significantly from the estimated amounts included in the accompanying statutory financial statements.

(f) Reinsurance

In the normal course of business, the Company seeks to reduce the loss that may arise from extremely large losses and catastrophic events by reinsuring certain levels of risk with other insurance enterprises. Premiums earned and losses and loss adjusting expenses incurred relating to reinsurance are accounted for in a manner consistent with the underlying policies. Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policy.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

(g) *Income Taxes*

Effective 2001, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in surplus in the period that includes the enactment date.

The admissibility of the Company's deferred tax assets is determined by identifying the amount of loss carrybacks exceeding the amount of gross deferred tax assets that can be recovered by the end of the subsequent calendar year. This amount is deemed to be admissible according to NAIC statutory accounting principles. The amount calculated will be subjected to further reduction if it exceeds 10% of capital and surplus or it exceeds the amount of gross deferred tax liabilities.

Federal income taxes are provided based upon a calculation of income taxes currently payable or benefits currently recoverable. The federal income tax returns of the Company are filed on the basis of annual statements filed with the Insurance Division.

The Company files a separate return for state premium taxes. The Company is exempt from state income taxes.

(h) *Use of Estimates*

The preparation of statutory financial statements requires management to make estimates and assumptions that affect the reported amounts of admitted assets and liabilities and disclosure of contingent assets and liabilities at the date of the statutory financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

(2) Investments

The admitted value and the fair value of investments in debt securities are summarized as follows:

	<u>Admitted value</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>
At December 31, 2002:				
U.S. government bonds	\$ 443,864	73,636	—	517,500
Municipal bonds	5,884,798	14,952	—	5,899,750
Corporate bonds	936,896	40,367	—	977,263
Mortgage-backed securities – U.S. government agencies	<u>700,728</u>	<u>—</u>	<u>—</u>	<u>700,728</u>
Total debt securities	<u>\$ 7,966,286</u>	<u>128,955</u>	<u>—</u>	<u>8,095,241</u>
At December 31, 2001:				
U.S. government bonds	\$ 442,769	—	—	442,769
Municipal bonds	5,507,663	747	—	5,508,410
Corporate bonds	1,264,699	18,898	—	1,283,597
Mortgage-backed securities – U.S. government agencies	<u>696,668</u>	<u>—</u>	<u>—</u>	<u>696,668</u>
Total debt securities	<u>\$ 7,911,799</u>	<u>19,645</u>	<u>—</u>	<u>7,931,444</u>

A summary of the amortized cost and fair value of the Company's investments in debt securities at December 31, 2002, by contractual maturity, is as follows:

	<u>Amortized cost</u>	<u>Fair value</u>
Years to maturity:		
One or less	\$ 250,152	250,152
After one through five	1,664,454	1,757,252
After five through ten	1,028,556	1,049,761
After ten	<u>5,023,124</u>	<u>5,038,076</u>
Total	<u>\$ 7,966,286</u>	<u>8,095,241</u>

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

Proceeds from the sale of investments in debt securities during 2002 and 2001 were \$822,735 and \$4,728,546, respectively; gross gains of approximately \$900 and \$42,000, respectively; and gross losses of approximately nil and \$11,000 were realized on those sales, respectively.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

(3) Investment in Subsidiaries

The Company records its investment in insurance subsidiary (MRC) based on the underlying statutory equity, and the investment in noninsurance subsidiaries (MAFS and EMPAQ) based on the underlying GAAP equity. As of December 31, 2002, the Company's investment in its wholly owned subsidiaries is as follows:

	<u>MRC</u>	<u>MAFS</u>	<u>EMPAQ</u>	<u>Total</u>
Assets	\$ 4,526,685	94,219	7,539	4,628,443
Liabilities	2,541,119	76,762	—	2,617,881
Equity	1,985,566	17,457	7,539	2,010,562
Net gain/(loss)	41,718	1,777	(800)	42,695

(4) Federal Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. Income tax is allocated to the subsidiaries on a separate-return basis.

Total income tax expense for the years ended December 31, 2002 and 2001 was allocated as follows:

	<u>2002</u>	<u>2001</u>
Income from operations	\$ 141,191	301,000
Change in deferred income taxes	<u>(87,000)</u>	<u>(166,000)</u>
Total income tax expense	\$ <u>54,191</u>	<u>135,000</u>

The tax effects of temporary differences that give rise to significant portions of deferred tax assets at December 31, 2002 and 2001 are as follows:

	<u>2002</u>	<u>2001</u>
Deferred tax assets:		
Nondeductible portion of losses and loss adjustment expenses	\$ 366,000	299,000
Unearned premiums	15,000	16,000
Deferred compensation	<u>11,000</u>	<u>—</u>
Total gross deferred tax assets	392,000	315,000
Nonadmitted deferred tax assets	<u>(302,000)</u>	<u>(179,000)</u>
Admitted deferred tax assets	90,000	136,000
Deferred tax liabilities – other	<u>(2,000)</u>	<u>(12,000)</u>
Deferred income tax assets, net	\$ <u>88,000</u>	<u>124,000</u>

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

Income tax expense of \$54,191 in 2002 and \$135,000 in 2001 differs from the “expected” tax expense for those years (computed by applying the current federal corporate income tax rate of 34% to income before federal income taxes) as follows:

	<u>2002</u>	<u>2001</u>
Computed “expected” tax expense	\$ 138,000	176,000
Tax-exempt interest income	(78,000)	(27,000)
Other	<u>(5,809)</u>	<u>(14,000)</u>
	<u>\$ 54,191</u>	<u>135,000</u>

(5) Losses and Loss Adjustment Expense Reserves

Activity in the losses and loss adjustment expense reserves for the years ended December 31, 2002 and 2001 are as follows:

	<u>2002</u>	<u>2001</u>
Reserve balance, beginning of year	\$ <u>5,011,881</u>	<u>2,278,500</u>
Incurred related to:		
Current year	3,674,000	3,980,000
Prior year	<u>382,059</u>	<u>(691,791)</u>
Total incurred	<u>4,056,059</u>	<u>3,288,209</u>
Less paid losses and loss adjustment expenses relating to:		
Current year	651,000	292,000
Prior year	<u>2,298,328</u>	<u>262,828</u>
Total paid	<u>2,949,328</u>	<u>554,828</u>
Reserve balance, end of year	\$ <u><u>6,118,612</u></u>	<u><u>5,011,881</u></u>

As indicated above, included in losses and loss adjustment expenses incurred for 2002 and 2001 is an adjustment of \$382,059 and \$(691,790), respectively, in the estimates of the ultimate settlement value of claims in the prior claim reporting years. This adjustment is the net effect of changes made to case and incurred-but-not-reported reserves as additional information became available.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

(6) Reinsurance

The Company's reinsurance program provides for the protection against individual losses and against multiple claims from the same incident. Generally, for policies effective prior to January 1, 2001, the Company cedes all indemnity losses in excess of \$100,000 and 100% of all loss adjusting expense costs incurred, such as legal defense costs. Beginning with policies effective January 1, 2001, the Company cedes combined indemnity and loss adjusting expense costs in excess of \$250,000. Reinsurance contracts do not relieve the Company from its obligation to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company.

At December 31, 2002 and 2001, the Company had ceded outstanding losses and loss adjustment expense reserves totaling \$4,067,000 and \$4,073,000, respectively. Also, at December 31, 2002 and 2001, the Company had ceded paid losses and loss adjusting expenses recoverable from reinsurers approximating \$584,000 and \$65,000, respectively.

The Company had direct and ceded premiums written of approximately \$7,838,000 and \$2,627,000 in 2002 and approximately \$7,302,000 and \$2,457,000 in 2001, respectively, and direct and ceded premiums earned of approximately \$7,879,000 and \$2,641,000 in 2002 and approximately \$7,220,000 and \$2,502,000 in 2001, respectively. Ceded incurred losses and loss adjustment expenses for the years ended December 31, 2002 and 2001 totaled approximately \$1,272,000 and \$1,354,000, respectively.

(7) Surplus

The Company is required, by the Insurance Division, to maintain minimum capital and surplus requirements of \$500,000. The maximum amount of dividends which can be paid by state of Hawaii insurance companies without prior approval of the Insurance Commissioner is subject to certain restrictions. The maximum dividend payout which may be made without prior approval is the lesser of statutory net income, not including realized capital gains, or 10% of statutory unassigned surplus as reported in the annual statement for the preceding period. Dividends can be paid only to the extent of a positive unassigned surplus. Also, no dividends which would reduce surplus to an amount less than the minimum required by the state of Hawaii can be declared or paid. The maximum amount of dividends allowed to be paid by the Company without prior approval of the Insurance Commissioner for the year ending December 31, 2003 amounts to \$263,700. The Company paid policyholder dividends of \$173,473 and \$23,549 for the years ended December 31, 2002 and 2001, respectively.

(8) Risk-Based Capital

The Company is subject to risk-based capital (RBC) requirements imposed by the Insurance Division. The RBC calculation serves as a benchmark for the regulation of property and casualty insurance companies by state insurance regulators. RBC provides for surplus formulas similar to target surplus formulas used by commercial rating agencies. The RBC guidelines define specific capital levels based on a company's authorized control level RBC (ACLCL) that is determined by the ratio of the company's total adjusted capital (TAC) to its ACLCL.

As of December 31, 2002 and 2001, the Company's TAC exceeded the ACLCL required at the "Company Action Level."

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Notes to Statutory Financial Statements

December 31, 2002 and 2001

(9) Related Party Transactions

An agreement exists between the Company and MedAmerica, Inc. whereby MedAmerica, Inc. provides administrative services to the Company. MedAmerica, Inc. is majority owned by California Emergency Physicians Medical Group (CEP). The majority of the Company's policyholders are CEP physicians. Total administrative fees paid to MedAmerica, Inc. were \$50,500 and \$75,000 for 2002 and 2001, respectively.

Beginning January 1, 2001, the Company leases office space from MedAmerica, Inc. under a noncancelable operating lease agreement that expires in December 2004. Rental expense for 2002 was approximately \$79,000. Future minimum lease payments under this sublease are \$80,500 and \$73,800 for the years ended December 31, 2003 and 2004, respectively.

During 2001, the Company incurred costs related to managing the operations of MRC totaling \$100,000. These costs included employee compensation, administrative and general office costs, professional service fees, and travel costs.

(10) Fair Value of Financial Instruments

The fair value of financial instruments is the amount at which the instrument could be exchanged in a current transaction between willing parties. The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and Short-Term Investments, Receivables, and Other Assets – the admitted values approximate the fair values because of the short maturity of these instruments.

Investments in Debt Securities – the fair values, which amounted to \$8,095,241 and \$7,931,444 at December 31, 2002 and 2001, respectively, are estimated based on quoted market prices for these investments. Admitted values amounted to \$7,966,286 and \$7,911,799 at December 31, 2002 and 2001, respectively.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Supplemental Schedule – Investment Summary Schedule

December 31, 2002

	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	Percentage	Amount	Percentage
Bonds:				
U.S. treasury securities	\$ 443,864	4%	\$ 443,864	4%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies		0%		0%
Issued by U.S. government sponsored agencies		0%		0%
Foreign government (including Canada, excluding mortgage-backed securities)		0%		0%
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
States, territories, and possessions general obligations	1,566,244	15%	1,566,244	15%
Political subdivisions of states, territories, and possessions and political subdivisions general obligations	1,876,609	18%	1,876,609	18%
Revenue and assessment obligations	2,441,945	24%	2,441,945	24%
Industrial development and similar obligations	936,896	9%	936,896	9%
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA		0%		0%
Issued by FNMA and FHLMC	700,728	7%	700,728	7%
Privately issued		0%		0%
CMOs and REMICs:				
Issued by FNMA and FHLMC		0%		0%
Privately issued and collateralized by MBS issued or guaranteed by GNMA, FNMA, or FHLMC		0%		0%
All other privately issued		0%		0%
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)		0%		0%
Unaffiliated foreign securities		0%		0%
Affiliated securities		0%		0%
Equity interests:				
Investments in mutual funds		0%		0%
Preferred stocks:				
Affiliated		0%		0%
Unaffiliated		0%		0%
Publicly traded equity securities (excluding preferred stocks):				
Affiliated		0%		0%
Unaffiliated		0%		0%
Other equity securities:				
Affiliated	2,010,562	19%	2,010,562	19%
Unaffiliated		0%		0%
Other equity interests including tangible personal property under lease:				
Affiliated		0%		0%
Unaffiliated		0%		0%
Mortgage loans:				
Construction and land development		0%		0%
Agricultural		0%		0%
Single-family residential properties		0%		0%
Multifamily residential properties		0%		0%
Commercial loans		0%		0%
Real estate investments:				
Property occupied by company		0%		0%
Property held for production of income (includes \$0 of property acquired in satisfaction of debt)		0%		0%
Property held for sale (\$0 including property acquired in satisfaction of debt)		0%		0%
Policy loans		0%		0%
Receivables for securities		0%		0%
Cash and short-term investments	455,440	4%	455,440	4%
Other invested assets		0%		0%
Total invested assets	<u>\$ 10,432,288</u>	<u>100%</u>	<u>\$ 10,432,288</u>	<u>100%</u>

See accompanying independent auditors' report.

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Supplemental Schedule – Investment Risks Interrogatories

December 31, 2002

Answer the following interrogatories by stating the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments as shown on the Summary Investment Schedule. All reporting entities must answer interrogatories 1, 2, 3, 4, 11 and, if applicable, 20 through 24. Answer each of the interrogatories 5 through 19 (except 11) only if the reporting entity's aggregate holding in the gross investment category addressed in that interrogatory equals or exceeds 2.5% of the reporting entity's total admitted assets. For Life, Health, and Fraternal blanks, responses are to exclude Separate Accounts.

1. State the reporting entity's total admitted assets as reported on Page 2 of the annual statement. \$ 12,053,493
2. State by investment category the 10 largest exposures to a single issuer/borrower/investment, excluding U.S. government, U.S. government agency securities, and those U.S. government money market funds listed in the Appendix to the SVO Purposes and Procedures Manual as exempt, property occupied by the Company and policy loans.

<u>Investment category</u>	<u>Amount</u>	<u>Percentage of total admitted assets</u>
a. Class One Money Market Mutual Funds	\$ 396,301	3.29%
b. Special Revenue & Special Assessment – Issuer Obligation	247,787	2.06%
c. Special Revenue & Special Assessment – Issuer Obligation	243,599	2.02%
d. Political Subdivisions of States, Territories & Possessions – Issuer Obligation	225,520	1.87%
e. States, Territories & Possessions – Issuer Obligation	216,691	1.80%
f. States, Territories & Possessions – Issuer Obligation	216,394	1.80%
g. Political Subdivisions of States, Territories & Possessions – Issuer Obligation	210,085	1.74%
h. Special Revenue & Special Assessment – Issuer Obligation	209,488	1.74%
i. Special Revenue & Special Assessment – Issuer Obligation	208,709	1.73%
j. States, Territories & Possessions – Issuer Obligation	206,976	1.72%

3. State the amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating.

<u>Bonds</u>	<u>Amount</u>	<u>Percentage of total admitted assets</u>
NAIC-1	\$ 8,262,859	68.55%
NAIC-2	99,727	0.83%
NAIC-3	NONE	
NAIC-4	NONE	
NAIC-5	NONE	
NAIC-6	NONE	

Preferred stocks:

NONE

4. State the amounts and percentages of the reporting entity's total admitted assets held in foreign investments (regardless of whether there is any foreign currency exposure) and unhedged foreign currency exposure (defined as the statement value of investments denominated in foreign currencies which are not hedged by financial instruments qualifying for hedge accounting as specified in SSAP No. 31 – *Derivative Instruments*), including (i) foreign-currency-denominated investments of \$0, (ii) supporting insurance liabilities denominated in that same foreign currency of \$0, and excluding (iii) Canadian investments and currency exposure of \$0.

Assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatories 5-10.

Yes [X] No []

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Supplemental Schedule – Investment Risks Interrogatories

December 31, 2002

5. Aggregate foreign investment exposure categories by NAIC sovereign rating. **NONE**
6. Two largest foreign investment exposures to a single country, categorized by the country's NAIC sovereign rating. **NONE**
7. Aggregate unhedged foreign currency exposure. **NONE**
8. Aggregate unhedged foreign currency exposure categorized by NAIC sovereign rating. **NONE**
9. Two largest unhedged foreign currency exposures to a single country, categorized by the country's NAIC sovereign rating. **NONE**
10. List the 10 largest sovereign (i.e., nongovernmental) foreign issues. **NONE**
11. State the amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure, including Canadian-currency-denominated investments of \$0 supporting Canadian-denominated insurance liabilities of \$0.
Assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 12. Yes [X] No []
12. Aggregate Canadian investment exposure. **NONE**
13. State the aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions (defined as investments having restrictions that prevent investments from being sold within 90 days).
Assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 13. Yes [X] No []
14. State the aggregate amounts and percentages of admitted assets held in the largest 10 equity interests (including investments in the shares of mutual funds, preferred stocks, publicly traded equity securities, and other equity securities, and excluding money market and bond mutual funds listed in the Appendix to the SVO Practice and Procedures Manual as exempt or Class 1). Yes [] No [X]
Assets held in equity interests less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 14.

Investment category	Amount	Percent
Assets held in equity interests:		
Subsidiary:		
MedAmerica Reinsurance Company, Inc.	\$ 1,985,566	16.47%
MedAmerica Financial Services, Inc.	17,457	0.14%
EMPAQ Purchasing Group, Inc.	7,539	0.06%
15. State the amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities (included in other equity securities) and excluding securities eligible for sale under Securities Exchange Commission (SEC) Rule 144a or SEC Rule 144 without volume restrictions. Assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 15. Yes [X] No []		
Aggregate statement value of investments held in nonaffiliated, privately placed equities		NONE
Largest 3 investments held in general partnership interest		NONE
16. State the aggregate amounts and percentages of the entity's total admitted assets held in general partnership interests (included in other equity securities). Assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 16. Yes [X] No []		
Aggregate statement value of investments held in general partnership interests		NONE
Largest 3 investments with contractual sales restrictions		NONE

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Supplemental Schedule – Investment Risks Interrogatories

December 31, 2002

With respect to mortgage loans reported in Schedule B, state the amounts and percentages of the reporting entity's total admitted assets held.

Mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatories 17 and 18. Yes No

Each of the 10 largest aggregate mortgage interests. The aggregate mortgage interest represents the combined value of all mortgages secured by the same property or same group of properties. **NONE**

Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date.

Loan-to-value:

Residential, Commercial, and Agricultural	NONE
Construction loans	NONE
Mortgage loans over 90 days past due	NONE
Mortgage loans in the process of foreclosure	NONE
Mortgage loans foreclosed	NONE
Restructured mortgage loans	NONE

State the amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A, excluding property occupied by the company.

Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 19. Yes No

State the amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

Securities lending (do not include assets held as collateral for such transactions)	NONE
Repurchase agreements	NONE
Reverse repurchase agreements	NONE
Dollar repurchase agreements	NONE
Dollar reverse repurchase agreements	NONE

State the amounts and percentages indicated below for warrants not attached to other financial instruments, options, caps, and floors:

Hedging	NONE
Income generation	NONE
Other	NONE

State the amounts and percentages indicated below of potential exposure (defined as the amount determined in accordance with the NAIC Annual Statement Instructions) for collars, swaps, and forwards:

Hedging	NONE
Income generation	NONE
Replications	NONE
Other	NONE

MEDAMERICA MUTUAL RISK RETENTION GROUP, INC.

Supplemental Schedule – Investment Risks Interrogatories

December 31, 2002

23. State the amounts and percentages indicated below of potential exposure (defined as the amount determined in accordance with the NAIC Annual Statement Instructions) for futures contracts:
- | | |
|-------------------|-------------|
| Hedging | NONE |
| Income generation | NONE |
| Replications | NONE |
| Other | NONE |
24. State the amounts and percentages of 10 largest investments included in the Write-ins for Invested Assets category included on the Summary Investment Schedule. **NONE**

See accompanying independent auditors' report.

INDEPENDENT AUDITORS' REPORT

The Board of Directors MedAmerica Mutual Risk Retention Group, Inc.

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of MedAmerica Mutual Risk Retention Group, Inc. as of December 31, 2002 and 2001, and the related statutory statements of income, changes in surplus, and cash flows for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits 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 audits provide a reasonable basis for our opinion.

As described more fully in note 1 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Insurance Division of the Department of Commerce and Consumer Affairs of the State of Hawaii, which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between the statutory basis of accounting and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of MedAmerica Mutual Risk Retention Group, Inc. as of December 31, 2002 and 2001 or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of MedAmerica Mutual Risk Retention Group, Inc. as of December 31, 2002 and 2001, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in note 1.

Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included in schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the basic statutory financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic statutory financial statements and, in our opinion, is fairly stated on the basis of accounting described in note 1, in all material respects, in relation to the basic statutory financial statements taken as a whole.

The Insurance Division of the Department of Commerce and Consumer Affairs of the State of Hawaii requires that the National Association of Insurance Commissioners' (NAIC) Accounting Practices & Procedures Manual be used to prepare statutory financial statements to the extent those practices and procedures do not conflict with the Hawaii Insurance Code. As discussed in note 1 to the statutory financial statements, effective January 1, 2001, the NAIC adopted a newly codified Accounting Practices & Procedures Manual which resulted in changes to the accounting practices used by the Company to prepare the accompanying statutory financial statements.

KPMG LLP

Honolulu, Hawaii
May 23, 2003

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