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An Audit:

Injured Patients and Families
Compensation Fund

Office of the Commissioner of Insurance

March 2007

Report Highlights

The Fund maintains a sound financial position.

Recent court decisions and legislative action changed limits on noneconomic damages the Fund may be required to pay.

A 2005 actuarial audit concluded the Fund's loss liability estimates were reasonable, although conservative.

An aging computer system that maintains provider accounts is experiencing operational problems.

The Injured Patients and Families Compensation Fund insures participating physicians and other health care providers in Wisconsin against medical malpractice claims that exceed the coverage limits of their primary malpractice insurance. Statutes require most health care providers that operate or have permanent practices in Wisconsin to maintain primary malpractice coverage of $1 million for each incident and $3 million per policy year, and to participate in the Fund by paying assessments that help to fund claims.

The Fund has paid more than $633.6 million in claims from its inception through December 31, 2006. There is no limit to the compensation it will pay on behalf of participating providers for economic damages, such as medical costs and loss of income. Noneconomic damages, which include compensation for suffering, mental distress, and loss of companionship and affections, are l imited by statutes.

Statutes require the Legislative Audit Bureau to perform financial audits of the Fund at least once every three years. Our audit report contains our unqualified opinion on the Fund's financial statements and related notes as of and for the years ending June 30, 2006, 2005, and 2004.

In light of ongoing interest in the Fund's financial position, we also reviewed changes in provider assessments, annual claims payments, and the Fund's accumulated cash and investments; recent legislation and court decisions affecting the Fund; and the results of an actuarial audit completed in 2005. In addition, we reviewed the condition of the Fund's computer system for maintaining the accounts of participating providers.

Financial Position

Since its creation in 1975, the Fund has typically taken in more provider

assessments and investment income than it has paid out in claims and administrative expenses. As a result, it has accumulated $737.4 million in cash and investments as of June 30, 2006.

However, the Fund's financial position is also significantly affected by its loss liabilities, which are based on estimates of what it may be required to pay for malpractice incidents that have occurred but may not yet have been settled or even reported.

Key Facts and Findings

The Fund provides secondary medical malpractice insurance to almost 14,000 health care providers.

Since its inception, the Fund has paid more than $633.6 million for 626 claims.

In audited financial statements, the Fund reported a balance of $59.8 million as of June 30, 2006.

The Fund had accumulated $737.4 million in cash and investments as of June 30, 2006.

An actuarial audit was completed in 2005.

Both the uncertainty and the longterm nature of medical malpractice claims make it difficult to predict the size and timing of claims that will be settled and paid from the Fund. The Board of Governors, which manages the Fund, relies on a consulting actuarial firm to estimate the Fund's claims experience and related loss liabilities.

In the past, the Fund had reported accounting deficits because estimated loss liabilities exceeded the cash and investments available to pay them. However, it has maintained a positive accounting balance since June 30, 1999. The net asset balance reported in the audited financial statements for June 30, 2006, is $59.8 million. That is the highest year-end balance reported by the Fund since its inception.

Audited Net Asset Balance[1]
As of June 30

Year	Amount (In Millions)
1997	$(38.4)
1998	(22.2)
1999	8.6
2000	27.2
2001	28.4
2002	6.6
2003	7.9
2004	24.6
2005	31.7
2006	59.8

[1] Represents the Fund's assets less its liabilities.

The Governor's 2007-09 Biennial Budget Proposal includes a one-time transfer of $175.0 million from the Fund to a newly created heath care quality fund. This new fund would support a variety of health care quality improvement activities, including the Governor's E-Health initiative.

However, we caution that such a transfer would place the Fund in a deficit accounting position and may result in future increases in provider assessment rates. The Legislature will also need to evaluate whether the proposed uses of the transfer meet the purposes and uses of the Fund set forth in s. 655.27(6), Wis. Stats., which states that the Fund is "held in

irrevocable trust for the sole benefit of health care providers participating in the fund and proper claimants."

Noneconomic Damages

Legislative changes and legal challenges to statutory limits on noneconomic damages have affected the Fund's loss liabilities and provider assessment rates.

Legislation enacted in 1985 limited noneconomic damages to $1 million from June 14, 1986, through December 31, 1990, when that limit expired.

In 1995, the Legislature re-established a limit on noneconomic damages for incidents that occurred after May 25, 1995. That limit was initially $350,000 and was adjusted at least annually to reflect changes in the consumer price index.

The constitutionality of the limits on noneconomic damages has been challenged in many court cases. In July 2005, the Wisconsin Supreme Court ruled that the $350,000 inflation-adjusted limit was unconstitutional because it violated equal protection guarantees. Subsequently, 2005 Wisconsin Act 183 limited noneconomic damages to $750,000 for occurrences on or after April 6, 2006.

However, as a result of the July 2005 court decision, there are no limits on noneconomic damages for incidents occurring from January 1, 1991, through April 5, 2006. The Fund's consulting actuary has estimated that undiscounted loss liabilities will increase by approximately $173.0 million for unsettled claims for this period. In response, provider assessment rates have been increased by 25.0 percent for fiscal year (FY) 2006-07.

Actuarial Audit

Estimating the Fund's loss liabilities is challenging because:

- a claim may be filed years after an incident occurs;
- there is no limit on the amount of economic damages the Fund may be required to pay; and
- limits on noneconomic damages have changed in response to changes in legislation and court decisions.

Over the past several years, the Fund's consulting actuary, Milliman, Inc., has regularly reduced past estimates of the Fund's loss liabilities because claims experience has been more favorable than originally expected. Consequently, some interested parties have expressed concerns that Milliman has been overly conservative in estimating the Fund's liabilities. We therefore recommended in 2001, and again in 2004, a comprehensive review of the methods and assumptions used by Milliman in estimating the Fund's loss liabilities. Such actuarial reviews or audits have become fairly common for critical and complex actuarial analyses, such as those completed for the Fund.

In July 2005, another actuarial firm reviewed Milliman's actuarial estimates of the Fund's liabilities and concluded they were reasonable, although conservative. That firm also recommended two changes to the process for

estimating the Fund's loss liabilities. The first was for Milliman to develop best estimates and then explicitly specify a risk margin that would be added to address the risk of actual losses being higher than predicted. In the past, Milliman's actuarial estimates had included an implicit risk margin of 33.0 percent that had not been separately identified.

On Milliman's advice, the Board of Governors has approved an explicit risk margin of 5.0 percent. As a result, the Fund's estimated loss liabilities as of June 30, 2006, were approximately $240.4 million less than they would have been if the 33.0 percent implicit risk margin had again been used in the calculation. The new 5.0 percent risk margin will also make loss liability estimates less conservative in the future.

The actuarial audit also recommended reducing the Fund's investment return assumption, suggesting it be no more than 4.0 percent. However, with the Board of Governors' approval, the Fund's loss liabilities as of June 30, 2006, were estimated using a 5.7 percent return on a market-value basis.

Another actuarial audit is expected to be completed by the end of 2007. If the Governor's proposed transfer of $175.0 million from the Fund is approved as part of the State's 2007-09 biennial budget, closely monitoring actuarial assumptions will become increasingly important.

Provider System

A continuing challenge for the Fund is the decreasing effectiveness of an aging computer system that maintains the accounts of participating health care providers. The provider system was developed in the early 1990s to track medical malpractice claims. Since then, it was expanded for billing and maintaining information about health care providers' compliance with primary liability coverage requirements.

The system has not been able to easily accommodate these increasing demands. As a result, errors occur in provider accounts, including incorrect billing and noncompliance notices. Staff have implemented manual procedures to detect system problems but note that other errors may not be detected until providers contact the Fund.

The issues with the provider system have also limited the Fund's ability to ensure that data cannot be viewed or changed by unauthorized users. Staff indicate that making changes to address these concerns could result in system integrity issues or other unintended consequences. The regular occurrence of errors and the control weaknesses noted in the system increase the risk associated with the Fund's operations and, consequently, also require additional audit effort.

In light of the critical nature of the provider system, OCI has taken steps to begin developing a new provider system. The Governor's 2007-09 Biennial Budget Proposal recommends additional funding of $600,000 over the biennium for the services of two contract programmers, hardware, and software. If the additional funding is not approved, it is not clear when a new system could be implemented.

Recommendations

Our recommendations address the need for the Fund's Board of Governors

to:

- require the next actuarial audit to again evaluate the appropriateness of the Fund's loss liability risk margin and investment return assumption, and report on the results in its annual report to the Legislature *(**p. 20**)*.

We also include a recommendation for the Office of the Commissioner of Insurance to:

- closely monitor access to and the integrity of the data and processing of the Fund's provider system until a new system has been fully implemented *(**p. 22**)*.

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