INDUSTRY UPDATE

By Eric J. Wunder and Chad C. Karls

2021 Financial Results—What is Normal?

As the world moved through the year 2021 a sense of normalcy seemed to slowly return in many ways. The same may be said about the medical professional liability (MPL) insurance industry. 2021 saw the return of a firming market and the expected associated rate increases. Courts shook off pandemic-related slowdowns and closures to return to near pre-pandemic levels of service. Prior year reserve releases continued, as did underwriting losses and an overall profit driven by investment gains.

Following a year that may have surprised some with respect to MPL direct written premium declines in 2020, 2021 showed renewed tailwind for MPL rate increases. These rate increases respond to long-term trends of deteriorating combined ratios, despite pandemic-related relief in recent years on both the frequency and severity of MPL claims.

Regardless of these underwriting losses, the MPL industry provided policyholders with modest dividend payments, especially relative to its net income. This is likely a function of well-capitalized balance sheets and continued competition in the market.

Those balance sheets appear to have a stronger reserve position at the end of 2021 than at the beginning, at least on the surface. Unpaid loss and loss adjustment expense (LAE) reserves are nearly $1 billion higher at year-end 2021 than they were a year prior. This 9% increase is the largest increase since the last hard market in 2005. Part of this increase may be a result of changing beliefs regarding reserve adequacy—given the continued low reserve releases in 2021—however, pandemic-related delays in the court system contributed to more open claims than would typically be seen. This caused claim liabilities to remain on the balance sheet instead of moving through the income statement, increasing the

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uncertainty with respect to the ultimate payment of those claims.

The pandemic appears to have had a favorable impact on the 2020 coverage year—especially with regard to claim frequency. Although 2021 is showing signs of a rebound with respect to reported claims, it is still lower than historical trends might have suggested. What remains to be seen is whether these frequency gains are permanent or—more likely from our perspective—temporary.

Severity levels have also moderated during the pandemic, following years of increased severity due to the disproportionate impact of large claims. We believe this pause in increasing severity is being driven by pandemic-related court closures and other court-related slowdowns. If one imagines that the type of claims that are most likely to result in large indemnity payments are also those most likely to push for trial, it makes sense the type of claims being settled during this period have been lower severity claims. In other words, this pause in severity is likely driven by the types of claims being settled more than changes in the environment that have brought additional large claims.

We have based this picture of the current state of the MPL industry on the financial results of a composite of 51 of the largest specialty writers of MPL coverage. Using statutory data obtained from S&P Global Market Intelligence, we have compiled financial metrics for the industry based on:

- Written premium
- Overall operating results
- Reserve releases
- Capitalization
- Policyholder dividends

In considering the financial results, note that the 51 companies included in the metrics are all established MPL specialty writers. The composite excludes any MPL specialty writer that has become insolvent or otherwise left the market as well as multiline commercial writers and smaller writers. The companies in each of these three excluded categories are generally not capitalized as well as the 51 companies included here. In addition, the underwriting results of the multiline commercial writers, as well as some of the smaller writers, have generally been somewhat less profitable. Of course, this is also true for the writers that became insolvent. Thus, the results presented below reflect the experience of the established specialty writers, which is inherently more favorable than a view of the industry as a whole.

Written Premium

2021 saw the largest direct written premium growth for the composite since 2004. The $370 million increase represents growth of 9.2% over 2020. Cumulatively, the 2021 direct written premium is up over 15% from the composite's recent low in 2016. However, given that premiums had fallen by 22% from 2006 to 2016, the composite is still about 10% below the 2006 high-water mark as shown in Figure 1. Some of the 2021 increase was likely a result of pent-up demand for rate from 2020 —a year that saw insurers grant premium relief to physicians dealing with pandemic-related hardships as well as a reticence on the part of insurance departments to approve rate increases.

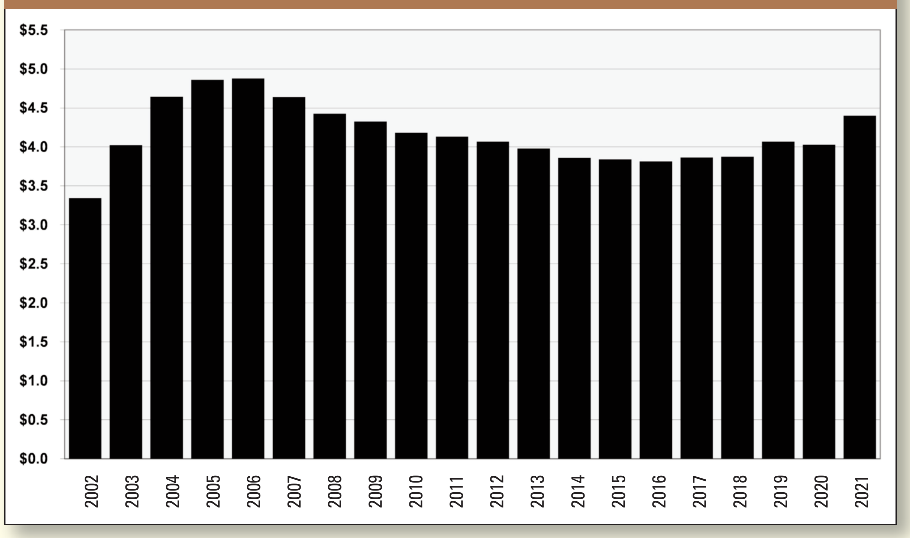
It is worth noting that although Figure 1 focuses solely on the composite's MPL direct written premium, composite companies have been increasing their diversification into other lines of business—especially in recent years. Although MPL premium still represents 96% of the composite's direct written premium, that figure is down from a high of 98% in 2007. During the period from 2006 to 2016, while the MPL direct written premium declined by 22%, the non-MPL premium actually rose by 20%. Now, concurrent with the MPL premium growth beginning in 2016, non-MPL premiums have increased another 85% from $100 million to $180 million. This diversification is prevalent in about half of the composite, but the growth is being driven by a smaller contingent of the composite.

Although the pandemic seemed to put a pause on the hardening market in 2020, the rate increases have resumed. The market we currently find ourselves in has important differences relative to the start of the last hard market in the early 2000s. Notably, the degree of rate inadequacy appears to be less, and present in fewer locales. Additionally, as we will discuss below, the reduction in claim frequency over the last two decades and resulting impact on the composite's surplus, has the composite in a stronger balance sheet position from which to weather any rate inadequacies. This may mean a slower hardening and more moderated rate increases than we saw in the hard market 20 years ago.

Overall Operating Results

The 2021 operating ratio improved 6 points from 2020 to 88%. Although this is 10-points better than the 2019 results, it is still 30 points off the composite's most profitable year in recent memory—he 58% operating ratio in 2010, as seen in Figure 2.

Figure 1. Direct Written MPL Premium ($ Billions)



The primary driver of the increasing underwriting ratio has been declining reserve releases, which have been trending downward since 2012. The 2021 reserve release, relative to net earned premium, remained steady at 4% compared to 2020. Underwriting expenses also contributed to the increased underwriting ratio, which experienced a more than 10 point increase in the last two decades. However, the 2021 underwriting expense ratio decreased 2 points from a high of 28% down to 26%. This decrease was not driven by lower underwriting expenses, which continue to climb at about 3.5% per annum. Instead, premium growth outpaced the expense growth, which drove the ratio down. Combined ratios have now been above 100% since 2016, as seen in Figure 3, and as such the composite remains reliant on investment income for profitability.

Investment gain ratios for the composite have hovered above 20% over the last two decades, and 2021 was no exception. The 2021 investment gain ratio matched 2020 at 23%. If we consider the pieces that comprise the investment gains, however, we see an interesting trend developing. Investment income has been falling each of the last four years to a new low of 13% of net earned premium in 2021. Offsetting these decreases have been realized capital gains, which reached a 20+ year record of 10% of net earned premiums in 2021, up 2 points from the previous high in 2020.

The 2021 calendar year loss and LAE ratio fell 3-points from 2020 to 82%. To put that in context with the recent past, the low point for the calendar year loss and LAE ratio was in 2011 at 54%, but the high point was in 2002 when the ratio reached 111%. As noted earlier, declining reserve releases have driven these changes with much more muted changes in the starting loss and LAE ratio.

The starting loss and LAE ratio for each coverage year over the past two decades has ranged from a high of 103% in 2002 to a low of 80% in 2007. In the last decade, this ratio has normalized, and typically comes in around the high 80s and low 90s. The 2021 starting loss and LAE ratio is at the low end of this range at 86%. We believe that the pandemic-related frequency reductions, coupled with premium increases, likely contributed to this lower loss and LAE ratio for 2021.

Figure 2. Operating Ratio

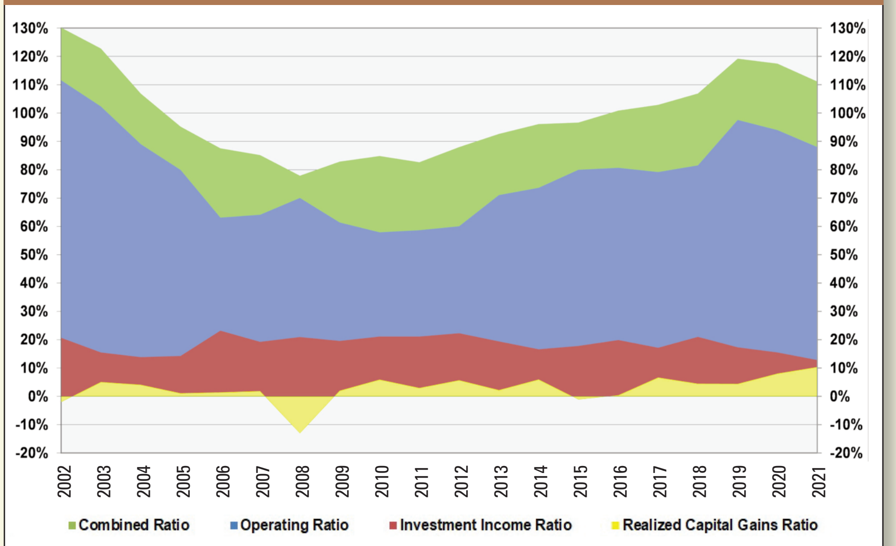
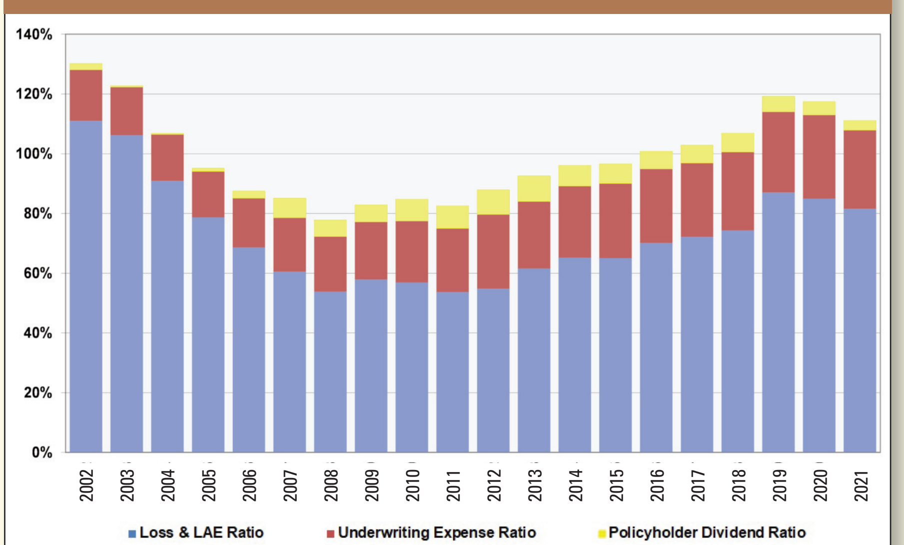


Figure 3. Combined Ratio



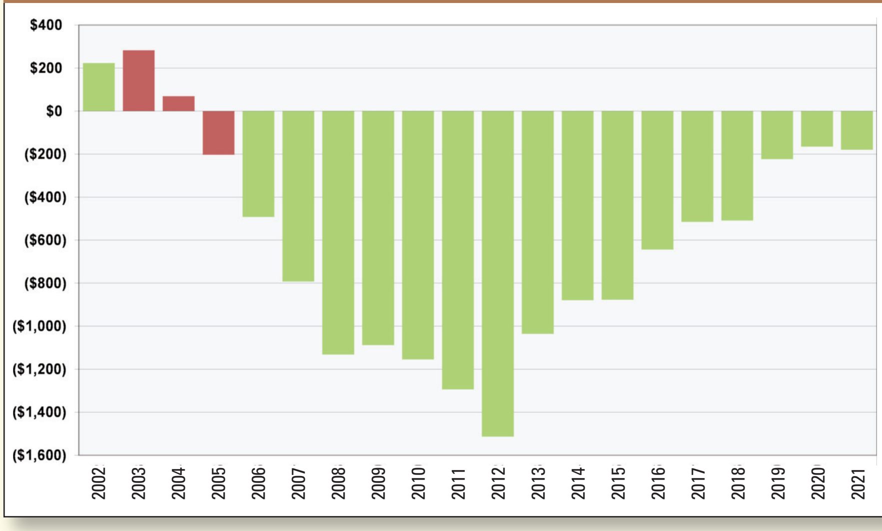
Reserve Releases

The composite released about $180 million in prior year reserves during 2021. This is a slight rebound from the 2020 low of $165 million, but otherwise represents the smallest release since the last adverse reserve development in 2004 (Figure 4). To put these releases into perspective, the peak reserve release for the composite occurred in 2012, which saw more than $1.5 billion of prior year reserves released—more than eight times the 2021 release.

One possible reason that prior year reserve releases are low in 2021 is because claims are remaining open longer. A review of Schedule P, Part 5 data shows that the number of open claims increased from 2019 to 2020 by about 6%, and from 2020 to 2021 increased another 3%. This is despite the fact that the number of reported claims decreased by 17% from 2019 to 2020 and stayed low in 2021, only 5% higher than 2020. The difficulty closing claims is, in our view, highly correlated with the court slowdowns/closures because of the pandemic.

One measurable way in which we can see

Figure 4. Reserve Release ($ Millions)



the impact of the pandemic on the courts is by observing the number of trial attendance and travel hours invoiced by attorneys over the last three years (Figure 5). Using a proprietary database containing on average 28,000 open claims at any given time over the last three years, we saw trial hours plummet to near-zero for almost a full year. Beginning in March of 2021, those hours began to rebound, and by the end of 2021 they appear to be approaching a sense of normalcy again. That said, we believe this has had a direct impact on the ability of insurers to move claims through the process, which led to fewer payments during 2020 and 2021 than we otherwise would have seen. Even as the courts return to "normal" we do not believe there are enough resources to quickly catch up on lost time. Therefore, this lag may persist for some time, leading to higher reserve uncertainty and more reserves being held on the balance sheet.

Capitalization

The composite's surplus increased during 2021 by about $735 million and is now approaching $15 billion (Figure 6). As mentioned previously, this increase was due, in no small part, to record levels of realized capital gains. Net income for the composite contributed a robust $500 million to the surplus growth. This may be a low amount relative to the recent profitable run from 2005-2018 which saw an average of $900 million of net income, but much better than 2019, which saw a net income of less than $100 million.

Despite the increase in surplus, the risk-based capital (RBC) ratio for the composite continued a trend of decreases. The RBC ratio for the composite now sits at 933%, the lowest level since 2009. The RBC ratio provides a comparison of a company's statutory surplus to the minimum amount needed from a regulatory perspective (although, from a practical perspective, given market fluctuations, many would consider the practical minimum amount of capital needed to be well in excess of this regulatory minimum). Despite the recent decreases, the RBC ratio for the composite remains strong relative to that of most insurance markets, per results aggregated from S&P Global Market Intelligence.

Policyholder Dividends

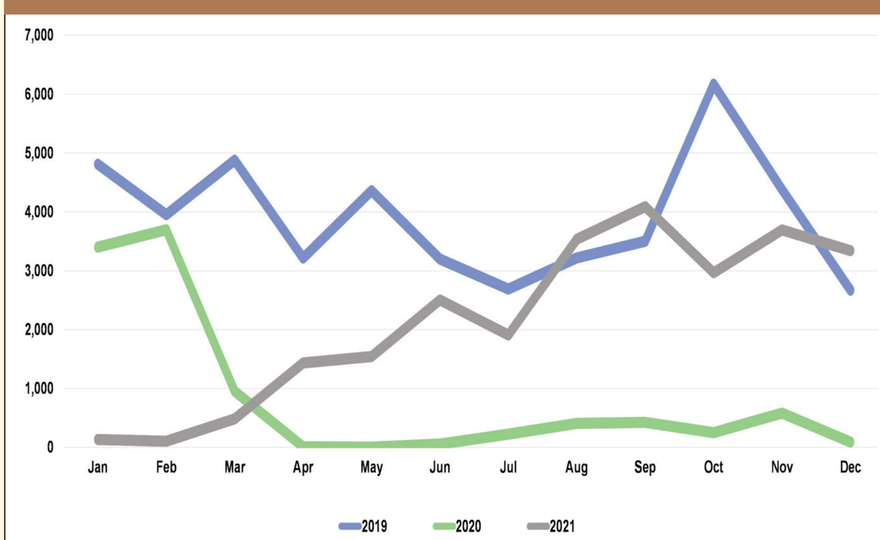
Policyholder dividends have been a staple of the composite for the last decade-plus. In fact, policyholder dividends have averaged 7% of net earned premium from 2007-2020. These dividends have trended lower in recent years, culminating with a 2021 policyholder dividend of just 3% of net earned premium, as seen in Figure 3. These policyholder dividend payments were likely funded, in part, by the composite's reserve releases. Therefore, as reserve releases have dwindled, so too have the policyholder dividend payments. That being said, the composite has collectively paid nearly $3.8 billion in policyholder dividends in the last two decades.

Although from an absolute perspective, dividends have decreased in recent years, as a percent of net income they have been very healthy. Starting in 2007, when policyholder dividends became more mainstream within the composite, dividend payments to policyholders have averaged 30% of net income. 2021 shows a continued commitment to those levels of support for the composite's policyholders, coming in at 27% of net income.

A Return to Normalcy?

As the pandemic appears to be waning—evidenced in the courts by the attorney trial

Figure 5. Attorney Trial Attendance and Travel Hours

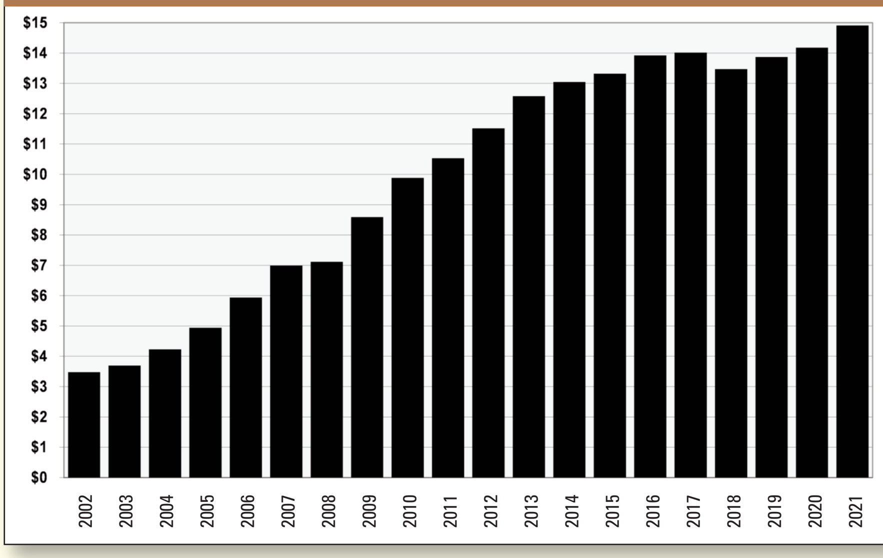


hours shown in Figure 5 and elsewhere by the triumphant return of in-person conferences—we anticipate a return to some semblance of normalcy in the coming years. Then again, what is normal but a constantly changing set of challenges facing the MPL industry? Triple-digit combined ratios will likely be met with rate increases during 2022 and beyond. The tort reform pendulum is again swinging in the pro-plaintiff direction. This includes 2021 laws in Illinois, Public Act 102-0006, and California, S.B. 447, which may each put upward pressure on MPL costs in their own way. Additionally, California's long-standing MICRA legislation may again be on the ballot come November.

Inflation, and now war, are on the minds of many. The impact of these on the overall economy and the trickle-down impact to the MPL industry could have material impacts. These uncertainties will affect both the stock and bond side of the asset portion of the composite's balance sheet. In addition, inflation and the court reopenings referenced earlier are likely to increase claim severity on the liability side of the balance sheet.

Another metric we are watching closely is claim frequency. The long-term decline in claim frequency has been well documented over the years; however, the decrease in 2020 discussed earlier was much steeper than we saw historically. The fact that a modest rebound in reported claims occurred in 2021 begs the question whether we should expect claim frequency to continue to rebound to 2019 levels, or whether longer-term frequency decreases will continue. Furthermore, what will these years of lower frequency do to the composite's ability to get approval for rate increases and might that stymie a firming market? MPL

Figure 6. Policyholder Surplus ($ Billions)



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