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# Lawyers professional liability update: Insurers continue to weather the soft market with enhanced underwriting discipline

**By Susan J. Forray and Shaun P. Cullinane**

Specialty writers of lawyers professional liability (LPL) continued to exhibit stable financial results in 2011. As in 2010, the operating ratio for the LPL industry was about 85%, an approximate five- to 10-point improvement from 2008 and 2009. Insurers were able once again to release reserves, and a large portion of the releases were returned as policyholder dividends. The industry's surplus is also at an all-time high, providing additional capital support for the current soft market.

At the same time, operating results since 2008 have been somewhat less profitable than in preceding years. Claim frequency remains higher than the levels seen in 2004 through 2007. In addition, most companies implemented modest decreases in rate levels during and following this time period. Any future continued increase in frequency, combined with the potential impact of inflation on claim severity, could materially impact underwriting results.

To further discern the state of the LPL industry today, we have performed an analysis of the financial results of a composite of the 14 specialty writers of LPL coverage for solo practitioners and small groups. This excludes one LPL specialty writer that became insolvent during the time period considered. Data was obtained from SNL Financial. We have compiled various financial metrics for the industry, categorized by:

- Overall operating results
- Reserve releases
- Claim frequency
- Capitalization
- Net retentions

## Overall operating results

While the industry posted strong operating results in 2011, the past four years of operating results have been worse than those experienced in the prior 15 years—even during the previous soft market of the late 1990s through 2001 (see Figure 1). The results of the past four years have been driven by an increase in the loss and loss adjustment expense (LAE) ratios incurred by these writers in the most recent coverage years. The loss and LAE ratios incurred by the LPL specialty writers averaged about 75% from 2008 through 2011 (see Figure 2), roughly eight points higher than during the preceding five to 10 years.

Reserve releases for the 2008 to 2011 period have been comparable to the five years preceding this time period (see Figure 3). We believe this suggests that the industry expects the coverage years 2008 through 2011 to produce loss and LAE ratios higher than those of the preceding years. This is consistent with the moderate rate decreases taken during this time period. Coupling this issue with the greater frequency experienced during this time period only serves to compound the effect of the lower rate levels.

**Figure 1: Aggregate Calendar-year Operating Results for the LPL Specialty Writers**

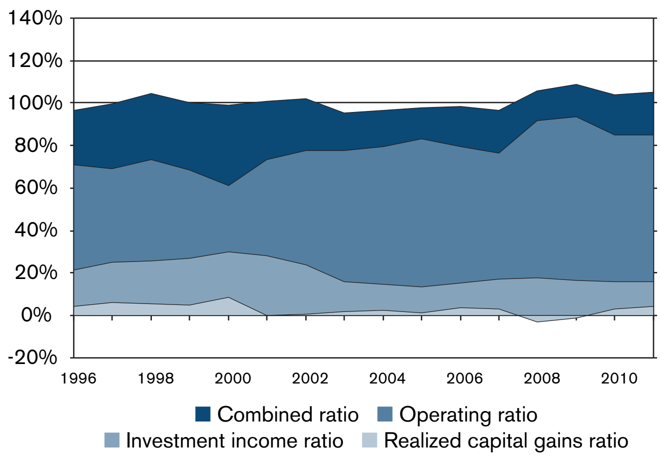


**Figure 2: Breakdown of the Aggregate Combined Ratios by Calendar Year for the LPL Specialty Writers**

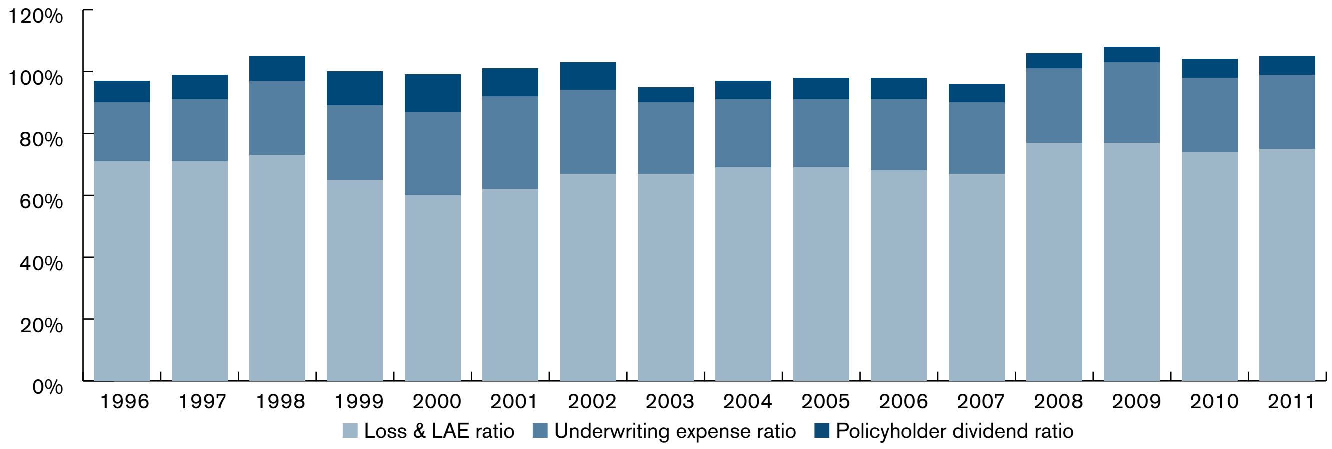
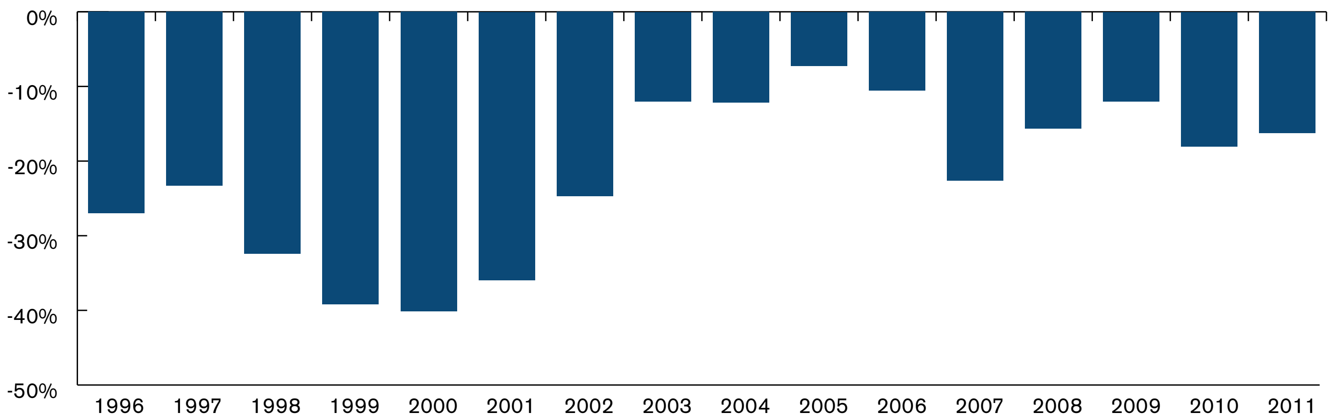



**Figure 3: Calendar-year Loss and Allocated Loss Adjustment Expense (ALAE) Reserve Releases for the LPL Composite**




The underwriting expense ratio was at 24% in 2011, very similar to other years of the past decade. About 6% of net earned premium was returned by the composite as policyholder dividends. The policyholder dividend ratio has been increasing since 2008 but remains less than the policyholder dividends of the 1997 to 2002 time period. In part this may be due to reserve releases (discussed below), which have also decreased since this time and are oftentimes viewed as the most available source to fund policyholder dividends.

The realized capital gains ratio for the LPL writers hit an 11-year high of 4% of net earned premium, as companies continued to sell assets for amounts greater than their carried values, which was due to previous write-downs. The investment income ratio was at 16%, comparable to other recent calendar years. As a result, the investment gain ratio of 20% was the second-highest experienced by the composite since 2002.

## Reserve releases

Reserve releases for the industry in 2011 were a relatively moderate $29 million, or 16% of net earned premium. While noticeable, this should also be put in the context of the reserves carried by the composite, which for net loss and LAE totaled $369 million as of year-end 2010. It is also important to recognize that a history of favorable calendar-year reserve development is not necessarily indicative of redundant reserves currently.

As mentioned previously, the industry saw a dramatic decrease in reported frequency from 1999 to 2005. We believe this has been the main cause of subsequent favorable reserve releases, as LPL writers initially assumed that the reduction in frequency was due to fewer *nuisance* claims. Only with the benefit of hindsight were we able to see that the reduction in frequency occurred for claims with indemnity payment as well.

## Claim frequency

While actuaries typically measure frequency as claim counts relative to the number of insured attorneys, ultimately it is premium dollars that must pay these claims, and thus considering frequency as claim counts relative to premium is a relevant statistic for insurers. Measured on this basis, we see that frequency per $1 million of gross earned premium reached its lowest point for the

**Figure 4: Reported Claim Frequency per $1 Million of Gross Earned Premium**

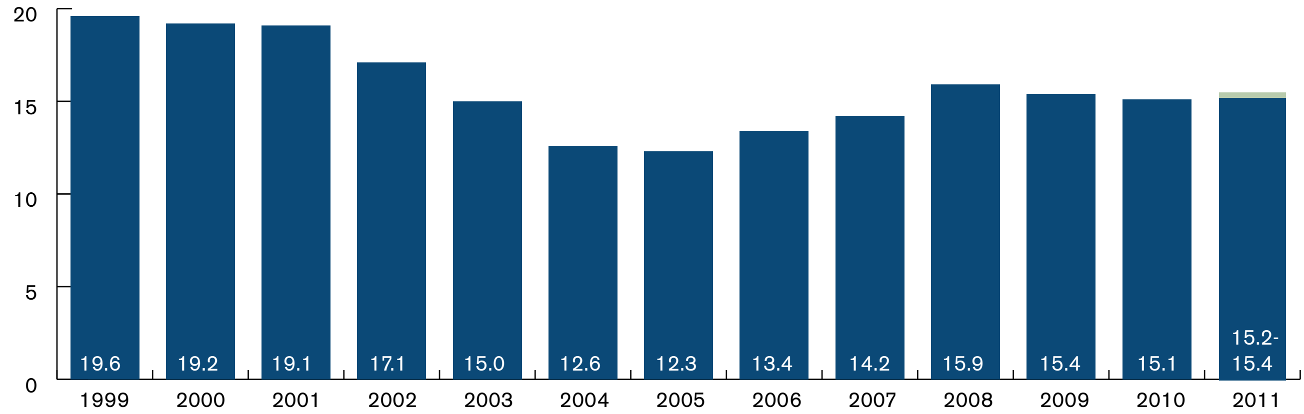
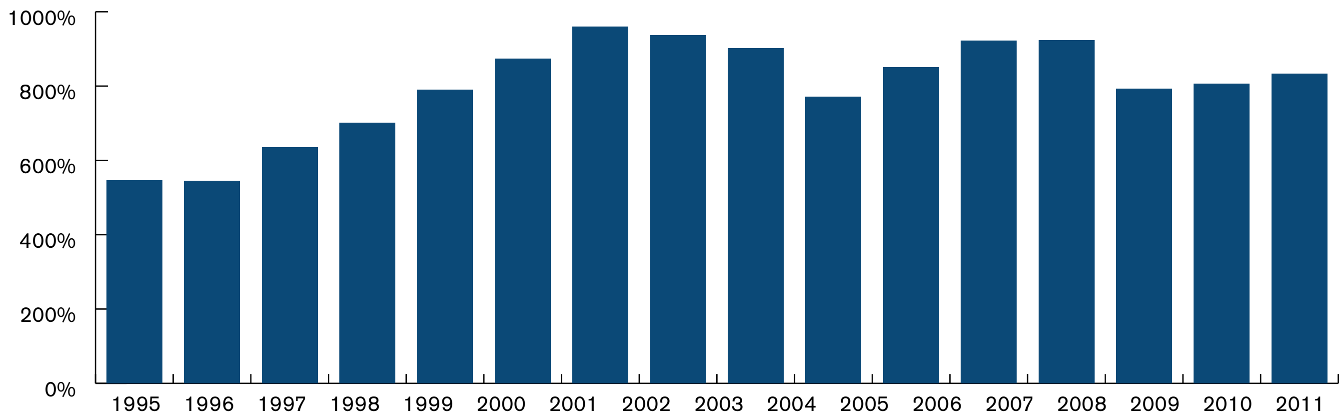



**Figure 5: Aggregate Risk-based Capital Ratio of the LPL Specialty Writers**




industry in 2005 (see Figure 4). Reported frequency subsequently increased from 2005 until 2008 and has declined somewhat since this time. We believe that the decline in claim frequency since 2008 has been largely driven by a decline in the number of real estate claims (and the increase going into 2008 was in part driven by these claims as well). Absent this unique phenomenon, claim frequency during the past several years might have been roughly flat.

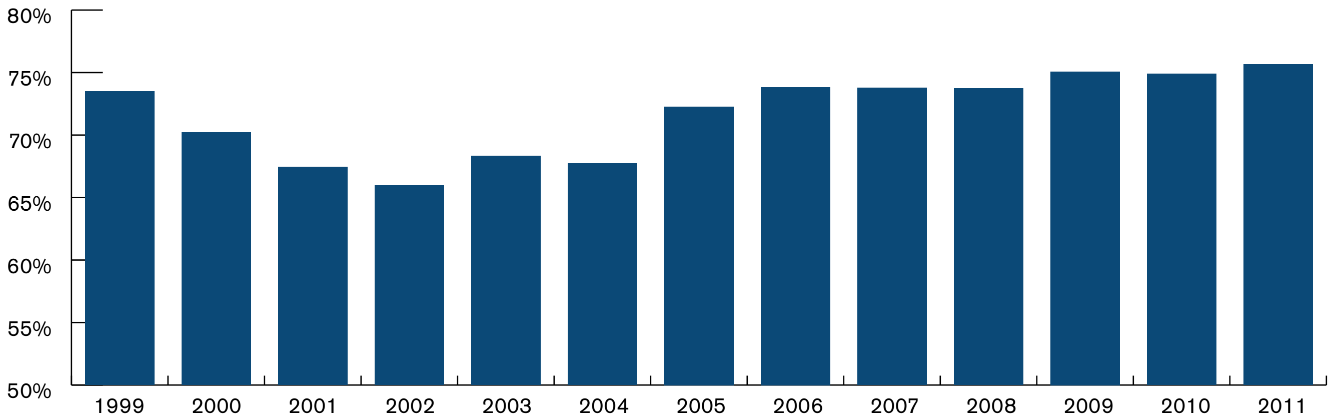
Note that, in Figure 4, we have adjusted the 2011 frequency to include a provision for *pipeline* claims (i.e., incidents that evolve into claims), in order to provide an indication comparable to the older report years. Prior development suggests that with the inclusion of these pipeline claims, the frequency for the 2011 report year is likely between 15.2 and 15.4 claims per $1 million of gross earned premium. Reported frequency has declined slightly since 2008, but remains more than 20% higher than in 2005. This increase is the result of moderate rate decreases for the industry as a whole as well as increases in *true* frequency—i.e., claim frequency per insured attorney.

## Capitalization

The industry's profitable operating results in 2011 resulted in an increase in surplus during the year of about 4%, from about $488 million to $508 million. This is a meaningful gain, but must be put in a broader context. To do so, consider the risk-based capital (RBC) ratio for the industry. This metric provides a comparison of a company's actual surplus to the minimum amount needed from a regulatory perspective (although, from a practical perspective, given market fluctuations, many would consider the actual amount of capital needed to be well in excess of this regulatory minimum).

The RBC ratio of the LPL writers increased to 849% in 2011 (see Figure 5). However, this is somewhat less than it has been at most year-end evaluations during the past decade. Its current level is comparable to its level as of year-end 1999 and 2000, what some might consider the peak of the previous soft market. In addition, individual RBC ratios as of year-end 2011 vary considerably within the composite, from a low of 350% to a high of 2,560%.

**Figure 6: Ratio of Net to Gross Earned Premium**




## Net retentions

The generally favorable operating results of the past decade, as well as increases in surplus, have allowed the specialty writers to decrease the amount of premium (and corresponding loss and LAE) ceded to reinsurers. The industry's average ratio of net to gross earned premium (see Figure 6) increased most noticeably between 2004 and 2005, although it has increased steadily since this time as well. In part this increase was motivated by increases in the cost of reinsurance during the initial years of this time frame. Given the generally favorable underwriting results experienced by the composite, the increase in net retention has in turn served to contribute to subsequent favorable operating results, as insurers retained profitable layers of coverage.

## Forecast

While currently in a strong financial position, the above observations have the potential to produce future operating results that are dramatically different from the historical experience of the industry. Loss and LAE ratios are currently projected by the industry to be about 10% higher than they were five years ago; however, frequency appears to be about 20% higher than the nadir of this time frame. Combined with an increase in severity over the same time period, these factors themselves may be sufficient to eliminate the favorable reserve development that has been the historical pattern of the industry. While operating results have been profitable to date, without favorable reserve development they would have been roughly break-even in most years. Thus if rates prove inadequate going forward, and without favorable reserve development to rely upon, the industry may experience unprofitable operating results as a whole for perhaps the first time.

On the other hand, we have observed recent rate action taken by many of these companies. While rate increases across the board have not been the norm, companies are paying increased attention to rating factors, with the real estate area of practice being a particular example. This, combined with an increased underwriting discipline in recent years, may serve to offset the adverse observations above. While we envision a continued soft market for the LPL industry, the impact on surplus and overall operating results will be muted by this increased underwriting focus.

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