

UNDERWRITING INCOME CONTINUES TO DECLINE, WITH FAINT SIGNS OF A FIRING MARKET ON THE HORIZON

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The year 2018 manifested a continued decline in underwriting income for the medical professional liability (MPL) insurance industry. However, this downward movement in the industry's profitability continues to occur at a relatively slow pace.



In 2018, the industry's combined ratio increased to 107%, 4 points over the prior year. Driving this increase was a significant decline in reserve releases, compounded by somewhat higher expenses.

While investment gains increased slightly, to 26% of premium, surplus declined by 5%, primarily due to unrealized capital losses from common stock investments. Yet the underwriting income and investment gains produced a return on revenue of nearly 20%, thus, once again, making it possible for the MPL industry to return a substantial portion

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of its income as dividends to policyholders. And despite the modest decline in surplus, measures of surplus adequacy remained consistent with the past several calendar years.

For more than a decade, the favorable operating ratios in the MPL industry have had one primary cause—the release of prior-year reserves. In 2017 and 2018, reserve releases contributed an average of 15 points to the industry's operating ratio in each year. However, this is a noticeable decline from the reserve releases of prior years. In the decade preceding 2017, reserve releases contributed an average of 28 points to the industry's operating ratio each year. Yet, without these reserve releases, the industry would have remained profitable in 2018, albeit by a much smaller margin.

The industry's long-term trend of declining frequency appears to have ended several years ago. Since then, we have seen the reporting of claim counts stabilize for most companies, with some volatility evidenced for certain writers and both increases and decreases seen. Per annum trends in defense costs remain in the mid-single digits. Indemnity severity trends remain manageable for smaller-dollar claims, but an increased frequency of larger claims has fueled overall increases in indemnity costs.

In part, consolidation in healthcare has driven this trend toward higher indemnity payments. Whereas an occurrence might previously have resulted in payments on behalf of both a hospital and an independent physician, that independent physician is, in many

cases, now employed by the hospital. As a result, the hospital is likely to assume the full indemnity payment—leaving overall indemnity unchanged in this example, but increasing the average indemnity per claim. At the same time, the hospital typically carries higher limits than the physician, so there may be greater availability of coverage for indemnity payments.

Rates have continued to fall for many writers, although this pattern seems to have stabilized, as evidenced by the small increase in premium volume of the industry as a whole. Yet certain markets have seen a cumulative decline in rate levels in excess of 25% over the past half-decade. It is common for companies to see certain of their competitors writing at rates perceived to be inadequate, forcing companies to choose between losing market share and writing at levels that they themselves believe are unprofitable. While this trend in declining rate levels has somewhat abated, any rate increases seen have been modest.

A trend that has not abated is healthcare consolidation, as evidenced by the acquisition of physician practices by hospitals and healthcare systems and by many newly trained physicians opting to join these larger systems rather than enter into independent practice. MPL carriers continue to face declining market from these acquisitions. Healthcare reform only served to accelerate

the trend in physician employment that was already well underway. Discussions of a single-payer healthcare system, while taking various forms, suggest that an abatement of the trend in physician employment is unlikely—change and uncertainty are hardly an encouragement to independent physician practices.

We have based this picture of the current state of the MPL industry on the financial results of a composite of 55 of the largest specialty writers of MPL coverage (“the composite”). Using statutory data obtained from S&P Global Market Intelligence, we have compiled various financial metrics for the industry, categorized by:

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

In considering the financial results discussed above and further below, note that the 55 companies included here are all established MPL specialty writers. (Astute readers may notice that the number of companies in this year’s composite is up from the 35 included last year. We have expanded the composite to include certain smaller, yet established, specialty writers. While the number of companies has increased considerably, their addition represents less than 30% additional volume,

as measured by premium, and 20% additional volume, as measured by surplus.)

The composite excludes any MPL specialty writer that has become insolvent or otherwise left the market and the multiline commercial writers of MPL coverage, as well as the smaller writers. The companies in each of these three excluded categories are generally less well-capitalized than the 55 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 was 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

The years 2017 and 2018 were the first years in which direct written MPL premium increased for our composite, following a decade of premium decline (Figure 1). Cumulatively, premium decreased by \$1.1 billion between 2006 and 2016—approximately 20% of the premium written at the beginning of that decade. To put that in perspective, consider: in the 40-year history of the MPL industry, no other period of decreasing premiums has lasted longer than two years, and the greatest consecutive-year premium reduction was 7%. Increases since 2016 have been modest, with the most recent measure of premium for our composite 2% above the 2016 amount.

Declining rate levels were only one factor driving premium decreases during this timeframe. Also contributing to the lower level of premium was the loss of business to self-insurance mechanisms. Throughout this timeframe, MPL companies lost business due to healthcare system acquisitions of both hospitals and physician practices, which typically then joined the self-insurance mechanisms of these systems. In earlier years—through about 2008—companies also frequently lost business due to the formation of new captives.

A distinct difference between the current market and the previous soft market, of the

Figure 1. Direct Written MPL Premium (\$ Billions)

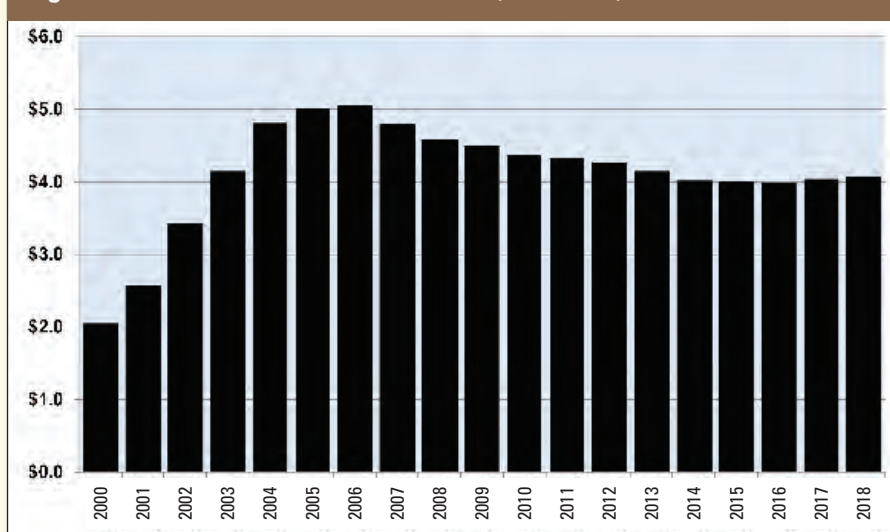


Figure 2. Operating Ratio

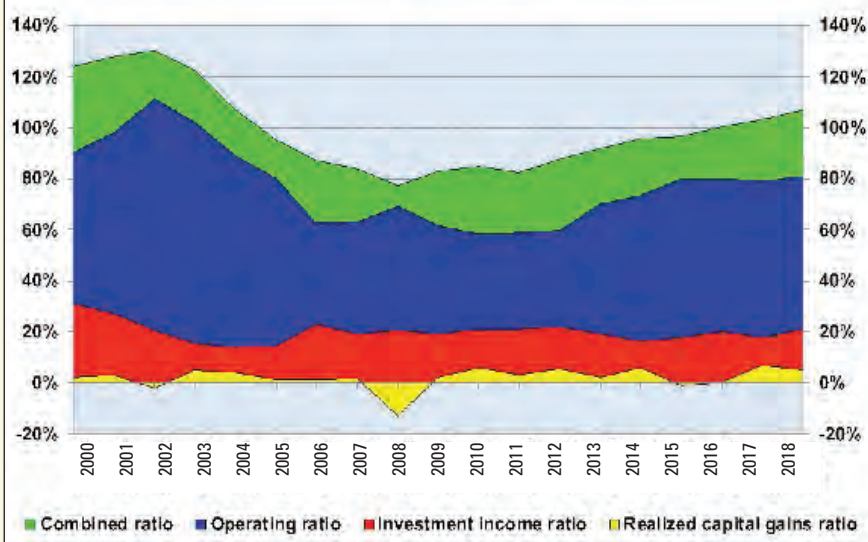
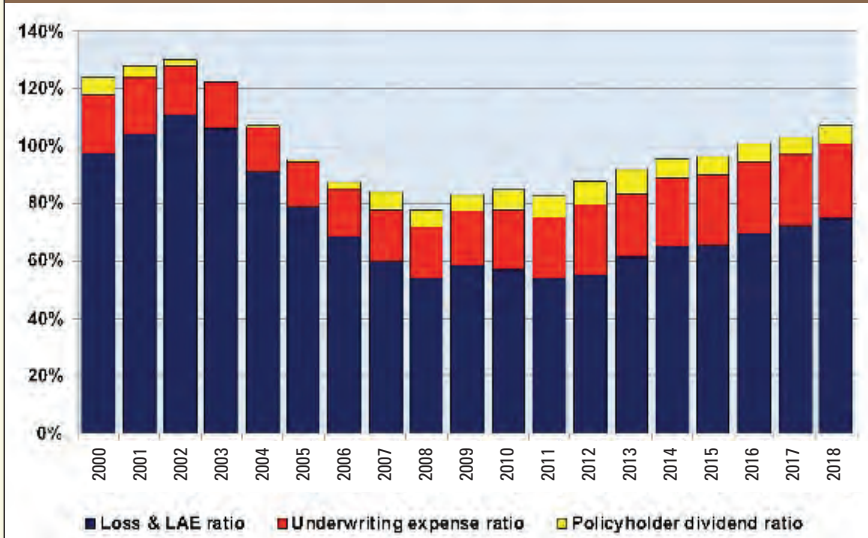


Figure 3. Combined Ratio



mid-to-late 1990s through the early 2000s, lies in the degree of rate adequacy within each time period. Both the current and prior soft markets have shown inadequate rate levels, though to a lesser extent, and in fewer locales, in this current soft market, as compared with the previous soft market. During this prior time period, rate deficiencies—including those documented in rate filings—ultimately culminated in adverse financial results. The dramatic reduction in frequency since the early 2000s means that MPL rates are in a much better position now than they were 20 years ago. However, we continue to see rate inadequacies in a number of markets

and have observed significant premium reductions on nonrenewed, large accounts.

Overall operating results

As measured by the composite operating ratio, the industry reached its peak profitability during 2010. During that year, the composite posted an operating ratio of 58%, which has risen to about 80% since that time (Figure 2). Reserve releases have driven this deterioration in the operating ratio, beginning in 2013, and an increase in underwriting expenses exacerbated it. The 2018 combined ratio for the industry was 107%, up 30 points from a low of 77% in 2008 (Figure 3). This is

the third year in a row that the industry's combined ratio has exceeded 100%, meaning that the industry would have been unprofitable each year since 2016 without its investment income.

The investment gain ratio of 26% in 2018 was the highest achieved by the composite since 2012. This is a noticeable increase from 2015 and 2016 in particular, in which the investment gain ratio averaged 18%. In large part, the lower investment gain ratios of these two years were due to the accounting treatment by one larger carrier of its investment in its affiliates. The composite's capital gains ratio increased to 7% in 2017 and 5% in 2018, up from an average of 0% in 2015 and 2016.

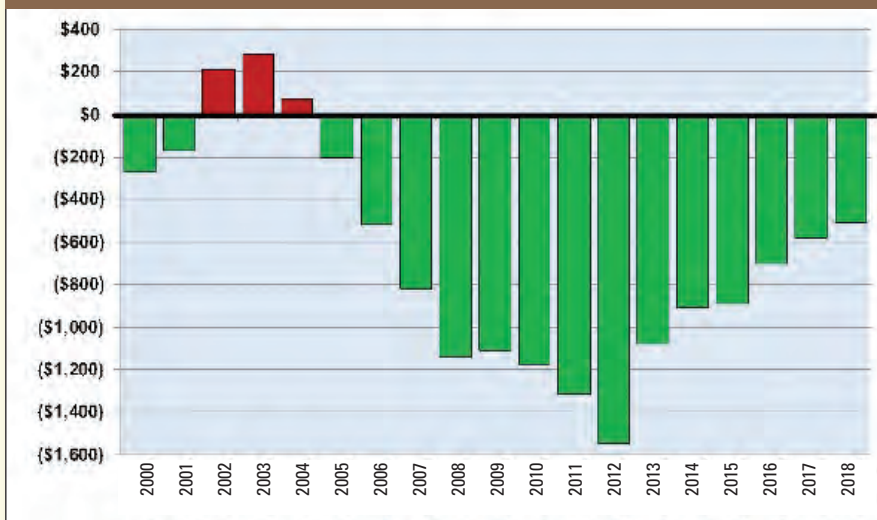
The 2018 calendar-year loss and loss adjustment expense (LAE) ratio of 75% is higher than any year since 2005, and represents an increase of about 20 points since the 2008 to 2011 time period. As noted earlier, reserve releases have driven this increase. We discuss these further below. The starting loss and LAE ratio for each coverage year has changed little during this time period.

Information from the composite on the 2018 coverage year, such as claims relative to premium, suggests the 2018 coverage year may be comparable to 2017, but it is starting from a slightly weaker position than other recent coverage years. This suggests that reserve releases will continue to decline prospectively.

As noted previously, the industry saw a dramatic decrease in reported frequency during the 2000s. However, for most companies, frequency (on a per-physician basis) has since stabilized. Other companies have continued to see small declines in frequency, while for some writers, frequency has turned slightly upward again.

Given the rate decreases of the past decade, frequency has of course increased more relative to premium than to the number of insured physicians. Reported frequency per \$1 million of direct earned premium increased significantly leading into 2012, although increases have been smaller since then. Thus, for every claim reported, fewer premium dollars have been available to defend or settle the claims than was the case at the beginning of this timeframe.

Figure 4. Reserve Release (\$ Millions)



Cumulatively, reported claim frequency (measured relative to premium) has increased by almost 40% since 2009. This increase is largely the result of rate decreases (mostly in the form of greater premium credits, as opposed to manual rate changes).

Reserve releases

The composite released \$510 million in reserves during 2018, an amount that has declined annually from the \$1.1 billion to \$1.5 billion released in each of the years 2008 through 2013 (Figure 4). Despite this decline, the reserve releases remain material. Yet, when considered in the context of the reserves carried by the composite, they represent 5% of the \$9.9 billion reserve carried as of year-end 2017. A relatively benign trend in indemnity severity during the past several calendar years has driven these reserve releases, along with, for some companies, a lower-than-expected ratio of claims closing with indemnity payment.

It is important to recognize that a history of favorable calendar-year reserve development is not necessarily indicative of redundant reserves currently. In fact, a review of calendar-year development segregated by coverage year shows that favorable calendar-year reserve development has historically continued two to three years past the point when reserves were subsequently found to be adequate. Thus, if the industry's reserves are theoretically exactly adequate as of year-end 2018, history would suggest that we will see favorable reserve

development, on a calendar-year basis, through 2020 or 2021. Adverse development would then follow in subsequent calendar years (at least for the older coverage years).

Capitalization

The composite's surplus decreased during 2018 from about \$14.3 billion to \$13.6 billion (Figure 5). This represents the first noticeable decline in surplus for the composite since 2002. The decline was primarily due to unrealized capital losses in the companies' common stock portfolios. While net income for the composite was \$720 million, companies returned a third of this income to policyholders in the form of dividends, discussed fur-

ther below.

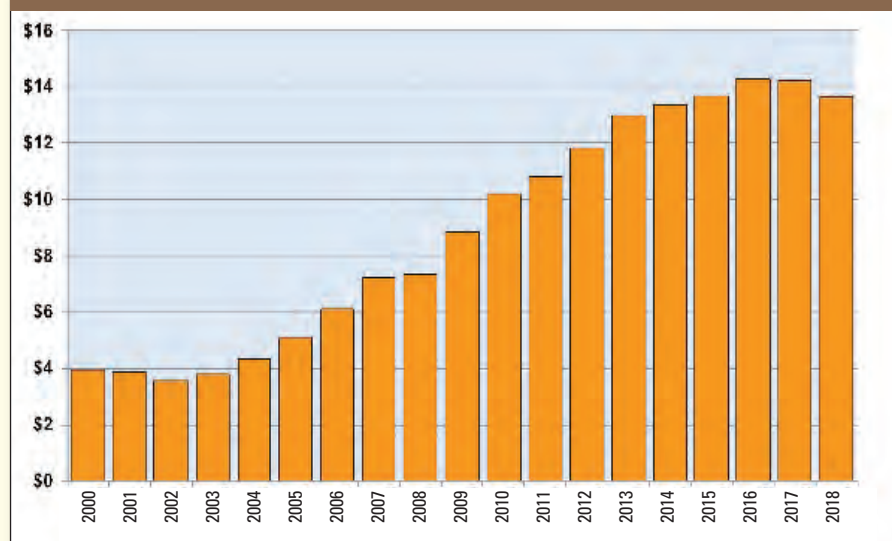
However, to put the industry's capitalization level in a broader context, consider the risk-based capital (RBC) ratio for the industry. This metric provides a comparison of a company's actual surplus to the minimum amount needed, from a regulatory perspective (although, from a practical perspective, given market fluctuations, many would consider the practical minimum amount of capital needed to be well in excess of this regulatory minimum). The RBC ratio of our MPL composite was 1150% in 2018, approximately the same level it has had since 2013. However, individual RBC ratios vary considerably within the composite.

Policyholder dividends

The decrease in the composite's surplus is in part due to the significant amount of policyholder dividends that MPL writers have continued to pay. In 2018, the composite writers paid almost \$240 million in policyholder dividends, representing more than 6% of net earned premium (Figure 3). Cumulatively, the composite has paid \$3.2 billion in policyholder dividends since 2005.

MPL writers have sustained a steady pattern of policyholder dividend payments, despite a decline in the reserve releases that have historically funded these dividends. Since 2013, policyholder dividends have constituted approximately one-third of net

Figure 5. Policyholder Surplus (\$ Billions)



income in each year. This represents an increase from an average of approximately 25% of net income in each of the preceding six years.

Typically, companies pay these dividends to all renewing policyholders as a percentage of premium. Thus, on a dollar basis, the dividends have provided greater benefit to those physicians who have historically paid higher premiums. We expect that policyholder dividends will continue for several more years, given their consistency over the past decade and the composite's strong balance sheet.

Profitability expected to continue—but so is its decline

In its most recent "Review & Preview" report, A.M. Best estimated a net total reserve redundancy of \$2.8 billion for the MPL line of business as a whole. This is approximately 10% of the carried net reserves, which implies a redundancy for our composite of \$1.0 billion.

Thus, we expect that reserve releases will continue to mask underwriting results on current business. Insurers face other risks to the bottom line as well: possible increases in frequency and severity, including challenges to tort laws in multiple states; uncertainty surrounding the push for single-payer health care; and a declining market share, among other factors.

Although the soft market will exert further pressure on the industry's rate adequacy in many states, certain markets will see rate increases. In spite of stock market volatility, MPL companies' capital remains strong, and we expect that discussion of its appropriate deployment will continue to be a common topic of conversation.

Despite the rate increases seen in multiple states, we see the overall soft market extending several years into the future. The small magnitude of these rate increases, the relative flatness of trends in frequency, stagnant rate levels in most states, and consistent

capital adequacy, in particular, combine to suggest that the current equilibrium may persist for some time.

In the past, we have attempted to speculate on when the market might harden, writing that we know not much more than that the market will harden only when it finishes softening. Looking back at 2018, we have seen not only the continuation of aggressive competition in most regions, but also small rate increases in certain markets. It seems that, for the first time in this market cycle, we are able to foresee the end of the soft market approaching, although perhaps not the beginning of the hard market. In an industry that remains profitable, we expect that it will be at least several years before the hard market appears on the horizon. **MPL**

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