2014 YEAR-END RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS: PROFITS REMAIN HIGH, BUT TREND IS NEGATIVE

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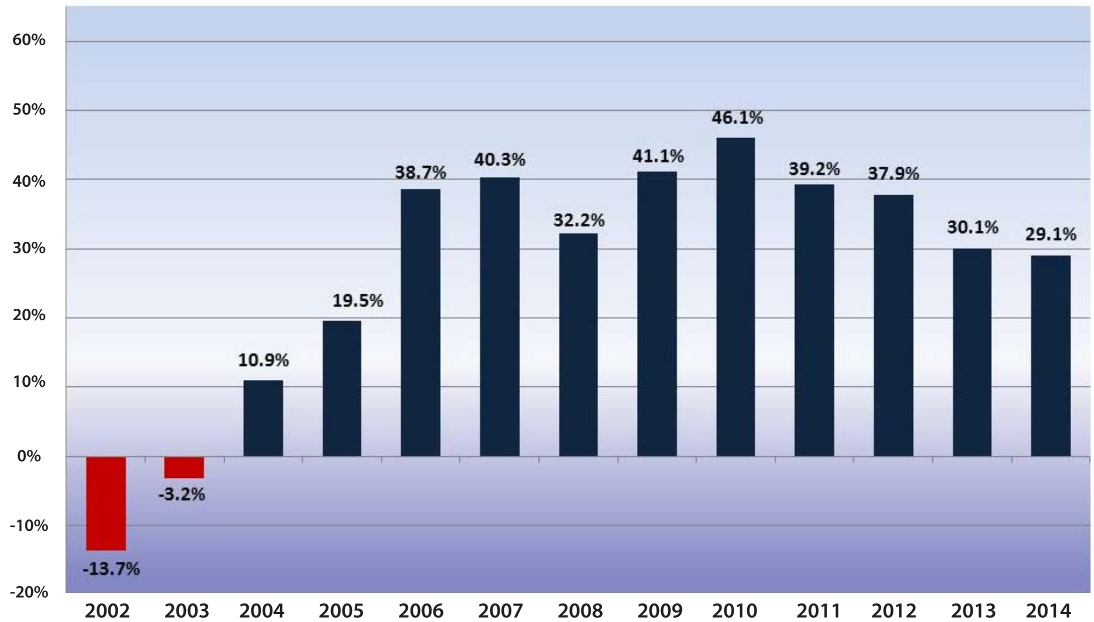
FIGURE 2 CALENDAR-YEAR OPERATING MARGIN



The close of the 2014 calendar year marks the fifth consecutive for which we have followed the development of key statutory financial results for a composite of medical professional liability (MPL) specialty writers. We report the results in the MEDICAL LIABILITY MONITOR on a quarterly basis. As each quarter elapses, we attempt to get a better sense for what year-end financial results might have in store.

At the same time, we try to identify changes in market trends that continue to produce outstanding financial results for the MPL segment of the insurance industry. The 2014 year-end financial results, while down only slightly from 2013, provide some evidence to suggest that the levels of profitability experienced by MPL writers in recent years could be waning. However, we did not uncover any distress signals for MPL writers during our review of the 2014 results, and the year only adds to what has now become more than a decade of continuous profitability.

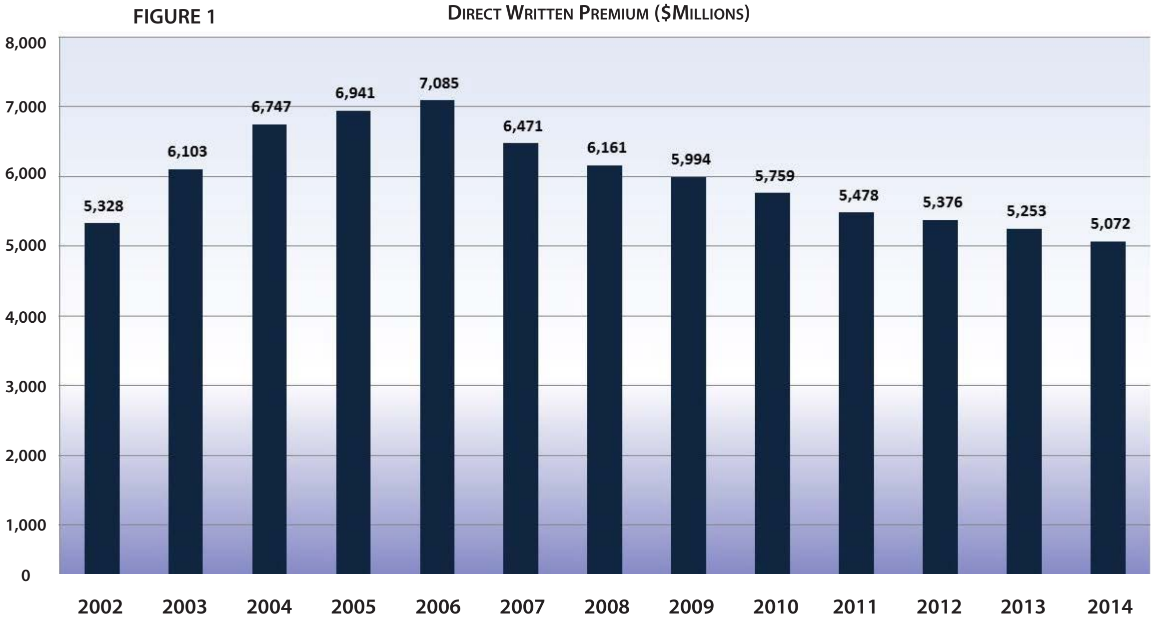
The analysis that follows is based on the composite financial results of insurers that specialize in MPL coverage. The data used in our analysis dates back to 2002, and is provided by SNL Financial. The composite includes 81 MPL specialty companies with a total direct written premium just exceeding $5 billion in 2014.

As shown in Figure 1, direct written premium for this composite declined in 2014 for the eighth straight year. The total is down 28 percent from its high of nearly $7.1 billion in 2006, dropping another $180 million in 2014. After an average annual decline of 5 percent from year-end 2006 through year-end 2011, the decline has weakened during the past three years with annual declines of 1.9 percent, 2.3 percent and 3.4 percent. Despite the declining premium levels, the composite's calendar-year profits have remained consistently strong.

PROFITS REMAIN HIGH WITH NEGATIVE TREND

Despite a few noteworthy drops in operating margin for the composite during the past five years, 2014 represents the eleventh consecutive year of positive operating profit for the composite (see Figure 2). The 1-percent decrease in operating margin in 2014 is the smallest decrease since the operating margin peaked in 2010. Underlying the change in operating margin for 2014 was an increase in the combined ratio from 91.7 percent to 93.3 percent. This deterioration was partially offset by a slight increase in the investment gain ratio from 21.8 percent to 22.3 percent.

FIGURE 1 DIRECT WRITTEN PREMIUM ($MILLIONS)



NET INCOME DECLINES DRIVEN BY LESS FAVORABLE RESERVE DEVELOPMENT

Not unexpectedly, as the composite's operating margin trends downward its net annual income has followed suit. Figure 3 shows (on page 7) that the net income for MPL specialty writers not only declined for the fourth-straight year, but fell below $1 billion for the first

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time since 2005.

Earning nearly $1 billion dollars in net annual income, by itself, is hardly a cause for concern. However, the nearly 40 percent decline in net income since 2010—coupled with the fact that the net income amounts in Figure 3 have tracked very closely with the favorable one-year reserve development during that same period (Figure 4)—is definitely something to keep an eye on.

Capital Continues to Strengthen

Eleven-consecutive years of profitability has helped accumulate more than $14.4 billion in policyholder surplus as of Dec. 31, 2014, almost tripling the $5 billion held at the end of 2002. Figure 5 illustrates the degree to which the composite capital base has strengthened—as evidenced by the dramatic growth during the past decade in the National Association of Insurance Commissioners (NAIC) Risk-Based Capital (RBC) Ratios (defined as total adjusted surplus divided by authorized control level capital).

The 2014 year-end financial results provide some evidence to suggest that the levels of profitability experienced by MPL writers in recent years could be waning.

Conclusion

When we first set forth in our effort to track the financial results of this composite of MPL specialty writers back in 2010, we began asking the question, "How long can unprecedented levels of favorable reserve development support the sizable annual profits being earned by these insurers?"

Five years later, to the benefit of many of the companies in our composite, we still do not have an answer to this question. It is clear to see that the composite's profitability, while still very strong by any reasonable standard, is displaying a negative trend, and as has been the case for some time, these profits would all but disappear in the absence of the favorable reserve development from prior years business. While it appears that the composite's bottom line is safe for the immediate future, it will be interesting to see how the next several years play out.

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Figure 3 — Net Income ($Millions)

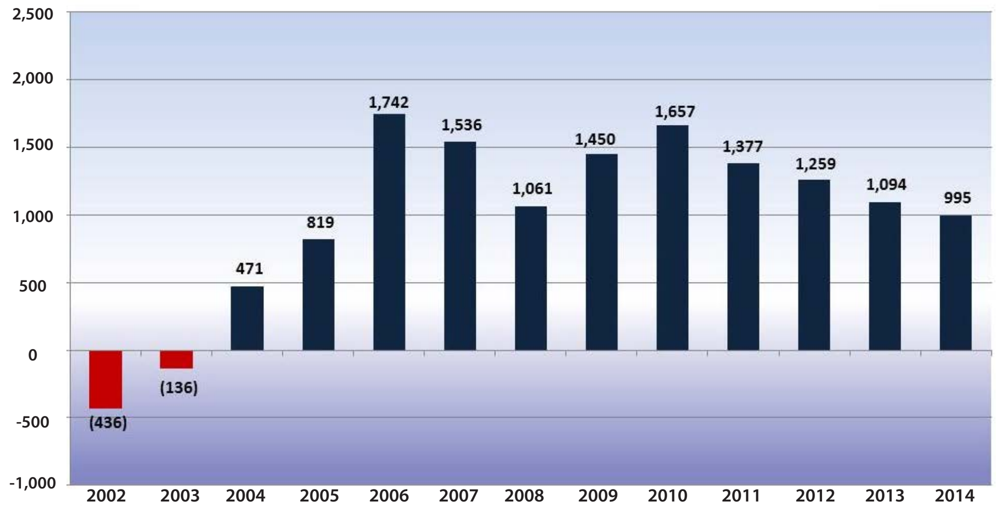

Figure 4 — One-Year Reserve Development ($Millions)

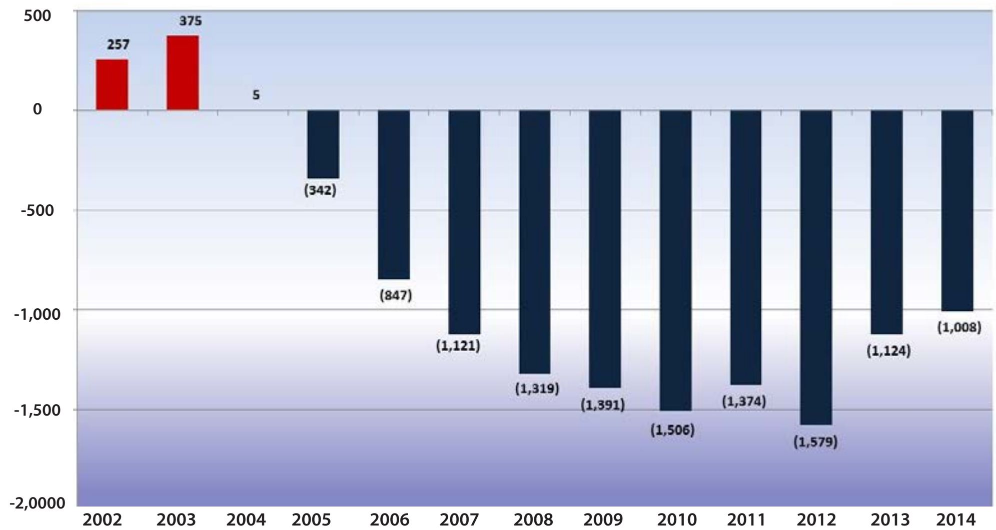

Figure 5 — NAIC RBC Ratio