By Susan J. Forray
and Chad C. Karls

Industry Update

Insurers Continue to Strengthen Position, Despite Prolonged Soft Market

The year 2012 was once again a year of financial growth for the medical professional liability (MPL) insurance industry, despite declining profitability. While the industry's operating ratio remains well below 100%, it has increased noticeably relative to 2011, driven by a decline in reserve releases. Despite this decline in profitability, the MPL industry again returned a substantial portion of its income as dividends to policyholders. Surplus also grew moderately in 2012, providing the MPL industry with additional capital support.

However, the industry's profitability continues to be squeezed from both sides, albeit slowly. Frequency increased again during 2012, for some companies. Like the continuing decrease in rate levels, this modest increase in frequency had only a minor impact on the industry's underwriting results. More widespread increases in frequency, going forward, would further cut into the industry's bottom-line results.

The increased capitalization and favorable operating ratios in the MPL industry of late have had one primary cause—the release of prior-year reserves. In 2012 in particular, reserve releases contributed 27 points to the industry's operating ratio. Even without these reserve releases, though, the industry would have been profitable. However, these reserve releases represent a 6-point decline, relative to 2011. A continued decline over the next several years—perhaps combined with an increase in frequency—could change that picture significantly.

Today's MPL market shows mixed characteristics. Increased competition has exacerbated declines in rate level and, for some insurers, has led to declines in the amount of business written as well—the result of underwriting discipline utilized in the face of this competition. These observations are characteristic of a soft market, yet the financial results demonstrated by the industry continue to be characteristic of a hard market. We believe that, taken together, these results suggest a prolonged soft market, in which lower rate levels will continue to be the norm for several years to come.

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Also facing MPL writers is a possible increase in inflation. Since 2007, increases in indemnity severities for MPL writers have been flat to small, although increases in defense costs per claim have been in the range of 6% to 8% per annum for most carriers. An increase in indemnity claim costs going forward could impact the adequacy of both rates and reserves. In addition, an increase in inflation could significantly devalue bonds, by far the largest asset class for MPL writers.

MPL insurers also continue to face uncertainties stemming from healthcare reform. Although the Supreme Court has

Susan J. Forray, FCAS, MAAA, and Chad C. Karls, FCAS, MAAA, are Principals and Consulting Actuaries in the Milwaukee office of Milliman.

upheld almost all aspects of this legislation, most provisions of healthcare reform have yet to take effect, making the potential impact almost as uncertain today as it was a year ago. Healthcare reform will likely result in a decline in the availability of healthcare providers due to an increase in the insured population. Presumably, such an outcome could only impact MPL writers negatively, as patients begin to experience greater frustration with their providers.

In certain states, MPL insurers are facing challenges to the tort system itself. Within the past year, bills have been introduced in the Florida and Georgia legislatures that would remove MPL claims from the tort system and also expand the number of claims eligible for compensation, fundamentally altering the landscape for MPL insurers. The actual magnitude of the resulting increase in loss costs is unclear at this point, in particular, because of uncertainty as to the number of additional filed claims. Also unclear is how much leeway insurers will have to file for any resulting indicated rate increase. As of this writing, the Florida bill remains active, while the Georgia bill has been tabled.

Figure 1 Direct Written MPL Premium ($ Billions)

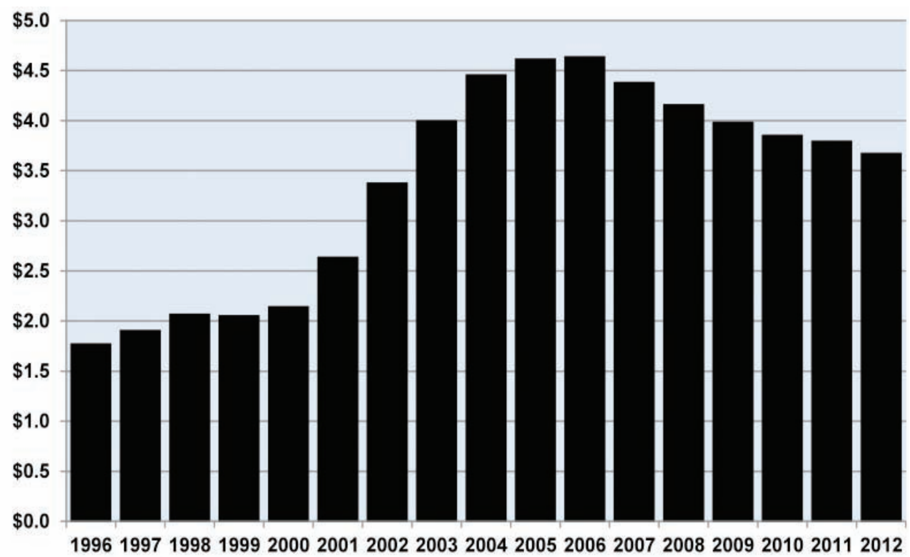
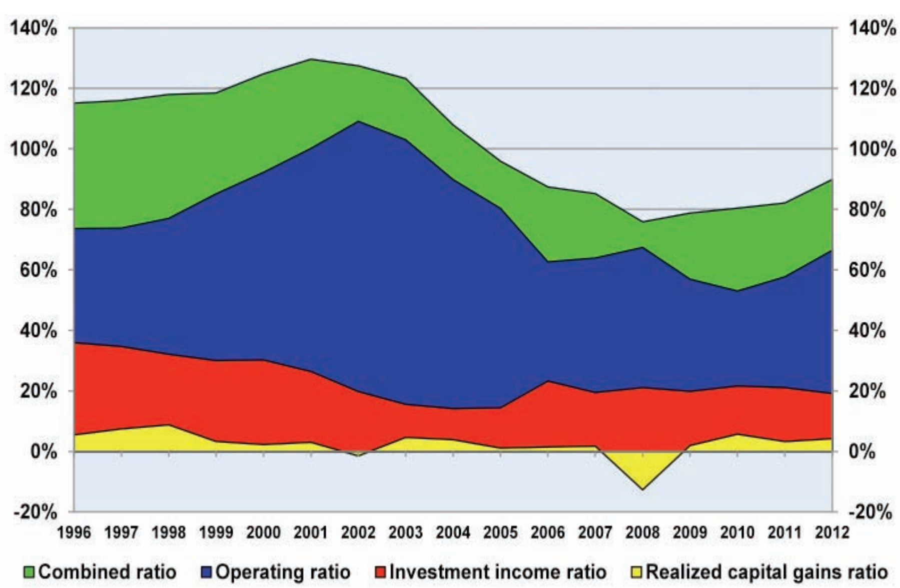


Figure 2 Operating Ratio



To get a more detailed picture of the state of the MPL industry today, we have analyzed the financial results of a composite of 43 specialty writers of MPL coverage ("the composite"), all of which can be considered well established. We have excluded the "startup" writers, because, nationwide, they remain a minority in terms of volume of written premium; including them might have skewed our analysis of long-term trends, because of the growth they experienced during the previous decade. Using statutory data obtained from SNL Financial, we have compiled various financial metrics for the industry, categorized by:

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

In viewing the financial results discussed below, it is important to consider that the 43 companies included here are all long-term MPL specialty writers. As mentioned above, they exclude the startup writers and any MPL specialty writer that has become insolvent or otherwise left the market, as well as the multi-line commercial writers of MPL coverage. The companies in each of these three excluded categories are generally less well capitalized than the 43 companies included here. In addition, while the underwriting results of the startup companies have typically been comparable to those of the composite, the underwriting results of the multi-line commercial writers have generally been somewhat less profitable. This was, of course, also true for the writers that became insolvent. Thus, the results presented below reflect the experience of long-term specialty writers today, which is inherently more favorable than a view of the industry as a whole.

Written premium

Last year, 2012, marked the sixth straight year of decreases in direct written MPL premium for our composite (Figure 1). Cumulatively, premium has decreased by almost $1.0 billion since 2006—more than 20% of the premium written in this year. To put that in perspective, consider that in the close to 30-year history of the MPL industry, no period of decreasing premiums has lasted longer than two years, and the greatest consecutive-year premium reduction was 7%. On the surface, this would suggest that the circumstances of the current market are much worse than those of the previous soft market of the late 1990s through 2001.

Yet the current market has some characteristics that distinguish it from the previous soft market. Both have shown decreasing rate levels, but only in the previous soft market was there clear evidence of rate inadequacy, such as the deficiencies documented in rate filings themselves. The reduction in frequency for MPL writers means that their rates are in a much better position now than they were a decade ago, although the decreasing frequency trend appears to have slightly reversed itself.

Overall operating results

As measured by the composite operating ratio, the industry appears to have reached its nadir during 2010. During that year, the composite posted an operating ratio of 53%, which has risen to 67% since that time (Figure 2). The increase has largely been driven by the decline in reserve releases during 2012, but also by a modest increase in underwriting expenses and a small decline in investment returns. The 2012 combined ratio for the industry was 90%, up from 80% in 2010 and 82% in 2011 (Figure 3).

The investment gain ratio of 23% in 2012 declined from a 10-year high of close to 28% in 2010. This result was perhaps to be expected, given the declining impact of the write-downs taken on invested assets during 2008. In 2010, the realized capital gains ratio hit a 10-year high of 6% of net earned premium, as companies sold these previously devalued assets. Subsequently, there have been fewer devalued assets remaining from the 2008 time period, and the realized capital gains ratio has declined, settling at 4% in 2012. The decline in the investment income ratio has been similar, from nearly 22% in 2010 and 21% in 2011 to slightly more than 19% in 2012.

The calendar-year loss and loss adjustment expense (LAE) ratio for 2012, 61%, was noticeably higher than the comparable figure for 2011, 54%. The increase was driven largely by the decline in reserve releases noted earlier, and discussed further below. The increase in the initial loss and LAE ratio carried for the 2012 coverage year was small. The loss and LAE ratio carried for the 2012 coverage year is about 88%, 1 percentage point higher than the 87% loss and LAE ratio carried for the 2011 coverage year as of year-end 2011. In light of the small increases in frequency in certain jurisdictions, along with continued rate decreases in virtually every locale, an increase in the initial loss and LAE ratio seems reasonable.

Reserve releases

As noted above, the industry was able to continue releasing reserves in 2012. However, the amount released declined noticeably for the composite, to just over $1.0 billion, from the high of more than

Figure 3 Combined Ratio

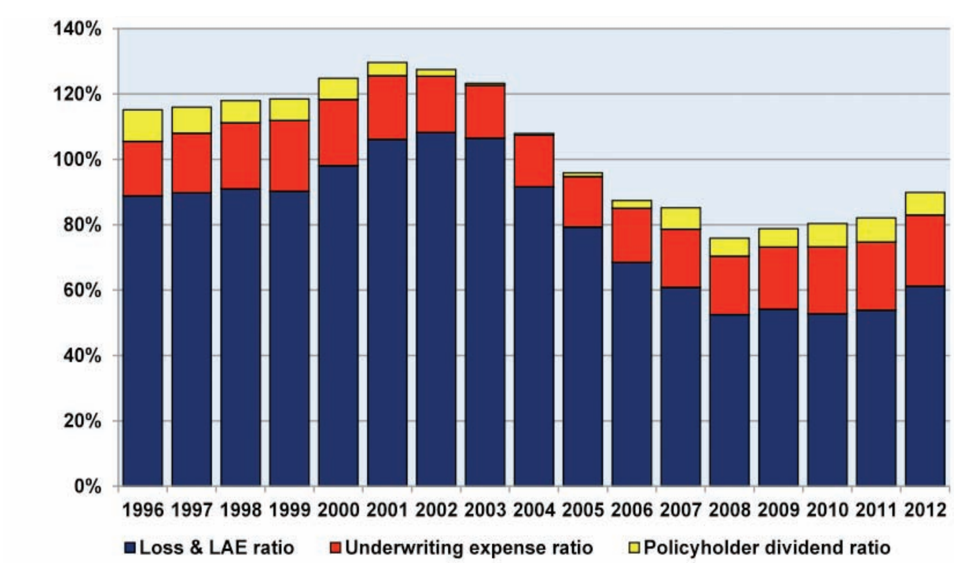
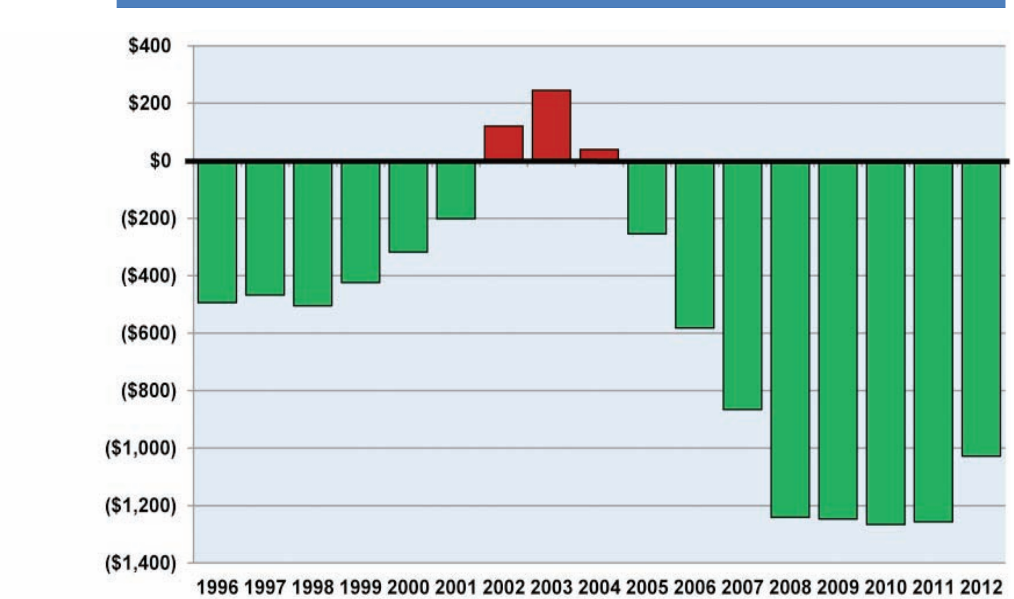


Figure 4 Reserve Release ($ Millions)



$1.2 billion released each year in 2008 through 2011 (Figure 4). Despite the decline, the reserve releases remain material. Yet, they should be put in the context of the reserves carried by the composite, which for net loss and LAE totaled more than $10.1 billion as of year-end 2011. The release of reserves was driven by the ongoing impact of a lower frequency, combined for many companies with a relatively benign indemnity severity trend during the past several calendar years.

While a lower frequency in MPL claims has been recognized for some time, provisions in the reserving process for many companies initially assumed that the decrease in loss payments would be less than the decrease in reported frequency. In other words, companies assumed that the decrease in reported frequency would be driven by fewer "nuisance" or "closed no payment" claims. While this has been the case for some writers, most have seen that the decrease in frequency has affected claims of all types equally, while some have in fact seen a greater decrease in indemnity claims than in their reported claims overall.

Due to the three- to five-year payment lag, only during the past several years have companies begun to see the impact of the lower reported frequency on claim payments themselves, and as a result, the industry has been able to sustain favorable reserve releases, as this impact has proved favorable. This may also explain the decline in reserve releases during 2012, as the effect of the payment lag begins to run its course. However, this continues to be an area of significant uncertainty in the reserving process, particularly in light of the recent increases in reported frequency for some companies.

It is also 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 Schedule P 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 is currently at a level where reserves are theoretically exactly adequate, history would suggest we will see favorable reserve development on a calendar-year basis through 2014 or 2015. This would then be followed by adverse development (at least for the older coverage years) in subsequent calendar years.

Finally, as we have mentioned several times now, the industry has seen a dramatic decrease in reported frequency over the past decade. However, for many companies, frequency (on a per-physician basis) has stabilized. For others, frequency has turned upward again.

Given the rate decreases of the past several years, frequency has of course increased more relative to premium than to the number of insured physicians (Figure 5). Frequency per $1 million of gross earned premium reached its lowest point for the industry in 2007. Reported frequency has increased each year since

Figure 5 Reported Claim Frequency per $1 Million of Gross Earned Premium

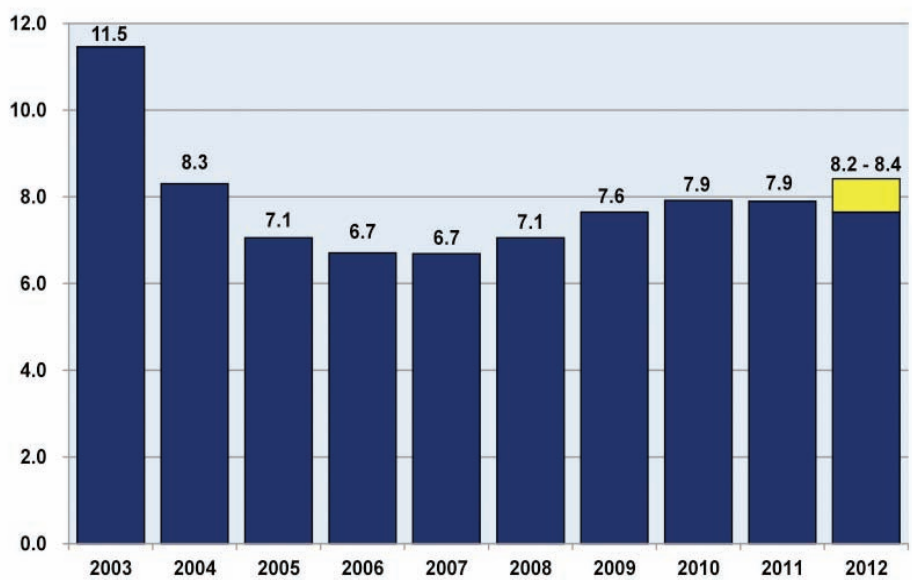
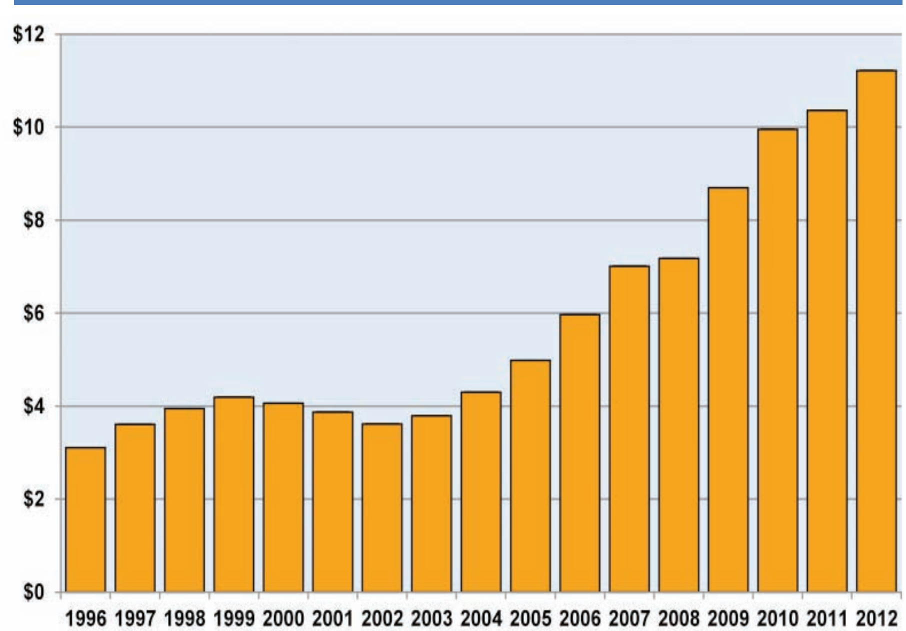


Figure 6 Policyholder Surplus ($ Billions)



this time. Thus, for every claim reported, fewer dollars have been available each year to defend or settle the claims.

Note that, in Figure 5, we have adjusted the 2012 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 2012 report year would likely be between 8.2 and 8.4 claims per $1 million of gross earned premium. This suggests a frequency somewhat greater than in 2011. Thus, cumulatively, frequency (measured relative to premium) has increased by 20% to 25% since the 2007 year. This increase is largely the result of rate decreases (mostly in the form of greater premium credits, as opposed to manual rate changes) coupled with modest increases in "true" frequency—i.e., claim frequency per insured physician.

Capitalization

The industry's strong operating results in 2012 fueled a significant increase in surplus during the year of about 9%, from $10.3 billion to $11.2 billion (Figure 6). This is a noticeable gain, but still less than each of the gains experienced in the years 2004 through 2010 (with the exception of 2008, when industry surplus increased only slightly, due to the effect of other-than-temporary impairment on assets). It is somewhat higher than the gain in surplus of about 6% in 2011. In addition, the biggest contributor to the gain in surplus was the favorable reserve development discussed earlier, which cannot be expected to continue at the same level over the long term.

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 actual amount of capital needed to be well in excess of this regulatory minimum). The RBC ratio of our MPL composite increased to slightly more than 1,100% in 2012, and, over the last several years, has followed a pattern of increase similar to that of surplus. However, individual RBC ratios vary considerably within the composite, from a low of 450% to a high of more than 6,700%.

Policyholder dividends

At the same time, the increase in surplus has been slowed by the significant amount of policyholder dividends that MPL writers have continued to pay. In 2012, the composite writers paid $260 million in policyholder dividends, or 7% of net earned premium (Figure 3). This was a moderate decline from the two all-time highs of more than $270 million paid by the composite in 2010 and 2011. Cumulatively, the composite has paid $1.6 billion in policyholder dividends since 2005. The historical pattern of policyholder dividends is very similar to that of reserve development. Thus, a large portion of the after-tax income resulting from reserve releases has been returned to policyholders.

Typically, these dividends are paid 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 historically cyclical behavior.

When will the hard market come?

In its most recent "Review & Preview" report, A.M. Best estimated a net reserve redundancy of $2.7 billion for the MPL line of business as a whole. This is approximately 9% of the carried net reserves, which implies a redundancy for our composite of $900 million. Thus, continued reserve releases can be expected to mask deteriorating underwriting results on current business, both prolonging the soft market and increasing the risk that rates may become inadequate in the future. Insurers face other risks to the bottom line as well: possible increases in frequency and severity, the potential for a decline in asset values, uncertain impacts of healthcare reform, and a likely decline in market size, as hospitals continue to acquire physician practices, among others factors.

> **We envision a continuation of the protracted soft market that we find ourselves in now. The amount of reserve releases will decline, but will nonetheless buoy the combined ratio of the industry, for perhaps several years to come.**
>
> **Absent a significant shock to the capacity of the MPL industry, it will likely be several years before rates begin to increase again.**

Looking ahead, we envision a continuation of the protracted soft market that we find ourselves in now. The amount of reserve releases will decline, but will nonetheless buoy the combined ratio of the industry, for perhaps several years to come. Rate adequacy will continue to erode for many insurers, due to claim cost inflation, possible increases in frequency, and the continued use of schedule credits. Absent a significant shock to the capacity of the MPL industry, it will likely be several years before rates begin to increase again. PIAA

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