THE HOME STRETCH: WHAT WE CAN ANTICIPATE AT YEAR-END 2013 BASED ON Q3 FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY WRITERS

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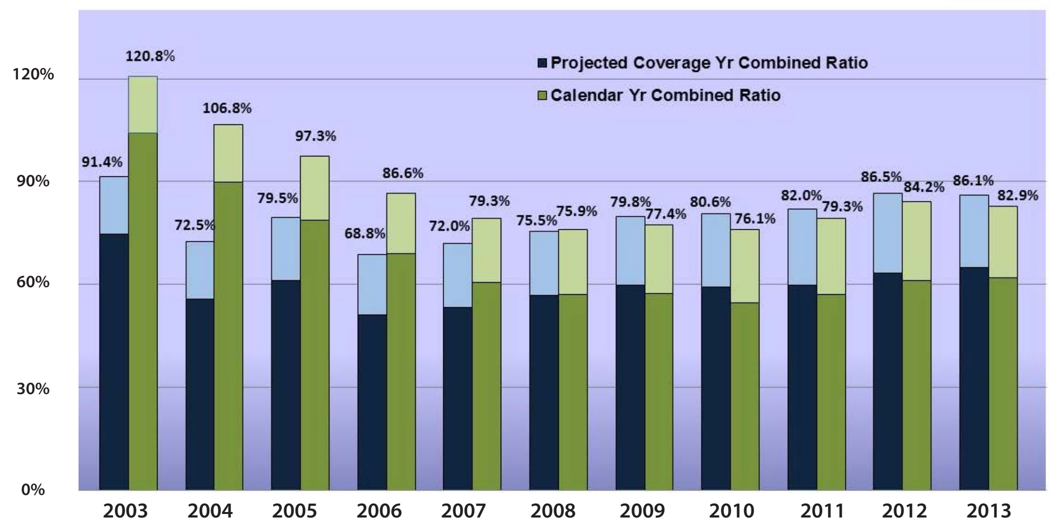
As we near the end of 2013, we are taking the opportunity to review the recently available financial results of medical professional liability (MPL) specialty insurers as of the third quarter and attempt to project year-end 2013 financial results.

Our analysis is based on the collective financial results of a large group of insurers specializing in MPL coverage. The data used in our analysis dates back to 2003, compiled by SNL Financial from financial statements. The composite includes 83 companies with direct total written premium exceeding $6.2 billion in 2012. Considering the relationship of the composite's quarterly financial results to year-end results during the past decade, we estimate what financial results might look like for MPL writers at the end of 2013.

FIGURE 2 COVERAGE-YEAR VS. CALENDAR-YEAR COMBINED RATIOS (EXCLUDING DIVIDENDS)



As a whole, third-quarter financial results for MPL specialty writers in 2013 are behaving in much the same way as they have during the past few very profitable years. The composite premium volume continues to gradually decline, while at the same time, coverage-year combined ratios are climbing. Historically low bond yields continue to negatively impact investment income, putting further pressure on composite operating margins. Finally, the favorable development of historical claim reserves continues to bolster calendar-year results and expand overall capital levels.

However, given the continuation of the above trends, are we beginning to see some subtle signs of change?

IS THE DECLINE IN PREMIUM LEVELING OFF?

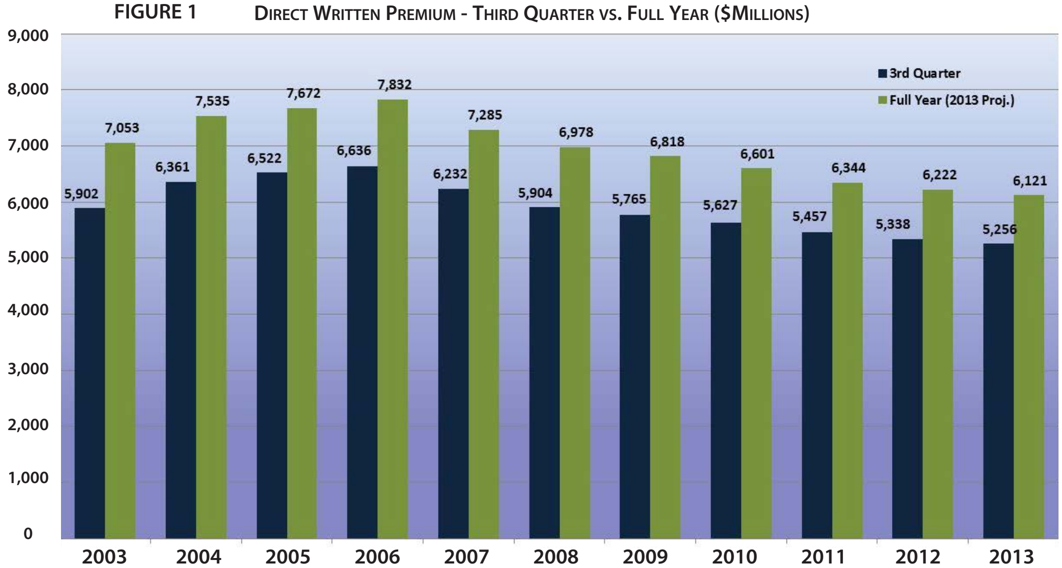
In 2006, this group of companies wrote a combined $7.8 billion in direct written premium. Since that time, premium totals have declined every year, sinking to a low of $6.2 billion at year-end 2012—a 20 percent total decline. Through third quarter 2013, this trend appears to continue with direct written premium down another 1.5 percent from the same point in 2012. However, this is the smallest year-over-year decline since premium volume started falling in 2007, as displayed in Figure 1. We project the 2013 premium volume for this composite to be approximately $6.1 billion. Almost 22 percent off its high mark in 2006, it would be the smallest annual decline since 2007.

The continuing decline in premium revenue in recent years has gradually made an impact on underwriting results. While calendar-year combined ratios (excluding dividends) have remained strong, due to the aforementioned claim reserve releases, the comparison of projected coverage-year combined ratios in Figure 2 shows how the softening market conditions have impacted the loss and loss adjustment expense ratios as well as underwriting expense ratios.

INVESTMENT YIELDS EXPECTED TO RISE

The profitability of long-tailed casualty insurers continues to be hindered by historically low treasury yields and investment returns. However, the composite's investment income has somewhat rebounded with approximately $717 million earned through Sept. 30, compared to $682 million earned for the same period in 2012. Projected to year-end, this implies $990 million of investment income for this composite in 2013, versus $967 million in 2012 (see Figure 3). While this 2.4 percent bump in investment income should not be considered a pronounced increase, it might

FIGURE 1 DIRECT WRITTEN PREMIUM - THIRD QUARTER VS. FULL YEAR ($MILLIONS)



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WHAT MPL Q3 FINANCIAL RESULTS INDICATE FOR YEAR-END 2013

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signal the beginning of a market trend as we expect yields on bonds to gradually rise.

Has Favorable Reserve Run-off Peaked?

In recent years, reserve releases in prior coverage years have bolstered calendar-year operating results for MPL insurers and more than offset deteriorating underwriting as well as investment performance. We expect this trend will continue in 2013, but perhaps to a lesser extent.

Figure 4 compares the composite's aggregate reserve change through the first nine months of each year to the reserve change for the entire year. Favorable reserve development through the third quarter of 2013 is lagging slightly behind 2012, but is still very much in line with third-quarter development figures witnessed during the previous four record setting years. However, during the past three years, fourth-quarter reserve development—as a percent of annual reserve development—has steadily decreased. We project that reserve releases for the full-year 2013 will again exceed the robust $1 billion threshold, but not reach $1.4 to $1.5 billion as in the past four years.

Capital Position Continues to Strengthen

With MPL insurers' exceptional profitability in recent years, it only follows that we would see continued growth in composite levels of policyholder surplus. Indeed, through the third quarter of 2013, composite surplus has increased more than $1 billion over that observed at the same point last year. Figure 5 displays the composite policyholder surplus after three quarters and at year-end for this composite from 2003 through 2013.

Conclusion

MPL specialty writers again approach the end of another very profitable year. While it is far too early to predict for certain, several of the trends that have remained constant since 2007 are showing signs of a possible reversal.

On the bright side for MPL writers, the continued decline in premium revenue appears to be leveling off while investment yields are expected to climb. Conversely, it appears that favorable reserve developments may have reached their peak and, while they still continue to contribute to very healthy bottom lines, it is possible we might be seeing the start of the inevitable downward trend. In the near term, MPL specialty writers can expect to continue to delight in superior financial results.

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FIGURE 3 Investment Income - Third Quarter vs. Full Year ($Millions)

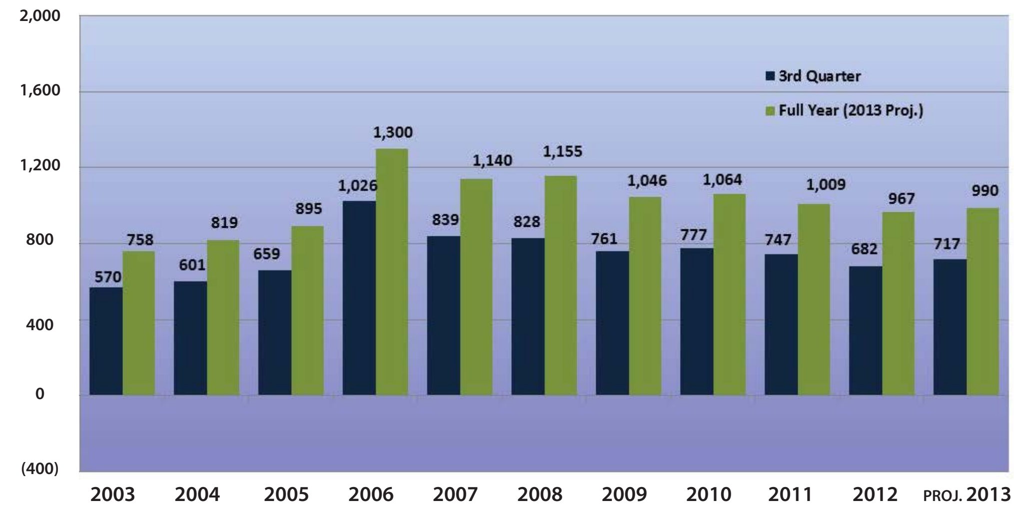

FIGURE 4 One-Year Reserve Development ($Millions)

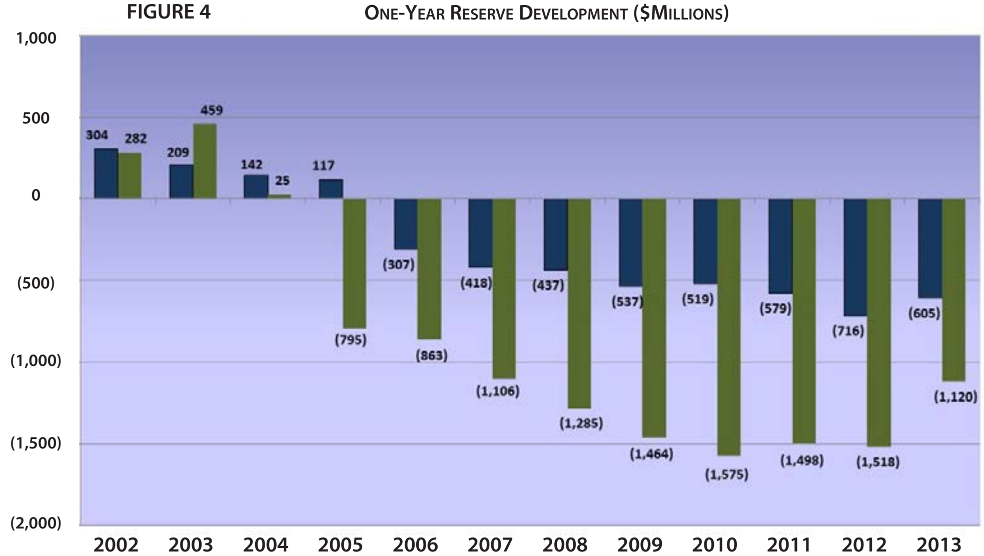

FIGURE 5 Policyholder Surplus - Third Quarter vs. Year End ($Millions)