PROFITABILITY TREND CONTINUES: FIRST QUARTER FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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This latest installment marks our fifth year of summarizing quarterly financial results for medical professional liability (MPL) specialty writers in the *Medical Liability Monitor*. Our analyses have coincided with an unprecedented span of profitability within the MPL market.

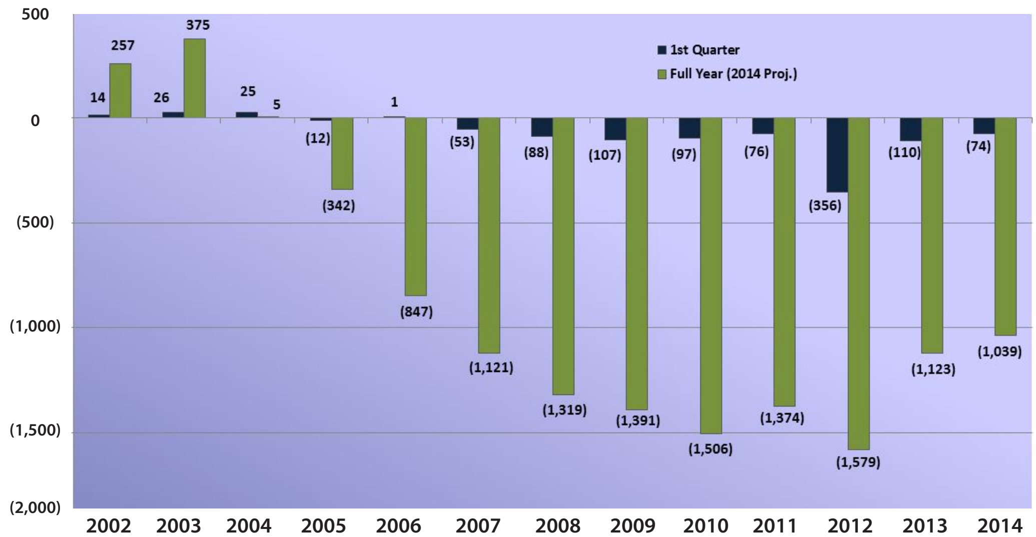
As we have frequently discussed, the MPL market has sustained very favorable calendar-year financial results in the face of soft-market conditions. With the continuing decline in premium levels and steadily increasing operating ratios in recent years, the saving grace for the market continues to be sizeable reserve releases driven by an unprecedented decline in claims frequency. Fortunately for MPL writers, it appears that 2014 comes out of the gate with a continuation of the persistent trends that have led to sustained profitability for the past 10 years.

Our analysis was 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 2002 and consists of aggregate statutory financial information compiled from SNL Financial. The composite includes 81 MPL specialty companies with total direct written premium of approximately $5.3 billion in 2013.

Written Premium Continues its Gradual Decline

As shown in Figure 1, first quarter 2014 direct written premium is down yet again when compared to first quarter 2013. However, the 1.9-percent, year-over-year decline in first-quarter premium is a significant improvement over the average annual decline of 4.2 percent from 2006 through 2013. For the full year, we project total direct written premium for the composite to end up below $5.1 billion in 2014. This would represent a 28.5-percent total decline since the high point of of $7.1 billion in 2006.

FIGURE 2 Calendar-Year Reserve Development ($Millions)

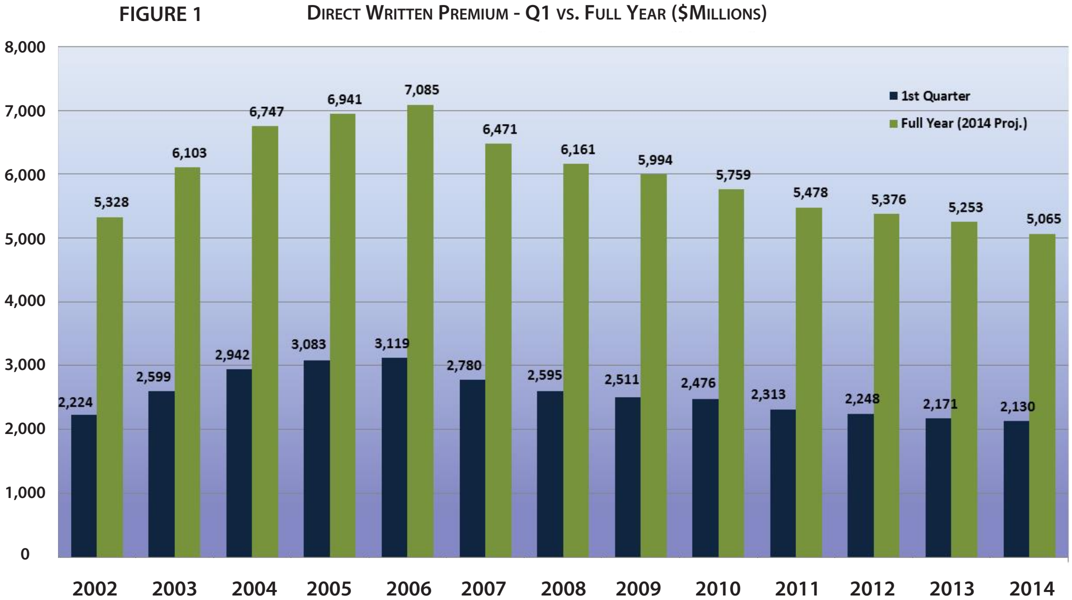


Sizeable Reserve Run-offs Showing Little Sign of Subsiding

In 2014, the composite showed favorable first-quarter reserve development for the eighth consecutive year. Figure 2 suggests that reserve releases made during the first quarter can provide an indication of expected reserve releases for the entire year.

Favorable reserve development in the first quarter of 2014 is lower than the previous two years. However, favorable development of this approximate magnitude in each of the past eight years ultimately led to at least $1.1 billion in reserve releases for the entire year. If the same pattern holds in 2014, we can expect to see another year of favorable reserve development in excess of $1 billion.

FIGURE 1 Direct Written Premium - Q1 vs. Full Year ($Millions)



Combined Ratios on the Rise

The composite's calendar-year 2013 combined ratio of 91.7 percent was its highest since 2005, yet still marked the ninth consecutive year below the underwriting breakeven point.

Based on results through the first quarter of 2014, we expect the combined ratio to inch higher in 2014, while the composite's underwriting results remain profitable (see Figure 3)—the higher combined ratio primarily driven by a higher loss and loss-adjustment expense ratio due to the decline in premium mentioned above

→ CONTINUED ON PAGE 7

2014 Q1 FINANCIAL RESULTS FOR MPL SPECIALTY WRITERS

CONTINUED FROM PAGE 5

and the expected decline in favorable reserve development.

The steadfastly reliable profits enjoyed by MPL writers in recent years have led to steadily increasing surplus levels as summarized in Figure 4. Surplus as of first quarter 2014 exceeded $14 billion for this composite, a 5.5 percent annual increase over first quarter 2013.

Still Waiting on Higher Investment Yields

Investment income continues to hold steady so far in 2014 (see Figure 5). However, this reflects lower yield as the invested assets of this composite have increased slightly over 2013. Insurers continue to wonder the direction of interest rates.

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Higher interest rates might help to extend the stable rate environment as higher investment yields would be considered in prospective pricing. This assumes, of course, that the higher interest rates will not be accompanied by higher claim-cost inflation.

Conclusion

At first glance, the MPL insurance industry's 2014 financial results reveal an awfully familiar story that history tells us should result in another happy ending for MPL specialty insurers.

We project another profitable underwriting year for the composite in 2014, while profit margins will likely decline relative to the levels seen in recent years. Pricing pressure continues to be fueled by increasing surplus levels and the desire to maintain exposures against increasing competition and the potential migration of physicians to self-insured employment settings. The largest remaining uncertainty lies in the likelihood that prior-year reserve releases can be sustained to the extent observed in recent years.

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FIGURE 3 Annual Combined Ratios

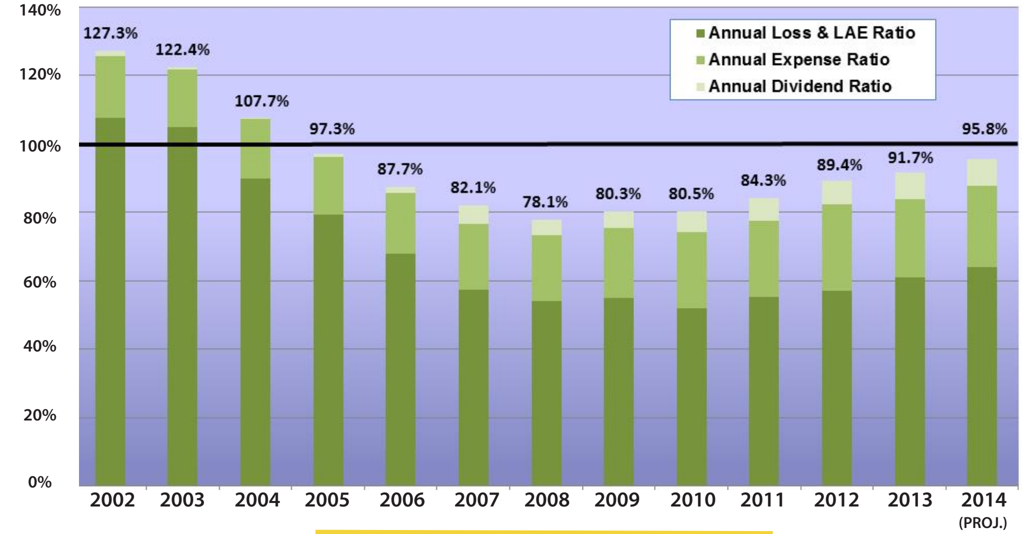

FIGURE 4 Policyholder Surplus - as of Q1 ($Millions)

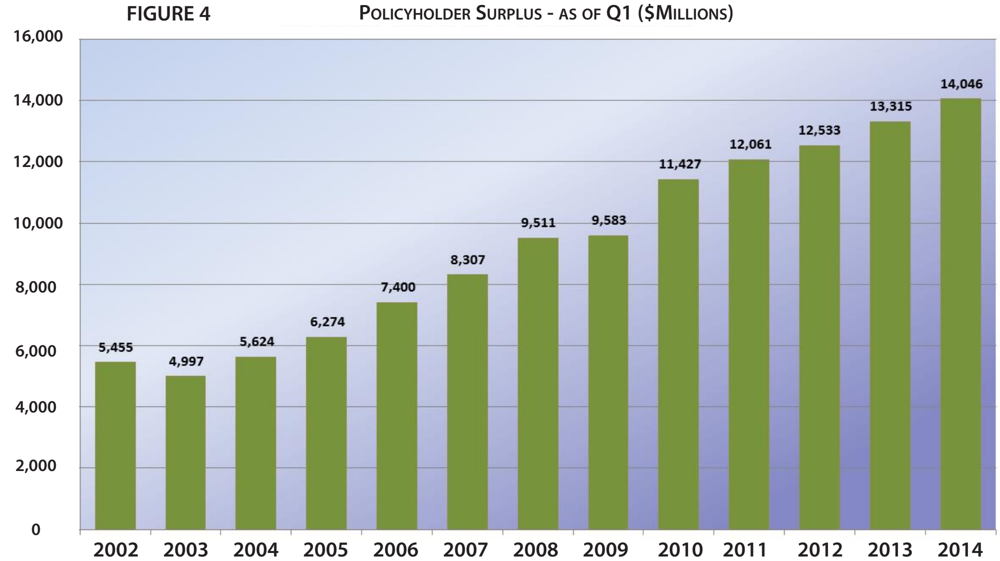

FIGURE 5 Investment Income - Q1 vs. Full-Year ($Millions)