A PIAA PUBLICATION FOR THE MEDICAL PROFESSIONAL LIABILITY COMMUNITY

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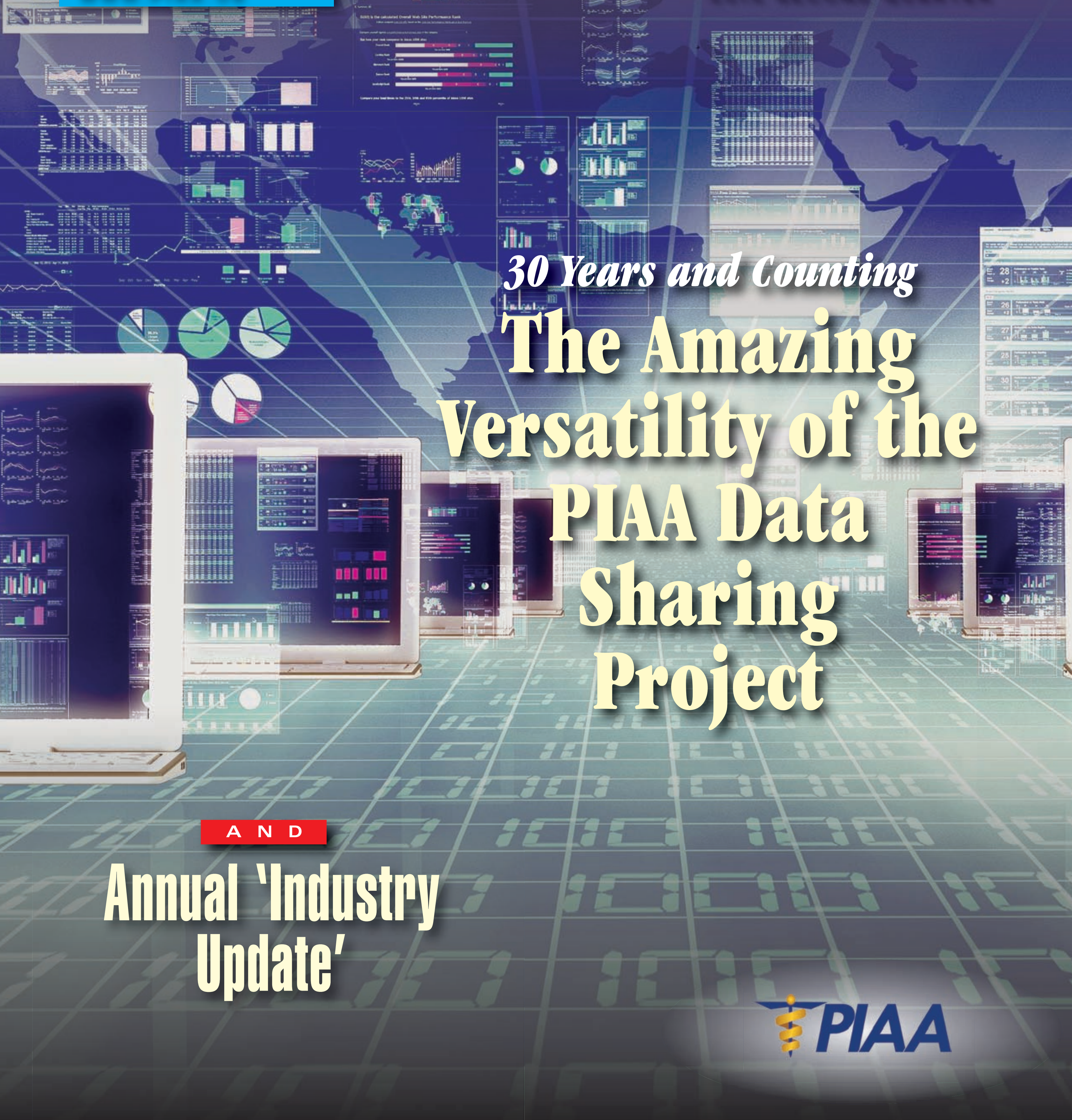
2015 SECOND QUARTER



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"As compared with databases solely comprised of paid claims, the DSP data enables comparisons of closed claims vs. paid claims, thus providing a critical metric for assessing the current status of the MPL sector: the paid to close ratio."
—*Cover story*

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Profitability Continues to Decline from Peak Levels; Reserve Releases Fund Dividends while Surplus Stabilizes

By Susan J. Forray and Chad C. Karls

The year 2014 was a year of financial stability for the medical professional liability (MPL) insurance industry, despite a continued decline in profitability. While the industry's operating ratio remains below 100%, it increased by several points over the prior year, as it has for each year since 2010. Insurers continued to experience a decline in reserve releases, increased expenses, and diminished investment income.

Despite this decline in profitability, the MPL industry again returned a substantial portion of its income as dividends to policyholders. Surplus grew slightly in 2014, leaving the MPL industry in a financial position roughly consistent with where it has been since year-end 2011.

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 2014 in particular, reserve releases contributed 25 points to the industry's operating ratio. Even without these reserve releases, though, the industry would have been profitable. These reserve releases represent a decline relative to each of the years 2008 through 2013, during which reserve releases contributed an average of 31 points to the industry's operating ratio each year.

Rates continue to fall for many writers, as evidenced by the declining premium volume of the industry as a whole. Certain markets have seen a cumulative decline in rate levels in excess of 20% over the past several years. It is not uncommon for companies to see certain of their competitors writing at rates perceived to be inadequate, in some cases forcing companies to choose between losing market share and writing at rate levels they themselves believe are inadequate.

At the same time, the industry's pattern of declining frequency has ended, and we have seen the reporting of claim counts stabilize for most companies. Indemnity severity trends have remained manageable, although trends in defense costs continue to remain in the range

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of 5% to 8% per annum. While rate levels generally remain adequate for most companies in the MPL industry, a continued pattern of declining rate level combined with eventual increases in claim costs would work, over time, to impact the industry's rate adequacy.

In certain states, MPL insurers are facing challenges to the tort system itself. As of this writing, bills have been filed in several state legislatures that would remove MPL claims from the tort system, creating what these bills term a "patient compensation system" (PCS; see *Inside Medical Liability*, First Quarter 2014, pages 28–31). If passed, these bills would create a formulaic approach to determining compensation for MPL claims and, depending on the particular language of the state's bill, would significantly expand the number of claims eligible for compensation, fundamentally altering the landscape for MPL insurers. In addition, caps on damages continue to be challenged in various states, typically in the courtroom. On a favorable note for the industry, advocacy groups failed in their challenge to MICRA at the ballot box in California last November, although many expect California to face a similar proposition again soon.

The overturn of tort reform can be expected to lead not only to direct increases in claim severity, but also, indirectly, to increases in the number of claims as well. Absent a functional cap on damages, there is additional financial motivation for plaintiff's attorneys to accept cases. A plaintiff with a less meritorious case will have a better chance of obtaining representation if the plaintiff's attorney believes that the lesser likelihood of a plaintiff verdict is offset by a greater potential for a damages award.

MPL insurers also continue to face declining market share due to the continued acquisition of physician practices by hospitals and healthcare systems, as well as the preference of newly trained physicians to join these larger systems rather than enter into independent practice. Healthcare reform has only served to accelerate the trend in physician employment that was already well underway. In addition, healthcare exchanges have only recently begun to impact the landscape of patient care. Once they have become more fully operational, we expect that the long-predicted decline in the availability of healthcare providers will become accelerated, due to the increased demand in services from a more fully insured population. Presumably, such an outcome could only impact MPL writers negatively, as patients begin to experience greater frustration with their providers.

To get a more detailed picture of the state of the MPL industry today, we have analyzed the financial results of a composite of 38 of the largest specialty writers of MPL coverage ("the composite"). 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 38 companies included here are all established MPL specialty writers. They exclude most of the relatively recent 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 38 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 the established specialty writers, which is inherently more favorable than a view of the industry as a whole.

Written premium

Last year, 2014, marked the eighth straight year of decreases in direct written MPL premium for our composite (Figure 1). Cumulatively, premium has decreased by more than $1.1 billion since 2006—almost 25% of the premium written in that year. To put that in perspective, consider: in the 30-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%. 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 mid- to late 1990s through early 2000s.

Yet the current market has some characteristics that distinguish it from the previous

Figure 1 Direct Written MPL Premium ($ Billions)

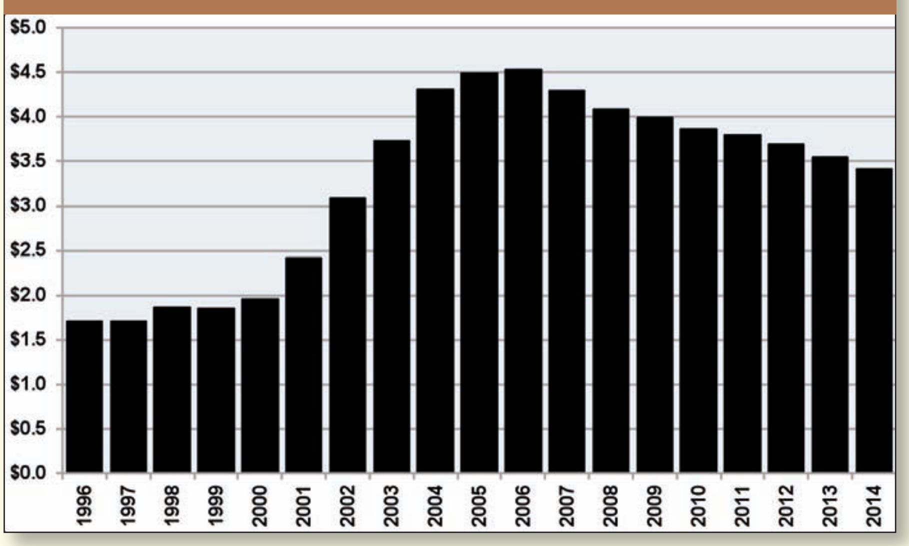


Figure 2 Operating Ratio

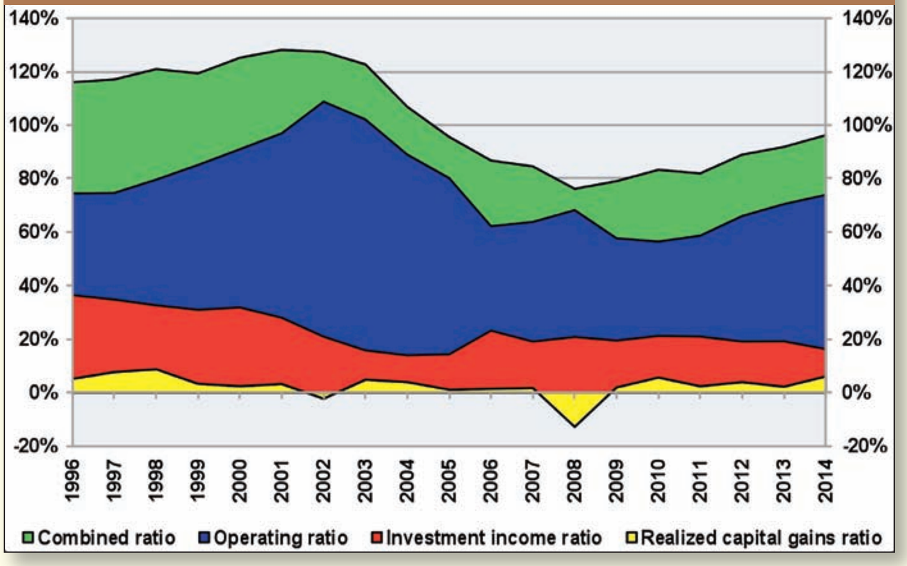
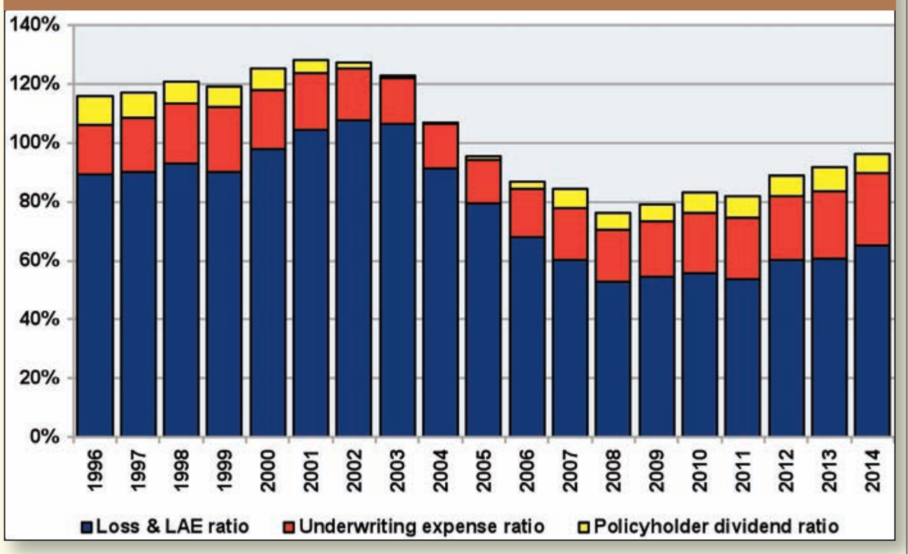


Figure 3 Combined Ratio



soft market. Both have shown decreasing rate levels, but similar evidence of rate inadequacy has not been manifest in the current soft market, versus the previous soft market. During this prior time period, rate deficiencies—including those documented in rate filings—ultimately culminated in adverse financial results. The reduction in frequency for MPL writers means that their rates are in a much better position now than they were a decade ago. However, we are beginning to see aggressive rate action in certain markets, exemplified by double-digit rate decreases filed by certain carriers.

Overall operating results

As measured by the composite operating ratio, the industry appears to have reached its peak profitability during 2010. During that year, the composite posted an operating ratio of 56%, which has risen to 74% since that time (Figure 2). The increase has been driven by the decline in reserve releases beginning in 2012, but also by an increase in underwriting expenses and continued lower levels of investment returns. The 2014 combined ratio for the industry was 96%, up from a low of 76% in 2008 (Figure 3).

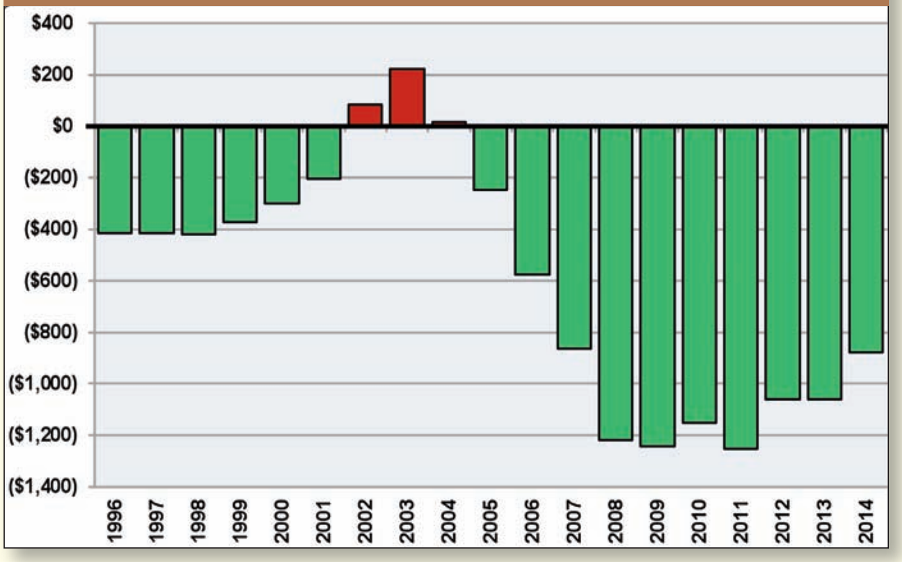
The investment gain ratio of 22% in 2014 is similar to other recent years, but it represents a decline from the ten-year high of 27% in 2010. Investment gains, as split between investment income and capital gains in 2014, differed noticeably from prior years as the result of the accounting by one larger carrier of its investment in its affiliates. Thus, the industry's capital gains ratio reached 6% (up from 2% in 2013) for the first time since the 1990s, while the investment income ratio declined from 19% in 2013 to 16% in 2014. If this one instance of an accounting treatment is set aside, we believe results indicate that investment income for the industry as a whole maintained a similar pattern in 2014 as was observed in 2013.

The calendar-year loss and loss adjustment expense (LAE) ratio for 2014, 65%, is higher than in any year since 2006, and represents an increase of more than 12 points since 2008, when the ratio was less than 53%. The increase has been driven largely by the decline in reserve releases noted earlier, and is discussed further below. The loss and LAE ratio carried for the 2014 coverage year is 90%, the same as the loss and LAE ratio carried for the 2013 coverage year, as of year-end 2013, and only a five-point increase over the 2008 starting loss and LAE ratio of 85%. In light of the rate decreases during this time period in virtually every locale, a greater increase in the initial loss and LAE ratio would be expected. Thus, this modest increase suggests that the 2014 coverage year is starting out from a weaker, or perhaps less strong, position than other recent coverage years.

Reserve releases

As discussed above, the composite released close to $900 million in reserves during 2014, a decline from the almost $1.1 billion released in each of 2012 and 2013 and the $1.2 billion released each year between 2008 and 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 almost $9.9 billion as of year-end 2013. The release of reserves was driven by

Figure 4 Reserve Release ($ Millions)



the ongoing impact of a lower frequency, combined, for many companies, with a relatively benign indemnity severity trend during the past several calendar years.

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 is currently at a level where reserves are theoretically exactly adequate, history would suggest that we will see favorable reserve development, on a calendar-year basis, through 2016 or 2017. 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. Other companies have continued to see small declines in frequency, while for some writers, frequency has turned slightly upward again.

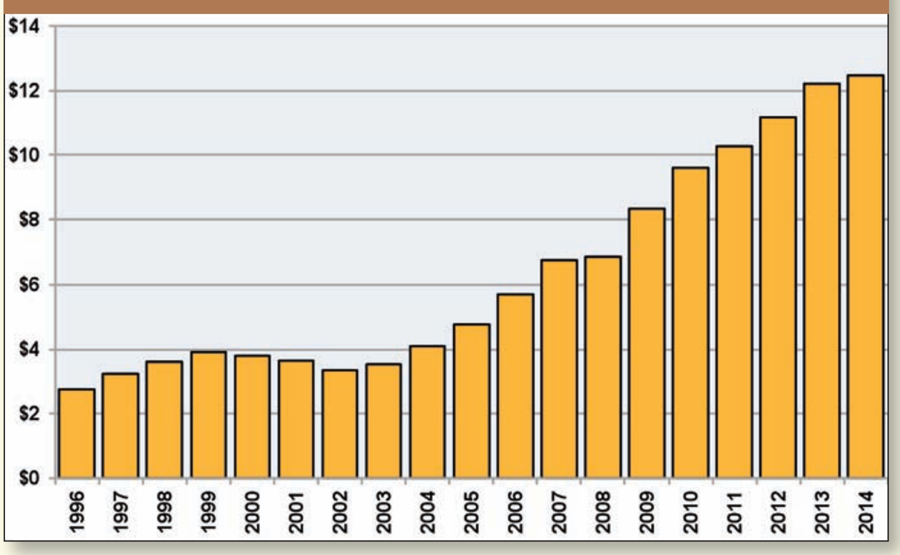
Given the rate decreases of the past several years, frequency has of course increased more relative to premium than to the number of insured physicians. Frequency per $1 million of gross earned premium reached its lowest point for the industry in 2006. Reported frequency has increased each year since this time, although there have been small declines in both 2013 and 2014. Thus, for every claim reported, fewer premium dollars have been available to defend or settle the claims than was the case several years ago. Cumulatively, reported claim frequency (measured relative to premium) has increased by about 25% since the 2006 year. This increase is largely the result of rate decreases (mostly in the form of greater premium credits, as opposed to manual rate changes), although some writers have seen modest increases in "true" frequency—i.e., claims per insured physician.

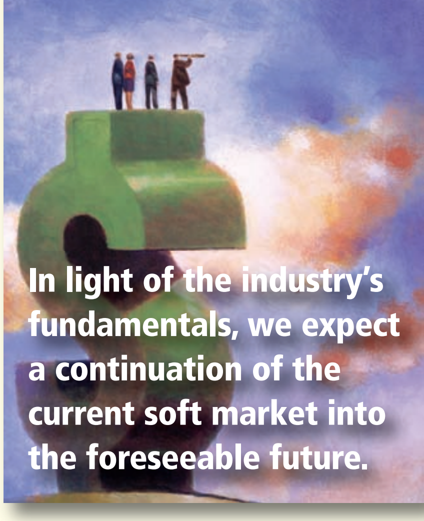
Capitalization

The industry's surplus increased just slightly during 2014, from $12.2 billion to $12.5 billion, a growth rate of 2% (Figure 5). While net income for the industry exceeded $800 million, a large portion of this income was returned to policyholders in the form of dividends, discussed further below. The industry's growth in surplus during 2014 represents a noticeable decline from the double-digit growth rate seen during most of the prior decade.

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 declined in 2014 for the first time in over ten years, from 1,140% to about 1,120% and now sits at a level comparable to 2012. However, individual RBC ratios

Figure 5 Policyholder Surplus ($ Billions)





vary considerably within the composite, from a low of 640% to a high of nearly 10,000%.

Policyholder dividends

The stabilization of the industry's capitalization level is in part due to the significant amount of policyholder dividends that MPL writers have continued to pay. In 2014, the composite writers paid $240 million in policyholder dividends, representing almost 7% of net earned premium (Figure 3). Cumulatively, the composite has paid $2.2 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 and the composite's strong balance sheet.

More of the same to come

In its most recent "Review & Preview" report, A.M. Best estimated a net total reserve redundancy of $2.5 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. Insurers face other risks to the bottom line as well: possible increases in frequency and severity, including the threats to the tort system and tort laws in various states, the potential for a decline in asset values, the continued impact of healthcare reform, and a decline in market size, as hospitals continue to acquire physician practices, among others factors.

In light of the industry's fundamentals, we expect a continuation of the current soft market into the foreseeable future. This will exert further pressure on the industry's rate adequacy, and profitability will continue to slowly erode, albeit from a relatively strong position. The appropriate use of capital will become an increasingly common topic of conversation, as the industry's capital continues to reach record levels. PIAA

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