



THIRD QUARTER FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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As the end of the year draws near, we're going to glance back at the financial results through the first nine months of 2015 to estimate how year-end results might look for medical professional liability (MPL) writers, looking to see if the persistent favorable financial trends and soft-market conditions of recent years will continue.

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 data assembled by SNL Financial. The current composite includes more than 80 companies with total direct written premium of approximately \$5.1 billion in 2014.

In forecasting financial results for MPL writers, we consider the historical relationship of the composite's third-quarter financial results to the results as of year-end. As the charts that follow indicate, this relationship has proved to be a reliable indicator of what to expect from annual financial results.

RATE OF PREMIUM DECLINE INCREASES IN 2015

The aggregate level of direct premium written by this composite continues its steady decline. However, in recent years, the rate of decline had slowed from an average annual rate of 5 percent from 2006 through 2011 to an average annual decline of 1.5 percent from 2012 to 2014. Through three quarters of 2015, the composite's direct written premium level is roughly 5-percent-below premium levels at

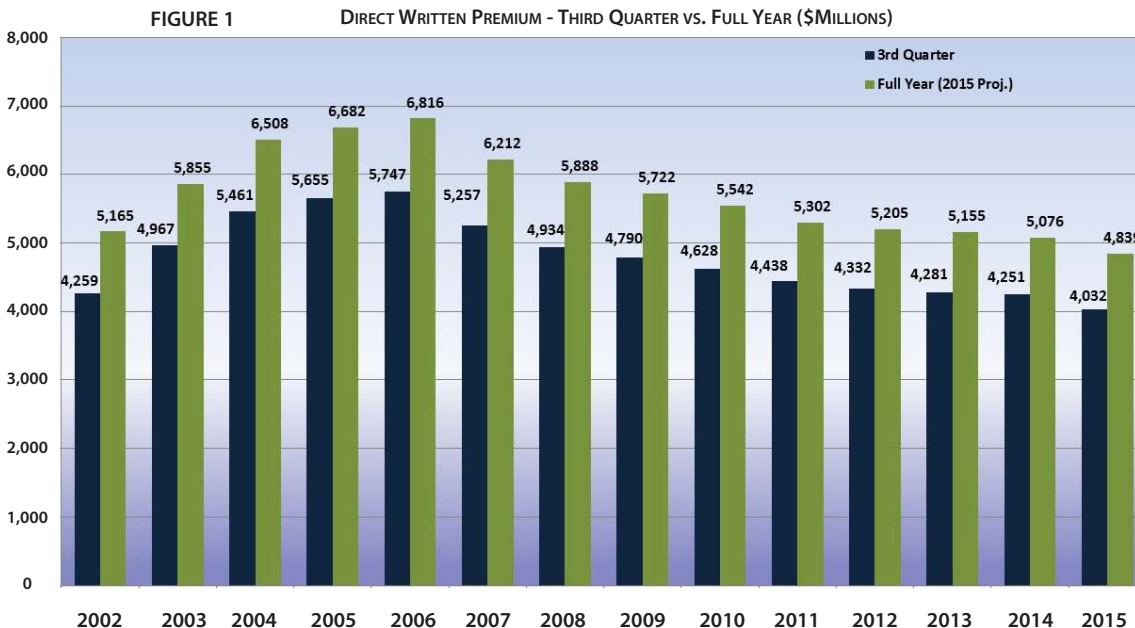
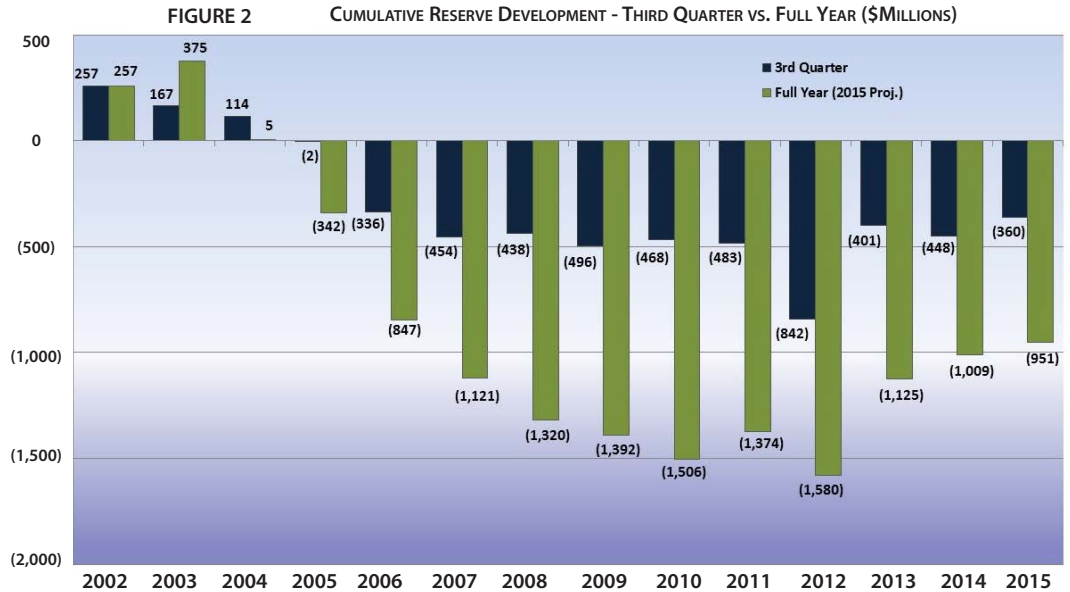
the same point in 2014. If this relationship holds, projected year-end 2015 premium levels for the composite would drop below \$5 billion for the first time in our 14-year history of compiled financial data (Figure 1).

FAVORABLE RESERVE DEVELOPMENT CONTINUES

The prolonged profitability enjoyed by the MPL market continues to be driven by low claim frequency, stable loss severity and, most notably, by large reserve releases in prior coverage years due to conservative reserving practices. These reserve releases have declined each year since 2012 (Figure 2). However, with a projected 2015 reserve release exceeding \$900 million, it appears the MPL market's run of profitability will remain intact for the foreseeable future.

ELEVATED COMBINED RATIOS

As Figure 2 indicates, the reserve releases that result in such profitable year-end financial results for the MPL market have primarily occurred during the fourth quarter of each year as companies prepare year-end financial statements. The impact of these fourth-quarter reserve releases on the composite's combined ratio is displayed in Figure 3 where we compare third-quarter combined ratios to those at year-end. Note that it is not uncommon for large reserve releases during the fourth quarter to cause drops in the year-end combined ratio in excess of 10 percentage points relative to



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third-quarter ratios. The third-quarter results compared to the year-end ratios also suggests that the persistent decline in premium is driving underwriting results above the breakeven underwriting point when measured in the absence of the favorable fourth-quarter reserve development.

Consistent with declining reserve releases and steadily increasing combined ratios, the composite's overall net income has dropped each year since 2010 (Figure 4). As of the third quarter, after-tax net income is down 27 percent when compared to 2014 and is at its lowest point since the third quarter of 2004. Additionally, we expect total net income for 2015 to fall below the amount of favorable annual reserve development for the fourth consecutive year.

A.M. Best recently estimated the remaining reserve redundancy in MPL reserves to be approximately \$3.4 billion, or enough to support several more years of favorable financial results.

INVESTMENT INCOME CONTINUES NEGATIVE TREND

The composite's annual investment yield has been slow to react to the trend in U.S. treasury yields, which have been increasing slowly—but steadily—from their low in 2012. While investment income as of third quarter 2015 is up nearly 4 percent when compared to 2014 (Figure 5), recent history and the reluctance of the Federal Reserve to increase interest rates provide little evidence to suggest that the composite's 10-year decline in annual investment income will reverse course in the near term.

Since we began published quarterly financial results in *MEDICAL LIABILITY MONITOR* back in 2010, MPL specialty writers have continued to benefit from large redundancies in prior-year reserve levels, while observing waning premium levels and declining underwriting results. A.M. Best recently estimated the remaining reserve redundancy in MPL reserves to be approximately \$3.4 billion, or enough to support several more years of favorable financial results. Whatever the number of years turns out to be, until these reserve redundancies are diminished, we do not foresee a scenario arising that would result in upward pressure on MPL rates.

FIGURE 3 COMBINED RATIOS - THIRD QUARTER VS. FULL YEAR

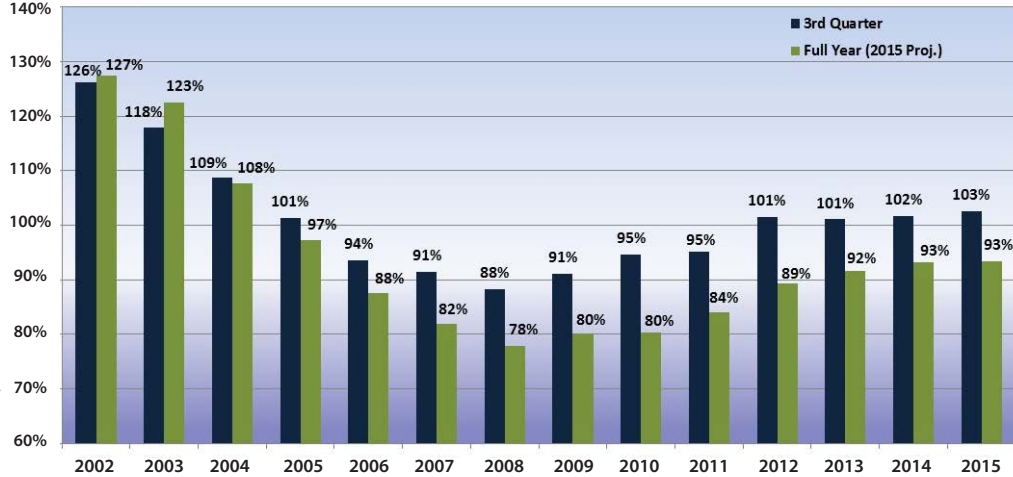


FIGURE 4 NET INCOME - THIRD QUARTER VS. FULL YEAR (\$MILLIONS)

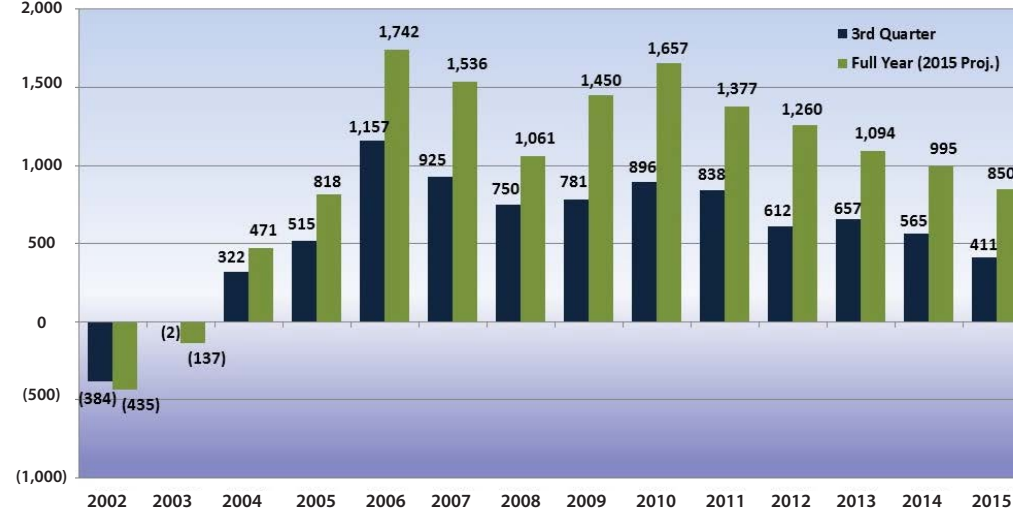
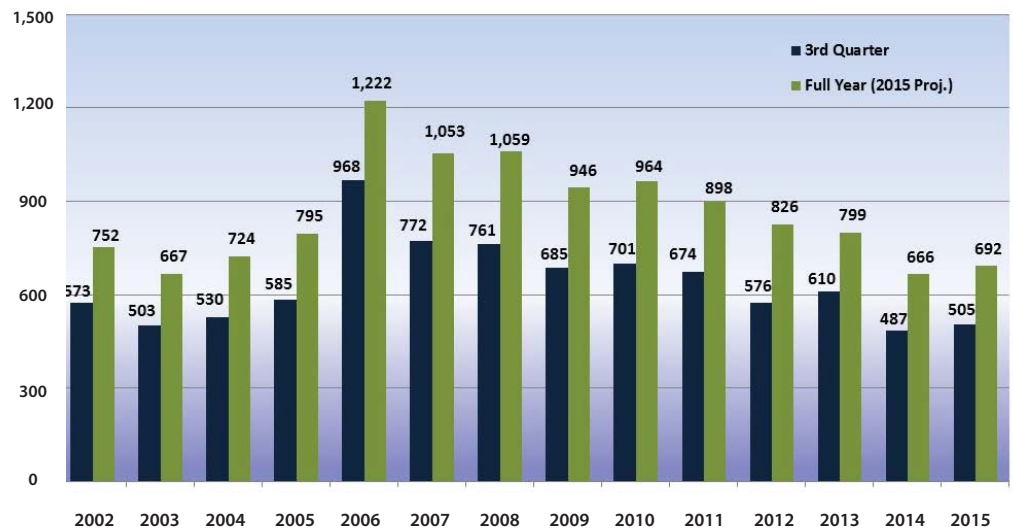


FIGURE 5 INVESTMENT INCOME - THIRD QUARTER VS. FULL YEAR (\$MILLION)



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