2015 YEAR-END RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS: PROFITS REMAIN, WHILE DOWNWARD TRENDS CONTINUE

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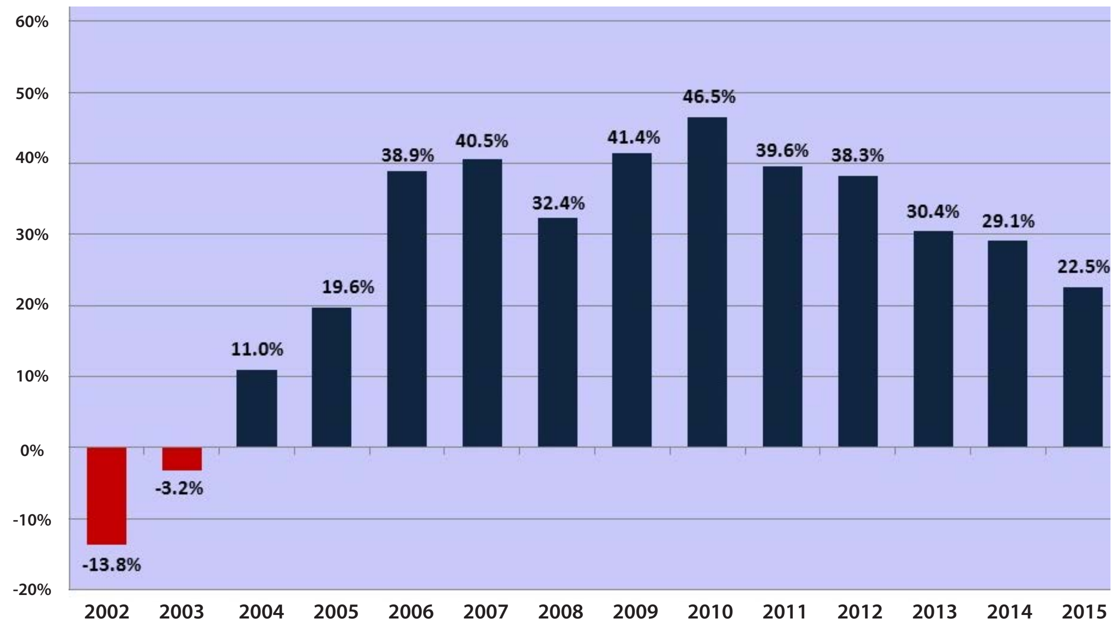
For the past six years, we have tracked the development of key statutory financial results for a composite of medical professional liability (MPL) specialty writers, reporting the overall results of this composite in *Medical Liability Monitor*.

A year ago, as we were turning the page from 2014 to 2015, we noted the continued profitability for MPL specialty writers, but cautioned that negative pressure on overall financial results was showing no signs of slowing down. At the same time, given the lofty perch from which these results began their descent, we recognized there was not yet cause for alarm for the segment as a whole. Fast forward to the present and the MPL financial results are telling a similar tale. For calendar year 2015, this particular segment of the casualty insurance industry can boast yet another healthy bottom line, but one should again take notice that declines in both the premium level and the amount of favorable annual-reserve development appear to be taking their toll on overall net income.

FIGURE 2 CALENDAR-YEAR OPERATING MARGIN

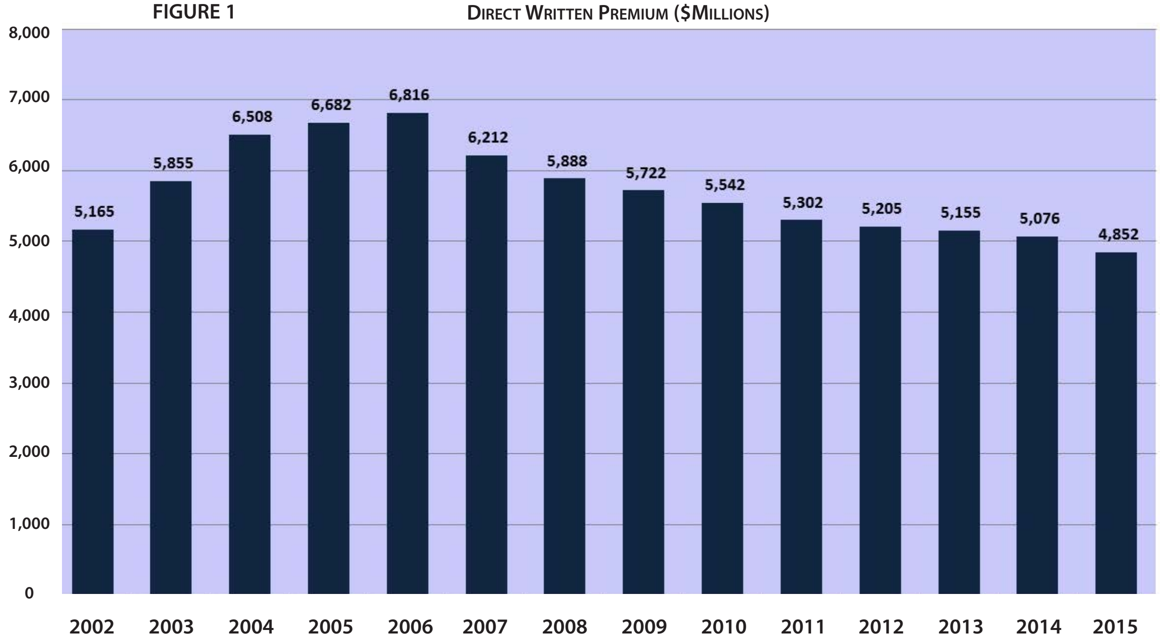


The analysis that follows is based on the composite financial results of insurers that specialize in MPL coverage. The data used in our analysis dates back to 2002 and is obtained from SNL Financial. The composite includes 81 MPL specialty companies with total 2015 direct written premium of just under $5 billion.

As shown in Figure 1, the amount of premium written by the composite has declined in each of the past nine years—down nearly 29 percent from the high-water mark of $6.8 billion in 2006. Total written-premium during 2015 dropped by 4.4 percent when compared to 2014, making it the largest single-year percentage decline in premium since 2007 - 2008.

Steadily declining premium levels have contributed to the erosion of the composite's annual underwriting profit. The composite's combined ratio reached 95 percent in 2015—its highest mark since 2005. Moreover, the combined ratio has increased in each of the past seven years by a total of 17.2 percent. This, together with the composite's worst investment performance since the start of the Great Recession, have combined to produce the lowest calendar-year operating margin in the past decade (see Figure 2).

FIGURE 1 DIRECT WRITTEN PREMIUM ($MILLIONS)



Repeatedly over the past six years, we have tied the prolonged stretch of profitability enjoyed by MPL specialty writers to the favorable reserve development from business written in prior years. In fact, 2010 was the last year in which the composite's annual net income exceeds the annual reserve release by any noticeable margin (see Figures 3 and 4), suggesting that profitability would all but dry up in the absence of the favorable development.

In 2015, the composite's reserve release of nearly $950 million is still a considerable sum, however, it marks the first year since 2006 that this amount has dropped below $1 billion. Fittingly, as reserve releases

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decline, the composite has suffered a five-year slide in annual net income (as shown in Figure 4)—with 2015 down more than 53 percent, compared to 2010.

While it's easy to look at Figures 1 through 4 and focus on the downward trend in financial results, we shouldn't lose sight of the fact that the overall 2015 results are still very positive. The MPL market's sustained run of profitability has nearly tripled the $5 billion of policyholder surplus held at the end of 2002 to $14.7 billion. Figure 5 illustrates the degree to which the composite capital base has strengthened as evidenced by the dramatic growth during the past decade in the National Association of Insurance Commissioners Risk-Based Capital Ratios (defined as total adjusted surplus divided by authorized control-level capital).

If current trends continue, it seems there should be enough favorable development to support at least another year of strong financial results. However, the uncertainty in what lies beyond the next few years could prove unsettling for the MPL market.

In recent years, it has been somewhat of a challenge to present the financial results for the MPL market each quarter as the 'story' has seemed to remain unchanged. That story has been one of MPL writers as a composite relying on a redundant reserve base to produce strong financial results and uninterrupted profitability in the face of declining premium levels. This is a story that MPL specialty writers, no doubt, will not soon tire of hearing.

The 2015 financial results as presented here do not rewrite that story, however, signs that the large reserve redundancies were subsiding appeared a few years back and seemed to have gained momentum. If current trends continue, it seems there should be enough favorable development to support at least another year of strong financial results. However, the uncertainty in what lies beyond the next few years could prove unsettling for the MPL market.

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FIGURE 3 ONE-YEAR RESERVE DEVELOPMENT ($MILLIONS)

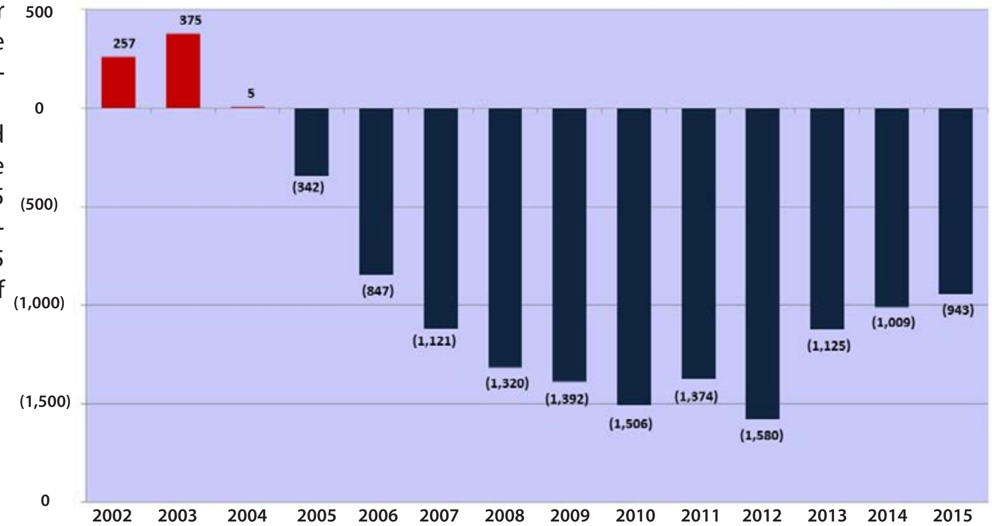

FIGURE 4 NET INCOME ($MILLIONS)

FIGURE 5 NAIC RBC RATIO