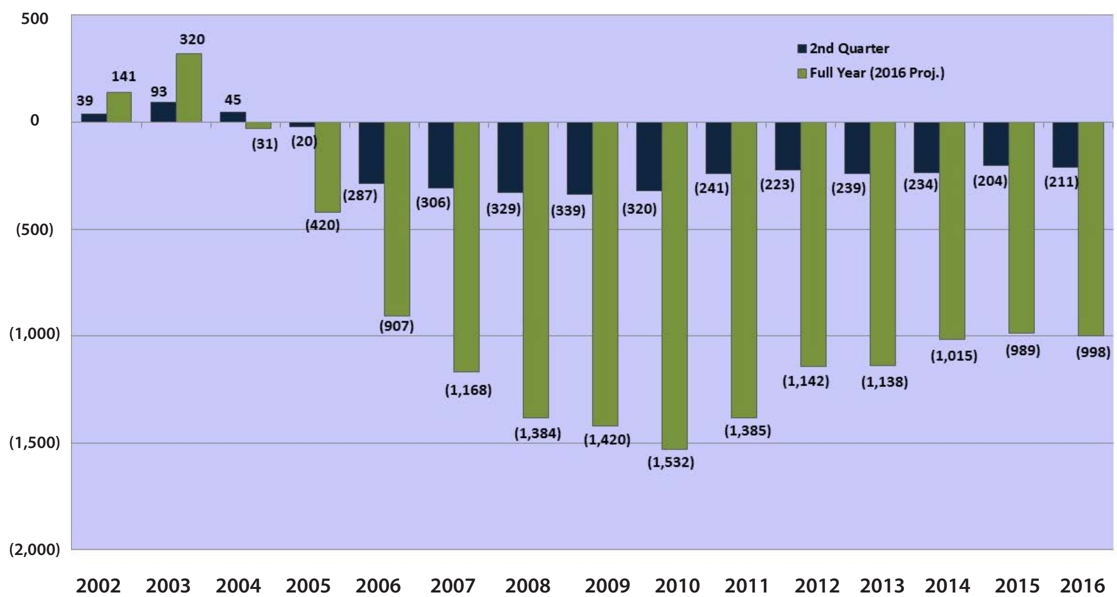
MID-YEAR 2016 FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

by Eric J. Wunder, FCAS, MAAA
Brad J. Parker, ACAS, MAAA

In the following paragraphs, we summarize the financial results for medical professional liability (MPL) specialty insurers through the first six months of 2016. Calendar-year, net-after-tax income continues its downward trend, coinciding with the continuing decline in premium volume and low investment yields. However, overall calendar-year financial results remain strong due to conservative reserving practices.

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 current composite includes 83 MPL specialty companies with total direct written premium of approximately $4.8 billion in 2015.

FIGURE 2 Cumulative Reserve Development - Second Quarter vs. Full Year ($Millions)



Premium Descent Slows Pace

Recent financial results for this composite have shown a leveling off of the now decade-long decline in MPL premium volume. As Figure 1 shows, premium through the second quarter of 2016 declined just 0.2 percent compared to the same point in 2015, indicating—one might conclude—that this downward trend is coming to an end. However, until we see premium levels reverse course and begin to climb, we hesitate to draw any conclusions from the flattening premium curve. We witnessed similar flattening trends throughout 2013 and 2014 only to see premiums drop 4.4 percent in 2015 relative to 2014. At the current rate, calendar-year 2016 premium for this composite will again fall just shy of $4.8 billion, nearly 30-percent lower than the amount written 10 years ago.

Favorable Reserve Development Remains Key to Profitability

A promising development for MPL specialty writers has been a halt, at least for the time being, in the decline of the favorable reserve development that has been so vital to the MPL market's sustained run of positive financial results.

Reaching a peak in 2010, the reserve releases, observed primarily at the end of each calendar year, rapidly declined in 2011 and 2012. Since then, the downward trend has slowed and, for the past three years, has settled in at about the $1 billion mark. Figure 2 shows that, historically, there has been a reasonably strong correlation between mid-year and annual reserve releases. If the same relationship holds for 2016, MPL writers will see yet another year of favorable reserve development at about that same $1 billion level.

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

Income Weakening

In our analysis of the composite's first-quarter 2016 MPL financial results (see *MLM*, July 2016), we made note of a sharp decline in net first-quarter income relative to that of recent years. It shouldn't be surprising in light of declining premium, a competitive MPL market and historically low investment yields that we would begin to see a collective toll taken on MPL net income levels. Figure 3 displays historical

CONTINUED ON PAGE 7

Q2 FINANCIAL RESULTS FOR MPL SPECIALTY WRITERS

CONTINUED FROM PAGE 5

mid-year versus year-end net income for the composite with 2016 mid-year income off 40 percent from the prior five-year average. This actually indicates a more gradual decline than the highly leveraged first-quarter results seemed to indicate, but a disconcerting drop in profitability nonetheless. As Figure 3 illustrates, year-end net income doesn't necessarily follow the rise and fall of income after six months, but given the current market conditions, we expect the downward trend in annual net income, an average annual decline of more than 14 percent since 2010, to continue in 2016.

No Growth in Investment Income

As the MPL market underwriting results continue to deteriorate, investment income for MPL writers becomes a larger percent of total net income. In fact, the composite has earned more profits on the investment side than through underwriting in each of the past five years. That said, investment income declined consistently in the years following the financial crisis. As five-year Treasury-yields fell near 1 percent, the composite's investment yield fell under 2.4 percent (see Figure 4).

During the past several years, the composite's investment yield and investment income appear to have stabilized, but with economic conditions showing no real signs of improvement, prospects for investment growth in the near future do not look promising.

Operating Margin Falls

The continued run of large annual loss reserve releases raises the concern that the favorable reserve development is solely responsible for keeping the calendar-year financial results afloat. A look at the latest data for this composite suggests that calendar-year results are indeed in a steady decline with an operating margin less than half of where it stood in 2010 (Figure 5).

Conclusion

At the midpoint of 2016, MPL specialty writers continue to produce positive operating results, and although net income continues to decline and direct written premium has remained stagnant, favorable reserve development continues to act as a saving grace for the MPL market. The redundant reserve levels continue to cover for declining underwriting results and stubbornly low investment yields.

Eric Wunder is a consulting actuary, and Brad Parker an associate actuary, at Milliman Inc., an independent actuarial and consulting firm.

Figure 3 After-Tax Net Income - First Quarter vs. Full Year ($Millions)

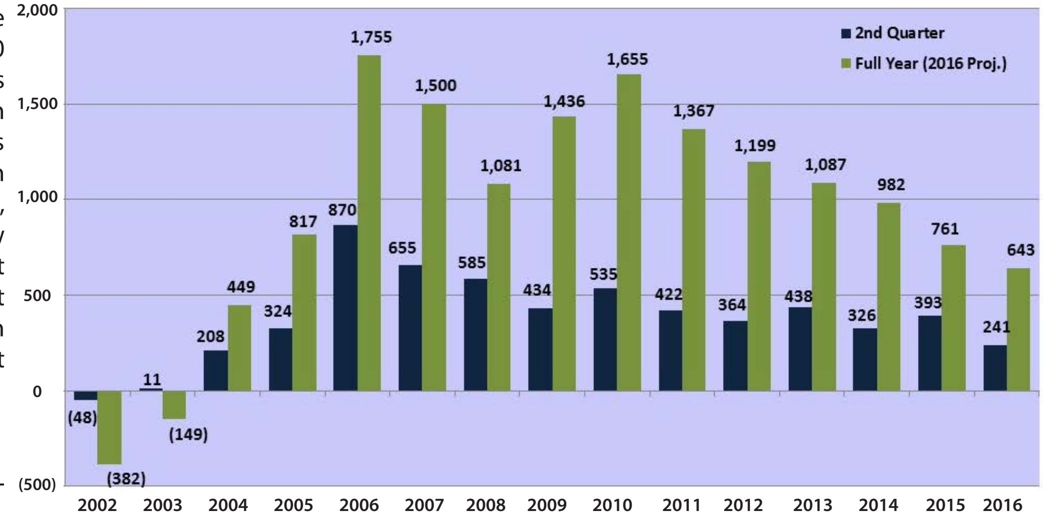


Figure 4 Industry Yield vs. Five-Year Treasury Bond Yield

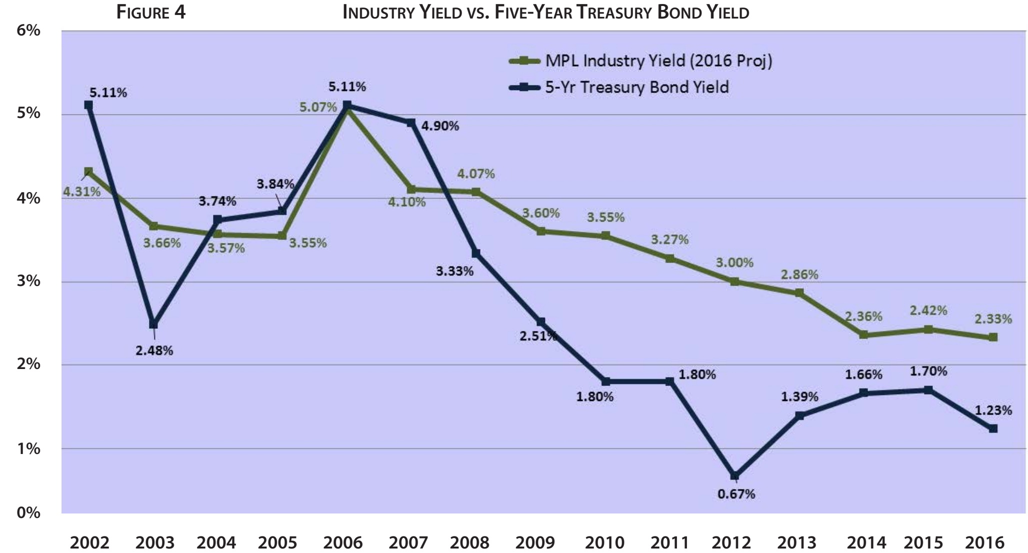


Figure 5 Calendar-Year Operating Margin