FIRST QUARTER FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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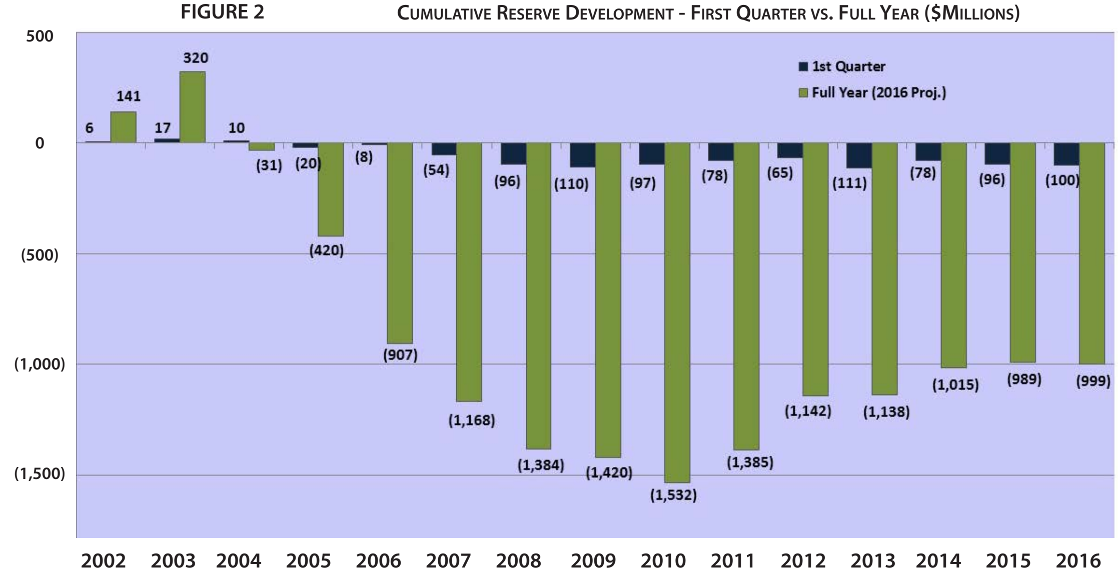
This article summarizes some key financial results for medical professional liability (MPL) specialty writers from the first quarter of 2016 and marks the beginning of the seventh year of Milliman tracking these results for the *Medical Liability Monitor*.

The MPL specialty market opens 2016 experiencing similar trends to those seen in recent years. This period has seen the market maintain favorable calendar-year financial results despite declining premium volume and steadily increasing operating ratios. If the historical relationship between first quarter and year end holds, MPL specialty writers can expect weaker financial results compared to recent years, yet still an overall profitable year.

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 a total direct written premium of approximately $4.8 billion in 2015.

FIGURE 2 CUMULATIVE RESERVE DEVELOPMENT - FIRST QUARTER VS. FULL YEAR ($MILLIONS)



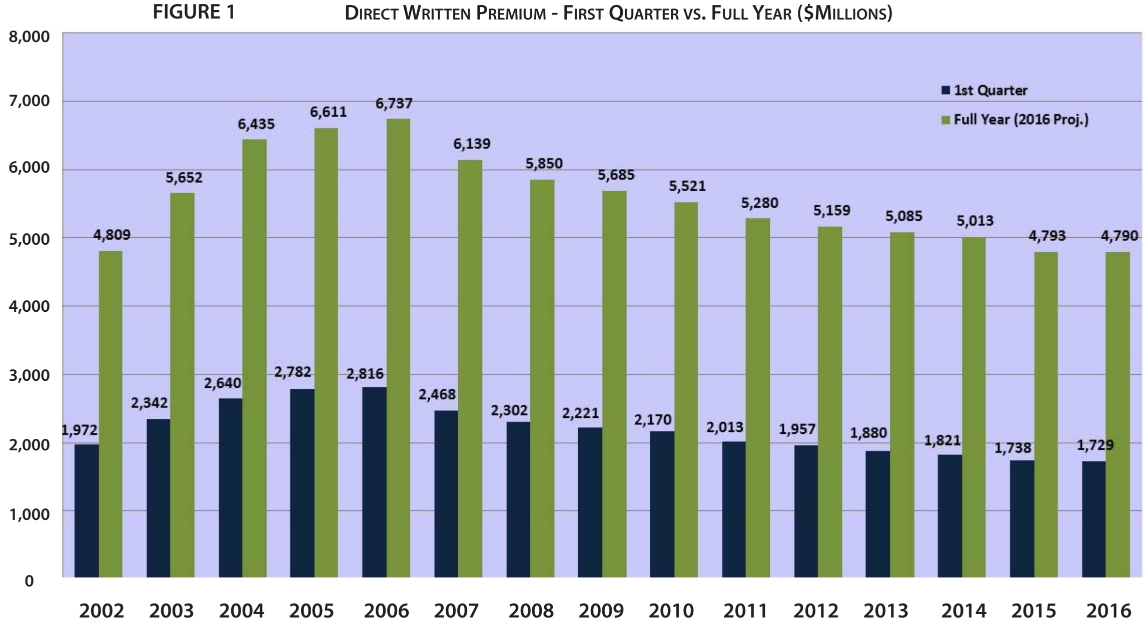
DECLINING PREMIUM LEVELS BEGINNING TO STABILIZE?

As displayed in Figure 1, first-quarter direct written premium declined for the tenth consecutive year, falling about $9 million for this composite. The 0.5-percent decline from first-quarter 2015 is the smallest single-year percentage drop since premiums began declining in 2007. Assuming recent trends and relationships hold, we anticipate the composite's annual 2016 premium to essentially equal that of 2015. This would represent a 29-percent total decline from the peak in 2006, when this composite wrote more than $6.7 billion.

FAVORABLE RESERVE DEVELOPMENT CONTINUES TO YIELD LARGE PROFITS

In 2016, the composite showed favorable first-quarter reserve development for the twelfth-consecutive year with the average annual favorable reserve development for those years exceeding $1.1 billion. Furthermore, the annual reserve development shows a pattern of increasing releases to a peak in 2010, followed by a steady decline in annual reserve releases in recent years. As shown in Figure 2, first-quarter reserve releases seem to provide an indication, though highly leveraged, of the expected reserve release for the entire year. First-quarter 2016 development falls in line with that of the past several years, which would suggest another year of favorable annual reserve development at, or near, $1 billion.

FIGURE 1 DIRECT WRITTEN PREMIUM - FIRST QUARTER VS. FULL YEAR ($MILLIONS)



SHARP DECLINE IN FIRST QUARTER NET INCOME

As favorable reserve releases have continued to decline, so too has annual net income for MPL specialty writers, which have seen an average annual decline of 14 percent during the past five years. We should note that first-quarter net income has been less predictive of annual results when compared to other quarterly financial statistics. Figure 3 indicates the failure of first-quarter results to provide evidence of the downward annual trend during the past six years. That being said, the sharp decline in 2016 first-quarter net income—down more than 80 percent from

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the average first-quarter net incomes during the past decade—might be cause for concern. A closer look reveals the 2016 drop in net income is a result of higher loss and loss expense costs coupled with continued declines in premium and investment gains (particularly in realized capital gains in 2016) when compared to recent first-quarter results.

Combined Ratios Approach Breakeven Point

The composite's projected calendar-year combined ratio for 2016 inched closer to breakeven underwriting—steadily increasing from its low of 77 percent in 2008 to an estimated ratio just shy of 100 percent for 2016. If this projection holds, 2016 will be the twelfth-consecutive year that the composite produces positive underwriting profit (see Figure 4). Slowly increasing loss and LAE ratios during the past five years, combined with more recent increases in underwriting expense ratios, have been the primary drivers of the upward trend in combined ratios. However, in the face of the increasing loss costs and expenses, profits remain.

Investment Income Significance Continues to Grow

With underwriting profits dwindling, we shift our attention to net income's other major contributor. As Figure 5 shows, for the past five years, investment income has overtaken underwriting income to become the primary driver of total net income for MPL specialty writers. This was the case in the years leading up to the peak reserve release years of 2007-2011 and appears to be a new normal as the gap has grown in recent years. This gap could be wider still if not for the historically low treasury yields brought on by the financial crisis of 2007-2008. Increasing investment yields that were expected based on the belief that interest rates will soon rise have not yet materialized. The result is a composite investment yield that has decreased from more than 5 percent in 2006 to a yield approaching 2 percent in 2016.

Conclusion

Initial 2016 financial results for MPL writers again tell a similar story as those of recent years. The composite's less than impressive first quarter net income is something to keep an eye on moving forward, but overall, despite declining premium levels applying upward pressure on the composite's underwriting ratios and a stagnant investment environment, there is still reason to be hopeful that favorable reserve development on prior years business will yet again lead to positive annual financial results for the MPL market in 2016.

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

Figure 4 Annual Combined Ratios

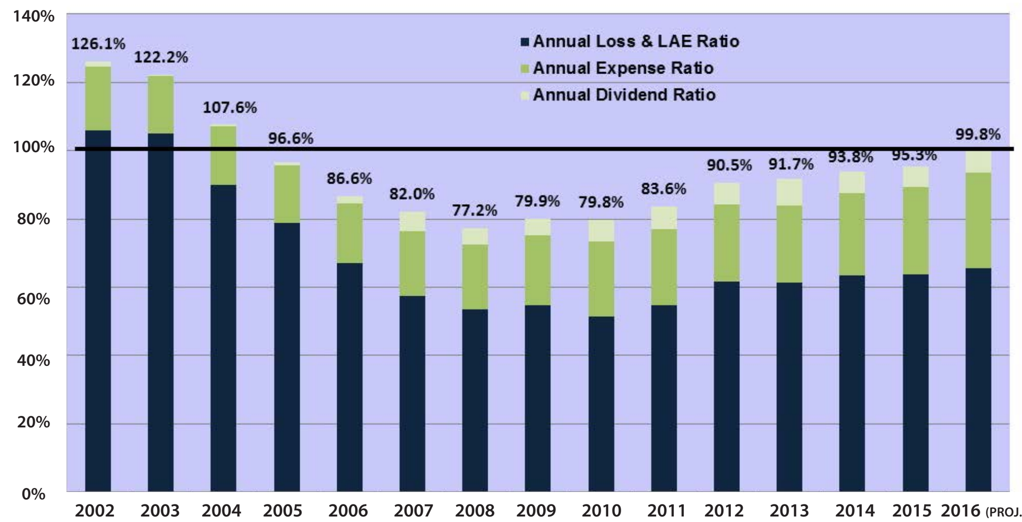
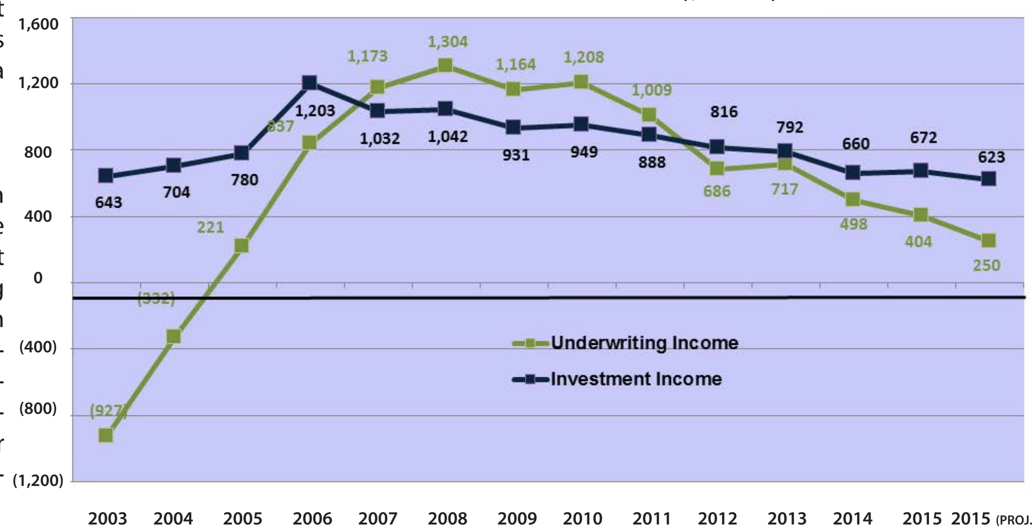


Figure 5 Underwriting vs. Investment Income ($Millions)



Note: *Underwriting income is pre-tax and excludes other income. Investment income excludes realized capital gains.*