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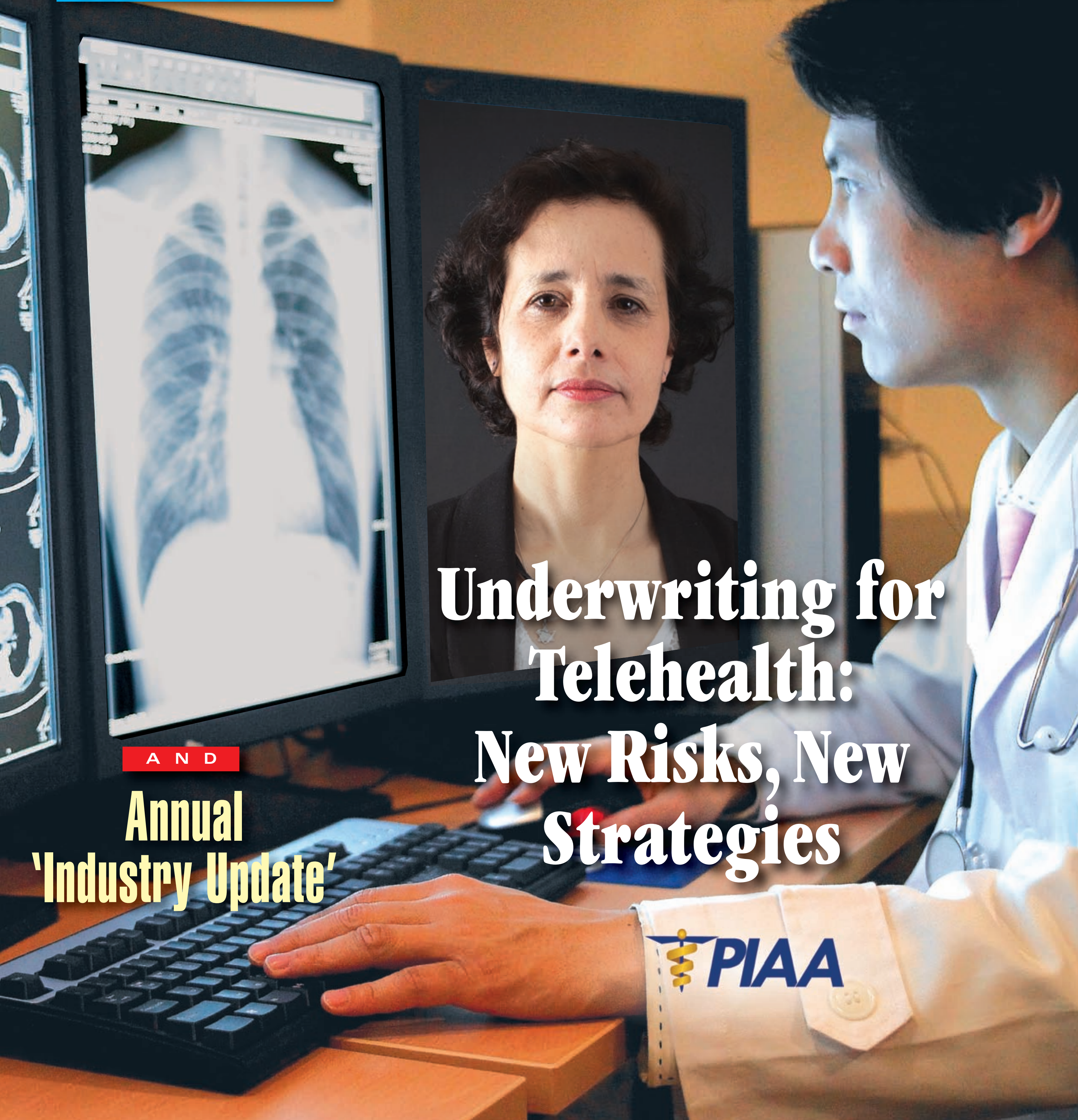

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A Glass Half Empty or Half Full? Industry's Profitability Declines While Maintaining Overall Favorable Results

By Susan J. Forray and Chad C. Karls

The year 2015 manifest continued declining profitability for the medical professional liability (MPL) insurance industry. For those who had grown accustomed to operating ratios below 70%, the industry's most recent results might seem like a glass half empty. The industry's operating ratio increased to 81%, 7 points over the prior year, a larger increase than what was seen in any recent year except 2012.

Meanwhile, insurers continued to experience a decline in reserve releases, lower rate levels, increased expense ratios, and diminished investment gains.

Yet others would observe that the operating ratio remains well below 100%. Despite the decline in profitability, the MPL industry again returned a substantial portion of its income as dividends to policyholders. Surplus grew slightly in 2015, leaving the MPL industry in a financial position roughly consistent with where it has been since year-end 2011. Is the glass half full?

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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 2015 in particular, reserve releases contributed 24 points to the industry's operating ratio. The reserve releases are similar to those during 2014 and 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. Yet despite this decline in reserve releases, without them, the industry would have been unprofitable for the first time since 2003.

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 25% 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 levels they themselves believe are unprofitable.

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 remain in the range 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.

MPL insurers have seen increased caps on damages in some states and, in others, challenges to the tort system itself. MPL insurers in several states face legislative bills that, if passed, would remove MPL claims from the tort system, creating what these bills term a" patient compensation system." 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.

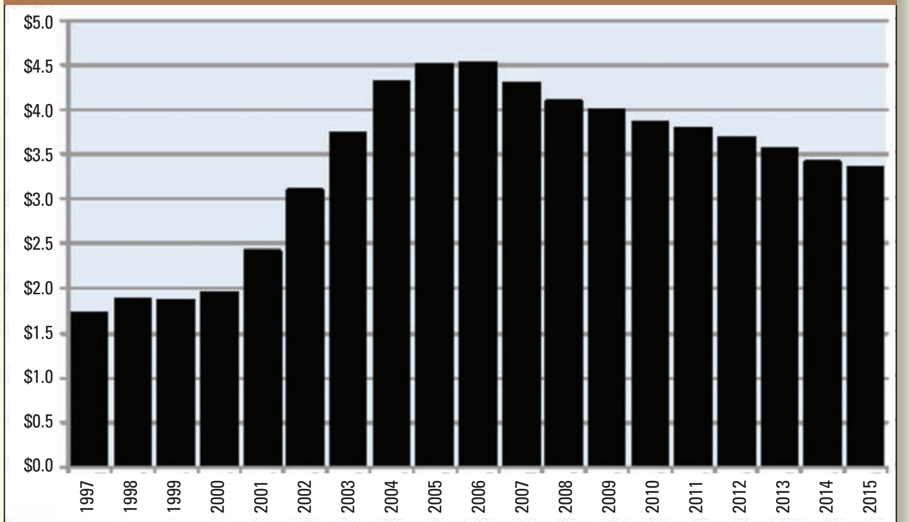
MPL insurers also continue to face declining market share because of the ongoing acquisition of physician practices by hospitals and healthcare systems, and because many newly trained physicians have opted to join these larger systems rather than enter into independent practice. Healthcare reform has only served to accelerate the trend in physician employment that was already well underway. In addition, we expect that the long-predicted decline in the availability of healthcare professionals 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 professionals.

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 considering 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.

Figure 1 Direct Written MPL Premium ($ Billions)



Written premium

Last year, 2015, marked the ninth straight year of decreases in direct written MPL premium for our composite (Figure 1). Cumulatively, premium has decreased by almost $1.2 billion since 2006—more than 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%.

Premium decreases during this time frame have been driven only in part by declining rate levels. An additional—and perhaps primary—driving factor behind the lower level of premium has been the loss of business to self-insurance mechanisms. Throughout this timeframe, PIAA companies have been losing business due to hospital acquisitions of physician practices. In earlier years---through about 2008—companies also frequently lost business due to the formation of new captives.

This is a distinct difference between the current market and the previous soft market, of the mid- to late 1990s through the early 2000s. Both the current and prior soft markets have shown decreasing rate levels, but a comparable level of rate inadequacy has not been manifest in this current soft market, as compared with 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 15

Figure 2 Operating Ratio

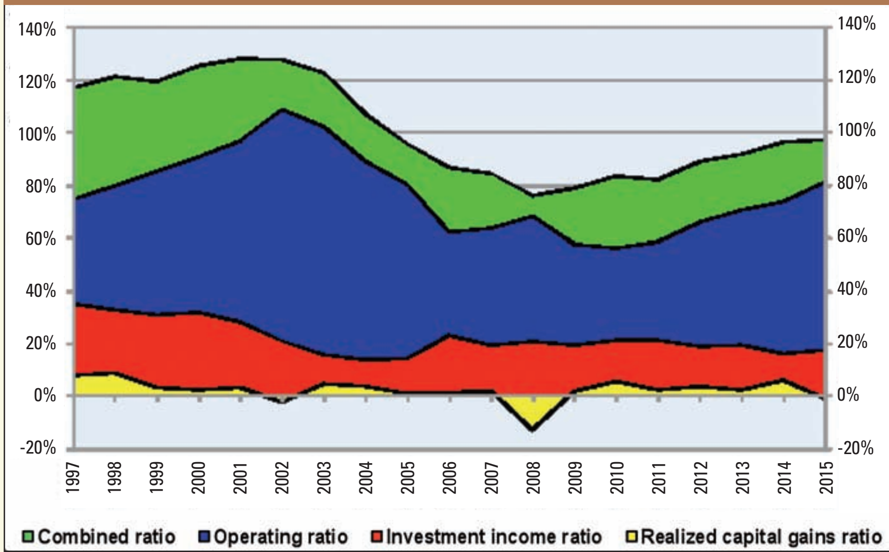
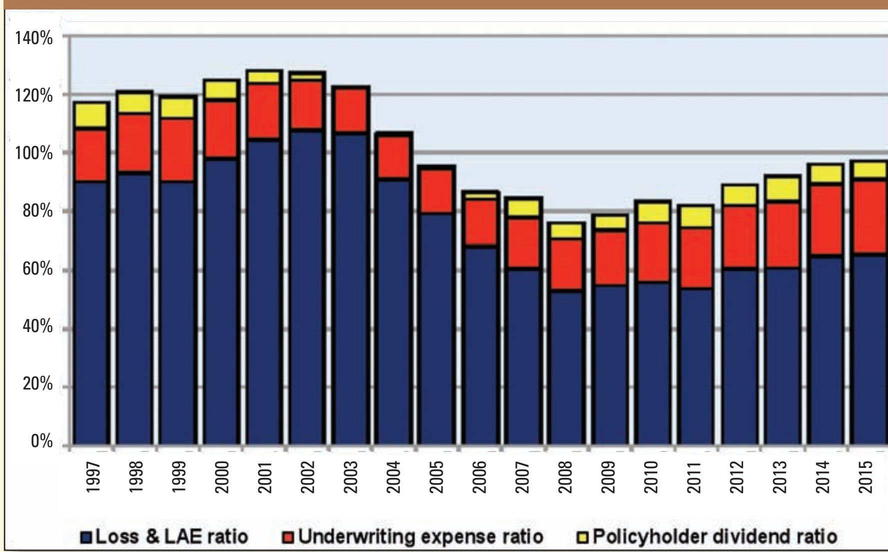


Figure 3 Combined Ratio



years ago. However, we continue 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 81% 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 ongoing lower levels of investment returns. Several points of the increase have also been driven by an increase in the initial carried loss and the loss adjustment expense (LAE) ratio for the most recent coverage year, which has increased from 82% in 2007 to 89% in 2015. The 2015 combined ratio for the industry was 97%, up from a low of 76% in 2008 (Figure 3).

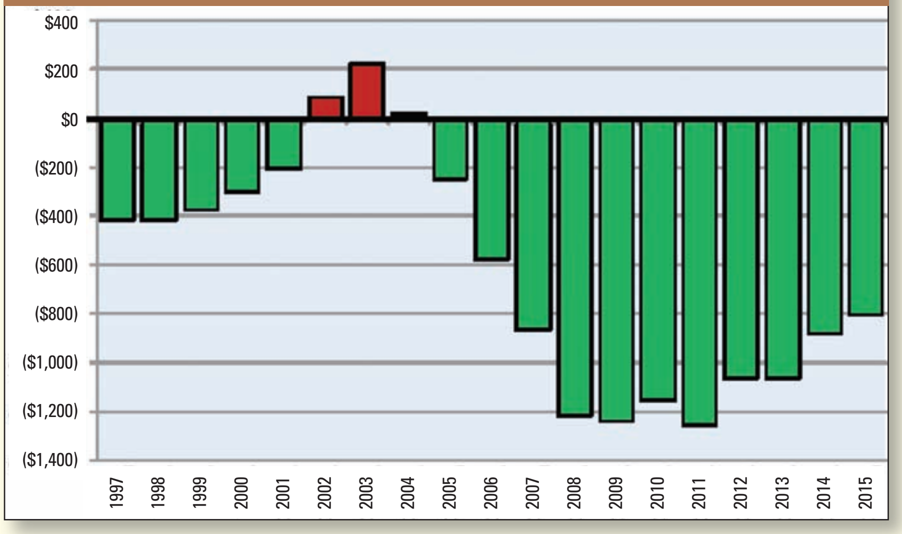
The investment gain ratio of 16% in 2015 represents a noticeable decline from the previous six years, in which the investment gain ratio ranged from 21% to 27%. In large part, this was due to the accounting treatment by one larger carrier of its investment in its affiliates. Thus, the industry's capital gains ratio declined from 6% in 2014 to negative 1% in 2015, the first time the capital gains ratio has been negative since 2008. The investment income ratio increased from 16% in 2014 to 18% in 2015, although this remains less than any year since 2005. Even absent this one instance of an accounting treatment, the industry's capital gains ratio would nonetheless have decreased by approximately 4 points in 2015, and the investment gain ratio by about 3 points.

The calendar-year loss and LAE ratio for 2015, 65%, is higher than in any year since 2006, and represents an increase of almost 13 points since 2008. 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 2015 coverage year is 89%, only a 4-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 2015 coverage year is starting out from a weaker position than other recent coverage years.

Finally, as noted previously, the industry saw a dramatic decrease in reported frequency over the decade following 2001. However, for most companies, frequency (on a per-physician basis) has since 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. Reported frequency per $1 million of direct earned premium has increased year-over-year since 2006, although there were 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 more than 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

Figure 4 Reserve Release ($ Millions)



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 increased to 1215% in 2015, although this appears to be due largely to the effect of the accounting treatment for several acquisitions. However, individual RBC ratios vary considerably within the composite, from a low of 625% to a high of nearly 5000%.

seen modest increases in "true" frequency—i.e., claims per insured physician.

Reserve releases

As discussed above, the composite released $800 million in reserves during 2015, a decline from the $1.2 billion released in each of the years 2008 through 2011 and the $900 million to $1.0 billion released each year subsequently (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 $9.7 billion as of year-end 2014. The release of reserves was driven by the ongoing impact of a lower frequency, combined, for many companies, with a relatively benign trend in indemnity severity 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 2017 or 2018. This would then be followed by adverse development (at least for the older coverage years) in subsequent calendar years.

Capitalization

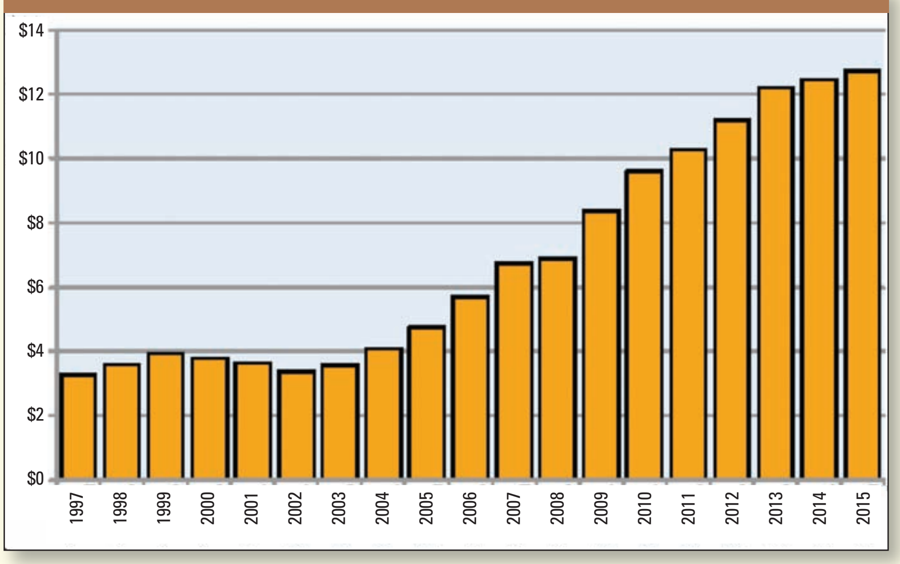
The industry's surplus increased just slightly during 2015, from $12.5 billion to $12.7 billion, a growth rate of 2% (Figure 5). While net income for the industry was close to $600 million, a major portion of this income was returned to policyholders in the form of dividends, discussed further below. The industry's growth in surplus during 2015 represents a noticeable decline from the double-digit growth rate seen during most of the prior decade.

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 2015, the composite writers paid $214 million in policyholder dividends, representing more than 6% of net earned premium (Figure 3). Cumulatively, the composite has paid $2.4 billion in policyholder dividends since 2005.

MPL writers have sustained a similar pattern of policyholder dividend payments, despite a decline in the reserve releases that have historically been used to fund these dividends. In 2015, policyholder dividends

Figure 5 Policyholder Surplus ($ Billions)



We expect that further pressure will be exerted on the industry's rate adequacy as the soft market continues, and that profitability will continue its slow erosion, as a result.

increased to 37% of net income from approximately 30% in 2013 and 2014. Policyholder dividends were roughly 20% to 25% of net income in the preceding several years.

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.

Profitability expected to continue—but so is its decline

In its most recent "Review & Preview" report, A.M. Best estimated a net total reserve redundancy of $3.3 billion for the MPL line of business as a whole. This is approximately 12% of the carried net reserves, which implies a redundancy for our composite of $700 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 continued impact of healthcare reform, and a decline in market size, among others factors.

So is the glass half empty or half full? More important than this debate is the direction of the trend is the glass becoming fuller or losing volume? The industry's declining profitability amounts to a glass half full that is, at this point, slowly becoming depleted.

Put in more common insurance vernacular, we expect that further pressure will be exerted on the industry's rate adequacy as the soft market continues, and that profitability will continue its slow erosion, as a result. Yet capital remains strong, and we expect that discussion of its appropriate deployment will continue to be a common topic of conversation. Given the current slow rate of change in the industry's financials, we expect that it will be at least several years before we can begin to speak of the hard market in the present tense again. PIAA

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