FIRST-QUARTER FINANCIAL RESULTS FOR COMPOSITE OF MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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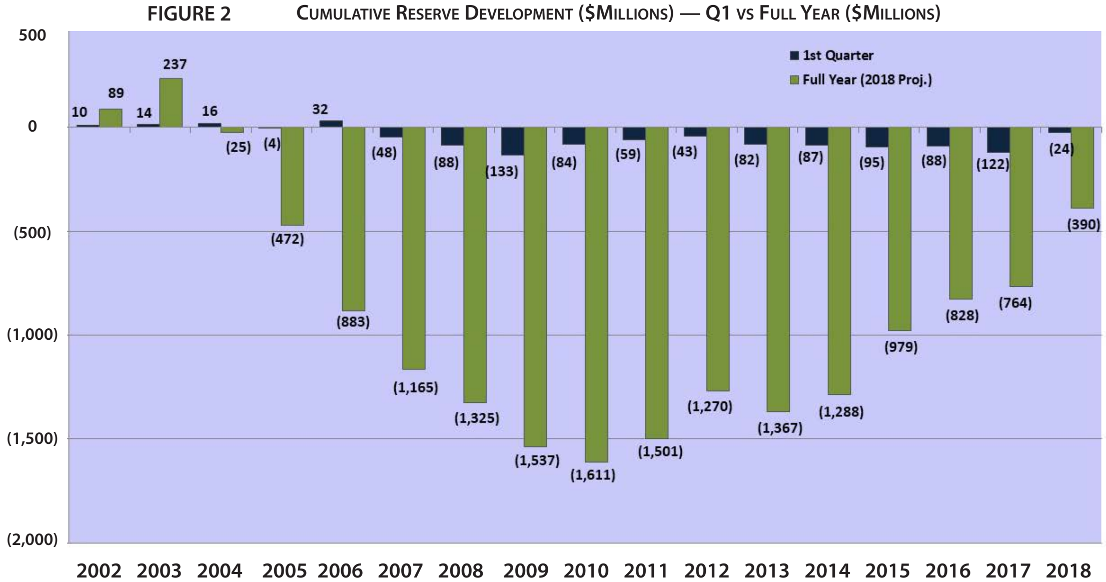
This article summarizes some key financial results for medical professional liability (MPL) specialty writers from the first quarter of 2018 and begins our ninth-consecutive year of tracking and publishing these results for *Medical Liability Monitor*.

As in past years, this article compares historical first-quarter financial results to historical annual results to get a glimpse at where, perhaps, 2018 annual financial results might be headed. With first-quarter premium reversing its 11-year decline, the MPL financial results begin to reflect what just might be the beginning of a hardening of the MPL market. Capital gains have driven superior investment performance as underwriting results continue to underperform.

FIGURE 2 CUMULATIVE RESERVE DEVELOPMENT ($MILLIONS) — Q1 VS FULL YEAR ($MILLIONS)



Our analysis is 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 S&P Global Market Intelligence. The current composite includes 169 MPL specialty companies with total direct-written premium of approximately $5.1 billion in 2017.

Q1 Written Premium Ends Eleven-Year Decline

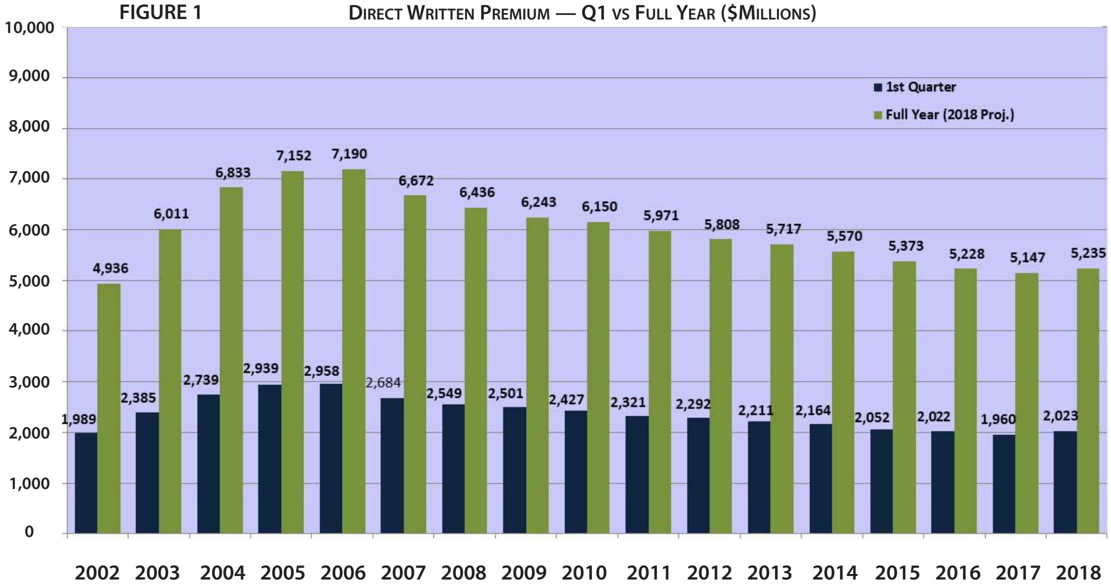
It appears first-quarter written premium may have finally bottomed out in 2017 as the composite's direct written premium through the first quarter of 2018 increased by 3.2 percent relative to 2017 (see Figure 1). The increase brought first-quarter premium back above $2 billion. The MPL industry is now back in line with 2016 premium levels and marks the first increase of its kind in 12 years. The modest increase through just three months of the year does not yet qualify as a reversal of the long downward trend in MPL premium, but it is a continuation of signs that we began to see towards the end of 2017 when the composite's annual gross and net written premium increased.

Reserve Redundancies Expected to Decline Once Again

While first-quarter reserve releases have not typically been predictive of annual reserve development, we note that first-quarter 2018 releases were the lowest since 2006 (see Figure 2). The annual release has been declining steadily with an average annual decline of nearly 10 percent since 2010. We expect this trend to continue in 2018 — perhaps indicating that the stretch of years in which the composite's profitability is primarily driven by favorable reserve development has reached its end.

Investment Results Boost Operating Margin

FIGURE 1 DIRECT WRITTEN PREMIUM — Q1 VS FULL YEAR ($MILLIONS)



The composite's after-tax net income through three months increased by 65 percent relative to 2017 (see Figure 3) thanks to surging investment gains. The composite's first-quarter net realized capital gains increased by more than $100 million from last year, which when combined with all other investment income, makes 2018 the composite's best in terms of first quarter investment gain as far back as our data shows.

Net income should also benefit in 2018 due to the tax law changes. These gains were offset to a degree as underwriting results deteriorated slightly despite the modest increase in premium. At the end of the day,

CONTINUED ON PAGE 7

FIRST-QUARTER FINANCIAL RESULTS FOR MP SPECIALTY WRITERS

CONTINUED FROM PAGE 5

the stellar investment gains saw the composite's first quarter operating margin reach 12.2 percent, its highest mark since 2011.

Underwriting Performance Remains Unprofitable

As Figure 4 suggests, combined ratios through the first quarter tend to be high with results improving after each quarter until we reach the final year-end ratio. The composite's combined ratio through the first quarter of 2018 was 118 percent. While it remains relatively flat compared to recent years, it is still its highest first-quarter ratio since 2002 — and a 2.5 percent increase relative to first quarter 2017 — though 1.5 percent of the increase is due to policyholder dividends. Given the fairly consistent relationship between the first- and fourth-quarter ratios, we expect the 2018 year-end combined ratio to fall slightly above the break-even point.

Industry Investment Yields Should Follow Rising Treasury Yields

Earlier we discussed the composite's surging investment gains when including gains from investments tied to rising security prices (realized capital gains). However, investment yields on the composite's investments tied to interest rates have been flat of late, after the long downward trend following the economic crisis (see Figure 5). This chart also shows that these yields historically tend to change direction as treasury yields change direction. With treasury yields on a sustained two-year incline, and expectations for this trend to continue as the economy strengthens, it follows that MPL industry yields, as represented by our composite, should begin to increase in the near future.

Conclusion

In recent analyses for this composite, we have seen trends developing in the overall financial results and first-quarter 2018 appears to be consistent with these trends. The loss of revenue from declining reserve redundancies continues and is being "replaced" by revenue from improving investment performance and — perhaps now — by increasing premium revenue. Considering the developments described above, and a strongly capitalized market to handle any bumps in the road, the early results suggest 2018 looks to be yet another in a long stretch of profitable years for MPL specialty writers.

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Figure 3 After-Tax Net Income — Q1 vs Full Year ($Millions)

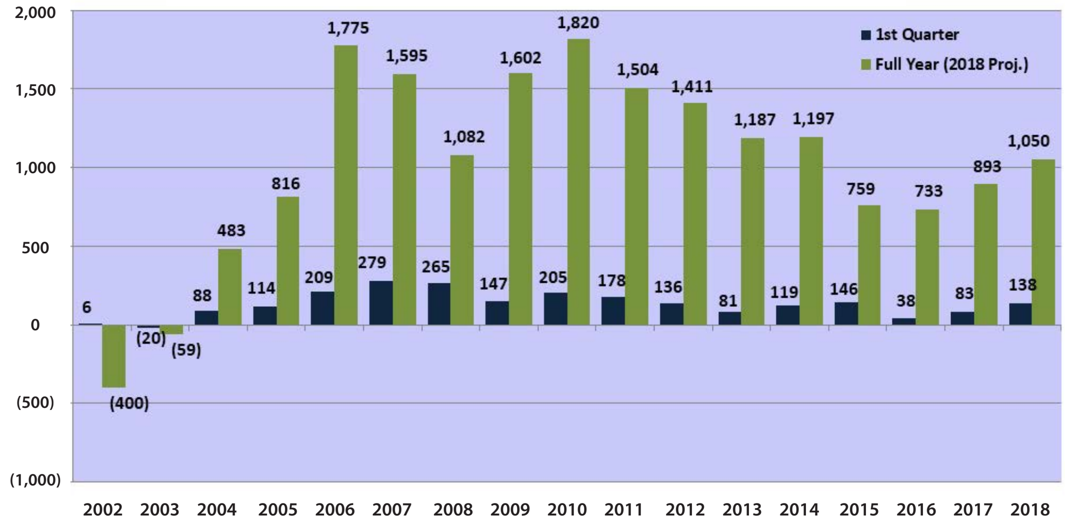

Figure 4 Combined Ratios (After Dividends) — Q1 vs Full Year ($Millions)

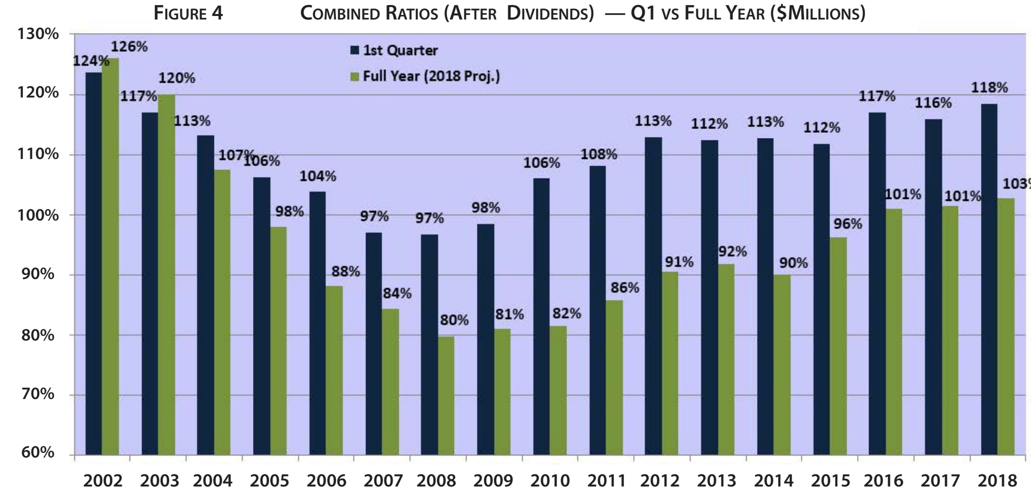

Figure 5 Industry Yield vs Five-Year Treasury Bond Yield