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Analyzing Financial Strength Ratings

AND

Adverse Verdicts on the Rise

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Has The MPL Specialty Industry Reached Its Peak in Financial Strength Ratings?

The medical professional liability (MPL) insurance industry as a whole has been riding a wave of positive results for the past decade. This run of profitability has led to strong balance sheets across much of the industry, specifically as measured by surplus and Best's Capital Adequacy Ratio model (BCAR). As one might expect, these trends have led to generally higher ratings from A.M. Best across the MPL industry.

In this article, we examine the A.M. Best financial strength ratings (FSR) as well as A.M. Best's outlook for MPL specialty insurers. Recent history shows a generally upward trend in ratings, but also a more recent trend that has left an increasing number of MPL specialty insurers with a negative outlook. We explore the reasons behind these negative outlooks and what they may presage for the industry as a whole, going forward. At issue is the potential for an FSR downgrade, which, given the soft state of the MPL market, may result in lost business. (Note that we were only able to review high-level, publicly available financial data, as compiled by SNL Financial, for these MPL specialty companies and have not reviewed the companies in the same degree of detail as A.M. Best.)

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Balance sheet strength results in rating upgrades

The profitability experienced by the industry since the mid-2000s, and the resulting strengthening of balance sheets, has not gone unnoticed by A.M. Best. As seen in Figure 1, an increasing number of MPL specialty companies have been receiving A ratings over the past five years. This is an expected outcome, given that A.M. Best's definition of an FSR is: "an independent opinion of an insurer's financial strength and

ability to meet its ongoing insurance policy and contract obligations."[1] The surplus accumulated over the industry's long profitable stretch supports these changes.

Rating increases give way to negative outlooks

In more recent years, however, an increasing number of MPL specialty companies have been receiving negative outlooks from A.M. Best (Figure 2). This new trend prompts questions regarding whether MPL specialty companies have reached a peak in terms of FSR. It also begs the question, what about these companies, relative to the other MPL specialty companies, is driving the negative outlook? Milliman examined the financial information of approximately 40 MPL specialty companies rated by A.M. Best. We compared the companies that had received a negative outlook with all of the other companies, using several relevant metrics to assess the differences between these two cohorts.

Why the negative outlooks?

We first explored the changing balance sheets of these companies to determine whether significant deterioration had occurred. To measure this phenomenon, we collected the historical BCAR scores for each company and averaged them by group, as shown in Figure 3. While there has been some deterioration for the negative-outlook companies, the BCAR scores for them remain near 300. (Under this methodology, a BCAR score of 175 or more implies an A++ balance sheet strength.)

Second, we explored the geographic diversification of these MPL specialty insurers. In past years, A.M. Best has expressed some concerns about mono-line, mono-state companies, since their lack of diversification meant that a single legal, legislative, or other event could have an undue impact on the company. Since each of the companies we looked at is primarily a mono-line entity, we did investigate whether the MPL specialty companies that had received negative outlooks were also mono-state. However, the negative-outlook companies represented a wide range of geographic coverage, from writing in just one state to writing in all 50 states, so geographic diversification does not appear to be the driver of these negative outlooks.

The income statement, on the other hand, shows noticeable differences between these cohorts. Figures 4 and 5 display the operating ratio and combined ratio, respectively, over the last five years. These ratios are generally worse for the negative-outlook companies and are largely trending away from profitability. Interestingly, the gap between the cohorts is wider from an operating perspective. The implication here is this: not only are the negative-outlook companies performing worse from an underwriting standpoint; they are also lagging behind in investment income.

In addition, Figure 6 shows the one-year loss reserve development history, which has steadily deteriorated for the negative-outlook companies, declining from favorable development to adverse development. The remaining companies also appear to be trending in the wrong direction in recent years, but this group continues to produce favorable development on prior years.

Strong balance sheets but weak income statements—recipe for a negative outlook

As displayed in Figures 4 and 5, the income statement appears to be driving the negative outlooks for these MPL specialty companies. While we agree that these negative results will give rise to balance sheet deterioration, we believe that these potential rating decreases may be premature. As mentioned previously, the FSR is A.M. Best's opinion of an insurer's financial strength and ability to meet its ongoing obligations. It is not clear how long and under what accounting basis the insurer must be able to meet these obligations. However, given that A.M. Best performs annual reviews of its clients and the BCAR model itself relies

Figure 1. Companies receiving A or A- Ratings

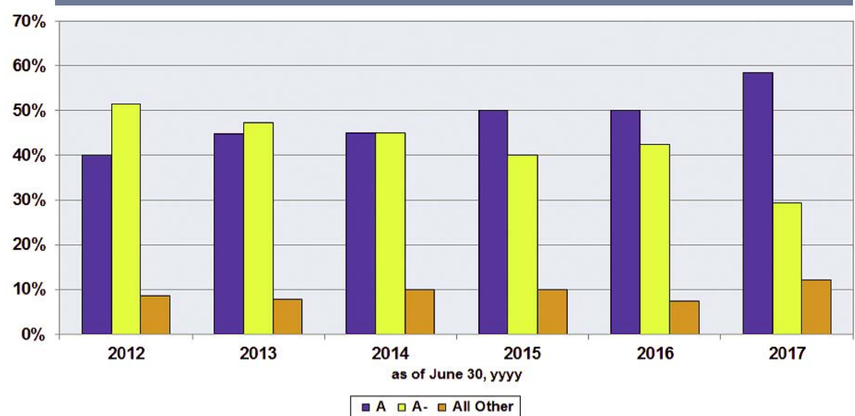
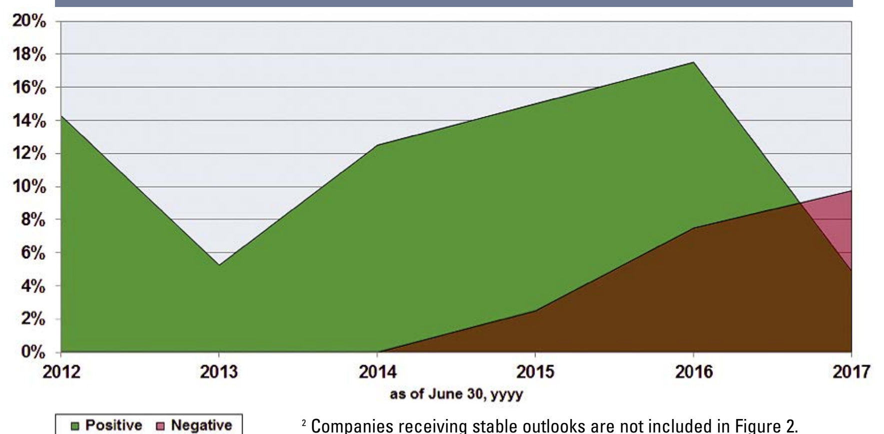


Figure 2. Companies Receiving Positive or Negative Outlooks[2]



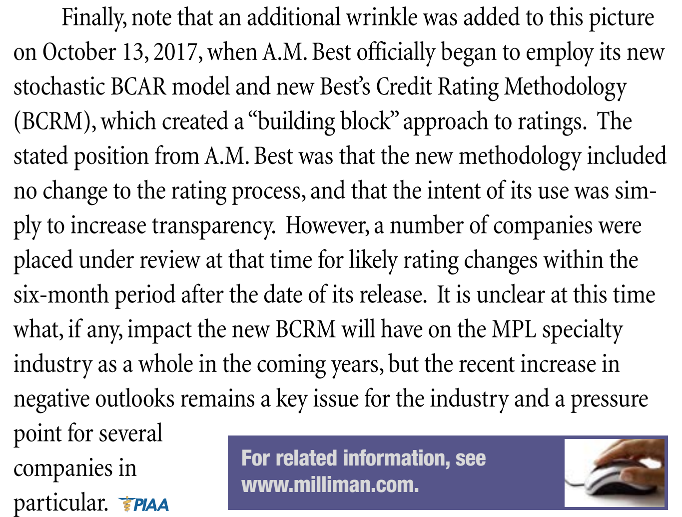
[2] Companies receiving stable outlooks are not included in Figure 2.

on statutory data, one might assume that the obligations to be met might well be short- to medium-term on a run-off basis. Generally speaking, given the balance sheet strength of these companies relative to their poor income statements, their balance sheets will continue to look strong for many years.

This surmise is exacerbated to some extent by the fact that most observers highlight the fact that exposures are exiting the individual and small-group market and moving to coverage from captives or self-insurance instead. Although that challenge is a significant one for the MPL industry, from the perspective of a deteriorating income statement and its impact on the balance sheet, it simply means that fewer dollars of potential losses will be able to negatively impact the balance sheet. In other words, the impact of the income statement on the balance sheet, all else being equal, will decline as fewer exposures are insured.

What's next?

If A.M. Best is truly focused on income statement strength, companies looking to maintain their rating will need to increase rates or reduce expenses. But if they do that, the companies may lose market share. On the other hand, they have such strong balance sheets that executives and company boards have multiple options for deploying their surplus. We would advise those decision makers to do what they believe is right: Run your own company. In the late 1990s, when A.M. Best had similar issues with MPL specialty companies, it recommended diversification of the insured portfolio, which for most companies meant writing business in more states. The MPL industry subsequently experienced a hard market: Many companies lost money, and that, ultimately, resulted in weaker balance sheets.



Finally, note that an additional wrinkle was added to this picture on October 13, 2017, when A.M. Best officially began to employ its new stochastic BCAR model and new Best's Credit Rating Methodology (BCRM), which created a "building block" approach to ratings. The stated position from A.M. Best was that the new methodology included no change to the rating process, and that the intent of its use was simply to increase transparency. However, a number of companies were placed under review at that time for likely rating changes within the six-month period after the date of its release. It is unclear at this time what, if any, impact the new BCRM will have on the MPL specialty industry as a whole in the coming years, but the recent increase in negative outlooks remains a key issue for the industry and a pressure point for several companies in particular. PIAA

For related information, see www.milliman.com.

Footnotes

1. Best's Credit Rating Methodology, draft, October 13, 2017, p. 46.

Figure 3. Historical BCAR Scores

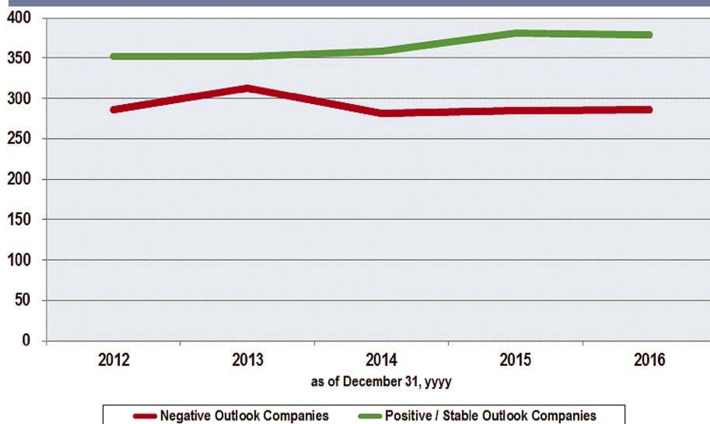


Figure 4. Operating Ratio

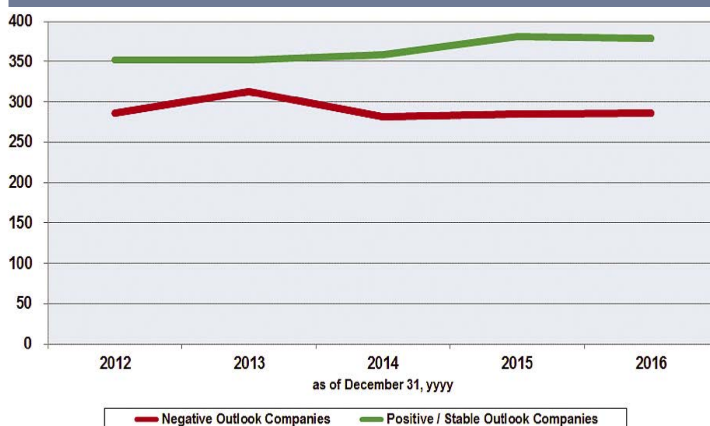


Figure 5. Combined Ratio

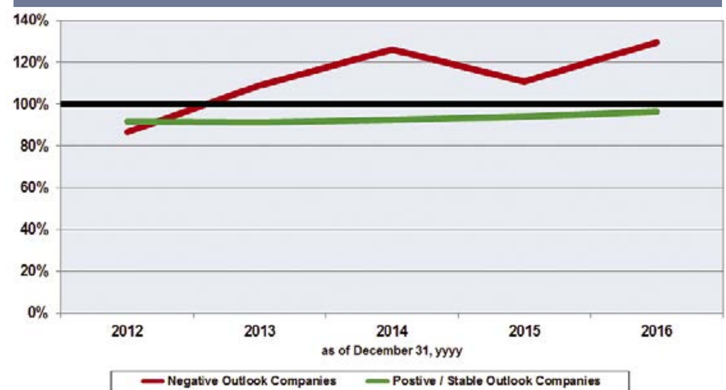


Figure 6. One-Year Loss Reserve Development as a Percent of Prior Policyholders' Surplus