OCTOBER **2014**

P&C PERSPECTIVES
Current Issues in Property and Casualty

LAWYERS PROFESSIONAL LIABILITY UPDATE: INSURERS' STRING OF STRONG FINANCIAL RESULTS CONTINUES

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Specialty writers of lawyers professional liability (LPL) continued a pattern of strong financial results in 2013. The operating ratio for the LPL industry was about 74%, the lowest in more than 10 years. Insurers returned over 30% of their net income to policyholders in the form of dividends, which in large part was due to reserve releases during the year. The industry's surplus also reached an all-time high, having increased 9% over 2012.

Claim frequency also fell 9% in 2013, the largest year-over-year decrease in available history. This was driven by a decline in the number of claims as well as rate increases implemented by certain insurers (increasing the premium base used in the frequency calculation). Claim severity has also fallen for many insurers as larger claims (generally resulting from the real estate crisis of 2008) have become noticeably less common.

To further discern the state of the LPL industry today, we have analyzed the financial results of a composite of 14 specialty writers of LPL coverage for solo practitioners and small firms. This excludes one LPL specialty writer that became insolvent during the time period considered. Statutory data was obtained from SNL Financial. We have compiled various financial metrics for the industry, categorized by:

- Overall operating results
- Reserve releases
- Claim frequency
- Capitalization
- Net retentions

Overall operating results

The industry's strong operating results in 2013 were largely the result of an increase in reserve releases as well as a slight improvement in the 2013 coverage year itself. However, this should be put in the context of the preceding years. The operating results of 2008 to 2011 were worse than those experienced in the prior 15 years—even during the previous soft market of the late 1990s through 2001 (see Figure 1). The favorable operating results of 2012 and 2013 can thus be seen as a return of the industry to results that were more typical of the decade preceding 2008.

FIGURE 1: AGGREGATE CALENDAR-YEAR OPERATING RESULTS FOR THE LPL SPECIALTY WRITERS

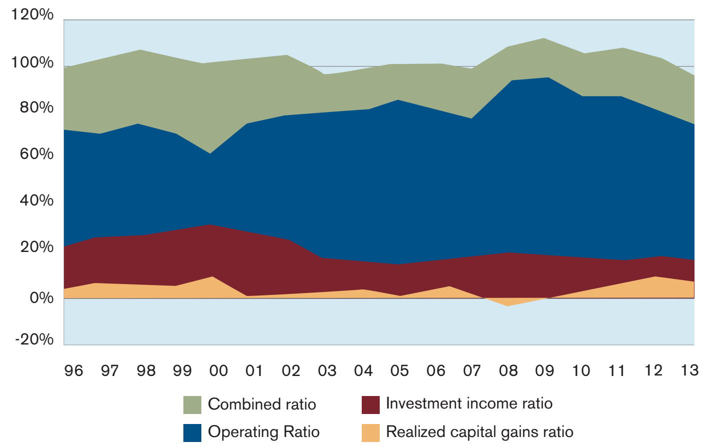
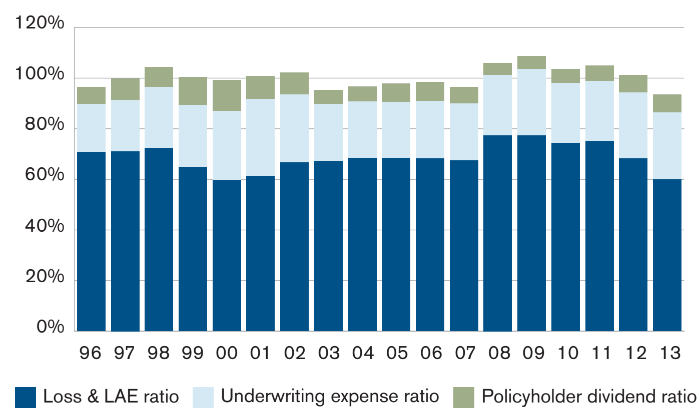


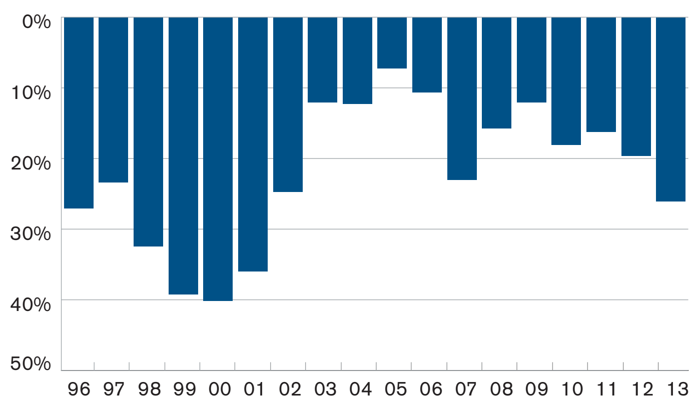
FIGURE 2: BREAKDOWN OF THE AGGREGATE COMBINED RATIO BY CALENDAR-YEAR FOR THE LPL SPECIALTY WRITERS



The underwriting expense ratio sat at 26% in 2013, slightly above other years of the past decade. About 7% of net earned premium was returned by the composite as policyholder dividends. The policyholder dividend ratio has been increasing since 2008 but remains below the policyholder dividend ratios of the 1997-to-2002 time period. In part this may be due to reserve releases (discussed below), which have generally been less in recent years than during this earlier time. Reserve releases are often viewed as the most available source to fund policyholder dividends.

Investment gains fell relative to 2012, from 24% to 20%, but otherwise remained at or above results for any year since 2002. The realized capital gains ratio for the LPL writers fell from 8% to 5%, as 2012 proved to be an unusual year in the sale of assets for amounts greater than their carried values. The investment income ratio fell slightly to 15% from ratios seen in other recent calendar years.

FIGURE 3: CALENDAR-YEAR LOSS AND ALLOCATED LOSS ADJUSTMENT EXPENSE (ALAE) RESERVE RELEASES FOR THE LPL COMPOSITE, RELATIVE TO NET EARNED PREMIUM



Reserve releases

Reserve releases for the composite in 2013 totaled $47 million, or 26% of net earned premium (see Figure 3). While noticeable, this should be put in the context of the reserves carried by the composite, which for net loss and loss adjustment expense (LAE) totaled $359 million as of year-end 2012. It is also important to recognize that a history of favorable calendar-year reserve development does not necessarily imply that current reserves will run off favorably.

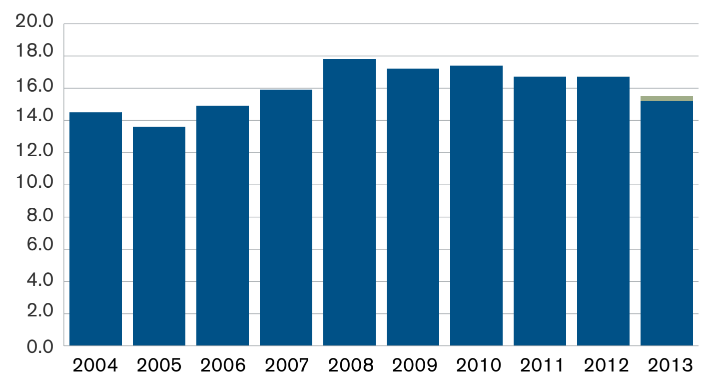
As mentioned previously, the industry has seen a decrease in reported frequency since 2008, accompanied by a decrease in severity. This has contributed to subsequent favorable reserve releases, as the reduction in severity was largely unexpected. With hindsight we have seen that the decline in severity for many carriers stemmed from a reduction in the larger real estate claims filed during and following the financial crisis beginning in 2008. However, this was a time of great economic uncertainty and this decline in severity could not have been predicted in advance.

Claim frequency

While actuaries typically measure frequency as claim counts relative to the number of insured attorneys, ultimately it is premium dollars that must pay these claims, and thus it is relevant for insurers to consider frequency as claim counts relative to premium. Measured on this basis, we see that frequency per $1 million of gross earned premium reached its lowest point for the industry in 2005 (see Figure 4). Reported frequency subsequently increased from 2005 until 2008, driven in large part by a spike in the number of real estate claims.

Claim frequency since 2008 has declined slightly, although 2013 demonstrated the largest decrease in frequency, now falling below the 2007 level. For most writers, real estate claims in particular have declined to levels at or below the time period preceding the financial crisis. Other writers have continued to see generally flat frequency during this time

FIGURE 4: REPORTED CLAIM FREQUENCY PER $1 MILLION OF GROSS EARNED PREMIUM



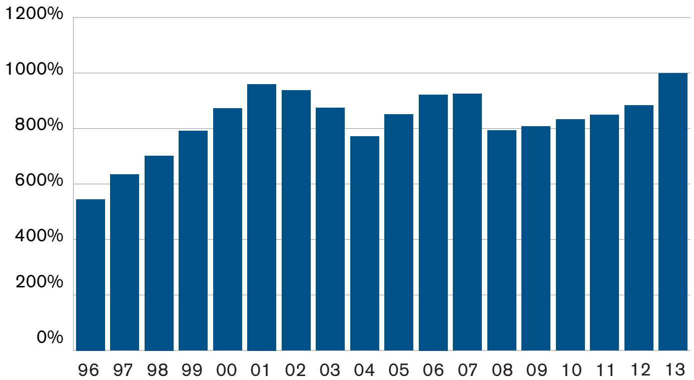
Note: Excludes two companies for which data was unavailable.

Note that, in Figure 4, we have adjusted the 2013 frequency to include a provision for "pipeline" claims (i.e., incidents that evolve into claims), in order to provide an indication comparable to the older report years. Prior patterns suggest that, with the inclusion of these pipeline claims, the frequency for the 2013 report year is likely between 15.2 and 15.5 claims per $1 million of gross earned premium.

Capitalization

The composite's profitable operating results in 2013 boosted surplus by about 9% year over year, from about $544 million to $593 million. This is a meaningful gain, but must be put in a broader context. To do so, consider the risk-based capital (RBC) ratio for the industry. This metric compares a company's actual surplus to the minimum amount needed from a regulatory perspective. (From a practical perspective, given market fluctuations, companies typically hold capital well in excess of this regulatory minimum.)

FIGURE 5: AGGREGATE RISK-BASED CAPITAL RATIO OF THE LPL SPECIALTY WRITERS

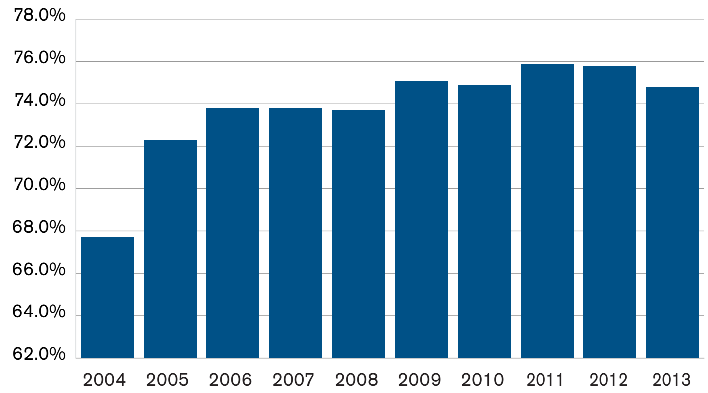


The aggregate RBC ratio of the LPL writers increased to nearly 1,000% in 2013 (see Figure 5). However, year-over-year fluctuations are seen in the RBC ratio throughout the past decade. In addition, individual RBC ratios as of year-end 2013 vary considerably within the composite, from a low of less than 400% to a high of about 2,000%.

Net retentions

The generally favorable operating results of the past decade, along with increasing surplus, have allowed the specialty writers to decrease the amount of premium (and corresponding loss and LAE) ceded to reinsurers. This pattern reversed itself—although only slightly—in 2013. The industry's average ratio of net to gross earned premium (see Figure 6) increased most noticeably between 2004 and 2005 and has continued to grow since then. This trend began as the result of an increase in the cost of reinsurance a decade ago. Given the generally favorable underwriting results experienced by the composite, the increase in net retention has contributed to subsequent favorable operating results, as insurers have retained profitable layers of coverage.

FIGURE 6: RATIO OF NET TO GROSS EARNED PREMIUM



Forecast

We expect the LPL industry to remain profitable for several years to come. Nonetheless, it should be recognized that the industry has historically depended almost entirely on reserve releases for its favorable operating results. Without favorable reserve development, operating results would have been roughly break-even in most years. The circumstances that have given rise to the most recent favorable reserve releases—the decline in both frequency and severity—cannot be expected to continue over the long term.

At the same time, we continue to observe many of the LPL writers taking rate action. Companies are paying increased attention to rating factors, with the real estate area of practice being a noteworthy example. These rate actions, combined with enhanced underwriting discipline, can be expected to offset the potential for adverse results. We believe a future decline in reserve releases will be at least partially offset by an increased underwriting focus.

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