ROUNDING THIRD & HEADING FOR HOME: THIRD QUARTER RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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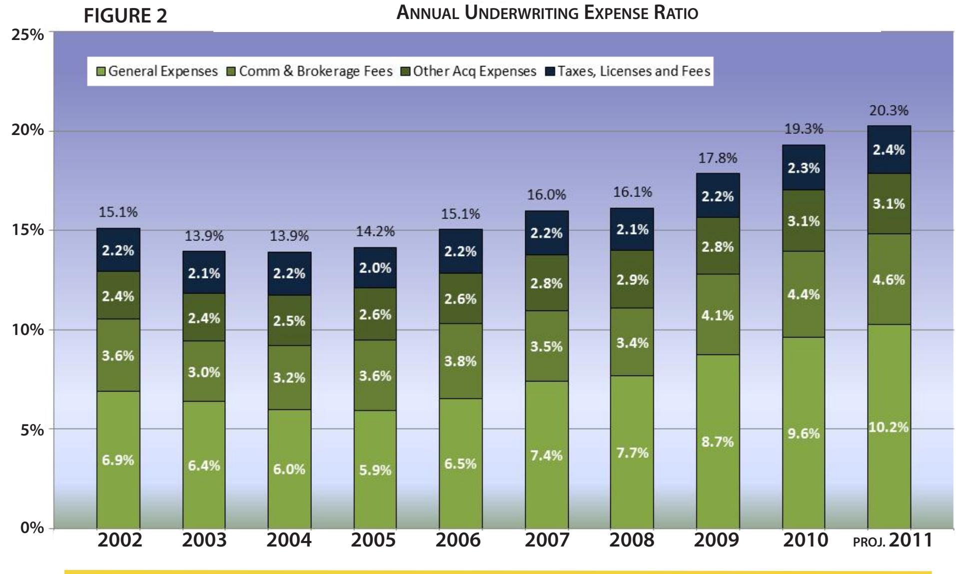
As medical professional liability (MPL) specialty insurers enter the home stretch for 2011, we continue our look at how the year is shaping-up financially. Based on available results for MPL specialty writers through the third quarter of 2011, recent financial trends persist. Premium volume continues to drift downward and coverage-year combined ratios continue to creep upward as softer rate levels impact underwriting results. Lower bond yields are reflected in lower investment income, further pressuring operating margins. Nonetheless, favorable takedowns of historical claim reserves continue to buoy calendar-year results and boost capital levels.

Based on data compiled by SNL Financial—a firm that collects, standardizes and disseminates relevant corporate, financial, market as well as merger-and-acquisition data—we examined the collective financial results of a group of insurers specializing in MPL coverage with direct written premium of about $4.3 billion in 2010. We compared the historical financial results through Sept. 30 of each year to full-year results in order to infer what year-end 2011 results might look like.

FIGURE 2 ANNUAL UNDERWRITING EXPENSE RATIO



DECLINING PREMIUM AND INVESTMENT INCOME PRESSURE RESULTS

Aggregate direct-written-premium for this composite of MPL specialty writers has declined steadily from its 2005 peak of $5.3 billion to $4.3 billion in 2010. Through the third-quarter of 2011, this trend appears to continue with direct-written-premium down about 5.2 percent from the same point in 2010. We expect the 2011 premium volume for this composite to be approximately $4.1 billion, or almost 23-percent below its high point in 2005.

This declining premium volume is taking its toll on underwriting results. While calendar-year combined ratios (excluding dividends) have looked good due to widely documented claim reserve drawdowns, a comparison of projected coverage-year combined ratios in Figure 1 shows how soft market conditions are negatively impacting both the loss and loss-adjustment-expense ratio as well as the underwriting-expense ratio. As a note, the underwriting expense ratios in Figure 1 are relative to net earned premiums.

A breakdown of the underwriting expense ratio, relative to direct premium, shows that the underwriting expense ratio has increased by 35 percent between 2005 and 2010. This is attributable to a 10-percent increase in nominal underwriting expenses on top of a 17-percent decrease in the underlying premium during this time period. While we expect 2011 underwriting expense dollars to stay roughly consistent with those in 2010, the continued premium decline will result in a higher expense ratio. The rise in the expense ratio from 2005 to 2009 was driven primarily by the general expense component with the ratios for other components staying relatively flat. During the last couple of years, however, we are seeing a steady increase in all expense components.

In addition, the bottom lines of long-tailed casualty insurers continue to be hindered by declining treasury yields and investment returns. Investment income continues its recent decline with approximately $612 million earned through Sept. 30, 2011. This is down almost 3 percent from $629 million at this point in 2010. Projected to full year, this would imply $850 million of investment income in 2011 compared to $874 million in 2011 for this composite. This is in spite of a 3.5-percent increase in average invested assets during the same time period. Looking forward, we expect these insurers will continue to see lower investment income yields as bonds have continued to rally in 2011, driving the five-year treasury yield below 1 percent.

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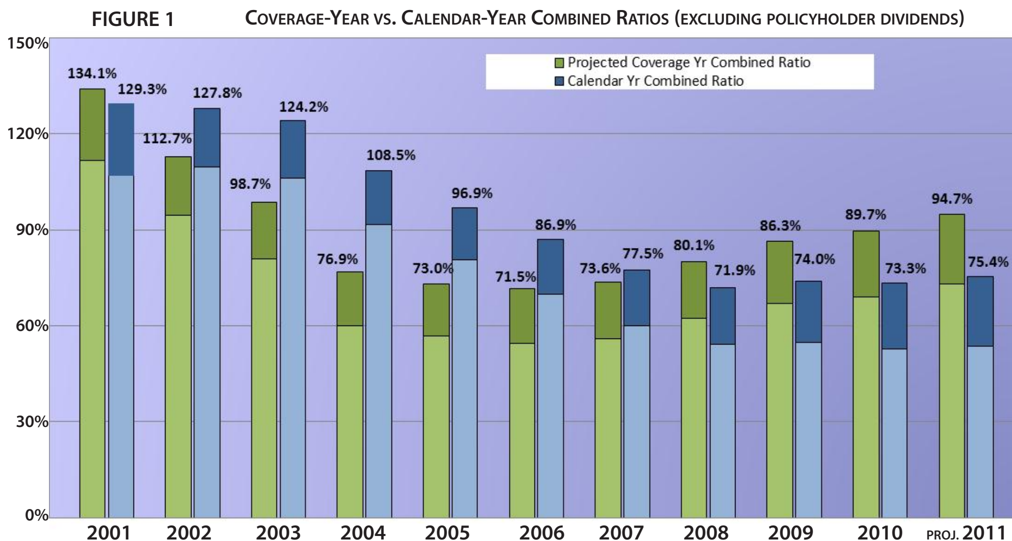
FIGURE 1 COVERAGE-YEAR VS. CALENDAR-YEAR COMBINED RATIOS (EXCLUDING POLICYHOLDER DIVIDENDS)



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Favorable Reserve Run-Off Boosts Calendar-Year Results

Of recent, reserve releases in prior coverage years have buoyed calendar-year operating results for MPL insurers, offsetting deteriorating underwriting and investment performance. This trend has continued in 2011. Figure 3 compares the composite's aggregate reserve change through the first nine months of each year to the reserve change for the entire year. After the first and second quarters of 2011, the reserve releases for 2011 were very favorable, but were tracking a little lower than in the past few years. However, favorable reserve development in the third quarter puts 2011 back on track with the 2009 and 2010 calendar years. Another year with reserve run-offs approaching $1.3 billion now seems very possible.

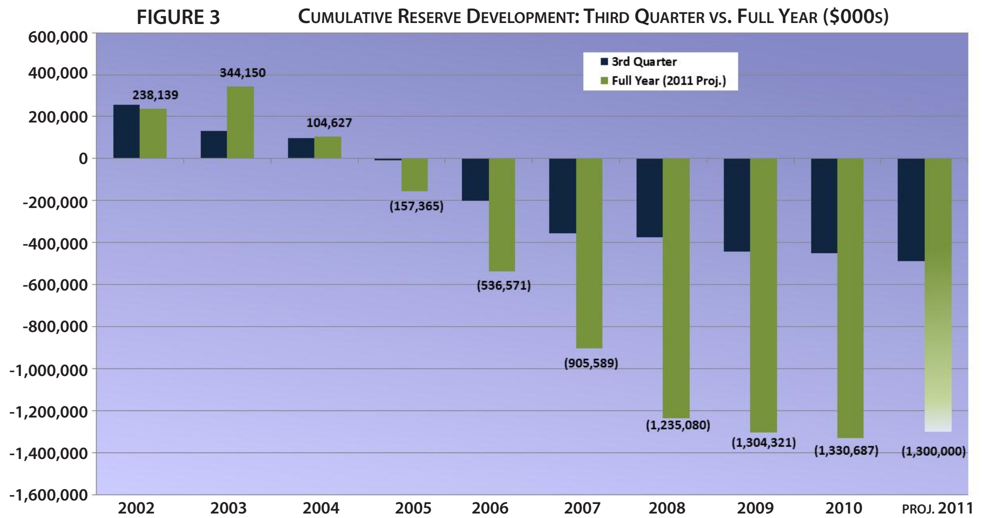

FIGURE 3 Cumulative Reserve Development: Third Quarter vs. Full Year ($000s)

Strong Capital Position

The exceptional profitability of MPL insurers in recent years is reflected by continued growth in policyholder surplus. Figure 4 displays policyholder surplus after three quarters and at year-end for this composite.

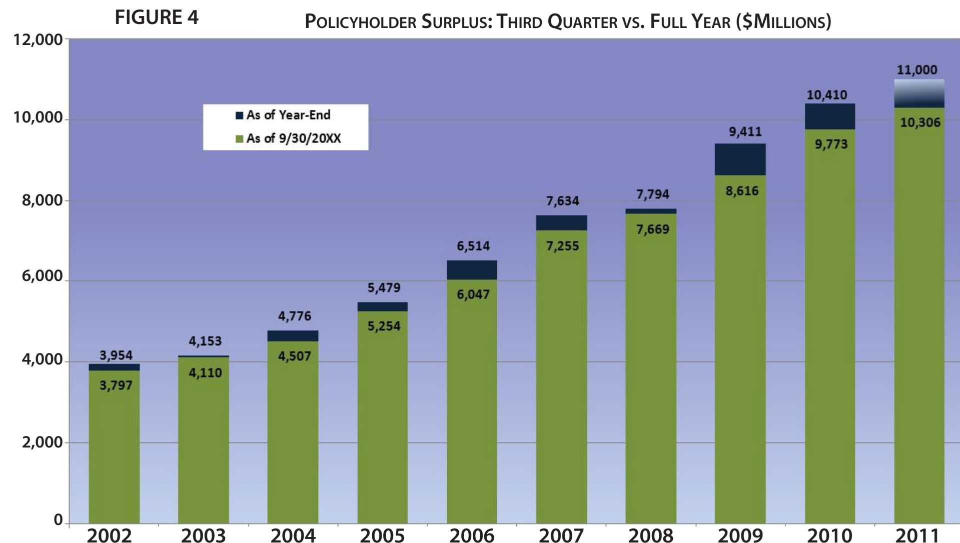

FIGURE 4 Policyholder Surplus: Third Quarter vs. Full Year ($Millions)

Dividend Growth

The continued profitability seen in this market has translated into sustained dividend growth. As displayed in Figure 5, this growth continues in 2011. Nine months into this year, policyholder dividends declared by members of this composite are up by almost 9 percent when compared to the same point in 2010. This would imply a full-year 2011 policyholder dividend rate of approximately 7.6 percent relative to net earned premium. This compares to a 6.7 percent policyholder dividend in 2010. Investors have also benefited as stockholder dividends are on pace to return an estimated 5.4 percent of policyholder surplus in 2011, compared to 5.6 percent in 2010. It's likely that much of the increase in stockholder dividends of recent can be attributed to increased merger and acquisition activity.

As we round the bases of what looks to be another "home run" year in regard to profitability for MPL specialty insurers, one is inclined to ask, "How much longer can this hitting streak last?" How much longer can the loss reserve development carry the load for slumping premium revenue and investment income? We will continue to closely monitor this moving forward. Perhaps 2012 will tell a different story, but for the time being, MPL specialty writers continue to enjoy great calendar-year results.

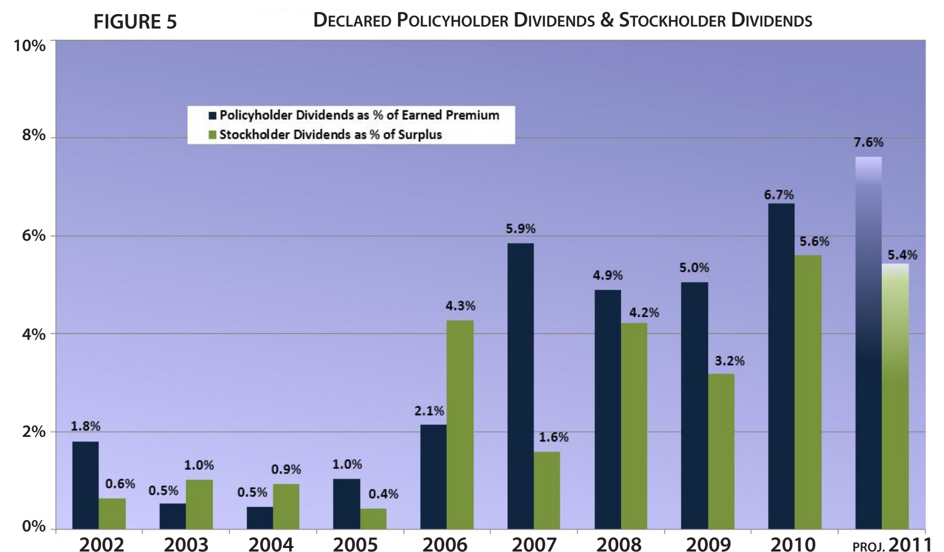

FIGURE 5 Declared Policyholder Dividends & Stockholder Dividends

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