HALFTIME UPDATE: 2010 FIRST-HALF RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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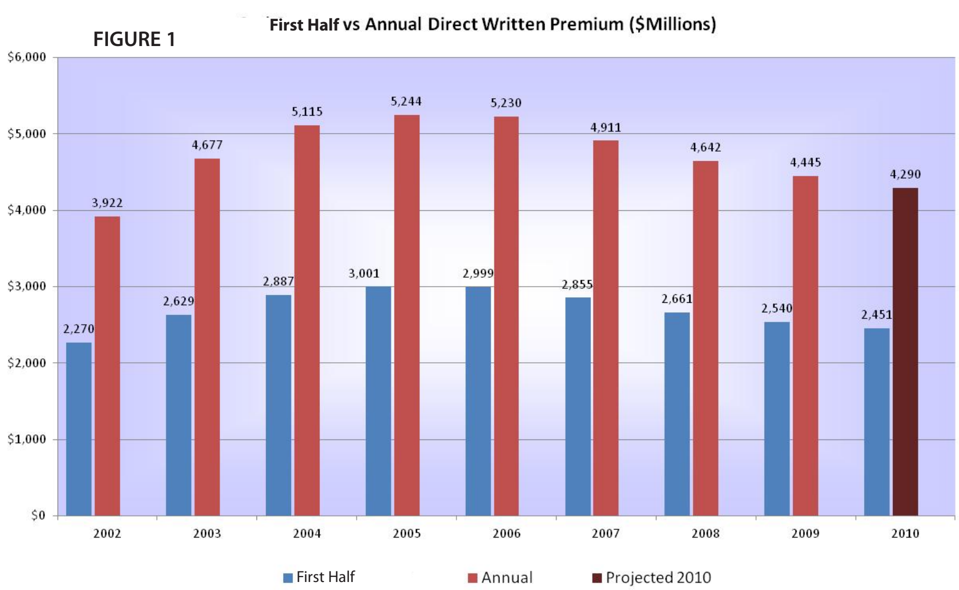
Uncertainty regarding the current state of the medical professional liability (MPL) market calls for close monitoring of financial developments. Based on results available for the first half of 2010, it appears that recent trends continue to play out for medical professional liability (MPL) specialty writers. Premiums are down slightly through the second quarter of 2010 compared to second quarter 2009; coverage-year combined ratios continue to creep upward as softer rate levels drive both loss and underwriting expense ratios higher; and investment income continues to decline. Still, favorable reserve developments continue to promote positive calendar year results and increased policyholder dividends.

Based on data compiled by National Underwriter Insurance Data Services from Highline Data, we examine the collective financial results of a group of insurers specializing in MPL coverage with direct written premium amounting to approximately $4.4 billion in 2009. Specifically, we consider the historical relationship between first-half and full-year financial results—together with our view of current market trends—to project what the year-to-date 2010 results might imply about the full year.

Premium and Investment Income Declines Continue to Pressure Results

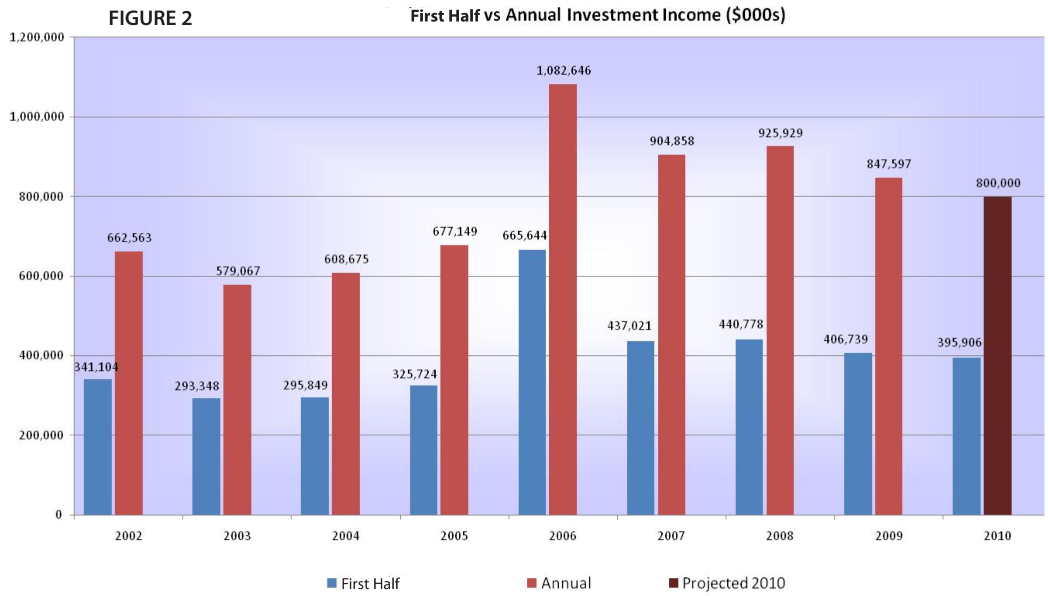
Aggregate direct written premium for this composite of MPL specialty writers has declined steadily from its 2005 peak of $5.2 billion to $4.4 billion in 2009. Six months into 2010, this trend appears to continue with direct written premium down approximately 3.5 percent from the same point in 2009 (See Figure 1).

FIGURE 1



Moreover, investment income continues its recent slide with first half 2010 levels down 2.7 percent from $417 million in 2009 to $396 million in 2010 (See Figure 2).

FIGURE 2



Favorable Reserve Run-off Continues to Boost Calendar Year Results

In recent years, reserve releases from prior coverage years have buoyed calendar year operating results for MPL carriers and have effectively offset the deteriorating underwriting and investment performance. With six months from which to base a conclusion, this trend continues in 2010.

Figure 3 (see page 7) compares first-half to full-year reserve changes on prior coverage. Projecting full-year reserve development from first-half results can prove treacherous since most reserve adjustments are made at year-end. However, second-quarter reserve development has historically provided a fairly reasonable prediction of the direction, if not the magnitude, of the reserve development for the entire year.

As Figure 3 illustrates, favorable reserve development through the second quarter of 2010 is the greatest in recent history. If this trend holds, we would expect to see a favorable reserve development upwards of $1.3 billion for the full year.

Policyholder Dividends Continue to Rise

Through the second quarter of 2010, policyholder dividends declared for the composite are up almost 37 percent compared to 2009. As Figure 4 (see page 7) illustrates, it appears safe to predict that the composite 2010 policyholder dividends will be higher than the 2009 dividends. The 2009 policyholder dividends were equal to $210 million—or 5 percent of net earned premium.

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Calendar Year Results Versus Coverage Year Performance

A comparison of calendar-year versus coverage-year operating results illustrates the impact of the favorable reserve development stemming from prior coverage years. Figure 5 contrasts calendar year operating margins and coverage year operating margins, showing that large operating profits generated by claim frequency declines in coverage years 2003 through 2007 are being realized in calendar years 2006 to 2010 through the recognition of favorable reserve runoff.

Additionally, Figure 5 demonstrates that coverage year margins, while still historically strong, have declined significantly since 2007. Once historical reserve redundancies are fully recognized, we expect to see calendar-year operating margins to follow suit.

As a note, coverage-year margins were projected based on booked Schedule P loss and loss-adjustment-expense ratios adjusted for an estimated $1.3 billion favorable reserve development projected for 2010. The projected 2010 reserve runoff was allocated to coverage year in the same proportions as calendar-year-2009 runoff was allocated to coverage year. No additional adjustment was made to reflect possible reserve redundancies existing beyond 2010.

Should these redundancies materialize, they would predominantly impact the 2008 to 2010 coverage years, causing the operating margins in these years to increase. If reserve redundancies exist beyond 2010, it may well be a few more years before we see significantly reduced calendar year margins.

As a final note, we have partnered with *Medical Liability Monitor* to continue to bring readers quarterly updates on the financial health of the medical professional liability specialty industry. We look forward to the opportunity, and if our quarterly analysis elicits any questions, please feel free to contact us via email through editor@mlmonitor.com. We will try to respond promptly.

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FIGURE 3

First Half vs Annual 1-Year Reserve Development ($000s)

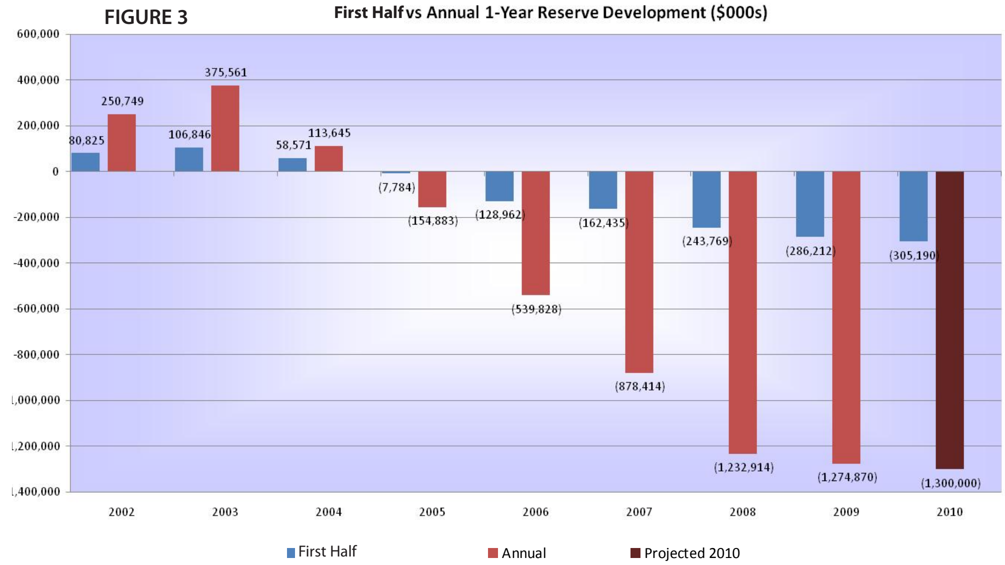

FIGURE 4

First Half vs Annual Policyholder Dividends ($000s)

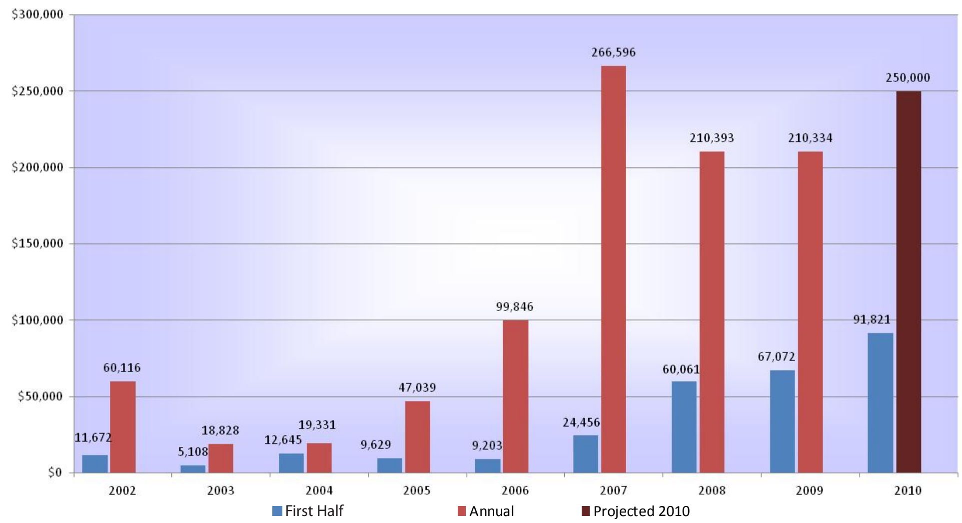

FIGURE 5

Operating Margin