



A LOOK AT 2011 YEAR-END FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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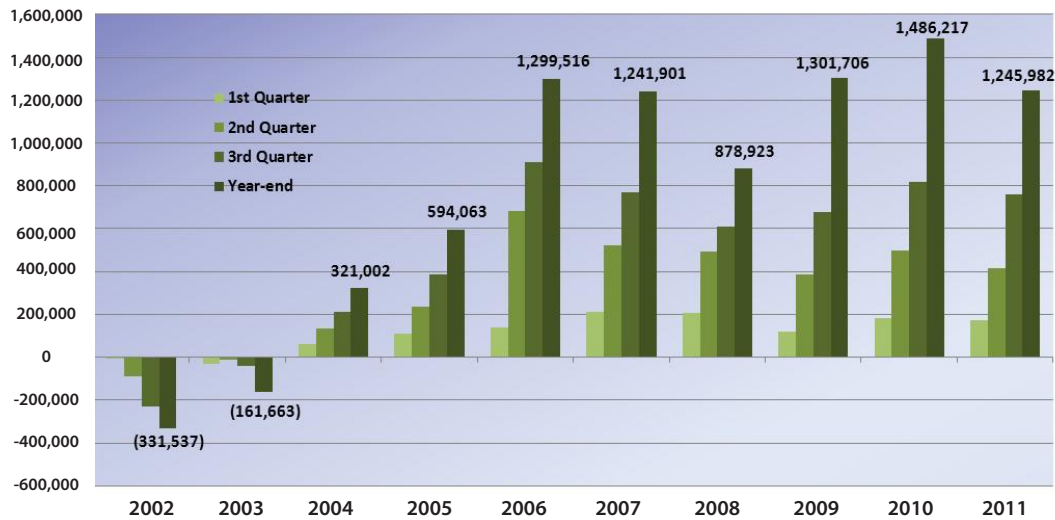
Throughout the course of 2011, we have tracked the quarterly financial results of a composite of medical professional liability (MPL) specialty writers. Based on the historical relationship between quarterly and year-end figures, we attempted to project the year-end results for this composite each quarter. With actual 2011 results now available, it's time to review how this composite performed and how well our projections held up.

Based on data compiled by SNL Financial, we examined the collective financial results of the composite, which had direct written premium totaling almost \$4.13 billion in 2011. Despite the fact that direct written premium for the composite declined for the sixth straight year, off 21 percent from a high of \$5.24 billion in 2005 and down five percent since 2010, this group of companies continues to achieve remarkable calendar-year profitability, which has been indicative of the broader MPL market.

\$136 million for the composite in 2011. Knowing the volatile nature of asset prices and the possibility of portfolio rebalancing during the fourth quarter, we did not attempt to project the movement of capital gains over the course of the year.

Another contributing factor, albeit one of smaller magnitude, was

FIGURE 2 NET INCOME BY QUARTERS (\$000s)



RECORD OPERATING RESULTS

Down more than six percent from last year, the composite still produced an eighth-straight year of operating profit in 2011, as shown in Figure 1 (below).

NET INCOME OUTPERFORMS PROJECTIONS

In our quarterly articles throughout 2011, we had been projecting that the composite's net income for 2011 would come in at approximately \$1 billion. As shown in Figure 2 (above, right), the composite outperformed our estimate by earning \$1.25 billion in net income.

A contributing factor helping to produce higher-than-projected net income came in the form of realized capital gains, which totaled

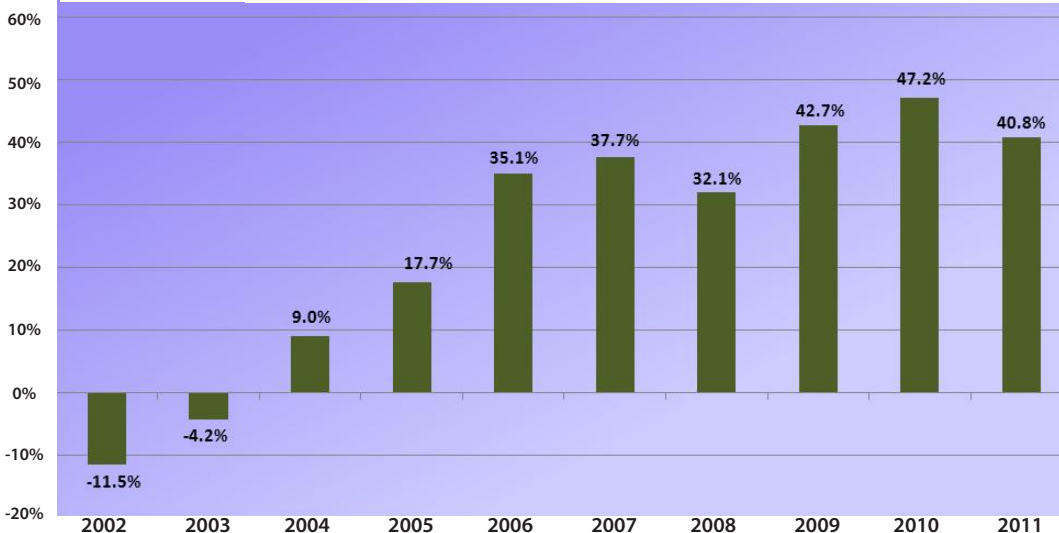
higher than usual income from aggregate write-ins for underwriting deductions. Investigating these figures further revealed various reasons for the increase, including beneficial retrospective premium adjustments, takedowns of premium deficiency reserves and unearned premium reserves related to death, disability and retirement tail benefits, among others. Taken as a whole, these actions could be indicative of how some companies may benefit further due to the improved loss environment within the current MPL market.

RESERVE RELEASES HIT THE MARK

A great majority of a company's changes in unpaid claim liability reserves are usually recognized in the fourth quarter, which suggests that they may be one of the more difficult provisions to extrapolate from quarterly results. In evaluating our accuracy, we continue to be impressed by the consistent historical relationship between the quarterly and year-end financial figures.

Trends in the medical liability market provided ample reason to project favorable reserve development for 2011, similar to what the composite has experienced in recent years—somewhere in the range of \$1.2 billion to \$1.3 billion. Indeed, the composite again generated favorable reserve development of almost \$1.25 billion in 2011. Figure 3 (page 7) shows how the reserves have developed

FIGURE 1 CALENDAR-YEAR OPERATING MARGIN



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by quarter for the composite since 2002.

MORE HELP TO COME FROM RESERVE REDUNDANCIES?

In Figure 4, we compare net loss and loss adjustment expense ratios for the composite from 2002 to 2011 based on Annual Statement - Schedule P information. The leftmost column for each year reflects the initial booked ratio at the end of each respective coverage year. The middle column represents the booked coverage-year ratio as of year-end 2011. The third column represents the projected ultimate coverage-year ratio using a standard actuarial development projection. A comparison of the current booked ratios to the projected ultimate ratios implies that a redundancy of almost \$3 billion still exists in the booked reserves of this composite as of year-end 2011. Given the uncertainty in the MPL claims environment due to dynamic changes in the industry (e.g., healthcare reform), it could be argued that this reserve position is prudent for the industry at this time. That said, we anticipate favorable reserve releases will continue to lift calendar-year profitability in the coming years, although future takedowns may be smaller in magnitude.

STRONG CAPITAL POSITION

The exceptional profitability of MPL insurers in recent years is reflected in the continued growth in policyholder surplus, which has increased 270 percent in the last decade, from \$4 billion as of year-end 2002 to \$10.8 billion as of year-end 2011. This growth in surplus has put the composite as a whole into a much stronger capital position, as reflected in the dramatically improved National Association of Insurance Commissioners Risk-Based Capital Ratios (defined as total adjusted surplus divided by authorized control level capital) for the composite displayed in Figure 5.

In 2011, MPL specialty writers continued to produce exceptional operating results consistent with the recent past. Continued surplus growth has produced an exceptionally strong capital position for the composite overall. The dramatically changing healthcare industry presents significant uncertainty in regard to future claim costs and insurance market conditions. Moreover, although calendar-year financial results remain strong, the MPL insurance market has been soft for a number of years. It may be prudent for MPL insurers to maintain strong capital ratios during this period of increased uncertainty and soft market conditions.

We will continue to monitor trends in the MPL market as reflected by this composite of MPL companies moving forward into 2012.

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