

BY CHARLES W. MITCHELL
AND CHAD C. KARLS



Coming of Age

A Look at the Latest Generation of MPL Companies

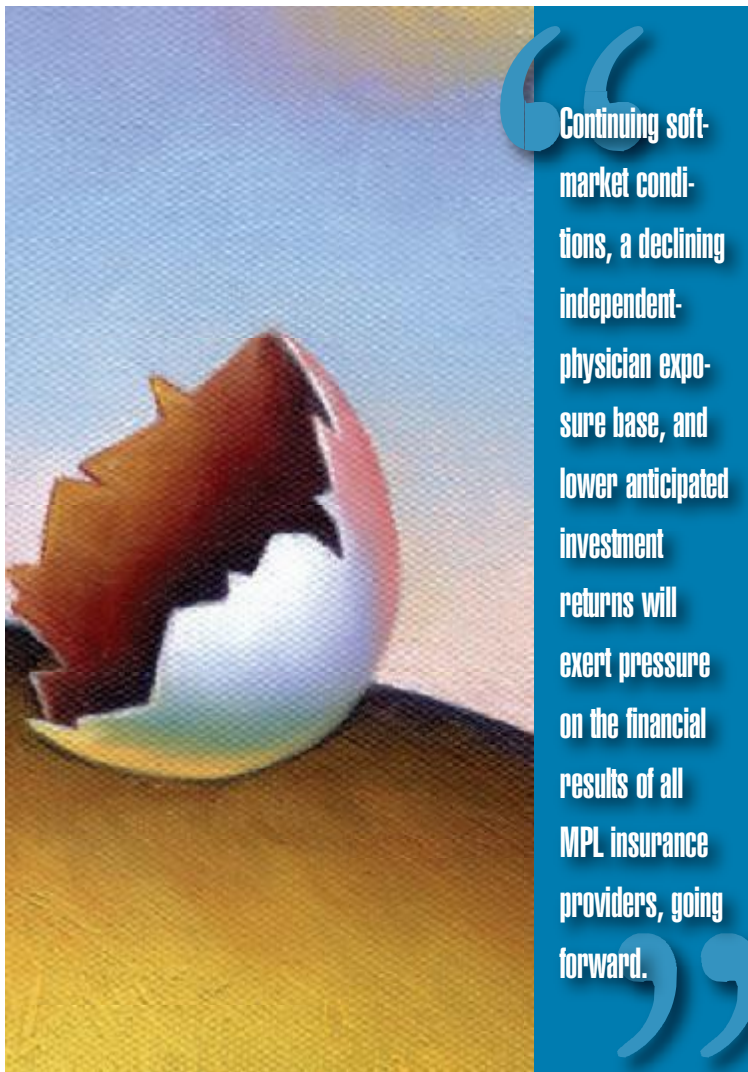
In response to the medical professional liability (MPL) coverage crisis in the early years of the last decade, many new insurance programs specializing in MPL were created, particularly between 2003 and 2006. Now that these companies have matured and posted several years of their own experience on their books, it is a good time to examine how they are performing relative to their long-established peers. In brief, the financial results of these companies have benefited from the hard market that fol-

Charles W. Mitchell, FCAS, MAAA, is a Consulting Actuary, and Chad C. Karls, FCAS, MAAA, is a Principal in the Milwaukee office of Milliman.

lowed the last MPL coverage crisis, as well as the broad-based decrease in the frequency of MPL claims.

But several recent challenges have emerged. Continuing soft-market conditions, a declining independent-physician exposure base, and lower anticipated investment returns will exert pressure on the financial results of all MPL insurance providers, going forward. In addition, the higher underwriting-expense ratios, on average, of these smaller programs will put additional pressure on this new generation of companies.

Based on our analysis of National Underwriter Insurance Data Services from Highline Data, we have identified 167 MPL specialty programs that were created since 2002; nearly 75% of them were formed between 2003 and 2006 (Figure 1). Note that



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these programs include only those that write predominantly MPL insurance, and exclude large multi-line writers that began writing MPL insurance in recent years. As in the previous MPL coverage crises in the 1970s and 1980s, most of these MPL specialty programs were created, and are owned by, the healthcare providers themselves. In addition, approximately 70% of the companies were set up as risk retention groups (RRGs). This is not surprising: the regulatory requirements for establishing and operating an RRG are less demanding than those for a mutual or stock insurance company, particularly for companies operating in multiple states.

Of the 167 MPL specialty programs formed since 2002, 26 have already reorganized or stopped writing business. At least ten programs were merged or acquired. Two RRGs converted to insurance companies, perhaps to expand coverage beyond their original focus, and one of these was subsequently acquired. One company was placed in rehabilitation by its insurance department, and several other programs have stopped writing premiums or otherwise ceased filing statutory financial statements (Figure 2).

The focus of our analysis was on the new generation of MPL programs: to find out how they are performing financially compared with their established peers. To this end, we compared

the financial results for two composites. The composite of new-generation companies consists of 107 of the companies profiled above that began operations in 2006 or prior and had filed 2010 statutory financials. These companies accounted for about \$1.0 billion of direct written MPL premium in 2010. Focusing on these companies allowed us to develop comparisons, over a period of time, that are not distorted by new programs entering the composite.

This new-generation composite is compared with a composite of 48 “established” MPL specialty writers whose total MPL direct written premium was approximately \$4.2 billion in 2010. Like the new-generation companies, most of these established companies were formed in response to prior crises and are predominantly provider-owned and/or -operated companies that specialize in providing MPL insurance coverage. Unlike the established MPL specialty writers, the new-generation composite has been able to maintain its top-line revenues over the past five years of soft-market conditions (Figure 3).

To evaluate the financial performance and stability of the new generation companies, we compared each composite’s operating results and capitalization levels.

Impressive earnings overall

Overall operating results

The new-generation companies, in aggregate, have performed well and posted profitable operating results every year since their formation. Figure 4 shows the composites’ pre-tax net operating income relative to net earned premium. The results of the established-company composite have continued to improve in recent years, such that the established companies have outperformed the new-generation companies since 2006, though both composites have demonstrated strong operating results since 2004.

To find out what is driving these results, we reviewed the major components of the composites’ operating results—loss and loss adjustment expense (LAE) costs, underwriting expense costs, and investment returns.

Combined ratios

The combined ratios displayed in Figure 5 are divided into loss and LAE (lower portion of bars), underwriting expense (middle

portion of bars), and policyholder dividends (upper portion of bars). The main driver behind the improving results for the established companies is the substantial improvement in the loss and LAE ratio since 2002. On the other hand, the new-generation companies have posted relatively consistent loss and LAE ratios, hovering just above the 60% mark.

Two other observations are offered in regard to Figure 5. First, both groups of companies have increased their policyholder dividends in recent years. The policyholder dividends declared by the established companies equated to nearly 7% of net earned premiums, compared with a 4% ratio for the new-generation composite.

Second, the new-generation composite continues to have a higher underwriting expense ratio, and both composites have increasing underwriting expense ratios. The increasing expense ratio in recent years is most likely a product of fixed overhead costs relative to declining rate levels. The new-generation entities are impacted more significantly, because they do not benefit from the economies of scale enjoyed by the larger, established companies. While it is expected that new-generation companies

will have higher costs relative to the established companies in their initial years of operation, because of the adverse impact of statutory accounting rules on the recording of underwriting expenses, the persisting differential remains a challenge for these companies (Figure 6).

Reserve development

Since 2005, the calendar-year loss and LAE ratios presented in the combined-ratio chart have been significantly impacted by favorable reserve development from prior coverage years (Figure 7). This favorable experience is largely attributable to the substantial and unanticipated drop in claims frequency seen generally throughout the MPL industry. In particular, the 2010 loss and LAE ratios were favorably impacted by almost 14 percentage points for the new-generation composite and by nearly 34 points for the established companies.

Investment results

Both groups have benefited during the last couple of years from a rebound in investment returns, which reflect net investment

Figure 1 Number of Start-up MPL Programs by Year Commencement

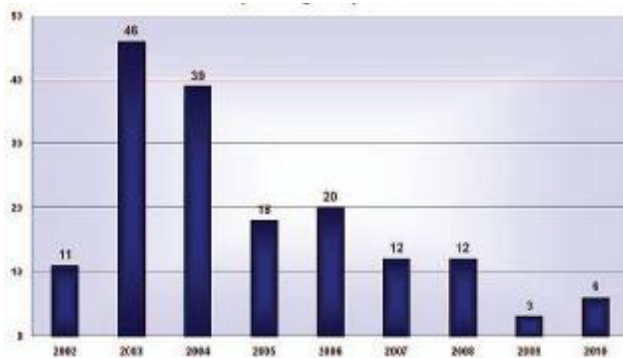


Figure 3 Direct Written MPL Premium

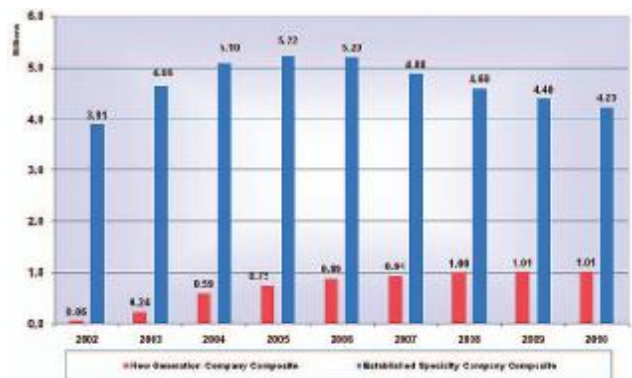


Figure 2 Companies That Have Reorganized or Left the Market

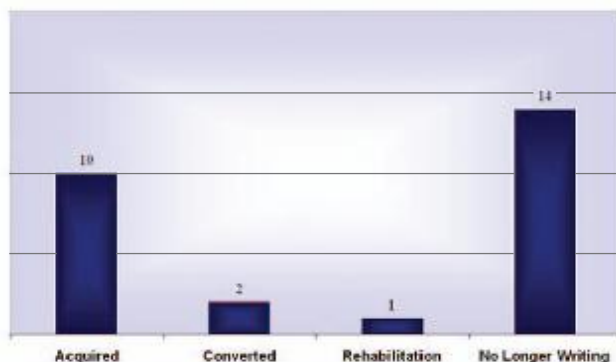


Figure 4 Operating Margin



income plus realized capital gains relative to net earned premium (Figure 8). The increase in investment income was achieved in spite of decreasing Treasury yields, and reflects the increasing asset base produced by the highly profitable market of the last six years or so. The higher investment ratios of the established companies relative to the new-generation companies reflect the greater leverage derived from a larger reserve base; also, the older companies keep a greater proportion of their assets invested, as opposed to holding them as cash.

Policyholder surplus

The surplus levels of both groups have benefited from the profitable market of recent years. In 2010, the new-generation companies increased surplus by 10.6%, and the established companies increased it by 10.8% (Figure 9).

Capitalization levels remain strong

Risk-based capital ratios¹

In addition to evaluating the ongoing operating performance of

these companies, we utilized statutory risk-based capital (RBC) ratios to compare their balance sheet strength (Figure 10). These ratios represent policyholder surplus relative to the minimum amount of capital that is required to avert specifically defined regulatory actions.² In aggregate, both groups demonstrate strong capital positions. However, there has been some divergence between the composites: the established-company composite has increased its relative balance sheet strength considerably over the past five years.

Looking beyond the aggregate

Both composites have posted profitable operating results of late, and they continue to demonstrate strong capital positions. However, these overall results somewhat mask the divergent results of individual companies. To get some sense of individual performance, we stratified the current operating ratios and risk-based capital (RBC) ratios by quartile in Tables 1 and 2.

When we stratify the 2010 operating results for each composite, we see that the worst-performing quartile of companies in the new-generation composite lost money on an operating basis,

Figure 5 Combined Ratio

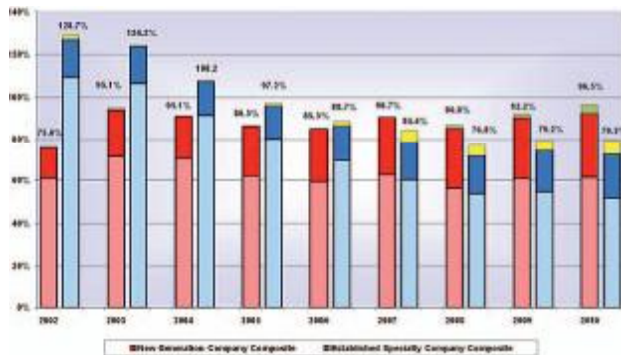


Figure 7 Reserve Development

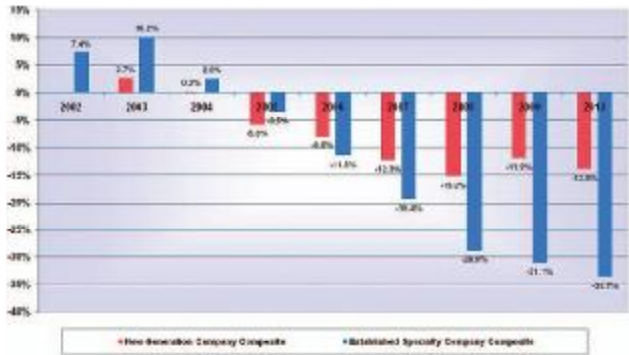


Figure 6 Underwriting Expense Ratio

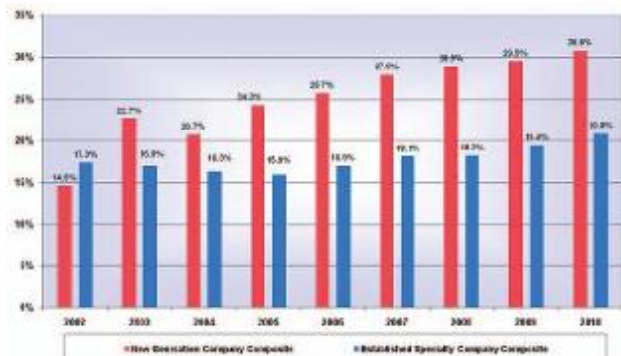
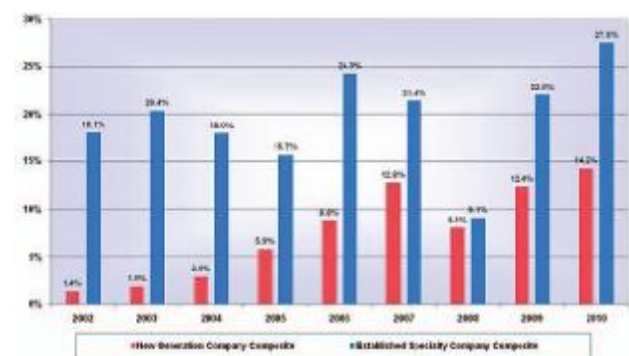


Figure 8 Investment Gain Ratio



whereas the worst-performing quartile for the established companies still produced a significant operating profit, in aggregate.

Like the operating results, the RBC position was relatively strong in the aggregate. Specifically, the overall RBC ratio of 590% for the new-generation composite suggests that these companies had almost three times the minimum amount of capital that is required to avoid the regulatory "Company Action Level." However, a policyholder does not purchase a policy from an aggregate of companies but rather, from an individual company. When one examines this metric on an individual-company basis, it turns out that 19 of these companies had a RBC ratio that was below 300%. Further, the overall RBC ratio of the bottom quartile of companies was only 221%, not far from the first regulatory-action level. Note that the RBC quartiles above exclude three Missouri-based "Chapter 383" companies, because these companies are not subject to the NAIC capital requirements.

Last word

In summary, it is clear that the impact of this latest generation of MPL specialty companies has been, and will continue to be, significant. In the aggregate, these companies are currently well-capitalized and profitable. However, the results vary significantly by individual company. When assessing the long-term viability of a new-generation company, it is important that physicians consider the financial results of the individual company.

Going forward, these relatively young companies will face a number of challenges. First, they have no doubt benefited from the overall decline in the frequency of MPL claims generally seen during the last few years. It is difficult to say whether many

"The results of the established-company composite have continued to improve in recent years, such that the established companies have outperformed the new-generation companies since 2006."



of these companies can continue to operate profitably once claim frequency levels off or, even more so, in an environment of rapidly increasing claim costs regularly seen in this line of business. Second, increased competition and softer rate levels in recent years will pressure both the loss ratio and underwriting expense ratio. Furthermore, the overall underwriting expense ratio currently produced by the new-generation companies puts them at a relative disadvantage, vis-à-vis their more established competitors.

Footnotes

1. National Association of Insurance Commissioners (NAIC) RBC ratio as computed in the Statutory Annual Statement equals total adjusted surplus divided by authorized control level risk-based capital.

2. Once a company's RBC ratio dips below 200%, it falls into the first level of regulatory oversight from a RBC standpoint, called "Company Action Level." At this level, the company needs to file an action plan with its domiciliary insurance department describing its plans to improve its capitalization levels. There are three additional levels of regulatory action, depending on a company's RBC ratio: Regulatory Action Level, Authorized Control Level, and Mandatory Control Level.

Table 1			Table 2		
2010 Operating Margins			Year-end 2010 RBC Ratios		
	New Generation Company Composite	Established Specialty Company Composite		New Generation Company Composite	Established Specialty Company Composite
Quartile 1	28.7%	22.6%	Quartile 1	215.7%	536.6%
Quartile 2	11.8%	29.8%	Quartile 2	433.2%	910.4%
Quartile 3	33.6%	44.7%	Quartile 3	750.1%	1227.4%
Quartile 4	77.0%	88.1%	Quartile 4	1456.4%	2073.9%
Total	17.8%	48.2%	Total	585.9%	960.8%

Figure 9 Policyholder Surplus

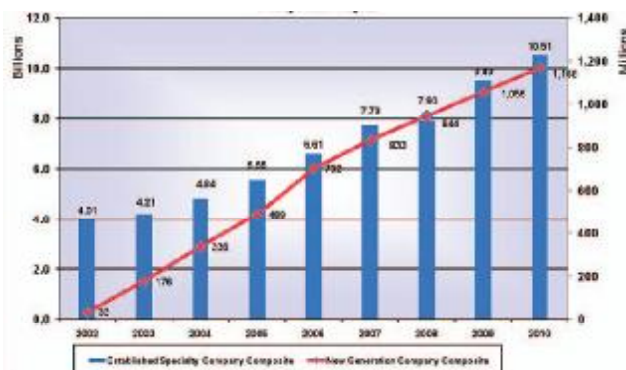


Figure 10 Risk-Based Capital Ratio

