2011 SNEAK PEEK: FIRST QUARTER RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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This year is shaping up as a continuation of recent financial trends for insurers that specialize in medical professional liability (MPL). Two main themes prevail, overall premiums continue to decline and favorable reserve releases boost calendar-year financial results.

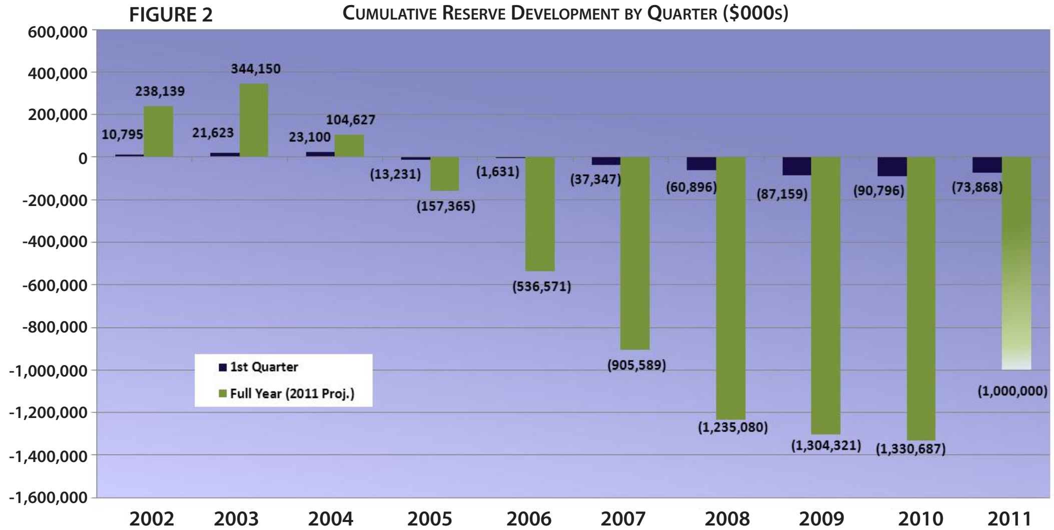
There is, it seems, considerable uncertainty regarding the current state of the MPL market. Declining claim frequency over the latter half of the past decade has brought on favorable reserve development. This, in turn, has supported strong calendar-year financial results in the face of declining rate levels. In this light, let us take a sneak peek at how 2011 might be shaping up for MPL specialty writers based on first-quarter financial results and offer commentary as to what current market trends might suggest looking forward.

Based on data compiled by National Underwriter Insurance Data Services from Highline Data, we examine the collective financial results of a collection of insurers specializing in MPL coverage with direct written premium amounting to approximately $4 billion in 2010. Specifically, we consider the historical relationship between first-quarter financial results of the MPL composite and financial results at year-end together with our view of current market trends to project what the first-quarter 2011 results might imply about the full year.

Premium Levels Continue to Decline

As illustrated in Figure 1, first quarter 2011 direct written premium is down another 7 percent, compared to first quarter 2010. Direct written premium is down 24 percent for this composite since its peak in 2005. Because of recent claim-frequency declines and reduced exposure levels as a result of physicians migrating to hospital employment or to self-insured plans, there is some debate over the degree of softness in the market from a rate adequacy perspective. However, recent analyses lead many to believe that claim frequency has bottomed. As such, the enduring premium decline may likely be evidence of continued pricing pressure and rate deterioration.

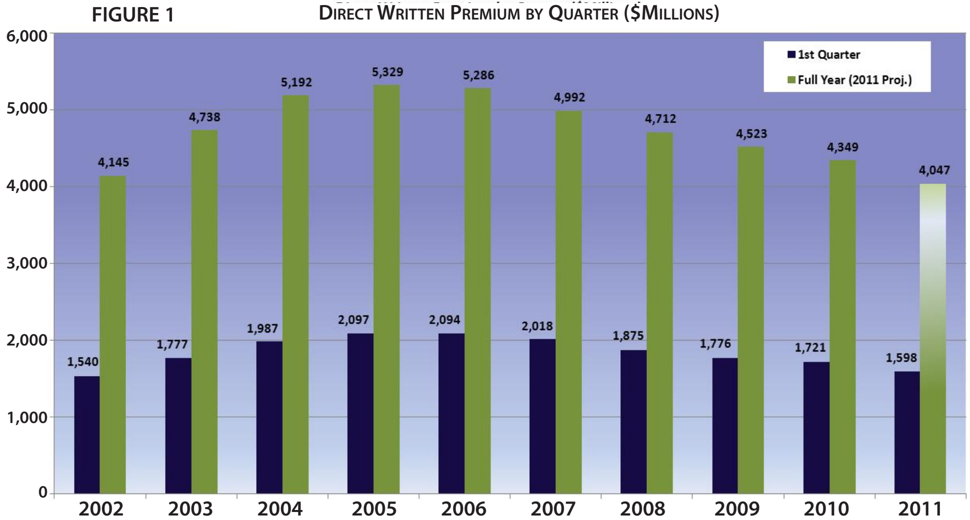
FIGURE 2 Cumulative Reserve Development by Quarter ($000s)



Favorable Reserve Run-off Continues to Boost Calendar Year Results

For a number of years now, reserve releases from prior coverage years have had a significant impact on calendar-year results for MPL insurance writers. This trend appears certain to continue in 2011. Figure 2 compares first-quarter to full-year reserve movements on prior coverage years. While we recognize that the information exhibited is highly leveraged, Figure 2 provides evidence that first-quarter reserve development historically provides an adequate prediction of the direction, if not the magnitude, of reserve development for the entire year. Although favorable reserve development through the first quarter of 2011 is less than that seen in the last two years, an extrapolation still suggests that full-year favorable development upwards of $1 billion is reasonably obtainable for this composite.

FIGURE 1 Direct Written Premium by Quarter ($Millions)



Net Income Driven by Favorable Reserve Development

Net income for this MPL composite during the four-year period from 2007 to 2010 was approximately $4.9 billion, and the

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cumulative favorable reserve releases over this same period were approximately $4.8 billion. It appears that 2011 will tell a similar story with $1 billion of favorable reserve development supporting roughly $1 billion of net income. Figure 3 displays the historical net income for this composite.

Operating Results Expected to Recede From Record Levels

We expect the calendar year 2011 operating ratio to retreat from its record-setting level of 2010. In order to remain vigilant to the divergence between calendar-year and projected-coverage-year results, they are contrasted in Figure 4. It is instructive to note the lag between calendar-year and coverage-year results.

Favorable coverage-year margins rose in 2003, but weren't immediately recognized in calendar-year results as it took some time for companies to recognize the reserve redundancies in preceding coverage years. Once recognized, it took added time for companies to be confident that these redundancies truly existed before they were comfortable releasing reserves. The same will likely be true in the current environment of deteriorating operating margins. The calendar-year deterioration will lag behind the coverage-year deterioration as reserve redundancies from prior coverage years buoy the calendar year results.

Policyholder Dividends Expected To Grow

Record profitability has boosted the surplus of these companies from approximately $4 billion in 2003 to almost $11 billion at the end of first-quarter 2011. As a result, policyholder dividends have re-emerged and may increase again from $270 million in 2010 to a projection of almost $300 million in 2011. This would equate to approximately 7.5 percent of net earned premium (see Figure 5).

Conclusion

The early indications for 2011 suggest that good times will continue for MPL specialty insurers. However, pricing pressure continues to be fueled by high surplus levels and the desire to maintain exposures against increasing competition as physicians move to employment settings that provide coverage through self-insured plans. Close attention needs to be paid to deteriorating coverage year margins as even the slightest rebound in claim frequency would fan the flames of this decline.

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FIGURE 3 Net Income by Quarter ($000s)

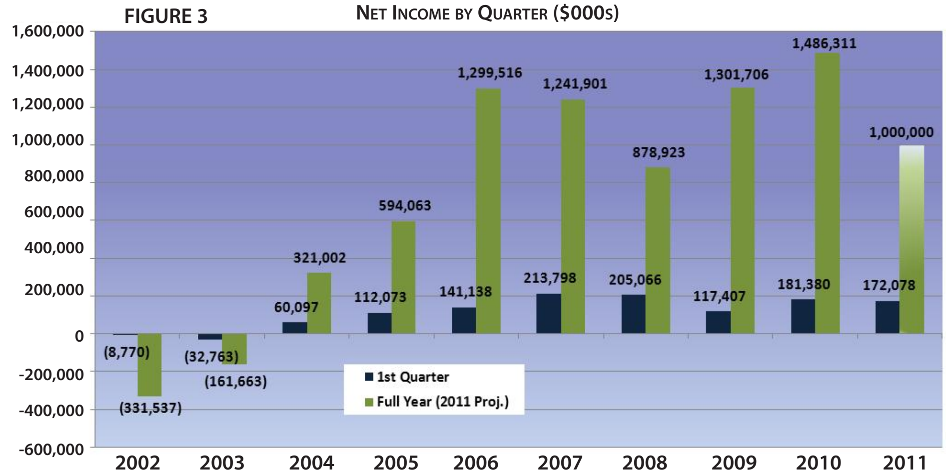

FIGURE 4 Operating Margin

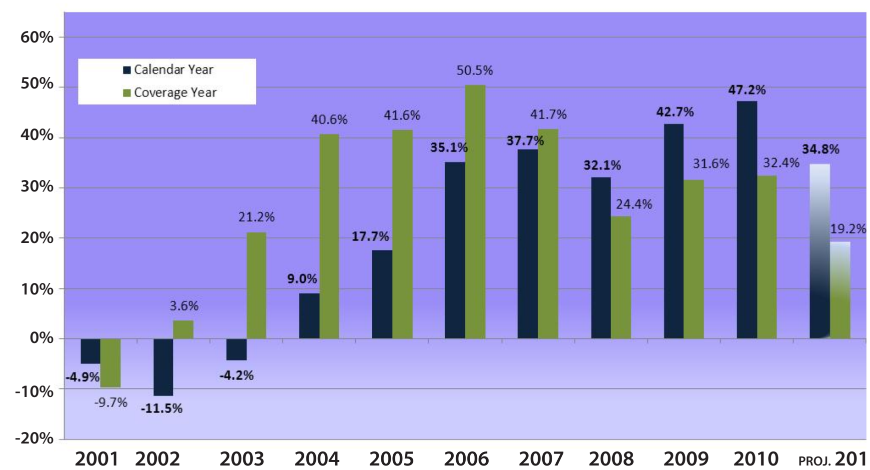

FIGURE 5 Policyholder Dividends/Net Earned Premium