FIRST QUARTER SNEAK PEEK: HOW IS 2010 SHAPING UP FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS?

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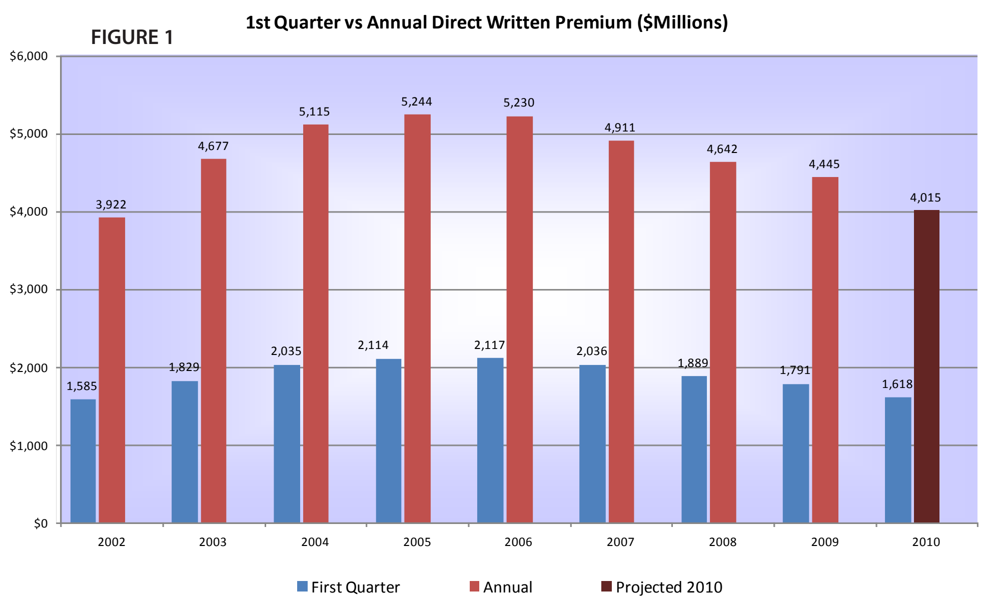
There is considerable uncertainty regarding the current state of the medical professional liability (MPL) market. Declining claim frequency during the latter half of this decade resulted in favorable reserve developments, which, in turn, has supported strong calendar-year financial results in the face of declining rate levels. As such, let's take a sneak peek at how 2010 might be shaping up for MPL specialty writers based on first quarter financial results and offer some insights as to what current market trends might suggest moving forward.

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 quarter and year-end financial results together with our view of current market trends to project what the first quarter 2010 results might imply about the full year.

Premium Levels Continue to Decline

As illustrated below in Figure 1, first quarter 2010 direct written premium is down 10 percent compared to first quarter 2009. Premium declines in recent years have typically corresponded with declines in claim frequency—so there has been some debate as to whether the market was soft from a rate adequacy perspective. However, analyses performed on 2009 claims have led many to question whether the recent declines in claim frequency have bottomed. As such, the continued premium decline in 2010 provides greater evidence of a market that continues to soften.

FIGURE 1

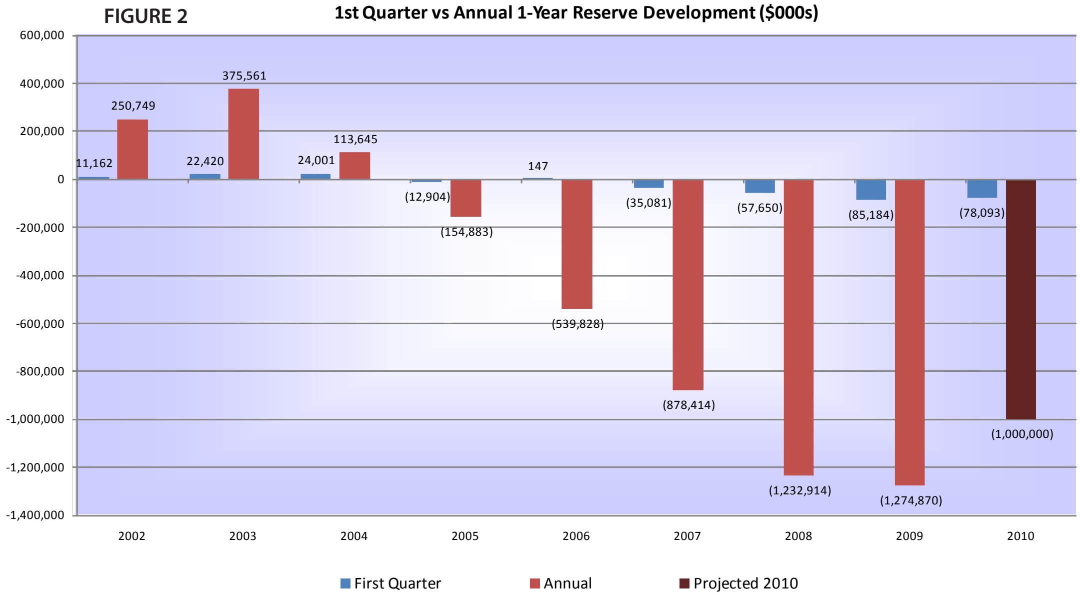


Favorable Reserve Run-off Continues to Boost Calendar-Year Results

In recent years, reserve releases from prior coverage years have had a significant impact on calendar-year results for MPL carriers. With three months from which to base a conclusion, it appears this trend is continuing in 2010.

Figure 2 compares first-quarter to full-year reserve changes on prior coverage. As the graph illustrates, albeit quite leveraged, first quarter reserve development has historically provided a fairly accurate prediction of the direction, if not the magnitude, of the reserve development for the entire year. Based on a review of historical results, we estimate that the MPL composite calendar-year 2010 financials will again benefit from the impact of significant favorable reserve development, perhaps approaching $1 billion. This is consistent with A.M. Best's projection, which estimates that the MPL industry in total (including MPL insurance writers not in this composite) had approximately $2.8 billion of reserve redundancies as of year-end 2009.

FIGURE 2



Investment Income Hurt by Lower Bond Yields

Treasury yields continue to fall, having an increasingly negative impact on MPL insurers' investment income. Changes in investment income for MPL insurers often lag behind treasury yield changes as the current portfolio matures and is rolled into new bonds. Figure 3 (see page seven) shows investment income yields for the composite of MPL specialty writers compared to the five-year U.S. treasury yield since 1996. This comparison suggests that the average investment yield for these carriers will continue to decline in 2010.

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As evidence of the declining investment return, total investment income for the MPL composite is down nearly 10 percent—with $187 million earned in the first quarter of 2010, compared to $208 million in the first quarter of 2009. This is despite a 2-percent increase in average invested assets during the same time period. Given stubbornly low investment yields, we believe this to be indicative of investment results for the remainder of 2010. For the 2009 full year, these companies earned a total of $848 million in investment income.

Net Income Driven Mainly by Favorable Reserve Development

Net income for the MPL composite during the three-year period from 2007 to 2009 was approximately $3.4 billion (see Figure 4), compared to favorable reserve releases during this same period of approximately $3.4 billion. As such, the entire net income for this period can be predominantly attributed to reserve releases. It appears that 2010 may indeed tell a similar story with an estimated $1 billion of favorable reserve development, supporting roughly $1 billion of net income.

Calendar Year Combined Ratio

The calendar-year combined ratio is projected to increase in 2010, reflecting the impact of reduced premium on fairly stable loss and loss adjustment expense, underwriting expense and policyholder dividends. That being said, calendar-year 2010 is projected to be the sixth straight year to produce an underwriting profit for these MPL specialty writers, as shown in Figure 5.

2010 Coverage Year Results Differ From Calendar-Year Results

The fact that the 2010 calendar-year is shaping up to be another good year for MPL specialty writers does not imply that the soft market has not dramatically impacted current rate level adequacy. As we have shown, projected 2010 net income can be primarily attributed to projected reserve releases on prior coverage. While the projected calendar-year loss and loss adjustment expense ratio for 2010 is almost 60 percent, the coverage-year loss and loss adjustment expense ratio is projected to be upwards of 85 percent.

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FIGURE 3 Industry Yield vs Five-Year Treasury Bond Yield

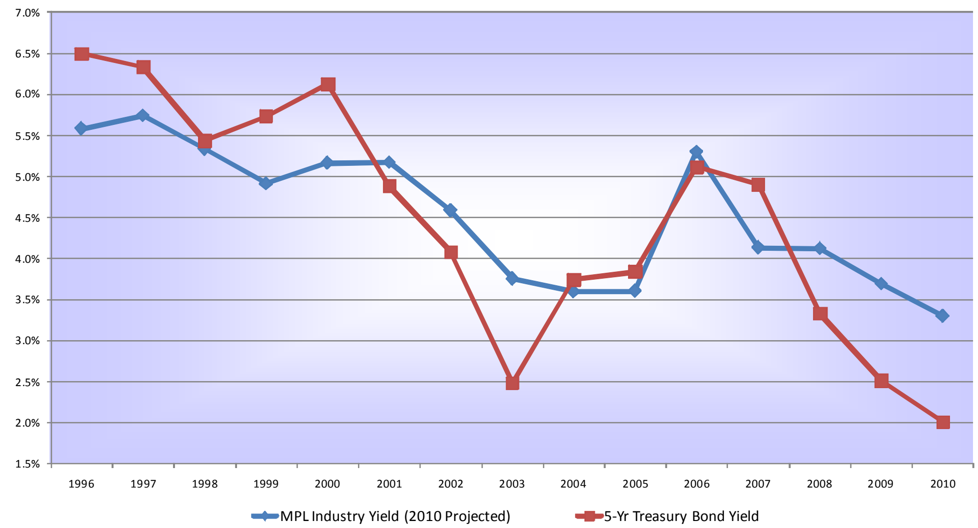

FIGURE 4 1st Quarter vs Annual Calendar Year Net Income ($000s)

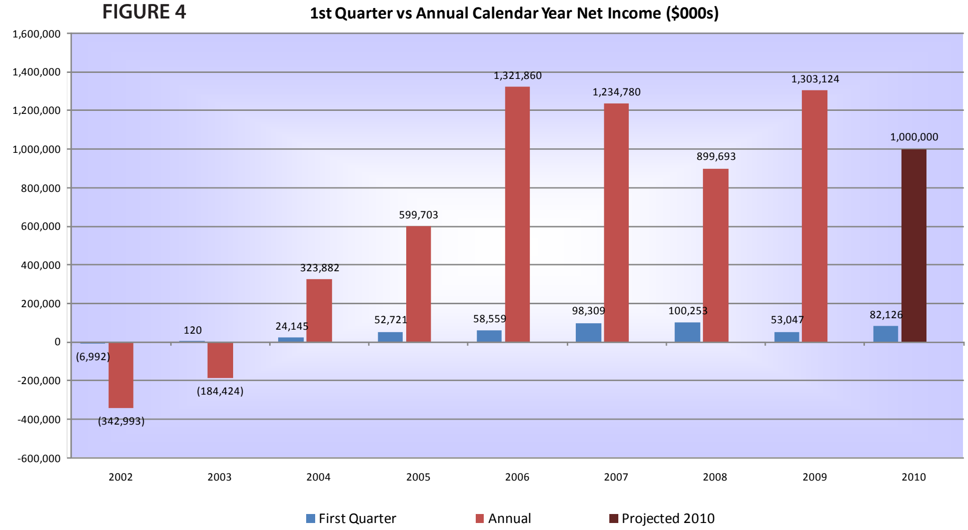

FIGURE 5 Annual Combined Ratios