BEST'S REVIEW
May 2004

Priced to Sell

Some well-capitalized physician-owned mutuals keep competitors at bay with aggressive pricing strategies.

by Chad C. Karls and Susan J. Forray

The rates physicians pay for professional liability insurance have increased by double- and triple-digit percentages in recent years. Some doctors put the onus for the increases at the door of runaway jury awards. Others have been tempted to conclude that significant profit provisions must underlie current rates. In many cases, insurers have had an uphill battle to convince their policyholders that the rate increases are in fact necessary, having resulted from an increased severity of losses and the rate inadequacies of the soft market of the late 1990s.

Given this perception, the result of a review of current medical malpractice rate filings might surprise even insurance professionals. According to the actuarial support underlying these filings, today's manual rates in certain markets would prove inadequate for most writers. Even in cases in which the underlying analysis serves to justify the filed rates as adequate for the submitting company, a review of the underlying provisions shows that the filed rates are often derived under aggressive pricing assumptions with which most other writers cannot compete.

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State Market Shares

Each of the companies in the study is the market leader in its respective domiciliary state.

Company	State Market Share	Effective Date of Reviewed Filing
A	25% - 35%	1st Quarter 2003
B	45% - 55%	2nd Quarter 2003
C	45% - 55%	1st Quarter 2003
D	30% - 40%	1st Quarter 2002
E	40% - 50%	1st Quarter 2003
F	30% - 40%	2nd Quarter 2002
G	50% - 60%	3rd Quarter 2002
H	20% - 30%	1st Quarter 2003
Average	**40%**	

Source: Based on 2002 Annual Statement medical malpractice direct written premium as compiled by A.M. Best

Certain well-capitalized mutual insurers, in particular, continue to price aggressively by using their surplus to subsidize rates, among other means. Given the policyholder-owned status of these companies, using surplus to subsidize rates may be an appropriate use of their capital. The implication for potential competitors of these companies, however, is that they, too, must meet these aggressive standards or be forced to exit the market.

The following research findings demonstrate how eight physician-owned mutual insurance companies have elected, consciously or otherwise, to maintain an aggressive posture in pricing their current policies. Each of these companies is the market leader in its respective domiciliary state with an average medical malpractice market share of approximately 40%. The companies will be identified throughout this article by a letter of the alphabet. (See)

As a note, some of the companies we highlight have submitted filings effective subsequent to those discussed in this article. We are in the process of reviewing these filings.

Recent Indicated and Filed Physicians' Professional Liability Rate Increases

Indicated increases are levels supported by underlying analysis.

Company	Indicated Increase	Filed Increase	Residual Indicated Increase	Effective Date
A	70%	70%	0%	1st Quarter 2003
B	13%	13%	0%	2nd Quarter 2003
C	20%	20%	0%	1st Quarter 2003
D	28%	19%	8%	1st Quarter 2002
E	24%	24%	0%	1st Quarter 2003
F	50%	22%	23%	2nd Quarter 2002
G	31%	2%	28%	3rd Quarter 2002
H	12%	12%	0%	1st Quarter 2003

Source: Milliman USA

Behind the Numbers

There appear to be four issues underlying the current competitive pricing practices:

1) A continued differential between companies' filed rates and the levels indicated by the analyses underlying these rates;

2) Low expense provisions;

3) The use of investment income from surplus to subsidize rates; and

4) Optimistic investment

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yield assumptions.

The first of these items was a more significant source of rate inadequacy in the soft market of the late 1990s than it is today. Although the presence of significant residual rate indications has dissipated in today's hard market, smaller residual rate indications remain in select markets. (See ■)

It is worth noting that, of the filings listed in the table, it is only those effective in 2002 for which a significant residual rate indication remained after implementation. This suggests what some have observed: while the market began to harden in late 2001, the easing of downward pressure on rates was a process that continued throughout 2002. At least for some companies, it was not until 2003 that the filed rates approached indicated levels.

One might conclude from the information above that it is now possible for insurers in most states to write physicians' professional liability policies and achieve their desired return objectives. This may be true for companies such as those detailed in this article, all of which are well-capitalized mutual insurers. While a competing insurer might be able to file its desired rates with the insurance departments to which the foregoing filings were submitted, competing profitably with the aggressive pricing assumptions of this group will prove more difficult.

Target Combined Ratios

Each "prior to residual" combined ratio is the target combined ratio of the given insurer, provided the insurer is able to write at the level of its indicated rate increase. The "subsequent to residual" target combined ratios are the target combined ratios implicit in the level of rate increase approved by the department.

Company	As Indicated (Prior to Residual)	As Filed (Subsequent to Residual)
A	150.5	150.5
B	122.7	122.7
C	118.7	118.7
D	117.3	126.4
E	117.3	117.3
F	114.4	140.4
G	113.7	145.8
H	112.3	112.3
Average	**120.9**	**129.3**

Source: Milliman USA

Performance Goals

The best example of this difficulty is demonstrated by the target combined ratios underlying the rate filings submitted. (See ■)

The target combined ratio is the targeted ratio of losses and expenses to premium underlying the pricing of policies. Each "prior to residual" combined ratio shown in the table is the target combined ratio of the given insurer, provided the insurer is able to write at the level of its indicated rate increase. The "subsequent to residual" target combined ratios are the target combined ratios implicit in the level of rate increase approved by the department; that is, they are the "prior to residual" target combined ratios adjusted for the companies' respective residual rate indications.

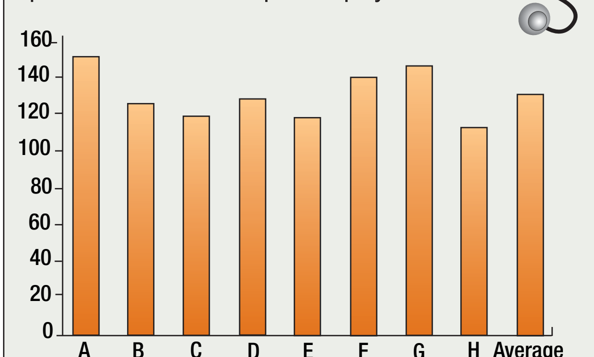
We compare the filed target combined ratios visually to a 100 combined ratio in the graphic "Filed Target Combined Ratios." (See ■)

If a target combined ratio of 100 is met, it means 100% of the premium written will be spent on loss and expense payments. The insurer will still make a profit, however, from any income earned from investment of the premium between the time of its receipt and the time it is spent for losses and expenses. An insurer of physicians' professional liability whose goal is to break even on its prospective policies (after accounting for investment income) might write at a combined ratio between 105 and 115, depending upon the investment yield and loss and expense payment pattern projected by the insurer.

In the January 2004 Property/Casualty edition of *Review/Preview*, A.M. Best Co. estimated a break-even combined ratio of 114 for medical malpractice, assuming an investment yield of 4%. We can expect the break-even combined ratio for most physicians' professional liability insurers to be lower than 114 given the current state of the investment markets, in particular the high-grade fixed income sector, in which the majority of these insurers' funds are invested. Given this, the difficulty of making a profit while competing with the insurers whose filed target combined ratios average almost 130 becomes apparent.

Filed Target Combined Ratios

If a target combined ratio of 100 is met, it means 100% of the premium written will be spent on loss and expense payments.



Source: Milliman USA

Expenses vs. Losses

The target combined ratio can be decomposed into two components: the target loss and loss adjustment expense ratio and the target expense ratio. An examination of the foregoing target combined ratios into these two components provides insight into one of the advantages these mutual insurers have—lower operating expenses.

Expense ratios for companies that provide physicians' professional liability coverage often lie between 20 and 30. Thus, one of the competitive advantages of this selected group of mutual insurers is

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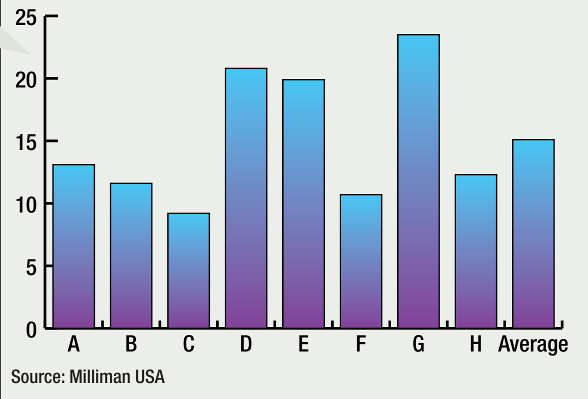
that they are able to write policies with smaller expense provisions than their competitors. (See)

They accomplish this, in part, by writing primarily on a direct basis, but also by simply constituting a large share of the physicians' professional liability marketplace within their respective states. This provides them an efficiency of size not available to their competitors.

These low expense provisions allow the group to target high loss and loss adjustment expense ratios. For example, Company A, which has an expense ratio of 13.1, targets a loss and LAE ratio of 137.4 (using the calculation of 150.5 – 13.1 = 137.4). Thus for every $100 of premium written Company A projects $137.40 for allocation to loss and loss adjustment expense, in addition to the $13.10 allocated to expenses.

Target Expense Ratios

One of the competitive advantages of this selected group of mutual insurers is that they are able to write policies with smaller expense provisions than their competitors.



Source: Milliman USA

Aggressive Assumptions

How is Company A able to rationalize this? The answer, as implicit in the support included with its rate filing, is twofold. Company A has sufficient capital that for every $100 of premium written, it expects to allocate $10.64 from the investment income it will generate on its surplus to subsidize its rates. In addition, Company A projects $40.27 of income will result from the investment of its premium. Further, in making this projection, Company A assumes it will earn a rate of return of 7.5% on its investments.

Company B used similarly aggressive assumptions in its rate filing. For every $100 of premium it writes, $7.81 from the investment income generated on its surplus is allocated to subsidize its rates. Company B projects that $15.56 of income will result from investment of the premium itself. Company B assumes that it will earn a rate of return of 5.5% on its investments.

The rates of return assumed by these insurers range from 5% to 7.5%. (See)

For comparison, during the period in which the reviewed filings became effective, the annualized rate of return on five-year U.S. Treasury securities did not exceed 5% (and, in fact, has not exceeded 3.5% since the first half of 2002, according to Federal Reserve Statistical Releases).

That these companies have chosen, either consciously or otherwise, to use the investment income generated on their surplus to subsidize their rates, in contrast to other insurers, is largely a function of their strong capitalization. As mentioned previously, given their structure as mutual insurers, this may be an appropriate use of their capital. Other insurers seeking to compete in these markets, however, will have difficulty doing so if their operating objectives—for example, targeting a combined ratio of 100 or a 15% return on equity—are in contrast to those of these market leaders.

Assumed Investment Yields

The rates of return assumed by these insurers range from 5% to 7.5%.

Company	Assumed Investment Yield	Reviewed Filing Effective Date
A	7.5%	1st Quarter 2003
B	5.5%	2nd Quarter 2003
C	5.0%	1st Quarter 2003
D	6.0%	1st Quarter 2002
E	5.0%	1st Quarter 2003
F	5.3%	2nd Quarter 2002
G	5.0%	3rd Quarter 2002
H	5.5%	1st Quarter 2003
Average	**5.6%**	

Source: Milliman USA

Strategic Decisions

Each of the selected mutual insurers we have discussed has been faced with strategic decisions in the course of serving its physician insureds. Some have been able to subsidize the rates of their insureds, and all have priced aggressively, keeping the livelihood and needs of their physician insureds at the forefront. For a mutual insurer, this may be an appropriate role. Integral to playing this role well is understanding the effect of these pricing assumptions on future financial results and recognizing the trade-off between these results and meeting the desires of insureds.

We have highlighted the presence of competitively priced mutual insurers in some states. Insurers attempting to compete in these marketplaces must be aware of their competition. States without the presence of a large, well-capitalized mutual insurer or in which such an insurer exists but has chosen not to price as aggressively may prove better grounds for a competitor. A competitor that chooses to write in states with a well-capitalized, aggressively priced mutual insurer present must be aware that writing at rates competitive with this dominant writer and still achieving its operating objectives will necessitate that it be better able to underwrite risks or otherwise able to compete on issues other than price. With the financial pressures facing physicians today, this may prove to be difficult. BR

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