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Industry Update

Insurers Continue to Strengthen Position, Despite Prolonged Soft Market

The year 2011 was once again a year of financial growth for the medical professional liability (MPL) insurance industry. While the industry's combined ratio and operating ratio increased slightly from 2010, both remained near the low levels seen since 2006. Insurers were able to release reserves once again, and they returned a substantial portion of these releases as policyholder dividends. Despite the slight decline in financial results, the MPL industry once again set a record for the amount of dividends returned to policyholders during 2011. Surplus also grew moderately in 2011, providing the MPL industry with additional capital support.

At the same time, the profitability of the industry continues to be squeezed from both sides, albeit slowly. Frequency increased modestly during 2011 for some companies. Along with rate levels that have continued to decrease, this moderate increase in frequency had a small impact on the industry's underwriting results. Additional increases in frequency, going forward, could impact bottom-line results for MPL writers.

In addition, the increased capitalization and favorable operating ratios experienced by the MPL industry of late have had one primary cause—the release of prior-year reserves. In 2011 in particular, reserve releases contributed 32 points to the industry's operating ratio. Even without these reserve releases, the industry would have been profitable in 2011—but an increase in frequency going forward could change that picture.

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Today's MPL market shows mixed characteristics. Increased competition has exacerbated declines in rate level and, for some insurers, has led to declines in the amount of business written as well—the result of underwriting discipline utilized in the face of this competition. These observations are characteristic of a soft market, yet the financial results demonstrated by the industry are very much characteristic of a hard market. Taken together, these results suggest to us that the industry is in a prolonged soft market, in which lower rate levels will continue to be the norm for several years to come.

Also facing MPL writers is a possible increase in inflation. Since 2007, increases in indemnity severities for MPL writers have been flat to small, although increases in defense costs per claim have been in the range of 6% to 8% per annum for most carriers. An increase in indemnity claim costs going forward, at a rate consistent with more typical levels of inflation, could impact the adequacy of both rates and reserves.

Possibly more concerning is the impact of inflation on asset values. Treasury yields reached historically low rates in 2011; even the 5-year Treasury bill had a yield of less than 1% per annum by the end of the year. An increase in yield rates going forward could significantly devalue bonds, by far the largest

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asset class for MPL writers. Insurers could be forced to sell assets to meet ongoing obligations (whose costs have also been adversely impacted by inflation) for amounts that result in capital losses and, possibly, declines in surplus.

In last year's "Industry Update," we commented extensively on the possible impact of healthcare reform on the MPL industry. Since most provisions of healthcare reform have yet to take effect, and several are in fact still being deliberated by the U.S. Supreme Court, this potential impact remains almost as uncertain today as it was a year ago. If the reform is deemed constitutional, one likely outcome will be a decline in the availability of healthcare providers, as a result of an increase in the insured population. Presumably, such an outcome could only impact MPL writers negatively, as patients experience a greater level of frustration with their providers, and perhaps more adverse outcomes due to delays in obtaining medical care.

To get a more detailed picture of the state of the MPL industry today, we have analyzed the financial results of a composite of 46 specialty writers of MPL coverage ("the composite"), all of which can be considered well established. We have excluded the "startup" writers, because, nationwide, they remain a minority in terms of volume of written premium; including them might have skewed our analysis of long-term trends, because of the growth they experienced during the past decade. Data was obtained from SNL Financial. We have compiled various financial metrics for the industry, categorized by:

- Written premium
- Overall operating results
- Reserve releases
- Capitalization
- Policyholder dividends.

Figure 1 Direct Written MPL Premium ($ Billions)

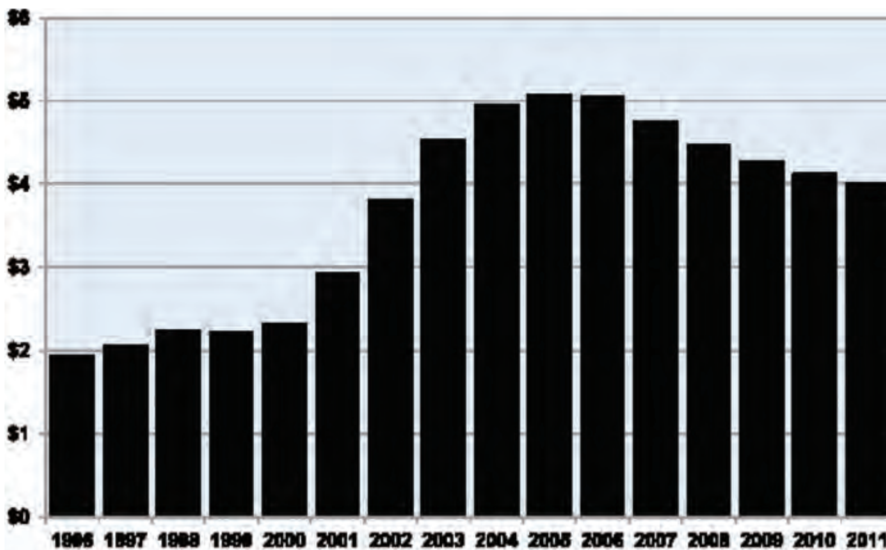
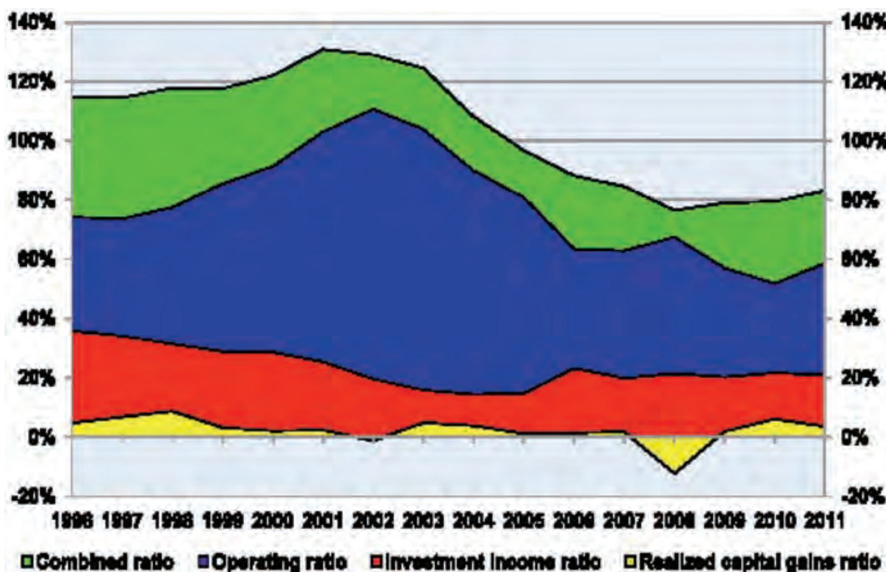


Figure 2 Operating Ratio



In viewing the financial results discussed below, it is important to consider that the 46 companies included here are all long-term MPL specialty writers. As mentioned above, they exclude the startup writers and any MPL specialty writer that has become insolvent or otherwise left the market, as well as the multi-line commercial writers of MPL coverage. The companies in each of these three excluded categories are generally less well capitalized than the 46 companies included here. In addition, while the underwriting results of the startup companies have typically been comparable to those of the composite, the underwriting results of the multi-line commercial writers have generally been somewhat less profitable. This was, of course, also true for the writers that became insolvent. Thus, the results presented below are indicative of the experience of long-term specialty writers today, which is inherently more favorable than a view of the industry as a whole.

Written premium

Last year, 2011, marked the sixth straight year of decreases in direct written MPL premium for our composite (Figure 1). Cumulatively, premium has decreased by almost $1.1 billion since 2005—more than 20% of the premium written in this year. To put that in perspective, consider that in the close to 30-year history of the MPL industry, no period of decreasing

premiums has lasted longer than two years, and the greatest consecutive-year premium reduction was 7%. On the surface, this would suggest that the circumstances of the current market are much worse than those of the previous soft market of the late 1990s through 2001.

Yet the current market has some characteristics that distinguish it from the previous soft market. Both have shown decreasing rate levels, but only in the previous soft market was there clear evidence of rate inadequacy, such as higher target combined ratios and substantial differences between the indicated and selected manual rate changes in filings. The reduction in frequency experienced by MPL writers puts their rates in a much better position now than they were a decade ago, although that decreasing frequency trend appears to have slightly reversed itself.

Overall operating results

As measured by the composite operating ratio, the industry appears to have reached its nadir during 2010. During that year, the composite posted an operating ratio of 52%, which rose to 59% in 2011 (Figure 2). The increase in 2011 was driven by a slight deterioration in underwriting results, as well as a small decline in investment returns. The combined ratio for the industry was 83%, up from the 79% combined ratio of 2010 (Figure 3).

The investment gain ratio of 24.5% in 2011 declined from a ten-year high of almost 28% in 2010. This was perhaps an expected result, given the declining impact of the write-downs taken on invested assets during 2008. In 2010, the realized capital gains ratio hit a ten-year high of 6% of net earned premium, as companies sold these previously devalued assets. In 2011, there were fewer devalued assets remaining from the 2008 time period, and the realized capital gains ratio declined for the MPL writers to 3.5% of net earned premium. The decline in the investment income ratio was somewhat less, going from close to 22% in 2010 to about 21% in 2011, comparable to other recent calendar years.

The calendar-year loss and loss adjustment expense (LAE) ratio for 2011 of 55% was slightly higher than the comparable figure for 2010, 52%. The increase was driven by smaller reserve releases in 2011 as well as an increase in the initial loss and LAE ratio carried for the 2011 coverage year, relative to what companies carried for 2010 a year ago. The loss and LAE ratio carried for the 2011 coverage year, as of year-end 2011, is about 87%, two percentage points higher than the 85% loss and LAE ratio carried for the 2010 coverage year as of year-end 2010. Given the small increases in frequency, along with continued rate decreases in many locales, this increase seems reasonable, and it may suggest a modest decrease in the level of reserve adequacy for the industry in 2012.

Figure 3 Combined Ratio

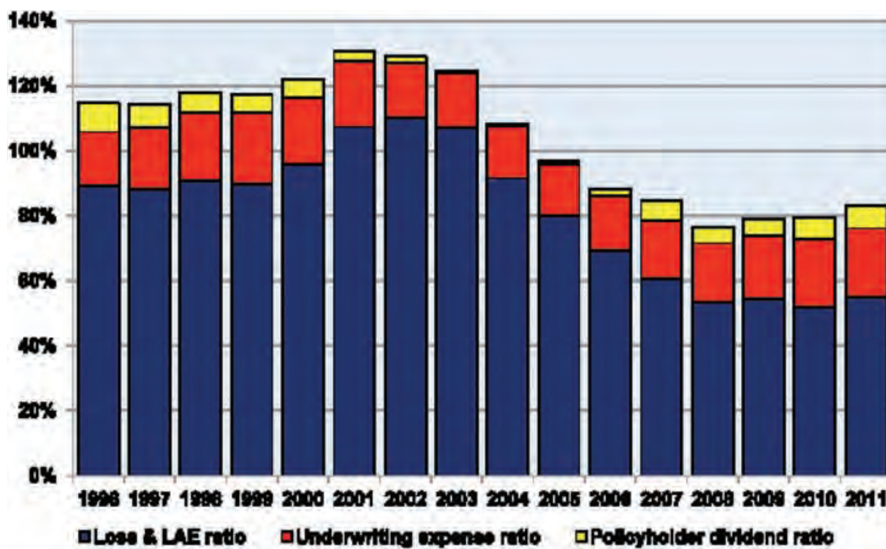
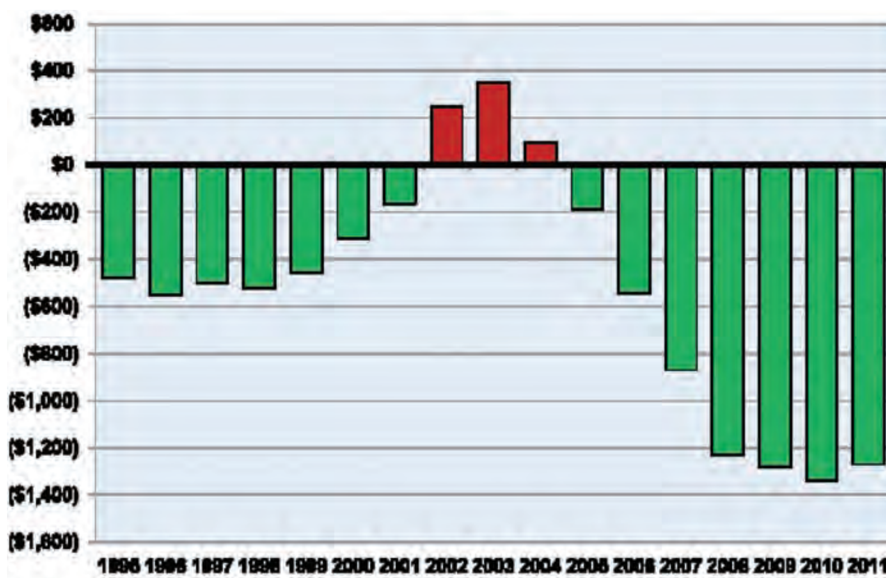


Figure 4 Reserve Release Relative to Net Earned Premium



Reserve releases

Reserve releases for the composite in 2011 declined slightly, to just under $1.3 billion, from the all-time high of more than $1.3 billion in 2010 (Figure 4). While significant, these releases should be put in the context of the reserves carried

by the composite, which for net loss and LAE totaled $11.3 billion as of year-end 2010. The release of reserves was driven by the continued impact of a lower frequency, combined for many companies with a relatively benign severity trend during the past several calendar years.

While a lower frequency in MPL claims has been recognized for some time, provisions in the reserving process for many companies initially assumed that the decrease in loss payments would be less than the decrease in reported frequency. In other words, companies assumed that the decrease in reported frequency would be driven by fewer "nuisance" or "closed no payment" claims. While this has been the case for some writers, most have seen that the decrease in frequency has affected claims of all types equally, while some have in fact seen a greater decrease in indemnity claims than in their reported claims overall. Due to the three- to five-year payment lag, only during the past several years have companies begun to see the impact of the lower reported frequency on claim payments themselves, and as a result, the industry has experienced favorable reserve releases as this impact proves favorable. However, this continues to be an area of significant uncertainty in the reserving process, particularly in light of the recent increases in reported frequency for some companies.

It is also important to recognize that a history of favorable calendar-year reserve development is not necessarily indicative of redundant reserves currently. In fact, a review of calendar-year development segregated by Schedule P year shows that favorable calendar-year reserve development has historically continued two to three years past the point at which reserves were later found to be adequate. Thus, if the industry is currently at a level where reserves are theoretically exactly adequate, history would suggest we will see favorable reserve development on a calendar-year basis through 2013 or 2014. This would then be followed by adverse development (at least for the older coverage years) in subsequent calendar years.

Finally, as we have mentioned several times now, the industry has seen a dramatic decrease in reported frequency over the past decade. However, for many companies, frequency (on a per-physician basis) has stabilized. For others, frequency has turned upward again, typically, beginning in 2009. Given the rate decreases of the past several years, frequency has of course increased more relative to premium than to the number of insured physicians (Figure 5).

While actuaries typically measure frequency as claim counts relative to the number of insured physicians, at the end of the day, it is premium dollars that must pay these claims, and thus considering frequency as claim counts relative to premium is a relevant statistic for insurers. Measured on this basis, we see that frequency per $1 million of gross earned premium reached its lowest point for the industry in 2007. Reported frequency has increased each year since this time.

Figure 5 Reported Frequency per $1 Million of Gross Earned Premium

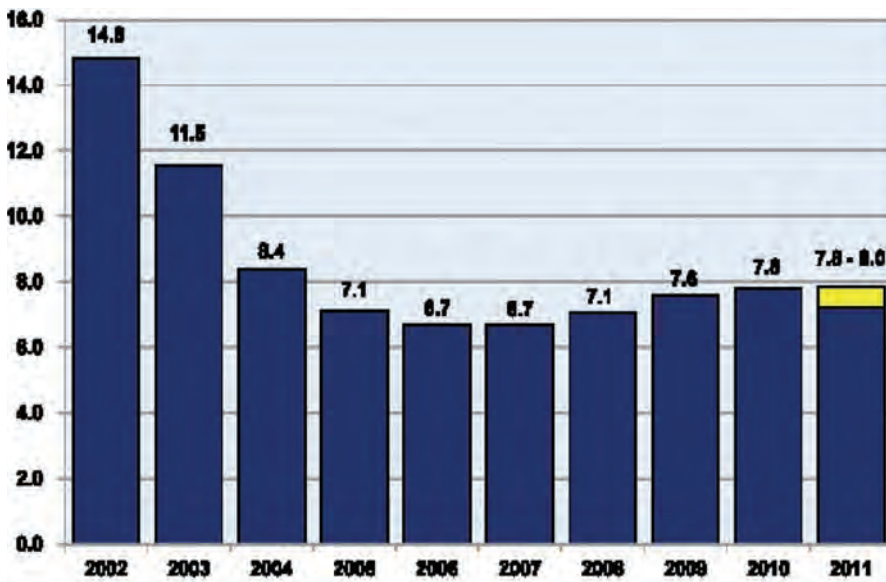
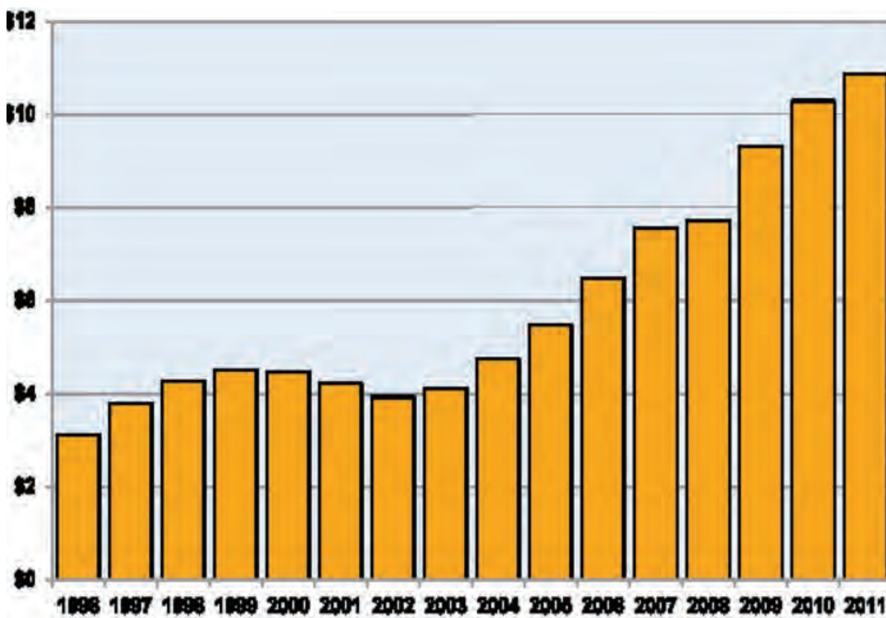


Figure 6 Policyholder Surplus ($ Billions)



Note that, in Figure 5, we have adjusted the 2011 frequency to include a provision for "pipeline" claims (i.e., incidents that evolve into claims), in order to provide an indication comparable to the older report years. Prior development suggests that with the inclusion of these pipeline claims, the frequency for the 2011 report year would likely be between 7.8 and 8.0 claims per $1 million of gross earned premium. This suggests a frequency slightly greater than in 2010. Thus, cumulatively, frequency (measured relative to premium) has increased by 15% to 20% since the 2007 year. This increase is largely the result of rate decreases (mostly in the form of greater premium credits, as opposed to manual rate changes) coupled with modest increases in "true" frequency—i.e., claim frequency per insured physician.

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Capitalization

The industry's strong operating results in 2011 resulted in a significant increase in surplus during the year of about 6%, from $10.3 billion to $10.9 billion (Figure 6). This is a noticeable gain, but still less than each of the gains experienced (on a percentage basis) in the years 2004 through 2010 (with the exception of 2008, when industry surplus increased only slightly, due to the effect of other-than-temporary impairment on assets). In addition, the biggest contributor to the gain in surplus was the favorable reserve development discussed earlier, which cannot be expected to continue over the long term.

To put the industry's capitalization level in a broader context, consider the risk-based capital (RBC) ratio for the industry. This metric provides a comparison of a company's actual surplus to the minimum amount needed from a regulatory perspective (although, from a practical perspective, given market fluctuations, many would consider the actual amount of capital needed to be well in excess of this regulatory minimum). The RBC ratio of our MPL composite increased to 998% in 2011, and, over the last several years, has followed a pattern of increase similar to that of surplus. However, individual RBC ratios vary considerably within the composite, from a low of 450% to a high of over 5,300%.

Policyholder dividends

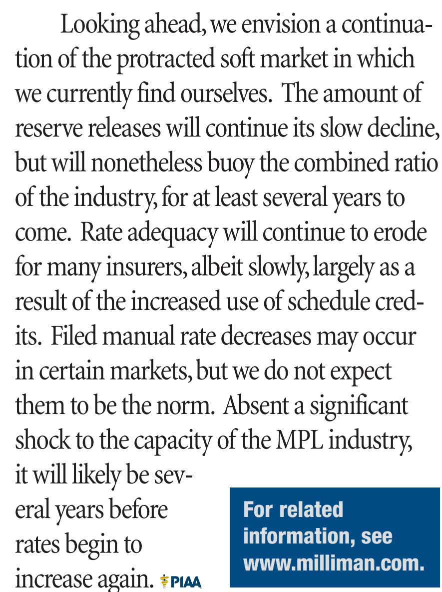
At the same time, the increase in surplus has been slowed by the increasing amount of policyholder dividends paid by MPL writers. In 2011, the composite writers paid an all-time high of $277 million in policyholder dividends, or 7% of net earned premium (Figure 3). Cumulatively, the composite has paid almost $1.4 billion in policyholder dividends since 2005. The historical pattern of policyholder dividends is very similar to that of reserve development. Thus, a large portion of the after-tax income resulting from reserve releases has been returned to policyholders.

Typically, these dividends are paid to all renewing policyholders as a percentage of premium. Thus, on a dollar basis, the dividends have provided greater benefit to those physicians who have historically paid higher premiums. We expect that policyholder dividends will continue for several more years, given their historically cyclical behavior and the year-over-year increases seen to date.

When will the hard market come?

In its most recent "Review & Preview" report, A.M. Best estimated a net reserve redundancy of $3.0 billion for the MPL line of business as a whole. This is approximately 10% of the carried net reserves, which implies a redundancy for our composite of $1.2 billion. Thus, continued reserve releases can be expected to mask deteriorating underwriting results on current business, both prolonging the soft market and increasing the risk that rates may become inadequate in the future. Insurers face other risks to the bottom line as well: increased frequency and severity, a decline in asset values, possible impacts of healthcare reform, and a decline in market size due to continued hospital acquisition of physician practices, among others. That said, the most likely scenario is one in which the impact of these risks is felt only slowly, over the course of time.

Looking ahead, we envision a continuation of the protracted soft market in which we currently find ourselves. The amount of reserve releases will continue its slow decline, but will nonetheless buoy the combined ratio of the industry, for at least several years to come. Rate adequacy will continue to erode for many insurers, albeit slowly, largely as a result of the increased use of schedule credits. Filed manual rate decreases may occur in certain markets, but we do not expect them to be the norm. Absent a significant shock to the capacity of the MPL industry, it will likely be several years before rates begin to increase again. PIAA



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