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Industry Update

Insurers Continue to Weather Soft Market, But Harder Times Loom Ahead

By most financial measures, the medical professional liability (MPL) insurance industry had one of its best years to date in 2010. The operating ratio was at an all-time low, and the combined ratio was nearly at its lowest point. Insurers were able once again to release reserves, and a large portion of the releases were returned as policyholder dividends. In fact, the MPL industry returned more dividends to its policyholders in 2010 than during any other year in its history. The industry's surplus also increased relative to 2009, providing additional capital support for what may be challenging and uncertain times ahead.

At the same time, the profitability of the industry is being squeezed from both sides. Frequency has shown definite signs of increase, albeit relatively modest compared with the frequency decrease experienced several years ago. Along with rate levels that have continued to decrease, even a moderate increase in frequency could materially impact underwriting results. Making this observation more concerning is this: since it is not entirely clear what contributed to the sizeable reduction in frequency in the first place, it is difficult to identify and monitor the events or circumstances that might lead to its potential increase.

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If the salient characteristic of a soft market is declining rates, or even just declining rate adequacy, then the MPL industry is clearly in the middle of a soft market now. However, if we narrow our definition and consider a soft market to be one where rates are believed to be insufficient to meet costs, then the MPL industry is somewhere in the middle of a transition from a hard to a soft market. And certainly, the increasing level of capitalization and decreasing operating ratio seen within the MPL industry are more characteristic of a hard market than a soft one—or at least, characteristic of an industry transitioning from the one to the other.

That said, 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 2010 in particular, reserve releases contributed 34% to the industry's operating ratio. Thus, even without these reserve releases, the industry would have been profitable in 2010—but an increase in frequency going forward could change that picture.

> **"The impact of healthcare reform on claim severity is also uncertain."**

Of course, 2010 also saw the passage of healthcare reform, a significant source of uncertainty for the MPL industry at this time. If the universal mandate for health insurance coverage is upheld by the courts, physicians' patient loads may be further strained. Patients may become frustrated with additional office wait times, their ability to make an appointment promptly, and with the amount of time a physician may be able to spend with them during an appointment itself. This additional frustration could contribute to a greater likelihood that an MPL claim will be filed, and thus contribute to greater frequency overall.

On the other hand, the universal mandate could also encourage previously uninsured individuals to seek medical care. Over the long term, adverse outcomes might be reduced if these individuals engage in preventive medicine. This development would presumably lower claim frequency, although which of the competing effects on frequency will have the greater impact is highly uncertain.

The impact of healthcare reform on claim severity is also uncertain. Possible changes in frequency could result in a very different mix of claims, with settlement costs greater for some and less for others. In addition, many MPL writers have benefited from a relatively modest trend in claim severity during the past several calendar years. If concerns regarding general inflation are realized, the trend in MPL claim severity can be expected to increase. However, it will be difficult to distinguish the impact of inflation on claim severity from other effects on MPL claim costs, such as the impact of healthcare reform.

To further discern the state of the MPL industry today, we have performed an analysis of the financial results of a composite of 48 specialty writers of MPL coverage, all of whom can be considered well established. We have excluded the "startup" writers, because, nationwide, they remain a minority in volume of written premium, so 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 National Underwriter Insurance Data Services from Highline Data. We have compiled various financial metrics for the industry, categorized by:

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

In viewing the financial results discussed below, it is important to consider that the 48 companies included here are all long-term MPL specialty writers. As mentioned above, they exclude the start-up writers and any MPL specialty writer that has become insolvent, as well as the multi-line commercial writers of MPL coverage. The member companies of each of these three excluded categories are generally less well capitalized than the 48 companies included here. In addition, while underwriting results of the startup companies have typically been comparable to the composite considered here, 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 better than a view of the industry as a whole.

Figure 1 Direct Written MPL Premium ($ Billions)

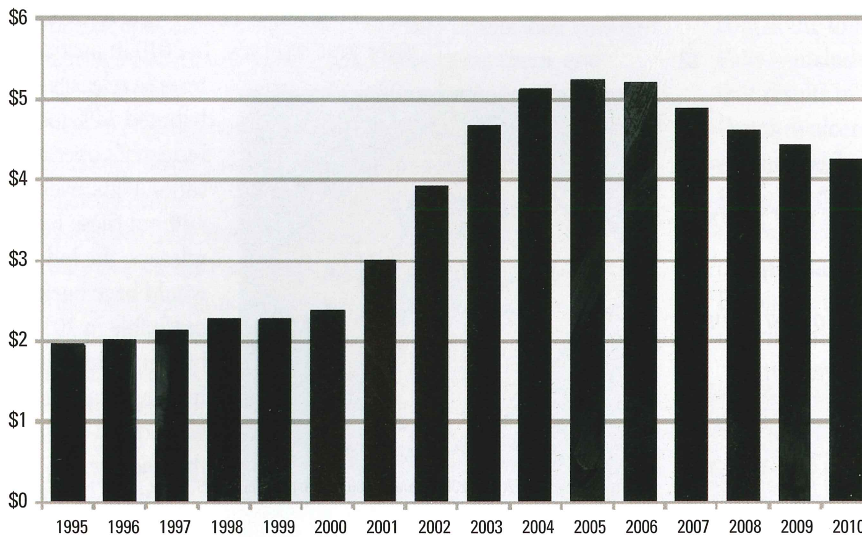
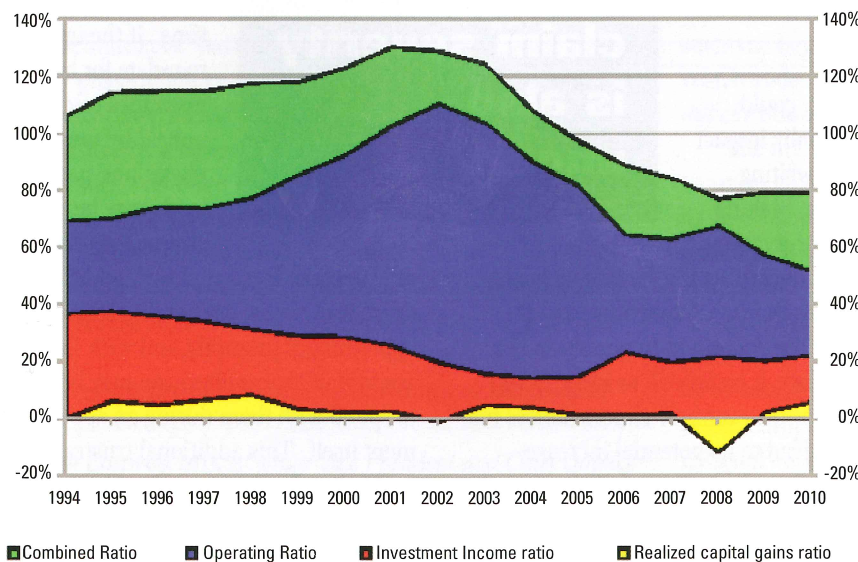


Figure 2 Operating Ratio



Written premium

Last year, 2010, marked the fifth straight year of decreases in direct written MPL premium for our composite (Figure 1). Cumulatively, premium has decreased by almost $1.0 billion since 2005—close to 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 distinct characteristics 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 large 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 reversed itself.

Overall operating results

The industry posted its strongest operating results to date during 2010, with a composite operating ratio of 52% (Figure 2). This was driven by underwriting results that were comparable to 2009 and a slight improvement in investment returns. The combined ratio for the industry was 79%, comparable to the levels posted in the past several calendar years (Figure 3).

The realized capital gains ratio for the MPL writers hit a ten-year high of nearly 6% of net earned premium, as companies sold assets for amounts greater than their carried values, due to previous write-downs. The investment income ratio was at 22%, comparable to other recent calendar years. The resulting investment gain ratio of 28% was the highest experienced by the composite since 2001.

The calendar-year loss and loss adjustment expense (LAE) ratio for 2010 of 52% was slightly lower than the 2009 ratio of 55%, which was driven almost entirely by greater reserve releases in 2010. The loss and LAE ratio carried for the 2010 report/accident year as of year-end 2010 is comparable to that carried for the 2009 report/accident year as of year-end 2009—both were about 85%. However, given the increasing frequency, along with continued rate decreases in many locales, this is in itself indicative of a decreasing level of reserve adequacy for the industry in 2010.

Reserve releases

Reserve releases for the industry in 2010 were at an all-time high of close to $1.4 billion, or 34% of net earned premium (Figure 4). While significant, this should be put in the context of the reserves carried by the composite, which for net loss and LAE totaled $12.1 billion as of year-end 2009. The release of reserves was driven by the continued impact of a lower frequency, combined for many companies with a relatively modest severity trend during the past several calendar years.

While the lower frequency has been known 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,

Figure 3 Combined Ratio

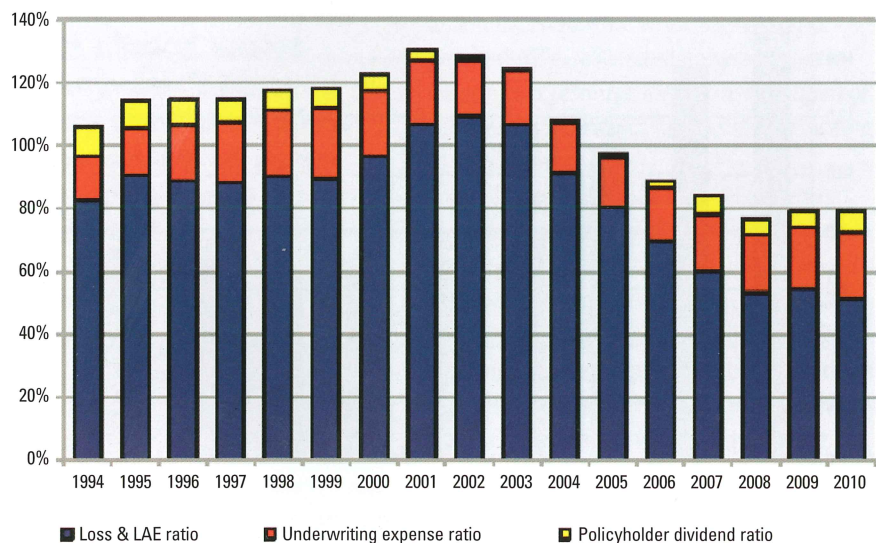
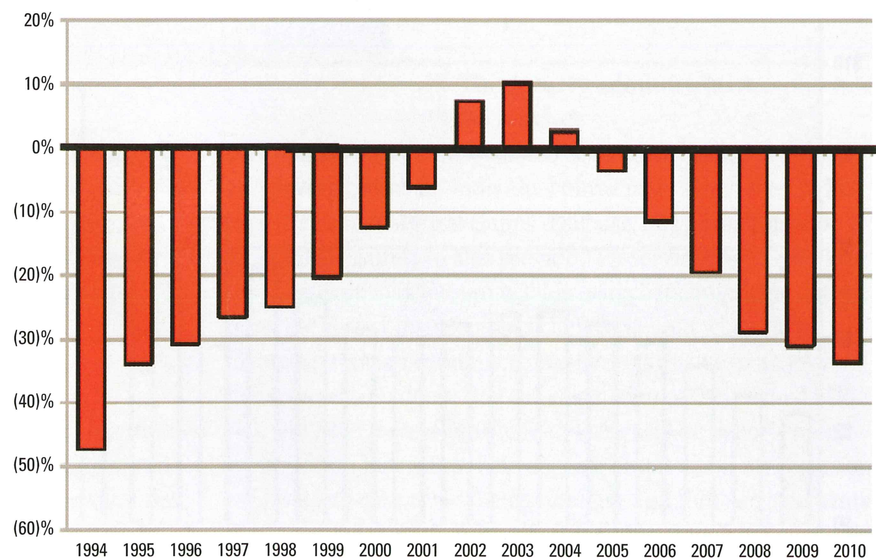


Figure 4 Reserve Release Relative to Net Earned Premium



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 writers 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 increase in reported frequency for many 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 will be theoretically exactly adequate at the end of 2011, 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 older Schedule P years) in subsequent calendar years.

> **"The trend in frequency (on a per-physician**

Finally, as we mentioned several times before, the industry has seen a dramatic decrease in reported frequency over the past decade. However, for many companies, the trend in frequency (on a per-physician basis) 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 (see 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.

Note that, on Figure 5, we have adjusted the 2010 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 2010 report year would likely be between 7.6 and 7.8 claims per $1 million of gross

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

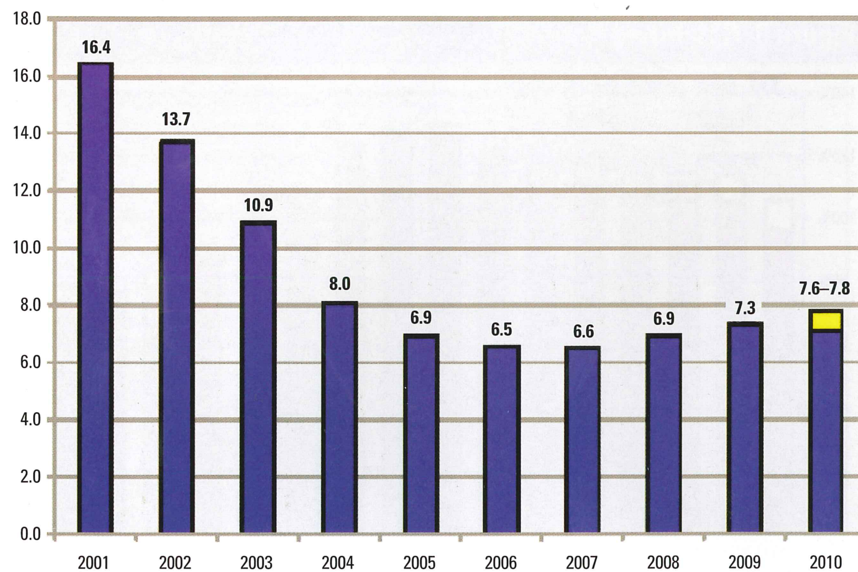
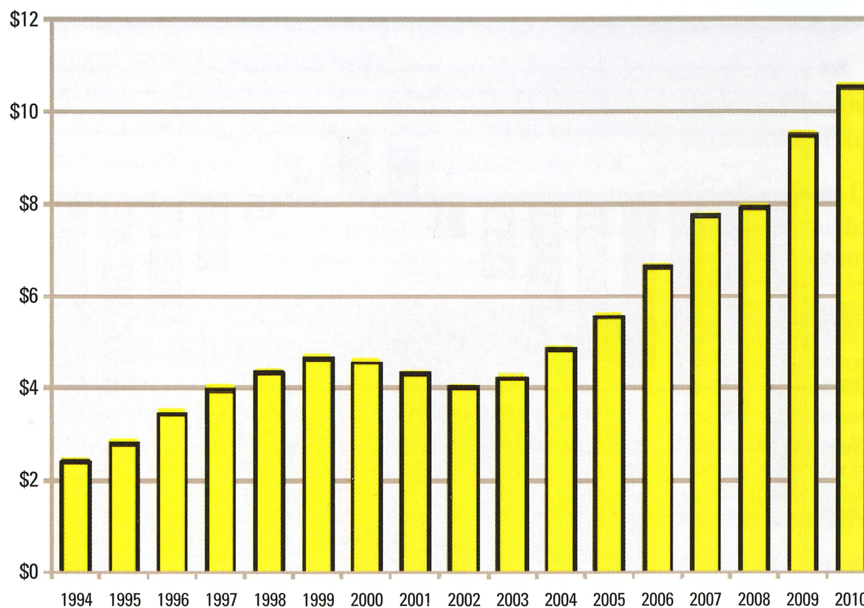


Figure 6 Policyholder Surplus ($ Billions)



basis) has turned upward again, typically, **beginning in 2009.**

earned premium. This represents an increase of roughly 4% to 7% over 2009, which was itself approximately 6% higher than 2008. This increase is the result of rate decreases (largely in the form of greater premium credits, as opposed to manual rate changes) and modest increases in "true" frequency—i.e., claim frequency per insured physician.

Capitalization

The industry's strong operating results in 2010 resulted in a significant increase in surplus during the year of about 11%, from $9.5 billion to $10.5 billion (Figure 6). This is a sizable gain, but still less than each of the gains experienced (on a percentage basis) in the 2004 through 2009 years (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 largest 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 961% in 2010, 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 400% to a high of about 3,900%.

Policyholder dividends

Slowing the increase in surplus has been the increasing amount of policyholder dividends paid by MPL writers. In 2010, the composite writers paid in excess of $270 million in policyholder dividends, or nearly 7% of net earned premium (see Figure 3). Cumulatively, the composite has paid more than $1.0 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

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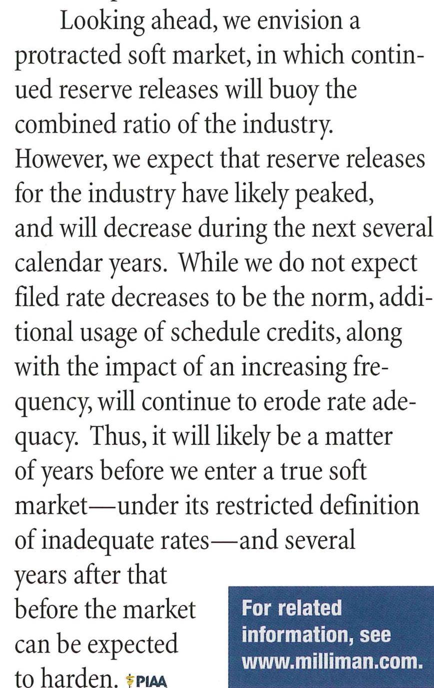
paid higher premiums. We expect that policyholder dividends will continue for several years, given their historically cyclical behavior and the year-over-year increases seen to date.

Forecast

In its most recent "Review & Preview" report, A.M. Best estimated a net reserve redundancy of $3.5 billion for the MPL line of business as a whole. This is approximately 12% of the carried net reserves, which implies a redundancy for our composite of $1.4 billion. Thus, continuing 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 addition, healthcare reform is a potential risk to MPL writers, at both the bottom line and the top line. At the bottom line, MPL writers could be subject to increased frequency and severity. They could also be subject to greater uncertainty in measuring these changes, as a result of changing characteristics of claims and an inability to distinguish the impact of healthcare reform from other cost determinants, such as inflation. This inability creates additional uncertainty in setting reserves and rate levels going forward.

At the top line, insurers face competition, not just from other writers in the standard marketplace, but also from hospitals and accountable care organizations (ACOs). The competition from hospitals is not new; for several years now, hospitals have increased their employment of physicians, often by purchasing independent physician practices. ACOs are an emerging source of competition, and they have gained momentum with the passage of healthcare reform. It is possible that the structure of many ACOs will include liability coverage for member physicians (whether these physicians are employed by the ACO or, if they retain an independent practice, as part of a group purchasing arrangement). Under either arrangement, the market for the coverage offered by traditional physician insurers can be expected to shrink.



Looking ahead, we envision a protracted soft market, in which continued reserve releases will buoy the combined ratio of the industry. However, we expect that reserve releases for the industry have likely peaked, and will decrease during the next several calendar years. While we do not expect filed rate decreases to be the norm, additional usage of schedule credits, along with the impact of an increasing frequency, will continue to erode rate adequacy. Thus, it will likely be a matter of years before we enter a true soft market—under its restricted definition of inadequate rates—and several years after that before the market can be expected to harden. PIAA

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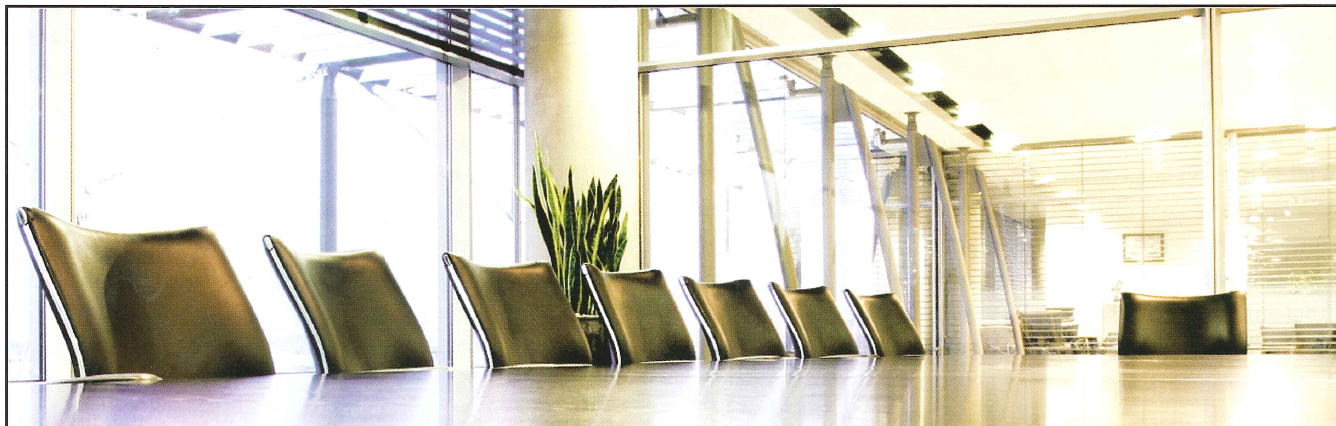

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