HEADING INTO THE HOME STRETCH: 2012 Q3 RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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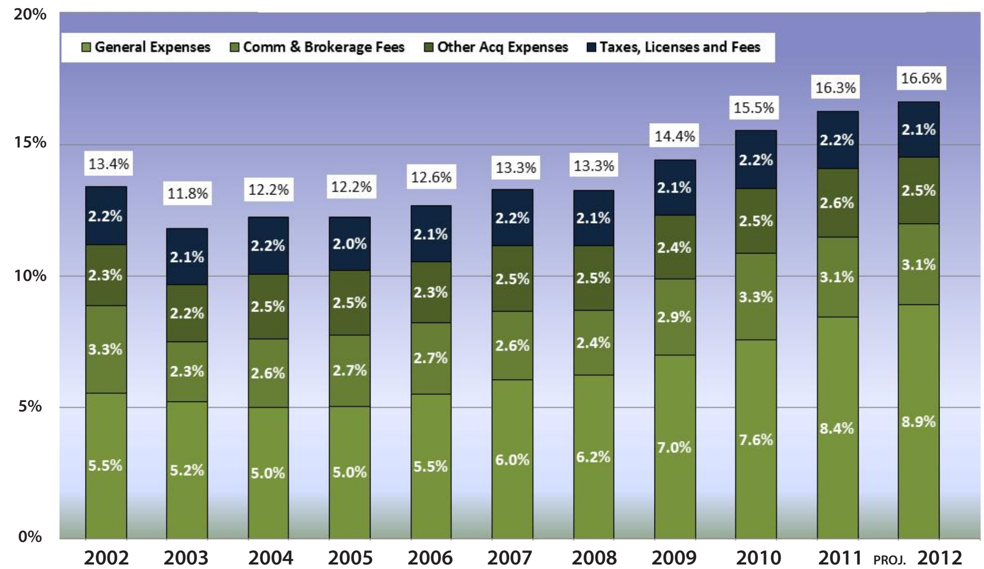
With the end of 2012 quickly approaching, we take a step back to see what the financial results of medical professional liability (MPL) specialty insurers as of third quarter might foretell with regard to year-end results.

As we do each quarter for the Medical Liability Monitor, based on data compiled by SNL Financial, we examine the collective financial results of a large group of insurers that specialize in MPL coverage—a group whose combined direct written premium in 2011 totaled more than $6.3 billion. By comparing the composite financial results of this group as of Sept. 30, 2012, to composite results at year-end over the past decade, we speculate what financial results might look like for MPL writers as a whole as of year-end 2012.

At this time in 2011, we reported that third-quarter financial results for MPL specialty writers were showing a persistent continuation of recent trends. In 2012, there is no new tale to tell as the composite results are showing a stubborn resistance to abandon the familiar financial trends of recent years. The composite premium volume continues its descent. At the same time, coverage-year combined ratios are inching upward due in part to depressed underwriting results in light of softening rate levels. Lower bond yields are reflected in lower investment income, putting further pressure on composite operating margins. Again, however, the bright shining light in the face of mostly negative trends is the favorable development of historical claim reserves, which continues to boost the calendar-year results and expand the composite capital levels.

FIGURE 2 Annual Underwriting Expense Ratios

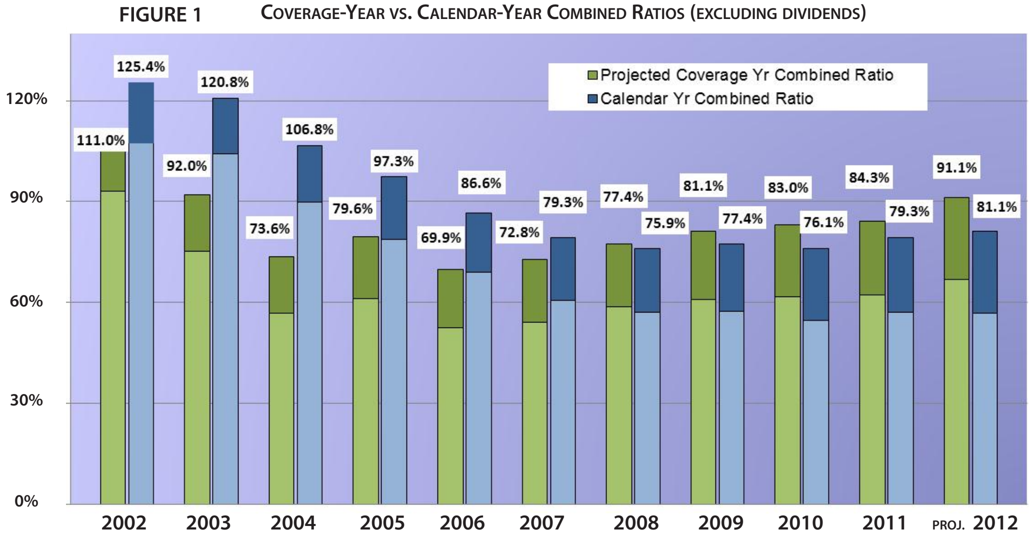


Declining Premium & Investment Income Continue to Put Pressure on Financial Results

In 2006, MPL specialty companies wrote a combined $7.8 billion in direct written premium. Since that time, premium totals have declined each and every year, sinking to a recent low of $6.3 billion at year-end 2011, a 19-percent decline. Through the third quarter of 2012, this trend appears to continue with direct written premium down another 1.1 percent from the same point in 2011. We project the 2012 premium volume for this composite to be approximately $6.2 billion, 21 percent off its high mark in 2006.

This declining premium volume is gradually taking its toll on underwriting results. While calendar-year combined ratios (excluding dividends) have looked good due to the aforementioned and widely documented claim reserve drawdowns, the comparison of projected coverage year combined ratios in Figure 1 shows how the softening market conditions are having a negative impact on both loss and loss-adjustment expense ratios as well as underwriting expense ratios. As a note, the underwriting expense shown ratios in Figure 1 are relative to net earned premiums.

FIGURE 1 Coverage-Year vs. Calendar-Year Combined Ratios (excluding dividends)



A breakdown of the underwriting expense ratios in Figure 2 shows how the individual expense components have changed relative to direct premium levels from 2005 through 2011. The rise in the expense ratio from 2005 to 2012 is driven primarily by the general expense component—with the ratios for other components staying relatively flat. Underwriting expenses as a whole have increased by more than 33 percent during this span, attributable to a 14-percent increase in nominal underwriting expenses on top of a 15-percent decrease in the underlying premium during this time period. While we expect 2012 underwriting expense dollars to stay roughly consistent with those in 2011, the continued premium

CONTINUED ON PAGE 7

HEADING INTO THE HOME STRETCH: 2012 Q3 RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

→ CONTINUED FROM PAGE 5

decline will result in a higher expense ratio.

In addition, the bottom lines of long-tailed casualty insurers continue to be hindered by declining treasury yields and investment returns. Investment income continues its recent decline with approximately $677 million earned through Sept. 30, 2012. This is down almost 9 percent from the $742 million earned at this point in 2011. Projected to a full year, this would imply $921 million of investment income for this composite in 2012, versus $1.01 million in 2011. This in spite of a 2.9-percent increase in average invested assets over the same time period—from $29.5 billion as of Sept. 30, 2011, to $30.4 billion as of Sept. 30, 2012. Looking forward, we expect that these insurers will continue to see lower investment income yields as the yields on bonds have continued their rapid decline in 2012 (see Figure 3).

Favorable Reserve Run-off Continues to Rescue Overall Performance

In recent years, reserve releases in prior coverage years have buoyed calendar-year operating results for MPL insurance carriers and have more than offset deteriorating underwriting and investment performance. This trend will continue in 2012. Figure 4 compares the composite's aggregate reserve change through the first nine months of each year to the reserve change for the entire year. Favorable reserve development through the third quarter appears to put 2012 ahead of the pace set by recent calendar years.

Strong Capital Position

As should be expected, the exceptional profitability of MPL insurers in recent years is evidenced by continued growth in composite levels of policyholder surplus. Figure 5 displays the composite policyholder surplus after three quarters and at year-end for this composite from 2002 through 2012 (year-end 2012 projected).

Conclusion

As we near the end of what looks to be another very profitable year for MPL specialty insurers, we once again wonder how long the overall financial performance can remain strong. Only time will tell how much longer the favorable loss reserve development can carry the load for slumping premium revenue and investment income. We will continue to closely monitor this moving forward. For the remainder of 2012 anyway, it appears that MPL specialty writers will continue to enjoy exceptional financial results.

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FIGURE 3 INDUSTRY YIELD VS. FIVE-YEAR TREASURY BOND YIELD

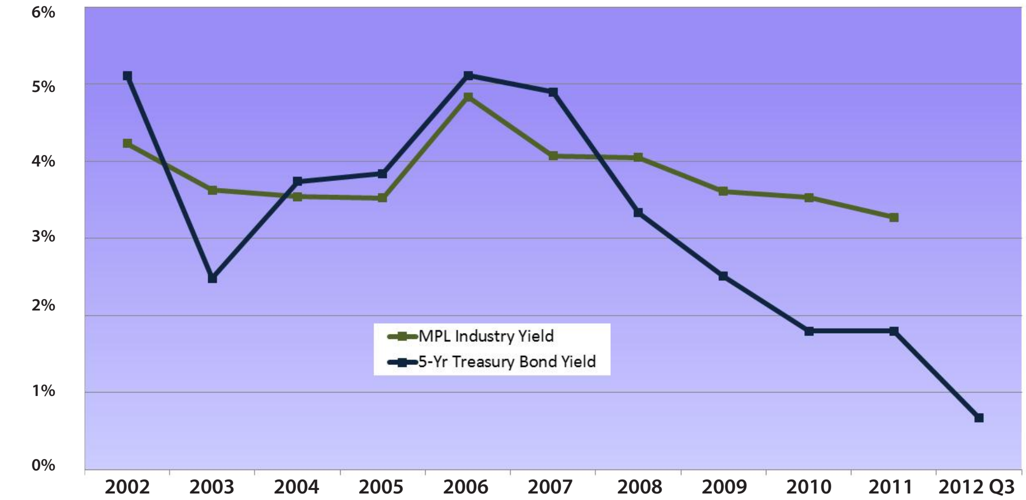

FIGURE 4 CUMULATIVE RESERVE DEVELOPMENT BY QUARTER ($000S)

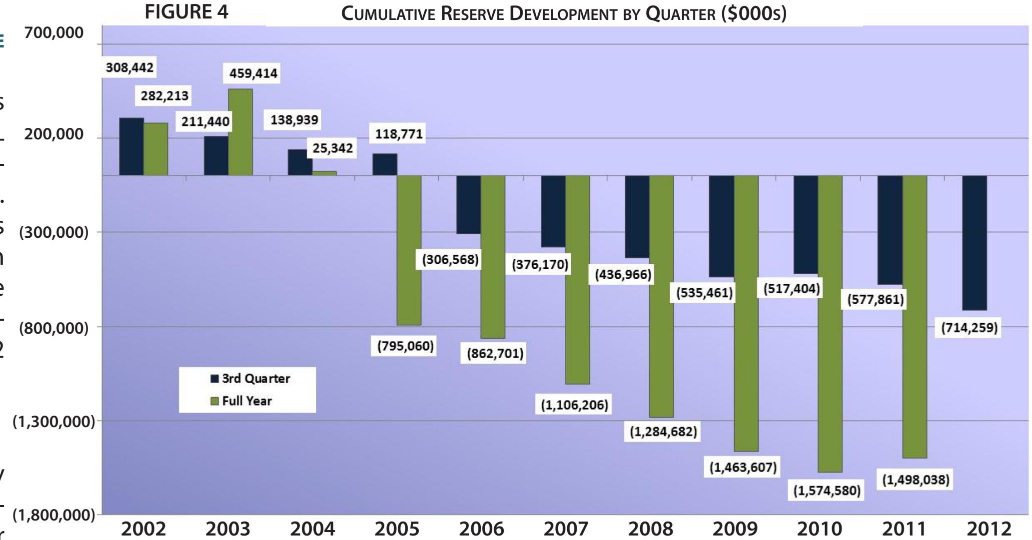

FIGURE 5 POLICYHOLDER SURPLUS - THIRD QUARTER VS. YEAR-END ($MILLIONS)