Cause for Reinsurance Concerns on the Rise For Med Mal Insurers

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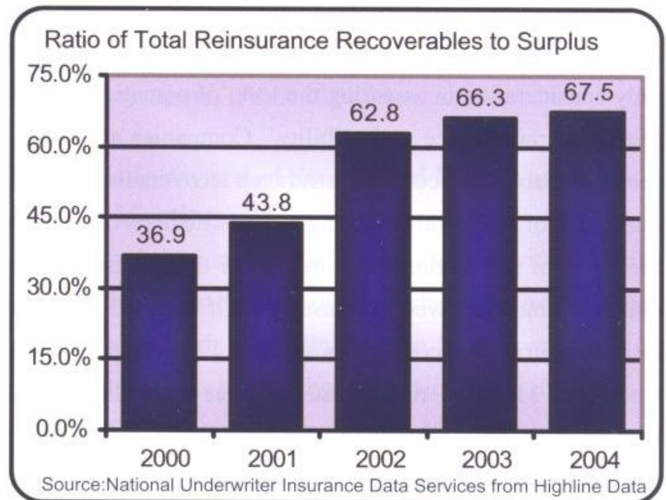
In the past several months, there has been an unprecedented level of media coverage related to the use of reinsurance by property and casualty insurance companies. The primary focus of this attention has been placed on risk transfer issues associated with "finite reinsurance" and the corresponding accounting implications. Another important, though less discussed, industry-wide issue surrounding the use of reinsurance relates to the collectibility of recoverables. The specialty medical malpractice market, like most other markets, has managed this timeless issue over the years. For the specialty medical malpractice market, this consideration has become increasingly important over the past several years. The magnitude of the potential concern can be assessed in the context of the following elements:

- Balance sheet leverage
- Degree of collateralization
- Concentration of ceded reserves

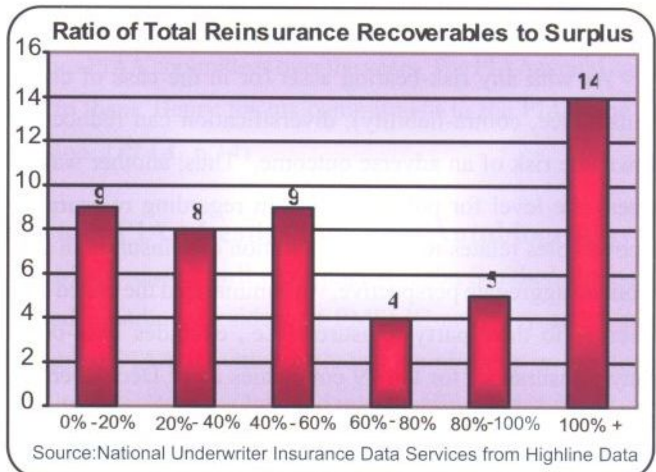
Balance Sheet Leverage

One way to measure the relative importance of potential reinsurance collectibility issues is to review the ratio of reinsurance recoverables to surplus. The chart below displays the historical change in this leverage ratio in the aggregate for the specialty medical malpractice market. For reference, we have defined this medical malpractice specialty market as being comprised of 49 insurance companies primarily providing medical malpractice coverage. In 2004, these companies collectively wrote $6.6 billion out of the total $11.8 billion of direct medical malpractice premium. The general profile of these companies is healthcare-provider owned and/or governed companies.

As can be seen in the chart following, the ratio of total reinsurance recoverables to surplus has nearly doubled between 2000 and 2004. This leveraging effect makes the impact on surplus of potentially uncollectible reinsurance nearly twice as important today relative to five years ago.



It is important to note that on an individual company basis, this balance sheet leverage can be significantly more pronounced than in the aggregate. The chart below illustrates the range of these reinsurance leverage ratios for the 49 specialty medical malpractice companies as of December 31, 2004.



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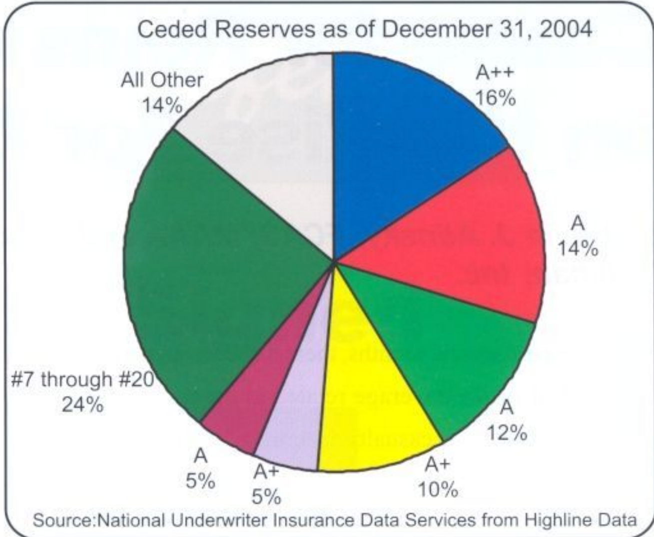
As can be seen in the chart above (page 25), for 14 of the 49 companies, or nearly 30 percent of them, their entire surplus is comprised of reinsurance recoverables. Further, for six of these 14 companies, more than 200 percent of surplus is carried as reinsurance recoverables. In other words, for these six companies, if merely 10 percent of their reinsurance recoverables falter for any reason, their surplus will be impaired by more than 20 percent, subject to any collateral offsets.

Collateralization Levels

The amount of recoverables relative to surplus is not the only consideration in assessing the level of potential concern related to reinsurance collectibility. Companies are able to secure the ability to collect reinsurance recoverables via several types of collateral including a funds held account under the terms of some reinsurance treaties or other offsets attributable to amounts owed to reinsurers. Of the $4.5 billion of total reinsurance recoverables for the 49 companies as of December 31, 2004, roughly $0.9 billion was collateralized in this fashion. However, the remaining reinsurance recoverables totaled $3.6 billion which compares to surplus of $6.6 billion. It should be noted that statutory accounting principles include a provision for uncollectible reinsurance recoverables known as the Provision for Reinsurance (a.k.a. the Schedule F Penalty) as a liability on a company's balance sheet, although as of December 31, 2004 this provision only amounted to $17.5 million for the 49 companies.

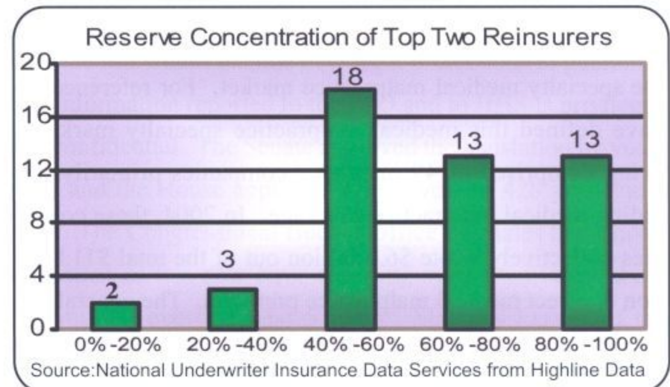
Concentration of Ceded Reserves

As with any risk-bearing asset (or in the case of ceded reinsurance, contra-liability), diversification can reduce the downside risk of an adverse outcome. Thus, another way to assess the level for potential concern regarding reinsurance recoverables relates to the concentration of reinsurers in use. From an aggregate perspective, we summarized the ceded loss reserves to third party reinsurers (i.e., excludes intra-company reinsurance) for the 49 companies as of December 31, 2004. The following chart lists the A.M. Best ratings of the top six third party reinsurers to the specialty medical malpractice market and also provides a sense for the aggregate level of concentration with regard to the use of reinsurance.



As can be seen in the chart above, the top six reinsurers comprise over 60 percent of the total ceded loss reserves to third party reinsurers from the specialty medical malpractice market. Additionally, the top 20 reinsurers comprise over 85 percent of the total ceded loss reserves. While each of the reinsurers listed above have secure ratings from A.M. Best, it is important to note that reinsurance collectibility issues can emanate from either an inability *or* unwillingness (e.g., disputed contract interpretation) to meet the obligations under the terms of reinsurance contracts.

Viewing reinsurance concentration on an individual company basis (defined as concentration of the top two reinsurers based on ceded loss reserves) illustrates that the concentration risk is significantly more pronounced for certain of the medical malpractice specialty companies as displayed in the following chart.



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The 13 companies with a reinsurance concentration greater than 80 percent are more exposed to the risk that one of their two major reinsurers becomes unable or unwilling to meet its obligations.

Conclusion

While the issue of reinsurance collectibility may not be a front-page story, in our view, it is clear that this issue for the medical malpractice specialty market warrants more attention today relative to several years back. This conclusion holds true not only when assessing the aggregate metrics, but in particular for certain individual companies that fall toward the extreme ends of the diagnostics outlined in this article. On a positive note, even with some withdrawals from the medical malpractice reinsurance market, to date there has been relatively little disruption to the medical malpractice specialty market due to reinsurance collectibility problems. This does not mean, however, that there will not be future disruptions, particularly considering the increased reliance on, and thus importance of reinsurance. During the latest medical malpractice crisis, the specialty companies have leaped significant hurdles related to operational challenges. Now that the acute portion of the crisis has largely passed, it might be an opportune time for these companies to assess their exposure to potential reinsurance collectibility concerns. ●

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