HALFTIME UPDATE: MID-YEAR 2012 RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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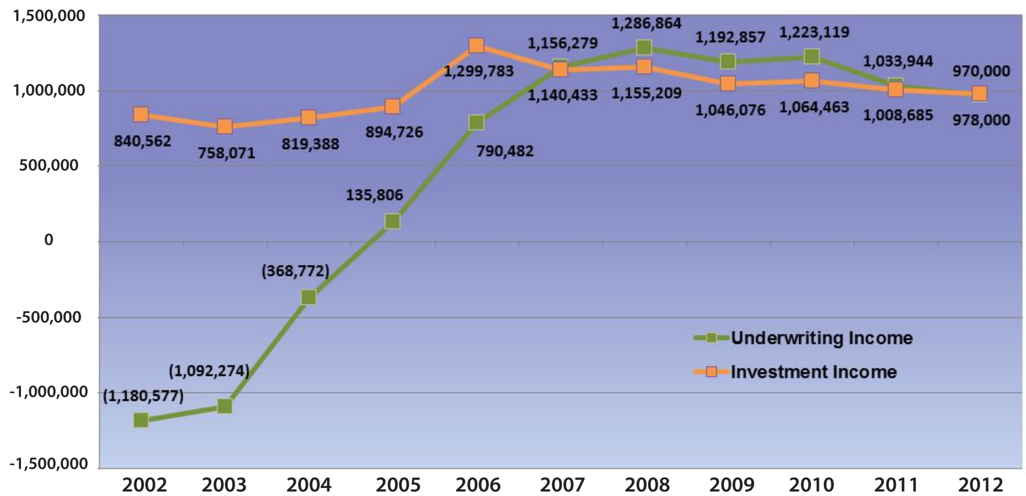
The familiar trends from recent years continue during the first half of 2012 for medical professional liability (MPL) specialty insurers. Calendar-year, net-after-tax income continues its downward trend along with premium volume. Overall calendar-year results are strengthened by familiar reserve releases, which act as camouflage for softening rate levels. Nonetheless, the aggregate bottom line for MPL specialty writers continues to be strong.

Based on data compiled by SNL Financial, we continue our quarterly exercise of examining the collective financial results of a composite of 83 insurance companies that specialize in MPL coverage. The direct written premium for this composite totaled slightly more than $6.3 billion in 2011. In our analysis, we attempt to identify patterns in the historical relationship between the financial results at the end of each quarter compared to the financial results at year-end. Taking into consideration this relationship, together with our view of current market trends, we attempt to project what the year-to-date 2012 results might foretell about future market conditions.

FIGURE 2 — UNDERWRITING VS. INVESTMENT INCOME ($000S)



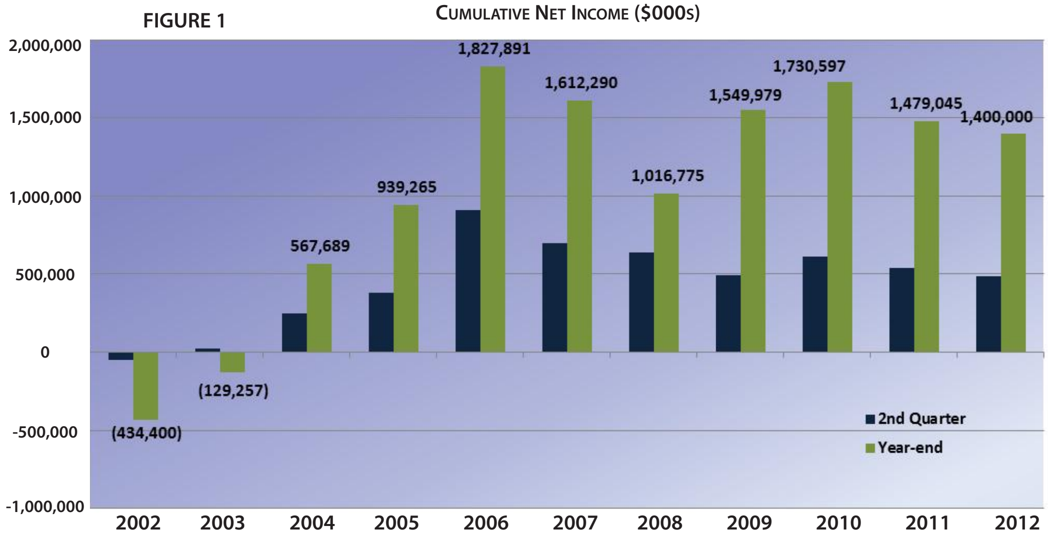
Premium and Income Declines Still Produce Strong Profits

Aggregate direct written premium for this composite of MPL specialty writers continues its decline from a high in 2006 of $7.8 billion to $6.3 billion in 2011, a 19 percent decrease. Six months into 2012, this trend continues with direct written premium down 4 percent from the same point in 2011. By the end of 2012, we expect premium volume for this composite to total just under $6.1 billion, or 22-percent below its high point in 2006.

In the face of premium declines, robust competition and historically low investment yields, these companies continue to make profits and grow their surplus. Net income for this composite is projected to be around $1.4 billion in 2012 (Figure 1).

However, in the face of these positive overall results, pre-tax calendar-year underwriting and investment income are gradually declining. Underwriting income and investment income are both projected to be down almost 25 percent in 2012, compared to their 2008 and 2006 peaks, respectively (See Figure 2). It should be noted however that the calendar-year underwriting results in the Figure 2 have been buoyed by favorable claim reserve releases. Furthermore, with Treasury yields hitting new lows as of late, there is no expected turnaround in investment income results for the foreseeable future.

FIGURE 1 — CUMULATIVE NET INCOME ($000S)



Favorable Reserve Developments

Going back to 2005, reserve releases from prior coverage years have had a significant impact on calendar-year underwriting results for MPL insurance writers. Similar to the trends mentioned up to this point, the favorable reserve releases appear certain to continue through 2012. Figure 3 (see page 7) shows reserve movements on prior coverage years through second quarter compared to the reserve movements after year-end during the past 10 years. The chart shows that for this composite, the favorable reserve development through the first half of 2012 was the greatest it's been during the past decade.

Calendar-Year vs. Coverage-Year Performance

Although there has been significant concern in the industry that favorable

→ CONTINUED ON PAGE 7

HALFTIME UPDATE: MID-YEAR 2012 RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

→ CONTINUED FROM PAGE 5

reserve releases are buoying calendar-year results, a look at the latest data for this composite suggests that coverage-year results are still quite strong. Using booked Schedule P net loss and loss adjustment expense development to project coverage year loss ratios, Figure 4 contrasts calendar-year and coverage-year operating margins. The chart demonstrates the lag that often exists between the calendar-year and coverage-year results.

As coverage-year experience improved between 2002 and 2006, the industry was reluctant to fully accept that the declining claims frequency was sustainable. Using hindsight, it becomes obvious that claim reserves were not reduced as aggressively as they could have been in order to reflect the full improvement of claim costs. This created a build-up in reserve redundancies for these insurers and caused their calendar-year margins to fall below the coverage-year margins. In more recent years, the opposite has been true. Coverage-year margins are decreasing for reasons previously discussed. Calendar-year margins are now better than coverage-year margins as insurers continue to run-off the reserve redundancies.

Surplus Continues to Grow

Given the sustained favorable financial results for MPL writers, Figure 5 takes a look at its impact on policyholder surplus for the composite. Not surprisingly, surplus for the composite continues to grow at a solid pace, improving by 4.3 percent during the past year. Annual surplus growth for this composite has averaged 7.4 percent during the last five years. This continued surplus growth has produced an exceptionally strong capital position for the composite overall.

So far in 2012, MPL specialty writers continue to produce exceptional operating results consistent with the recent past. Moreover, although calendar-year financial results remain strong, the MPL insurance market has been soft for a number of years and uncertainty in the healthcare industry persists.

As we've stated in the past, it might be prudent for MPL insurers to maintain strong capital ratios for the near future. We will continue to monitor trends in the MPL market as reflected by this composite of MPL companies throughout 2012.

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FIGURE 3 CUMULATIVE RESERVE DEVELOPMENT ($000S)

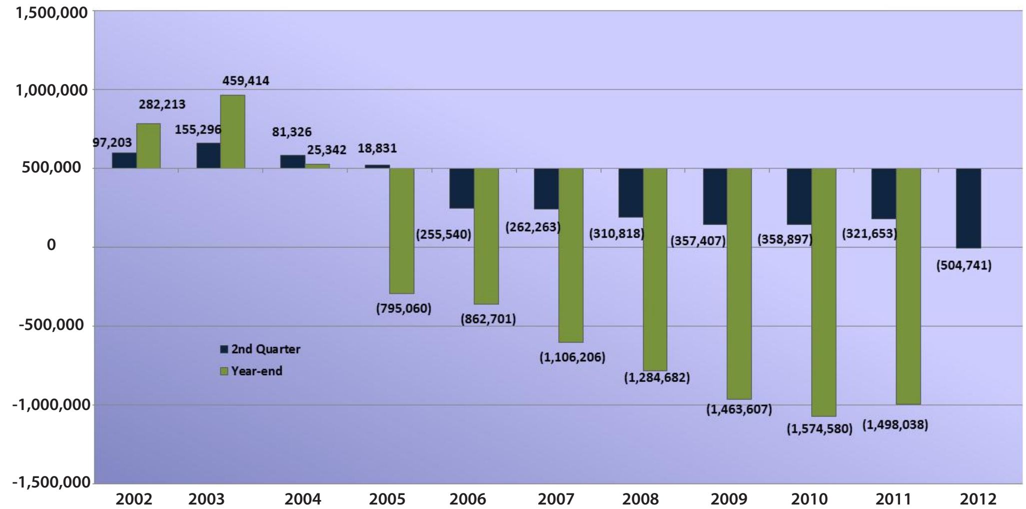

FIGURE 4 OPERATING MARGIN

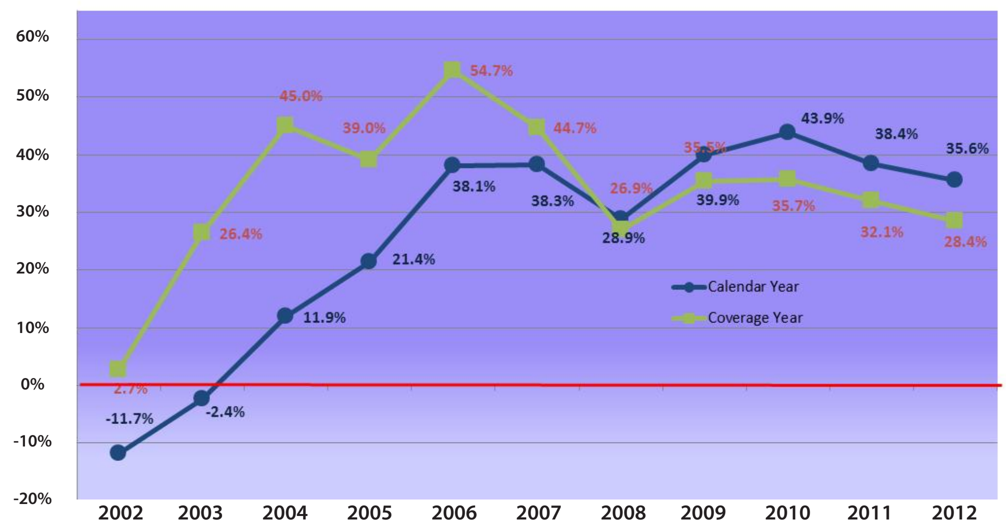

FIGURE 5 POLICYHOLDER SURPLUS - END OF SECOND QUARTER ($MILLIONS)