Industry Update

State of the Industry: The Brighter Side of Volatility

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The year 2006 was a good year for the collective PIAA membership, in particular as it relates to published financial results. The volatility inherent in this market is omnipresent, and can sometimes result in shifts in the underlying costs that drive the industry's financial results. These shifts have been a part of the market for several decades, and the 2006 financial results demonstrate the favorable side of this volatility, just as the results from a few years back were negatively impacted by the downside effects of this volatility.

We would assert that there are explainable reasons for the good fortune that the industry has experienced of late, including:

- Reduction in reported claim frequency experienced in many markets
- Broadly speaking, the achievement of rate level adequacy
- A thus far prudent response to the threat of soft market conditions.

We believe it is the last item listed that will ultimately prove to be the most important factor in the long-run success for individual carriers. By operating under the principles upon which they were founded, most of the PIAA member companies have some inherent insulation from soft-market pressures. For example, we have noted a PIAA member, faced with softening market conditions, that was able to meet its policy retention targets due to all that the company offered to the medical community beyond just its insurance policies (e.g., physician advocacy, education, and patient safety initiatives).

In addition, the operating philosophies of most PIAA members allow for the return of potentially redundant premiums in the form of policyholder dividends. We have observed declarations of policyholder dividends from a number of carriers during 2006, and would not be surprised to see more announcements during 2007—assuming, of course, that the loss cost environment trends, in both frequency and severity of claims, remain within reasonable expectations.

Specifically, assuming that the general improvement in reported claims frequency is sustained, reserve and rate levels will likely continue to remain adequate in the aggregate. In fact, one might argue that the general reduction in reported claims frequency has nearly as much to do with the improved operating results as the broad achievement of rate level adequacy. There are many hypotheses regarding the driving forces underlying the general reduction in reported

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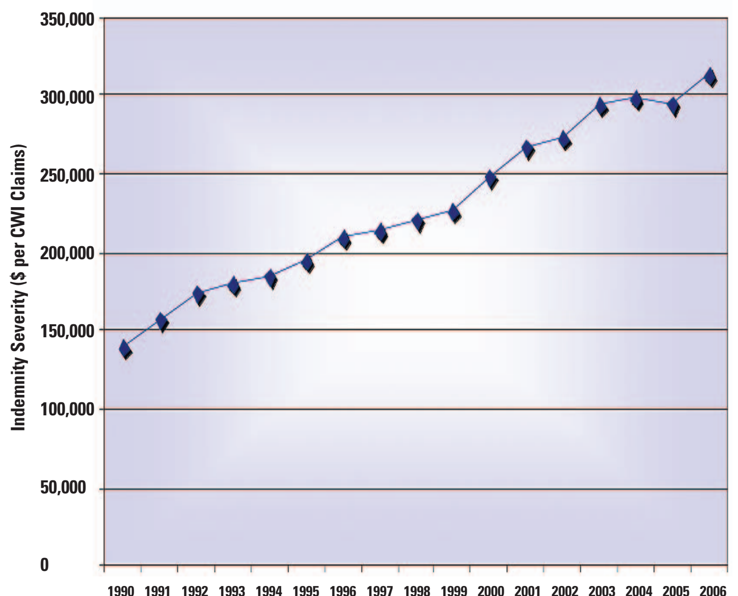
NPDB Countrywide Severity



claims frequency, and the most probable cause is the confluence of various factors, similar to the synergism among the unfavorable circumstances that led to the most recent crisis.

As a cautionary note, we recommend that companies monitor the percentage of claims that close with an indemnity payment. Some theories suggest a potential for an increase in this ratio for coverage years with a marked reduction in reported claims frequency, and this could impact the actuarial pricing and reserving assumptions.

With regard to claims severity, the graph displays nationwide calendar-year paid-claim severities, based on information contained in the most recent available National Practitioner Data Bank (NPDB).[1]

There is a persistent long-term upward inflationary pressure on claims severity, and it would seem reasonable to assume that these pressures will continue into the future. While the NPDB closed-claim database suggests a relatively predictable severity trend, it does not account for individual market variations, which could be, and have been, sizable. They are influenced by factors such as the enactment of meaningful tort reform or the overturning of such reforms, behavioral changes in juries, systematic improvements in patient safety, and new theories on damages espoused by the trial bar. As history has proven, the individual market variations can present both positive and negative challenges to the claims environment.

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Last year, we noted the following list of highlights for the industry during 2005:

- Improved overall financial results
- Formation of new insurance programs
- Re-emergence of capacity in select markets
- Increased merger and acquisition activity
- Rate levels that are generally reaching a plateau.

While this list summarizes the highlights of 2005, the additional 12 months of information indicate that the list remains, for the most part, relevant for 2006.

For assessing performance in 2006, we compiled the financial results for 52 specialty medical professional liability insurance (MPLI) carriers. As a note of clarification, this data set does not include the entire universe of companies writing MPLI. The source data for the graphs that follow is a Milliman analysis of National Underwriter Insurance Data Services from Highline Data.

Consistent with the presentation of aggregate results contained in last year's article, we will review the following financial metrics for the composite of 52 specialty carriers:

- Top-line premium growth
- Operating results
- Capitalization levels.

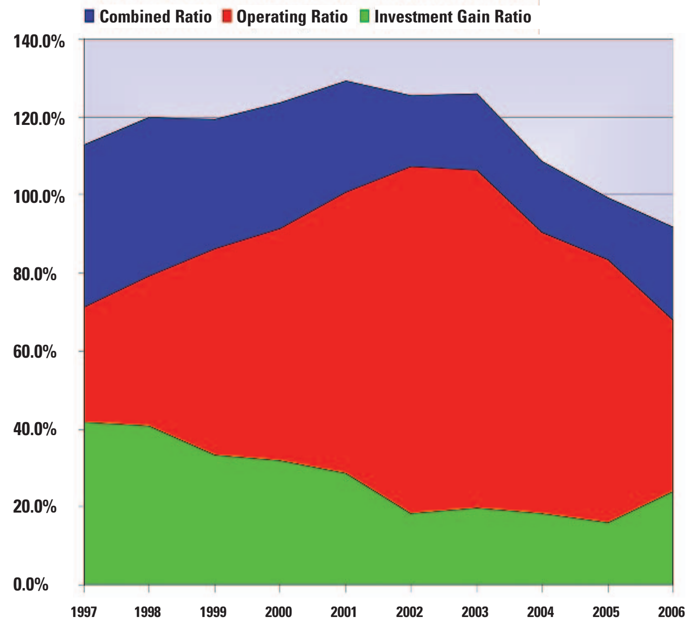
Top-Line Growth in Premium

The graph on "Direct Written Premium Growth" displays the growth in direct written MPLI premium between 1997 and 2006 for our 52-company composite sample of specialty writers.

Using growth in direct written premiums as a proxy for rate level movement, the data in the next graph suggests that overall rate levels remained fairly steady between 2004 and 2006. This is consistent with our perception of rate level activity during this time period. However, we note that there is a degree of variation among individual companies and individual states: there have been rate increases in some states, and rate reductions in oth-

Direct Written Premium Growth ($ Billions)

Underwriting and Operations Results



ers. The key factors that will help shape the course of this pattern in the future are as follows:

- Sustainability of improved reported claims frequency
- Containment of claims severity to within manageable trends
- Level of underwriting discipline maintained by the industry.

Operating Results

After sustaining operating losses during 2001, 2002, and 2003, this group of companies produced positive operating results during 2004 and 2005 and, more notably, in 2006. The improving overall operating results are driven primarily by the industry's underwriting performance (as measured by the combined ratio). The improvement in the underwriting performance is largely a result of the significant rate increases implemented during the period of 2001 through 2004, in addition to improvements in reported claim frequency, as noted above.

With the exception of a single significant transaction in 2006, the investment results have been relatively steady over the past five years. In reviewing the investment results in terms of the investment gain ratio (defined as investment gain divided by net earned premium) for the period 1997 through 2006, one can observe a marked decline in investment results beginning in 2002. Between 1997 and 2001, the investment gain ratio hovered in the 30% to 40% range; if the impact of the single large transaction noted above is excluded, the ratio has been near 20% since 2002.

The falloff in this metric was driven by the downward trend in the interest rate environment—the vast majority of the invested assets are held in fixed income securities—in addition to the industry's growth in net earned premium, which impacts the numerator and denominator of this metric, respectively. For reference, a reduction in the investment income offset necessitates a lower target combined ratio in order to achieve comparable operating results, all else being equal. The graph, "Underwriting and Operations Results," displays the operating ratios (defined as the combined ratio less the investment gain ratio) between 1997 and 2006, as well as the underlying components.

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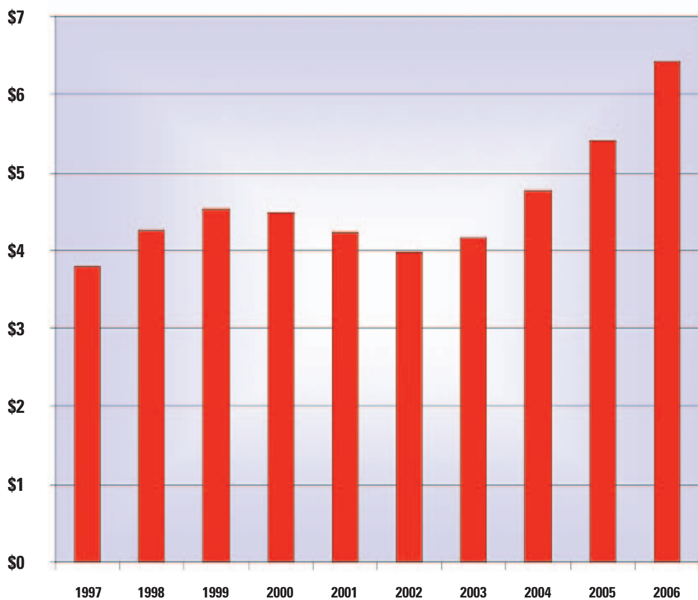
Capitalization Levels

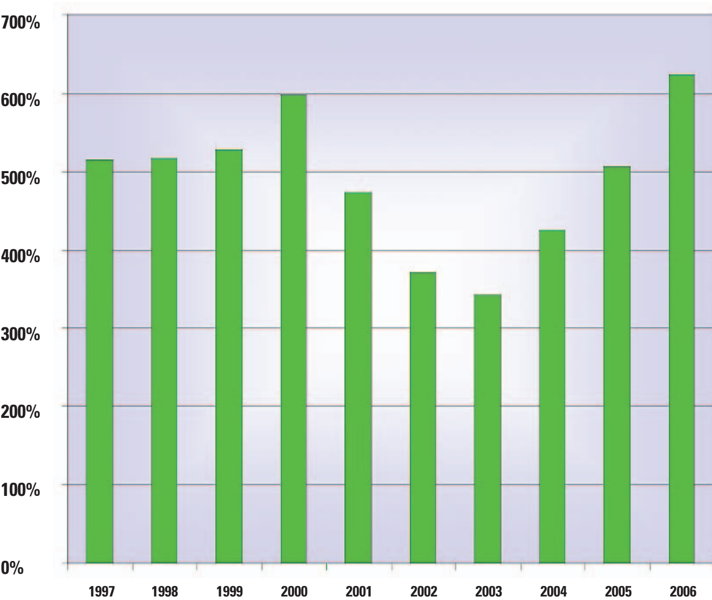
The composite of companies included in this analysis has had double-digit growth in its capital (defined as statutory surplus) in each of the past three years. The improved capital position during this period has been largely driven by retained earnings. As a result of the limitations on mutual companies in accessing new capital, as compared with publicly traded stock insurance companies, operating results tend to correlate with changes in capital position. This is not to say that there are no other factors that affect surplus levels nor that additional capital is not available to these carriers, but it does underscore the need for mutual companies to maintain appropriate levels of capital to weather the unforeseen. The graph, "Growth in Policyholders' Surplus," charts the path of surplus growth over the past ten years.

While the graph demonstrates a steady growth in surplus over the past three years, note that the universe of companies only includes those that successfully navigated the latest crisis, and thus excludes several carriers whose deteriorating

Growth in Policyholders' Surplus ($ Billions)



RBC Ratio



financial results ultimately led to their financial failure. As a result, this segmentation of the data introduces the potential for distortions in the financial statistics.

The nominal value of surplus is of limited value in assessing the true capitalization levels of the medical liability specialty industry, because it does not normalize for, or take into account, the changing levels of risk inherent in the insurance operations. One commonly referenced measure of capital adequacy is the risk-based capital (RBC) model promulgated by the NAIC. For reference, an RBC ratio of less than 200% triggers various levels of regulatory action; if the ratio is more than 200%, no regulatory action ensues (barring an exceptional situation). The graph,

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"RBC Ratio," shows that capitalization levels (as measured by the RBC ratio) were in steady decline during the latest medical malpractice crisis beginning in 2001, and hit a ten-year low point in 2003. With the rebound in operating results, companies have restored the capital levels they had prior to the crisis— both necessary and prudent, given the volatility in this market, as demonstrated in the historical swings in underwriting as well as investment results.

Conclusion and Forecast

In last year's "Conclusion and Forecast" section, we noted the significant improvement in the overall financial health of the industry and suggested that 2006 would be a continuation of that trend, despite the slowdown in rate increases and the long-term cost pressures that persist. One year later, we believe that these comments remain relevant for 2007. We also noted last year that this favorable outlook is somewhat precarious due to the historical volatility that has plagued the industry over the past several decades, which also remains relevant today. Thus, while the improvement in the industry's overall financial position is partly a reflection of the brighter side of the market's volatility, we believe it provides the industry with the requisite financial means to absorb the darker side of this market's volatility if—or rather, when—it returns.

PIAA

For related information, see www.milliman.com

1. U.S. Department of Health and Human Services, Health Resources and Services Administration, Bureau of Health Professions, Office of Workforce Evaluation and Quality Assurance, Practitioner Data Banks Branch.

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