

Industry Update

State of the Industry: Tilting Away from Further Improvement

In closing last year's "State of the Industry" update, we posed the question, "Is this as good as it gets?" With the benefit of one additional year of information, it appears that the answer may be, probably so. With all the chaos that has unfolded in the broader economy, we should step back and appreciate that 2008 reflected record underwriting results for the PIAA member composite—though offset, to some degree, by fallout from the impairment in the financial markets. Further, the industry has maintained its strong capitalization levels, but we should caution that the level of enterprise risk, uncertainty, and challenges has increased markedly within the past year, beyond what was already prevalent in this marketplace.

After reviewing the following financial results, information, and accompanying narrative, we believe you will conclude that things could be much worse, and not much better, as we move into the next phase of the market cycle, which we would characterize as "uncharted."

In trying to gauge the future pattern of financial results, we assessed the current status of the underwriting cycle and concluded that, while it is

difficult to determine with any degree of certainty, there seem to be more ways in which the results could deteriorate than there are avenues for further improve-

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ment. As actuaries, part of our analysis was to search the past for the answers about the present and future. We found that the launching point for the future (i.e., 2009 and beyond) may resemble the period as of either 1999 or 1989, and that the differences in the subsequent results are very dramatic.

The year 1999 represented the end of a golden era and the beginning of the slide into a third crisis for the medical professional liability (MPL) segment. On the other hand, 1989 was the beginning of that golden era, and entailed the building up of surplus, which was at least partially driven by a marked reduction in reported claims frequency and a moderately stable claim-severity environment. Since we are dealing with two extreme outcomes, it is likely that the future will lie somewhere in the middle, but it seems fair to say that the

chances that we are headed into a golden era are somewhat remote.

One piece of encouraging news is mentioned in this edition of the "Highlights and Insights" column: a cautiously optimistic theory on future patterns in claims frequency. Sticking with positive events, we note that the PIAA member companies have once again been able to share good financial fortune with their insured doctors and have distributed more than \$200 million in policyholder dividends

during 2008 and more than \$450 million during the past two years.

This text, and the figures that follow, reflects our analysis of a 49-specialty carrier compilation of year-end financial statements provided by National Underwriter Insurance Data Services from Highline Data.

Of additional note, the AIG situation



(as it stands at the time of writing this) represents a large area of uncertainty with respect to the threat of competition, given the significant market share, and material amount, of MPL business written in nearly every jurisdiction. It seems that there might be added pressure on AIG to retain its property and casualty, including MPL, business, in the face of difficult negotiating circumstances created by the negative press. This would perhaps result in downward pressure on renewal quotes and possibly impact the market cycle. An unlikely and pessimistic scenario would be a failure of AIG, resulting in an enormous capacity void, on the order of that last experienced when St. Paul exited the MPL market in 2001.

As in past articles on the industry's aggregate financial results, we have compiled various financial metrics for the industry in terms of its:

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

Top-line premium growth

Following a fairly sizable reduction in direct written premium last year, the 2008 results showed a continued decline in top-line premium writings, as displayed in Figure 1. On-going competition, along with modest rate reductions and increased utilization of schedule credits, resulted in an approximate 5.5% decrease in the composite's direct written premium during 2008. This 5.5% reduction in direct written premium for 2008, coupled with the 2007 reduction of approximately 6.0%, has resulted in almost \$600 million of reduced revenue over this two-year period for our composite.

In terms of the industry's longer-term trends, we believe this approximate 11% reduction in direct written premium is the largest two-year reduction in the industry's history, at least dating back to 1979, which is as far back as we have statistics on the MPL business. In fact, based on data from the A.M. Best Company, there have been only two other times since 1979 that the industry experienced two consecutive years of reduced

Figure 1 Direct Written MPL Premium (\$Billions)

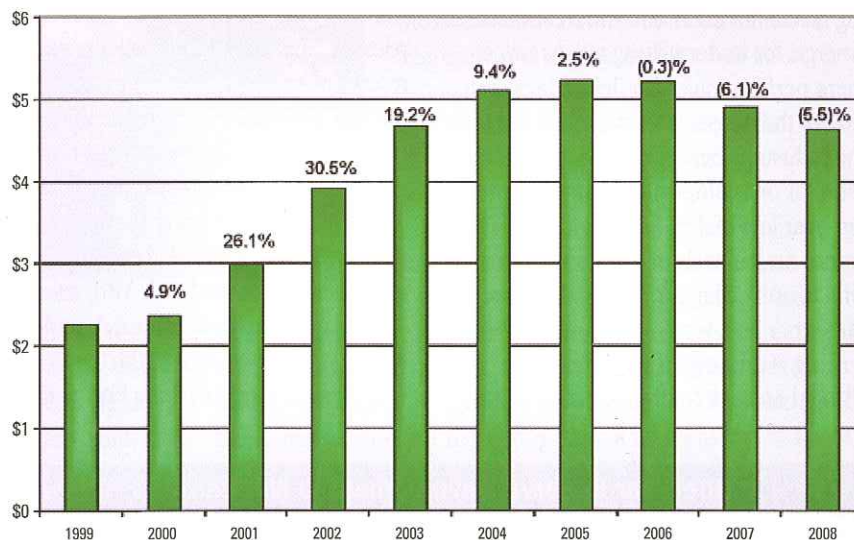
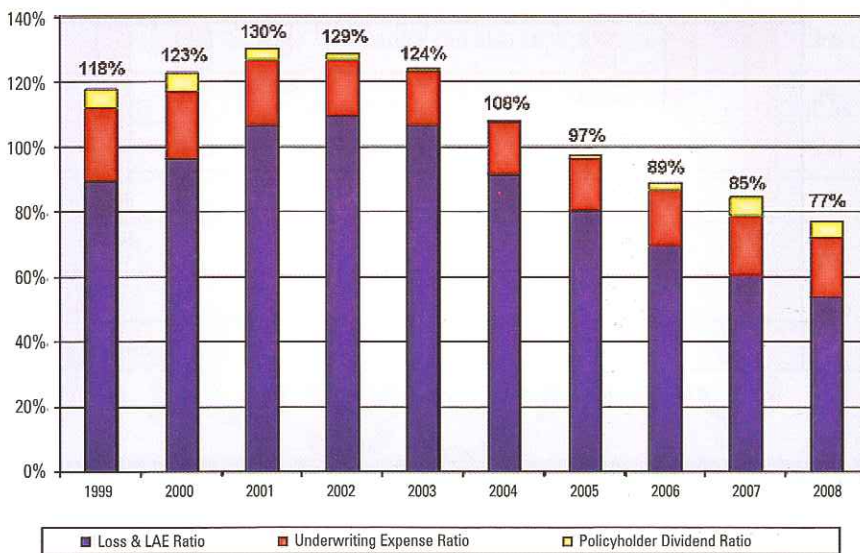


Figure 2 Combined Ratio



direct premiums: 1990 to 1991 and 1996 to 1997. Both of these prior periods showed a much smaller decline in direct premium than the most recent two years, with the cumulative change being approximately -7.5% over the 1990 to 1991 period and -2.5% over the 1996 to 1997 period. One difference between the current market and those of the prior two periods is that the underwriting results have continued to improve during a time of declining top-line revenue, whereas during the prior two periods, the underwriting results deteriorated with the

reductions to the top line.

We believe that the primary reason underwriting results have not deteriorated in concert with the reductions in direct written premium is the unexpected improvement in claims frequency that began around the middle of this decade. While the reasons underlying this phenomenon have been debated in this magazine and in other publications, what is no longer up for debate is the fact that the improvement occurred, and we believe it is one of the primary catalysts for the industry's underwriting results of late.

Operating results

When addressing the composite's operating results for 2008, two different pictures emerge, for underwriting versus investment performance. On the underwriting side of the house, 2008 may turn out to be the industry's best ever, with a combined ratio for our composite coming in at a ten-year low of 77% (see Figure 2). This comes on the heels of the results for 2007, which, until this year, was perhaps the industry's best year ever, from an underwriting standpoint (our composite showed an 85% combined ratio for 2007).

A key contributor to each of the last two years combined-ratio results came from the industry's prior year reserve releases. Specifically, the 2008 one-year reserve release relative to net earned premium was 28%, which, as a matter of context, represents our composite's largest reserve release over the last ten-year period. Figure 3 presents this metric over the past ten years and illustrates the volatility and importance associated with MPL reserves.

As good as the composite's underwriting results were for 2008, the investment results were anything but, as the

industry was not immune from the effects of the turmoil in the broader economy and financial community. Other than temporary impairments, realized losses on stock sales, corporate bond defaults, and devaluations, along with unrealized losses were, unfortunately, all too common this year. The investment gain ratio, defined as net investment income plus realized capital gains/losses relative to net earned premium, which has been in the 20% to 25% range since the early part of the decade, fell to 9% for 2008. The 12-point decline in this ratio from 2007 was driven by the largest amount of realized losses recorded by the composite (more than \$500 million) during the past ten years and, most likely, since the inception of these companies.

Figure 4 displays the operating results of the composite over the past ten years, whereby we have decomposed the investment gain ratio into its components, as described above. Of note is a new section for this year (in yellow), which depicts the composite's realized losses. Even with the poor investment results in 2008, the composite posted a very strong pre-tax operating ratio for the year, coming in at 68%, just slightly off from the impressive 2007 results, which reflect a 63% pre-tax operating ratio.

Figure 3 One-Year Reserve Development to Net Earned Premium

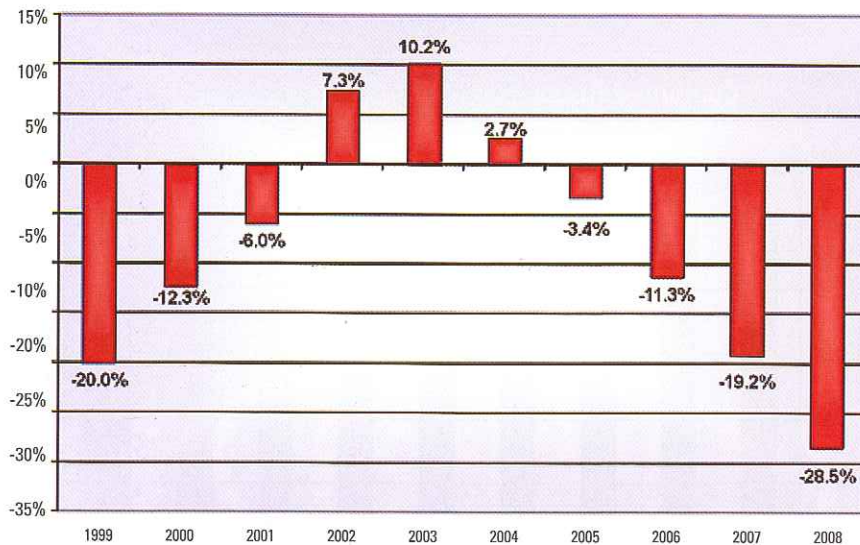
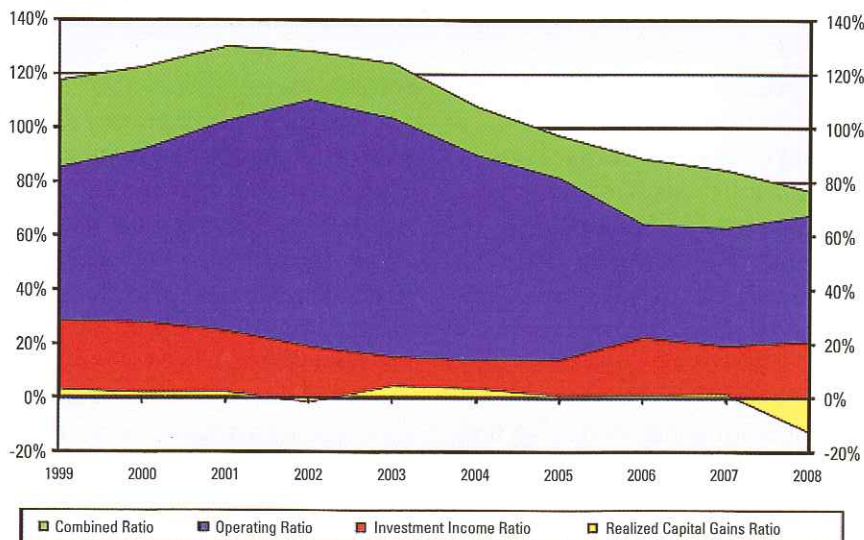


Figure 4 Operating Results



Capitalization levels

The composite's operating results translated into only modest gains in surplus levels due, in large part, to the impact of unrealized losses, stockholder dividends, and reductions in the amount of net deferred tax assets. In general, there has been a trend toward greater surplus movements, attributable to items other than retained earnings, in the recent past. After several years of double-digit surplus growth, the composite's surplus level increased by approximately 2%, ending the year at \$7.9 billion (Figure 5).

To put this surplus level into context, we reference the National Association of Insurance Commissioners' risk-based capital (RBC) metric, which provides a comparison of a company's actual surplus levels relative to the minimum amount of cap-

ital needed from a regulatory standpoint. Figure 6 presents this ratio, over the past ten years, for our composite, and it reflects the sizable increases in surplus over the past several years. Given the demonstrated volatility in this line of business, from both the historical underwriting results and, more recently, the investment results, we believe the additional amount of surplus, and strengthened RBC ratio, is essential as the industry attempts to manage its future risks.

Conclusion and forecast

Prior "Conclusion and forecast" sections have all reflected the very favorable conditions within this sector, and have gradually shifted toward a search for the tipping point (i.e., from last year: "Is this as good as it gets?"). In light of the magnitude of the reserve releases in 2008, an unprecedented \$1.2 billion, it seems as if the future financial results of the industry are once again largely pinned on the adequacy of the reserve position. In fact, the 2008 net income for the composite was \$900 million; thus, without the significant reserve releases, the net income would have been approximately negative \$300 million, roughly speaking. In 2007, this situation was a mirror image, as the net income was \$1.2 billion and reflected reserve releases of \$900 million. This sort of analysis provides insight into the underwriting and operating results on a coverage-year rather than calendar-year basis, which enhances our ability to forecast the future. Further, it illustrates our conclusion that reserve adequacy is a critical area to monitor in gauging the projected underwriting cycle.

Another critical area to watch, which is uncharacteristic for this industry, resides in future prospects for investment results. Beyond the uneasiness created by the macroeconomic turmoil, there is negative pressure on both components of the investment gain ratio, investment income, and realized capital gains/losses. With yields at all-time lows, the outlook for improvement in investment income does not appear positive. For reference, Figure 7 displays the historical 3-year U.S. Treasury

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Figure 5 Policyholder Surplus (\$Billions)

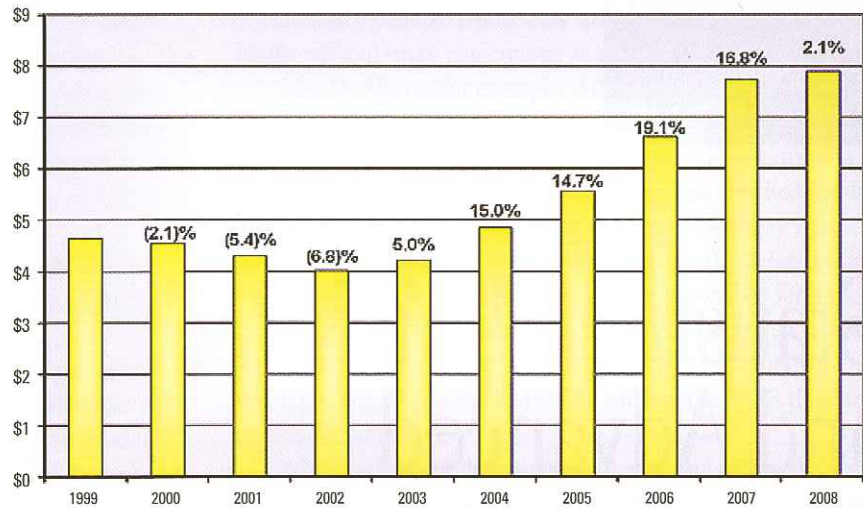


Figure 6 RBC Ratio

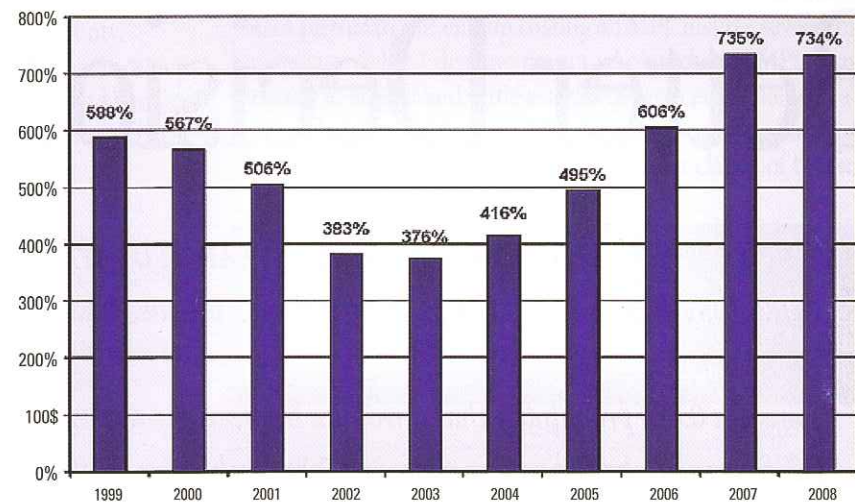
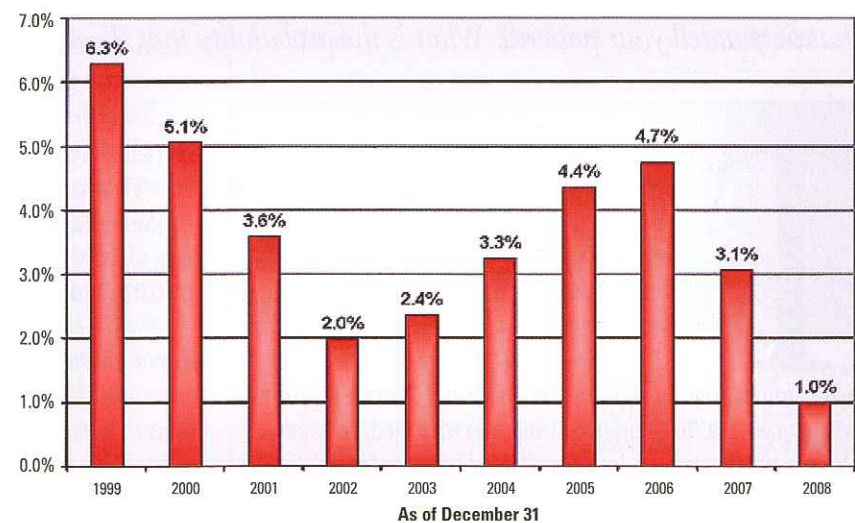


Figure 7 3-Year Treasury Yield Curve Rates



and material. It is important to peruse carefully the laws in all of the states where your company does business. Also, even if you do business in only one state, the benchmark established by the law could change from one examination to another.

So it is best to ascertain, before each examination period, that your company is compiling and retaining the appropriate records and documentation, as will be required for the coming year's audit.

Key takeaways

The new MAR impacts every insurer that:

- Is a non-public, standalone entity
- Is an insurance company, captive insurance company, or nonprofit insurer
- Files an annual statement with its state domiciliary state regulator.

The regulation is intended to strengthen the states' capability for surveillance over insurers' financial health, in three respects: (1) management reporting on internal control over financial reporting (ICFR); (2) the independence of the auditors, and the scope of the services they provide; and (3) enhancements to the requirements for the independence of the audit committee members.

Companies that fully understand the rationale behind the new MAR, as well as the particular requirements that are stipulated by it, will have a more straightforward path to compliance with this complex regulation.

PIAA initiative

To assist its member companies in gaining a broad overview of what is entailed

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yields as of successive December 31 dates. Further, the current investment dynamics make it somewhat difficult to envision that a material realized capital gain will find its way to the income statement, although we note that 2008 was very successful despite the need to absorb more than \$500 million in realized capital losses.

In making a forecast for the future, the only thing we can say with certainty is that 2009 will reveal important indicators as to future financial results. We believe there will be greater clarity with regard to claims frequency, reserve adequacy, and investments, which will help in charting the future course. With the forces at play skewed more toward deterioration than further improvement, it would suggest, on a statistical basis, that the industry may be reaching, or have reached, the tipping point. **PIAA**

in compliance with the new MAR, as well as a detailed grasp of the full roster of its requirements, the PIAA, through its Regulatory Affairs Committee, has prepared the checklist that follows here.

A pdf file of the checklist can be found on the PIAA website, www.piaa.us. Special thanks to Bob Boren for his work on this project.

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Think Beyond Plan B.

If you can anticipate the possibilities, you can prepare to manage them. That's why today's Enterprise Risk Management (ERM) considers multiple scenarios, giving companies the opportunity to prepare multiple contingency plans. But it's no easy endeavor. It requires advanced risk modeling technologies and a practiced use of ERM strategies and applications—not to mention the ability to optimize data quality and pinpoint correlated risks.

Daunted? Don't be.

Guy Carpenter's team of ERM specialists have literally written the book on ERM. *Enterprise Risk Analysis for Property & Liability Insurance Companies* is a practical guide that equips you with the latest strategies and applications in ERM from leading specialists in the field. This book addresses models and management frameworks as well as hazard, financial, operational, and strategic risks.

With this essential reference book, ERM strategies can be made manageable so that even Plans C, D, and E can be readily at hand.

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