



HALFTIME UPDATE: MID-YEAR 2011 RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

by **Charles W. Mitchell, FCAS, MAAA**
Brad J. Parker, ACAS, MAAA

Ongoing developments in the medical professional liability (MPL) market call for close monitoring of emerging industry financials. Based on available results for MPL specialty writers during the first half of 2011, it appears that recent trends will persist. Premium volume continues to drift downward, and coverage-year combined ratios continue to creep upward as softer rate levels impact underwriting results. Further, lower bond yields are reflected in lower investment income. It appears as though investment income will continue to decline as recent treasury yields have reached new lows, despite the recent downgrade of U.S. debt by Standard & Poor's. Nonetheless, favorable reserve development persists, supporting strong calendar-year results.

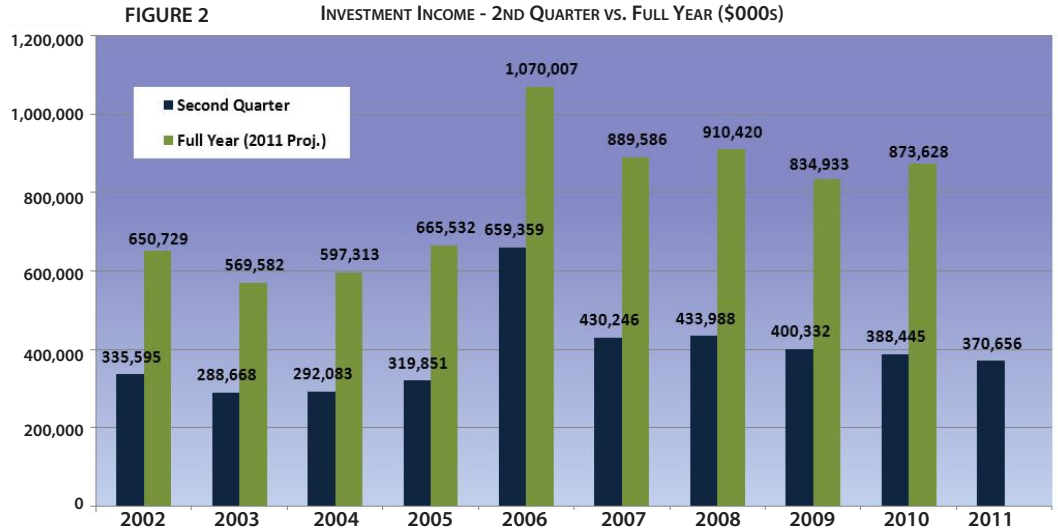
Based on data compiled by National Underwriter Insurance Data Services from Highline Data, we examined the collective financial results of a group of insurers specializing in MPL coverage with direct written premium amounting to almost \$4.4 billion in 2010. Specifically, we considered the historical relationship between first-half and full-year financial results together with our view of current market trends to project what the year-to-date 2011 results might imply about the market.

DECLINING PREMIUM AND INVESTMENT INCOME PRESSURE RESULTS

Aggregate direct written premium for this composite of MPL specialty writers has declined steadily from its 2005 peak of \$5.3 billion to \$4.3 billion in 2010. Six months into 2011, this trend appears to continue with direct written premium down almost 6 percent from

the same point in 2010 (See Figure 1). By the end of 2011, we expect premium volume for this composite to total just under \$4.1 billion or 23-percent below its high point in 2005.

Operating results are hit from both sides as soft rate levels pres-



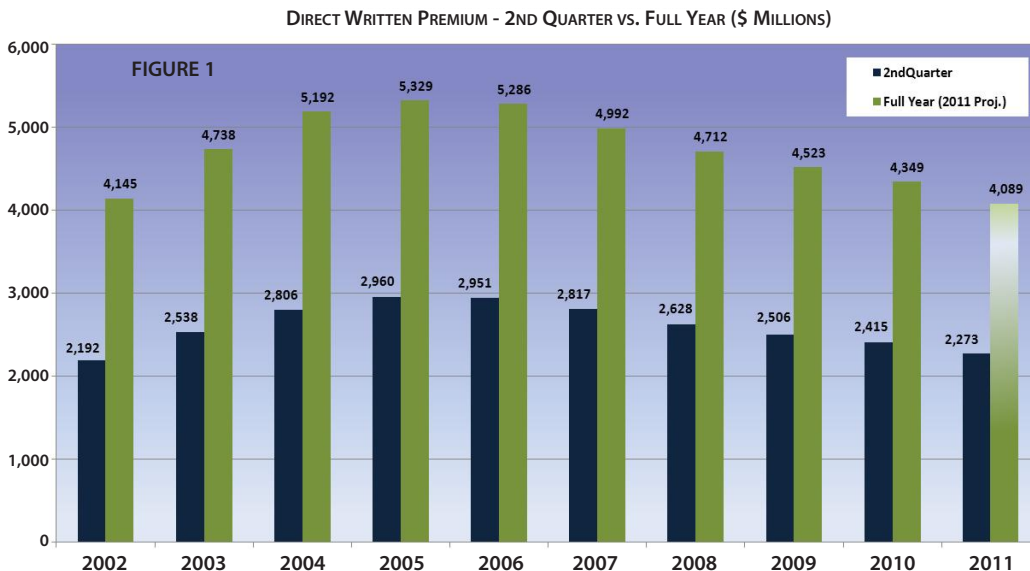
sure underwriting results and declining treasury yields hinder investment returns. Investment income continues its recent slide with a first-half 2011 level of \$372 million, down more than 4 percent from \$388 million at mid-year 2010 (See Figure 2).

Looking forward, we expect that these insurers will continue to see lower investment income yields. Despite the downgrade of U.S. debt by Standard and Poor's, U.S. treasuries have continued to rally, driving the five-year treasury yield below 1 percent (See Figure 3 on page 7).

FAVORABLE RESERVE RUN-OFF BOOSTS CALENDAR YEAR RESULTS

In recent years, reserve releases from prior coverage years have buoyed calendar-year operating results for MPL carriers and have effectively offset the deteriorating underwriting and investment performance. With six months from which to base a conclusion, this trend also appears to persist into 2011.

Figure 4 (see page 7) compares the collective first-half to full-year reserve change on prior coverage by the composite. Projecting full-year reserve development from mid-year results can prove treacherous since most reserve adjustments are made at year-end. However, second-quarter reserve development has historically provided a fairly accurate prediction of the direction, if not the magnitude, of the reserve development for the entire year. While less than last year, favorable



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reserve development through the second quarter of 2011 suggests we could still see upwards of \$1 billion in favorable reserve development again this year.

CALENDAR YEAR VS. COVERAGE YEAR PERFORMANCE

A comparison of calendar-year versus coverage-year operating results illustrates the impact of the favorable reserve development stemming from prior coverage years. Using booked Schedule P net loss and loss adjustment expense development to project coverage-year margins, Figure 5 contrasts calendar-year and coverage-year operating margins. The chart demonstrates that a lag exists between the calendar-year and coverage-year results.

As coverage-year experience improved between 2002 and 2006, the industry was reluctant to fully believe that the declining claim frequency was sustainable. In hindsight, claim reserves were not reduced as aggressively as they could have been in order to reflect the full improvement of claim costs.

In retrospect, this created a build-up in reserve redundancies for these insurers and caused their calendar-year margins to fall below their coverage-year margins. In more recent years, the opposite is true. Coverage-year margins are decreasing for reasons previously discussed. Calendar-year margins have surpassed the coverage-year margins as insurers run-off the reserve redundancies. Notwithstanding, few insurers would disapprove of a 19-percent coverage-year operating margin in this economy given the long-term performance of this market.

The profitability seen in this market for almost a decade has translated into sustained dividend growth, and this growth continues in 2011. Policyholder dividends declared for this composite are up more than 8 percent over the past 12 months, increasing from \$91.8 million as of June 30, 2010, to \$99.5 million as of June 30, 2011. This would extrapolate to a policyholder dividend of nearly \$300 million for the full-year 2011, which would imply a policyholder dividend ratio to net earned premium of 7.5 percent versus a ratio of 6.7 percent in 2010.

Charles Mitchell is a consulting actuary, and Brad Parker an associate actuary, at Milliman Inc., an independent actuarial and consulting firm.

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

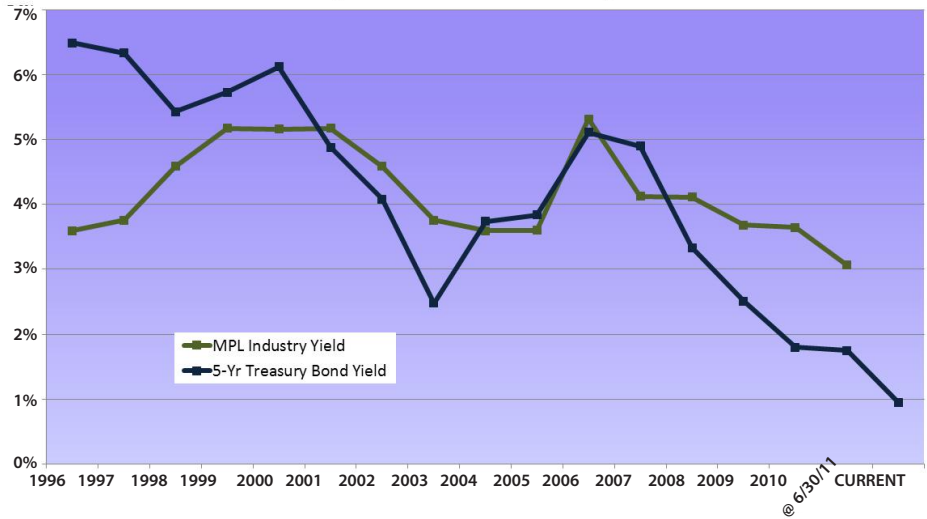


FIGURE 4 CUMULATIVE RESERVE DEVELOPMENT BY QUARTER (\$000s)

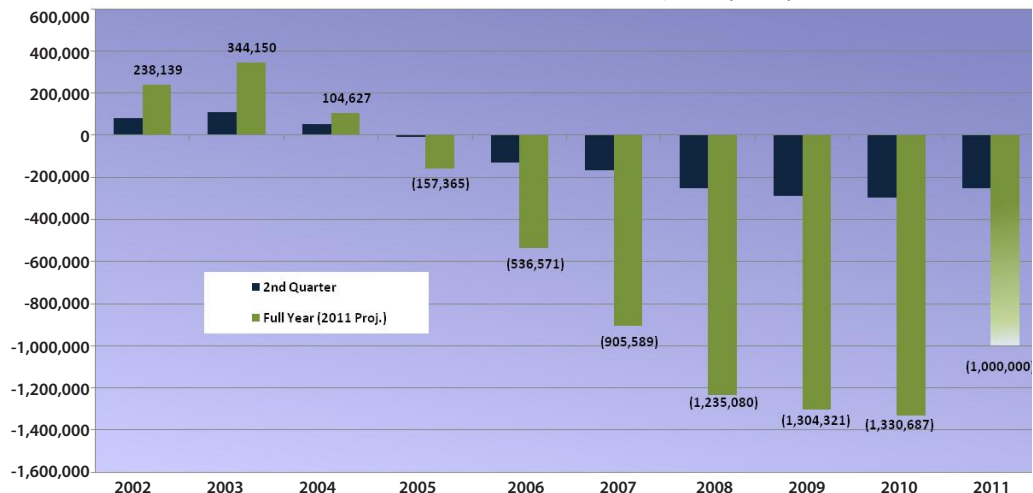


FIGURE 5 POLICYHOLDER DIVIDENDS/NET EARNED PREMIUM

