ROUNDING THIRD & HEADING FOR HOME: THIRD QUARTER RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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As medical professional liability (MPL) insurers enter the home stretch for 2010, there is little doubt, financially speaking, that they will enjoy yet another good year. But two questions remain: "How good will the final 2010 results be?" and "How long will these profitable results last?" As we continue to monitor quarterly financial data for medical professional liability (MPL) specialty writers during 2010, we attempt to uncover answers to these questions.

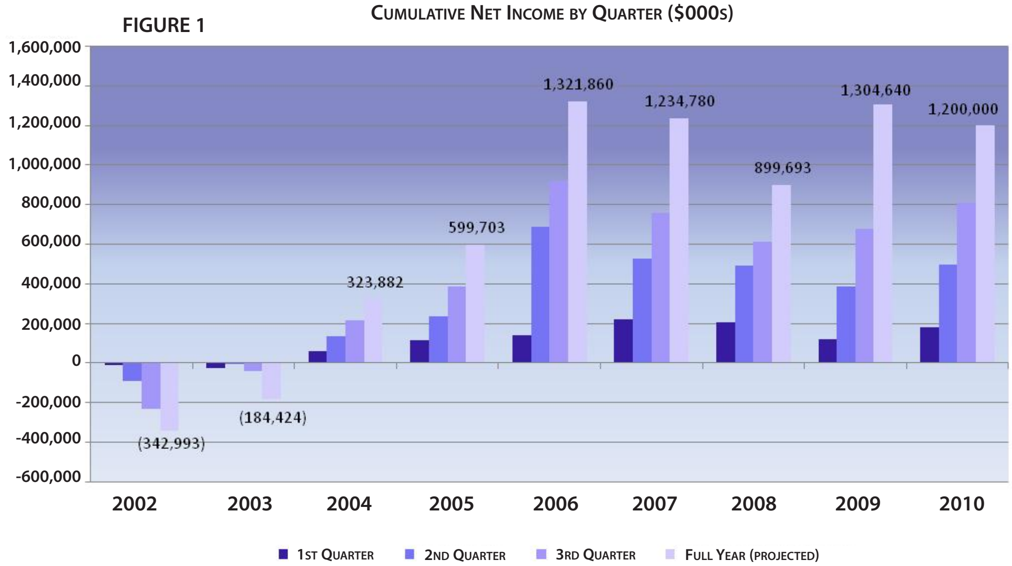
Based on data compiled by National Underwriter Insurance Data Services from Highline Data, we examine the collective financial results of a group of insurers specializing in MPL coverage with direct written premium totaling more than $4.4 billion in 2009. Specifically, we consider the historical relationship between quarterly and full-year financial results for this composite together with our view of current market trends to project what the year-to-date 2010 results might imply about the full year.

Net Income Projection

As shown in Figure 1, MPL specialty writers—as a whole—are on target for another profitable year in 2010. Favorable reserve development, expected to again exceed $1 billion for this composite in 2010, continues to be the greatest driver of this calendar year profitability. Further, an increase in realized capital gains, as we present below, is helping to offset a reduction in fixed investment income and prop up the already auspicious results.

FIGURE 1

Cumulative Net Income by Quarter ($000s)

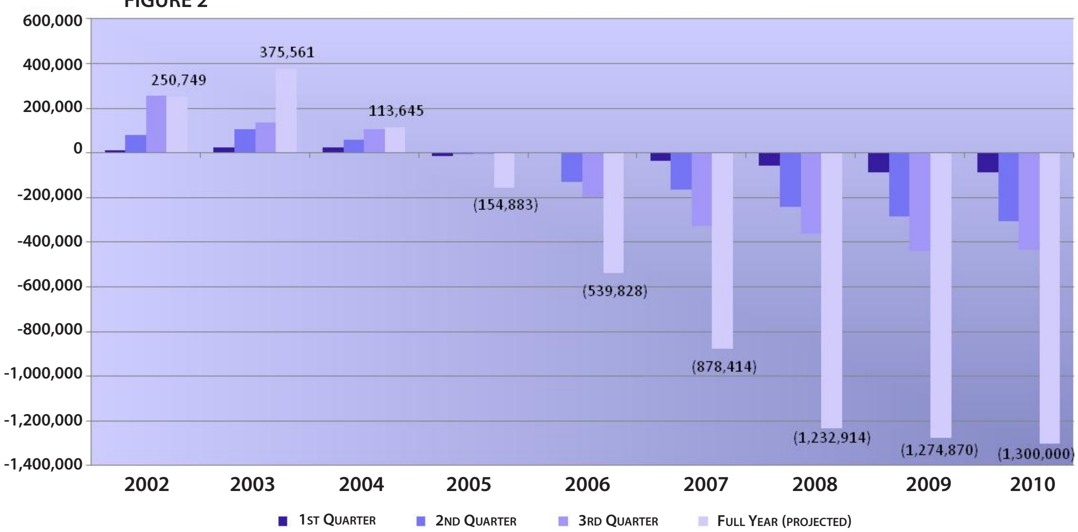


Reserve Run-Off

Comparing quarterly reserve changes in prior coverage years, Figure 2 illustrates that 2010 continues to slightly outpace 2008 and 2009.

FIGURE 2

One-Year Reserve Development by Quarter ($000s)



Knowing that the lion's share of prior-year reserve adjustments are implemented during the fourth quarter makes the full-year reserve change difficult to predict, however, the historical relationship between quarterly and full year results has been consistent.

Calendar Year vs. Coverage Year

As shown in Figure 3, located on page seven, composite results for MPL writers, buoyed by favorable prior-year reserve runoff, are headed for a seventh consecutive profitable calendar year. Coverage year results are also projected to produce an operating profit in 2010. However, removing the impact of favorable reserve developments shows recent coverage year results pale in comparison to calendar year results.

Investment Income & Realized Capital Gains

Figure 4, also on page seven, displays the annual investment gain (investment income plus net realized capital gains) for the composite since 2002. Investment income has trended downward since 2006 as a result of lower investment yields. However, in the last couple of years, the decline in investment income has been offset by realized capital gains.

Going forward, it may be more difficult to rely on capital gains to offset lower

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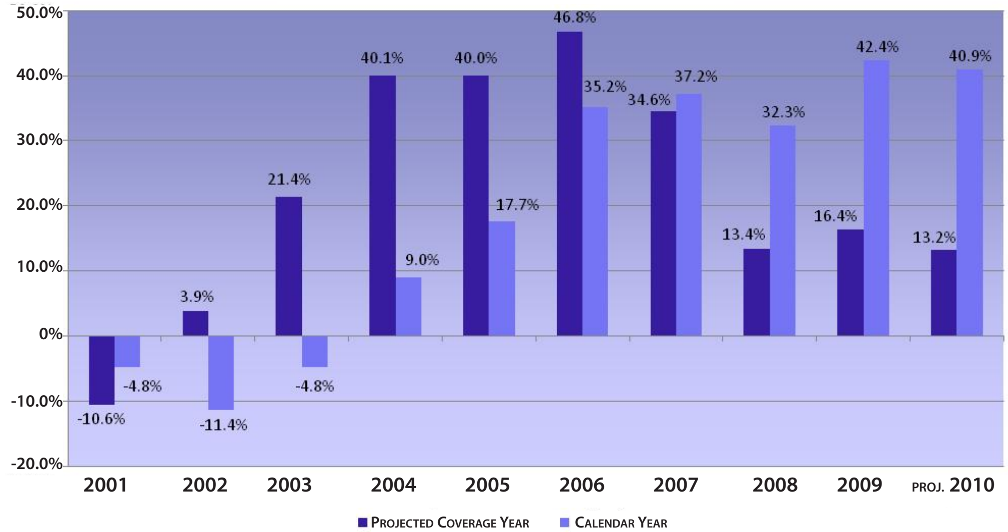
investment yields. As such, insurers will need to continue to adjust to lower investment returns and increase their focus on underwriting. As a note, our projected 2010 investment gain shown in Figure 4 reflects actual capital gains realized through the third quarter, since it would be challenging to predict fourth quarter market movements or capital management strategies.

FIGURE 3

Coverage Year vs Calendar Year Operating Margin

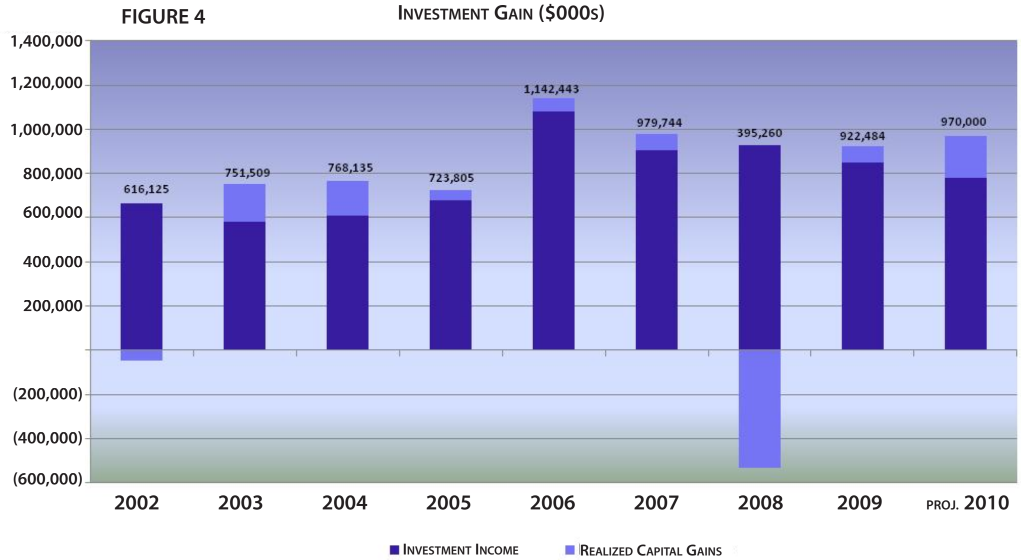


Controlling Expenses

In response to soft market conditions, we would expect companies to be focused on controlling underwriting expenses. The results over the last five years appear to support this expectation as nominal underwriting expenses have been fairly flat, as illustrated in Figure 5. However, the flat underwriting expenses relative to the lower premium volume does put some added pressure on the combined ratio for this composite.

FIGURE 4

Investment Gain ($000s)



In Conclusion

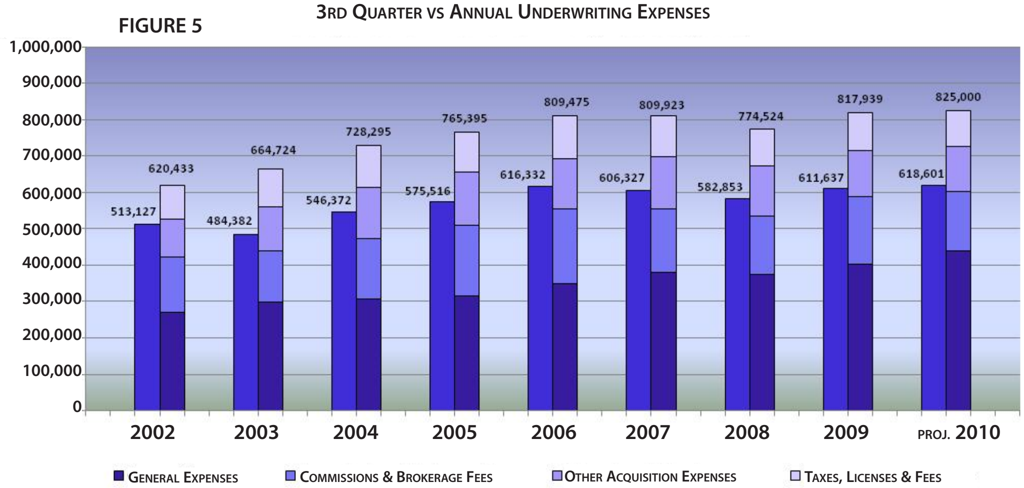
It seems a safe bet at this point to predict that 2010 will produce net income on par with the exceptional results of the previous three years.

Looking forward, we expect to see calendar-year results move in the direction of coverage-year results as reserve redundancies are recognized and exhausted.

Further, there are significant risks that could cause results to deteriorate beyond the impact of exhausting reserve redundancies. In addition to declining investment income and an increasing underwriting expense ratio, there are a number of other risks applying pressure to future profitability. First, signs suggest that the decline in claim frequency over the last several years, a decline that ultimately led to the exceptional profitability of late, may be reversing its trend. Moreover, there is an increasing risk of inflationary pressures on both general and medical loss costs. Together with soft rate levels, these threats lend evidence to what may be a slow painful end to the sizable profits enjoyed by the MPL industry in recent years.

FIGURE 5

3rd Quarter vs Annual Underwriting Expenses



Note: Underwriting expenses as of 3rd Quarter are not available by expense type

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