

Industry Update

State of the Industry: Survival of the Fit

In last year's "Industry Update," we suggested that the good times might be nearing an end, and that the forces were beginning to tilt away from further improvement. While that may be true when one focuses on the underlying fundamentals, it certainly was not the case when one simply reviews the 2009 calendar year financial results. As actuaries, we have requisitely grown accustomed to revising forecasts and exploring the causes for different interpretations. Ironically, the principal driver of the better than anticipated financial results in 2009 was the industry's collective revision of prior years' loss reserve estimates for PIAA member companies. While we had contemplated the reasonable potential for investment results to rebound back to "normal" levels, we did not anticipate the additional \$1.3 billion of favorable loss reserve development during 2009, though we did acknowledge the possibility. In fact, the stellar financial results during 2009, which included operating income of \$1.8 billion, can be accounted for within these two items. One comment made last year that did ring true, and will continue to be valid going forward, is the vital importance that the loss reserve position plays in future financial results for this industry.

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As evidence for this, one can perform a review of the impact that reserve development has had on the combined ratio for the medical professional liability (MPL) industry during the past 30 years. Most recently, over the past three years, reserve releases have yielded nearly \$3.5 billion in benefit, and they have had an average impact of 25 points per year on the PIAA composite combined ratio. If one were to unwind the impact of reserve development on the financial results during the past ten years (i.e., initial estimates for current coverage year), it would illustrate the effect of the marked rate increases that were implemented during the period, 2000 through 2004, followed by the gradual recognition

of the dramatic, though unanticipated, improvement in reported claims frequency, beginning around the time of the year-end 2005 financial statements.

Another driver of the reserve releases has been the severity trend for claims with an indemnity payment, which has proved to be more moderate than had been forecasted. This statement seems to make logical sense, particularly on the heels of the claim severity challenges that surrounded the previous MPL crisis at the

beginning of this decade. With actuarial trend assumptions integrating the claims experience during that turbulent period, it seems plausible to conclude that a relatively moderated claim severity environment in subsequent years would result in favorable loss reserve development. While we have not verified this theory in a quantitative fashion, our knowledge of the dynamics of the loss reserving process, along with our general perception of industry MPL historical claims experience, leads us to



conclude that this factor would be a likely contributor. Finally, we point to future claims frequency and severity trends as key to our collective financial futures, and promote the broad pursuit of advancement in these areas.

Another subject that has received much attention in the past couple of years is the status and consequences of the current market cycle. It would seem difficult to refute the assumption that the overall level of competition, based on price and/or coverage terms, has increased over the past couple years, and that the average premiums have declined. On the surface, it would appear that the term "soft market" would be perfectly applicable for describing the current status of the market cycle. However, we believe that a soft market cycle also typically connotes underwriting standards that do not match pricing targets. A review of the current coverage-year underwriting results indicates that PIAA member companies, in


composite, are booking in the vicinity of their likely pricing targets. Finally, the continuation of capital improvement suggests that the industry is not paying the price for soft-market types of behavior—at least not yet.

Perhaps the best indicator of the status of the market cycle comes from an analysis of the recent reductions in written premium, and an assessment of the portion attributable to actual reductions in loss costs, versus competitive pressure (i.e., assessing rate adequacy). As an aside, it is worth noting that, based on the operating principles of the vast majority of PIAA companies, it is considered desirable to reduce the costs paid by insureds in response to an improvement in the loss cost environment; and this philosophy is exemplified by the significant policyholder dividends issued over the past several years (nearly \$800 million returned between 2006 and 2009), during which the PIAA composite expe-

rienced unexpectedly favorable results. While this sort of assessment is rather straightforward at the individual-company level, it is virtually impossible at the industry level. As such, it makes sense that there would be debate and uncertainty regarding the current characterization of the market cycle. Furthermore, it makes little sense to dismiss the threat of the increased competition as an idle concern that companies can deal with at some later time. Given the increasing levels of sophistication in data processing and analytics, it would not take too much effort for a competitor with less detailed information to be at a disadvantage, and thereby be exposed to adverse selection, with resulting erosion in its underwriting performance.

A final subject that is necessary to mention is the potential ramifications of healthcare reform on the MPL insurance industry. At the time of this writing, it is

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unclear as to the final repercussions of the legislation, let alone the direction and magnitude of its possible impact on the MPL claims process. Nonetheless, it is important to follow this, because anything that materially changes the delivery and consumption of healthcare could easily disrupt the already volatile MPL loss cost environment.

The source for the data and figures that follow, as reflected in our analysis, is a compilation of 49 MPL specialty carriers' successive year-end financial statements, provided by National Underwriter Insurance Data Services from Highline Data. As has been the case in our previous updates 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

This past year marked the third straight year of mid-single-digit reductions in direct written MPL premium for the industry (Figure 1). Since 2005, the industry's direct written premium has fallen approximately \$800 million cumulatively—slightly more than 15%. While a total decrease of \$800 million in top-line revenue is certainly significant, and in fact, this is the largest decline ever experienced by the industry both in terms of dollars as well as on a percentage basis; it is worth noting that during the period 2001 through 2004, the average annual increase in direct written MPL premium was nearly \$700 million.

Many industry observers will point to these more recent premium numbers and conclude that this

industry is in the midst of a soft market. To be sure, the average premium collected by the industry per unit of exposure has declined. As discussed above, there are a number of other considerations in assessing the market cycle than average premium levels. In addition, that metric alone does not adequately account for the other, more subtle, changes that typically take place during a soft or competitive market cycle, such as changes in a company's underwriting criteria or coverage features. The liberalization of coverage that often-times accompanies rate pressures, while more difficult to quantify, can also materially impact the future underwriting results.

Operating results

The industry posted its strongest operating results in a long time—and perhaps ever—during 2009. A combination of the industry's underwriting results holding fairly steady with last year, coupled with a return towards normalcy in the investment markets, yielded a sub-60% pre-tax operating ratio for 2009. Figures 2 and 3 display the historical underwriting and operating results, respectively.

A year ago, 2008, the industry recorded an all-time low for the combined ratio: 77%. While the 2009 results did not quite match those of 2008, the 3-point increase in the combined ratio, to 80%, was more than offset by the nearly 13-point improvement in the investment gain ratio. Together, these two impacts resulted in the 10-point improvement in the pre-tax

operating ratio of the composite. The 58% operating ratio for 2009 followed on the heels of the industry's preceding three-year average, 65%.

A significant contributor to the industry's underwriting results of late has been the favorable development of prior-year loss reserves. The 2009 results were buoyed by favorable reserve releases that

Figure 1 Direct Written MPL Premium (\$Billions)

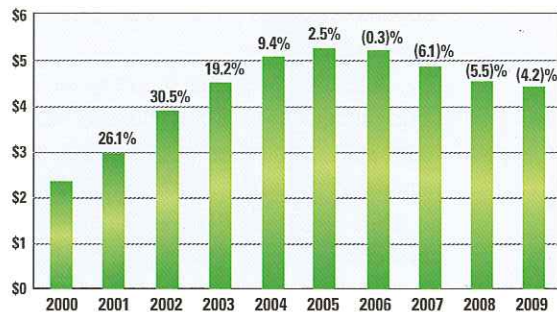
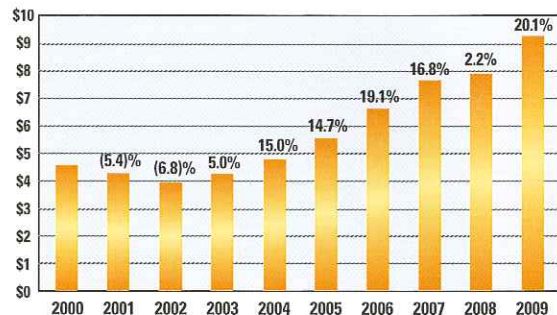


Figure 4 Policyholder Surplus (\$Billions)



equated to 30% of the industry's net earned premium. This 30-point impact on the operating results from favorable reserve run-off is the largest of the past ten years. In fact, one needs to go back to the three-year period, 1993 through 1995, to find the last time that the impact of prior-year reserve run-off exceeded 30% of net earned premium; in that period, it was more than 30% in each of these years.

With the last two years' worth of favorable reserve run-off having been realized, a natural question is, "What is the industry's reserve position now?" In its annual report, "Review and Preview," A.M. Best Company published its perception that the total MPL sector's reserve position is redundant, by \$2.8 billion. This \$2.8 billion figure translates to approximately 10% of the total industry's carried reserves at year-end 2009 (note: A.M. Best's total MPL sector includes many more companies than the 49 MPL specialty company composite that we reference throughout the remainder of this article—the 10% figure cited above accounts

STAY ALERT

Combined ratio, 2009: 80%

2009: Sizable gains in policyholder surplus

Figure 2 Combined Ratio

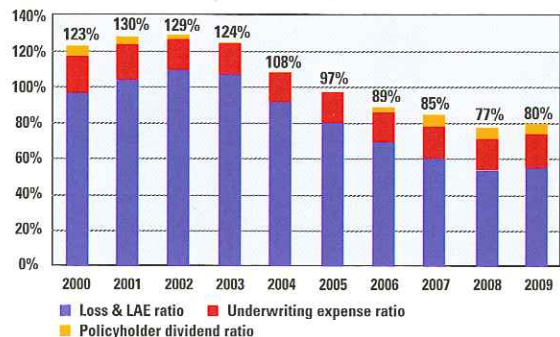


Figure 3 Operating Results

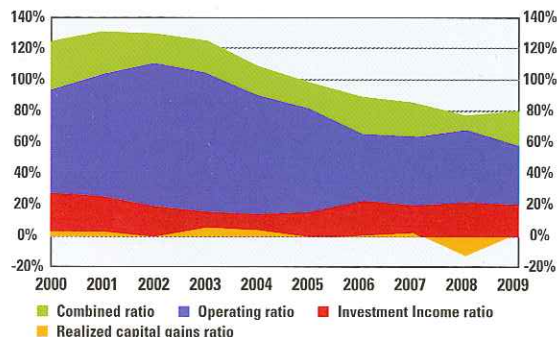
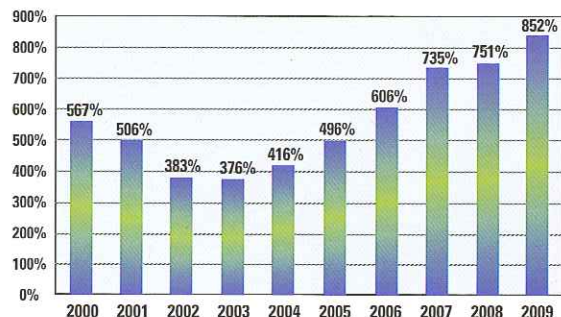


Figure 5 RBC Ratio



for these different composites).

Capitalization levels

The industry's strong operating results in 2009 translated into very sizable gains in its policyholder surplus for the year (Figure 4). The 20% change in surplus for 2009 represented the largest one-year gain for the decade. This \$1.6 billion surplus increase was driven by the year's retained earnings, along with recoveries in the investment portfolio from a year earlier, and leaves the composite's year-end 2009 surplus at \$9.5 billion.

To put this surplus level into context, we referenced the National Association of Insurance Commissioners' risk-based capital (RBC) metric, which provides a comparison of a company's actual surplus level relative to the minimum amount of capital needed from a regulatory perspective. Figure 5 presents this ratio over the past ten years for the composite of 49 companies, and it reflects the sizeable increases in surplus since 2005. As the figure shows, the industry's year-end

2009 RBC ratio of 850% has more than doubled, as compared with earlier in this decade. Given the increased volatility in this sector's underwriting and investment results over the past ten years, the higher RBC ratio provides the industry with a needed buffer, should the future volatility prove to be adverse, instead of the favorable version experienced of late.

Conclusion and forecast

The several prior "Conclusion and Forecast" sections have all reflected the very favorable conditions that existed within this sector, and have gradually shifted toward a search for the inflection point in the cycle. In light of the magnitude of the reserve releases in 2009, an unprecedented \$1.3 billion, it seems as if the future financial results of the industry are once again largely pinned on the adequacy of the reserve position. Another critical item to monitor is rate-level adequacy, particularly during a period of declining premiums. As we noted earlier, this may arguably be the most instructive way to assess the evolving status of the market cycle. In looking ahead, we would envision a generally protracted but non-severe softened market, barring any significant events.

We would anticipate that natural

upward inflationary pressure in loss costs, coupled with general downward competitive pressure on rates, will have a negative impact on the upcoming coverage-year underwriting results. Finally, we foresee that the future direction of the market cycle will be impacted by the financial pressures facing the healthcare system and the restricted ability to absorb any increases in MPL costs. This dynamic could be exacerbated by the current capitalization levels of the industry and the possibility for any remaining reserve redundancies, which would allow companies to (possibly) forestall implementing indicated rate increases. Offsetting these items is the opportunity for improvements in the underwriting process via enhanced analytical capabilities (e.g., predictive modeling).

We believe that 2010 will further clarify trends with regard to claims frequency, reserve and rate level adequacy, and investments in forecasting the future course of the market. The increasing challenges and opportunities facing the industry would seem to produce a "survival of the fit" type of environment at present. This characterization is much preferable to a "survival of the fittest" market, which would imply a struggle for solvency; and we should be close enough to the last MPL crisis to realize that the corresponding discomfort can be a source of motivation to push beyond the tendency toward complacency, and, rather, take the initiative. 