Cover Story

By Richard Lord and Stephen Koca

Understanding the Market Cycle:

Profitability reigns—but for how long?

MEDICAL PROFESSIONAL LIABILITY (MPL) INSURERS ARE IN THE MIDST OF AN EXTENDED PERIOD OF PROFITABILITY. *The last decade began with a sharp increase in premium rates, and, as the decade wore on, claim frequency decreased sharply. At present, capital is ample, and the loss ratio has been near a record low for the past several years.*

While MPL has never been a line whose stability makes for easy actuarial forecasting, its market cycles do provide some signposts.

By nearly all accounts, the road to continued profitability seems to stretch out before insurers as far as the eye can see. Or it would, if not for the fact that written premiums have decreased for four consecutive years, and a portion of the industry's enviable results flow from a release of prior-year reserves. For the past five calendar years, prior report-year reserve releases have contributed increasingly to insurers' low loss ratios and profitability. With the industry's calendar-year loss ratio now at a record low, few have even hinted at a downturn. But the question still remains: for how long, and to what extent, can the industry rely on reserve releases to boost profitability?

Predicting the future has always been tricky business. But if we can understand how prior years' underwriting results, claim frequency and severity trends, pricing, and investment income affect current income, we may be able to glimpse the future. While MPL has never been a line whose stability makes for easy actuarial forecasting, its market cycles do provide some signposts that can be used to understand what may happen in the years ahead.

A historical precedent?

In fact, market conditions of the past decade in some ways resemble the underwriting cycle that began in the mid-1980s, when premiums increased more than 100% over a five-year period, and then held steady for several years. A similar pattern emerged at the turn of the century when premiums began to rise, eventually climbing more than 100% between 1998 and 2006. These patterns are illustrated graphically in Figure 1.

Since the rapid rise over the first half of the past decade, premiums have been declining, and favorable insurance terms, with significant underwriting premium credits that typically pervade a soft market, have

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dominated. This period has proven to be a time of improving loss experience for the industry. But uncertainty is an inherent part of long-tailed MPL losses, which take several years to approach their ultimate value.

When the ultimate value of policy year losses is less than the initial estimate, the reserves are ultimately released into surplus, where they are used to fund future growth or paid out in dividends. Conversely, when the ultimate value of policy year losses is greater than the initial estimate, the additional needed reserves must be funded out of a reduction in surplus, and, as a result, carrier income declines

During times of reserve strengthening, there is upward pressure on rates, as income is low and, conversely, during times when reserves prove to be excessive, there is downward pressure on rates. A comparison of the Figures 2 and 3 shows the periods associated with reserve increases match closely the periods of premium increases, and periods of reserve decreases coincide with periods of stable or moderately declining premium.

This was the case after the hard market cycle of the late 1980s when, after years of improving losses that followed steep premium increases, insurers began to release redundant loss reserves. In 1989 the MPL industry reduced reserves by approximately $1.5 billion. Reserve releases continued for many years, reaching a peak of $2.1 billion, or 46% of net earned premium, in 1994. In the end, reserves decreased for 11 consecutive years, through 1999, the point at which premiums began their rapid ascent, through 2005. These periods of reserve strengthening and releases, and the associated premium changes, give us insight into the current state, and near-future direction, of the market.

The 11-year draw down in reserves spanning the 1990s, however, was not without its consequences. By the beginning of this decade, the calendar-year loss and LAE ratio soared to more than 130%, and the combined ratio (loss and LAE ratio plus all other insurer expenses) soared to more than 150%. The combined ratio is one measure of insurer underwriting profit, in which case, 100% would be considered a break-even and a ratio above 100% would be considered a loss. The other component of insurer profitability is investment income.

But even investment income could not forestall the devastating impact of soaring losses and dwindling premiums, for just as conditions in the MPL marketplace converged against insurers, we had just entered what would prove to be an extended low-interest-rate environment. From 1998 through 2001, MPL insurers saw decreases in their investment income amid falling interest rates on bonds, which typically comprised approxi-

Figure 1 Historical MPL Net Earned Premiums

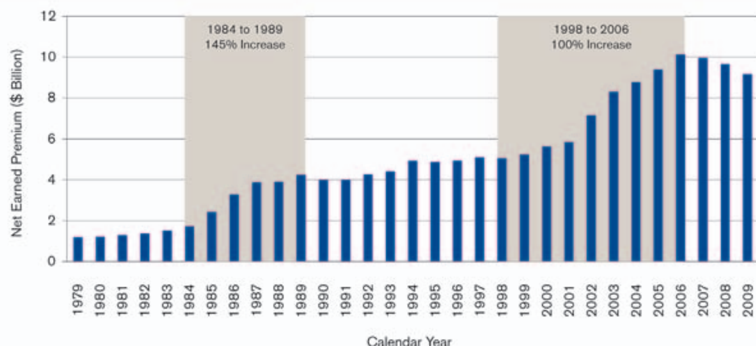


Figure 2 Historical MPL Reserve Changes as a Percentage of Net Earned Premiums

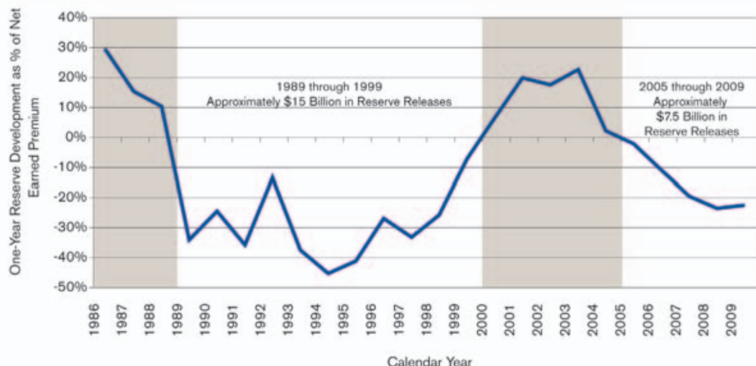
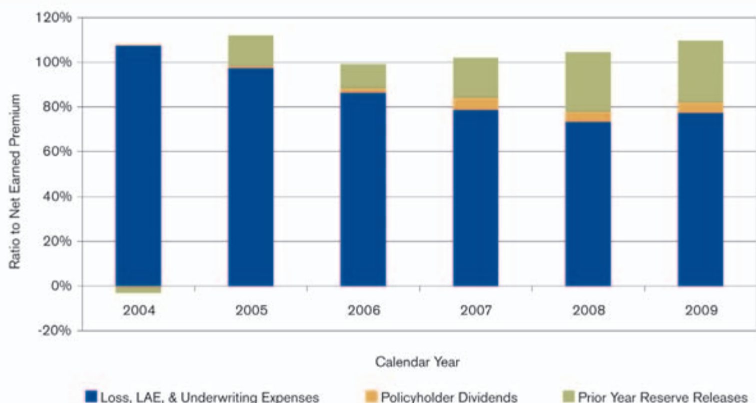


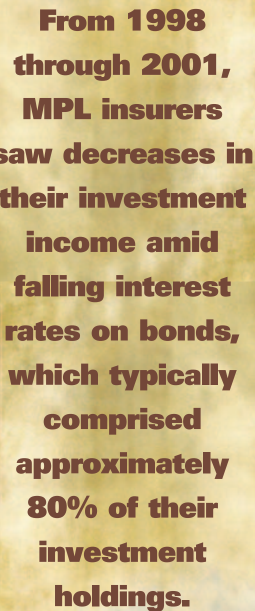
Figure 3 2004-2009 Combined Ratios, Before and After Reserve Releases



mately 80% of their investment holdings.

Since the late 1990s, MPL rates have increased dramatically. Much like the hard market of the early 1990s, steep increases came in the first few years of the turn in the market, climbing at a hefty double-digit pace in each of 2001 and 2002. And while premiums started to level off by the middle of the decade, losses have declined, due largely to a drop-off in claim frequency.

Some evidence suggests that the recent decline in claims frequency stemmed partly from the comprehensive tort reforms that were passed in a handful of states. The enactment of "I'm Sorry" laws—which some 35 states have now adopted—may have also served to lower costs, by deterring some claims or promoting early settlements. And healthcare providers' ten-year effort to improve transparency and the quality of care has likely resulted in fewer medical errors.



From 1998 through 2001, MPL insurers saw decreases in their investment income amid falling interest rates on bonds, which typically comprised approximately 80% of their investment holdings.

Overshooting the mark

The fortuitous decline in claims frequency came on the heels of the hefty rate increases during the early 2000s, which in retrospect overstepped the mark of expected future claims. Both factors—the decline in claims and rate increases—have greatly added to MPL insurers' capital resources, increasing profitability and attracting new carriers looking to expand their market shares. This in turn triggered a more competitive environment and the current soft market.

But the real effect of insurers' languishing premium streams has been camouflaged by the loss reserve releases that started in 2005. Data for a group of 44 select physician MPL insurers* shows $4.3 billion in loss reserve releases over the past five years ending in 2009, most of it taken down in 2008 and 2009. These numbers are significant in themselves, but they also provide a new perspective in relation to premiums. Were it not for the reserve releases in calendar 2008 and 2009, the combined ratio for this peer group of companies would have been 27 percentage points higher than it in fact was.

Even with these large releases, loss reserves are likely still sufficient, a position that will allow many insurers to continue to post profits that are better than the current-report-year results may indicate. The question is, for how long?

If the current cycle unfolds like the past one, insurers could continue to release reserves for another three or four years. But by 2014, they may find themselves confronted with combined ratios in the range of 120% or higher, with a decreasing capacity to use prior-year reserve releases for negating potentially inadequate policy-year pricing. This may be the point when hard-market conditions pervade the market, and premium begins to show steep increases.

And while the past does provide a window into the future, it is only a rough guideline. This is so often the case, because the diverse forces that drive MPL results do not necessarily converge in quite the same way.

For example, it is possible the lower-claim-frequency level that has led the charge to current enviable results is only a temporary phenomenon. If claim frequency were to suddenly revert to levels seen prior to report-year 2004, prior-year reserves would provide less of a buffer than in the previous cycle, and current reserve indications could increase sharply. We could find both rates and premium quickly back on the upswing.

A different reality

A changing regulatory and legal environment could further compress the time interval during which insurers feel comfortable about releasing reserves. In February, the Illinois Supreme Court ruled unconstitutional a measure passed in 2005, which capped certain types of MPL awards at $500,000 for verdicts against doctors and $1 million for judgments against hospitals. In Missouri, opponents of caps on awards have used the same arguments before that state's Supreme Court, as part of their effort to overturn a similar law that limits non-economic damages in MPL suits. Other jurisdictions as well have seen attacks on tort reform.

As a new wave of legal activism takes hold, Congress also considered revoking health and MPL insurers' antitrust exemption under McCarran-Ferguson, as part of the massive health reform bill. Should this provision be re-introduced in Congress and ultimately pass, it would reverse decades of practice that gave insurers access to data for rate-making purposes, a change that could cause insurers' rates to rise.

These legal and regulatory developments have ratcheted up the uncertainty in the market, which is already seeing a possible uptick in claims frequency. If the tide has turned on tort reform, as many in the industry believe, and some of insurers' regulatory protections are removed, insurers' claims severity and operating expenses could increase. This reversal could increase the possibility that the reserve releases that are now buoying insurers' results would evaporate faster than they did previously, and compress the cycle. But by how much? Time will tell.

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** Physician MPL writers with more than $35 million DWP in any of 2006 through 2009, excludes New York dominant writers and non-physician MPL dominant writers.*