As we approach the end of yet another profitable year for medical professional liability (MPL) writers, we take a look at the financial results through the third quarter of 2014 to estimate how the year-end results might turn out and whether recent financial trends are continuing.

Our analysis was based on the collective financial results of a large group of insurers specializing in MPL coverage. The data used in our analysis dates back to 2002 and consists of aggregate statutory financial information compiled from SNL Financial. Our composite includes more than 80 companies with combined direct total written premium exceeding $5.2 billion in 2013.

Considering the relationship of the composite’s financial results at the end of the third quarter to year-end results since 2002, we are able to forecast financial results for MPL writers at the end of 2014.

**STEADILY DECLINING PREMIUM LEVELS OFF**

The composite’s direct written premium level through three quarters has decreased each year since 2006—with the same pattern holding, not surprisingly, for annual premium levels (see Figure 1).

Though the downward premium trend continues into 2014, the 0.6-percent drop between third quarter 2013 and third quarter 2014 marks the smallest decline during the last eight years. It also marks the fourth straight year that this percentage change has decreased, suggesting that the decline in the composite’s overall annual premium level could finally bottom out at about $5.2 billion.

**FAVORABLE RESERVE DEVELOPMENT ENDURES**

The prolonged profitability enjoyed by the MPL market continues to be driven—with the help of continued low claim-frequency and a stable loss-severity—by large reserve releases in prior coverage years (see Figure 2).

Reserve releases, the size of which seemed unsustainable a few years back, are proving to be quite resilient. If the relationship between reserve releases through the third quarter, and annual reserve releases remain consistent in 2014, the market should see annual reserve releases above the $1 billion mark for the eighth consecutive year.

**COMBINED RATIOS INCH HIGHER**

As Figure 2 illustrates, a large majority of the annual reserve releases have historically occurred during the fourth quarter as companies prepare year-end financial statements.

The impact of the fourth quarter reserve releases on the composite’s combined ratio is displayed in Figure 3 (see Page 7) where we compare third-quarter combined ratios to those at year-end.

Note that it is not uncommon for large reserve releases during the fourth quarter to cause drops in the year-end combined ratio in excess of 10 percentage points relative to third-quarter ratios. Figure 3 also suggests that the persistent decline in premium has driven underwriting results above the breakeven point when measured in the absence of the

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favorable fourth-quarter reserve development.

INVESTMENT INCOME HITS NEW LOW

Despite a slight increase in U.S. treasury yields from their lowest point in 2012, they are still quite low—historically speaking. Likewise, the MPL industry yields have not yet turned the corner. As a result, investment income for our composite through the third quarter of 2014 is at its lowest point during the 13-year history used in our analysis (see Figure 4). Accordingly, we expect investment income at year-end to be at its lowest point during that same time frame, approximately 46-percent below its peak in 2006.

NET INCOME DECLINES

It follows from the information presented above that the bottom line for MPL specialty writers would take a hit in 2014—as it has each year since 2010 (see Figure 5).

As of third quarter, after-tax net income is at its lowest point since 2005. That said, the composite will likely still earn an amount approaching $1 billion dollars in net income in 2014. It is interesting to note however that for the past two years, with a similar result likely for 2014, the composite’s year-end net income is less than the total reserve runoff for each respective year.

CONCLUSION

Since we began tracking results for the Medical Liability Monitor in 2010, we’ve been repeating a central theme: MPL specialty writers are continuing to benefit from large redundancies in prior-year reserve levels. While this theme holds true to this point in 2014, a not so subtle transformation has emerged in the past few years—that being, reserve runoffs are no longer bolstering the profit level. Rather it could be argued that reserve runoffs are responsible for the profits as a whole.

A.M. Best recently estimated the remaining reserve redundancy in MPL reserves to be approximately $3.5 billion—or enough to support at least another year or two of waning premium levels and declining underwriting results if current trends hold. As we near the end of more than a decade of bloated reserve levels and enter the era of the Affordable Care Act as well as all of the unknowns it will insert into the equation, we look forward to monitoring the impact of these and other variables on our composite of MPL writers and the industry as a whole.

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