A PIAA PUBLICATION FOR THE MEDICAL PROFESSIONAL LIABILITY COMMUNITY

Inside Medical Liability

WWW.PIAA.US

2014 SECOND QUARTER

What It Takes To Win in Washington

Achieving Protection for Healthcare Professionals

AND

Our Annual 'Industry Update'

Profitability Declines from Previous Levels; Reserve Releases Fund Dividends and Additions to Surplus

By Susan J. Forray and Chad C. Karls

The year 2013 was once again a year of financial growth for the medical professional liability (MPL) insurance industry, despite a continued decline in profitability. While the industry's operating ratio remains well below 100%, it has increased noticeably relative to 2011, driven by a decline in reserve releases, increased expenses, and diminished investment income.

Despite this decline in profitability, the MPL industry again returned a substantial portion of its income as dividends to policyholders. Surplus also grew moderately in 2013, providing the MPL industry with additional capital support.

However, the industry's profitability is being squeezed from both sides, and more so than was the case a year ago. Frequency increased during 2013, albeit modestly, for some companies. More concerning for many companies are the decreases in rate level seen in certain markets, some of which have seen declines in rate level in excess of 20%. It is not uncommon for MPL carriers to see certain of their competitors writing at rates perceived to be inadequate, in some cases forcing companies to choose between losing market share and writing at rate levels they believe to be inadequate themselves.

The increased capitalization and favorable operating ratios in the MPL industry of late have had one primary cause—the release of prior-year reserves. In 2013 in particular, reserve releases contributed 29 points to the industry's operating ratio. Even without these reserve releases, though, the industry would have been profitable. These reserve releases are comparable to 2012 and yet represent a decline relative to the years 2008 through 2011, during which reserve releases contributed an average of 33 points to the industry's operating ratio each year.

Also, MPL writers continue to confront the risk associated with a possible increase in inflation. Since 2007, increases in indemnity severities for MPL writers have been flat to small, although increases in defense costs per claim have been in the range of 6% to 8% per annum for most carriers. As a result of this prolonged disparity in trend rates, more than half of the MPL companies in the composite we examined spent more on defense costs than indemnity costs. An increase in claim costs going forward could impact the adequacy of both rates and reserves. In addition, an increase in inflation could significantly devalue bonds, by far the largest asset class for MPL writers.

MPL insurers also continue to face uncertainties stemming from healthcare reform. The most significant impact to date on MPL insurers due to healthcare reform has been the continued acquisition of physician practices by hospitals and other healthcare systems (already a trend preceding the healthcare reform legislation). However, healthcare exchanges have only recently begun to impact the landscape of patient care. Once they have become more fully operational, we expect that the healthcare exchanges will accelerate the

Susan J. Forray, FCAS, MAAA, and Chad C. Karls, FCAS, MAAA, are Principals and Consulting Actuaries in the Milwaukee office of Milliman.

long-predicted decline in the availability of healthcare providers, due to the increased demand in services from a more fully insured population. Presumably, such an outcome could only impact MPL writers negatively, as patients begin to experience greater frustration with their providers.

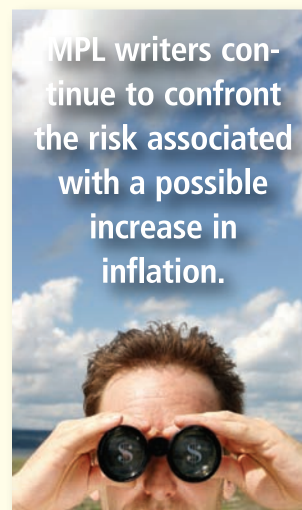
In certain states, MPL insurers are facing challenges to the tort system itself. As of this writing, there is ongoing debate on bills in the Florida and Georgia legislatures that would remove MPL claims from the tort system and also expand the number of claims eligible for compensation, fundamentally altering the landscape for MPL insurers (see *Inside Medical Liability*, First Quarter 2014, pages 28-31). Caps on damages have been overturned, with examples including Missouri, Oklahoma, and Florida. Advocacy groups are challenging MICRA at the ballot box in California, while caps on damages are being challenged in the courts in various other states.

The overturn of tort reform can be expected to lead not only to direct increases in claim severity, but also, indirectly, to increases in the number of claims as well. Absent a functional cap on damages, there is additional financial motivation for plaintiffs' attorneys to accept cases. A plaintiff with a less meritorious case will have a better chance of obtaining representation if the plaintiff's attorney believes that the lesser likelihood of a plaintiff verdict is offset by a greater potential for a damages award.

To get a more detailed picture of the state of the MPL industry today, we have analyzed the financial results of a composite of 38 of the largest specialty writers of MPL coverage ("the composite"). Using statutory data obtained from SNL Financial, we have compiled various financial metrics for the industry, categorized by:

- Written premium
- Overall operating results
- Reserve releases
- Capitalization
- Policyholder dividends.

In viewing the financial results discussed below, it is important to consider that the 38 companies included here are all established MPL specialty writers. They exclude most of the startup writers and any MPL specialty writer that has become insolvent or otherwise left the market, as well as the multi-line commercial writers of MPL coverage. The companies in each of these three excluded categories are generally less well capitalized than the 38 companies included here. In addition, while the underwriting results of the startup companies have typically been comparable to those of the composite, the underwriting results of the multi-line commercial writers have generally been somewhat less profitable. This was, of course, also true for the writers that became insolvent. Thus, the results presented throughout this article reflect the experience of the established specialty writers, which is inherently more favorable than a view of the industry as a whole.

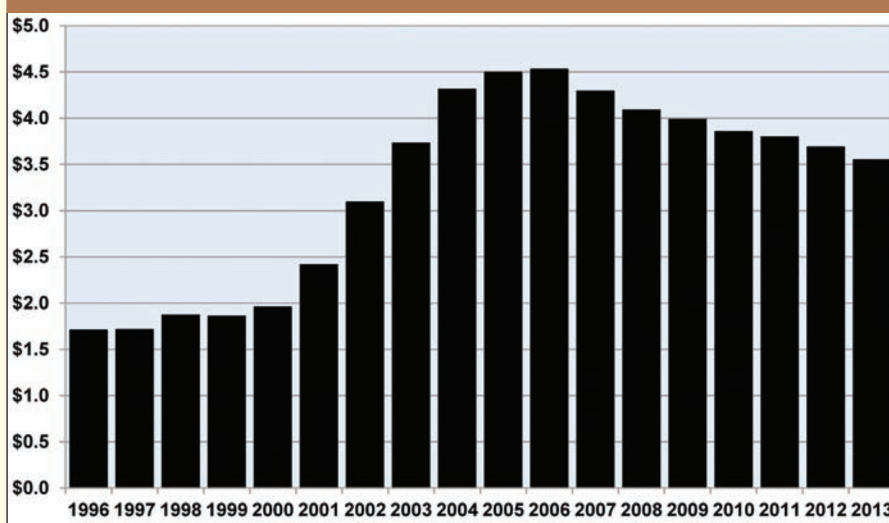


Written premium

Last year, 2013, marked the seventh straight year of decreases in direct written MPL premium for our composite (Figure 1). Cumulatively, premium has decreased by almost $1.0 billion since 2006—more than 20% of the premium written in this year. To put that in perspective, consider that in the 30-year history of the MPL industry, no other period of decreasing premiums has lasted longer than two years, and the greatest consecutive-year premium reduction was 7%. On the surface, this would suggest that the circumstances of the current market are much worse than those of the previous soft market, of the mid- to late 1990s through early 2000s.

Yet the current market has some characteristics that distinguish it from the previous soft market. Both have shown decreasing rate levels, but evidence of rate inadequacy has not been manifested in the current soft market, versus the previous soft market, when there was evidence such as the deficiencies in rate filings documented during this period, which ultimately culminated in adverse financial results. The reduction in frequency for MPL writers means that their rates are in a much better position now than they were a decade ago, although the decreasing-frequency trend appears to have slightly reversed itself of late. In addition, we are beginning to see aggressive rate action in certain markets, exemplified by double-digit rate decreases filed by certain carriers.

Figure 1 Direct Written MPL Premium ($ Billions)



Overall operating results

As measured by the composite operating ratio, the industry appears to have reached its nadir during 2010. During that year, the composite posted an operating ratio of 56%, which has risen to 70% since that time (Figure 2). The

Figure 2 Operating Ratio

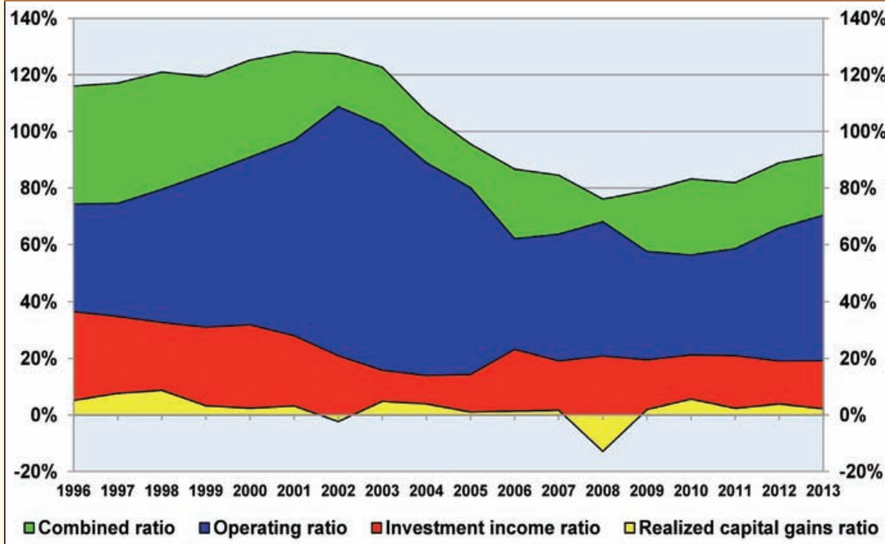
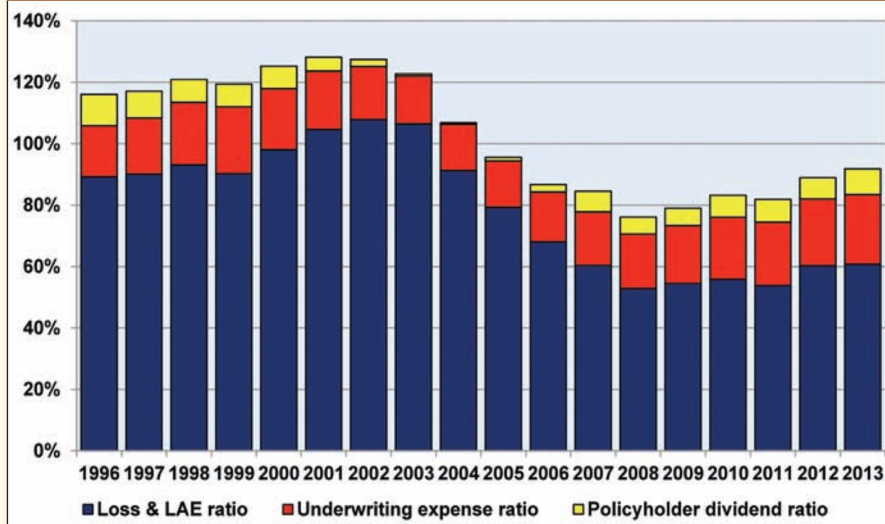


Figure 3 Combined Ratio



increase has largely been driven by the decline in reserve releases during 2012 and 2013, but also by a modest increase in underwriting expenses and a small decline in investment returns. The 2013 combined ratio for the industry was 92%, up from a low of 76% in 2008 (Figure 3).

The investment gain ratio of 21% in 2013 declined from a 10-year high of close to 27% in 2010. This result was perhaps to be expected, given the declining impact of the write-downs taken on invested assets during 2008. In 2010, the realized capital gains ratio hit a 10-year high of 6% of net earned premium, as companies sold these previously devalued assets. Subsequently, there have been fewer devalued assets remaining from the 2008 time period, and the realized capital gains ratio has declined, settling at 2% in 2013. The investment income ratio declined modestly in 2013, from 21% in 2010 to 19% in 2013. This occurred in spite of the continued deterioration in the book yield, as the persistent deleveraging of the composite's balance sheet has resulted in more invested assets supporting each premium dollar, thus buoying the overall investment income results reported on the composite's income statement.

The calendar-year loss and loss adjustment expense (LAE) ratio for both 2012 and 2013, 61%, was noticeably higher than the comparable figure for 2011, 54%. The increase has been driven largely by the decline in reserve releases noted earlier, and is discussed further below. The increase in the initial loss and LAE ratio carried for the 2013 coverage year was small. The loss and LAE ratio carried for the 2013 coverage year is 89%, one percentage point higher than the 88% loss and LAE ratio carried for the 2012 coverage year as of year-end 2012. In light of the small increases in frequency in certain jurisdictions, along with continued rate decreases in virtually every locale, a several-point increase in the initial loss and LAE ratio would be expected. Thus, this modest 1-point increase suggests that the 2013 coverage year is starting out from a weaker, or perhaps less strong, position than did the 2012 coverage year.

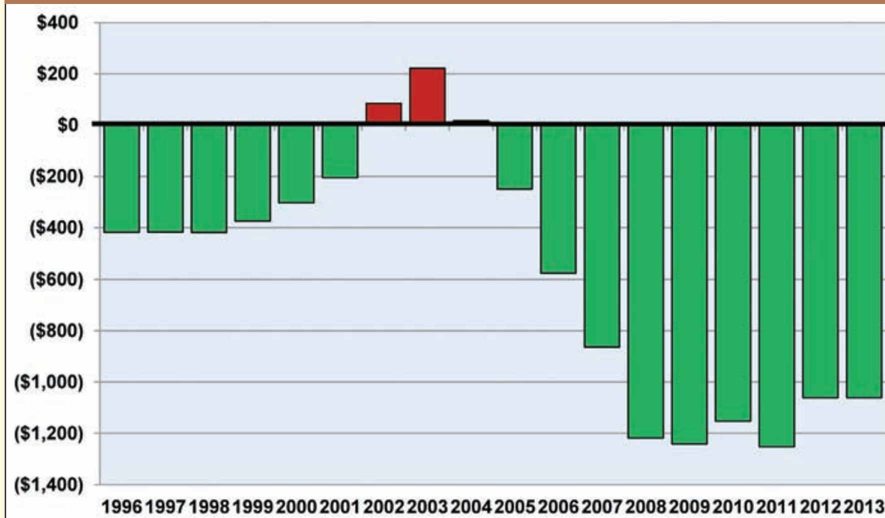
Reserve releases

As discussed above, the industry released close to $1.1 billion in reserves during 2013, as it had during 2012. However, these amounts constitute a decline, for the composite, from the high of more than $1.2 billion released each year in 2008 through 2011 (Figure 4). Despite the decline, the reserve releases remain material. Yet, they should be put in the context of the reserves carried by the composite, which for net loss and LAE totaled more than $10.1 billion as of year-end 2012. The release of reserves was driven by the ongoing impact of a lower frequency, combined, for many companies, with a relatively benign indemnity severity trend during the past several calendar years.

While a lower frequency in MPL claims has been recognized for some time, provisions in the reserving process for many companies initially assumed that the decrease in loss payments would be less than the decrease in reported frequency. In other words, companies assumed that the decrease in reported frequency would be driven by fewer "nuisance" or "closed no payment" claims. While this has been the case for some writers, most have seen that the decrease in frequency has affected claims of all types equally, while some have in fact seen a greater decrease in indemnity claims than in their reported claims overall.

Due to the three- to five-year payment lag, only during the past several years have

Figure 4 Reserve Release ($ Millions)



companies begun to see the impact of the lower reported frequency on claim payments themselves, and as a result, the industry has been able to sustain favorable reserve releases, as this impact has proved favorable. This may also explain the decline in reserve releases during 2012 and 2013, as the effect of the payment lag begins to run its course. However, this continues to be an area of significant uncertainty in the reserving process, particularly in light of the recent increases in reported frequency noted for some companies, along with the unknown impact of the overturning of caps on damages in certain jurisdictions.

It is also important to recognize that a history of favorable calendar-year reserve development is not necessarily indicative of redundant reserves currently. In fact, a review of calendar-year development segregated by coverage year shows that favorable calendar-year reserve development has historically continued two to three years past the point when reserves were subsequently found to be adequate. Thus, if the industry is currently at a level where reserves are theoretically exactly adequate, history would suggest that we will see favorable reserve development on a calendar-year basis through 2015 or 2016. This would then be followed by adverse development (at least for the older coverage years) in subsequent calendar years.

Finally, as we have mentioned several times now, the industry has seen a dramatic decrease in reported frequency over the past decade. However, for many companies, frequency (on a per-physician basis) has stabilized. For others, frequency has turned upward again.

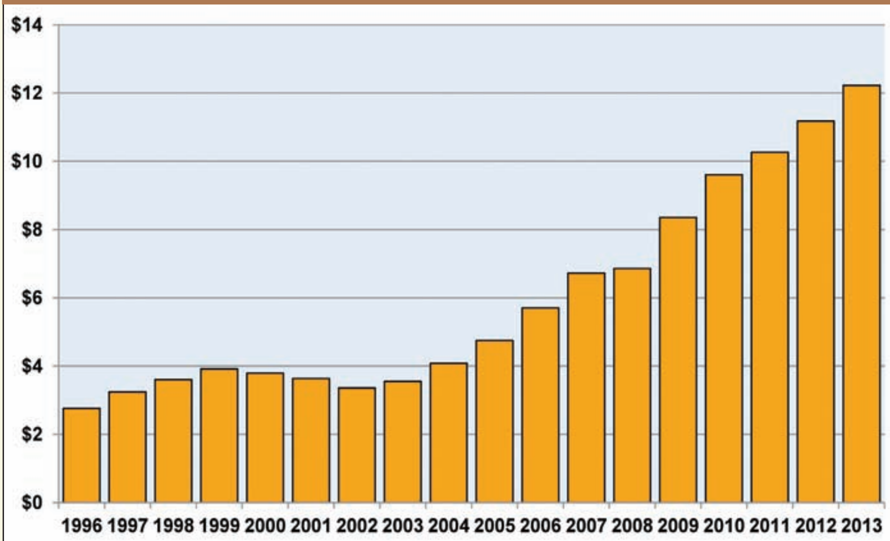
Given the rate decreases of the past several years, frequency has of course increased more relative to premium than to the number of insured physicians. Frequency per $1 million of gross earned premium reached its lowest point for the industry in 2006. Reported frequency has increased each year since this time. Thus, for every claim reported, fewer dollars have been available each year to defend or settle the claims. Cumulatively, reported claim frequency (measured relative to premium) has increased by about 30% since the 2006 year. This increase is largely the result of rate decreases (mostly in the form of greater premium credits, as opposed to manual rate changes) coupled with modest increases in "true" frequency—i.e., claim frequency per insured physician.

Capitalization

The industry's strong operating results in 2013 fueled a significant increase in surplus during the year of about 9%, from $11.2 billion to $12.2 billion (Figure 5). This is a noticeable gain, but represents a lesser gain than was experienced annually in the years 2004 through 2010 (with the exception of 2008, when industry surplus increased only slightly, due to the effect of other-than-temporary impairment on assets). It is comparable to the gains in surplus of about 7% and 9% posted in 2011 and 2012, respectively. In addition, the biggest contributor to the gain in surplus was the favorable reserve development discussed earlier, which cannot be expected to continue at the same level over the long term.

To put the industry's capitalization level in a broader context, consider the risk-based capital (RBC) ratio for the industry. This metric provides a comparison of a company's actual surplus to the minimum amount needed from a regulatory perspective (although, from a practical perspective, given market fluctuations, many would consider the actual amount of capital needed to be well in excess of this regulatory minimum). The RBC ratio of our MPL composite increased only 2% in

Figure 5 Policyholder Surplus ($ Billions)



2013, from 1,115% to about 1,140%, although, over the last several years, the pattern of increase in the RBC ratio has generally been similar to that of surplus. However, individual RBC ratios vary considerably within the composite, from a low of 580% to a high of more than 8,500%.

Policyholder dividends

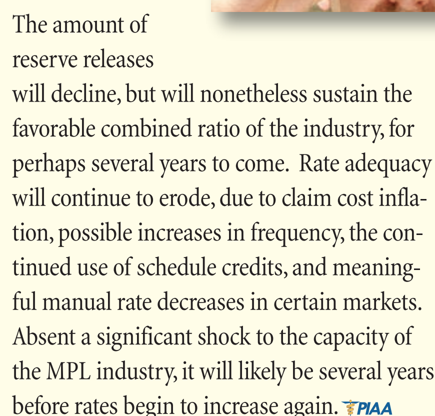
At the same time, the increase in surplus has been slowed by the significant amount of policyholder dividends that MPL writers have continued to pay. In 2013, the composite writers paid $310 million in policyholder dividends, an all-time high representing 8% of net earned premium (Figure 3). Cumulatively, the composite has paid $1.9 billion in policyholder dividends since 2005. The historical pattern of policyholder dividends is very similar to that of reserve development. Thus, a large portion of the after-tax income resulting from reserve releases has been returned to policyholders.

Typically, these dividends are paid to all renewing policyholders as a percentage of premium. Thus, on a dollar basis, the dividends have provided greater benefit to those physicians who have historically paid higher premiums. We expect that policyholder dividends will continue for several more years, given their historically cyclical behavior and the composite's strong balance sheet.

When will the hard market come?

In its most recent "Review & Preview" report, A.M. Best estimated a net reserve redundancy of $3.5 billion for the MPL line of business as a whole. This is approximately 12% of the carried net reserves, which implies a redundancy for our composite of $1.2 billion. Thus, continued reserve releases can be expected to mask deteriorating underwriting results on current business, both prolonging the soft market and increasing the risk that rates may become inadequate. Insurers face other risks to the bottom line as well: possible increases in frequency and severity, including the threatened overturn of tort reform in various states, the potential for a decline in asset values, the continued impact of healthcare reform, and a decline in market size, as hospitals continue to acquire physician practices, among others factors.

The industry's profitability is being squeezed from both sides, and more so than was the case a year ago.



Looking ahead, we envision a continuation of the protracted soft market that we find ourselves in now. The amount of reserve releases will decline, but will nonetheless sustain the favorable combined ratio of the industry, for perhaps several years to come. Rate adequacy will continue to erode, due to claim cost inflation, possible increases in frequency, the continued use of schedule credits, and meaningful manual rate decreases in certain markets. Absent a significant shock to the capacity of the MPL industry, it will likely be several years before rates begin to increase again. PIAA

For related information, see www.milliman.com.

Litigation: Information Is Power!

- Level the playing field
- Thousands of transcripts at your fingertips
- Economical cost structure

Join the PIAA Expert Witness Database Today!

Contact Bill Burgess at 301.947.9000, ext. 236 or bburgess@piaa.us