FIRST QUARTER FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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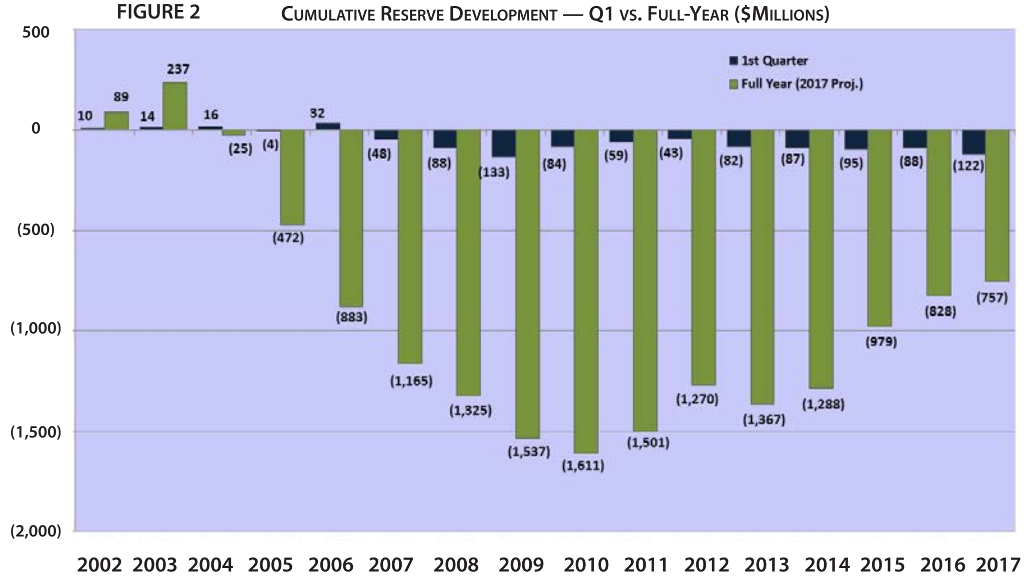
This article summarizes some key financial results for medical professional liability (MPL) specialty writers from the first quarter of 2017 and begins our eighth year of tracking these results for the MEDICAL LIABILITY MONITOR.

At the close of 2016, we noted a disturbing trend gaining momentum in the MPL market that was beginning to threaten its 13-year run of profitability. The market's persistent decline in premium is now paired with a steady decline in the magnitude of favorable reserve releases — the existence of the latter has been integral to the market's profitability in recent years. While profitability for the MPL market as a whole remains, these developments have significantly lessened the market's overall net income in recent years.

FIGURE 2 CUMULATIVE RESERVE DEVELOPMENT — Q1 VS. FULL-YEAR ($MILLIONS)



As in years past, this article compares historical first-quarter financial results to historical annual results to get a glimpse at where 2017 financial results might be headed. Our analysis is 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. The current composite includes 169 MPL specialty companies with total direct written premium of approximately $5.2 billion in 2016.

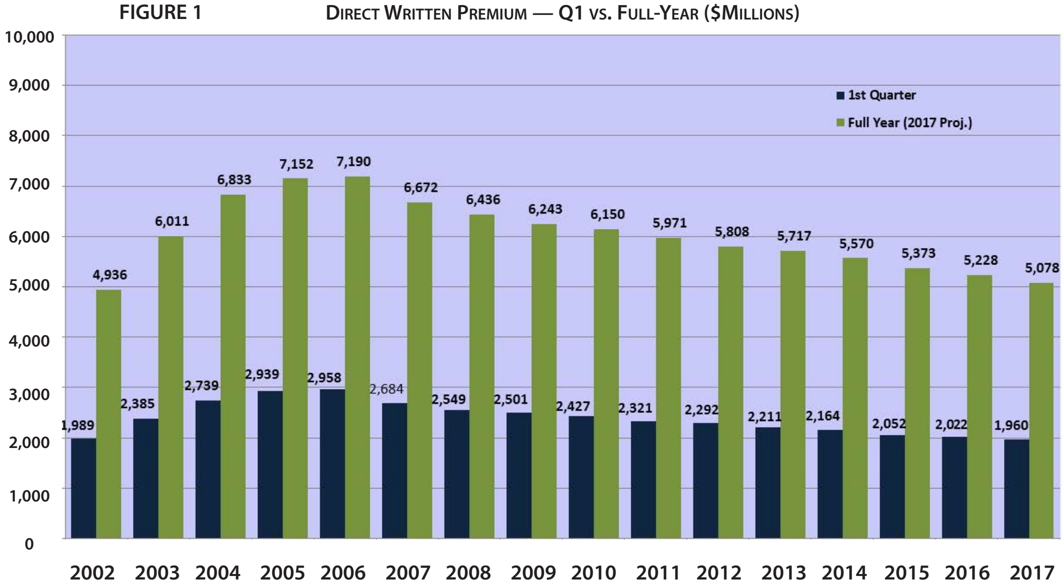
PREMIUM LEVELS CONTINUE TO DECLINE

Figure 1 displays the all-too familiar downward trend in direct written premium for the MPL market. First-quarter premium declined for the eleventh-consecutive year, dropping below the $2 billion mark for the first time since 2002. The 3.1-percent decrease relative to first-quarter 2016 is consistent with the average annual decrease seen during the past five years, indicating that this trend remains strong. A similar decline in annual 2017 premiums would put total premium levels at roughly $5.1 billion — more than 29-percent lower than 2006, when the market first began to soften.

RESERVE REDUNDANCIES EXPECTED TO DETERIORATE

As shown in Figure 2, favorable reserve development in the first quarter of 2017 is at its highest point since 2009 — almost 30-percent higher than the recent five-year average. While a positive development, and a good sign that the reserve redundancies from which the market has benefited for more than a decade still remain, history suggests first-quarter results are highly leveraged, and the reserve release for a given year is largely dependent on fourth-quarter reserve action. That said, we expect overall market trends will prevail come year-end and lead to a continued decline in the annual reserve release.

FIGURE 1 DIRECT WRITTEN PREMIUM — Q1 VS. FULL-YEAR ($MILLIONS)



OVERALL PERFORMANCE REMAINS PROFITABLE

As might be expected, the loss of premium revenue combined with lessening relief offered by the release of redundant reserves has taken its toll on the composite's net income.

Figure 3 illustrates the downward trend in income since 2010, reflecting the decline in favorable reserve development during that same period shown in Figure 2. A modest increase in the composite's investment yields, combined with an increasing surplus level off which the composite can collect, has helped offset deteriorating underwriting results, leading to projected 2017 income that — albeit highly leveraged — remains relatively flat compared to 2016.

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Q1 FINANCIAL RESULTS FOR MPL SPECIALTY WRITERS

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Underwriting Performance Deteriorates

The composite incurred a $40 million underwriting loss (after dividends) in 2016 — its first underwriting loss in any year since 2004 (See Figure 4). The declining premium has been putting pressure on the underwriting expense ratios and has been compounded by steadily increasing losses as well as loss adjustment expenses.

More recently, first-quarter 2017 loss and expense ratios are relatively flat compared to first-quarter 2016, which marked the highest first-quarter loss and LAE ratio since 2004. However, in the absence of underwriting profitability, overall profits remain and policyholders continue to receive dividends. The composite's annual policyholder dividends have averaged between 5 percent and 6 percent of net earned premium since 2007 and fall in that same range through the first quarter of 2017.

Capitalization Remains Strong

Profitability translates into increased surplus in the insurance market, and the MPL segment has been the posterchild of profitability for the property and casualty insurance market during the last decade. Figure 5 shows the steady growth in the composite's policyholder surplus during the past 15 years, averaging more than 9-percent annual growth and more than tripling its level from first-quarter 2003. Primarily due to the reasons mentioned earlier, the rate of growth has slowed in recent years — with first quarter 2017 surplus just 1.6-percent more than 2016.

Conclusion

From a financial perspective, with our MPL composite is well-financed and consistently turning profits, the foreseeable future still appears bright for MPL specialty writers despite the unfavorable underwriting performance of late.

However, with an analysis such as this, which focuses for the most part on historical financial results, we shouldn't fail to see the larger picture. The MPL market faces an uncertain future as physicians continue to enter hospital groups, thereby eroding the market's revenue source. Furthermore, potentially landscape-changing laws are being considered with respect to "Repeal and Replace" — not to mention tort reform. Regardless, we will continue to monitor the MPL market's financial progress to see where it takes us for the remainder of 2017 and beyond.

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Figure 3 After-Tax Net Income — Q1 vs. Full-Year ($Millions)

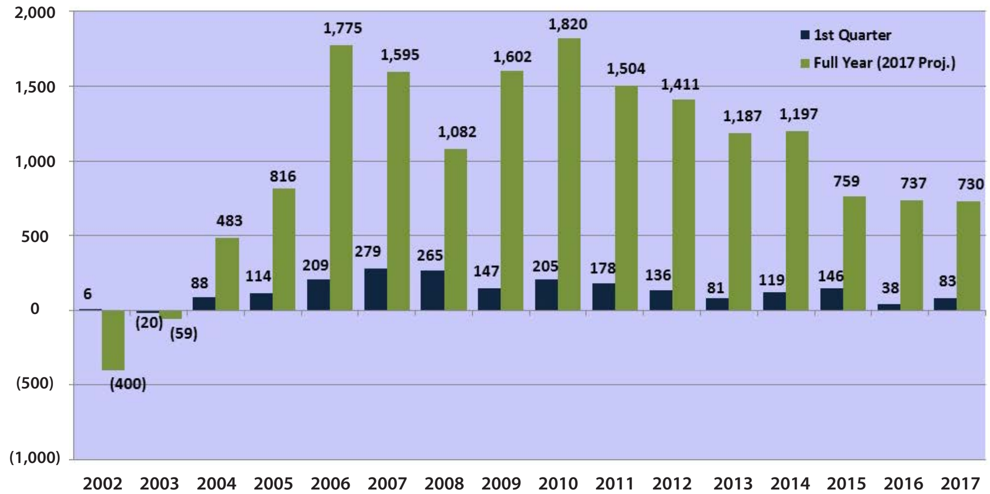

Figure 4 Annual Combined Ratios

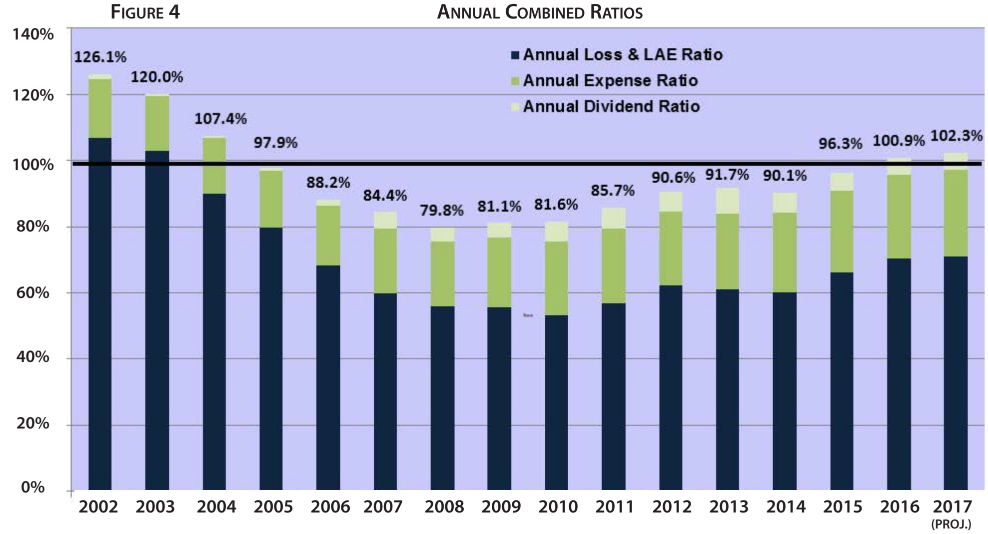

Figure 5 Policyholder Surplus — as of Q1 ($Billions)