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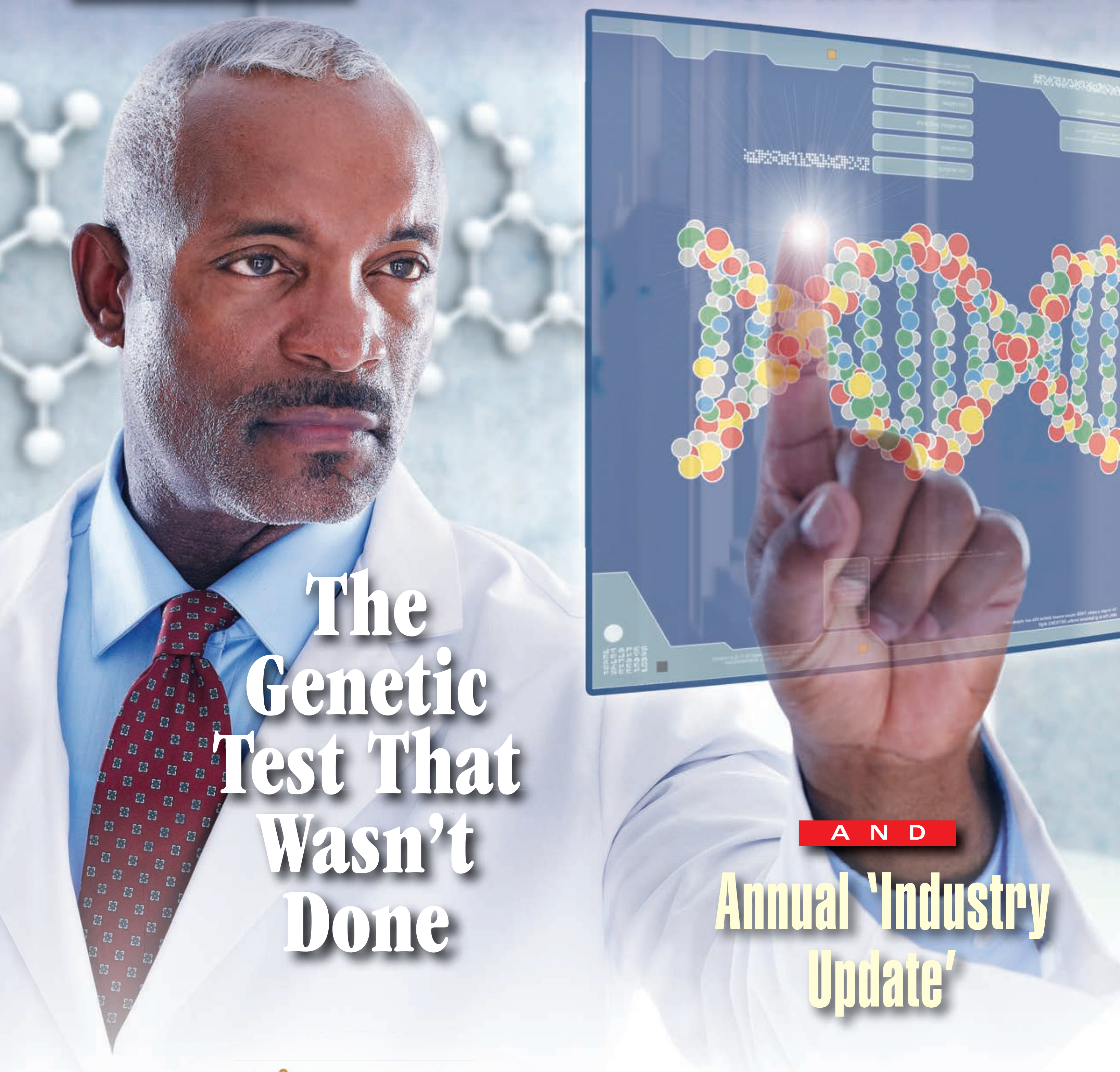

The Genetic Test That Wasn't Done

AND

Annual 'Industry Update'

PIAA

Industry's Profitability Declines Slightly While Maintaining Overall Favorable Results

By Susan J. Forray and Chad C. Karls

"The nice part about being a pessimist is that you are constantly being either proven right or pleasantly surprised."—George F. Will

The year 2016 manifested continued declining profitability for the medical professional liability (MPL) insurance industry. While on a downward trend, movement in the industry's profitability has occurred at a relatively slow pace. In 2016 the industry's operating ratio increased slightly to 81%, just 1 point over the prior year. Meanwhile, insurers continued to experience a significant decline in reserve releases, compounded by both lower rate levels and increased expense ratios.

Some would observe that the industry's operating ratio remains well below 100%. Despite the decline in profitability, the MPL industry again returned a substantial portion of its income as dividends to policyholders. Surplus grew slightly in 2016, leaving the MPL industry in a financial position roughly consistent with where it has been for the past half-decade.

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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 2016, reserve releases contributed 18 points to the industry's operating ratio. However, this is a noticeable decline from the reserve releases of 2015, as well as those of prior years. In the decade preceding 2016, reserve releases contributed an average of 27 points to the industry's operating ratio each year. Yet despite this decline in reserve releases, without them, the industry would have remained profitable in 2016, albeit by the slimmest of margins.

Rates continue to fall for many writers, as evidenced by the declining premium volume of the industry as a whole. Certain markets have seen a cumulative decline in rate levels in excess of 25% over the past several years. It is common for companies to see certain of their competitors writing at rates perceived to be inadequate, forcing companies to choose between losing market share and writing at levels they themselves believe are unprofitable. MPL insurers have seen increased caps on damages in some states and, in others, challenges to the tort system itself in the form of "Patient Compensation System" legislation (see "Patient Compensation Systems Evolve—But Are No Less Worrisome" available online at: https://www.piaa.us/docs/OnlineExtra/2017_Online_Extra_Patient_Compensation_Systems.pdf).

At the same time, the industry's one-time pattern of declining frequency ended several years ago. We have seen the reporting of claim counts stabilize for most companies, with some volatility evidenced for certain writers. Indemnity severity trends have remained manageable, although trends in defense costs remain in the range of 4% to 6% per annum. We have seen rate levels vary by state and industry segment, remaining adequate in most locales but deficient in some.

MPL insurers also continue to face declining market share because of the ongoing acquisition of physician practices by hospitals and healthcare systems, and because many newly trained physicians have opted to join these larger systems rather than enter into independent practice. Healthcare reform only served to accelerate the trend in physician employment that was already well underway. Whatever reversals to healthcare reform lie in the short-term or long-term future, it is unlikely that any such changes would reverse or even slow the trend in physician employment—change and uncertainty are hardly an encouragement to independent physician practices.

We have written previously that under healthcare reform we expected that the long-predicted decline in the availability of healthcare professionals would become accelerated, 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 would begin to experience greater frustration with their professionals. This frustration might even be exacerbated under any reversals to healthcare reform, as segments of the populace may be tempted to blame healthcare providers for changes in healthcare availability. Regardless of their understanding of the reasons for such changes, it is unlikely that these events would contribute positively to the patient-provider relationship.

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 S&P Global Market Intelligence, we have compiled various financial metrics for the industry, categorized by:

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

In considering the financial results discussed below, it is important to consider that the 38 companies included here are all established MPL specialty writers. They exclude any MPL specialty writer that has become insolvent or otherwise left the market, the multi-line commercial writers of MPL coverage, as well as smaller MPL writers with less established histories. The companies in each of these three excluded categories are generally less well capitalized than the 38 companies included here. In addition, the underwriting results of the multi-line commercial writers as well as some of the smaller writers have generally been somewhat less profitable. This was, of course, also true for the writers that became insolvent. Thus, the results presented below 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, 2016, marked the tenth straight year of decreases in direct written MPL premium for our composite (Figure 1). Cumulatively, premium has decreased by over $1.1 billion since 2006—more than 25% of the premium written in that year. To put that in perspective, consider: in the close-to-40-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%.

Premium decreases during this time frame have been driven only in part by declining rate levels. An additional factor behind the lower level of premium has been the loss of business to self-insurance mechanisms. Throughout this timeframe, PIAA companies have been losing business due to healthcare system acquisitions of both hospitals and physician practices. In earlier years—through about 2008—companies also frequently lost business due to the formation of new captives.

This is a distinct difference between the current market and the previous soft market, of the mid- to-late 1990s through the early 2000s. Both the current and prior soft markets have shown inadequate rate levels, but to a lesser level and in fewer locales in this current soft market, as compared with the previous soft market. During this prior time period, rate deficiencies—including those documented in rate filings—ultimately culminated in adverse financial results. The dramatic reduction in frequency since the early 2000s

Figure 1 Direct Written MPL Premium ($ Billions)

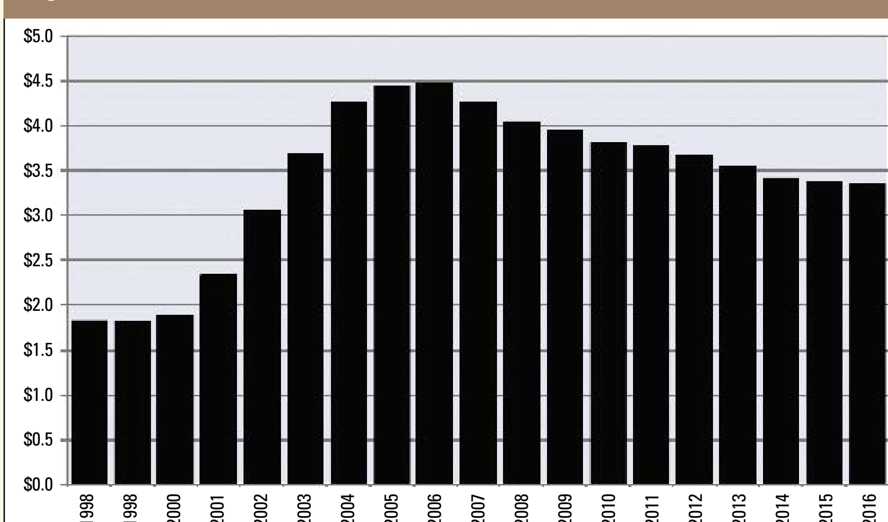


Figure 2 Operating Ratio

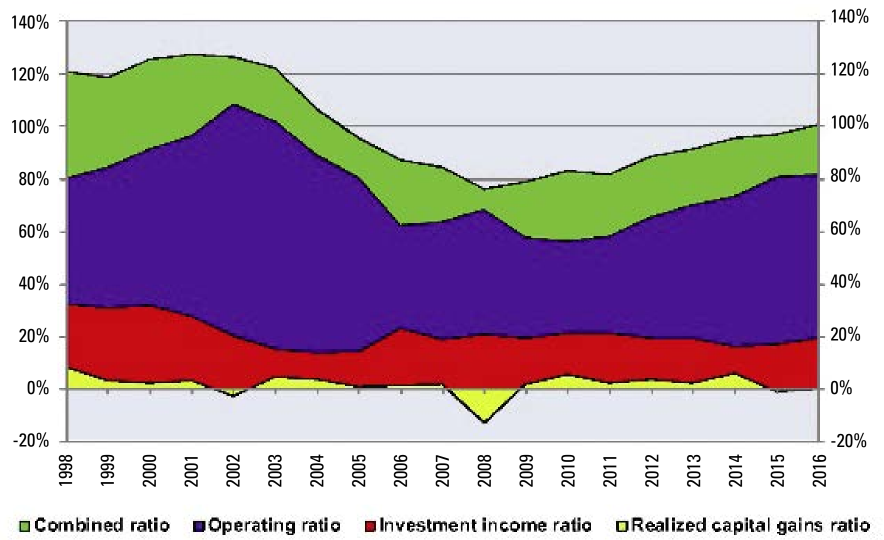
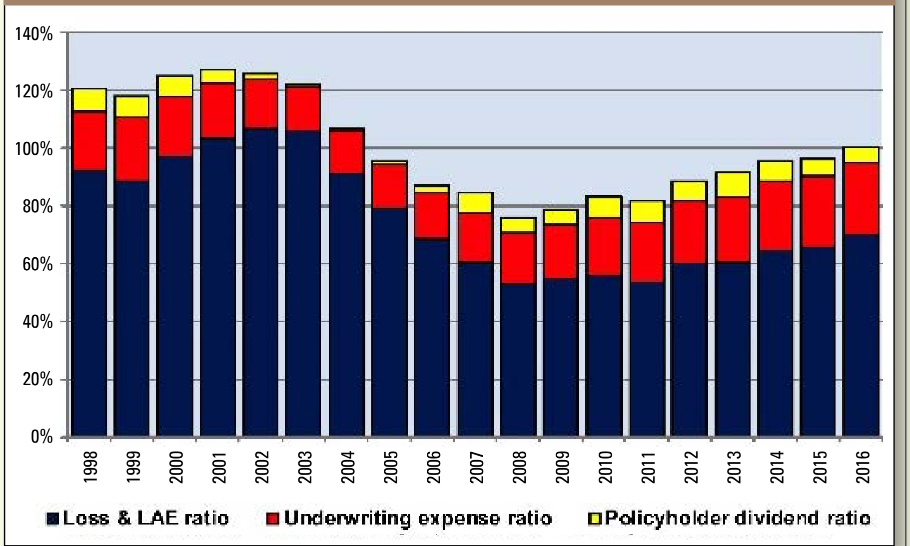


Figure 3 Combined Ratio



means that MPL rates are in a much better position now than they were 20 years ago. However, we continue to see aggressive rate action in certain markets and have observed significant premium reductions on non-renewed, large accounts.

Overall operating results

As measured by the composite operating ratio, the industry reached its peak profitability during 2010. During that year, the composite posted an operating ratio of 56%, which has risen to 81% since that time (Figure 2). The increase has been driven by the decline in reserve releases beginning in 2012, but also by an increase in underwriting expenses and ongoing lower levels of investment returns. The 2016 combined ratio for the industry was 101%, up from a low of 76% in 2008 (Figure 3). This represents the first time since 2004 that the industry's combined ratio exceeded 100%, meaning that the industry would have been unprofitable in 2016 without its investment income.

The investment gain ratio of 19% in 2016, while up slightly from the 2015 investment gain ratio of 16%, represents a noticeable decline from the previous six years, in which the investment gain ratio ranged from 21% to 27%. In large part, the lower investment gain ratios of the past two years have been due to the accounting treatment by one larger carrier of its investment in its affiliates. Thus, the industry's capital gains ratio declined from 6% in 2014 to slightly negative amounts in both 2015 and 2016. The investment income ratio increased from 17% in 2015 to 19% in 2016.

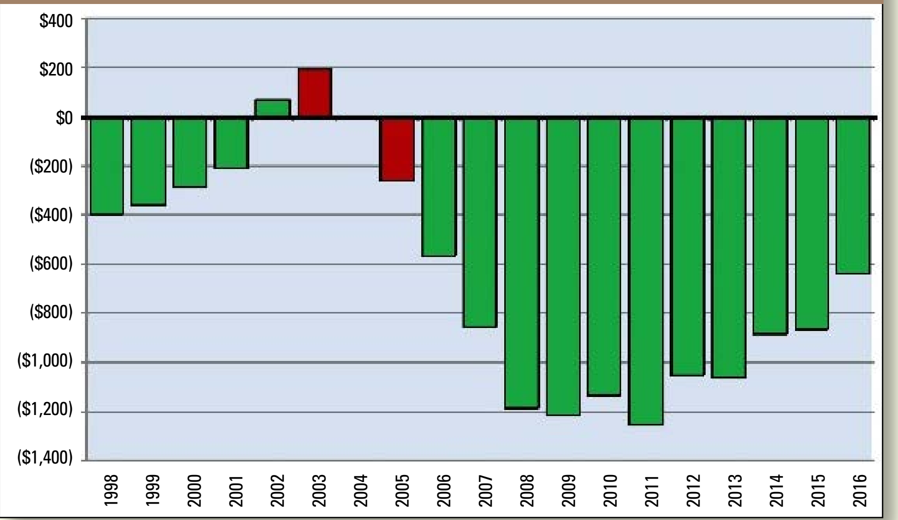
The calendar-year loss and loss adjustment expense (LAE) ratio for 2016, 70%, is higher than in any year since 2005, and represents an increase of 17 points since 2008. The increase has been driven largely by the decline in reserve releases noted earlier, which is discussed further below. Also contributing to the increase in the calendar year loss and LAE ratio has been an increase in the starting loss and LAE ratio for the most recent corresponding coverage year.

However, the starting loss and LAE ratio for the composite fell for the first time in 10 years, to 88%, in 2016. Information from the composite on the development of its 2016 coverage year to date, such as claim frequency, would not suggest that the 2016 coverage year will outperform its predecessors. This implies that the 2016 coverage year is starting from a weaker position than other recent coverage years.

Finally, as noted previously, the industry saw a dramatic decrease in reported frequency since the early 2000s. However, for most companies, frequency (on a per-physician basis) has since stabilized. Other companies have continued to see small declines in frequency, while for some writers, frequency has turned slightly upward again.

Given the rate decreases of the past decade, frequency has of course increased more relative to premium than to the number of insured physicians. Reported frequency per $1 million of direct earned premium increased significantly leading into 2012, although increases have been smaller since then. Thus, for every claim reported, fewer premium dollars have been available to defend or settle the claims than was the case at the beginning of this time frame. Cumulatively, reported claim frequency (measured relative to premium) has increased by

Figure 4 Reserve Release ($ Millions)



almost 40% since 2007. This increase is largely the result of rate decreases (mostly in the form of greater premium credits, as opposed to manual rate changes), although some writers have seen modest increases in "true" frequency—i.e., claims per insured physician.

Reserve releases

The composite released $640 million in reserves during 2016, a decline from the $1.1 to $1.2 billion released in each of the years 2008 through 2013 and the $900 million released in each of 2014 and 2015 (Figure 4). Despite this 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 $9.5 billion as of year-end 2015. The release of reserves was driven by the ongoing impact of a lower frequency, combined, for many companies, with a relatively benign trend in indemnity severity during the past several calendar years.

It is 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 2018 or 2019. This would then be followed by adverse development (at least for the older coverage years) in subsequent calendar years.

Capitalization

The composite's surplus increased modestly during 2016, from $12.6 billion to $13.1 billion, a growth rate of 4% (Figure 5). While net income for the composite was close to $600 million, a large portion of this income was returned to policyholders in the form of dividends, discussed further below. The industry's growth in surplus during 2016 represents a noticeable decline from the double-digit growth rate seen during most of the prior decade.

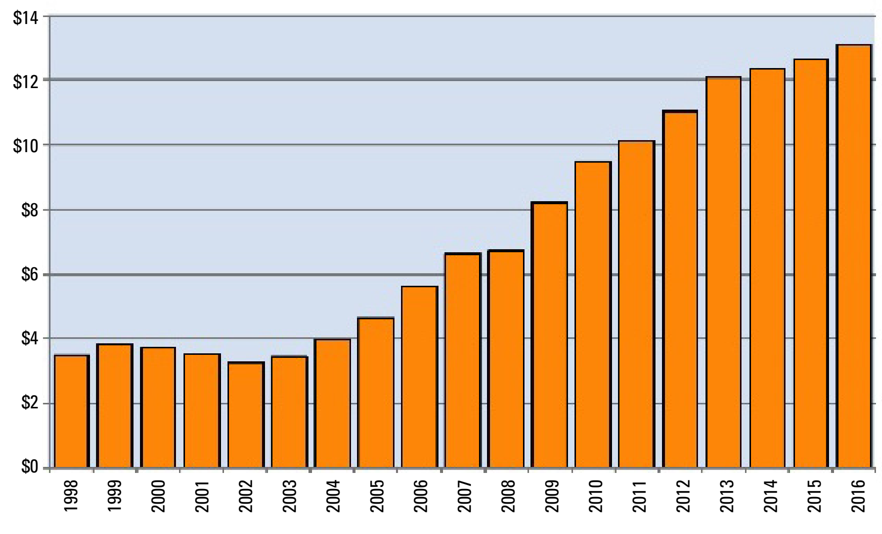
To put the industry's capitalization level in a broader context, consider the risk-based capital (RBC) ratio for the industry. This metric provides a comparison of a company's actual surplus to the minimum amount needed from a regulatory perspective (although, from a practical perspective, given market fluctuations, many would consider the practical minimum amount of capital needed to be well in excess of this regulatory minimum). The RBC ratio of our MPL composite was 1150% in 2016, approximately its same level since 2012. However, individual RBC ratios vary considerably within the composite, from a low of 650% to a high of more than 3000%.

Policyholder dividends

The stabilization of the industry's capitalization level is in part due to the significant amount of policyholder dividends that MPL writers have continued to pay. In 2016, the composite writers paid slightly more than $200 million in policyholder dividends, representing close to 6% of net earned premium (Figure 3). Cumulatively, the composite has paid more than $2.5 billion in policyholder dividends since 2005.

MPL writers have sustained a steady

Figure 5 Policyholder Surplus ($ Billions)



pattern of policyholder dividend payments, despite a decline in the reserve releases that have historically been used to fund these dividends. In 2015 and 2016, policyholder dividends were approximately 35% of net income in each year. This represented an increase from an average of approximately 25% of net income in each of the preceding eight years.

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.

Profitability expected to continue—but so is its decline

In its most recent "Review & Preview" report, A.M. Best estimated a net total reserve redundancy of $3.0 billion for the MPL line of business as a whole. This is approximately 11% of the carried net reserves, which implies a redundancy for our composite of $1.0 billion. Thus, continued reserve releases can be expected to mask deteriorating underwriting results on current business, both prolonging the soft market and possibly increasing the risk of rate inadequacy. Insurers face other risks to the bottom line as well: possible increases in frequency and severity, including the threats to the tort system and tort laws in various states, the continued impact of healthcare reform or its reversal, and a decline in market size, among others factors.

We expect that further pressure will be exerted on the industry's rate adequacy as the soft market continues, and that profitability will continue its slow erosion as a result. Yet capital remains strong, and we expect that discussion of its appropriate deployment will continue to be a common topic of conversation. Any "pleasant surprise" that comes to the industry, or to us as arguable pessimists, will take the form only of declines in profitability that are less than expected, or a longer time period during which current capital levels are maintained, prior to declining.

If you have been reading this annual series of articles for several years, you will know that for some time we have seen the soft market extending further and further into the future. We have attempted to speculate on when the market might harden, knowing not much more than that the market will harden only when it is done softening. In an industry that remains consistently, but decliningly, profitable, we expect that it will be at least several years before we can begin to speak of the hard market in the present tense again. PIAA

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