

# UNDERWRITING INCOME CONTINUES TO DECLINE, OFFSET BY 2017 INVESTMENT GAINS

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*The year 2017 manifested a continued decline in underwriting income for the medical professional liability (MPL) insurance industry. While on a downward trend, however, movement in the industry's profitability continues to occur at a relatively slow pace.*



In 2017 the industry's combined ratio increased to 103%, 3 points over the prior year. Behind this increase, insurers experienced significant declines in reserve releases, compounded by lower rate levels.

At the same time, investment gains increased almost 5 points, to 24% of premium. This produced an operating ratio of 79%, well below breakeven. Despite the decline in underwriting profitability, the MPL industry again returned a substantial portion of its income as dividends to policyholders. Surplus declined slightly in 2017, the first time this

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has occurred since 2002. Nonetheless, the MPL industry remains in a financial position roughly consistent with where it has been for the past five years.

For most of the past decade, the favorable operating ratios in the MPL industry have had one primary cause—the release of prior-year reserves. In 2016 and 2017, reserve releases contributed an average of 17 points to the industry's operating ratio in each year. However, this is a noticeable decline from the reserve releases 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 2017, albeit by a smaller margin.

The industry's onetime pattern of declining frequency ended several years ago. We have since seen the reporting of claim counts stabilize for most companies, with some volatility evidenced for certain writers and increases seen in certain markets. Trends in defense costs remain in the range of 4% to 6% per annum. Indemnity severity trends remain manageable for smaller-dollar claims, but an increased frequency of larger claims has fueled overall increases in indemnity costs.

This trend towards higher indemnity payments has been driven, in part, by consolidation in healthcare. Whereas an occurrence might previously have resulted in payments on behalf of both a hospital and an independent physician, that independent physician is

in many cases now employed by the hospital. As a result, the hospital is likely to assume the full indemnity payment—leaving overall indemnity unchanged in this example, but increasing the average indemnity per claim. At the same time, the hospital typically carries higher limits than the physician, so there may be greater availability of coverage for indemnity payments.

Rates have continued 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. At the same time, this trend in declining rate levels has somewhat abated.

A trend that has not abated is healthcare consolidation, as evidenced by the acquisition of physician practices by hospitals and healthcare systems and by many newly trained physicians opting to join these larger systems rather than enter into independent practice. MPL carriers continue to face declining market share as a result of these acquisitions. 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 completely reverse the trend in physician employment—change and uncertainty are hardly an encouragement to independent physician practices.

To get a more detailed picture of the state of the MPL industry today, we have analyzed the financial results of a composite of 35 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 35 companies included here are all established MPL specialty writers. They exclude any MPL specialty writer that has become insolvent or otherwise left the market and the multiline commercial writers of MPL coverage, as well as the smaller MPL writers with less-established histories. The companies in each of these three excluded categories are

generally less well capitalized than the 35 companies included here. In addition, the underwriting results of the multiline commercial writers as well as some of the smaller writers have generally been somewhat less profitable. Of course, this was 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, 2017, marked the eleventh 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 time frame, 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 means that MPL rates are in a much better

**Figure 1. Direct Written MPL Premium (\$ Billions)**

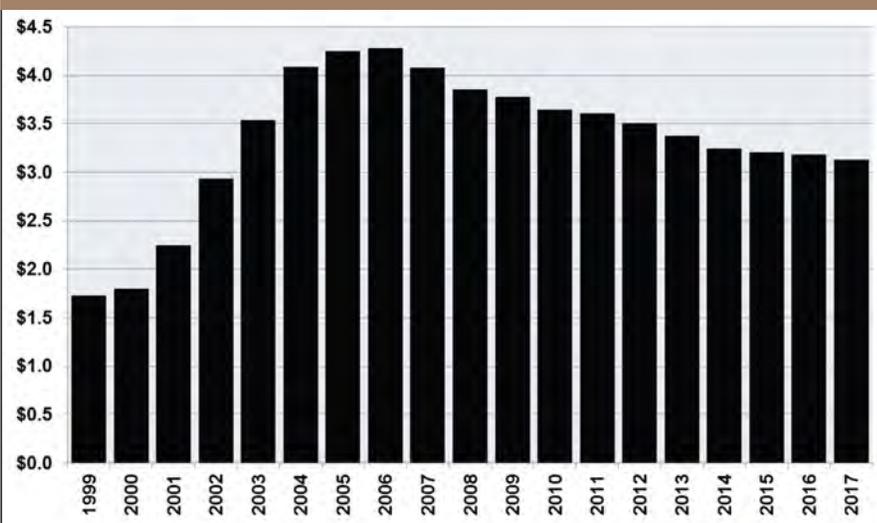


Figure 2. Operating Ratio

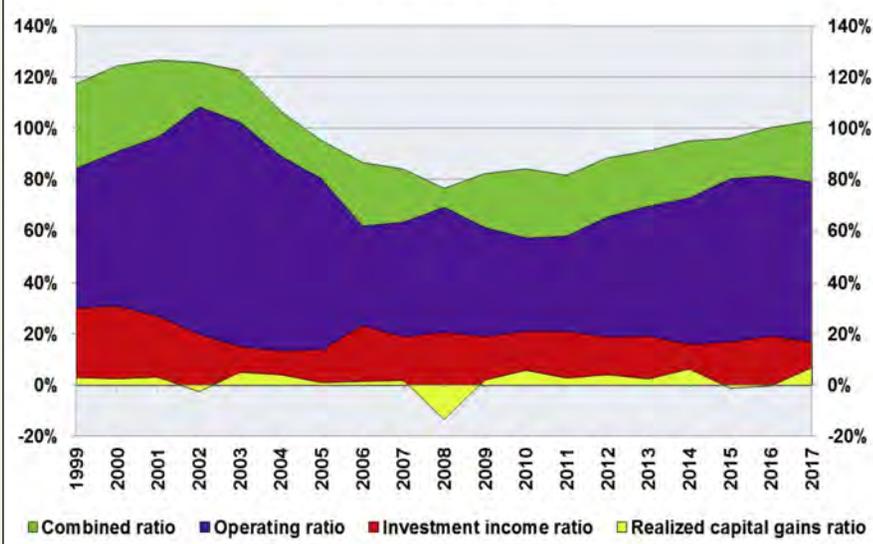
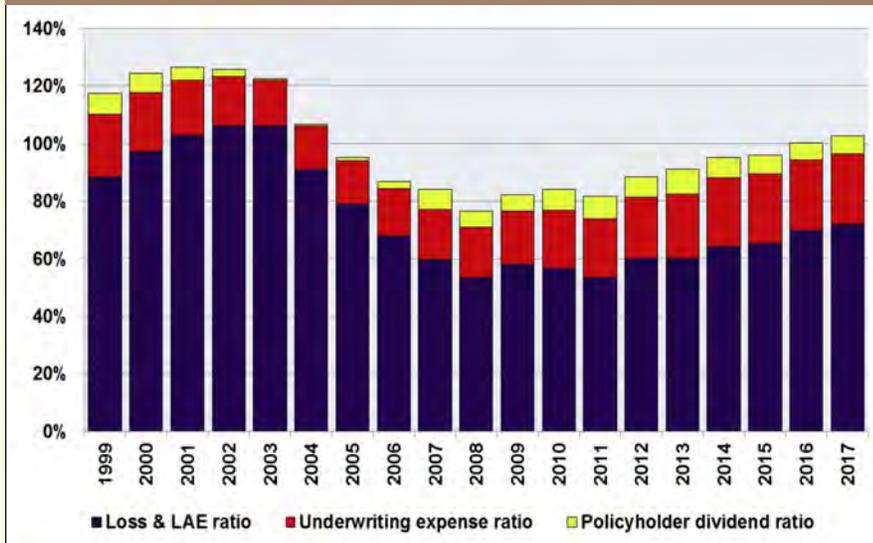


Figure 3. Combined Ratio



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 57%, which has risen to about 80% since that time (Figure 2). The increase has been driven by the decline in reserve releases, beginning in 2012, and by an increase in underwriting

expenses. The 2017 combined ratio for the industry was 103%, up from a low of 77% in 2008 (Figure 3). This is the second year in a row that the industry's combined ratio has exceeded 100%, meaning that the industry would have been unprofitable during the past two years without its investment income.

The investment gain ratio of 24% in 2017 was the highest achieved by the composite since 2010. This is a noticeable increase from 2015 and 2016 in particular, in which the investment gain ratio averaged 17%. In large part, the lower investment gain ratios of these two years were due to the accounting treatment by one larger carrier of its invest-

ment in its affiliates. The industry's capital gains ratio increased to 7% in 2017 from slightly negative amounts in both 2015 and 2016. The investment income ratio decreased from 19% in 2016 to 17% in 2017.

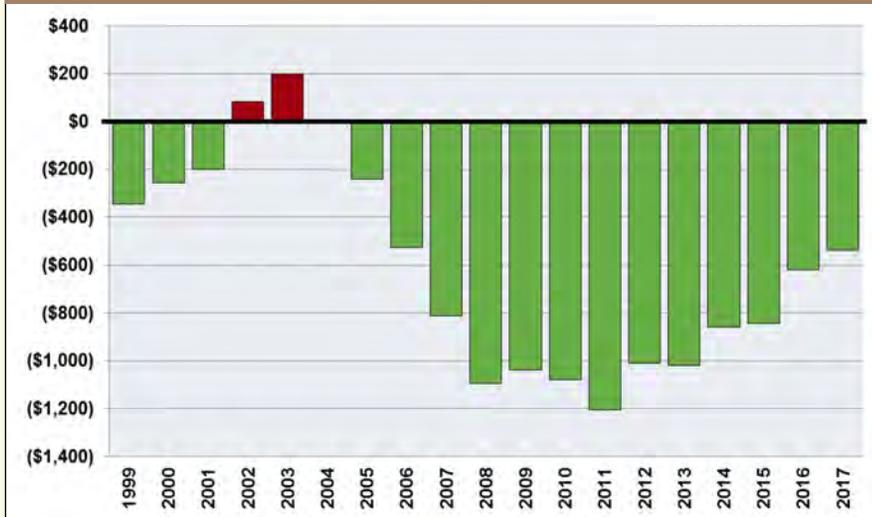
The calendar-year loss and loss adjustment expense (LAE) ratio for 2017, 72%, is higher than in any year since 2005, and represents an increase of 18 points since 2008. The increase has been driven largely by the decline in reserve releases noted earlier, which is discussed further below. The starting loss and LAE ratio for the most recent corresponding coverage year has changed little during this time.

Information from the composite on the development of the 2017 coverage year to date, such as claim frequency, would not suggest that the 2017 coverage year will perform comparably to its predecessors. This implies that the 2017 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 during the 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 30% since 2008. 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.

**Figure 4. Reserve Release (\$ Millions)**



### Reserve releases

The composite released \$540 million in reserves during 2017, an amount that has declined annually from the \$1.0 to \$1.2 billion released in each of the years 2008 through 2013 (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 \$9.0 billion as of year-end 2016. The release of reserves was driven by a relatively benign trend in indemnity severity during the past several calendar years along with, for some companies, a less-than-expected ratio of claims closing with indemnity payment.

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 2019 or 2020. This would then be followed by adverse development (at least for the older coverage years) in subsequent calendar years.

### Capitalization

The composite's surplus decreased slightly

during 2017, from about \$12.3 billion to \$12.2 billion (Figure 5). Although relatively small, this represents the first decline in surplus for the composite since 2002. In part this decline was due to significant adjustments to surplus by two carriers in the composite. Even without these adjustments, the composite's surplus would have grown only 2% during 2017.

Between 2012 and 2017, the composite's surplus grew an average of 2% in each year. This represents a noticeable decline from the double-digit growth rate seen during most of the prior decade. While net income for the composite was close to \$650 million, a large portion of this income was returned to policyholders in the form of dividends, discussed

further below.

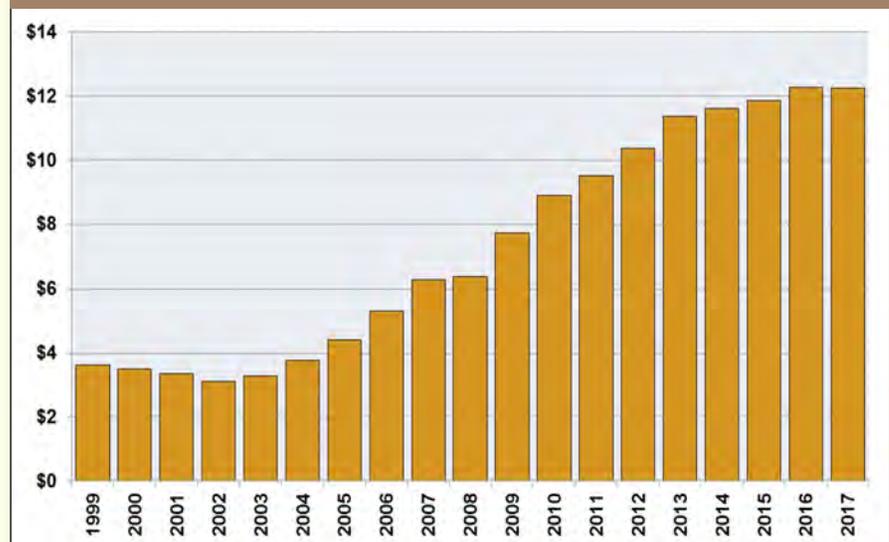
To put the industry's capitalization level in a broader context, consider the risk-based capital (RBC) ratio for the industry. This metric provides a comparison of a company's actual surplus to the minimum amount needed from a regulatory perspective (although, from a practical perspective, given market 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 1100% in 2017, approximately its same level since 2012. However, individual RBC ratios vary considerably within the composite, from a low of 250% to a high of more than 3600%.

### 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 2017, the composite writers paid slightly more than \$200 million in policyholder dividends, representing more than 6% of net earned premium (Figure 3). Cumulatively, the composite has paid \$2.7 billion in policyholder dividends since 2005.

MPL writers have sustained a steady pattern of policyholder dividend payments, despite a decline in the reserve releases that

**Figure 5. Policyholder Surplus (\$ Billions)**



have historically been used to fund these dividends. Since 2015, policyholder dividends have been approximately 35% of net income in each year. This represents 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 \$3.3 billion for the MPL line of busi-

ness as a whole. This is approximately 12% of the carried net reserves, which implies a redundancy for our composite of \$1.1 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 challenges to tort laws in several states; the continued impact of healthcare reform or its reversal; and a declining market share, among other 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 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.

We continue to see the soft market extending further and further into the future. The relative flatness of trends in frequency, rate levels, and capital, in particular, suggests that the current equilibrium could be maintained for some time. In the past, we have attempted to speculate on when the market might harden, but in truth we know not much more than that the market will harden only when it is done softening. In an industry that remains consistently, although 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. 

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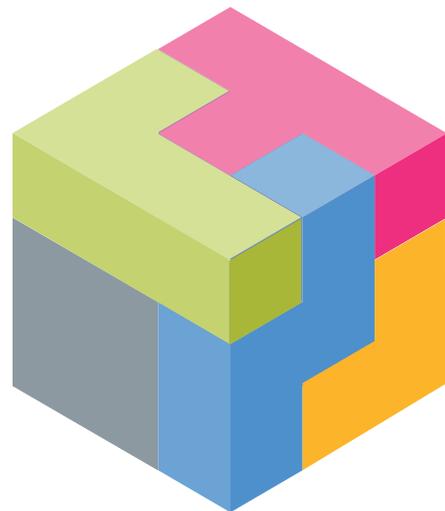
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