State of the Industry: More Good News, But Caution Lies Ahead

By Kevin J. Atinsky and Chad C. Karls

The terms "soft" or "softening" have been the most common characterizations used to describe the current market conditions for medical professional liability (MPL) insurance. To the casual observer, it may appear to be stating the obvious—rates have been generally flat to turning downward, and competitive pressures to maintain policy retention targets have increased within the past couple years. The words "soft" and "market," when placed side by side, tend to connote irresponsible behavior by market participants, particularly on the heels of the latest (and recent) MPL insurance crisis.

In our opinion, general market behavior by PIAA member companies has thus far been prudent and in step with financial performance and the underlying loss cost dynamics, most notably, the marked improvement in reported claim frequency. We would assert that the combination of a reduction in reported claim frequency along with, broadly speaking, the achievement of rate level adequacy provides support for the rate actions of the MPL specialty industry as a whole. Additionally, it has been a few years since claim severity has been a hot topic of discussion, and national statistics have thus far warranted the reduced attention, until perhaps now. Figure 1 displays countrywide calendar-year paid claim severities, based upon information contained in the most recently available file from the National Practitioner Data Bank.[1]

In Figure 1 (following page), one can observe an increased trend line between 2005 and 2007, which may be corroborative of certain theories regarding the dynamics surrounding the reduction in reported claims frequency [see "Reported Claim Frequency Down, Beware (or at Least Be Aware of) the CWI Ratio," *Physician Insurer*, fourth quarter, 2007, for additional discussion].

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"Is this as good as it gets?"

Regardless of the causes for the recent up-tick, the historical volatility of claims severity for the MPL industry should provide reason enough to keep a watchful eye on severity and perhaps consider refining the tools used in monitoring and assessing these emerging trends as warranted. Further, this recent trend line is relatively consistent with the pattern that unfolded leading up to the latest crisis, which was largely driven by issues with claim severity.

With regard to more pleasant events, the recent announcements of numerous policyholder dividends by PIAA member companies is something that the group can take pride in, and it would be easy to glean a sense of vindication over the critics of the MPL industry. Not just recently, but over the years, the PIAA member companies have, as a group, followed through on their primarily mutual-based organization structures and core principles implicit in the overall mission of physician advocacy. Table 1 displays the 10-year history of policyholder dividends, on both an incremental and cumulative basis, that PIAA member companies have transferred back to the doctors. The source data of Table 1 (and the figures that follow) reflects a Milliman analysis of National Underwriter Insurance Data Services from Highline Data for a compilation of 49 specialty MPL carriers.

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As can be seen in Table 1, the specialty MPL industry returned more than a quarter of a billion dollars during 2007, bringing the ten-year total to more than $1 billion. In light of this, it would appear difficult to assert claims of "profiteering," as has been done by various critics of the industry.

In addition to the recent events discussed above, we would note the following list of highlights for the industry during 2007:

- Further improvement in overall financial results
- Generally increased levels of competition
- Stabilization in the market presence of the MPL start-up operations
- Continued merger and acquisition activity
- Rate levels that have generally reached a plateau or are moving downward.

In terms of the 2007 financial performance, consistent with the presentation of aggregate results contained in recent state-of-the-industry articles, we will review the following financial metrics for the universe of specialty carriers noted above:

- Top-line premium growth
- Operating results
- Capitalization levels.

Table 1 Policyholder Dividends

Year	Incremental Policyholder Dividends $(000's)	Cumulative Policyholder Dividends $(000's)
1998	133,267	133,267
1999	134,621	267,888
2000	137,038	404,926
2001	96,057	500,983
2002	60,116	561,099
2003	18,828	579,926
2004	19,331	599,257
2005	47,039	646,296
2006	99,846	746,142
2007	266,596	1,012,738

Figure 1 Calendar-Year Claim Severities

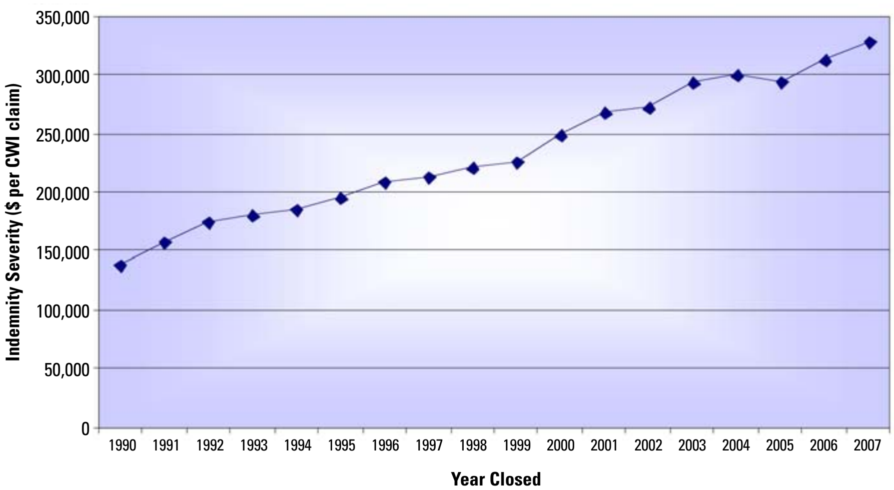
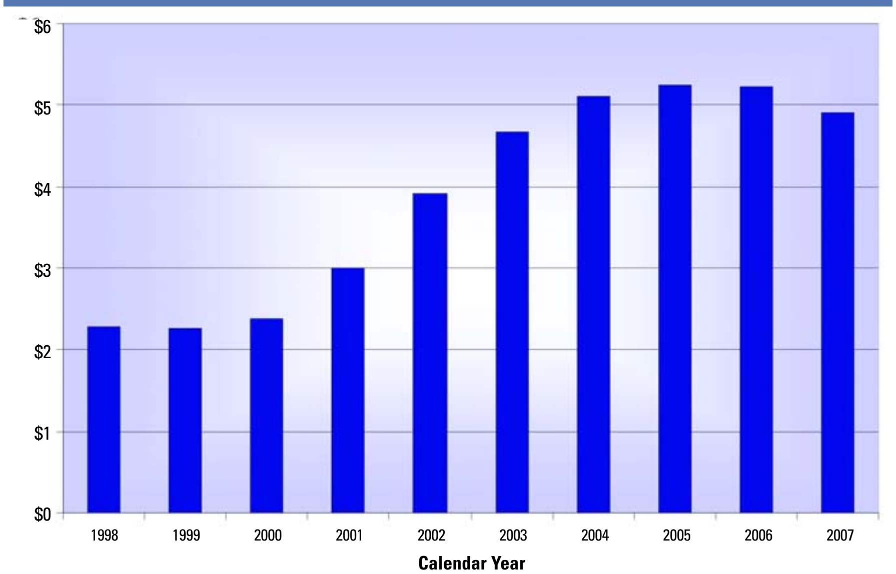


Figure 2 Direct Written Premium in $ (billions)



Top-line growth in premium

Figure 2 displays the growth in direct written MPL premium between 1998 and 2007 for our 49-company composite sample of specialty writers.

Using growth in direct premiums as a proxy for rate level movement, Figure 2 would suggest that overall rate levels remained fairly steady between 2004 and 2006, with a fairly sizable reduction in 2007. This is consistent with our perception of rate level activity during this period; however, we would note that there exists a degree of variation on an individual-company and individual-state basis. As noted in last year's "Industry Update" (*Physician Insurer,* second quarter, 2007), key factors that will help shape the course of this pattern in the future are as follows:

- Sustainability of improved reported claims frequency
- Containment of claims severity to within manageable trends
- Level of underwriting discipline maintained by the industry.

Given the current state of the MPL insurance marketplace, it seems that there exists a fair amount of uncertainty with respect to all of the factors cited above, and the dynamics are bound to vary based upon individual market-specific issues. Further, as a cautionary note, with the improved financial results for this sector over the past several years (discussed further below), there exists the potential for new, opportunistic capital to

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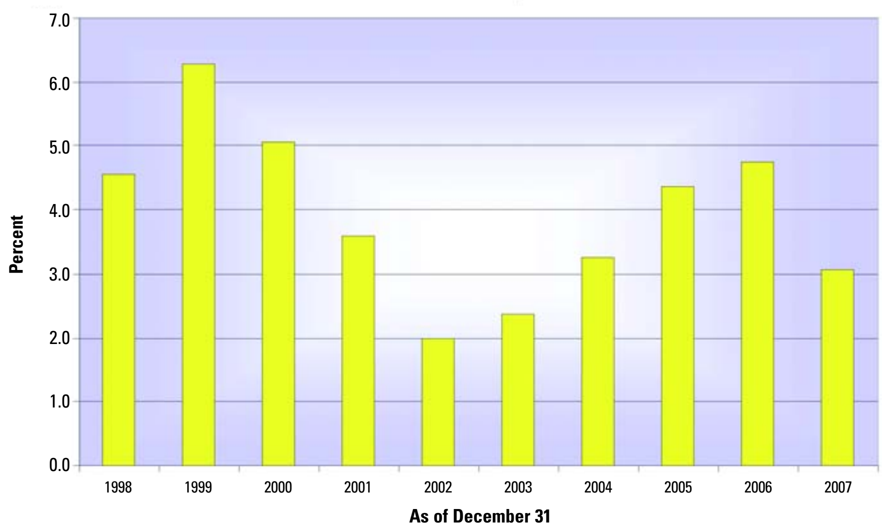
enter this market, thus adding more competitive pressure to the industry's top line.

Operating results

After sustaining operating losses in the early 2000s, this group of companies produced strong operating results starting with 2004, most notably during 2007 (see Figure 4 for additional detail). The improving overall operating results have been driven primarily by the underwriting performance. The improvement in the underwriting performance is largely a result of the significant rate level increases implemented during the period of 2001 through 2004, in conjunction with the improvements in reported claim frequency.

The investment results have been relatively steady over the past five years, though we would raise caution with regard to the recent declines in the interest rate environment and the added uncertainty created by the current macro-level condition of the economy. For illustrative purposes, Figure 3 displays the historical 3-Year U.S. Treasury yields as of successive years, as of December 31 of each year.

Figure 3 3-Year U.S. Treasury Yield

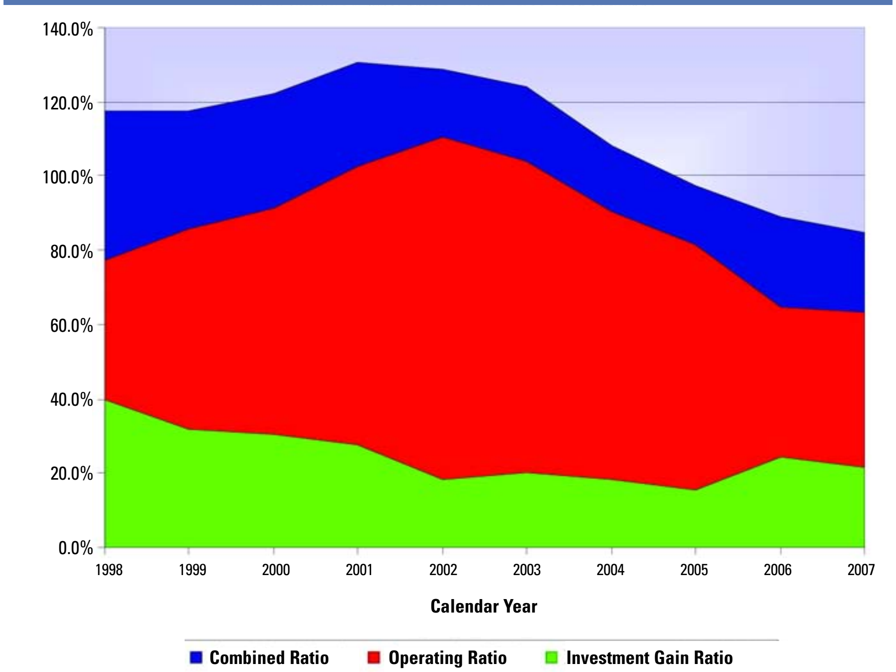


In reviewing the investment results via the investment gain ratio in Figure 4 (defined as investment gain divided by net earned premium) for the period 1998 through 2007, one can observe a marked decline in this ratio beginning in 2002. This decline was driven by the rather dramatic shift experienced in the interest rate environment during this period (displayed in Figure 3), as the vast majority of the invested assets reside in fixed income securities, as well as the significant rate increases, which impacts the denominator of the investment gain ratio.

It should be noted that investment gain contemplates both interest income, which tends to be correlated with interest rates, as well as realized capital gains. Between 1998 and 2001, the investment gain ratio hovered in the 30% to 40% range; and since 2002, it has generally been near 20%. For reference, a reduction in the investment income offset necessitates a lower target combined ratio in order to achieve comparable operating results, all else being equal. Figure 4 displays the operating ratios (defined as the combined ratio less the investment gain ratio) between 1998 and 2007, as well as the underlying components.

As can be seen in Figure 4, the operating ratio results for the latest two calendar years reflect this group's most profitable over the past ten years.

Figure 4 Underwriting and Operating Results



Capitalization levels

This composite of companies has experienced significant growth in capital (defined as statutory surplus) of late, with double-digit rates of surplus growth in each of the past four years. The improved capital position during this period has been largely driven by retained earnings (i.e., net income). As a result of the limitations of mutual companies to access new capital as compared to stock insurance companies, operating results tend to be correlated with changes in capital position.

This is not to say that there are no other factors that affect surplus levels nor that additional capital is not available to these carriers; but it does underscore the need for mutual

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companies to maintain prudent and appropriate levels of capital to weather the unforeseen. Figure 5 charts the path of surplus growth over the past ten years.

While Figure 5 demonstrates a steady growth in surplus over the past four years, it should be noted that the universe of companies only includes those that persevered the latest crisis, and thus excludes carriers that had deteriorating financial results and subsequently failed. This introduces the potential for distortions or bias in the financial statistics.

The nominal value of statutory surplus provides limited meaningfulness in assessing the true capital adequacy levels of the MPL specialty industry, due to the fact that it does not normalize for, or take into account, the changing levels of risk inherent in the insurance operations. The NAIC has promulgated its own measure of capital adequacy known as risk-based capital (RBC), which is utilized by the insurance departments to monitor solvency. For reference, an RBC ratio of less than 200% results in various levels of regulatory action; and a ratio above 200% results in no regulatory action (barring an exceptional situation). As can be seen in Figure 6, capitalization levels (as measured by the RBC ratio) were in steady decline during the latest MPL insurance crisis, beginning in 2001, and hit a ten-year low point in 2003.

With the rebound in operating results, the industry has restored and exceeded the capital levels that existed prior to the crisis, which is both necessary and prudent given the historical swings in underwriting, as well as investment results, that have plagued this industry.

Figure 5 Policyholders' Surplus in $(Billions)

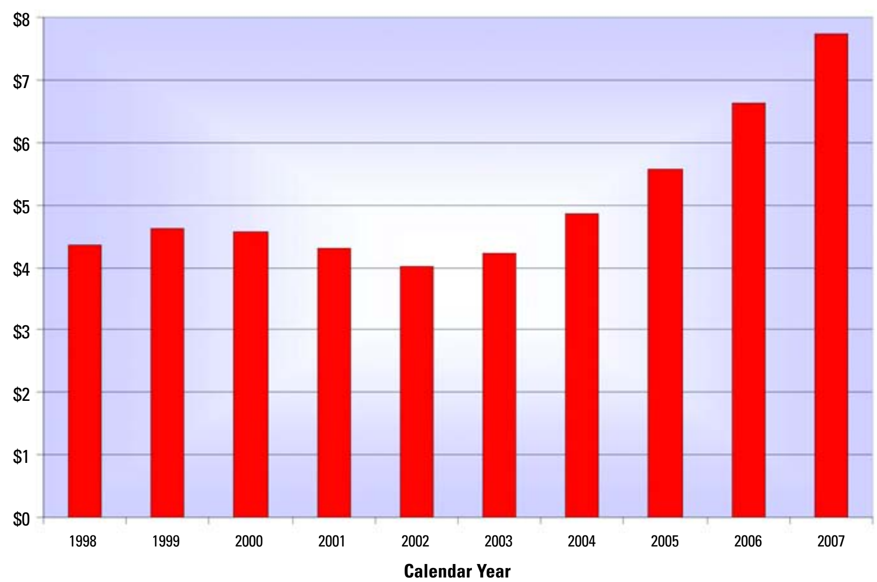
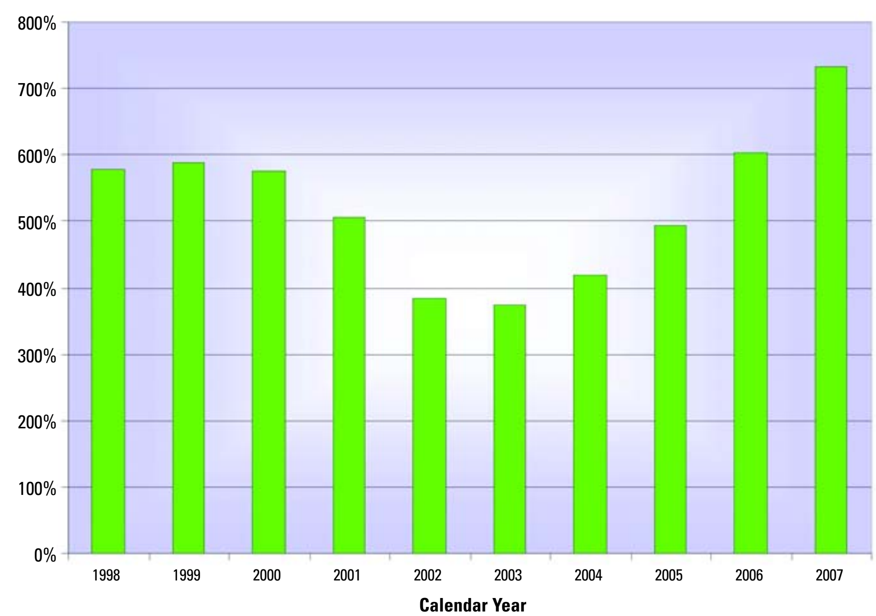


Figure 6 RBC Ratio



Conclusion and forecast

In last year's "Conclusion and forecast" section, we noted the vast improvement in the overall financial health of the industry and suggested that 2007 would be another profitable year, despite the slow-down in rate level increases and the long-term cost pressures that persist.

One year later, we believe that these comments remain relevant with respect to 2008, though we would interject a couple points of caution. Specifically, we have highlighted the concerns regarding increasing competitive pressures, potentially rising claim severities along with uncertainty with respect to the CWI ratio as well as the volatility in the interest rate environment. With the emergence of these cautionary signals and the stellar financial results during 2007, it leads us to pose the question: Is this as good as it gets?

PIAA

For related information, see www.milliman.com.

1. National Practitioner Data Bank Public Use File, December 31, 2007, U.S. Department of Health and Human Services, Health Resources and Services Administration, Bureau of Health Professions, Office of Workforce Analysis and Quality Assurance, Practitioner Data Banks Branch.