



MPL Actuarial Valuations in M&As

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Mergers and acquisitions (M&As) continue to shape the healthcare landscape. In these transactions, it is critical that the medical professional liability (MPL) insurance program be accounted for properly, considering that the unpaid losses and loss adjustment expenses associated with the program can be a significant item on a balance sheet. Management should seek guidance from its broker, actuary, legal counsel, accountant, and other consultants before starting the process, because each will be able to provide a different viewpoint and different roster of concerns. A focus on the following areas will ensure an optimal actuarial estimation of the unpaid losses and loss adjustment expenses during an M&A.

Dangers and benefits of acquisitions

There can be both substantial benefits and dangers associated with M&As that are important for management to consider in the preliminary stages of the M&A process.

Some dangers may be:

- Rushing to complete the transaction, resulting in insufficient time devoted to decisions
- Poor records of claims, exposure information, and/or physician rosters
- A loss of interest in safety (to control claims) by the acquired entity
- A lack of understanding of applicable insurance coverages
- A lack of understanding of a new jurisdiction, if applicable
- Inability to change the culture of the acquired entity.

Some benefits may be:

- Additional negotiating power for any acquired hospital and/or physicians
- Reduction of overall claims costs by sharing of limits between hospital and physicians
- Joint defense savings, because finger-pointing at the other defendant/s is diminished
- Better control over risk management
- Consolidation of administrative burdens
- Larger insurance program means more credibility for actuarial estimates

An unbiased estimate and experienced actuary

Each side in an M&A may have a different motivation in the transaction. Full transparency should be demanded by all parties involved. When in doubt, it is best practice to hire an independent actuary. This will allow an additional, outside perspective for quantifying the estimates—without any bias. The independent actuary may also act as a facilitator in any conversations about differences in estimates between the parties involved in the M&A.

MPL is a specialized line of coverage with unique intricacies. Actuarial estimations involve assumptions and judgments, so it is possible to end up with varying answers even when the same data is provided to different actuaries. Experience in a particular captive domicile or jurisdiction, and with prior M&As, may improve the accuracy of the calculations and make the process run more smoothly.

Reliable data

Actuarial estimates with trustworthy or “good” data will have less uncertainty. Management should strive to provide complete, detailed records so the actuary will have to make fewer assumptions. Electronic information will make the audit process easier. It is particularly difficult to obtain complete physician rosters, because they are always changing and because they must include diverse fields, such as hire date, specialty, retroactive date, full-time employee (FTE) status, and termination date.

The actuary should be able to provide a comprehensive list of required data to management. Often, it is better for management to send more information than not enough. The data should be reconciled to any prior actuarial report, to make sure the information is being used correctly and consistently. Management should keep in mind that it may be difficult to obtain quality information from the acquired entity, and there will inevitably be a learning curve for the actuary, because hospitals track information differently.

A full understanding of the insurance program

The structures of MPL insurance programs are often complex. Deductibles and coverage limits change as the needs of the hospital, health system, or physicians evolve. Market conditions may dictate the amount of insurance available at a reasonable price. Previous M&As can complicate the picture even more.

Management should provide summaries of all insurance policies, including the coverage limits, treatment of loss adjustment expenses (i.e., inside or outside the limit), and coverage form (claims-made vs. occur-

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rence). Any tail policies, especially those offered to physicians, should also be provided with issue dates and retroactive dates. Summaries should also contain information on whether the hospital, its employees, or (employed or contracted) physicians are covered. The summaries will also need to state the hospital's retentions (if any), any applicable aggregate limits, and the amount of any excess insurance or reinsurance. The broker is another good resource for this information and should have it readily available.

Actuarial judgments

An actuary applies mathematical models to estimate the unknown losses or future losses based on prior history. The unknown losses are referred to as incurred but not reported (IBNR) losses. This includes claims that have not yet been reported, further loss development on known claims, closed claims that will reopen, and claims that may be in the pipeline but are not yet in the claims-reporting system. The total of the known case reserves plus the IBNR equals the unpaid claims liability.

The actuary should try to use as much of the history of the hospital, health system, or physicians as is credible. An actuary will blend in data derived from an industry standard or may only utilize this standard when the data available is not fully credible. Inevitably, when selecting the pattern of future loss development, the actuary is applying judgments. Even a slight variation in one of the actuary's selections can significantly impact a loss estimate. Management should try to understand the actuary's thought process and challenge it when it seems to be out of line with management's perception of the company.

When forecasting losses, actuaries will apply both frequency and severity trends to adjust the historical years to the cost basis of the projected year. Trends may be estimated based on the hospital or physicians' own data, if credible, or it may need to be supplemented with industry information. An actuary may also apply a trend for change in exposure, to measure changes in utilization and/or number of physicians by specialty.

Financial presentation of actuarial results

Unpaid claims liabilities and loss forecasts may be estimated on a discounted or undiscounted basis. The decision as to whether to employ discounting is made by management. Management usually supplies the actuary with any discount rate assumption, but the assumption must be supported. Typical methods of support include documentation of the historical return on segregated assets, using a corresponding return from a bond where the duration matches the average payment length, or simply using the risk-free rate. Any change in market conditions may warrant an adjustment to the discount rate assumption. In a merger or acquisition, several different discount-rate assumptions may be necessary, so management can see the relative sensitivity of the discount rate assumption.

Loss estimates may be provided at the actuarial central estimate, formerly known as the best estimate, or presented as a distribution (i.e., at various confidence levels). A transaction will frequently be done using the actuarial central estimate level, with confidence levels quantified. The higher the confidence level, the

lower the probability that actual losses will be greater than the estimated losses. Contingency margins are proportional to the number of losses and the size of the hospital or health system or physician group. The more losses, and the more consistency in the losses, the lower the contingency margin.

Understanding management's expectations

Management should define the scope of the project with the actuary right at the start of any M&A. The actuary will need to be informed by management about any strategic goals, to ensure that all members are on the same page. Often, the actuary and other consultants need to rely on each other to obtain the best information efficiently.

The actuary may customize the executive summary of the report to help management pinpoint the results of the analysis that are critical to the M&A. In addition, management may want the actuary to complete an analysis completely "blind," in which the results of any other actuarial analyses are not initially shared. Results of the other analyses may then be shared after the draft results have been produced. This is frequently an effective strategy for analyzing differences between any actuarial analyses and may prove to be of great value during a M&A. 

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