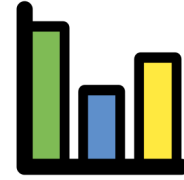


MPL Industry Financial Snapshot: Looking at 2016 and Beyond

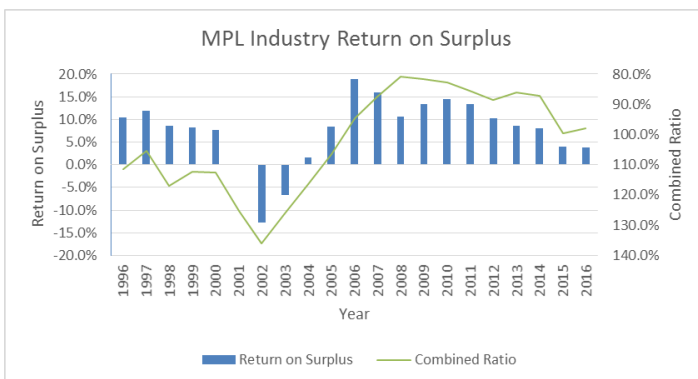


By Greg Chrin, FCAS, MAAA, Senior Manager, Deloitte Consulting LLP

The medical professional liability (MPL) industry has a long history of ups and downs. The last cycle, which began in the early months of 2004, has provided 13 straight years of positive returns on surplus for MPL insurers. However, as the old adage states, "All good things must come to an end." While the industry continues its profitable ways, the flow of those returns has slowed considerably. The returns of 10% to 20% seen between 2006 and 2012 have been replaced by returns in the low single digits. (Figure 1)

The lower returns are driven by a number of factors, including an increasingly competitive underwriting environment, a shift toward self-insurance by some of the most profitable risks, lower investment returns, and a reduction in the favorable reserve releases coming from older years.

Figure 1. MPL Industry Return on Surplus



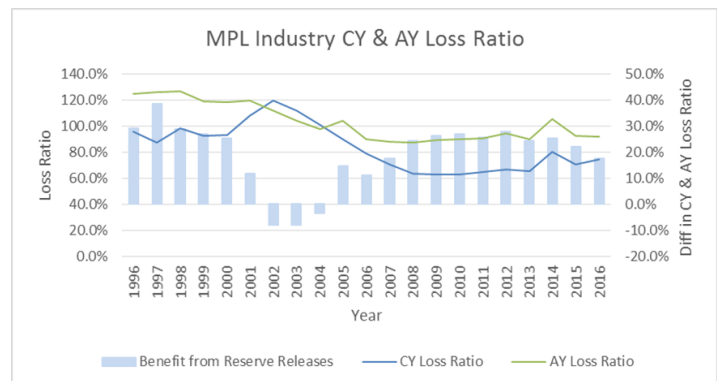
Source: SNL Financial.

MPL insurers reported a calendar year net loss ratio of 74% for 2016. During the profitable years of 2006 through 2012, the comparable loss ratio was 7 percentage points (pp) lower, at 67%, as shown in Figure 2. Conversely, the accident year net loss ratio of 91% for 2016 is on par with the 90% posted for 2006 through 2012. Therefore, the increase in the calendar year loss ratio is primarily a consequence of a decrease in the benefit derived from prior-year reserve releases. The benefit from prior reserve releases for 2016 is only 17 pp compared with 23 pp for 2006 through 2012. It is expected that the benefit will continue to decrease as newer accident year

loss ratios increase and risk margins included in the initial accident year ultimate loss ratio selections decrease.

While we don't expect the benefits to turn into penalties, as happened in 2002 through 2004, within the next few years,

Figure 2. MPL Industry Calendar Year and Accident Year Loss Ratio

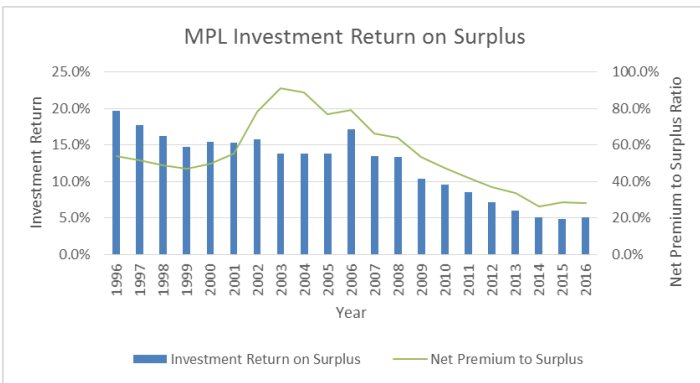


Source: SNL Financial.

softening in MPL pricing and volatility in the marketplace due to healthcare legislation could impact the overall trend going forward if it is not properly monitored and addressed in rate filings and underwriting decisions.

As underwriting results have fallen off, so too have the investment returns achieved by MPL insurers. For the years 1996 through 2009, insurers could count on double-digit investment returns to supplement their underwriting results. Since 2009, much like many other lines of insurance, investment returns for MPL have continued to regress, now hovering around 5% of surplus.

Figure 3. MPL Investment Returns on Surplus



Source: SNL Financial.

Compounding the impact of reductions in overall investment returns, insurers are writing less in net premiums as a percentage of surplus, as shown by the line in Figure 3. Various strategies have been employed by insurers to redeploy the capital, including mergers and acquisitions, new products, and trying to attract new customers. However, it has proved difficult for many insurers to redeploy the surplus they accumulated during the period 2006 to 2012.

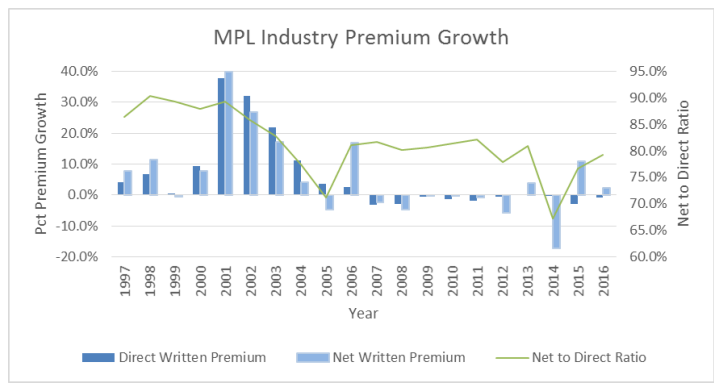
The MPL industry appears to be close to a transition from a soft market into a hard market, but there is little doubt that the transition has been the slowest in recent history. The industry has experienced some pockets of pain (e.g., overturned caps, large awards, competitive pressures, etc.), but there hasn't been a catastrophic industry event like the MPL crisis of the early 2000s that drove combined ratios north of 130%. As a result, the current pain may not be enough to push the industry to harden in the next three years.

Premiums

Over the past decade, direct written premiums have been slowly declining, at a rate of about 1% per year. This period of slow and steady decline follows the period of sharp increases related to the MPL crisis of the early 2000s, when premium levels increased from \$3.2 billion in 2000 to \$8.4 billion by 2006. The decline in premiums since 2006 has been related to patient safety efforts that have culminated in a lower frequency of claims, as well as exposures, which has meant that the market linked with hospitals and physicians has retained more of the risks.

During the late 1990s, MPL insurers retained approximately 90% of the direct business written, as shown in Figure 4. During the MPL crisis, MPL insurers looked to spread risk through reinsurance; ultimately reaching a 71% net-to-direct ratio by 2005. Since 2006, the industry has settled on a new normal retention level of approximately 80%. Reinsurers have been willing to share in the current profitability of the business, but are very cautious about the increasing severity of claims and the occurrence of batch claim events.

Figure 4. Premium Growth in the MPL Industry

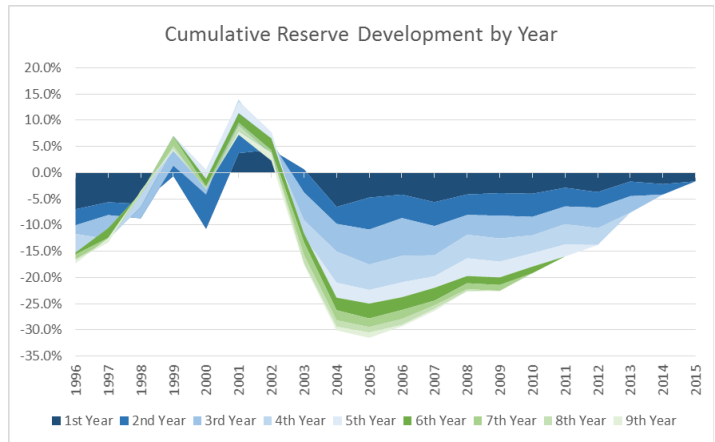


Source: SNL Financial.

Loss ratios

The tightening of the bands since 2005 shows the reduction in benefits experienced from prior-year reserve reductions. As shown in Figure 5, the cumulative benefit from reserve releases has been decreasing since 2005. Each band represents a year of development. The tightening of the bands since 2005 shows the reduction in benefits experienced from prior-year reserve reductions.

Figure 5. Cumulative Reserve Development, by Year



Source: SNL Financial.

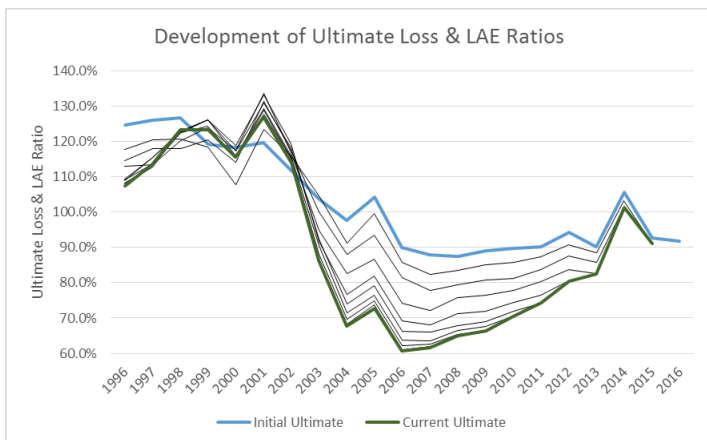
Prior to the MPL crisis of the early 2000s, the downward trend in development in the first three development years was robust. It wasn't until the fourth development year that reserve releases quickly dried up and reverted into reserve increases. That shift was very dramatic, compared with the current slowing of reserve releases. There does not appear to be much concern about a new MPL crisis; rather, the data have shown a more tempered narrowing of calendar and accident year results.

While the reserve reductions have been decreasing, the initial ultimate loss ratio selections (Figure 6, blue line) have been fairly steady since 2006. The current ultimate loss ratio selections (Figure 6, green line) have been increasing annually by about 4% since 2006. Based on historical reserve developments, we can expect that the current ultimate loss ratio selections will flatten out a little and exhibit a slightly less significant trend, but the trend on accident years is nonetheless expected to increase in future years.

an end, but future success will depend on insurers' capacity to adapt to the shifting market. Leon Megginson may have said it best: "It is not the strongest or the most intelligent who will survive, but those who can best manage change."

¹Decrease in the 2014 net to direct ratio in Figure 4 is heavily impacted by Medical Protective's loss portfolio agreement with related parties.

Figure 6. Development of Ultimate Loss and LAE Ratios



Source: SNL Financial.

Surplus

In 2016, the surplus for MPL insurers grew by a modest 2%. This is a significant slowdown from the double-digit annual growth experienced between 2006 and 2013, but slightly better than was posted 2015, as shown in Figure 7.

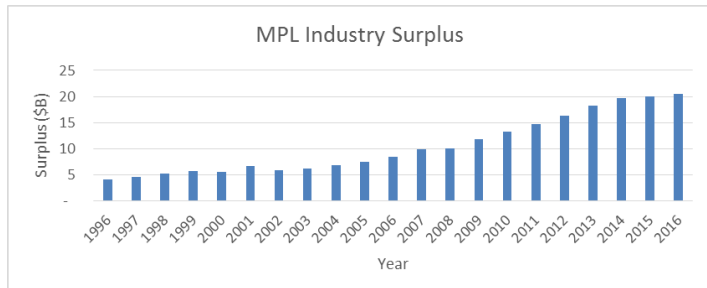
Background

Our analysis included 192 MPL insurers that wrote a combined \$7.2 billion of direct written premiums in 2016. We focused on insurers whose direct written premium was more than 75% related to medical professional liability. By restricting the study to primary MPL insurers, we are able to review returns on surplus and investment income relevant to MPL insurance without major interference from the impact of other lines of insurance.

Our review period includes data from the past 20 years (1996-2016) as reported by MPL insurers in their annual statutory financial statements and captured by SNL Financial. We have reviewed direct and net written premiums, calendar and accident year net loss & LAE ratios, other underwriting expenses incurred, net investment income earned and surplus as regards to policyholders. Throughout this article, the term "loss ratio" includes both loss and loss adjustment expense as reported within the statutory financials.

For related information, see www2.deloitte.com.

Figure 7. MPL Industry Surplus



Source: SNL Financial.

Conclusion

For several years, the MPL industry has lingered in the softer side of the underwriting cycle. Recent years show that the industry appears to be experiencing some pain and may indicate the beginning of some hardening, going forward. However, hardening typically happens after a catastrophic industry event. The current pain has been gradual, and it may not be sufficient to push the industry to a hard market in the next three years.

In the meantime, insurers are currently weathering the storm via mergers and acquisitions, combined with innovation in products and operations. The good times may be coming to

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