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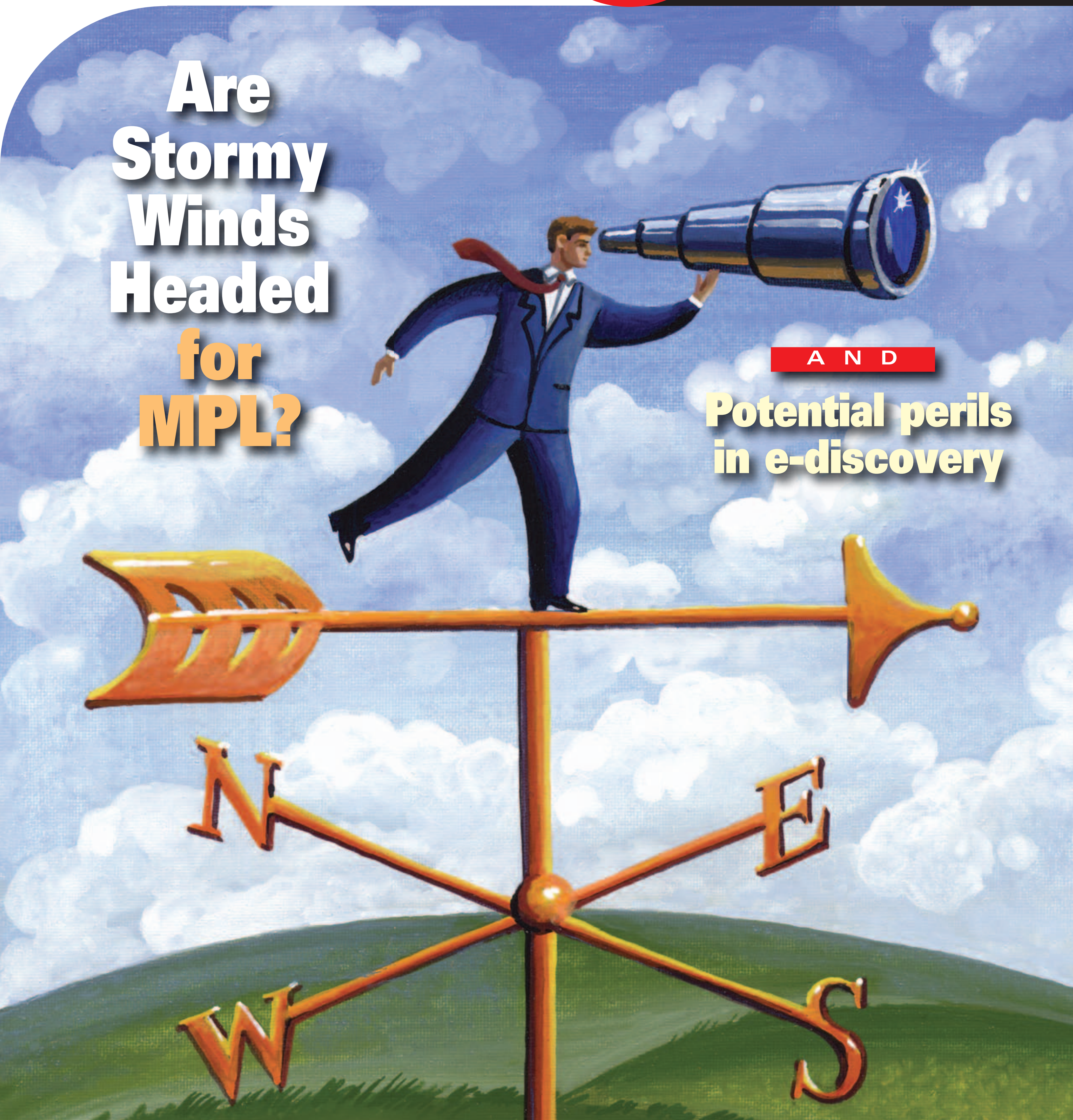
physicianinsurer

Are Stormy Winds Headed for MPL?

AND

Potential perils in e-discovery



Cover Story

By Richard B. Lord and Stephen J. Koca

Medical Professional Liability Market: Stormy Winds Begin to *Blow*

Medical professional liability (MPL) insurers have likely passed an inflection point in the market cycle. Its subtlety, however, may not be evident to the casual observer, especially when the industry is still reporting positive income results. Insurers' continued strong financial position would typically allay all concerns. The problem is that a key measure of insurers' profitability has started to show signs of deteriorating.

The index known as the calendar-year combined ratio—which measures insurers' losses and expenses relative to their premium writings—jumped 4 percentage points, to 90%, in 2010. At this point in the cycle, most any increase would raise some eyebrows, but such a large jump has caught the attention of some analysts.

The 90% ratio is still far lower than levels reached at the height of the cycle, which led to the previous hard market when it topped 150%. Nonetheless, it seems to be rapidly approaching insurers' underwriting break-even point of 100. Once the index moves above that level, insurers are losing money, from an underwriting perspective.

What may be even more of a concern is that MPL insurers' current profitability largely stems from policies written years ago during the hard market of the early- to mid-2000s, when premiums adequately covered losses and then some. Over the four- to five-year period, industry premiums doubled to $10 billion, as insurers increased premiums to cover burgeoning losses.

On the heels of the premium increases that insurers were implementing, claims cost unexpectedly began to fall. From 2003 through 2007, insurers' claims frequency fell approximately 40%. The combined effect has been that the ultimate value of the losses for the policies written during the early to mid-2000s is much less than insurers' initial estimate. The loss reserves that insurers built up during the beginning of the decade are now buoying their sagging underwriting results for current policies.

Richard B. Lord, MCAS, MAAA, *is a Principal & Consulting Actuary with Milliman in Pasadena, California.* ***Stephen J. Koca, FCAS, MAAA,*** *is a Consulting Actuary with Milliman in Pasadena, California.*

Reserve releases commence

Insurers first realized the redundancy of these prior-year loss reserves in 2005. Uncertain of the level of loss redundancy at that time, insurers moved cautiously, slowly releasing reserves, but momentum built in the ensuing years, and increased further in 2010. Based on data compiled by Milliman from a select group of physician MPL insurers, $5.7 billion in reserves were released over the six-year period, whereas the MPL industry as a whole released $10.2 billion in reserves over this period. While reserve figures are still evolving, the peak of reserve releases was likely reached in 2010, and insurers may have to start to put the brakes on the releases in the near future.

Reserve releases have kept insurers' profitability on solid footing, at least on a calendar-year basis, but if we look at insurers' results on what is known as a policy-year basis—results for just those premiums written during a given year, let's say 2010, and any losses arising from those policies—we can see that the premiums that insurers are charging for their current writings are less than what actuaries expect the ultimate value of their future losses will be.

The effect of this underpricing can be seen in a 2010 policy-year combined ratio, which, when reserve releases are added back into losses, turns out to be 114%, an increase of 11 percentage points over the past 2 years. While losses for the most recent policy years are immature, this jump in the index should not be taken lightly, as it is more likely than not that we will see further increases in subsequent years due to current trends in claims and pricing.

Reserve releases have bolstered insurers' results in recent years, but they also created conditions that promoted a soft or buyers' market for MPL insurance. One way to think of the market impact of reserve releases is in terms of pricing. If reserve releases averaged between 20% and 25% of written premium, as they have for the past several years, insurers need to charge insurance buyers only 80 cents on the dollar to break even on an underwriting basis. This means that insurers can take on business at an underwriting loss in a given year, when they are releasing reserves, and still report a profit because of their accumulated excess reserves.

Loss of premium revenue

How much premium revenue have insurers waved off? Annual written premiums have declined by around $1 billion since 2006, due primarily to the combined impact of lower average costs and reserve releases.

Time, however, may be running out on the profitability resulting from excess reserves: the reserve releases may continue for only another three to four years, declining each year, if the current cycle unfolds similar to the previous one, which until now it has.

In 1989, when the hard market just previous to the last ended, the MPL industry reduced reserves by approximately $1.5 billion, and continued to generate excess reserves for some ten years afterward. The peak was reached in 1994, when reserve releases topped $2 billion or 46% of earned premium. Based on this timeframe and the pattern of reserve releases thus far, insurers are now approximately just past the midway point of the current reserve release cycle.

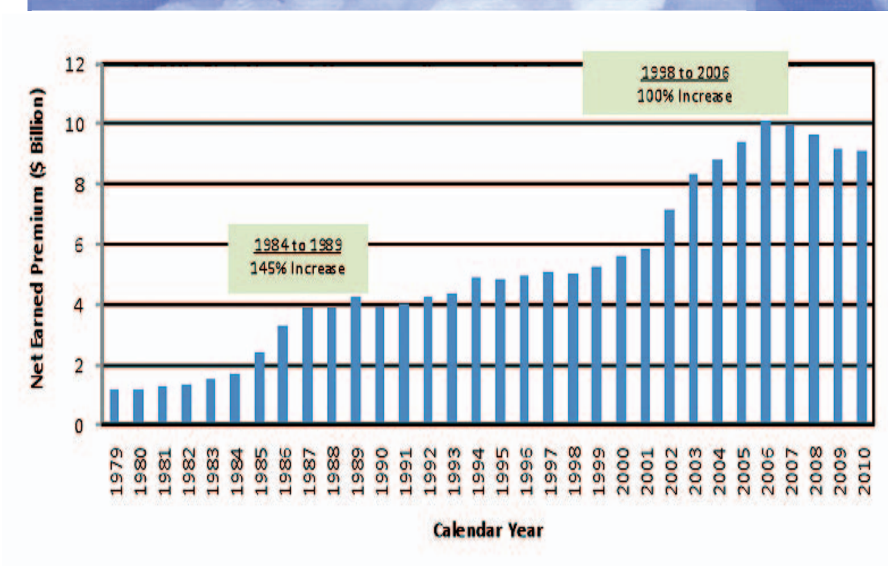
A challenging terrain

Unlike the previous cycle, however, insurers cannot rely on investment income to offset pricing discounts to the same extent they did during the 1990s and, for that matter, the past 30 years when generous investment income allowed insurers to periodically write business at an underwriting loss. But record low interest rates on bonds, which typically comprise approximately 80% of insurers' investments, have not provided the pricing subsidy that insurers once had. Moreover, many MPL insurers also sustained investment losses in 2008, which may have accelerated reserve releases in that and the following year, and may have also shortened the time over which insurers can use reserves to support income.

At the same time, claims cost inflation remains stubbornly high. Even though insurers are seeing significantly less claims than they did ten years ago when claims frequency began to tumble, medical cost inflation has greatly increased the cost of each claim. Insurers also no longer benefit from a declining claims frequency, which appears now to be level.

The other dark horse for insurers is the potential impact of the Patient Protection and Affordable Care Act on the MPL mar-

Figure 1 Historical MPL Net Earned Premiums



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ket. On the surface, the law is likely to have little direct impact for one simple reason: the law does not address MPL in any meaningful way.

The law, however, could increase the cost of care, as more people enter the healthcare system and began to utilize services. As medical costs increase, so would the cost of MPL claims, or what is known as claims severity. The increase in the raw number of people in the system—many of whom may not be as healthy as current healthcare users—would also increase exposure, which in turn could trigger a rise in number of claims or claims frequency. This situation—an increase in claims severity and frequency—is often toxic for MPL insurers.

In the long term, the increased numbers of people in the system cause medical costs to ease somewhat, as more people receive regular care, which promotes better overall health and lower costs. But over the next three or four years, the law's potential drag on the MPL market lines up with a period when the cost outlook is already tenuous.

Whether this cost rationale becomes reality is a matter of considerable speculation, but it is plausible and contributes to the growing number of challenges facing MPL insurers.

Also counted among that number is the stall, if not reversal, in tort reform, which not too long ago had been instrumental in limiting punitive and non-economic damages in a number of states. In February 2010, the movement was dealt a considerable blow by a decision of the Illinois Supreme Court, which ruled a cap on MPL awards unconstitutional. And while the course of court rulings has rarely been clear, even to the most astute legal observer, state legislatures have rarely been motivated to take up actions to support MPL tort reform when insurers' capital position is unthreatened.

And MPL insurers may face an ever-dwindling market, as more and more physicians leave private practice for employment in hospitals. Over the past several years, the movement that started some ten years ago seems to have gained traction and could accelerate when MPL insurers raise premiums. Rather than absorb double-digit premium increases, as many physicians did during the previous hard market, greater numbers may prefer to seek shelter under a hospital's cover. This move would decrease MPL insurers' market at a vulnerable time.

For now, the market is relatively calm. But it also seems that just as an array of positive factors converged during the beginning of the decade to propel MPL insurers toward profitability, negative forces are now gathering to disturb the market once again and send prices higher. How and when they take shape could greatly alter the trajectory of the cycle. PIAA

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Figure 2 Historical MPL Reserve Changes, as a Percent of Net Earned Premiums

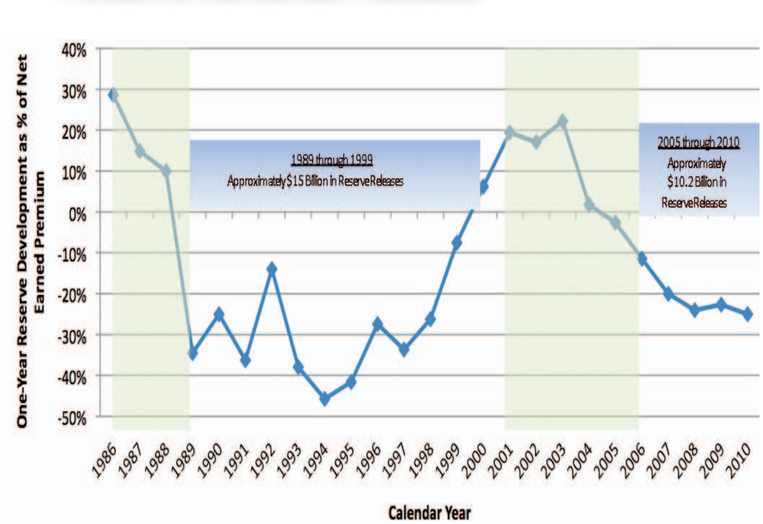

Figure 3 2005-2010 Combined Ratios, Before and After Reserve Releases