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AND

Setting Reserves for Captives

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THE BIG COUNTDOWN

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Current pricing for MPL coverage is simply inadequate

Over the past seven years, reserve releases from previous years' policy writings have been a mainstay of the medical professional liability (MPL) market, contributing to insurer's profits in the early years and, more recently, buoying results. But they've also been the engine of competition, undercutting price levels at a time when insurers have seen their client base shrink. The apparent convergence of these two forces—a runoff of reserves and consolidation within the healthcare industry—raises the question: Could their intersection cause the market to harden, quite suddenly?

Competition, spurred by a massive buildup in reserves, is nothing new to MPL insurers. But unlike other soft market cycles, the present competition is not the only reason for insurers' pricing woes.

Over the past 10 to 15 years, MPL insurers have seen their market shrink as physicians, faced with stagnating or declining revenues and rising costs, have sought employment with hospitals or large group practices. According to the American Hospital Association, the number of physicians employed by hospitals increased 32% from 2000 through 2010.

This trend has only accelerated in recent years with the prospect of implementation of the Patient Protection and Affordable Care Act (ACA), which, among its other provisions, gave new impetus to physicians to partner with hospitals or large groups that may be better able to manage the evolving risk-based compensation models of the new healthcare landscape. Hospitals or integrated delivery systems now employ more than half of the practicing physicians in the United States.[1]

As more and more physicians seek employment in hospitals or large group practices that often rely on self-insurance or other alternative risk management mechanisms for MPL protection, primary MPL insurers have been forced to compete for business in a shrinking market.

The impact of consolidation within the healthcare market may already be reflected to some degree in the unprecedented decline in earned premium, which has fallen nearly 15%, to well below $9 billion over the past six years (Figure 1). And while it is difficult to conclude with absolute certainty that consolidation has contributed to the decline, this type of premium shortfall hasn't happened in more than 30 years, a period that included two soft markets.

What may be an even more direct consequence of consolidation in the healthcare market and competition within the industry is the upswing in merger and acquisition activity among insurers.

A time of reckoning?

Some insurers have been able to shrug off the competition of the past few years, largely because of the trove of reserves amassed during the hard market.

Since then, insurers have released some $14 billion in reserves on policies written during the first half of the 2000s, when prices jumped in steep increments and claims frequency fell at an unprecedented rate. The combined impact of fewer claims and higher prices made it possible for insurers to build up massive loss reserves on these policies, which have bolstered results for the past seven years.

A time of reckoning, however, may be ahead. Last year, insurers posted a combined ratio of 90% on a calendar-year basis, 5 percentage points worse than the 2011 result, but still well below insurers' break-even point of 100%. The concern is that, much like the previous six years, a considerable part of insurers' 2012 profitability has come not from their current-year operations but rather from policies written during the hard market.

Without the $1.8 billion in reserves released last year, for example, insurers' combined ratio for their current 2012-year policies, or what actuaries call policy-year results, would have been 115%. This type of disparity between calendar-year and policy-year results has been more or less the case for the past six years, during which reserve releases have accounted for between 20 and 25 percentage points of the insurers' combined ratio (Figure 2).

Reserve releases were hardly a concern in the earlier years, when the policy-year combined ratio hovered at slightly more than 100%, and

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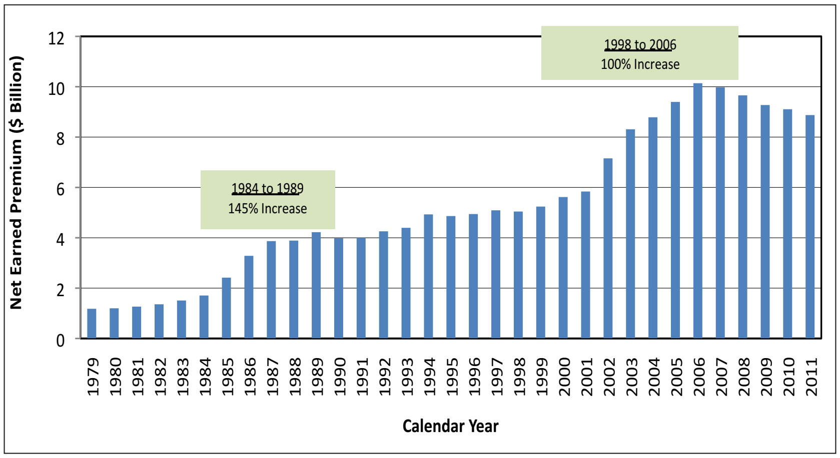
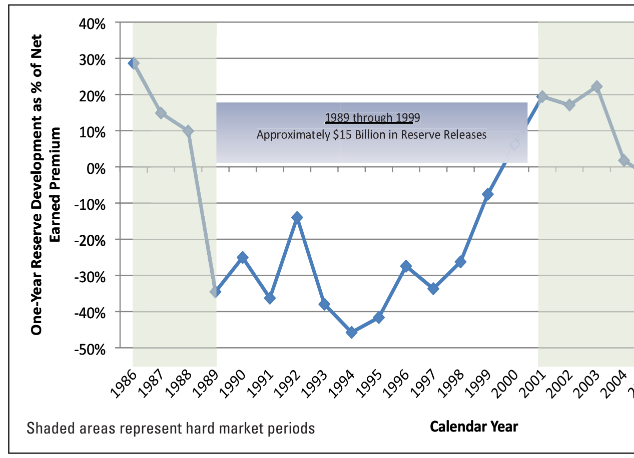
Figure 1 Historical MPL Net Earned Premiums



Source: Medical Professional Liability Industry Aggregate, Highline Data / A.M. Best Aggregates & Averages

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



Source: Medical Professional Liability Industry Aggregate, Highline Data / A.M. Best Aggregates & Averages

investment income could offset most, if not all, of insurers' pricing shortfalls. But in recent years, the policy-year combined ratio has climbed to the mid- to high teens—a level that puts profitability, on a policy-year basis, beyond the reach of insurers' investment income.

At around 20% of earned premium, reserve releases are only modestly less than the previous year's levels, which might mistakenly lead some to conclude that insurers still have a wellspring of reserves (Figure 3). But insurers are now in their eighth year of reserve releases, and they have likely exhausted the majority of their stockpiles. Without the reserve cushion provided by policies written during the hard market, insurers will need to depend much more heavily on the performance of underpriced policies written in recent years. How unsustainable the pricing on these policies turns out to be will determine whether future prices will explode—or rise rationally.

The big question for some insurers is not so much when the market will start to firm—though that is an important issue—but rather, how rapidly the momentum in price increases will build. This is because some smaller MPL insurers with relatively modest capital resources may reach a point where they need to increase prices sooner and more rapidly than their larger competitors, many of which still have massive capital reserves, despite the competition of the past years. If larger insurers were to move slowly on raising prices, smaller insurers could be forced to accept prices that generate less than sufficient revenue. This situation could bring about further consolidation within the MPL industry.

How quickly the market will turn, however, will likely be up for grabs, especially if frequency were to jump sharply. And while a sudden increase would be an anomaly, based on historical experience, the possibility is plausible, in light of the steep decreases in frequency that began more than 10 years ago and have only been partially explained by past tort reform initiatives, healthcare providers' increased attention to risk management, and the advent of "I'm sorry" laws, among other theories.

Despite these well-thought-out explanations, no definitive answer has surfaced. Without a clear understanding of the forces that caused a steep decrease in frequency, the reverse could happen just as easily.

Healthcare reform: challenge or opportunity?

The uncertainty surrounding future trends in claims is only compounded by enactment of the ACA. With its implementation, 14 million people are expected to gain access to healthcare services through insurance exchanges and expansion of Medicaid in 2014. This figure is expected to increase to 30 million in the coming decade.[2]

Increased utilization is expected to shift the demand curve for services to higher medical-cost levels. As one of the main drivers of MPL claims costs, these higher medical costs could cause claims severity to balloon, at least in the short term. And with increased use of the healthcare system, claims frequency could also rise, all things being equal. But all things are not equal.

ACA's focus on coordinated, integrated care could improve efficiency and quality of care and thereby reduce medical errors. But should this come to pass, it is unclear whether the reduction in medical errors would come in the form of fewer incidental medical errors, which might lower claims frequency, or fewer catastrophic errors, which might reduce claims severity, or both.[3]

The focus of accountable care organizations (ACOs) on cost control might also lead to a reduction of noncritical procedures, including fewer diagnostic tests. They may yield savings on the side of cost of care, but these reductions could result in more claims related to failure to diagnose.

The management structure of an ACO could precipitate a shift in the composition of claims costs. For example, hospital-dominated ACOs might seek to settle claims early rather than endure a long costly defense. Coordinated defense strategies among defendants might also be more easily achieved in an ACO environment, which could reduce the indemnity portion of liability claims.

The countless twists and turns that the trajectory of insurers' claims could take is indeed a daunting puzzle, but it is not a challenge

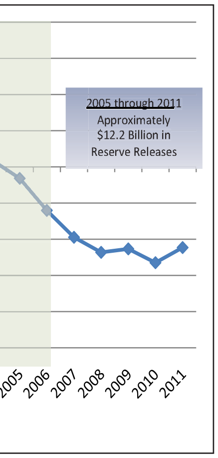
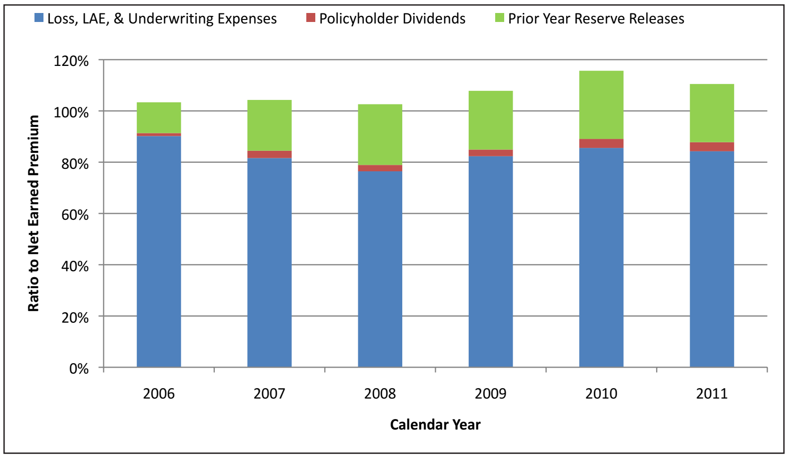


Figure 3 2006-2011 Combined Ratios, Before and After Reserve Releases



Source: Highline Data: All companies excluding Swiss Re

insurers should shirk.

Now, more than ever, attention to the movement of current pricing and calendar- and policy-year results can help insurers unravel the complexities of the healthcare market and navigate the impending changes. This assessment is certainly critical in understanding current market pressures, which continue to indicate that pricing levels are inadequate.

With excess reserves apparently nearly exhausted, current pricing is unsustainable. All indications suggest that a turn in the market is near, perhaps only a year off. But the longer pricing remains inadequate, and the more widely consolidation spreads throughout the healthcare industry, the more likely the upturn in the market will be swift and sharp. Under this scenario, insurers could be faced with managing change on two fronts simultaneously: the healthcare industry and the MPL market. PIAA

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