2016 YEAR-END FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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With this article, we conclude our seventh year of analyzing the quarterly and annual statutory financial results for a composite of medical professional liability (MPL) specialty writers and reporting our findings in the MEDICAL LIABILITY MONITOR. The composite’s 2016 financial results, without context, are again quite positive and represent 13-straight years of profitability. Net income remains strong, and improving investment yields are providing a boon for the composite’s investment income. However, direct written premium continues to fall and loss reserve redundancies from prior years — the annual release of which are still the driving force behind overall profitability — are also in decline.

The analysis that follows is based on the composite financial results of a large group of insurers specializing in MPL coverage. The data used in our analysis dates back to 2002 and consists of aggregate statutory financial information compiled from SNL Financial. The composite includes 83 MPL specialty companies with combined 2016 direct written premium of more than $4.7 billion.

TEN YEARS OF DECLINING PREMIUM

As shown in Figure 1, the composite’s direct written premium declined in 2016, as it has for each of the past 10 years. The latest decline puts 2016 premium almost 30 percent below the amount written in 2006, when premiums first started to slide. Of interest in 2016 is the composite’s first increase in net written premium in 10 years (1.2 percent), implying that a greater portion of the business is being retained.

FOURTH QUARTER RESERVE RELEASES SLIPS IN 2016

The pattern of loss reserve development through each of the first three quarters of 2016 was remarkably similar to that of the most recent four to five years — all of which were years where favorable reserve development at year-end approached or exceeded $1 billion. Given the relatively consistent relationship historically between third- and fourth-quarter reserve development, expectations for 2016 based solely on this relationship would naturally approach the same level. As Figure 2 shows, the overall 2016 reserve release of slightly more than $760 million falls considerably shy of that expectation and is the composite’s lowest in more than a decade.

2016 SEES FIRST UNDERWRITING LOSS SINCE 2004

Figure 3 illustrates the composite’s steadily deteriorating combined ratio since 2008. In the years leading up to 2016, the composite had relied on favorable fourth-quarter reserve development to remain below the underwriting break-even point for the year. In 2016 however, the fourth-quarter reserve releases discussed earlier, while still significant, were not enough to continue the composite’s 11-year stretch of underwriting profitability (after policyholder dividends).

The 2016 combined ratio of 101.9 percent represents a 6.6 point increase when compared to 2015 — the largest annual increase since a similar jump from 2011 to 2012. As was the case in 2012, the 2016 increase is primarily due to a deterioration in the calendar-year loss and loss adjustment expense experience (70.1 percent vs. 63.7 percent in 2015) as a result of a significant drop in the favorable reserve development when compared to the prior year. Decomposing the combined ratio further — the composite’s underwriting expense

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ratio in 2016 was 26.1 percent, a half percentage point higher than in 2015. In 2005, the composite’s expense ratio stood at 16.8 percent and it has increased every year during that time period. Finally, the 2016 dividend ratio of 5.7 percent is the composite’s lowest since 2009, though still significant relative to the much smaller dividend ratios seen from 2002 through 2006.

Although underwriting results applied downward pressure on the composite’s operating margin, the investment arm provided a positive boost. The composite’s investment gain (net investment income plus net realized capital gains) increased by more than 16 percent during 2015, ending a prolonged decline brought about by the financial crisis (see Figure 4). The increase in investment gain, however, was not enough to offset the decline in underwriting income that resulted in a 3.7 percent increase in the composite’s operating ratio. The 2016 operating ratio of 81.7 percent reached its highest point since 2004. Despite the deterioration, the composite’s overall financial results remain profitable in 2016 — with annual after-tax net income in excess of $640 million.

The composite’s capitalization continues to grow though declining premiums and deteriorating underwriting results have decelerated the rate of surplus growth in recent years. The composite’s required risk-based capital, as measured by the National Association of Insurance Commissioners (NAIC), has been increasing proportionately during the last five years. This has resulted in a fairly consistent ratio of total adjusted capital to authorized control level risk-based capital (the NAIC RBC ratio, see Figure 5). The composite’s NAIC RBC ratio experienced an annual average increase of nearly 13 percent from 2004 through 2012, but has slowed to roughly 1 percent in subsequent years.

While it’s difficult to paint too bleak a financial picture for the MPL market after reporting 13-straight years of healthy bottom lines, some concerning trends not only continued in 2016, but appear to have intensified. Net income is down more than 60 percent since 2010 and nearly 35 percent during the past two years. The decline in net income is tied primarily to less favorable reserve development, which is down more than 50 percent since 2010 and nearly 23 percent in 2016 alone. On the other hand, the Federal Reserve’s recent interest rate action, and signs of a broader economic recovery, offer cause for optimism. Good or bad, the next few years promise to be interesting.

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