FOUR QUARTERS MAKE A BUCK: 2010 YEAR-END RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS

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Throughout 2010, we have been tracking the quarterly financial results of a composite of medical professional liability (MPL) specialty writers. Based on the historical relationship between quarterly and year-end figures, we attempted to predict the year-end financial results for this composite. With year-end 2010 results now available, it’s time to review how this composite performed in terms of operating results, and secondarily, how well our projections held up.

Based on data compiled by National Underwriter Insurance Data Services from Highline Data, we examine the collective financial results of the composite that had direct written premium totaling nearly $4.28 billion in 2010. Despite the fact that direct written premium for the composite declined for the fifth straight year, down 18.3 percent from a high of $5.24 billion in 2005, and down 3.6 percent from 2009, this group of companies continues to achieve remarkable calendar year results.

RECORD OPERATING RESULTS

The composite experienced a sixth straight year of underwriting profit in 2010, and its highest calendar year operating margin in recent history, as shown in Figure 1 (see below).

NET INCOME PROJECTION

In our December 2010 article based on information through the first three quarters, we projected that 2010 net income would reach approximately $1.2 billion. As shown in Figure 2 (see below), the composite outperformed our estimate by earning a 10-year high of $1.5 billion in net income.

Actual net income came in higher than projected, in large part due to an under-projection of 2010 investment income and realized capital gains. With treasury yields decreasing again in 2010, we expected the composite investment income yield to likewise decline. Instead, the composite investment income yield on average invested assets held steady at 3.7 percent between 2009 and 2010. Further, the level of invested assets was greater in 2010, producing $886 million of investment income compared to $849 million in 2009. Not only did the composite net income benefit from its return on invested assets, it also experienced an increase in realized capital gains from $76 million in 2009 to $238 million in 2010.

POLICYHOLDER DIVIDENDS CONTINUE

The composite declared more than $271 million in policyholder dividends during 2010, a 29-percent increase over the $210 million declared in 2009. This amounts to 6.6 percent of net earned premium being returned to policyholders. Figure 3 (see page 7) displays policyholder dividends declared by the composite over the past decade.

UNDERWRITING EXPENSES CONTINUE TO RISE

After falling in 2008, underwriting expenses have risen slightly the last two years. Underwriting expenses in 2010 totaled $854 million, or 20.8 percent of net earned premium, up from $820 million (19.4 percent) in 2009.

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RESERVE RELEASES HIT THE MARK

Unpaid claim reserve changes are one of the more difficult provisions to extrapolate since a great majority of reserve changes are recognized in the fourth quarter. In evaluating the accuracy of extrapolating year-end results based on quarterly data, we were encouraged by a consistent historical relationship between quarterly and full-year financial figures. The first and second quarter 2010 reserve development emerged in a manner very similar to 2009. As such, market trends provided good reason to project similar favorable reserve development for the full year of 2010, somewhere in the range of $1.3 billion. Third quarter results continued to fall in line with prior year patterns. As it turns out, the composite of specialty companies recognized a slightly better than projected $1.36 billion in favorable reserve development during 2010. Figure 4 (at right) shows how reserves have developed since 2002 by quarter for the composite.

MORE HELP FROM RESERVES TO COME?

Figure 5 (at right) compares various coverage year net loss and loss adjustment expense ratios for the composite from 2001 to 2010 based on Annual Statement Schedule P information. The first is the initial booked ratio at the end of each respective coverage year. Second is the booked coverage year ratio as of year-end 2010. Finally, the third ratio represents the projected ultimate coverage year ratio based on a standard actuarial development projection.

Comparing the current booked ratios to the projected ultimate ratios implies that a significant redundancy still exists in the booked reserves of this composite as of year-end 2010. In fact, A.M. Best recently estimated that a $3.5 billion redundancy exists as of year-end 2010 for the MPL insurance industry as a whole. Our composite makes up about 40 percent of the MPL reserves booked by companies filing statutory financial statements. This would suggest that approximately $1.4 billion of the A.M. Best estimated redundancy can be attributed to this composite.

During 2010, MPL specialty writers continued to produce exceptional operating results. While we anticipate reserve releases to continue for a few years, future takedowns may be smaller in magnitude. The dramatically changing healthcare industry presents significant uncertainty in regards to future claim costs. Moreover, although calendar year financial results remain strong, the MPL insurance market has been soft for a number of years. MPL insurers may be wise in maintaining a strong reserve position in this period of increased uncertainty and soft market conditions.

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