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# Lawyers professional liability update: Insurers exhibit strong financial results but must remain vigilant

By Susan J. Forray and Shaun P. Cullinane

Specialty writers of lawyers professional liability (LPL) insurance exhibited strong financial results in 2012. The operating ratio for the LPL industry was about 77%, an eight-point improvement over 2010 and 2011. Insurers were able once again to release reserves, and a large portion of the releases were returned as policyholder dividends. The industry's surplus also reached an all-time high, having increased 7% over 2011.

At the same time, operating results since 2008 have been somewhat less favorable than in preceding years. Claim frequency remains above the levels seen in 2004 through 2007. In addition, many companies implemented modest decreases in rate levels during and following this time period. Others have maintained existing rate levels. Any future continued increase in frequency, combined with the potential impact of inflation on claim severity, could materially impact underwriting results.

To further discern the state of the LPL industry today, we have analyzed the financial results of a composite of the 14 specialty writers of LPL coverage for solo practitioners and small groups. This excludes one LPL specialty writer that became insolvent during the time period considered. Data was obtained from SNL Financial. We have compiled various financial metrics for the industry, categorized by:

- Overall operating results
- Reserve releases
- Claim frequency
- Capitalization
- Net retentions

## Overall operating results

The industry's strong operating results in 2012 were the result of an increase in reserve releases as well as an apparent improvement in the 2012 coverage year itself. However, this should be put in the context of the preceding years. The operating results of the period 2008 to 2011 were worse than those experienced in the prior 15 years—even worse than during the previous soft market of the late 1990s through 2001 (see Figure 1). The favorable operating results of 2012 can thus be seen as a return of the industry to results that were more typical of the decade preceding 2008.

Reserve releases for the period 2008 to 2012 have been comparable to those in the five preceding years (see Figure 3 on page 2). Taken together with the greater calendar year loss and allocated loss adjustment expense (ALAE) ratios observed during this time, this suggests that the industry expects the coverage years 2008 through 2012 to produce loss and ALAE ratios higher than those of the preceding years. This is consistent with the moderate rate decreases taken during this time period. Coupling this issue with the greater frequency experienced during this time period only serves to compound the effect of the lower rate levels.

**Figure 1: Aggregate Calendar-year Operating Results for the LPL Specialty Writers**

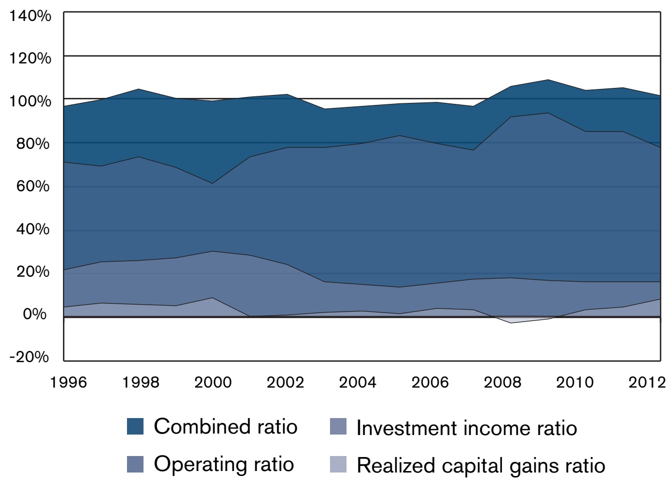


**Figure 2: Breakdown of the Aggregate Combined Ratios by Calendar Year for the LPL Specialty Writers**

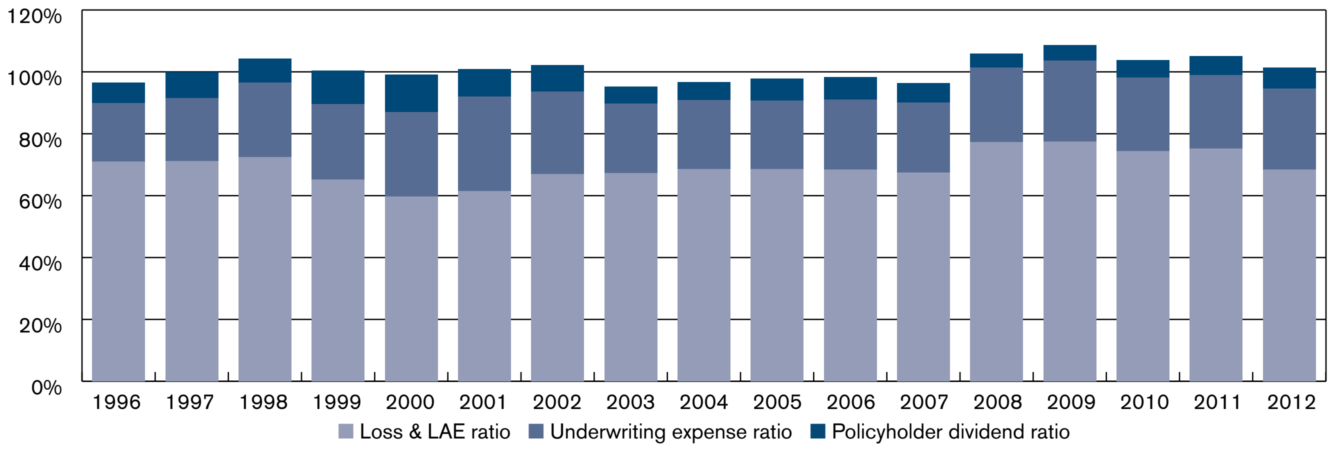
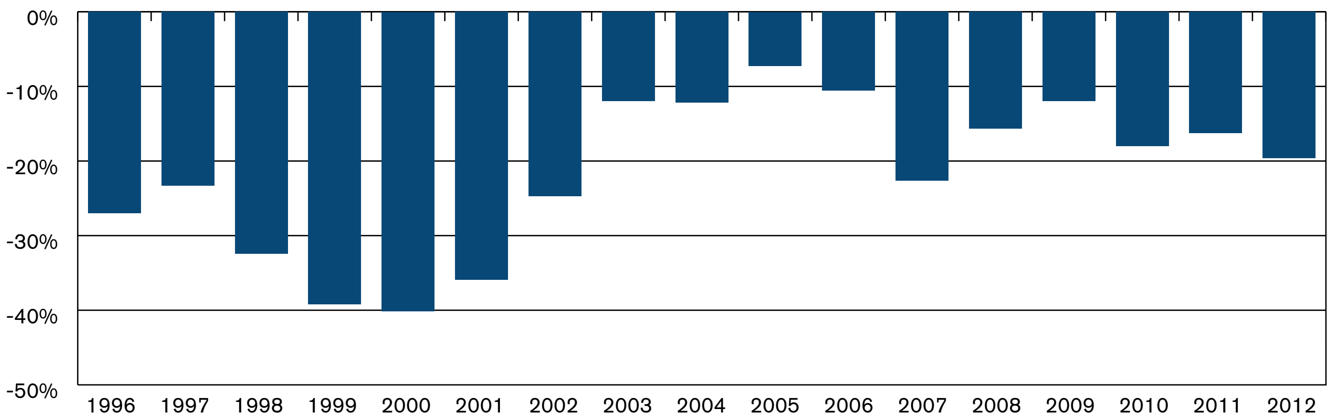



**Figure 3: Calendar-year Loss and Allocated Loss Adjustment Expense (ALAE) Reserve Releases for the LPL Composite**




The underwriting expense ratio was at 26% in 2012, slightly above other years of the past decade. About 7% of net earned premium was returned by the composite as policyholder dividends. The policyholder dividend ratio has been increasing since 2008 but remains below the policyholder dividend ratios of the time period 1997 to 2002. In part this may be due to reserve releases (discussed below), which have also moderated since this time. Reserve releases are often viewed as the most available source to fund policyholder dividends.

The realized capital gains ratio for the LPL writers hit a 12-year high of 8% of net earned premium as companies continued to sell assets for amounts greater than their carried values. The investment income ratio remained at 16%, comparable to other recent years. Driven by the growth in realized capital gains, the LPL composite achieved its highest investment gain ratio in 10 years.

## Reserve releases

Reserve releases for the industry in 2012 totaled $35 million, or 20% of net earned premium. While noticeable, this should be put in the context of the reserves carried by the composite, which for net loss and LAE totaled $359 million as of year-end 2011. It is also important to recognize that a history of favorable calendar-year reserve development does not necessarily imply that current reserves will run off favorably.

As mentioned previously, the industry saw a dramatic decrease in reported frequency from 1999 to 2005. We believe this has been the main cause of subsequent favorable reserve releases, as many LPL writers initially assumed that the reduction in frequency was due to fewer *nuisance* claims. Only with the benefit of hindsight were we able to see that the reduction in frequency occurred for claims with indemnity payment as well.

**Figure 4: Reported Claim Frequency per $1 Million of Gross Earned Premium**

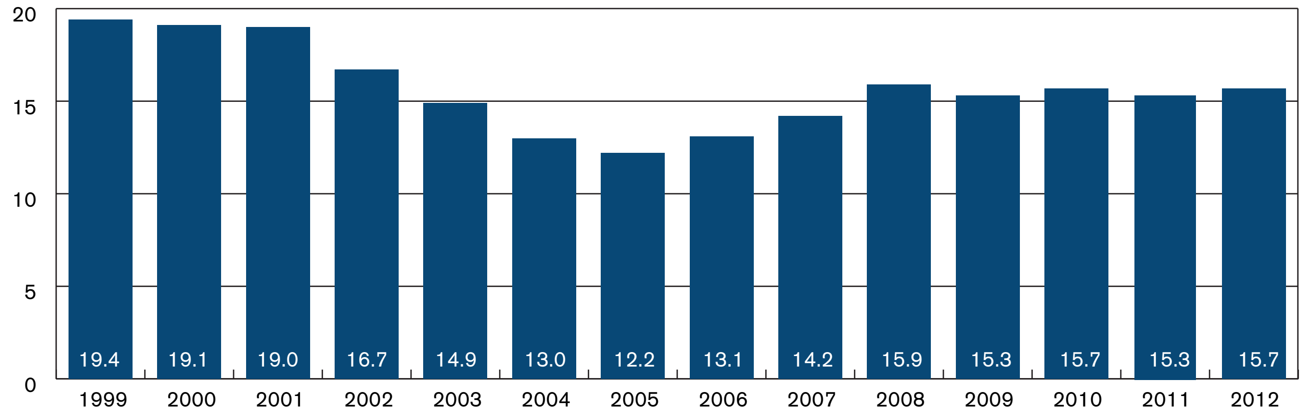
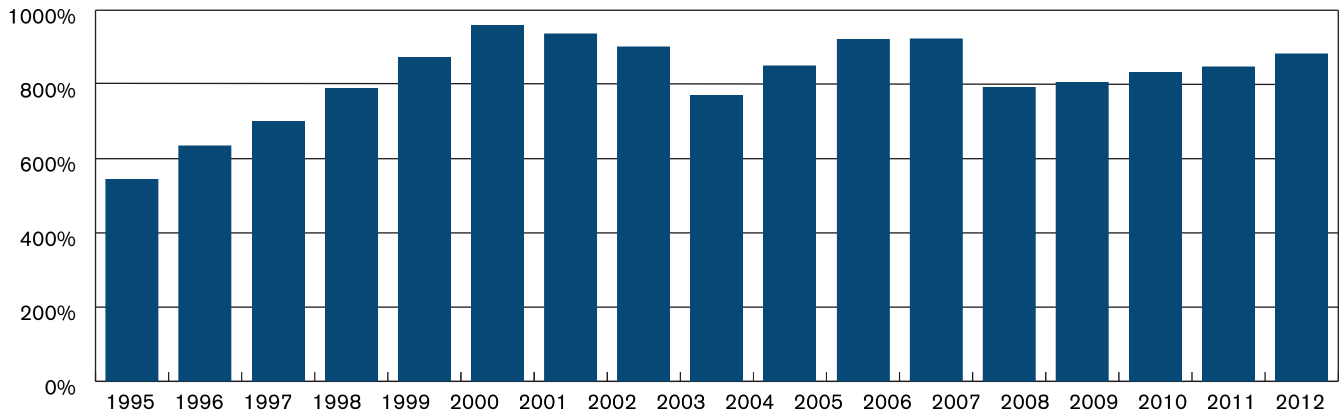



**Figure 5: Aggregate Risk-based Capital Ratio of the LPL Specialty Writers**




## Claim frequency

While actuaries typically measure frequency as claim counts relative to the number of insured attorneys, ultimately it is premium dollars that must pay these claims, and thus it is relevant for insurers to also consider frequency as claim counts relative to premium. Measured on this basis, we see that frequency per $1 million of gross earned premium reached its lowest point for the industry in 2005 (see Figure 4). Reported frequency subsequently increased from 2005 until 2008, driven in part by a spike in the number of real estate claims.

Claim frequency since 2008 has been roughly flat, although this varies noticeably between companies. For some writers, real estate claims in particular have declined to prior (or below prior) levels. Other writers have continued to see increases in frequency during this time.

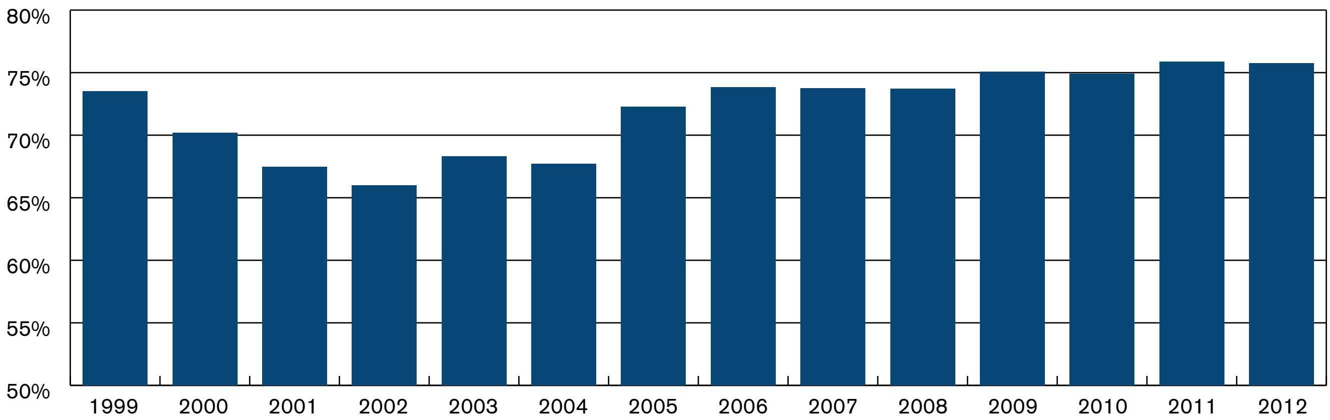
Note that, in Figure 4, we have adjusted the 2012 frequency to include a provision for *pipeline* claims (i.e., incidents that evolve into claims), in order to provide an indication comparable to the older years. Prior patterns suggest that, with the inclusion of these pipeline claims, the frequency for 2012 is likely between 15.5 and 15.7 claims per $1 million of gross earned premium.

## Capitalization

The industry's profitable operating results in 2012 boosted surplus by about 7% year over year, from about $508 million to $544 million. This is a meaningful gain, but must be put in a broader context. To do so, consider the risk-based capital (RBC) ratio for the industry. This metric compares a company's actual surplus to the minimum amount needed from a regulatory perspective. (From a practical perspective, given market fluctuations, companies typically hold capital well in excess of this regulatory minimum.)

The aggregate RBC ratio of the LPL writers increased to 883% in 2012 (see Figure 5). However, it has remained relatively constant over the past decade. Its current level nearly matches that of year-end 2000, which some would consider the peak of the previous soft market. In addition, individual RBC ratios as of year-end 2012 vary considerably within the composite, from a low of about 300% to a high of about 2,400%.

**Figure 6: Ratio of Net to Gross Earned Premium**




## Net retentions

The generally favorable operating results of the past decade, along with increasing surplus, have allowed the specialty writers to decrease the amount of premium (and corresponding loss and LAE) ceded to reinsurers. The industry's average ratio of net to gross earned premium (see Figure 6) increased most noticeably between 2004 and 2005 and has continued to grow since this time. This trend began as the result of an increase in the cost of reinsurance a decade ago. Given the generally favorable underwriting results experienced by the composite, the increase in net retention has contributed to subsequent favorable operating results, as insurers retained profitable layers of coverage.

## Forecast

While currently showing a strong financial position, the above observations have the potential to produce future operating results that differ from the historical experience of the industry. Loss and LAE ratios of the most recent coverage years are currently projected by the industry to be about 10% higher than they were five years ago; however, frequency appears to be about 25% higher than the nadir of this time frame. Combined with an increase in severity over the same time period, these factors themselves could be sufficient to eliminate the favorable reserve development that has historically been seen in the industry. While operating results have been profitable to date, without favorable reserve development they would have been roughly breakeven in most years. Thus, if rates prove inadequate going forward and if reserve development becomes less favorable, the industry as a whole could experience unprofitable operating results.

On the other hand, we continue to observe many of the LPL writers taking rate action. Companies are paying increased attention to rating factors, with the real estate area of practice being a noteworthy example. These rate actions, combined with enhanced underwriting discipline, can be expected to offset the potential for adverse results. For those companies implementing rate changes, the impact on surplus and overall operating results will be muted by this increased underwriting focus.

Susan J. Forray, FCAS, MAAA, is a principal and consulting actuary in the Milwaukee office of Milliman. Contact her at susan.forray@milliman.com.

Shaun P. Cullinane, FCAS, MAAA, is a consulting actuary in the Milwaukee office of Milliman. Contact him at shaun.cullinane@milliman.com.

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Inquiries may be directed to:

P&C Perspectives Editor
1301 Fifth Avenue, Suite 3800
Seattle, WA 98101-2605
+1 206 624 7940
pnc.perspectives.editor@milliman.com