Market Softening Continues in 2016—Signs of Pressure Emerge

By Steve Underdal, Greg Bliss, Matt Walter, and Blake Berman

Since the last hard market in the early 2000s, medical professional liability (MPL) insurers have faced a combination of both cyclical and secular pressures that have driven down rates and the number of insured exposures.

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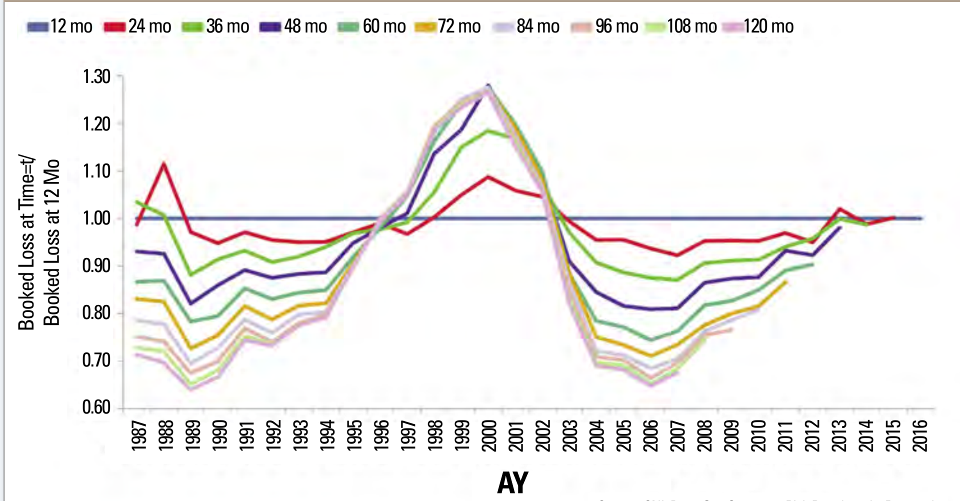
Since 2010, the MPL industry has been navigating a soft market, with declining profitability, diminished investment gains, and rising accident year operating ratios. Yet, reserve redundancies have kept calendar year combined ratios below 100%, allowing carriers to pay dividends to policyholders while maintaining favorable returns on equity. Recent trends in the MPL insurance industry, including more aggressive competition among carriers and a leveling off of frequency trends, are driving accident year combined ratios higher. Without the continued tailwind of favorable reserve development, current market rates could prove unsustainable, driving market hardening in the coming years.

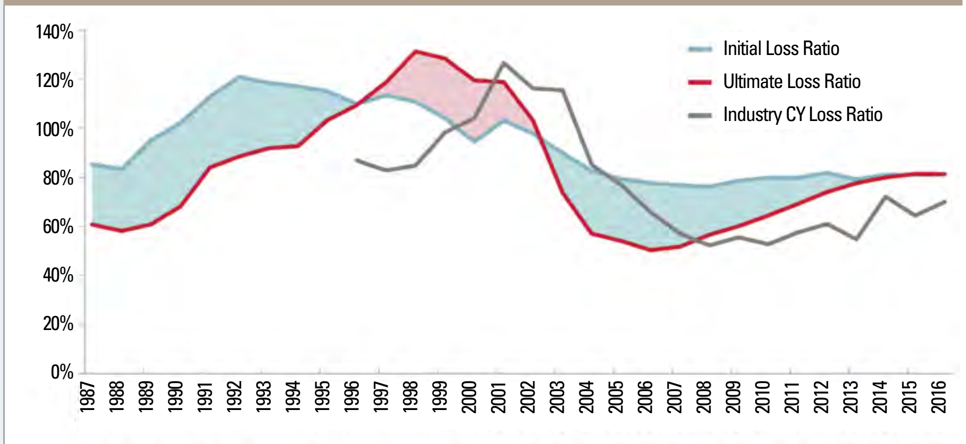
In a broader context, over the last 30 years the MPL industry's loss ratios have been strongly

Figure 1. MPL Reserve Development Cycle



Source: SNL Data, Guy Carpenter Risk Benchmarks Research

Figure 2. MPL Loss Ratio Cycle



Source: SNL Data, Guy Carpenter Risk Benchmarks Research

correlated with those of the general liability and commercial auto liability lines. As a result of economic, technological, and market factors, these lines began to show significant moderation in favorable reserve development and increases in accident year loss ratios in recent years, particularly in commercial auto liability, where both frequency and severity have trended unfavorably. Each line of business is different, but historical data points to a strong relationship in performance across casualty lines, which would indicate that future reserve releases in MPL will be materially less than what was reported over the past decade. Key trends in the MPL market are depicted in Figures 1 through 4.

Trends in premium

MPL direct written premiums have fallen every year since 2007: a cumulative decline of 23%. Healthcare reform has exacerbated this trend, by driving the acquisition of physician practices by hospitals, healthcare systems, and other self-insuring entities. During the same period, MPL rates fell by 8.4%, implying a reduction in exposure of 16% in the last decade. Favorable prior period reserve development as a percent of net earned premium (NEP) peaked at 27% in calendar year 2010, but has also deteriorated since, falling to 11% in 2016. The calendar year direct loss and loss adjustment expense ratio bottomed out at 50% in 2010, but higher claim defense costs and loss costs increased it to 73% by 2016. A reduction in favorable prior period development accounts for 16 points of the calendar year increase (27% in 2010 versus 11% in 2016), while the remaining 8 points result from higher accident year losses and loss adjustment expense. Concurrently, the industry's accident year combined ratio increased from 76% to 113% over the last 10 years, at the year-end 2016 evaluation.

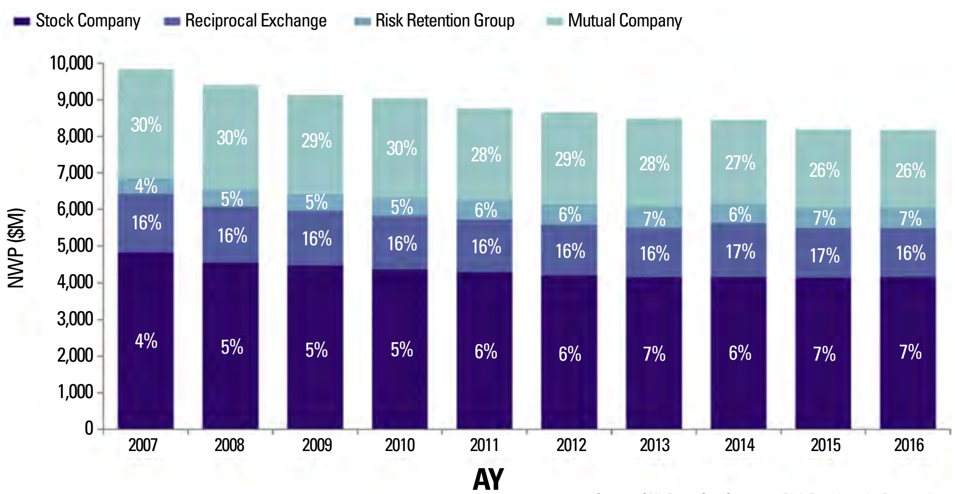
These trends in the MPL market have affected companies differently depending upon their capital structure. While the average size of an MPL writer (by NEP) has declined from $56.5 million in 2007 to $39.8 million in 2016, this is largely driven by the increase in numbers of smaller carriers and risk retention groups (RRGs). In terms of percentage of the total market, these companies have expanded from 4% to 7% in the last decade, while mutuals slipped from 30% to 26%, stock companies grew from 49% to 51%, and reciprocal exchanges stayed flat, at 16%.

Underwriting, investments

Stock companies have led the way in underwriting performance, with a combined ratio of 94% from 2007 to 2016, while RRGs (110%) and reciprocals (107%) have trailed the industry average of 99%. Mutuals have performed in line with the overall industry, at 100%. All of the companies have seen a slight decrease in operating leverage over the past 10 years, but stock companies have seen their leverage decline the least, because they can distribute excess capital to shareholders. In the last three years, stock companies have also reported the lowest loss adjustment expense ratio, 25%, while reciprocals have reported the highest (37%), and RRGs (28%) and mutuals (31%) have performed in line with the industry.

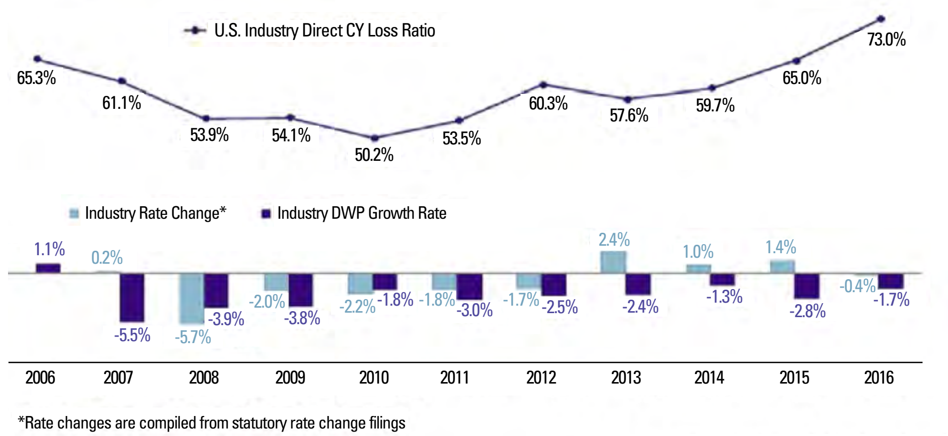
All of the companies have seen their return on invested assets fall in a declining interest rate environment, but RRGs have been hit the hardest, decreasing 2.1 points in the last 10 years.[1] With loss frequency and severity stabilized, industry hardening of the market will depend

Figure 3. MPL NWP, by Company Type



Source: SNL Data, Guy Carpenter Risk Benchmarks Research

Figure 4. MPL Calendar Year Loss and ALAE Ratio and Growth Rate



Source: SNL Data, Guy Carpenter Risk Benchmarks Research

most critically on the level of redundancy in current booked loss reserves.[2] Negative loss cost trends have held the 2016 industry rate change to -0.14%, compared with an estimated frequency trend of 3% and a severity trend of 0.6%.

Current accident year reserves are being booked at a nominal combined ratio of 119%, after the policyholder dividend. Based on current rates, this level of loss and expense is unsustainable, absent the expectation of continued favorable development on accident years 2016 and prior. While MPL writers tend to release redundant reserves over a longer time period than they realize adverse development (more than six years versus three to four years), favorable calendar year reserve development has historically continued two to three years past the point when reserves were subsequently found to be adequate. These recent development trends indicate that the industry is nearing a break-even point in reserve levels.

MPL booked loss ratios for the most recent accident years are highly uncertain and dependent on a variety of drivers that might impact future loss cost trends. If reserves on accident years 2011 to 2016 develop similarly to that of years 2008 to 2010, there will be approximately $6.9 billion of additional favorable development, proving today's booked reserves are 25% redundant. If they follow the pattern of the period 2004 to 2007, they are $10.2 billion redundant, or 37% of booked reserves. Conversely, if these years behave like years 1997 to 2001, they are currently $ 6.9 billion deficient, and the industry will need to strengthen reserves by 25%. Though the true answer likely lies somewhere between the numbers in these scenarios, most signs suggest that reinsurers are currently living off past profitability, and a market hardening may be on the horizon.

Authors' note: Guy Carpenter's *Insurance Risk Benchmarks Research Annual Statistical Review*, which has provided the basis for this analysis, is a comprehensive research project in the industry, representing more than 30 years of property/casualty insurance statutory financial data from more than 1,000 companies. The study's purpose is to provide a unique source of unbiased financial data, to help industry leaders better understand the sector's changes and evolution, including reserve volatility, expense management, and pricing cycles, to help them grow, profitably. PIAA

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Footnotes

1. Stock companies have decreased 1.4 points; reciprocals, 1.6 points; and mutuals, 1.3 points.

2. Loss frequency improved from -3% in the period 2001–2014 to -1 % in the period 2014–2016. Loss severity declined from 3% in the period 2001–2014 to -1% in the period 2014–2016.

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