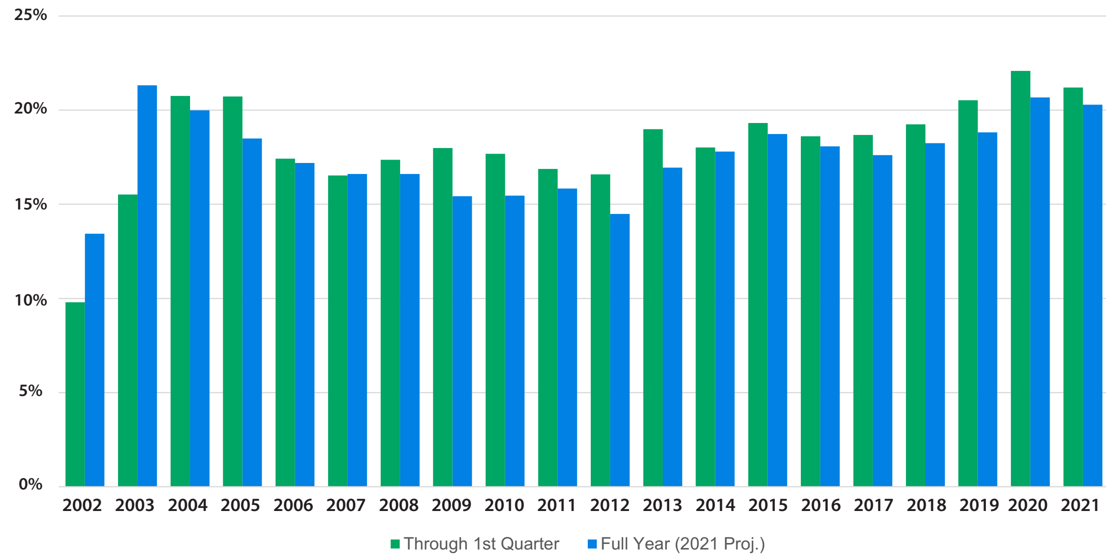
FIRST-QUARTER FINANCIAL RESULTS FOR MEDICAL PROFESSIONAL LIABILITY SPECIALTY WRITERS SHOW EFFECT OF DWINDLING RELEASES

by Eric J. Wunder, FCAS, MAAA, and Andy Kline

FIGURE 2 CEDED EARNED PREMIUM PERCENTAGE - Q1 VS FULL-YEAR



This article summarizes key financial results for medical professional liability (MPL) specialty writers from the first quarter of 2021 and kicks off our 12th-consecutive year of tracking and publishing these results for MEDICAL LIABILITY MONITOR. Here we compare historical first-quarter financial results to historical annual results in order to forecast where 2021's financial results could be headed.

Our analysis is based on the collective financial results of a large group of insurers specializing in MPL coverage. The data used in our analysis dates to 2002 and consists of aggregate statutory financial information compiled from S&P Global Market Intelligence. The current composite includes 178 MPL specialty companies with total direct written premium of more than $6 billion in 2020.

TOP-LINE PREMIUM GROWTH CONTINUES

With the MPL market widely considered to be hardening in recent years, first-quarter premium growth offers additional evidence to support this claim. The composite's direct written premium increased by a healthy 6.3% relative to the first quarter of 2021 (see Figure 1) as MPL writers continue to seek higher rate levels across multiple jurisdictions in response to poor underwriting results. This increase follows a first-quarter premium growth of 4.7% and 4.3% in 2019/2018 and 2020/2019, respectively. The full-year projection for 2021 reflects a 21.5% increase in top-line premium since the composite's 2017 nadir, notably outpacing general inflation rates.

REINSURANCE COSTS ON THE RISE

Although the MPL composite's direct business produced rising premiums in recent years, we have observed during this period that a smaller proportion of premiums were retained. Between year-end 2017 and the first quarter of 2021, the proportion of direct premiums ceded to reinsurers increased from 17.6% to 21.2% (see Figure 2). Reasons for this increase may include: higher limits of reinsurance coverage provided and increasing renewal rates due to both poor experience and reduced reinsurance capacity.

DWINDLING RESERVE REDUNDANCIES DRIVING UP COMBINED RATIOS

For the second straight year, the composite reported first-quarter adverse development on reserves related to prior years. Annual reserve redundancies have been trending downward for more than a decade — with the composite managing to maintain small, first-quarter reserve redundancies during this time. In both 2020 and 2021, however, first-quarter reserve levels developed adversely by approximately $11 million (see Figure 3 on Page 7). The 2020 year proved to be somewhat favorable as of year-end, and while we still consider it likely that the 2021 annual financial results will reflect some reserve redundancy, it is becoming increasingly clear that MPL specialty writers can no longer rely on favorable reserve development alone for profitability.

The composite's combined ratio through the first quarter of 2021 reached 116% (see Figure 4), which represents a 5-percentage-point reprieve from the same period in 2020 and its lowest mark since 2015. Declining reserve redundancies typically correlate to higher combined ratios. In this case, however, the 2021 first-quarter combined ratio benefitted from an initial coverage-year loss and LAE ratio that was at a 10-year low combined with an expense ratio lower than any first quarter

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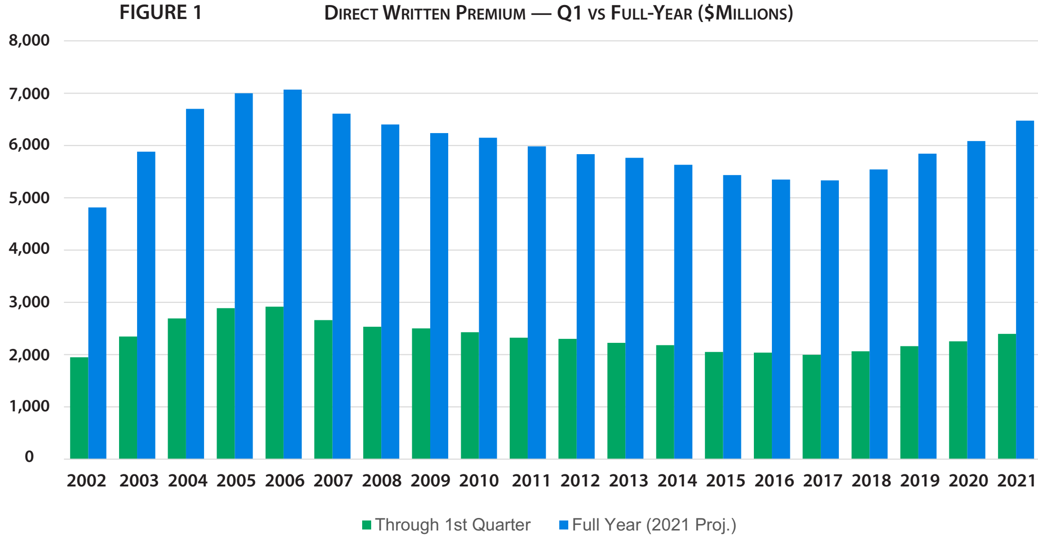
FIGURE 1 DIRECT WRITTEN PREMIUM — Q1 VS FULL-YEAR ($MILLIONS)



FIRST-QUARTER FINANCIAL RESULTS FOR MPL SPECIALTY WRITERS

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since 2015.

Figure 4 also provides a comparison of the composite's historical first-quarter combined ratios relative to annual combined ratios. It illustrates the growing concern for the MPL market's overall underwriting performance. A comparison of Figure 3 and Figure 4 shows how reserve redundancies have driven underwriting profitability during the past 15 years — with the difference in the combined ratio between first quarter and year end in Figure 4 attributable primarily to favorable reserve development.

Notice the considerable drops in reserve redundancies in 2019 and 2020 (Figure 3), which resulted in a much smaller decrease in the 2019 and 2020 combined ratio between first quarter and year end (Figure 4), relative to prior years. Given the small first-quarter adverse reserve development in 2021, it is reasonable to expect only moderate combined ratio relief from reserve development at year end.

Operating Margin Rebounds a Bit

Taking investment gains into account, we note that the composite's profitability remains intact. Aside from a hiccup in the first quarter of 2020 when the global financial markets were reeling from pandemic-related lockdowns (and before the trillions in stimulus programs to alleviate those concerns), margins have remained positive. The composite relies on its ample surplus more than ever to achieve these gains, and its investment yield has hovered between 2% and 3% for nearly a decade. Inflation concerns are putting downward pressure on the yield in 2021, but it remains to be seen how the composite will react to inflation concerns. One option may be to pursue a more aggressive investment strategy to combat lower bond yields.

With the worst of the COVID-19 pandemic hopefully in the rearview mirror, we look ahead at new uncertainties. Although top-line revenue has been growing at a rate not seen since the early 2000s, an increasing share of that revenue is earmarked for reinsurance markets. Net written premiums are still on the rise, but as reinsurance premiums continue to increase, direct premium increases may struggle to keep pace. Further, as reserve releases continue to dwindle, additional pressure will be placed on current-year loss ratios, expense ratios and investment yields. Thus far, however, it appears that the composite will maintain a positive operating margin this year.

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FIGURE 3 CUMULATIVE RESERVE DEVELOPMENT - Q1 VS FULL-YEAR ($MILLIONS)

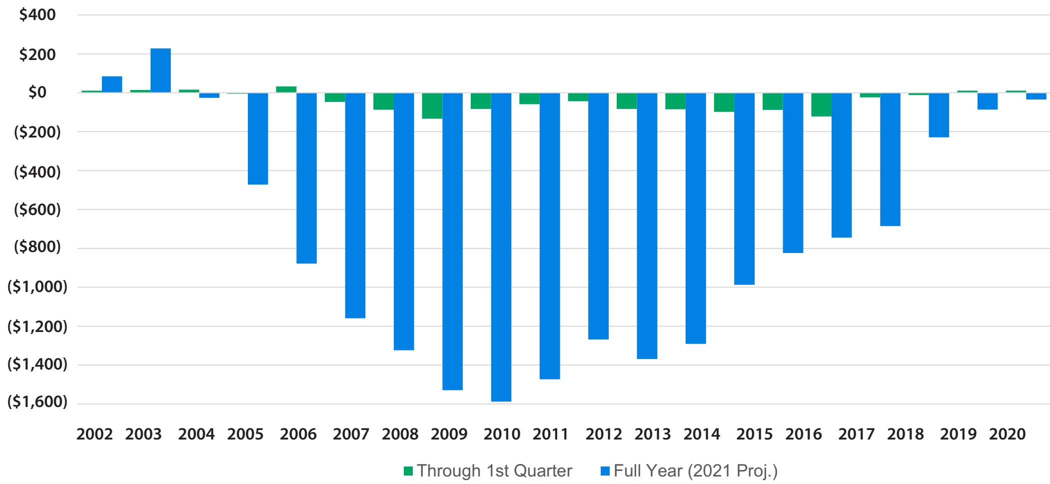

FIGURE 4 COMBINED RATIO (AFTER PH DIVIDENDS) - Q1 VS FULL-YEAR

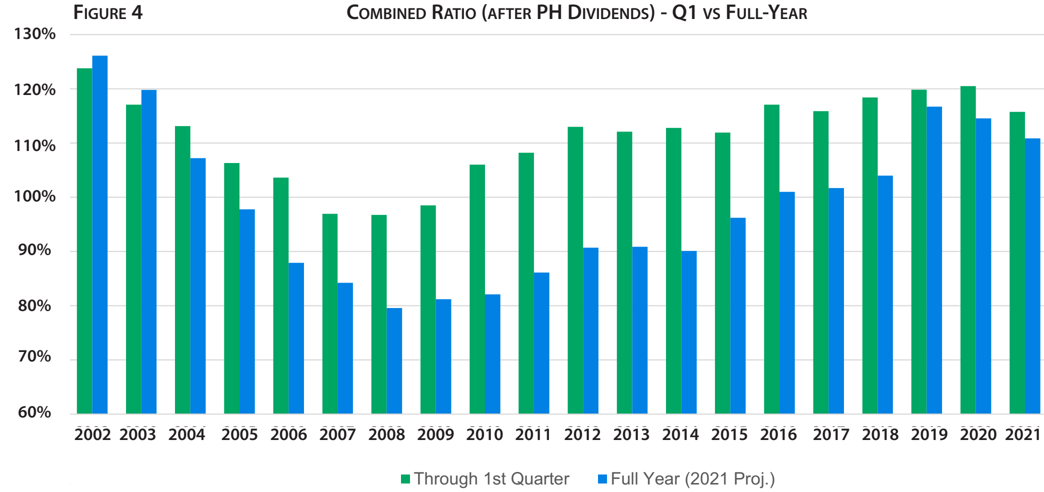

FIGURE 5 OPERATING MARGIN - Q1 VS FULL-YEAR