Captive Review (CR): It’s been nearly 15 years since the last MPL crisis. What is the solvency position for the industry today?

Timothy Mosler (TM): The industry clearly recovered from the last crisis. Based on financial reporting as of year-end 2017, the industry is probably in its very best position with regards to solvency over the past 20 years. The net premium to surplus ratio of about 25% is very low from a historical perspective. Regulators want premium to surplus ratios of less than 3.0 when testing solvency. So, the average company is now approximately 12 times below that threshold. In addition, the held loss and loss adjustment expense reserves are at about 75% of surplus. That means even if settling the open claims required two to three times what’s currently estimated, which would be unprecedented, the industry would still have enough surplus to absorb it. There are few, if any, solvency concerns in this sector.

Our observations are based on a sample of companies in this industry which are long-term insurers of physician medical professional liability and almost exclusively insure only medical professional liability. We base our observations on the sample because it allows us to directly measure amounts like surplus relative to MPL premium with the confidence that nearly all of the surplus is derived from the MPL line of business. That wouldn’t be possible if we included larger multi-line companies, such as CNA or AIG, that are active in many other lines of business besides MPL.

CR: How was industry profitability in 2017?

TM: The bottom line number is fantastic. Companies have an average operating ratio of 76%, so they’re keeping 24 cents on every dollar of premium earned. That’s actually not as high as in some prior years, but still exceptional.

CR: What is driving such a high level of profitability?

TM: It’s driven by investment gains. You can view a company’s profitability in two components — underwriting and investing. There’s actually a small loss on underwriting, so all of the profit is coming from investment gains.

What’s behind that is not a superior investment strategy. Insurance companies are somewhat limited by law on how creative they can be with their investments. What’s driving the profit is how much there is to invest. MPL companies are now at a point where their premium has declined significantly over the past 15 years, but when it was at a higher level, they had extremely strong underwriting results and built a very high level of surplus through those results. There’s now such a high level of surplus and invested assets relative to the current premium that even modest investment income can be 20% or more of premium.

Investment income has always been a consideration for MPL profitability. It’s a business characterised by a long lag between the collection of premium and the payment of claims. So, investment income is earned from the held loss and loss adjustment expense reserves on pending claims from several prior years, not just the current year. However, investment income also relates to earnings on the large invested surplus funds that accumulated in the post-crisis years, significantly boosting overall net income.

CR: Is there anything significant about the small underwriting loss?

TM: Normally it would not be significant. Companies can accept a small underwriting loss given the additional profit they will make on the investment side. What is significant in this case is that it’s a small underwriting loss after more than 10 years of favourable underwriting results; in some cases, very favourable underwriting results. The primary driver of an underwriting profit or loss is going to be the claims experience. Using 2017 as an example, we can think of the claims experience in two parts. First, there’s the initial estimate of losses on
claims incurred during the 2017 coverage year. Then, there are adjustments made during 2017 on the 2016 and prior coverage years that can affect profitability in calendar year 2017.

The second component is immaterial for certain short tail lines of business (such as property) but can be very material for MPL because of the long lag times between when the claim is reported and when the claim is settled.

In prior years, there was a trend of carriers setting their current year loss ratio estimates fairly high relative to premium, with significant takedowns in the estimates for the prior years. In recent years, the current year has continued to be set at high levels but the reserve adjustments on prior years, while still reductions, are not as large as they used to be. This has resulted in decreasing underwriting profits in the past several years with small underwriting losses in 2016 and 2017. Naturally, there is concern for increasing underwriting losses in future years.

CR: What are the biggest challenges MPL insurers face now and will face in the future?
TM: The biggest challenge is declining premium levels. Premiums have fallen significantly from the levels of a decade ago. That's partially driven by the large decreases in claims frequency. It's also driven by the consolidation in healthcare. Many of the physicians who used to purchase MPL insurance have given up their individual practice and are now employees of a hospital or a large physician group. They are likely part of that new organisation's self-insurance programme and therefore no longer a customer of any MPL insurers. So, not only is the MPL policy a product with a lower price, there are also fewer buyers of it. That is keeping the revenues for MPL insurers depressed.

A second challenge is the increased frequency and severity of large claims. That is, there are more large claims and the average size of the largest claims is increasing. If that continues or if it affects insurers' claim settlement strategies, it could cause the current small underwriting loss to be a more significant underwriting loss.

CR: Do you expect companies to file rate increases?
TM: You can expect a few rate increases in certain geographies and specialities. We've already seen examples in 2017. However, in terms of consistent industry-wide rate increases, I think we're still at least a few years away. Companies have a high level of surplus, the overall profitability is still great, and there's intense competition for premium.

CR: Long term, are industry-wide rate increases inevitable?
TM: While they are very likely, I can't say they are inevitable. First, if underwriting profitability stays constant and investment performance does not deteriorate, then each year assets will continue to grow relative to the premium. This will lead to more investment income and continued high levels of profitability. There would not be a need for rate increases in this scenario. That only happens if underwriting profitability can stay at a consistent level, which is questionable. It is also less likely if large amounts of surplus leave the industry through acquisitions.

Second, the healthcare industry is currently experiencing remarkable innovation through technology. We have seen in the past that dramatic improvement in patient safety and health outcomes can lead to a much lower level of medical professional liability claims. The frequency of claims reduced significantly in the early 2000s as many providers were implementing patient safety initiatives. Those frequency reductions of the past are levelling out somewhat in recent years, but it is entirely possible that healthcare technology could lead to continued frequency declines. If so, we may have rate decreases, rather than increases.

CR: What are the main takeaways for MPL captives based on the industry results?
TM: There are several. First, the physician group or health system that wants to form a captive should understand that it may not imply lower premiums. Prices are still very competitive and, if buyers receive multiple quotes, they are likely to receive at least a fair price. This is one of the reasons why we haven't seen more of an explosion in captive formation despite all of the consolidation that has happened in the healthcare industry. It's still possible to get a fair price without having to self-insure.

Second, and a corollary to the first, active MPL captives may benefit from exercising caution about retaining risk in the higher claim layers. This is in response to the upward trends in severity and large claims. Again, fair premiums can be found for the higher layers given the capacity in the industry and the desire for premium revenue.

The last takeaway is for the healthcare entity that wishes to own a captive to have a stake in their own claims experience but hesitates to take on the underwriting, claims handling, and captive management involved. That entity will have several MPL companies willing to partner with them. As a result of the decline in premium levels, companies are looking for additional revenue sources and that includes being a service provider to captives.