FEATURE

Industry Update: 2022 Financial Results—Decisions, Decisions…

By Eric J. Wunder and Chad C. Karls

Although we are now three years removed from the onset of the COVID-19 pandemic, the Medical Professional Liability (MPL) insurance industry is still feeling the impact from the many decisions outside of the industry's control that were made in response to the pandemic.

Decisions to largely close courtrooms have led to more and older open claims than we otherwise would have expected. Decisions to add vast sums of money into the economy to assist businesses and individuals dealing with the implications of COVID-19 led, in part, to higher inflation. Decisions to counteract inflation by increasing interest rates have led to steep declines in the prices of bonds held by most of the industry.

Following 2021, a year that may have surprised some with respect to increases in MPL direct written premium, 2022 was a much slower year for MPL rate increases. This slowdown appears to be driven by the balance-sheet strength of the industry as well as a continued, and perhaps surprising, run of lower reported claim frequency.

The low levels of reported frequency in 2022 were not enough to move the combined ratio below 100%, however. Despite these underwriting losses, the MPL industry again provided policyholders with dividend payments. This is likely a function of well-capitalized balance sheets and continued competition in the market.

Those balance sheets did take a hit in 2022. The biggest driver of the decrease in surplus was unrealized capital gains, which have been impacted by the attempts of the Federal Reserve Board (Fed) to control inflation. Unpaid claim liabilities also increased for the fourth consecutive year. This phenomenon appears to be slowing down in 2022, assisted by a lower starting loss and loss adjustment expense ratio. Pandemic-related delays in the court system contributed to more open claims these last few years than would typically be seen. Although the courts now appear to be running at capacity again, we are not observing court activity increasing beyond historical norms to make up for the prior lost time. However, this has spurred payment activity to pre-pandemic levels.

As we noted last year, the pandemic appears to have had a favorable impact on the 2020 coverage year—especially claim frequency. Reported claims showed early signs of a rebound in 2021, which we thought may extend into 2022. Thus far, however, coverage year 2022 is showing renewed declines in reported frequency. What remains to be seen is whether these frequency declines are permanent or temporary.

Severity levels also moderated during the pandemic, following years of increased severity due to the disproportionate impact of large claims. We believe this pause in increasing severity was driven by pandemic-related court closures and other court-related slowdowns. With the courts returning to normal, the types of claims closed in 2022 tended to be older than history would have suggested. Because the type of claims that are most likely to result in large indemnity payments are also those most likely to push for trial, it makes sense the type of claims being settled in 2022—and beyond—will be higher-severity claims. In other words, the temporary decline in severity was likely driven by the types of claims being settled. In fact, little has changed to suggest severity declines should be expected in the future, with inflation, social inflation, and tort reforms each applying upward pressure on future severity.

We have based this picture of the current state of the MPL industry on the financial results of a composite of 52 of the largest specialty writers of MPL coverage. Using statutory data obtained from S&P Global Market Intelligence, we have compiled financial metrics for the industry based on:

- Written premium
- Overall operating results
- Reserve releases
- Capitalization
- Policyholder dividends

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In considering the financial results, note that the 52 companies included in the metrics are all established MPL specialty writers. The composite excludes any MPL specialty writer that has become insolvent or otherwise left the market as well as multiline commercial writers and smaller writers.

The companies in each of these three excluded categories are generally not capitalized as well as the 52 companies included here. In addition, the underwriting results of the multiline commercial writers, along with some of the smaller writers, have generally been less profitable. Of course, this is also true for the writers that became insolvent. Thus, the results presented below reflect the experience of the established specialty writers, which is inherently more favorable than a view of the whole industry.

Written Premium

One year removed from the largest direct written premium growth for the composite since 2004, we saw much more muted premium growth in 2022. Although the 1.7% growth is the third largest in the last 15 years, it comes on the heels of an 8.8% increase in 2021. The premium increases since 2018 have the composite above 2008 premium levels, but the slowdown from 2021 to 2022 may indicate that the composite will not be approaching the 2006 high in 2023 as seen in Figure 1.

As we noted last year, although Figure 1 focuses solely on the composite's MPL direct written premium, composite companies have been increasing their diversification into other lines of business—especially in recent years. Although MPL premium still represents 95% of the composite's direct written premium, that figure is down from a high of 98%, 15 years ago. During that same period, the composite has been diversifying within the MPL sector as well. Physician premium, as recently as 2005, made up more than 90% of the composite's MPL direct written premium. In 2022, the figure is down to 77% with most of the shift moving to Other Professionals.

Considering current market dynamics, additional diversification may be needed for the composite to grow premium. Although rate increases are likely to continue, the composite's surplus strength and the continued competitiveness of this market suggest that a truly hard market is likely to still be several years away.

Overall Operating Results

The 2022 operating ratio climbed 3 points compared to 2021 despite a 4-point decrease to the combined ratio as seen in Figure 2. This divergence is unusual for the industry and was driven by the realized capital gains ratio. In fact, the 8-point decrease in the realized capital gains ratio is the largest decrease since the Great Recession in 2008.

A year ago in this article, we commented on how recent decreases in investment income were being offset by generally rising realized capital gains. Investment income stabilized, and even slightly improved in 2022; however, due to the steep decline in realized capital gains from 2021 to 2022, the composite is seeing its lowest investment gain ratio since the 2008 recession. This challenging investment environment puts added pressure on underwriting to maintain a profitable bottom line.

While investment gains softened in 2022, reserve releases continued their modest rebound since 2020. The 5% benefit to the operating ratio is quite different from releases of a decade ago that routinely sat between 25% and 30%. Underwriting expenses also continued a modest decline relative to premium, falling to 2018 levels. Like recent years, the decrease was not driven by lower underwriting expenses, which continue to climb at about 3% per annum. Instead, premium growth outpaced the expense growth which drove the ratio down. Combined ratios have now been above 100% since 2016 as seen in Figure 2, and as such, the composite remains reliant on investment income for profitability.

The calendar year loss and loss adjustment expense ratio fell 3 points from 82% in 2021 to 79% in 2022. That marks the third consecutive year of decreases after nearly a decade of consistent year-over-year increases. Given that the reserve releases have been relatively stable over that same period, it is the accident year (starting) loss and loss adjustment expense ratio that has been declining.

Figure 1: Direct Written Premium ($Billions)

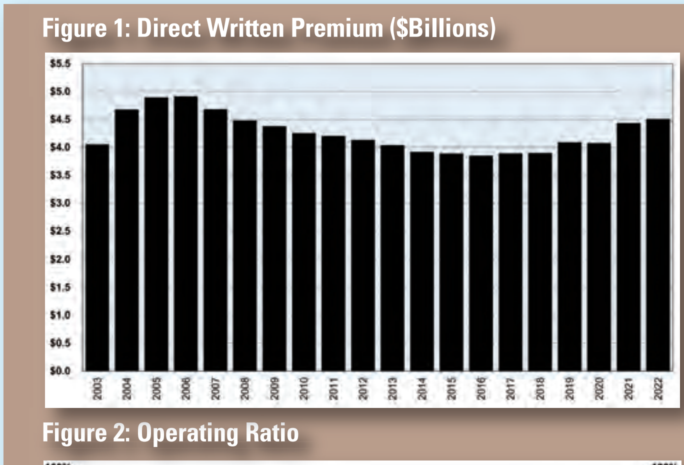


Figure 2: Operating Ratio

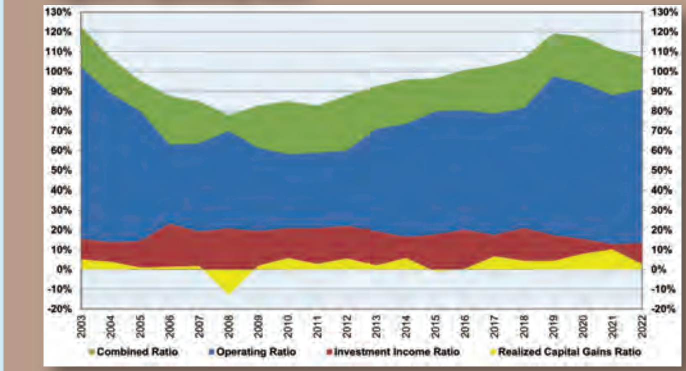


Figure 3: Reverse Release ($Millions)

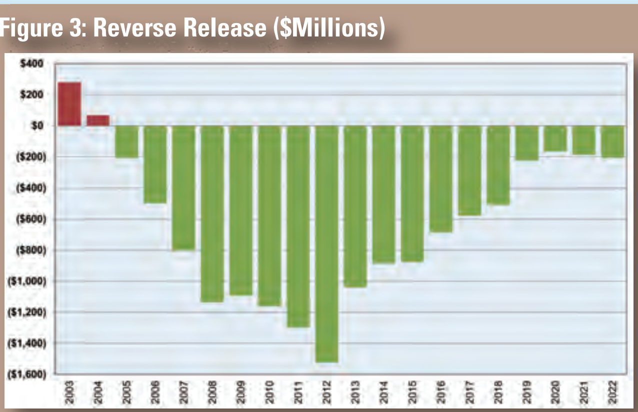
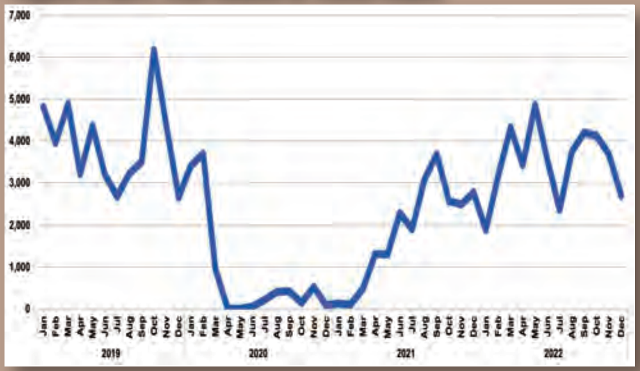


Figure 4: MPL Trial Attend & Travel Hours



The starting loss and loss adjustment expense ratio declined 10 points from 93% in 2019 to 83% in 2022. There are possible frequency-related reasons for the decline as COVID-19 had an unprecedented impact on the availability and usage of healthcare. In fact, according to Schedule P, Part 5, reported claims have declined over 21% over that same period, indicating that even with severity on the rise the starting loss and loss adjustment expense ratio is, perhaps, adequate, assuming the 2019 starting loss and loss adjustment expense ratio was adequate. Thus far, that 2019 coverage year, now at 48 months of development, is developing slightly favorably. It's worth noting, however, that the last time a starting loss and loss adjustment expense ratio was this low was 15 years ago, in 2008.

Reserve Releases

The composite released about $200 million in prior year reserves during 2022. This continues a slow rebound from the 2020 low of $165 million and is the fourth consecutive year of releases well-below $500 million, as seen in Figure 3. Prior to the last four years, this composite had a minimum $500 million release with an average of nearly $1 billion over the twelve-year period from 2007 through 2018.

The lower level of prior year reserve releases in recent years has contributed to a rising level of carried reserves for the composite. Since 2019, the composite's unpaid loss and loss adjustment expense reserves have increased by over 15%. A review of Schedule P, Part 5 data shows that the number of open claims has increased during that same period, although not to the same degree. Calendar year 2022, in fact, saw open claim levels fall by 5% as companies started to work through the open claim inventory that was delayed from COVID-related court slowdowns and closures.

One measurable way in which we can see the impact of the pandemic on the courts is observing the number of trial attendance and travel hours invoiced by attorneys over the last three years, as seen in Figure 4. Using a proprietary database containing on average 28,000 open claims at any given time over the last four years, we saw trial hours plummet to near-zero for almost a full year, according to a databased complied and maintained by Milliman. Beginning in March of 2021, those hours began to rebound, and they now appear to be close to pre-COVID levels. That said, we believe this has had a direct impact on the ability of insurers to move claims through the process, which led to fewer payments during 2020 and 2021 than we otherwise would have seen. In fact, Quarterly Statement data from this period shows that payments fell by about 30% following the COVID-related court slowdowns and closures as seen in Figure 5.

These delays have caused the average claim duration—defined as the time from report date to close date—to increase dramatically in 2022. Figure 6 shows that duration increased by about 20% in 2022 from a stable 2.5 years to over 3 years. This data, from the same proprietary database, contains an average of nearly 19,000 closed claims per year. Additional data on open claims suggests that duration may still be climbing in the short-term. These COVID-related slowdowns not only cause reserves to be held longer but may also result in higher claim severities for both loss and defense costs.

Figure 5: Quarterly Statement Industry MPL Payments ($Millions)

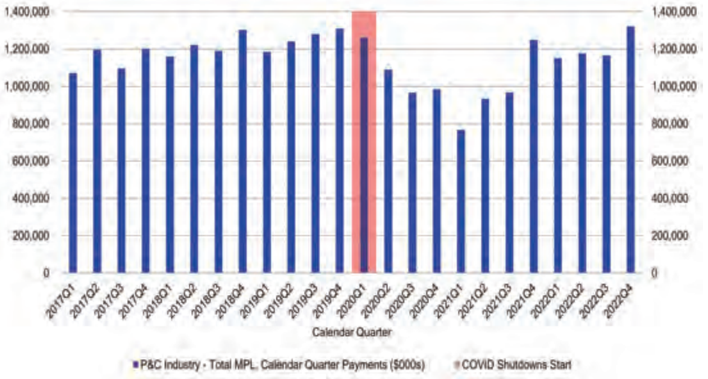


Figure 6: MPL Claim Duration/Years from Report Date to Closed Date

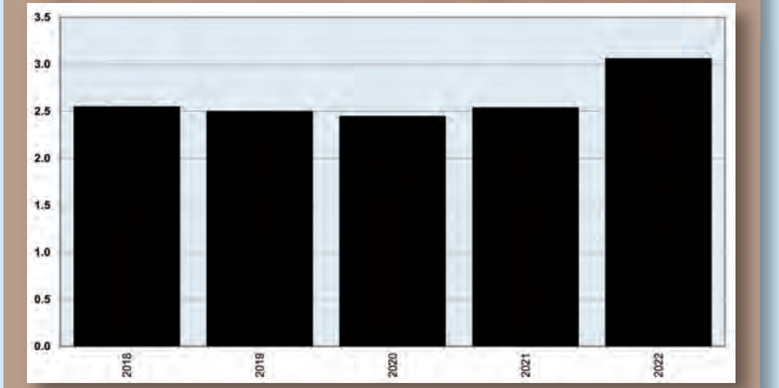
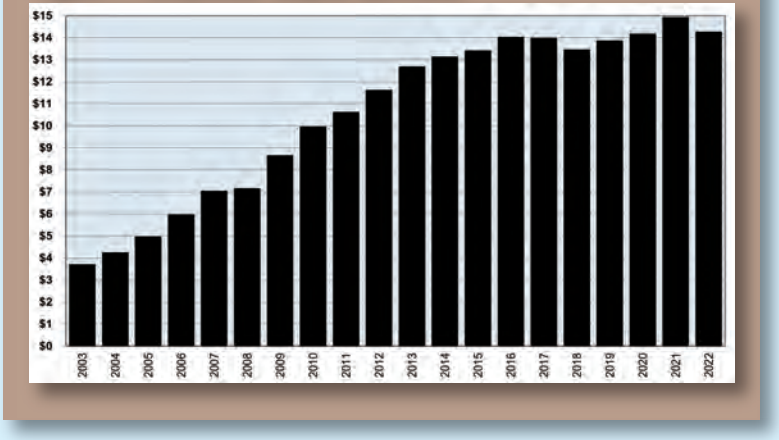


Figure 7: Policyholder Surplus ($Billions)



Capitalization

The composite's surplus decreased during 2022 by about $650 million, or 4%, as seen in Figure 7. This decline was the composite's largest ever in absolute dollars, and the largest in at least the last 20 years on a percentage basis. Unrealized capital gains were the culprit of the decline, counteracting a modest net income of $350 million.

Even with the decrease in surplus, the composite's capitalization is still strong relative to most other insurance segments, per results aggregated from S&P Global Market Intelligence. The measure of relative strength is the risk-based capital ratio, which remains higher than 900%. The risk-based capital ratio provides a comparison of a company's statutory surplus to the minimum amount needed from a regulatory perspective, although, from a practical perspective, the minimum amount of capital needed is well over this regulatory minimum.

Policyholder Dividends

2022 marked the fourth consecutive year of declines in the policyholder dividend ratio. Although policyholder dividends have been a staple of the composite for the last 15 years, dividends have trended lower in recent years. Historically, these policyholder dividend payments were likely funded, in part, by the composite's reserve releases. Therefore, as reserve releases have dwindled, so too have the policyholder dividend payments.

Although from an absolute perspective dividends have decreased in recent years, as a percentage of net income they remain stable. Starting in 2007, when policyholder dividends became more mainstream within the composite, dividend payments to policyholders have averaged about 25% of pre-dividend net income. 2022 shows a continued commitment to those levels of support for the composite's policyholders, coming in at 26% of net income.

One nuance lost in the aggregation of the composite is the number of companies that have been providing these dividends to their policyholders. Although the composite has remained steady in the amount of dividends paid, the number of companies providing dividends has declined by 40% in the last 5 years as the market has become more challenging. This leaves fewer than one-third of the composite's companies providing policyholder dividends in 2022.

What's next?

One of the more surprising takeaways from this year's analysis was the continued broad-based decline in reported frequency. The expectation for many was a rebound in frequency as the pandemic moved further into the rearview mirror. 2022 was, it seems, not that rebound year. Will it come in 2023 or 2024? Can the long-term frequency decline continue beyond then, and if so, how long? There are certainly new headwinds that may indicate a frequency increase sooner than later.

Tort reform, including caps on damages, collateral source rules, plaintiff attorney fee schedules, and more, has been shifting toward the plaintiff's bar in recent years. In 2022, several long-standing reforms were overturned or renegotiated. California's long-standing MICRA legislation, in danger of being essentially overturned via ballot initiative, was instead updated via compromise. Pennsylvania saw its "venue shopping" law overturned by the state Supreme Court.

Changes in other states made fewer headlines but are generally trending toward higher industry loss costs. Carriers will have decisions to make in terms of how to respond to these changes in consideration of a competitive market.

The economy at large, especially inflation, bond prices, and recessionary indicators, has already had an impact on the composite's held assets. How these and other economic issues will play out in the next year and beyond could have material impacts to the industry. What decisions will industry leaders make in response?

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Specialists and Non-specialists—More Alike Than We Might Realize

By Bill Burns

Historically, when reviewing financial results, a distinction has been made between MPL specialty insurers and multiline commercial insurers that write MPL business. However, these differences have become fuzzier as many of the specialist companies, especially those owned by physicians, have expanded into other healthcare sectors such as hospitals and other professionals.

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While the business focus, corporate missions, and size of the companies may differ dramatically, regardless of how we categorize companies, insurers in the MPL space have more in common than not. Examples of the similarities include:

- The MPL industry has not produced an underwriting profit (i.e., a combined ratio less than 100%) in nearly a decade. The combined ratio for the composite of the specialists' companies is in line with that of the industry, suggesting the specialists no longer outperform the industry.
- Due to steadily rising loss costs and deterioration in underwriting results, prices have been rising for all sectors of the MPL market. In 2022, these pricing increases resulted in premium growth ranging from low single digits for physicians, to high single digits for hospitals and other professionals. Barring a sudden improvement in underwriting results, price increases will probably continue for all MPL segments.
- From 2005 to 2018, the MPL industry hit well above its weight in terms of favorable loss reserve development. However, over the last several years, loss reserve releases have dropped significantly for both the specialists and the commercial insurers. While the industry reported favorable reserve development in 2022, most of the development came from accident/report years 2020 and 2021, those years most impacted by the pandemic. Therefore, it is possible that reserves for both the specialists and the commercial industry have reached a point of adequacy rather than redundancy.
- The phenomenon of social inflation does not discriminate between specialists and commercial insurers. While there is a tendency to associate social inflation and large verdicts with high policy limits that are carried by hospitals (as compared to more common policy limits of $1 million/$3 million that are carried by physicians), a recent study suggested that for the decade ending 2021, social inflation contributed approximately $3 billion in losses for physician-focused insurers.
- After several years of steady growth, the policyholders' surplus for many of the specialist companies dropped in 2022. This decrease was due to a large amount of unrealized capital losses that accrued during the year. Similarly, in an article dated March 30, 2023, Insurance Journal reported that policyholders' surplus for the property/casualty industry dropped in 2022 because of the same deterioration in unrealized capital losses.

There are lines of insurance that are not correlated, and results could vary dramatically over a given period (think workers' compensation and auto physical damage). However, MPL is a small line of business (representing less than 2% of written premiums for the property/casualty industry) and knowledge of the line is relatively concentrated. As demonstrated by the factors listed, it is possible the various sectors of the MPL market have become too interconnected to generate materially different results. As such, in its reviews of the MPL industry's financial results, the MPL Association will look at the total industry, rather than specialists and commercial insurers.