MPL INSURERS: ADJUSTING TO A NEW NORMAL?

Increasing competition compresses profit margins

By DWS

Medical professional liability (MPL) providers are under intense pressure to maintain profitability in the face of increasing competition, low interest rates, and the risk of the unknown impact of COVID-19. With the combined operating ratio of most MPL insurers hovering around 100%—most companies are between 90% and 110% depending on company size—investment income has become vital for these companies to remain competitive and bring their operating ratios below 100%.

Unfortunately, generating more investment income generally involves increased exposure to investment risk, particularly in today's interest rate environment. MPL insurers need to find ways to meet this challenge while remaining competitive in a continually evolving environment. MPL liability durations typically range between three and five years, with a high percentage of claims paid within two to four years (Figure 1).

With this kind of expected claim payment pattern, MPL insurers need sufficient cash on hand. While the insurer's investment portfolio may be a significant source of income, its liquidity risk must be carefully evaluated prior to setting any strategy. Moreover, in the current interest-rate environment, generating even the same amount of investment income that a portfolio may have produced in the past has become a challenge, if even possible.

Enter enterprise risk management analysis

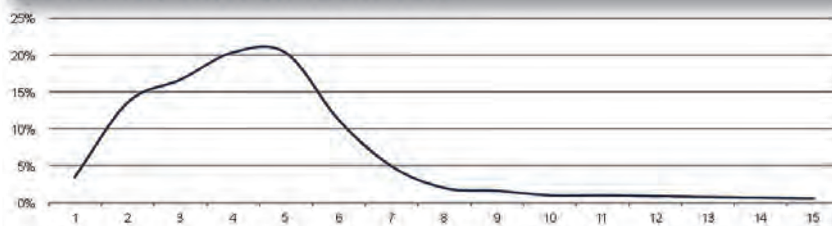
The goal of enterprise risk management (ERM) analysis is to help MPL insurers improve the efficacy of their investments by offering an in-depth examination of risk on both the liability and asset sides of the balance sheet. Analysis demonstrates that the selective addition of risk to an investment portfolio may have the potential to increase investment income.

As MPL companies grow in size, they tend to increase allocations to riskier asset classes—primarily equities—while decreasing allocations to cash and bonds. This typically leads to a concomitant increase in investment risk, which is apparently a comfortable adjustment for larger companies. This may not be a true apples-to-apples comparison as the bigger the company, the more likely they write other lines of business that could impact how they invest, and DWS isn't able to break out how a company separates investments by lines of business.

With bond yields near historic lows, opportunities to invest for yield have diminished. If this trend persists, investment income could decline further unless risk tolerance levels are reevaluated and the credit quality of investment portfolios is adjusted accordingly. High-yield corporate bonds, bank loans, securitized mortgages, or income-producing equity securities represent an attractive option for improving current income while remaining within a targeted risk spectrum. While increasing a portfolio's asset base many seem daunting, ERM analysis can provide valuable insights as well as a path toward implementation by employing a holistic view of the risks affecting both the asset and liability sides of the balance sheet. ERM analysis of MPL companies shows that an opportunity exists to potentially increase investment income by selectively raising risk tolerance levels.

As companies increasingly rely on investment income to meet future demands, thorough evaluation of investment portfolio composition and risk level has become more urgent. ERM analysis can be of value to MPL insurers as they seek to enhance margins and meet future financial and regulatory challenges.

Figure 1: Estimated Liability Cash Flows of Claims Over Time



Source: SNL 2020

Figure 2: Overall Net Written Premiums In Decline Since 2017

Medical Professional Liability	2010Y	2011Y	2012Y	2013Y	2014Y	2015Y	2016Y	2017Y	2018Y	2019Y
Net Premiums Written ($000)	8.63	8.40	8.35	8.22	8.21	7.97	8.06	7.93	8.34	8.67
NPW Ratios										
As % of entire P&C Industry	2.0%	1.9%	1.8%	1.7%	1.6%	1.5%	1.5%	1.4%	1.3%	1.4%
As % of C&S	67.5%	71.4%	70.0%	65.6%	66.4%	69.8%	69.1%	66.7%	77.1%	67.2%
Invested Assets/Capital	237.2%	242.1%	237.0%	228.1%	229.0%	230.6%	230.6%	228.2%	233.0%	220.7%

Figure 3: Realized Gains as a Percentage of Investment Income

Source: SNL 2019 Q4 STAT data. The data contained in this analysis was obtained from a third party. While we believe the data is accurate, we have not independently verified it and do not attest to its accuracy.

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Current issues affecting MPL insurers

MPL insurers are feeling the effects of stiff competition and changes due to mergers and hospital organizations creating MPL captives. Overall net written premiums have regressed back to 2010 levels. In fact, overall, net written premiums for the MPL industry, as a percentage of the entire property and casualty (P&C) industry, continue to decline on a year-over-year basis as seen in Figure 2. Despite this decline, MPL writers have been able to maintain stable net written premium ratios compared to capital and surplus as well as a stable ratio of invested assets to capital and surplus.

As insurance companies compete for a smaller piece of the MPL business, competition is only expected to increase. This trend will put downward pressure on premiums and underwriting margins, prompting leading companies to search for other strategies to increase profitability. Toward this end, insurers are turning to their investment portfolios as one method to offset these pressures (Figure 3).

How much longer can net gains be realized? During the past 10 years, realized gains have averaged about 24% of overall investment income, compared to 18% during the past two years. During the same period, gross bond yield has fallen, but it may have started to increase in the past two years. With current market turmoil resulting from economic conditions surrounding COVID-19, it may be harder to continue to take gains and invest in similar yielding securities. Also, if interest rates stay where they are today or increase, MPL companies will be hard pressed to continue realizing gains at their current level.

In addition, it seems that companies are trying to make up for lost investment income by increasing their allocations to riskier asset classes such as common stocks, schedule BA, high-yield securities, private equity, and hedge funds. As companies increase the percentage of capital and surplus they are comfortable investing in these riskier asset classes, one concern is setting a boundary around the maximum threshold an MPL company should be investing in these asset classes given their specific risk tolerance.

Currently, MPL companies deal with many other risks, including:

- The potential for COVID-19 to cause either an increase or a decrease in claims
- Tort reform
- Changes in claim frequency
- Competitors offering new coverages to gain market share
- Return of large carriers
- Business retention
- Less availability of reinsurance

Impact of recent trends

Recent capital market trends may drive further changes in asset allocation decisions and risk tolerance levels. Are we in a 2008 period again for bond yields? Rates have been coming down over the last decade and reinvesting maturing securities at similar yields has been a daunting task (excluding the current market volatility). If the current market volatility subsides, we could be back in a similar position as we have been in the past few years.

MPL insurers seeking to boost investment income in an environment of potential diminishing yields may benefit from a shift in asset allocation to potentially higher-yielding opportunities such as high-yield corporate and municipal bonds, bank loans, CLOs, and select opportunities within mortgage-backed securities, equity strategies (REITs, infrastructure) and commercial real estate credit strategies. Such assets may produce yields from 3.5% to over 7%, though they bring with them a higher risk profile. The higher-yielding asset classes discussed here may represent an attractive option for improving current income while remaining within a targeted risk spectrum, along with potential for additional diversification.

Analyze your risks and tolerances

This overview of the current situation provides some context for the unique issues that each MPL insurer faces. However, while industry averages are useful, applying averages to evaluating your specific business isn't. That's why each MPL insurer should reexamine their investment risk profile, taking in the broader market trends.

By performing an individual investment ERM analysis, companies can better understand their current investment profile, where allocations should change, and what returns are necessary to achieve going forward to meet company objectives. MPL

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