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P&C Perspectives

Current Issues in Property and Casualty

FALL 2002

How Will the Rating Agencies Respond?

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While this may be the question of the year, many companies often wonder how rating agencies such as A.M. Best or Standard & Poor's will respond to their business decisions after the fact. Management's strategic plan seemed to make sense to management, so why was it that only 12 months after implementation the company is facing serious rating pressure or even possibly a downgrade? Maybe a great market opportunity has come up. Should a company jump on this potential business or should it take a step back and try to understand what additional stress this opportunity may have on its capital?

While all business decisions should be made within the context of what makes business sense to the company and its management team, it is beneficial for an organization to understand how these decisions may impact its capital strength as well as other areas that could potentially impact its current or future rating.

Changing Market Conditions

After years of operating in a soft market and trying to maintain or at least minimize the bleeding of their business, companies are finally faced with increasing rates and additional premium on their books. However, due to the impact the soft market had on the financial results of so many companies, there has been a stronger separation of strong versus weak companies. Years of inadequately priced business and reserve deficiencies have taken their toll and forced many companies to either close up shop or be taken over by larger and somewhat stronger companies. This was evidenced by a strong percentage of downgrades by A.M. Best over the last 12 to 18 months.

For those companies that remain in business and still have adequate capital, there is an opportunity to write good business and pick up market share. What companies need to closely monitor is how much growth they can withstand without jeopardizing their capital strength. Is there a monitoring system in place that management is utilizing as it creates or acts upon its strategic plans?

Measures of Importance

For the longest time, companies have believed that as long as they wrote at or below a 2 to 1 premiums to surplus ratio their capital was conservatively leveraged. This may have been true before the soft market and even in the early years of the soft market. As time went on, however, more and more companies' premium volume decreased as a result of lower rates and competition. Before last year, the property/casualty industry average was less than 1 to 1 for premiums to surplus. This is not to say that all those companies with ratios above that level were downgraded but rather they were more closely scrutinized to make sure they were maintaining sufficient profitability on their exposure base.

Given the changing market dynamics, partially initiated in early 2001 due to fallout in the market from rate inadequacies, reserve deficiencies, and a continued downturn in the equity markets, and partially following the tragic events of September 11, pricing has dramatically improved with increases in certain markets continuing to exceed 20%. With these rapidly increasing rates, premium volumes for many companies have grown significantly over the last 12 months, even if their exposure base remained relatively stable. What is important to communicate to Best is the breakdown of new growth between rate and exposure. In the case where a company has higher premium volume due to higher pricing on the same exposure base, there is less concern and any growth factor charged against its premiums in Best's Capital Adequacy Model (BCAR) should be lowered accordingly. If a company's premium growth is largely new exposures due to market opportunities, management needs to provide information to Best that shows the breakout of types of new business, estimated profitability levels, as well as its continued focus on underwriting standards.

How Much Growth is Too Much?

Although many companies are still rejoicing in their ability to grow business after the prolonged soft market, there comes a point when any additional premium, without a comparable increase in surplus, will result in rating pressure. This point, however, cannot be measured by one ratio such as the premiums to surplus ratio. This is a dynamic exercise that addresses not just the higher level of premiums but also the higher corresponding reserve base and any changes in profitability projections that may impact future surplus levels. In addition, there potentially could be higher concentrations of risk associated with new business growth.

Various leverage measures can be used to help monitor growth levels associated with strategic business decisions. While the ratio of net premiums to surplus is a good starting point, reserves to surplus and the combination of these two ratios, or net leverage, can give additional insight into the true exposures facing a company. By adding the ratio of ceded reinsurance to surplus to net leverage, management will have a good estimate of its total underwriting risk. All of these measures can be calculated for an individual company or relative to its peers for rating comparisons. The industry average for these measures change as market conditions change.

Companies also need to incorporate into their plans the hardening of the reinsurance market if they wish to operate within a certain leverage profile. Will they be able to pass along the additional risk or even the same risks as last year? If their reinsurer is willing to assume these risks, will there be any exclusions and significant price increase for this protection? These factors can have a large impact on the ongoing profitability of a company.

To assess the total exposure to a company that includes not just the underwriting risk but also its credit and investment risk, management can utilize the BCAR reports prepared by Best for all rated companies. This report can give insight into the various charges associated with each of the risk components of a company. Companies that are well capitalized will have strong BCAR scores while those with excessive leverage measures or limited capital will have lower BCAR scores. Adding additional risk, whether through higher premiums or reserve strengthening, will have an impact on a BCAR score that management should be monitoring.

BCAR Does Not Equal Rating

Extra capital is important in providing companies a cushion against negative trends in results whether driven by adverse development, capital losses on investments, or declines in premium volume that may impact cash flow. However, having extra capital does not mean a company will be upgraded on that basis alone. In addition to the BCAR score and overall capitalization, a company's rating is also driven by stability in profitability and having a market presence that will ensure future profitability. Without positioning itself for future profitable business, a strong capital base will not survive in the long term.

Rating Triggers

While having extra capital alone will not prompt a rating upgrade, a company that has weak capital and a BCAR score that does not fall within an acceptable range for its rating level will face significant rating pressure. Similarly, a company whose profitability levels have consistently fallen to the point of eroding capital will face rating pressure even if its lower BCAR score remains within the range for their rating. Only those companies with both the solid capitalization and ongoing strong profitability relative to their peers would be considered for a rating upgrade.

Company's Role

Those companies that aggressively monitor their results and utilize tools to measure the impacts their strategic plans may have on capital and financial performance will be better positioned for responding to the rating agencies as well as having continued business success. While investment income can no longer be used as a crutch for supporting weak underwriting results, companies are being forced to get back to underwriting fundamentals. This adherence, despite the market opportunities many companies are facing, combined with the active management of results will allow more companies the ability to remain in the "secure" range of ratings.

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A Captive Solution to the Medical Malpractice Crisis

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The medical professional liability (otherwise known as medical malpractice) insurance industry is in the midst of a crisis the magnitude of which has not been seen since 1975. In response to this crisis, healthcare providers are now examining their risk transfer alternatives. At the top of the list of alternatives are captive insurance companies.

The Current Crisis

The failure of several medical professional liability underwriters and the withdrawal of market leaders from this market define the current crisis. Prominent examples include:

- The largest writer of medical professional liability insurance, the St. Paul Companies, announced its intention in December 2001 to withdraw completely from this market.
- PHICO, a Pennsylvania-domiciled insurer and the 10th largest writer of medical professional liability insurance, was placed into liquidation in February 2002.
- PIE Mutual Insurance Company, an insurer of more than half of the physicians in Ohio, was ordered into liquidation by the State Insurance Department in 1998, creating market dislocations in that state.
- Frontier Insurance Company withdrew from writing new and renewal business in 2001 and subsequently entered into a voluntary agreement for rehabilitation with the New York Insurance Department.
- More recently, A.M. Best downgraded the MIIX Group from a rating of A- to B- in response to significant adverse reserve development. As a result, the New Jersey Banking and Insurance Commissioner accepted a plan for a solvent run-off of MIIX Insurance Company. This plan called for the immediate discontinuation of non-New Jersey business.

The above events, along with many other examples of insurer failures, exits, downgrades, and consolidations, mean that hospitals, physicians, and other healthcare facilities and providers are now faced with the prospect of being unable to secure adequate insurance. In states such as Pennsylvania, many medical professionals cannot find insurance in the voluntary market.

The Underwriting Cycle

The current hard market is as severe as the last soft market was long. Beginning with the late 1980s and continuing throughout the entire decade of the 1990s, property/casualty insurance rates remained relatively flat. This was particularly true for medical professional liability, where the average physician in some states experienced rate decreases over that period.

In order to understand how this happened, you need to understand the way that medical professional liability insurance is priced. Medical malpractice insurance is one of the longest tailed liability lines of insurance, especially when written on an occurrence policy form. This means that there can be a very long lag between the date an accident occurs and the date the claim is reported, especially for newborns and young children. In addition, once a claim is filed, there is an additional lag until the claim is settled. The settlement lag is particularly acute for claims that become lawsuits. In total, the most difficult medical malpractice claims can take 20 years or more to settle.

The long payment horizon means that insurance companies can invest the premiums for a long period of time and will earn significant investment income on their investments. Insurance companies are then able to reduce their premium rates to reflect anticipated investment earnings. If the investment yield assumptions used in determining the premium rates prove to be too low (or too high), then the difference between actual and expected yields is compounded over the entire claim payment horizon.

The same long payment horizons make it difficult to estimate the ultimate value of the claims to be paid. When coupled with the uncertainty in investment yields, and other assumptions such as inflation rates, there can be large differences between the expected costs of writing medical professional liability insurance policies and the actual costs, which are not known until many years after the policy expires.

During the late 1980s and early 1990s, these uncertainties worked to the advantage of insurance companies. The pricing assumptions proved to be conservative (i.e., rates were set too high) and profits were realized. These profits brought competition from other insurers, resulting in several rounds of rate cutting. These same competitive forces, aided by low inflation and high investment returns, kept rates stable through the 1990s. By the end of that decade, however, the underwriting cycle had reversed itself as the average size of medical malpractice claims increased dramatically and investment yields fell. Profits had dried up and losses were the norm as the insurance industry paid the price for many years of flat rate levels.

Today, healthcare providers are faced with, at best, large rate increases and, at worst, lack of adequate insurance protection. Double-digit and often triple-digit rate increases are the rule more often than the exception.

The Captive Solution

After considering the underpinnings of the underwriting cycle and the challenges involved in pricing this type of insurance, a reasonable conclusion would be that medical professional liability insurance needs to be written by an insurer with a very long-term view. Competitive pressures make this difficult to accomplish. Further, stock insurance companies face additional pressures to produce consistent profits on a quarterly basis.

The ideal environment in which to insure medical malpractice exposures, therefore, is one where:

- the insureds have a stake in the insurance company,
- pricing is not subject to the ups and downs of the underwriting cycle, and
- short-term adverse results can be tolerated.

If structured properly, captives can provide this ideal environment. To be successful, captive owners must be willing to sacrifice certain short-term gains for long-term viability. They must be willing to (a) capitalize the captive, (b) not abandon the captive in "soft" insurance markets when prices are low and (c) pay an adequate, or even conservative, insurance premium in exchange for future dividends (i.e., return of expected profits once they are realized many years later).

In exchange, successful captive owners will be rewarded with a stable insurance market, potential profits, improved cash flow and, most importantly, control of their own destiny once the next hard market hits.

Medical Professional Liability Insurance in Captives

Since 1975, many hospitals and physician groups have used captives as a vehicle to insure their professional liability exposures. By current estimates, there are in excess of 125 healthcare-related captives and risk retention groups. These enterprises can take many forms.

Some of the popular choices of captive types are:

- *Single-Parent Captive*–This type of captive may be appropriate for a large hospital or chain of hospitals.
- *Association Captive*–This type may be suitable for physicians who are members of a common trade association, for example, a state medical society.
- *Sponsored Captive*–In this structure, each member's assets are protected in a separate cell within the captive. This may be useful to separate individual hospitals from each other and from physician groups, specific classes of physicians, etc.
- *Risk Retention Group (RRG)*–This is a captive-like entity that can be formed under the Federal Liability Risk Retention Act of 1986. An RRG may provide advantages for physician groups who practice across state borders. This advantage comes from the fact that a RRG effectively is allowed to operate as a licensed insurer in all 50 states as long as the RRG has obtained a license from its chartering state and has raised sufficient capital.

The climate is right for medical professional liability insurance in captives. Prospective captive owners should look for domiciles with a favorable captive insurance law, a comprehensive service provider infrastructure and a strong regulatory commitment. Ideally, there should be a regulatory team that is dedicated to alternative risk transfer mechanisms, such as captives.

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