

***Robust surpluses and conservative investments yield positive results for medical liability insurers in market recession***

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Insurers have been among the industries facing harsh realities in the current economic conditions. Life insurers as a group have experienced devastating results over the past twelve months. Property-liability insurers have fared quite a bit better, with the huge exception of American International Group (AIG), whose story is now infamous. With insurers receiving such high-profile negative press, the public is asking itself what is wrong with the insurance function, why are we being forced to provide tax money to prop up large insurers, and what can we expect from our existing coverage? Furthermore, the public has lost confidence in the ability of the industry to fulfill its promise. A recent survey conducted by the *Insurance Information Institute* found that 95% of Americans surveyed believed that economic problems affected the basic business of insurance, namely their ability to pay claims.

Despite public perception, we wonder if the current economic environment truly is proving to be devastating to the insurance industry overall. In particular, we are curious of the extent to which the property-liability industry is affected, most especially specialized insurers in the medical malpractice line of business. The property-liability insurance industry functions distinctly from the life insurance industry. Do these differences leave property-liability insurers in a different position from that of life insurers? The purpose of this discussion is to provide some answers to that question.

This article explores the impact of the financial crisis on property and liability insurers, focusing primarily on medical malpractice carriers. As background, the recent performances of AIG and the life insurance industry are briefly outlined in the next section. We follow with discussion of the performance of three medical malpractice insurers as expressed through interviews with top executives of their firms. These executives responded to a variety of questions surrounding the effects of the crisis on operations, risk appetite, underwriting, and finally, thoughts on the prediction of a hardening market.

### ***AIG***

While many property-liability insurers remained committed to their core insurance products over the past decade, AIG delved deeply into structured products outside their insurance competency. In July of 2007, often cited as the beginning of the current financial crisis, over-leveraged homebuyers faced with falling home prices sparked a fire that would spread to all corners of the globe. This fire would end up ruining the likes of Bear Stearns, Lehman Brothers, and the largest insurance company in the world, AIG. AIG's demise was not brought upon by weakness in core competencies, i.e., insurance. Rather, AIG's "Financial Products Group" risked nearly half a trillion dollars to guarantee domestic mortgages using complex financial products called credit default swaps. When homeowners began losing equity with falling home prices, defaults began accruing and AIG was called to pay. Thus was the beginning of the end for one of the most venerable insurance companies in the country. AIG lost \$62B for the first quarter of 2009. As of April 2009, AIG has received nearly \$170B in taxpayer assistance, with the government owning nearly 80% of the insurance giant. This collapse, however, was not caused by a failure of traditional investments or a failure of underwriting; rather, it was caused by entry into a

business outside of traditional insurance. A business that AIG entered having limited experience and foresight.

### ***LIFE-INSURERS***

Similar to the reasons behind the fall of AIG, life insurance companies were not hit by a failure of their core insurance product. Their troubles sprang from conditions of the overall recession: the loss of value in their equity holdings. All insurance companies are subject to market cycle fluctuations. Life insurers, however, have been hit particularly hard by the current crisis. While successful property-liability insurers employed a conservative investment approach with limited exposure to equities, life insurers have recently shifted their investments toward equities. Both because of investment philosophy and regulations governing the life insurance sector, stocks historically represented a relatively small portion of their total investment portfolio generally. Between 2006 and 2007, however, life insurer holdings of corporate stock and common stock rose nine percent.

While this increase was due in part to the changing yields of various investments, the dramatic growth of the variable annuity business also contributed to the increased risk. Life insurers sought higher returns to meet mandatory guaranteed payouts required by the variable annuity product, payouts not dependent upon stock market returns. This investment approach was a very risky bet, which they lost when the market turned. Thus, the plummeting value of equities caused by the financial downturn severely strained variable annuity business *and* investment income.

Further, insurers own approximately 18% of all corporate bonds outstanding. The demise of major corporate players, many of whom had a AAA rating, caused a trickle-down effect and forced write-offs on high-grade corporate bonds. Life insurer investment portfolios also included a healthy portion of residential mortgage and commercial real-

estate assets. When home prices began falling and delinquencies began to rise, so too did life insurers portfolio losses. To add insult to injury, when these investment losses occurred, many life-insurers were downgraded by rating agencies. Capital market performance reduced investment income to a point where, on April 8, 2009, the Treasury Department decided to extend bailout funds to struggling life-insurers.

The viability of many life-insurers still remains in question. A number of life insurers, including Hartford, Genworth, and Lincoln National prospectively struck deals last fall to buy regulated savings and loans in order to qualify as banks and have guaranteed access to government funds. Recent relative improvement in market conditions has reduced the chance of potential failure and bolstered consumer confidence leading to increased investment in the industry. As a result, many of the life insurers are now turning down the availability of TARP and some are returning money already received.

Despite the well-known problems of AIG and the life insurance industry, there has been limited publicity surrounding the performance of property-liability insurers in the current financial crisis. While the performance of AIG and life insurers is often presented as a failure of the insurance business, what about insurance performance in other sectors? It turns out that all is not bleak within the insurance industry.

### ***Performance of professional liability insurers***

In order to understand the effects of the financial crisis on professional liability insurers, interviews were conducted with executives of three medical malpractice carriers. Two of these are mutuals and a third is a publicly-traded insurer. After speaking with these leaders in the professional liability field, it is apparent that some members of the insurance industry have done quite well, considering the circumstances. Their stories may provide useful insight to others.

## Louisiana Medical Mutual Insurance Company

Louisiana Medical Mutual Insurance Company (LAMMICO) insures physicians, dentists, nurses, health care facilities, nurse practitioners, CRNA's, podiatrists and health care facilities in Louisiana, Arkansas and Texas. LAMMICO is the largest insurer of Louisiana physicians, insuring almost 5,000 doctors throughout Louisiana. Mr. Tom McCormick, the Chief Financial Officer of LAMMICO, believes that Lammico was fortunate in that their management philosophy allowed them to, generally, avoid the economic crisis prospectively. They are not, and have never been, a company that chased yield. First and foremost, their investment strategy is focused on maintaining principal. "We did not get into the more esoteric and newer investment vehicles that wound up being not what people thought they were ... this is because our overarching goal is to not put our doctors at risk." There was no exposure to subprime mortgages, only high quality tranches. In fact, in 2007, fixed income investments accounted for almost eighty six percent of their entire investment portfolio. Mr. McCormick admits, however, "that surplus has taken a hit, though, to reflect a markdown of our limited equity portfolio." As a result of the crisis, LAMMICO has increased oversight of their portfolio managers, speaking routinely with them regarding the capital market and their investments. "We are even more conservative now, if that's possible, with investments. Until the market settles, we will remain committed to this approach." Also, the crisis has refocused LAMMICO on the necessity of continually assessing their investment guidelines. It has reinforced their strategy as long-term investors, reminding them that they are not involved for short-term yields. "I must say, however, that having a robust surplus has allowed us to manage this crisis from a much better position."

Like others in the field, LAMMICO has yet to see the market harden in professional liability insurance. Accordingly, they face increased competition with new entrants who

engage in price undercutting to gain market share. LAMMICO exerts a focused effort to maintain pricing integrity. “While we are the largest writer in the state, we also have the *best data* in the state, hands down. This allows us to manage our pricing in the best interest of our insureds.” Mr. McCormick surmises that if the market does harden, history shows that it will also be accompanied by an increased claims frequency, forcing many of the new competitors to exit the market because of myopic management practices. “Despite the economic downturn, our sound management principles have allowed us to give back two 20 percent dividends to our physicians over the last two fiscal years with a 0 percent overall base rate increase in premiums from 2005-2008. Most of our insureds have actually seen their premiums *decrease*.”

#### The NORCAL Group

Through its two member companies, NORCAL Mutual Insurance Company and PMSLIC Insurance Company, the NORCAL Group insures more than 25,000 physicians and other healthcare providers in solo practice, medical groups, hospitals, clinics and allied healthcare facilities in California, Pennsylvania, Alaska, Delaware and Rhode Island. The NORCAL Group is one of the largest medical professional liability insurers in the nation. Chief Executive Officer Jim Sunseri says that the NORCAL Group has always had a conservative investment philosophy and that there are no plans to change that approach. They have also experienced only limited effects resulting from the economic crisis. “We have retained our policyholders throughout this crisis and our physicians, medical groups, clinics and hospitals are maintaining their medical liability insurance coverage.” The NORCAL Group’s balance sheet has remained consistent overall. However, they have had to take minimal write-offs on some AAA corporate bonds. The recession has not caused the NORCAL Group to rethink its investment strategy. “We are heavily invested in fixed-income,

so our exposure to the equities market is limited. This was our strategy before the crisis and has not changed as a result of the current state of the economy.” In 2007, fixed income investments represented approximately 67% of the NORCAL Group’s portfolio. The group has always considered its underwriting approach to be a strength. “Our underwriting perspective and standards have also remained consistent during the economic downturn,” Sunseri notes. “While many insurers are changing pricing policies because of the recession, we are not. We are not a pricing follower.” Mr. Sunseri does admit, though, that newcomers to the medical professional liability world continually enter the market, trying to undercut price and offer insurance at the lowest possible point. He cites these companies as the most likely ones presently having a difficult time. “We are not a market follower,” he says. “We are committed to delivering the highest quality insurance product at the lowest responsible cost.” Neither LAMMICO nor the NORCAL Group altered pricing strategy when faced with the recession and continued soft market.

Frequency in medical malpractice claims has dropped consistently since 2000. The *National Practitioner Data Bank* reported an approximate four percent annual decline in claims reported between 2001 and 2005. This trend is true for both California and the nation as a whole and resulted in a soft market. With regard to the potential causes of the soft market, Mr. Sunseri speculates, “Perhaps the hard market in the late 90’s caused a strengthening of our underwriting standards.” However, he admits there are too many possible causes for the soft market and that the hard market will return, but trying to predict the timing or its effects is not worthwhile. In assessing the timing and potential effects of a new hard market, it is important to recognize that the landscape of the professional liability insurance market is continually evolving. There are fewer professional liability insurers across the country, as compared to the late 90’s. Physicians and their insurers in some states also have benefited from changes in tort laws that favor them. The

reverse is also true in states such as Louisiana, which is considering a repeal of caps on damages in medical malpractice suits. Public attitude toward malpractice has morphed and changed with the times as well. While some plaintiff's still vilify physicians, this type of public sentiment appears to have been tempered. Mr. Sunseri reiterates, "To try to time and measure a potential hard market is unhelpful."

### ProAssurance Corporation

ProAssurance Corporation is a publicly traded, national professional liability insurer, which is one of the largest writers of professional liability insurance in America. Dave Maurer, Chief Operating Officer of the Northwest Division, discussed ProAssurance performance given the current economic state.

"It has reinforced our continued efforts to remain disciplined, allocate resources wisely and continue to make proper investments. When the market turns, we want to be poised to capitalize. We are very proud of the fact that we have had no layoffs as a result of the current crisis." The crisis did, however, impact investment income. Overall investment results declined 13% in 2008, with net realized losses of \$50.9 million for the year, including impairments. However, losses for the year are less than 2% of our \$3.6 billion portfolio, which is remarkably positive. Other professional liability insurers that are more thinly capitalized will undoubtedly be under increased pressure as investment income dries up. This will place greater pressure on current underwriting results to sustain their capital position. . "Because of good management, we are well capitalized and this will put us in a superior position when things turn." ProAssurance employs a measured growth strategy, focused on the geographic diversification of operations and the local application of consistent policies designed to ensure long-term strength. This strategy has not been compromised as a result of the current financial crisis. "Our acquisitions include Mid-

Continent, which provides inroads to ancillary healthcare providers through the excess and surplus line markets. These ancillary providers, such as home health nurses and other types of physician-extenders will become more important as healthcare reforms are implemented and cost containment becomes an even high priority. We now provide coverage to podiatrists across the country with the acquisition of the PICA Group. Also, the recent acquisition of Georgia Lawyers provides further diversification in our professional liability markets. This diversification has continued throughout the recent economic downturn ”

Like other medical professional liability insurers, ProAssurance has experienced the soft-market over the last 36 months and anticipates a coming hard-market due to the decreased flow of capital and the lower margins due to competitors’ aggressive pricing across the country. While claims frequency has stabilized, the cost of claims continues to increase every year. In the past two years alone, for example, The Wisconsin Injured Patients and Families Compensation Fund has seen a significant increase in medical malpractice payments, including several record-breaking judgments. “ProAssurance remains committed to constant monitoring of state trends to assess potential changes in our industry, which could affect insureds.”

### ***Lessons for the future***

After discussions with these leaders in the professional liability insurance field, it certainly appears that many property-liability companies fared well during the current financial downturn. According to A.M. Best, despite the financial market meltdown, in 2008, 81% of ratings actions were affirmations, 4% were upgrades and only 3.8% were downgrades, with the remaining actions still under review. Why has the property-liability insurance industry performed relatively better than most? According to the *Insurance Information Institute*, property and liability insurers have a strong emphasis on quality

underwriting which has buoyed them in these tough times. The dependence by property and liability insurers on underwriting profits has waxed and waned over the last thirty years; however, it has never been of more important than now. While underwriting profits were commonplace in the 1960's and 70's, A.M. Best has estimated that not a single annual industry-wide underwriting profit was made from 1979-2003. In fact, the *Insurance Information Institute* has estimated the cumulative underwriting deficit from 1975 through 2007 to be approximately \$422 billion. In the coming years, insurers will place increased importance on generating underwriting profits to offset the decline in investment income. Further, regulatory changes could require increased capital reserves, thus limiting investment amounts. The industry should be prepared to function in a world where investment earnings account for only a small portion of overall profit.

The downside to overleveraging will certainly be another key lesson learned from this financial crisis. Insurers did quite well in this regard. The insurance industry did not and has not, historically, operated with high leverage. Property-liability insurers do not borrow money to pay claims or diversify business. Thus, the credit crunch did not impact these companies to the extent that it did most financial service organizations. Another component of these companies' success: a conservative investment philosophy, which emphasized maintaining principal. Property-liability insurers had a total of \$1.3 trillion in invested assets as of January 2008 and each executive we interviewed talked about the limited exposure their company had to equities and other more risky investment vehicles as a bright spot in their company strategy. While investment income was admittedly down, total company write-offs were also, generally, limited to failed A-grade corporate bonds, the likes of which include those issued by Lehman Brothers, Bear Stearns, and AIG. The "maintenance of principal" investment philosophy will enable many property and liability

insurers to survive the current market and be poised to capture profits in the next bull market.

### ***The coming hard-market?***

And with regard to market cycles within the property and liability industry, many have heard the rumblings of a coming hard-market in the sector. Yet, I have heard this echo for the better part of the past 14 months. When, if ever, is it going to arrive? A recent study by Willis found that the predicted hard market was delayed by “record 2006 and 2007 surpluses, few impediments to new entrants, and competition with American International Group.” According to Willis, there are still signs that point to a hard market, including: decreased investment income, escalating reinsurance costs, and the prolonged soft market. Should insurers be anticipating this hard market and altering present risk and underwriting strategies in preparation? I would argue the current financial debacle has caused insurance buyers, now more than ever, to look beyond price considerations and focus on the underlying strength and soundness of the company and product. This consumer mindset, brought about directly as a result of the crisis, will be a significant benefit to the property and liability insurer and could usher in the next hard market. And as one leader said when asked the question about the coming market, quoting Mark Twain, “History does not repeat itself, but it does rhyme.”