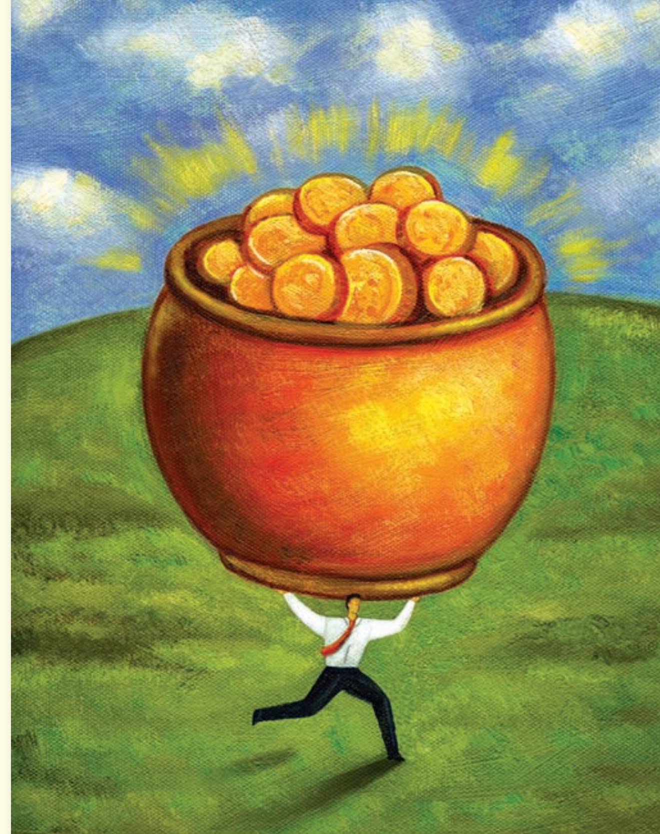

A DIFFICULT CHOICE

BY STEPHEN J. KOCA AND RICHARD B. LORD

If no news is good news, then PIAA members and other medical professional liability (MPL) insurers should be elated. Ten years of strong profitability have left them with massive stores of capital. But all is not well.

The relentless erosion of their market has also imbued them with a sense of foreboding about their future. How will they compete in a shrinking market? What will their role be? The answers lie much too far into the future, but the present does provide some hints about what may be ahead.

Over the past 10 to 15 years, the proportion of physicians who own their own practice has shrunk. One study by Accenture estimated that the figure was as low as 39% in 2012, down from 57% in 2000. But a benchmark survey by the American Medical Association (AMA) more optimistically pegged the number at 53% for 2012. That being said, the private physician market still contracted by 8% over the previous five years, according to the AMA survey.

No matter which starting point is used, though, the flight from private practice is undeniable. Over the years, independent physicians have been confronted with an onslaught of pressures, from reduced Medicare reimbursements to higher technology, costs that have taken their toll on income and fueled physicians' decisions to seek employment in hospitals or group practices. The trend has only accelerated with implementation of the Affordable Care Act (ACA), whose payment incentives have added yet another stress to physicians' top-line results.

During this time, MPL insurers have been fortunate to have enjoyed profitability strong enough to take the edge off the necessity of confronting this deep structural market change. But the time is drawing near when insurers will have to face the reality.

Tenuous steps

One option is to hunker down and try to sit out the storm of intensifying competition. Its effects are likely to first hit the specialty, single-state PIAA members that may lack the expertise to serve the risk needs of large hospital or group systems with broader reach. While these companies have excelled with vast expertise in their markets over the past 20 to 30 years, their limited scope and smaller capital base could make them fall victims to competitive market pressures and become acquisition targets of their larger, more diversified rivals.

Meanwhile, other PIAA insurers aren't waiting for the inevitable; they've made strategic acquisitions to gain economies of scale, and have used some of their large store of capital to diversify into other products or sectors. Some are more active in the large MPL excess-insurance market, taking sizable layers of risk that are typically well above the primary layer that has been their base of expertise for many years. And few have also been more active as risk-facilitators instead of risk-takers, providing fronting arrangements and/or unbundled underwriting, risk, and claims services. As the underlying exposures have become more sophisticated in the alternative risk market, so too must the PIAA companies become more sophisticated in how they provide their services to these risks.

The continuing growth in captive insurance companies and risk retention groups is one example of the greater sophistication exhibited by the underlying risks. But frequently, a health system captive is not able to directly insure its affiliated physicians, and PIAA members can step in with a fronting arrangement, insuring the physicians but ceding the risk back to the captive.

For some MPL insurers whose premium base has already transitioned to employment within a hospital or large practice, a fronting arrangement has allowed them to maintain a connection with their formerly insured members. If the pendulum were to swing back in the direction of independent practices, or if a health system captive were to have a misstep and need to scale back, the MPL fronting company

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would be well positioned to pick up the risk it once had in the fully insured market.

Wisely exploited, a captive arrangement can provide MPL insurers with an opportunity to continue to play a role as one element in the risk-handling mechanism, in ways that go beyond a mere paper exchange. For example, a deeper value in the relationship could stem from the MPL fronting company's ability to make use of one strategic asset still under its control: data on the physicians. With priority access to application and claims data, the MPL fronting company could build on its risk management services, moving from a defensive or purely preventive role to that of a strategic partner, by extracting latent information buried in the data that can be used to develop targeted improvements. By capitalizing on its expertise in analyzing and interpreting the data to determine major risk factors, for example, the MPL fronting company can cement its relationship with the captive and its physicians, and, at the same time boost the importance of its role.

The additional insight into the captive's MPL risks has also provided some MPL fronting companies with a point of entry into the excess reinsurance market, a market that was previously largely untapped by PIAA insurers. But the close working relationship with a captive can provide an opportunity for the MPL fronting company to build distinct knowledge of the captive's risks, based on which it could safely price the excess reinsurance that the captive or a health system might need.

Sounds like a plan?

But the fronting relationship comes at a considerable sacrifice. Since the fronting company does not bear the risk, it receives only a small percentage of the gross written premium. Pursued on a small scale, fronting

Figure 1. Medical Professional Liability 30-Year Net Earned Premium

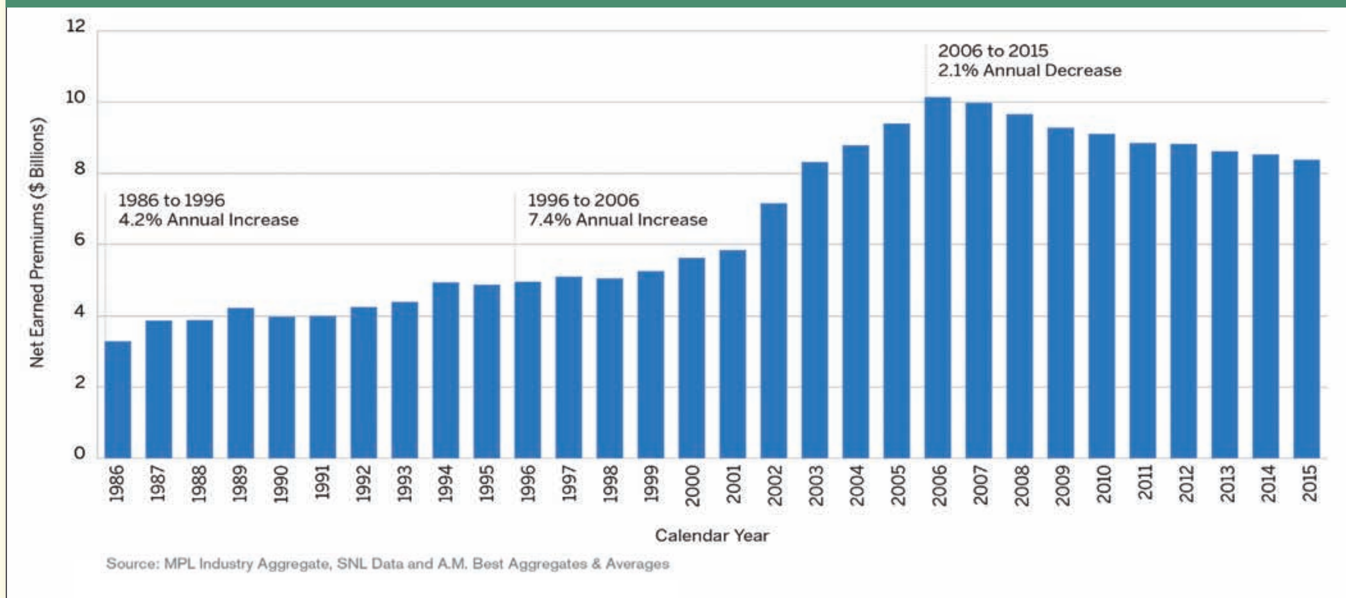
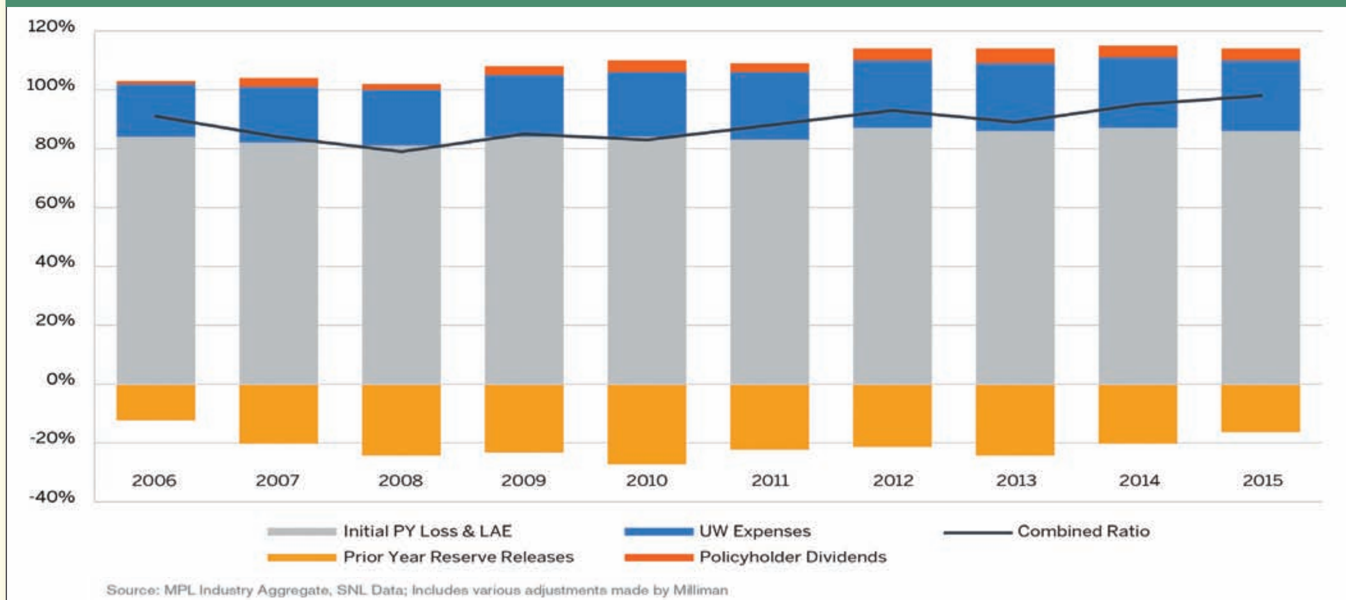


Figure 2. Medical Professional Liability 10-Year Combined Ratio Results



could serve as bridge between a fully insured model and the next phase of the MPL market, but widespread adoption of fronting as a new business model may cannibalize the companies' revenue base. As more MPL insurers opt to front for captive programs, their revenues would fall, gradually at first, but then, at some point, the decrease could reach a tipping point and, from there, accelerate beyond expectations.

Such a potentially precipitous falloff in revenue would likely pressure insurers to either cut costs or, more likely, lower prices on their remaining fully insured business in order to maintain market share. Like the sudden and still somewhat unexplained drop in loss frequency in the last decade, MPL insurers could reach another inflection point, but this time with declines in revenue. Rather than benefiting from a surge in net income as they did when frequency decreased, in this case, MPL insurers could struggle to remain relevant.

But the decision to transform may not be entirely in the hands of the MPL insurers. Hospitals and large group practices have already adopted alternative risk platforms as a risk management strategy, setting in motion the wheels of change. It remains for MPL insurers to decide what role they will assume in the new market (Figure 1).

This scenario is admittedly couched in a number of "what ifs," but it is still worth considering. Commercial MPL insurers' premium base has contracted at unprecedented rates and this contraction shows little signs of easing. And while it is difficult to discern how much of the decrease in premium is due to competitive rate environments versus the departure of exposures for alternative risk programs, both pose their own separate concerns.

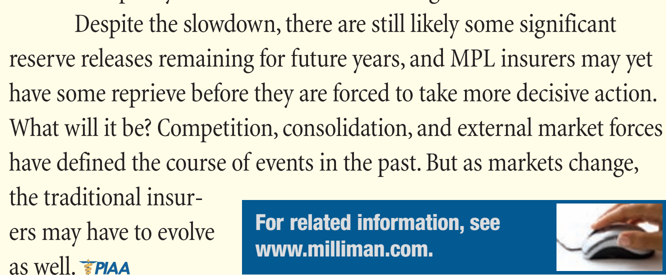
A little breathing room

More than a decade of positive operating results, led by significant reserve releases, has provided significant resources to explore and redefine roles where necessary. MPL insurers posted a combined ratio of 98% in 2015, marking the 10th straight year the MPL industry aggregate has been profitable even before the accounting of investment income.

However, creeping signs of difficulty continue to emerge as the 2015 combined ratio represents a 3-point deterioration from 2014, following immediately after what had been a 6-point deterioration from 2013 to 2014 (Figure 2).

The increase in combined ratio from 2014 to 2015 is largely related to a diminished release of prior-year reserves (i.e., the income that has typically been associated with reevaluation of losses on prior policy years). Meanwhile, despite the fact that the combined ratio is inching toward the break-even point before the investment barrier of 100%, policyholder dividends (or price competition by another name) have largely held steady, increasing slightly, at 4% of premiums returned to policyholders as a dividend during 2015.

Despite the slowdown, there are still likely some significant reserve releases remaining for future years, and MPL insurers may yet have some reprieve before they are forced to take more decisive action. What will it be? Competition, consolidation, and external market forces have defined the course of events in the past. But as markets change, the traditional insurers may have to evolve as well. PIAA



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