Foresight

In the Fourth Quarter 2011 Physician Insurer, *we asked two actuaries from BMS Group, Michael D. Larson and David Spiegler, to give us some insights on the interplay between the financial markets, medical professional liability (MPL) insurance companies' rates, and reserves. Now, in this issue, Michael Larson does a solo turn, and talks about BMS Group's new research on the role of the various asset classes in the portfolio of an MPL insurer.*

Michael D. Larson

PI: In our last interview, you mentioned that the uptick in stock market volatility in 2011 caused you to look at how the common stock investing practices of MPL-focused insurance companies had changed over the past three to five years. What were some of the findings from that study?

Larson: Between 2007 and 2010, we noticed very little change in the number of MPL-focused groups and companies that invested in common stock and only a slight increase in the percentage of cash and invested assets that was attributable to investments in common stock. From this it appears that the downturn in the financial markets in 2008 and 2009 had little impact on the long-term willingness of companies to invest in common stocks.

We did see some differences in the investment practices based on company size. We saw that companies with the largest cash and invested asset balances consistently invested in common stock, while those with the smallest cash and invested asset balances appeared to be less willing to invest in equities.

In the aggregate, MPL-focused groups and companies appeared to be less heavily invested in common stock when compared to an industry-wide sample of other companies with similar levels of policyholder's surplus (PHS).

Finally, while common stock made up a slightly greater percentage of cash and invested assets at year-end 2010 than it did at year-end 2007, and the value of those holdings increased by roughly 14%, the value of PHS for the group also rose substantially over that time period—by 33%. So, as a result, the year-end 2010 common stock investment leverage, common stock holdings as a percentage of PHS, was actually lower than it was at year-end 2007.

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PI: Have you looked at how the dramatic reduction in interest rates and U.S. Treasury yields over the past five years or so has impacted the fixed-income investment practices and overall investment yields of these same MPL-focused companies?

Larson: We haven't published a formal analysis of these investments, like we did for the common stock. But we have looked at fixed-income investment data for a subset of PIAA companies. And we found some interesting things.

Within the typical fixed-income portfolio, we noted that, on average, U.S. Treasuries have made up only about 6% to12% of the portfolio over the past ten years. This percentage has oscillated over time, reaching its low point in 2008, and then rebounding again in 2009 and 2010.

Note, however, that the magnitude of the move back into U.S. Treasuries in 2009 and 2010 was heavily influenced by the investment activity of one large company in that subset, which increased its U.S. Treasuries allocation from about 9% at year-end 2008 to roughly 25% at year-end 2010.

Nonetheless, while yields were on the way down in the 2008 to 2010 time period, we did clearly see an overall movement back into U.S. Treasuries, which was undoubtedly the result of the upheaval in the remainder of the market during this time period.

As far as the investment yields are concerned, the relatively low allocation in U.S. Treasuries meant that MPL companies' investment yields, overall, did not decrease nearly as quickly as the yields in U.S. Treasuries themselves.

As an example, if you look at the yield for the five-year U.S. Treasury, that dropped from about 4.5% in 2006 to less than 1% in 2011. At the same time, if you look at the overall investment yields of the MPL companies, that dropped by only about 1% during the same interval, from a little less than 4% in 2006 to a bit less than 3% in 2010.

PI: If MPL companies had invested more heavily in U.S. Treasuries as a normal practice, would that, in your opinion, potentially have led to rates hardening more quickly than they have?

Larson: I don't know if that, in isolation, would have done enough. If you recall Dave Spiegler's comments from our last discussion [*Physician Insurer*, Fourth Quarter 2011, page 50], there have been some $6.1 billion in prior year reserve releases over the past four or five years, which has maybe masked, for some companies, the reality that the underlying incurred year loss ratios have been deteriorating.

Had the underlying deterioration in the loss ratios not been masked and had overall investment yields been dropping as fast as U.S. Treasury yields, there certainly would have been more focus on the profitability of the current business being written. With that being said, the most recent analysis shows that the 2010 business is still reasonably profitable. So, the market in general really hasn't been anywhere close to the "point of pain," where they might have had to take corrective rate action.

PI: For a while, it seemed as if corporate bonds were very attractive to MPL companies. What happened with that trend?

Larson: One of the things that we noticed was that there was some movement elsewhere in the fixed-income portfolio in the recent past. Going back to late 2007 and into 2008, there was an increase in the allocation to

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municipal bonds at about the same time municipal bond yields spiked relative to those of U.S. Treasuries. Then in 2009–2010, there was a movement away from mortgage-backed securities and into corporate bonds, as, similarly, the yields on corporate bonds spiked relative to those of U.S. Treasuries. So, there was a fair amount of shifting between fixed-income sectors as companies went in search of higher yields.

Going back to the investment yield question for a moment, this shifting between sectors is a big reason that the drop in overall investment yields hasn't been nearly as great as the drop in U.S. Treasury yields. The other thing to keep in mind, of course, is that MPL losses pay out over a very long period of time. If the asset durations are matched properly against the expected loss payouts, the typical MPL company in 2009 and 2010 still had a lot of investment income being generated from bonds that were purchased several years back, when the yields were quite a bit higher.

Given that dynamic, we shouldn't be too surprised to see investment yields come under even more pressure over the next several years as more and more of those older bonds mature and are replaced by investments in bonds at today's much lower yields.

PI: In closing, I'd like to circle back to the investment practices issue for a moment. Is there anything else that you've noticed about the investment practices of some of the companies you've looked at that is of concern or interest?

Larson: The one thing that stood out for me when I looked at the data is this: diversification. We noticed some companies that had a significant portion (75% or more) of their overall fixed-income portfolio invested only in municipal bonds. Of course, those investment dollars are spread across a number of different securities, so there is diversification within

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that sector. Still, having that much of your fixed-income portfolio invested in one sector, like municipal bonds, seems a bit risky to me, especially when the value of that investment could, in many cases, be equal to or multiples of the PHS of the company. No matter how much surplus a company has, being too heavily concentrated in any one asset class or sector can be problematic. PIAA