



AMERICAN ACADEMY *of* ACTUARIES

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**Subcommittee on Health  
Committee on Energy and Commerce  
United States House of Representatives**

**Hearing on  
“Current Issues Related Medical Liability Reform”**

**Statement of James Hurley, ACAS, MAAA  
Medical Malpractice Subcommittee  
American Academy of Actuaries**

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## **INTRODUCTION**

The American Academy of Actuaries appreciates the opportunity to provide comments on issues related to medical malpractice. The Academy hopes these comments will be helpful as Congress considers related proposals.

This testimony discusses what has happened to medical malpractice financial results and its likely effect on rates, tort reform, and some discussion of frequent misconceptions.

## **MEDICAL MALPRACTICE – WHAT HAS HAPPENED?**

The medical malpractice insurance marketplace continues to be in serious turmoil. After an extended period of reported high profitability and competitiveness during the 1990s, this turmoil began with serious deterioration in financial results, continued with some consequences of these results and, still at this point, gives rise to an uncertain future. Industry-wide financial results reflect a 2003 combined ratio (the measure of how much of a premium dollar is dedicated to paying insurance costs of the company in a calendar year) of 138 percent, an improvement relative to the 2001 and 2002 results, but still well above profitable levels. The 2003 operating ratio (reducing the combined ratio for investment income) of about 116 percent extends the several year pattern of losing money after the inclusion of investment income. Projections for 2004 are for a slightly lower combined ratio (approximately 133 percent) and probable lesser improvement in the operating ratio. This follows 2001 and 2002 operating ratios exceeding 120 percent.

The consequences of these poor financial results are several. Insurers have voluntarily withdrawn from medical malpractice insurance (e.g., St. Paul, writer of approximately nine percent of total medical malpractice insurance premium in 2000) or have selectively withdrawn from certain marketplaces or segments of medical malpractice insurance. In addition, several insurers have entirely withdrawn due to poor financial results (e.g., Phico, MIIX, Frontier, Reciprocal of America, some of which are under regulatory supervision). Overall, premium capacity has been reduced by more than 15 percent. These withdrawals fall unevenly across the states and generally affect those identified as jurisdictions with more severe problems than others.

Capacity to write business would have decreased even more if not for the fact that much medical malpractice coverage is written by companies specializing in this coverage, some that were formed for this specific purpose.

These figures focus on the published insurance industry statistics. Parallel to industry experience is the growing volume of self-insured programs (e.g., deductible programs, trusts and captives), which have significantly increased their share of the medical liability exposure 'pie' over time; some would estimate this segment has responsibility for half or more of the exposure today. These self-insured entities, such as hospitals, see the dollars needed to cover their retentions increasing and are having increased difficulty securing excess or reinsurance coverage to manage their exposure.

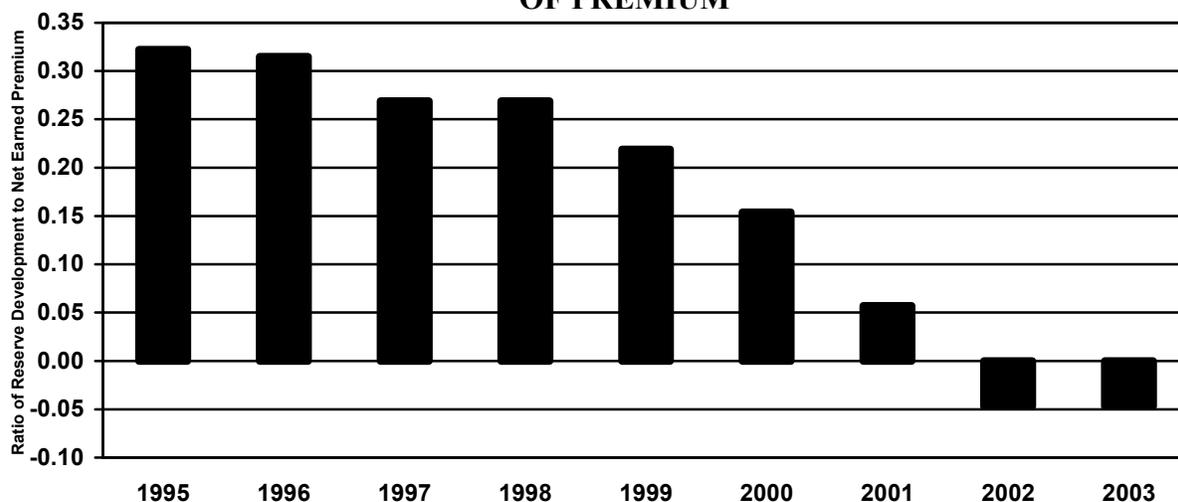
The future outlook is not positive, at least in the short term. Claim costs are increasing more rapidly now than they were historically. Further, full adjustment to the lower interest rate and tightened capacity environment would drive higher premium rates, even if losses were not increasing. The combined effect is that there are likely to be more poor financial results and additional rate increases.

### **Background—Market Conditions in the 1990s**

The current premium increases are hard to understand without considering the experiences of the last decade. Rates during this time period often stayed the same or decreased relative to the beginning of the period due to several of the following factors:

- Favorable Reserve Development--Ultimate losses for coverage years in the late 1980s and early 1990s have developed more favorably than originally projected. Evidence of this emerged gradually over a period of years as claims settled. When loss reserves for prior years were reduced, income was contributed to the current calendar years, improving financial results (i.e., the combined and operating ratios). That was the pattern during the middle to late 1990s for 29 provider-owned/operated medical malpractice insurers whose results are shown in Chart A. What is evident from that chart is that favorable reserve development (shown as a percentage of premium) was no longer occurring after 2001, as developments in 2002 and 2003 were unfavorable. This unfavorable development contributes to bottom line losses for these companies.

**CHART A: LOSS RESERVE DEVELOPMENT AS PERCENTAGE OF PREMIUM**



- Low Level of Loss Trend--The annual change in the cost of claims (frequency and severity) through most of the 1990s was lower than expected by insurers, varying from state to state and by provider type. This coincided with historically low medical inflation and may have benefited from the effect of tort reforms of the 1980s. Rates were established using the earlier anticipated higher loss trends and were able to cover these actual lower loss trends for a time. As a result, rate increases were uncommon and there were reductions in several states. This was justified in part because the rates established at the beginning of the last decade proved too high, inasmuch as carriers had assumed higher loss trends.

Insurers responded to the emerging favorable loss trend in different ways. Some held rates stable and paid policyholder dividends or gave premium discounts. Some reduced filed rates. Others increased rates modestly and tried to refine pricing models to improve overall program equity. In general, however, premium adequacy declined in this period. Collected rates came into line with insurers' costs, but competitive actions pushed rates even lower, particularly in some jurisdictions.

- High Investment Yields--During the 1990s, investment returns produced a real spread between fixed income rates of return and economic inflation. Medical malpractice investment results are based on a portfolio that is dominated by bonds with stock investments representing a minority of the portfolio. Although medical malpractice insurers had only a modest holding of stocks, capital gains on stocks also helped improve overall financial results. These gains improved both the investment income ratio and the operating ratio.

- Reinsurers Helped--Many medical malpractice insurers are not large enough to take on the risks inherent in this line of insurance on their own. The additional capacity provided by reinsurers allows for greater availability of medical malpractice. Similar to what was happening in the primary market, reinsurers reduced rates and covered more exposure, making the net results even better.
- Insurers Expanded Into New Markets--Given the financial results of the early-to-mid-1990s, some insurers expanded into new markets (often with limited information to develop rates). They also became more competitive in existing markets, offering more generous premium discounts. Both actions tended to push rates down.

### **What Has Changed?**

Although these factors contributed to the profitability of medical malpractice insurance in the 1990s, they also paved the way for the changes that began at the end of the decade.

- Loss Trend Began to Worsen--Loss cost trends, particularly claim severity, started to increase toward the latter part of the 1990s. The number of large claims increased, but even losses adjusted to eliminate the distortions of very large claims began to deteriorate. This contributed to indicated rate increases in many states.
- Loss Reserves are Strengthened --As the losses began to deteriorate, many insurers responded by strengthening their reserves. However, as of year-end 2003, the adequacy of the aggregate loss reserve levels for the industry is still being questioned despite the reserve strengthening recorded during the 2000-2003 period. The statistics for the earlier mentioned 29 companies have been better than the total industry, to date. Some observers suggest that aggregate reserves will require further increases, particularly if severity trends continue or intensify.

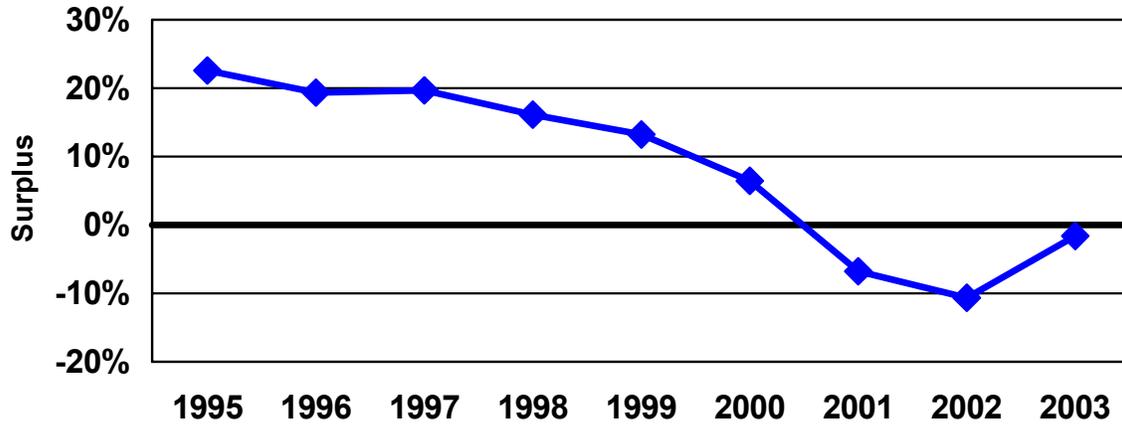
- Investment Results Have Declined--Bond yields have declined from 1990's highs. The lower bond yields reduce the amount of expected investment earnings on a future policy that can be used to reduce prospective rates. A one percent drop in interest rates can be translated to a premium rate increase of two to four percent (assuming no changes in other rate components) due to the several year delay in paying losses on average. A 2.5 percent drop in interest rates, which has occurred since 2000, can translate into rate increases of between 5 percent and 10 percent. Note low investment yields may cause an insurer to reduce its market presence and also may discourage new entrants. The recent increases in yields may alleviate some of the pressure from this source.
- The Reinsurance Market Has Hardened--Reinsurers' experience deteriorated as their results were affected by increased claim severity and pricing changes earlier in the decade. Because reinsurers generally cover the higher layers of losses, their results are disproportionately influenced by increases in claim severity. This, coupled with the broadly tightened reinsurance market after Sept. 11 2001, has caused reinsurers to raise rates substantially and tighten reinsurance terms for medical malpractice.

The bottom line is that these changes have required insurers to increase rates if they are to preserve their financial health and honor future claim payments.

### **The Results**

To obtain a better understanding of the effect of these changing conditions, we focus on the results of 29 specialty insurers that are primarily physician owned or operated and that write primarily medical malpractice business. Their results reflect the dynamics of the medical malpractice line. This sample represents about one-third of the insured exposures reported by the insurance industry in the United States.

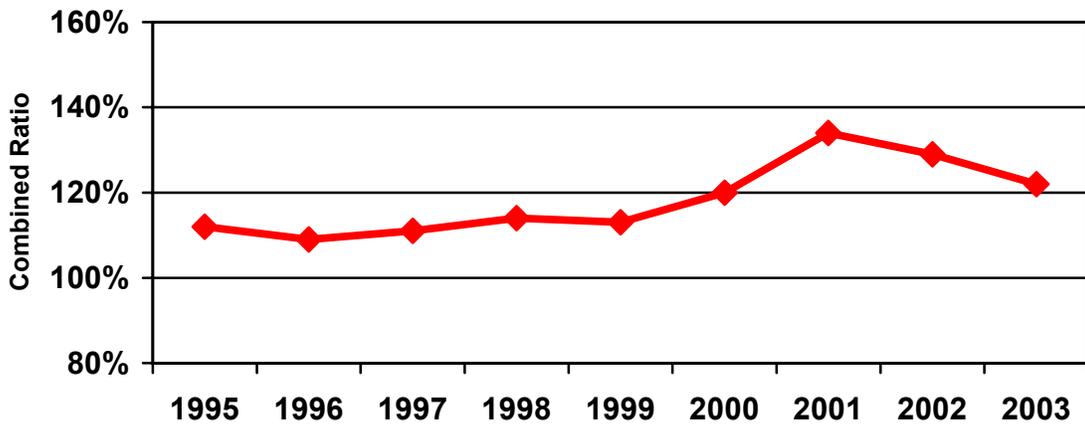
## CHART B: CALENDAR YEAR OPERATING RESULTS TURN NEGATIVE



These insurers, achieving more favorable financial results than that of the total industry, showed a slight operating profit (six percent of premiums) in 2000. This deteriorated to operating losses for years 2001 through 2003 (see Chart B), with 2002 reflecting an 11 percent loss, improving to a 2 percent loss in 2003.

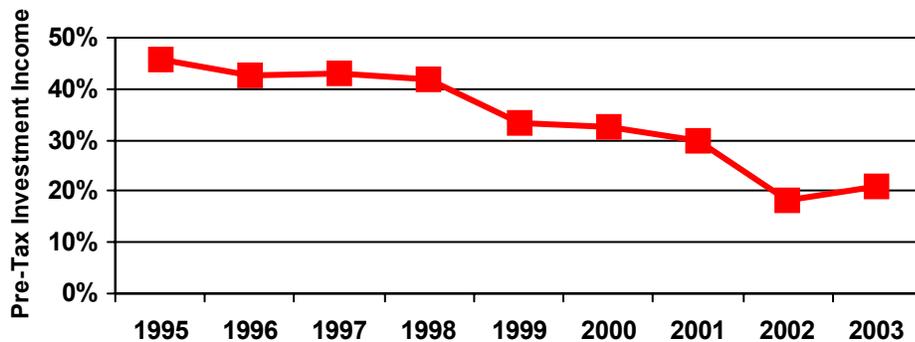
There are two key drivers of these financial results:

- Insurance Underwriting--For these companies, a simplified combined ratio was calculated by dividing calendar year loss and loss adjustment and underwriting expenses by premium. On this basis, the combined ratios peaked at 134 percent in 2001, improving to 129 and 122 percent for 2002 and 2003, respectively. That means in 2003, these insurers incurred \$1.22 in losses and expenses for each \$1.00 of premium. The five years preceding 2000 were fairly stable, from 110 percent to 115 percent. Deterioration of the loss and loss adjustment expense ratio drove these results; the underwriting expense ratio remained relatively constant (see Chart C).



- Investment income (pre-tax investment income (including realized capital gains and losses)) emanates from policyholder-supplied funds invested until losses are paid as well as from the company capital ('surplus'). The investment income offset to the underwriting loss is measured as a percentage of earned premiums. This statistic declined during the measurement period from the mid-40 percent level of the mid-1990s to the 20 percent level in 2002 and 2003 (see Chart D).

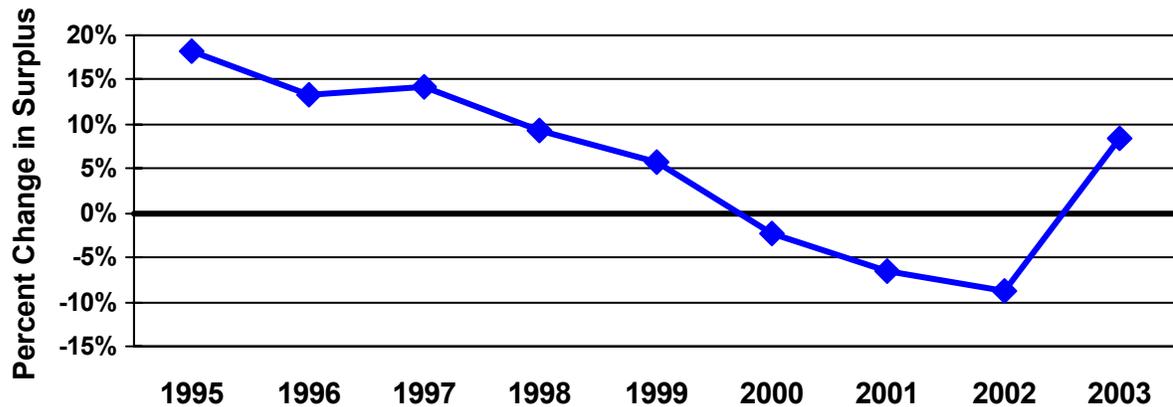
**CHART D: INVESTMENT INCOME AS A PERCENTAGE OF PREMIUM DECLINES**



This offset will continue to decline because (i) most insurer-invested assets are bonds, some of which were purchased before recent lower yields, and interest earnings do not yet fully reflect these lower yields; and (ii) the premium base is growing due to increased rates and growth in exposure. Invested assets are not increasing as rapidly as premium and, therefore, investment income as a percentage of premium will decline.

The effect of these results on surplus is reflected in Chart E, which shows the percent change in surplus from one year to the next. Surplus defines an insurer's capacity to write business prospectively and to absorb potential adverse loss development on business written in prior years (see Chart E). After three years of declines, the increase in 2003 is in part from external sources (e.g., surplus notes, capital contributions and trust preferreds).

**CHART E: SURPLUS CHANGE TURNS NEGATIVE**



## **TORT REFORM**

Some states enacted tort reform legislation after previous crises and in response to the current circumstances as a compromise between affordable health care and an individual's right to seek recompense. The best known is the Medical Injury Compensation Reform Act or MICRA, California's tort reform package. Since MICRA's implementation in 1975, California has experienced a more stable marketplace and lower premium increases than have most other states.

Tort reform has been proposed as a solution to higher loss costs and surging rates. Many are suggesting reforms modeled after California's MICRA, although some have cautioned against modifying the MICRA package. The Academy, which takes no position for or against tort reforms, has previously reviewed and commented on this subject. Based on research underlying the issue, we observe the following:

- A coordinated package of tort reforms is more likely than individual reforms to achieve savings in malpractice losses and insurance premiums.
- Key among the reforms in the package is a cap on non-economic awards (on a per-event basis and at some level low enough to have an effect, such as MICRA's \$250,000) and a mandatory collateral source offset rule.

- Such reforms may not assure immediate rate reductions, particularly given the size of some increases currently being implemented. The actual effect, including whether or not the reforms are confirmed by the courts, will not be immediately known.
- These reforms are unlikely to eliminate claim severity (or frequency) changes but they may mitigate them. The economic portion of claims is not affected if a non-economic cap is enacted. Thus rate increases still will be needed.
- These reforms should reduce insurer concerns regarding dollar awards containing large, subjective non-economic damage components and make the loss environment more predictable.
- Poorly crafted tort reforms could actually increase losses and, therefore, rates.

### **FREQUENT MISCONCEPTIONS**

In closing, it might be helpful to address some frequent misconceptions about the insurance industry and medical malpractice insurance coverage.

*Misconception 1: “Insurers are increasing rates because of investment losses, particularly their losses in the stock market.”*

As we have pointed out, investment income plays an important role in the overall financial results of insurers, particularly for insurers of medical professional liability, because of the long delay between payment of premium and payment of losses. The vast majority of invested assets are fixed-income instruments. Generally, these are purchased in maturities that are reasonably consistent with the anticipated future payment of claims. Losses from this portion of the invested asset base have been minimal, although the rate of return available has declined.

Stocks are a much smaller portion of the portfolio for this group, representing about 15 percent of invested assets. After favorable performance up through the latter 1990s, there has been a decline in the last few years, contributing to less favorable investment results and overall operating results. Investment returns are still positive, but the rates of return have been adversely affected by stock declines and more so by lower fixed income investment yields.

In establishing rates, insurers do not recoup investment losses. Rather, the general practice is to choose an expected prospective investment yield and calculate a discount factor based on historical payout

patterns. In many cases, the insurer expects to have an underwriting loss that will be offset by investment income. Since interest yields drive this process, when interest yields decrease, rates must increase.

*Misconception 2: “Companies operated irresponsibly and caused the current problems.”*

Financial results for medical liability insurers have deteriorated. Some portion of these adverse results might be attributed to inadequate knowledge about rates in newly entered markets and to being very competitive in offering premium discounts on existing business. However, decisions related to these actions were based on expectations that recent loss and investment markets would follow the same relatively stable patterns reflected in the mid-1990s. As noted earlier, these results also benefited from favorable reserve development from prior coverage years. Unfortunately, the environment changed on several fronts — loss cost levels increased, in several states significantly; the favorable reserve development ceased; investment yields declined; and reinsurance costs jumped.

While one can debate whether companies were prudent in their actions, today’s rate increases reflect a reconciliation of rates and current loss levels, given available interest yields. There is no added cost for past mispricing. Thus, although there was some delay in reconciling rates and loss levels, the current problem reflects current data.

*Misconception 3: “Companies are reporting financial losses to justify increasing rates.”*

This is a false observation. Companies are reporting financial losses primarily because claim experience is worse than anticipated when prices were set. Several companies have suffered serious adverse consequences given these financial results, including liquidation or near liquidation. Phico, MIIX, Frontier, and most recently, the Reciprocal of America, are all companies forced out of the business and in run-off due to underwriting losses. Further, the St. Paul Cos., formerly the largest writer of medical malpractice insurance, has withdrawn from this market. One reason for this decision is an expressed belief that the losses are too unpredictable to continue to write the business.

The Academy appreciates the opportunity to provide an actuarial perspective on these important issues and would be glad to provide the subcommittee with any additional information that might be helpful.