



# AMERICAN ACADEMY *of* ACTUARIES

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March 24, 2004

The Honorable Bill Frist  
United States Senate  
Washington, DC 20510

Dear Senator Frist:

On behalf of the American Academy of Actuaries'<sup>1</sup> Medical Malpractice Subcommittee, I appreciate the opportunity to provide an actuarial perspective on the issues related to patient access to health care and, in particular, the availability and pricing of medical malpractice insurance. As Congress considers medical malpractice liability reform (include S. 2207, the Pregnancy and Trauma Care Access Protection Act of 2004), the subcommittee feels it is important to highlight certain misconceptions in the current debate so Congress can more effectively address problems related to the availability and affordability of this insurance.

## **DETERMINING RATES**

Ratemaking is the term used to describe the process by which companies determine what premium is indicated for a coverage. In the insurance transaction, the company assumes the financial risk associated with a future, contingent event in exchange for a fixed premium before it knows what the true cost of the event is, if any. The company must estimate those costs, determine a price for it and be willing to assume the risk that the costs may differ, perhaps substantially, from those estimates. A general principle of ratemaking is that the rate charged reflects the expected costs for the coverage to be provided, not what has been paid or is going to be paid on past coverage. It does not reflect money lost on prior investments. In short, a rate is a reflection of future costs.

In general, the actuarial process used in making these estimations for medical malpractice insurance starts with historical loss experience for the specific coverage and, usually, for a specific jurisdiction. Rates are determined for this coverage, jurisdiction, and a fixed time period. To the appropriately projected loss experience, a company must incorporate consideration of all expenses, the time value of money and an appropriate provision for risk and profit associated with the insurance transaction.

Some lines of insurance coverage are more predictable than other lines. The unpredictability of coverage reflects its inherent risk characteristics. Most companies would agree that costs and, therefore, rates for automobile physical damage coverage, for example, are more predictable than for medical malpractice insurance because automobile insurance is relatively high frequency/low severity coverage compared to medical malpractice insurance. In the case of auto physical damage, one has a large number of similar

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<sup>1</sup> The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification, and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

claims for relatively small amounts that fall in a fairly narrow range. In medical malpractice insurance, one has a small number of claims that have a much higher average value and a significantly wider range of possible outcomes. There also is significantly longer delay for medical malpractice insurance between the occurrence of an event giving rise to a claim, the reporting of the claim, and the final disposition of the claim. This longer delay adds to the uncertainty inherent in projecting the ultimate value of losses, and consequently premiums.

## **RATES DON'T RECOUP PAST INVESTMENT LOSSES**

The ratemaking process is forward looking. In establishing rates, both state insurance laws and actuarial standards of practice prohibit recoupment of past investment losses. Instead of trying to make up for past losses, the general ratemaking practice is to choose an expected prospective investment yield and calculate a discount factor based on historical payout patterns. For medical malpractice, the insurer often expects to have an underwriting loss that will be offset by investment income. Since interest yields drive this process, when interest yields decrease, rates will increase.

Insurers are restricted in their investment activity due to state insurance regulation and competition in the market. The 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.

## **TORT REFORMS**

Tort reform has been proposed as a solution to higher loss costs and surging rates. Reforms modeled after California's Medical Injury Compensation Reform Act, or MICRA, are proposed to alleviate some of the financial pressure on the medical malpractice insurance system. The Subcommittee, which takes no position for or against tort reforms, observes the following:

- A coordinated package of tort reforms is more likely to achieve savings in malpractice losses and insurance premiums than an individual reform, like a cap on pain and suffering or non economic damages only.
- While a cap on non economic awards could substantially reduce claim losses (on a per-event basis and at some level low enough to have an effect; such as MICRA's \$250,000) other tort reform elements, such as a mandatory collateral source offset rule, are also important.
- Such reforms may not assure immediate rate reductions, particularly given the size of some rate increases being implemented currently. The actual effect, including whether the reforms are applied as intended, 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 are still likely to be needed.
- Such reforms should reduce concerns about large dollar awards containing significant subjective non-economic damage components and make the loss environment more predictable.

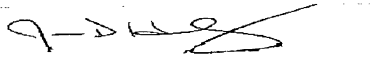
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Thank you very much for your consideration. Please do not hesitate to contact me or Greg Vass, the Academy's Senior Casualty Policy Analyst, at 202-223-8196 if you have any questions or would like additional information.

Sincerely,

A handwritten signature in black ink, appearing to read "J. Hurley". The signature is written in a cursive style with a prominent loop at the end.

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