



AMERICAN ACADEMY *of* ACTUARIES

**United States Senate
Committee on Health, Education, Labor, and Pensions
Committee on Judiciary**

**Hearing on
“Role of Litigation in Patient Access to Care”**

**Statement of James Hurley, ACAS, MAAA
Chairperson, 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 patient access to health care and, in particular, the availability and pricing of medical malpractice insurance. The Academy hopes these comments will be helpful as Congress considers related proposals.

This testimony discusses what is driving medical malpractice premium increases and the prognosis for future changes, tort reform, potential impacts on physicians and patients, and some discussion of insurance company practices.

MEDICAL MALPRACTICE – WHAT HAPPENED?

The medical malpractice insurance marketplace is in serious turmoil after an extended period of reported profitability and competitiveness during the 1990s. This turmoil began with serious deterioration in financial results, continued with some consequences of these results and, at least at this point, gives rise to an uncertain future. Industry-wide financial results reflect a 2001 combined ratio (the measure of how much of a premium dollar is dedicated to paying insurance costs of the company in a calendar year) that reached 153 percent and an operating ratio (reducing the combined ratio for investment income) of about 135 percent; the worst results since separate tracking of this line of business began in 1976. Projections for 2002 are for a lower combined ratio of approximately 140 percent and probable lesser improvement in the operating ratio. This follows 1999 and 2000 operating ratios of 106 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 Insurers have voluntarily withdrawn from medical malpractice insurance (e.g., St. Paul, writer of approximately nine percent of total medical malpractice insurance premium in 2000) or have selectively withdrawn from certain marketplaces or segments of medical malpractice insurance. In addition, several insurers have entirely withdrawn due to poor financial results (e.g., Phico, MIIX, Frontier, Reciprocal of America). 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 serious problems more severely 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 of whom were formed for this specific purpose.

The future outlook is not positive, at least in the short term. Claim costs are increasing more rapidly now than they were previously. Further, the lower interest rate environment would require 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.

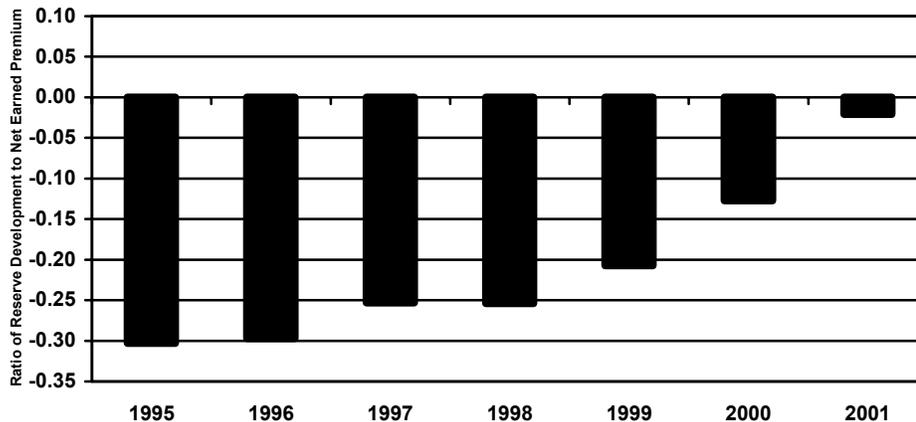
WHAT IS DRIVING PREMIUM INCREASES?

Background

Today's premium increases are hard to understand without considering the experiences of the last decade. Rates during this time period oftentimes 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, it contributed income 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 30 provider-owned 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 a significant factor in 2001 for these insurers as the effect approached zero. In contrast to the experience of these provider-owned insurers, the prior-year reserves for the total medical malpractice line of business actually deteriorated in 2000 and in 2001.
- 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 established earlier anticipated higher loss trends and were able to cover these lower loss trends to a point. 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.

CHART A: LOSS RESERVE DEVELOPMENT AS PERCENTAGE OF PREMIUM



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. Counter to what some may believe, 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 Became Suspect--As of year-end 2001, aggregate loss reserve levels for the industry are considered suspect. Reserve reductions seem to have run their course. As mentioned earlier, the total medical malpractice insurance industry increased reserves for prior coverage year losses in 2000 and 2001, although results vary on a company-by-company basis. Some observers suggest that aggregate reserves will require further increases, particularly if severity trends continue or intensify.

- Investment Results Have Worsened--Bond yields have declined and stock values are down from 1990s 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 two and one-half percent drop in interest rates, which has occurred since 2000, can translate into rate increases of between five percent and ten percent.
- 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 9/11, has caused reinsurers to raise rates substantially and tighten reinsurance terms for medical malpractice.

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

WHAT ABOUT TORT REFORM?

Some states enacted tort reform legislation after previous crises 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 are 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 being implemented currently, as 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.

EFFECTS ON PHYSICIANS AND PATIENTS

Besides commenting on the drivers of premium increases, the committee requested we also comment on the effects these changes are likely to have on physicians and patients.

The cost of medical malpractice insurance is an expense to a physician. In the past, an increase in a physician's expenses such as medical malpractice insurance could be passed on through increased fees. This did not diminish the shock of a large rate increase but did mitigate the financial effect to physicians' practices. Today, the ability to pass on these costs is constrained, at least in the short run, because the majority of physicians' payments come from regulated or negotiated rate payers.

The financial elements of the physicians' income and their changes in recent years are wide-ranging and varied. Property and casualty actuaries, who conduct rate and reserve analysis for medical malpractice insurance, do not normally delve into the areas of reimbursements, practice expenses, or the like. However, with the help of our health insurance actuary colleagues, we have investigated the physician reimbursement portion of health care in an effort to place the medical malpractice insurance price increases in perspective. What we have done is a simple approach, to demonstrate what can happen under a range of reasonable scenarios.

Beginning with 2001 physician expense information, as it relates to gross revenues, we determined the implied physician net income (including benefits and retirement funding). We separately identified a trend for the expenses into 2003 and the gross revenues to the beginning of 2003. This "trending" was assumed to be the same for all specialties, although variations might have existed. The resulting effect on a physician's practice net income was shown. From these results, a few broad conclusions were made:

- In states where medical malpractice insurance rate increases are most severe (we assumed rates increasing 200 percent during the two-year period), there is a clear and significant pattern that shows physician practice income materially down from prior 2001 levels (before potential 2003 increases in reimbursements). For example, under these assumptions, an OB/GYN who received a seven percent increase in commercial reimbursements in 2002 would still see about a 22 percent reduction in practice income from 2001 levels, prior to any increases (or decreases, as proposed for Medicare) in 2003 reimbursement rates.
- In states where medical malpractice insurance rate increases are most severe, the magnitude of the effect appears to correlate with the level that medical malpractice insurance costs represent to the total practice gross revenues. The higher this percentage, the more adverse the effect.
- In moderate states (in terms of rate increases), where medical malpractice insurance costs have increased at lower double-digit levels (we assumed rates increasing by 30 percent), a physician's net income still can be adversely affected in most cases, but the magnitude is not nearly as large.
- In moderate states, there appears to be some correlation to the level of Medicare activity by specialty. In other words, those specialties with a greater portion of their revenue coming from Medicare are harder hit than others. Other factors contribute as well. For example, the relatively higher percent of Medicaid and self-paid are a primary cause for the family practice results to reflect a sizeable reduction in practice income, despite a relatively low Medicare percentage.

These calculations are necessarily rough, but serve as a litmus test of physician-raised concerns about the combined affect of revenue and expense changes. Thus, while not conclusive, they do suggest that the economic circumstances are such that physicians may legitimately question whether to continue practicing medicine, or whether to provide services on a reduced basis. Such changes may effect healthcare quality and patient access to healthcare.

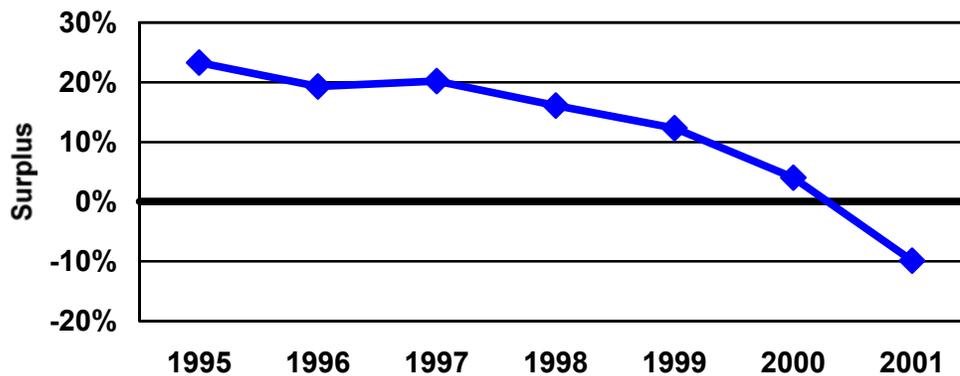
ARE INSURERS AT FAULT? - THE ROLE OF INVESTMENTS, UNDERWRITING AND COMPETITION

Some allege that medical malpractice insurers caused the current downturn through too rapid and reckless expansion. Given the positive results of the early 1990s, some carriers expanded into new markets and some offered more generous discounts in existing markets. But before assigning blame, it is important to consider the nature of the business and the circumstances of the last several years.

To obtain a better understanding of why medical malpractice insurance rates are rising, we focus on the results of 30 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 in the United States.

These insurers, which achieved more favorable financial results than that of the total industry, showed a slight operating profit (four percent of premiums) in 2000. This deteriorated to a ten-percent operating loss in 2001 (see Chart B).

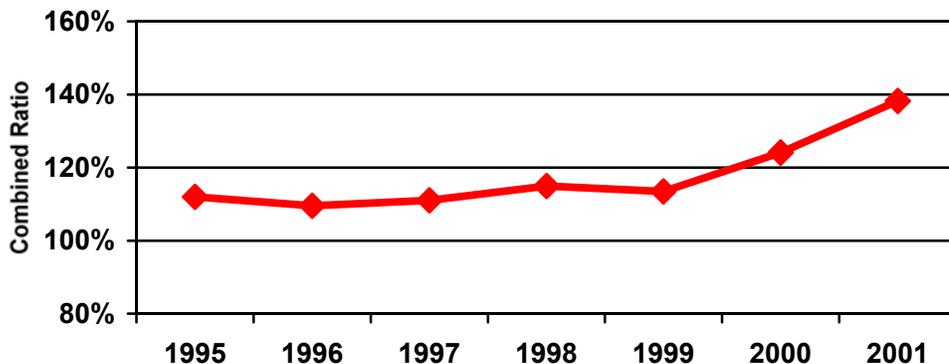
**CHART B: CALENDAR YEAR OPERATING RESULTS
TURN NEGATIVE**



There are two key drivers of these financial results:

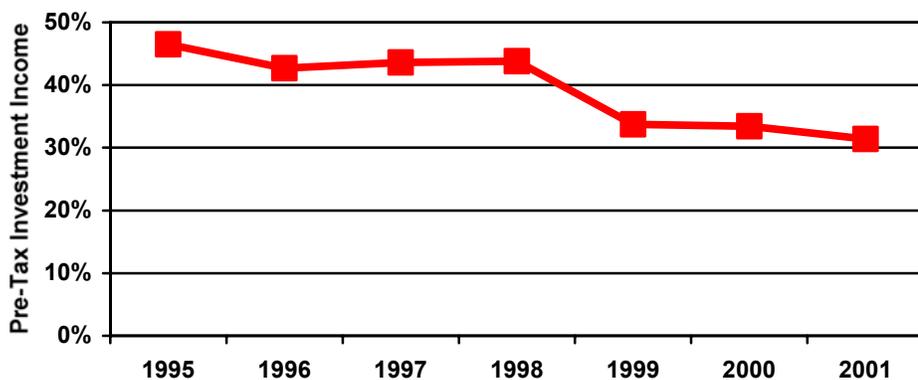
- Insurance Underwriting--For these companies, a simplified combined ratio was calculated by dividing calendar year loss and loss adjustment and underwriting expenses by premium. The combined ratios were 124 percent and 138 percent in 2000 and 2001, respectively. That means in 2001, these insurers incurred \$1.38 in losses and expenses for each \$1.00 of premium. The preceding five years 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).

CHART C: COMBINED RATIO



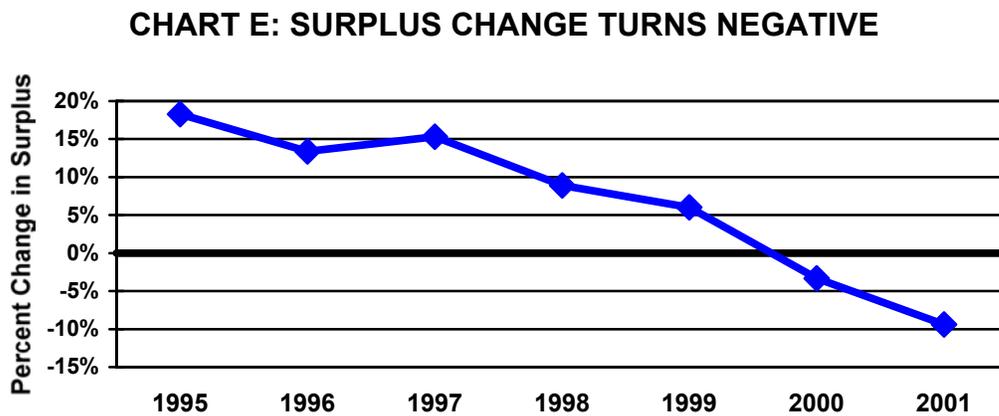
- Investment Income--Pre-tax investment income (including realized capital gains and losses) derives from policyholder-supplied funds invested until losses are paid as well as from the company capital ('surplus'). The ability of investment income to offset some of the underwriting loss is measured as a percentage of earned premiums. This statistic declined during the measurement period from the mid-40 percent to the mid-30 percent level and, in 2001, to 31 percent (see Chart D).

CHART D: INVESTMENT INCOME AS PERCTANGE OF PREMIUM DECLINES



This offset will continue to decline because (i) most insurer invested assets are bonds, many 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).



Insurers have some responsibility for the magnitude of today's price corrections, but this should be viewed in the context of the circumstances during the 1990s and through today. Given the positive results of the early 1990s, some carriers were very aggressive in expanding into new markets or in competing heavily for business in existing markets. This activity continued for several years, until signals of deteriorating claim cost trends appeared, favorable reserve development disappeared, reinsurance prices increased, and investment returns declined. The collision of a competitive market

and these adverse events has been dramatic and would have been difficult to predict. Nonetheless, conditions have changed and, like all businesses, insurers must respond accordingly in order to maintain their financial viability.

Medical malpractice insurance is a challenging line of business to underwrite successfully and is written, primarily, by insurers who specialize in it. It is a risky line of business given its characteristics because of low frequency and high severity claims, with long delays in the reporting and payment of claims. Even with the best of information, rates may be incorrect. This inherent pricing uncertainty can result in some insurers becoming optimistic and very competitive. If conditions deteriorate, or their assumptions prove to be incorrect, adverse financial results along with significant price increases can occur.

With respect to investments, insurers tend to be conservative because of regulatory restrictions on allowable investments, and because of the underwriting risk they face. For example, the group of medical malpractice insurers discussed earlier invests only 15 percent of their assets in equities. The other investments are composed largely of fixed income investments. Changes in stock values are, therefore, important but not critical to insurers' financial health. Insurers are more dependent on sustained interest income on bonds, which have been adversely affected by recent declines in yields.

Given the nature of their assets, therefore, insurers do not generally realize serious investment losses when the stock market declines. Further, past investment results do not make their way directly into the process of setting rates. Insurers adjust their rates for expected prospective investment yields, in conformity with insurance code and well-defined actuarial principles. The ratemaking process is a forward-looking process intended to estimate prospective claim losses, expenses, profit, and investment

income; it does not contemplate recoupment of past losses. Furthermore, given the competitive nature of the insurance business with its low barriers to entry, it would be very difficult for any company to maintain a recoupment provision for long without inviting new players into the market.

Regarding the regulation of insurance rates, we understand a bill has been introduced recently that prohibits price fixing, bid rigging, or market allocations in providing medical malpractice insurance. In discussions with colleagues and other industry representatives and based on our extensive industry experience, we understand that the vast majority of states view all these activities as illegal. Further, the behavior of the market historically and today is indicative of a competitive market with significant entries and exits, winners and losers, and significant variability in financial results, which does not seem consistent with a market engaging in collusive practices.

In addition, it is important for the insurance industry to be allowed to share certain types of information. It is likely that some damage could be done to the market if the law precluded some useful activities like industry-wide data collection, the development of common policy forms, and other activities that actually enhance competition and make insurance coverage more available.

The Academy appreciates the opportunity to provide an actuarial perspective on these important issues and would be glad to provide the committees with any additional information that might be helpful. For further information, please contact Greg Vass, Senior Policy Analyst, at 202-223-8196.