Medical Malpractice Insurance: Stable Losses/Unstable Rates 2003

***** NEWLY UPDATED STUDY BASED ON 2002 DATA*****

November 2003

Introduction and Summary of Findings

In October 2002, Americans for Insurance Reform (AIR), a coalition of over 100 consumer groups around the country, produced for the first time a comprehensive study of medical malpractice insurance from the 1970s through 2001. The study, *Stable Losses/Unstable Rates*, examined what insurers have taken in and what they've paid out over the prior 30 years. AIR found that the amount medical malpractice insurers paid out, including all jury awards and settlements, directly tracked the rate of medical inflation. On the other hand, medical insurance premiums charged by insurance companies have not corresponded to increases or decreases in payouts. Rather, they have risen and fallen in sync with the state of the economy reflecting gains or losses experienced by the insurance industry's market investments.

Now, AIR has added to this analysis newly-released insurance data from the year 2002, the year when many doctors around the country began experiencing sharp increases in insurance rates. Insurers told doctors that these premium increases were necessary because payouts and costs had dramatically risen. The data, however, does not support this view. Instead, 2002 reflects exactly the same trends as those of prior years.

This new study makes two major findings:

- First, contrary to what the insurance and medical lobbies have alleged, the years 2001 and 2002 saw no "explosion" in medical malpractice insurer payouts or costs to justify sudden rate hikes. In fact, rather than exploding, inflation-adjusted payouts per doctor dropped from 2001 to 2002. Payouts (in constant dollars) have been essentially been flat since the mid-1980s.

- Second, medical malpractice insurance premiums rose much faster in 2002 than was justified by insurance payouts. The 2002 hike is similar to the rate hikes of the past, which occurred in the mid-1980s and mid-1970s and were not connected to actual payouts. Rather, they reflect a weakened economy and losses experienced by the insurance industry's market investments and their perception of how much they can earn

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on the investment "float" (which occurs during the time between when premiums are paid into the insurer and losses paid out by the insurer) that doctors' premiums provide them.

Background

The nation's insurance companies are advancing a legislative agenda to limit liability for doctors, hospitals, HMOs, nursing homes and drug companies that cause injury. Federal and state lawmakers and regulators (and the general public) are being told by medical and insurance lobbyists that doctors' insurance rates are rising due to increasing claims by patients, rising jury verdicts and exploding tort system costs in general.

The insurance industry argues and, worse, convinces doctors to believe that patients who file medical malpractice lawsuits are being awarded more and more money, leading to unbearably high losses for insurers. Insurers state that to recoup money paid to patients, medical malpractice insurers are being forced to raise insurance rates or, in some cases, pull out of the market altogether.

Since insurers say that jury verdicts are the cause for the current "crisis" in affordable malpractice insurance for doctors, the insurance industry insists that the only way to bring down insurance rates is to limit an injured consumer's ability to sue in court.

Insurance rates for doctors have skyrocketed twice before: in the mid-1970s and in the mid-1980s, each "crisis" occurring during years of a weakened economy and dropping interest rates. Each of these periods was followed by a wave of legislative activity to restrict injured patients' rights to sue for medical malpractice. Medical and insurance lobbyists told legislators that changes in tort law were needed to reduce medical malpractice insurance rates.

However, history shows that the insurance industry has not cut, and has no plans to cut, insurance premiums as a consequence of tort restrictions. The American Insurance Association (AIA) and representatives of the American Tort Reform Association (ATRA) have already gone on record admitting this, with the AIA stating on March 13, 2002, "[T]he insurance industry never promised that tort reform would achieve specific premium savings."

The Center for Justice & Democracy's 1999 study, *Premium Deceit —the Failure of "Tort Reform" to Cut Insurance Prices*, found that tort law limits enacted since the mid-1980s have not lowered insurance rates in the ensuing years. Some states that resisted enacting any "tort reform" experienced low increases in insurance rates or loss costs relative to the national trends, and some states that enacted major "tort reform" packages saw very high rate or loss cost increases relative to the national trends. In other words, there was no correlation between "tort reform" and insurance rates.

More recently, Weiss Ratings, an independent insurance-rating agency in Palm Beach Gardens, Florida, found that between 1991 and 2002, states with caps on noneconomic damage awards saw median doctors' malpractice insurance premiums rise 48 percent -- *a greater increase than in states without caps*. In states without caps, median premiums increased only 36

percent. Moreover, according to Weiss, "median 2002 premiums were about the same" whether or not a state capped damage awards.

In January 2003, Ohio lawmakers enacted a cap on compensation for patients injured by medical malpractice. Almost immediately, all five major medical malpractice insurance companies in Ohio announced they would not reduce their rates. One insurance executive predicted his company would seek a 20 percent rate increase.

In Mississippi, lawmakers enacted a cap on medical malpractice verdicts in October 2002. Four months later, investigative news articles reported that surgeons still could not find affordable insurance and that many Mississippi doctors were still limiting their practice or walking off the job in protest.

Nevada also enacted a severe cap on compensation in 2002. Within weeks of the law's enactment, two major insurance companies proclaimed that they would not reduce insurance rates for at least another year to two, if ever. The Doctor's Company, a nationwide medical malpractice insurer, then filed for a 16.9 percent rate increase. Two other companies filed for 25 percent and 93 percent rate increases.

The "liability insurance crises" of the mid-1970s and mid-1980s were ultimately found to be caused not by legal system excesses but by the economic cycle of the insurance industry. Just as these liability insurance crises were found to be driven by this cycle and not a tort law cost explosion as many insurance companies and others had claimed, the "tort reform" remedy pushed by these advocates failed.

As this study confirms, it will fail again.

The 2003 Study

AIR, under the direction of actuary J. Robert Hunter (Director of Insurance for the Consumer Federation of America, and former Federal Insurance Administrator and Texas Insurance Commissioner), has produced a comprehensive study of medical malpractice insurance, examining specifically what insurers have taken in and what they've paid out, in constant dollars, over the last 30 years through 2002. AIR examined everything that medical malpractice insurers have paid in jury awards, settlements and other costs over the last three decades, and compared these actual costs with the premiums that insurers have charged doctors, as well as with the economic cycle of the insurance industry.

This AIR study explores whether or not there is, as the insurance industry claims, an explosion in lawsuits, jury awards or tort system costs justifying an increase in insurance premium rates, or whether premium increases simply reflect the economic cycle of the insurance industry, driven by interest rates and investments.

The Insurance Industry's Economic Cycle

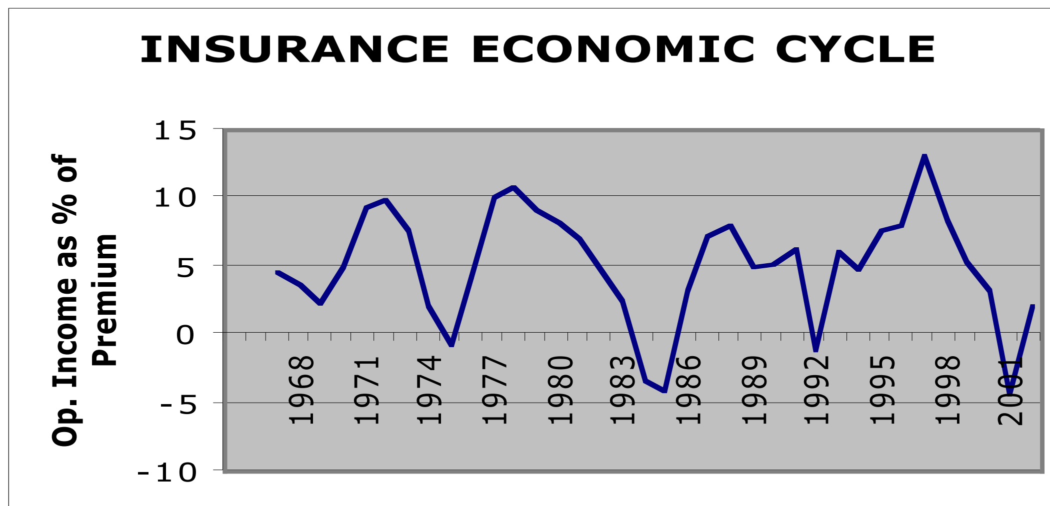
Insurers make most of their profits from investment income. During years of high interest rates and/or excellent insurer profits, insurance companies engage in fierce competition for premium dollars to invest for maximum return. Insurers severely underprice their policies and insure very poor risks just to get premium dollars to invest. This is known as the "soft" insurance market.

But when investment income decreases — because interest rates drop or the stock market plummets or the cumulative price cuts make profits become unbearably low — the industry responds by sharply increasing premiums and reducing coverage, creating a "hard" insurance market usually degenerating into a "liability insurance crisis."

A hard insurance market happened in the mid-1970s, precipitating rate hikes and coverage cutbacks, particularly with medical malpractice insurance and product liability insurance. A more severe crisis took place in the mid-1980s, when most liability insurance was impacted. Again, in 2002, the country experienced a "hard market," this time impacting property as well as liability coverages with some lines of insurance seeing rates going up 100% or more.

The following Exhibit shows the national cycle at work, with premiums stabilizing for 15 years following the mid-1980s crisis. (The 1992 data point was not a classic cycle bottom, but reflected the impact of Hurricane Andrew and other catastrophes in that year.)

Exhibit 1. The Insurance Cycle



Prior to late 2000, the industry had been in a soft market since the mid-1980s. The strong financial markets of the 1990s had expanded the usual six- to-ten year economic cycle. No matter how much they cut their rates, the insurers wound up with a great profit year when investing the float on the premium in this amazing stock and bond market. (The "float" occurs during the time between when premiums are paid into the insurer and losses paid out by the insurer —*e.g.,* there is about a 15 month lag in auto insurance and a 5 to 10 year lag in medical

malpractice.) Further, interest rates were relatively high in recent years as the Fed focused on inflation.

But in 2000, the market started to turn with a vengeance and the Fed cut interest rates again and again. This took place well before September 11th. The terrorist attacks sped up the price increases, collapsing two years of anticipated increases into a few months and leading to what some seasoned industry analysts see as gouging.[1] However, the increases we are witnessing are mostly due to the cycle turn, not the terrorist attack or any other cause. This is a classic economic cycle bottom.

Smoking Guns

AIR tested two hypotheses advanced by the insurance industry: First, if large jury verdicts in medical malpractice cases or any other tort system costs are having a significant impact on the overall costs for insurers' and are therefore the reason behind skyrocketing insurance rates, then losses per doctor should be rising faster than medical inflation over time. Second, if lawsuits or other tort costs are the cause of rate increases for doctors -- rather than decreasing interest rates and other economic factors -- those losses should be reflected in rate increases in line with such losses, not in ups and downs that instead reflect the state of the economy, the well-documented insurance economic cycle (Exhibit 1), interest rates, the stock market or the level of insurers' investment income.

AIR finds both hypotheses are completely false, demonstrated by Exhibits 2 and 3 below. First, these charts show that since 1975, medical malpractice paid claims per doctor have tracked medical inflation very closely (slightly higher than inflation from 1975 to 1985 and flat since). In other words, payouts have risen almost precisely in sync with medical inflation. Moreover, contrary to what the insurance and medical lobbies have alleged, the years 2001 and 2002 saw no "explosion" in medical malpractice insurer payouts or costs to justify sudden rate hikes. In fact, rather than exploding, inflation-adjusted payouts per doctor *dropped* from 2001 to 2002.   These data confirm that neither jury verdicts nor any other factor affecting total claims paid by insurance companies that write medical malpractice insurance have had much impact on the system's overall costs over time.

Second, while payouts closely track medical inflation, medical malpractice premiums are quite another thing. They do not track costs or payouts in any direct way. Since 1975, the data show that in constant dollars, per doctor written premiums — the amount of premiums that doctors have paid to insurers — have gyrated almost precisely with the insurer's economic cycle, which is driven by such factors as insurer mismanagement and changing interest rates, not by lawsuits, jury awards, the tort system or other causes. Moreover, medical malpractice insurance premiums rose much faster in 2002 than was justified by insurance payouts. This hike is similar to the rates hikes of the past, which occurred in the mid-1980s and mid-1970s and were not connected to actual payouts.

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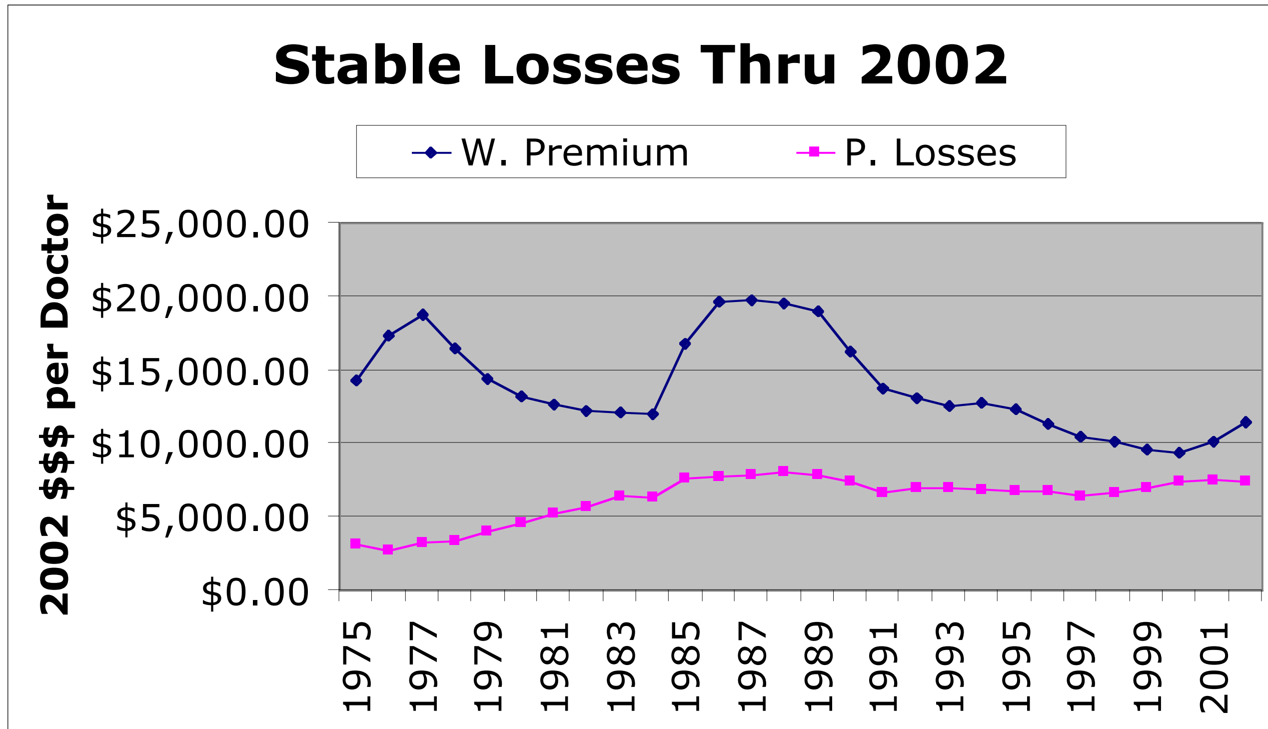
[1] "[T]here is clearly an opportunity now for companies to price gouge – and it's happening…. But I think companies are overreacting, because they see a window in which they can do it." Jeanne Hollister, consulting actuary, Tillinghast-Towers Perrin, quoted in, "Avoid Price Gouging, Consultant Warns," *National Underwriter*, January 14, 2002.

In sum, the results of AIR's analysis illustrated in Exhibits 2 and 3 are startling; premiums rise and fall with the insurance industry's economic cycle, as illustrated in Exhibit 1, but losses paid do not.

Exhibit 2



Sources:
A.M. Best and Co. special data compilation for AIR, reporting data for as many years as separately available; U.S. Bureau of the Census, 1975[2]; Inflation Index: Bureau of Labor Statistics, 1975 (1985 estimated). See Exhibit 3 for underlying data.

Definitions:

- **"W. Premium," "DPW"** or **"Direct Premiums Written"** is the amount of money that insurers collected in premiums from doctors during that year.
- **"P. Losses," or "Paid losses"** is what insurers actually paid out that year to people who were injured —all claims, jury awards and settlements —plus what insurance companies pay their own lawyers to fight claims.[3]

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[2] We calculate the paid losses on a per doctor basis to remove from the trend we are studying the effect of the ever increasing number of doctors in America. We acknowledge that the number of doctors includes a certain number of doctors that are retired or otherwise not in the medical malpractice system, but since we are interested in overall loss trends over time, and since the percentage of doctors in that category should not vary much year to year, this fact should not significantly impact our results.

[3] "Paid losses" are a far more accurate reflection of actual insurer payouts than what insurance companies call "incurred losses." Incurred losses are not actual payouts. They include payouts but also reserves for possible future claims – *e.g.,* insurers' estimates of claims that they do not even know about yet. While incurred losses do exhibit more of a cyclical pattern, observers know that this is because in hard markets, as we are currently experiencing,

Exhibit 3

Year	Direct Premiums Written (thousands)	Direct Losses Paid (thousands)	Loss Ratio	Number Doctors in USA (active)	Medical Care Inflation (CPI-U)	Direct Premiums Written per doctor	Direct Losses Paid per doctor	Year	Direct Premiums Written per doctor **2002 Dollars**	Direct Losses Paid per doctor **2002 Dollars**
1975	865,208	190,867	0.221	366,425	47.3	$2,361.21	$520.89	1975	$14,307.06	$3,156.17
1976	1,187,978	188,545	0.159	378,572	51.7	$3,138.05	$498.04	1976	$17,395.85	$2,760.91
1977	1,423,091	248,969	0.175	381,969	56.8	$3,725.67	$651.80	1977	$18,798.90	$3,288.86
1978	1,412,555	294,456	0.208	401,364	61.3	$3,519.39	$733.64	1978	$16,454.42	$3,430.03
1979	1,405,991	391,800	0.279	417,266	66.9	$3,369.53	$938.97	1979	$14,435.09	$4,022.55
1980	1,493,543	521,849	0.349	435,545	74.5	$3,429.14	$1,198.15	1980	$13,191.82	$4,609.27
1981	1,616,470	665,570	0.412	444,899	82.1	$3,633.34	$1,496.00	1981	$12,683.50	$5,222.34
1982	1,815,056	847,543	0.467	462,947	91.9	$3,920.66	$1,830.76	1982	$12,226.99	$5,709.41
1983	2,033,911	1,079,862	0.531	479,440	100.1	$4,242.26	$2,252.34	1983	$12,146.18	$6,448.76
1984	2,282,590	1,197,979	0.525	511,090	106.4	$4,466.12	$2,343.97	1984	$12,029.98	$6,313.74
1985	3,407,177	1,556,300	0.457	514,000	113.1	$6,628.75	$3,027.82	1985	$16,797.52	$7,672.62
1986	4,335,863	1,709,883	0.394	519,411	121.6	$8,347.65	$3,291.97	1986	$19,674.65	$7,758.86
1987	4,781,084	1,905,491	0.399	534,692	129.9	$8,941.75	$3,563.72	1987	$19,728.30	$7,862.67
1988	5,166,811	2,128,281	0.412	549,160	138.2	$9,408.57	$3,875.52	1988	$19,511.55	$8,037.08
1989	5,500,540	2,273,628	0.413	559,988	148.5	$9,822.60	$4,060.14	1989	$18,957.29	$7,835.93
1990	5,273,360	2,415,117	0.458	572,660	161.9	$9,208.54	$4,217.37	1990	$16,301.21	$7,465.70
1991	5,043,773	2,423,418	0.480	594,697	176.2	$8,481.25	$4,075.05	1991	$13,795.27	$6,628.31
1992	5,228,362	2,808,838	0.537	605,685	189.4	$8,632.15	$4,637.46	1992	$13,062.16	$7,017.40
1993	5,469,575	3,028,086	0.554	619,751	201.1	$8,825.44	$4,885.97	1993	$12,577.68	$6,963.30
1994	5,948,361	3,174,987	0.534	632,121	210.4	$9,410.16	$5,022.75	1994	$12,818.21	$6,841.83
1995	6,107,568	3,326,846	0.545	646,022	219.8	$9,454.12	$5,149.74	1995	$12,327.34	$6,714.81
1996	6,002,233	3,556,151	0.592	663,943	227.8	$9,040.28	$5,356.11	1996	$11,373.77	$6,738.63
1997	5,864,218	3,587,566	0.612	684,605	234.4	$8,565.84	$5,240.34	1997	$10,473.42	$6,407.35
1998	6,040,051	3,957,619	0.655	707,000	242	$8,543.21	$5,597.76	1998	$10,117.70	$6,629.42
1999	6,053,323	4,446,975	0.735	720,900	251.1	$8,396.90	$6,168.64	1999	$9,584.03	$7,040.75
2000	6,303,206	4,988,474	0.791	737,500	261.4	$8,546.72	$6,764.03	2000	$9,370.66	$7,416.11
2001	7,288,933	5,424,197	0.744	755,000	273.1	$9,654.22	$7,184.37	2001	$10,131.45	$7,539.51
2002	8,928,252	5,806,463	0.650	780,000	286.6	$11,446.48	$7,444.18	2002	$11,446.48	$7,444.18

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insurers will increase reserves as a way to justify price increases. In fact, the current insurance "crisis" rests significantly on a jump in loss reserves in 2001. Historically, reserves have been later "released" to profits during the "softer" market years. For example, according to a June 24, 2002, *Wall Street Journal* front page investigative article, St. Paul, which until 2001 had 20 percent of the national med mal market, pulled out of the market after mismanaging its reserves. The company set aside too much money in reserves to cover malpractice claims in the 1980s, so it "released" $1.1 billion in reserves, which flowed through its income statements and appeared as profits. Seeing these profits, many new, smaller carriers came into the market. Everyone started slashing prices to attract customers. From 1995 to 2000, rates fell so low that they became inadequate to cover malpractice claims. Many companies collapsed as a result. St. Paul eventually pulled out, creating huge supply and demand problems for doctors in many states. Christopher Oster and Rachel Zimmerman, "Insurers' Missteps Helped Provoke Malpractice 'Crisis,'" *Wall Street Journal*, June 24, 2002.

A Word About Loss Ratios

Loss ratios are the percent of premiums that insurers pay out in claims. These ratios will drop during hard market years reflecting sudden rate hikes, as they did during the years 1985-1987, and again in 2002, which this study shows. Otherwise, they tend to trend up as insurers cut premiums during the soft market.

Exhibit 3 shows this precise phenomenon of steadily increasing loss ratio between 1988 and 2001. This simply demonstrates the insurance cycle at work, which is the point of this study. Insurers did not respond to higher loss ratios during these years by raising rates because they were making significant money from investments. In fact, during the soft market, insurers are expected to take a larger underwriting loss (a combined loss ratio over 100 percent) than during the hard market as they benefit from more investment income during these times. As we show, when this income drops, insurers will then raise rates and loss ratios will also drop. This is indeed what is now happening.

Conclusion

Like the 2002 study, *Stable Losses/Unstable Rates,* this updated version analyzes what medical malpractice insurers have taken in and what they've paid out over the last 30 years, including jury awards, settlements and other costs. Its findings are startling. While insurer payouts directly track the rate of medical inflation, medical insurance premiums do not. Rather, they rise and fall in relationship to the state of the economy. Not only has there been no "explosion" in lawsuits, jury awards or any tort system costs at any time during the last three decades, but the astronomical premium increases that some doctors have been charged during periodic insurance "crises" over this timeperiod are in exact sync with the economic cycle of the insurance industry, driven by interest rates and investments. In 2001, rates began to spike, but payouts dropped. In other words, insurance companies raise rates when they are seeking ways to make up for declining interest rates and market-based investment losses.