



Medical Malpractice Insurance: Stable Losses/Unstable Rates 2007

March 28, 2007

Introduction and Summary of Findings

Since releasing its first *Stable Losses/Unstable Rates* study in 2002, Americans for Insurance Reform (AIR), a coalition of over 100 consumer groups around the country, has periodically produced updated studies examining three decades of the trends in medical malpractice insurance. With each report, AIR has reached similar conclusions regarding both the amount that medical malpractice insurers have paid out and the premiums charged to doctors by insurance companies.

Specifically, AIR has consistently found that total payouts have been stable, tracking the rate of medical inflation, but premiums have not. Rather, premiums that doctors pay rise and fall in sync with the state of the economy, reflecting profitability of the insurance industry, including gains or losses experienced by the insurance industry's bond and stock market investments.

The skyrocketing insurance rates hikes that hit doctors between the years of 2001 through 2004 have now leveled off. In fact, over the last three years, commercial insurance rates throughout the entire property/casualty industry have stabilized or dropped in every sector, including medical malpractice, as the country experiences a sustained soft market.¹

Now that the period of huge rate hikes had ended temporarily, AIR decided to take a look at the most recently-released insurance data through the year 2005 to definitely determine what caused this most recent insurance crisis for doctors, and if the same trends that AIR detected in prior studies continued to hold true.

¹ See, Americans for Insurance Reform, "Commercial Insurance Rates Continue to Fall While Insurer Profits Continue to Skyrocket to Record Levels," October 25, 2006; <http://www.insurance-reform.org/AIRSoftMarketProfits.pdf>.

This new study finds that, indeed, these trends have continued and makes several major findings:

- **Payouts:** Contrary to what the insurance and medical lobbies alleged, inflation-adjusted payouts per doctor not only failed to increase during the last several years, a time when doctors' premiums skyrocketed, but they have been stable or falling throughout this entire decade. Payouts (in constant dollars) have been essentially flat or dropping since the mid-1980s.
- **Premiums:** Medical malpractice insurance premiums rose much faster in the early years of this decade than was justified by insurance payouts. Inflation-adjusted medical malpractice insurance premiums, which rose beginning in 2001 despite no corresponding increase in payouts, reached a peak in 2004 and are now dropping as the soft insurance market takes hold. The rate hikes from 2001 through 2004 were similar to cyclical rate hikes of the past, which occurred in the mid-1980s and mid-1970s.
- **Insurance Cycle:** At no time were recent increases in premiums connected to actual payouts. Rather, they reflected a well-known cyclical phenomenon called a "hard" market. Property/casualty insurance industry "hard" markets have occurred three times in the past 30 years. Most recently, the hard market was prompted by a weakened economy, excessive insurer price cuts at the end of the 1990s decade-long "soft" medical malpractice insurance market, dropping interest rates and losses experienced by the insurance industry's market investments. They were also driven by their perception of how much insurers could earn 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.
- **Reserves:** In the last few years, medical malpractice insurers followed a pattern seen in previous hard markets of vastly (and unnecessarily) increasing reserves (used for future claims) despite no increase in payouts or any trend suggesting large future payouts. This may have been done as a way to justify imposition of large premium increases for doctors or out of excessive pessimism that prevails for insurers during hard market periods. The reserve increases in 2001 to 2004 (the hard market years), could have accounted for 60 percent of the price increases witnessed by doctors during the period. As in past soft markets, these reserves will now be released in coming years, as they are not needed to pay for future claims.

Background

In 2002, the nation's insurance companies stepped up their efforts 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) were told by medical and insurance lobbyists that doctors' insurance rates were rising due to increasing claims by patients, rising jury verdicts and exploding tort system costs in general.

The insurance industry argued and, worse, convinced 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 said that to recoup money paid to patients, medical malpractice insurers were being forced to raise insurance rates or, in some cases, pull out of the market altogether.

Since insurers said that jury verdicts are the cause for the “crisis” in affordable malpractice insurance for doctors, the insurance industry insisted that the only way to bring down insurance rates was to limit an injured consumer’s ability to sue in court.

Insurance rates for doctors had 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 as well as after excessive rate cuts by malpractice insurers as they competed for market share in the “soft” market immediately preceding the price jumps. 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 showed that the insurance industry had not cut, and had 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) went 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 did not lower 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 claims experience, “tort reform” and insurance rates.

Since that time, numerous studies confirmed this finding. A study by law professors at the University of Texas, Columbia University and the University of Illinois based on closed claim data compiled by the Texas Department of Insurance since 1988 concluded that “the rapid changes in insurance premiums that sparked the crisis appear to reflect insurance market dynamics, largely disconnected from claim outcomes.”² That study further concluded that, after controlling for the quantity of health care delivered, the frequency of large paid claims declined, the number of small paid claims declined sharply, and payout per claim on large claims remained constant over a 15-year period.

² Black, Silver, Hyman, and Sage, “Stability, Not Crisis: Medical Malpractice Claim Outcomes in Texas, 1988-2002,” *Journal of Empirical Legal Studies* (2005).

Similarly, an econometric analysis of the malpractice market by two Dartmouth economists found that “past and present malpractice payments do not seem to be the driving force behind increases in premiums,” and that premium growth may be affected by many factors beyond increases in claims payments, such as industry competition and the insurance underwriting cycle.³ The study analyzed National Practitioner Data Bank data on payments, as well as data on premiums, physicians, and treatments.

In sum, credible studies have found that the “liability insurance crises” for doctors in recent years has not been caused by legal system excesses and not a tort law cost explosion as many insurance companies and others claimed.

The 2007 Stable Losses 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 three decades, through 2005. 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 has been, as the insurance industry claims, any explosion in lawsuits, jury awards or tort system costs justifying an increase in insurance premium rates, or whether premium increases rather 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.

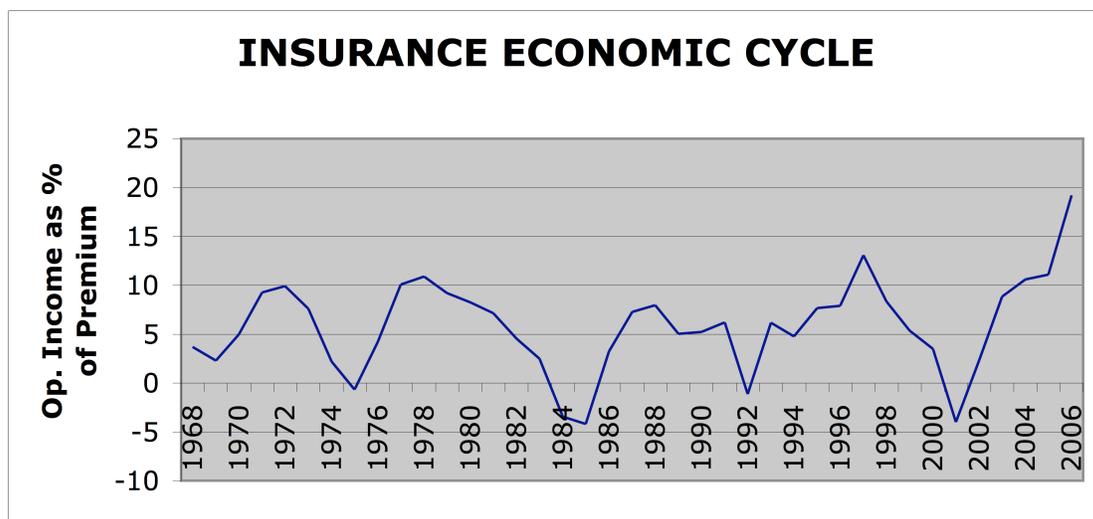
But when investment income decreases — because interest rates drop or the stock market plummets or the cumulative price cuts make profits become unbearably low — the industry responds by sharply increasing premiums and reducing coverage, creating a “hard” insurance market usually degenerating into a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

³ Katherine Baicker and Amitabh Chandra, National Bureau of Economic Research, “The Effect of Malpractice Liability on the Delivery of Health Care,” at 14 and 20 (Aug. 2004). *See also*, Amitabh Chandra, Shantanu Nundy, Seth A. Seabury, “The Growth of Physician Medical Malpractice Payments: Evidence from the National Practitioner Data Bank,” *Health Affairs*, May 31, 2005.

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, from 2001 through 2004, 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 began 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.⁴ However, the increases we witnessed were

⁴ “[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.

mostly due to the cycle turn, not the terrorist attack or any other cause. This was a classic economic cycle bottom.

The cycle top has yet to be seen, but the profit in 2006 was nothing short of astounding, approaching, as the above chart shows, an operating income of 20 percent⁵.

Smoking Guns

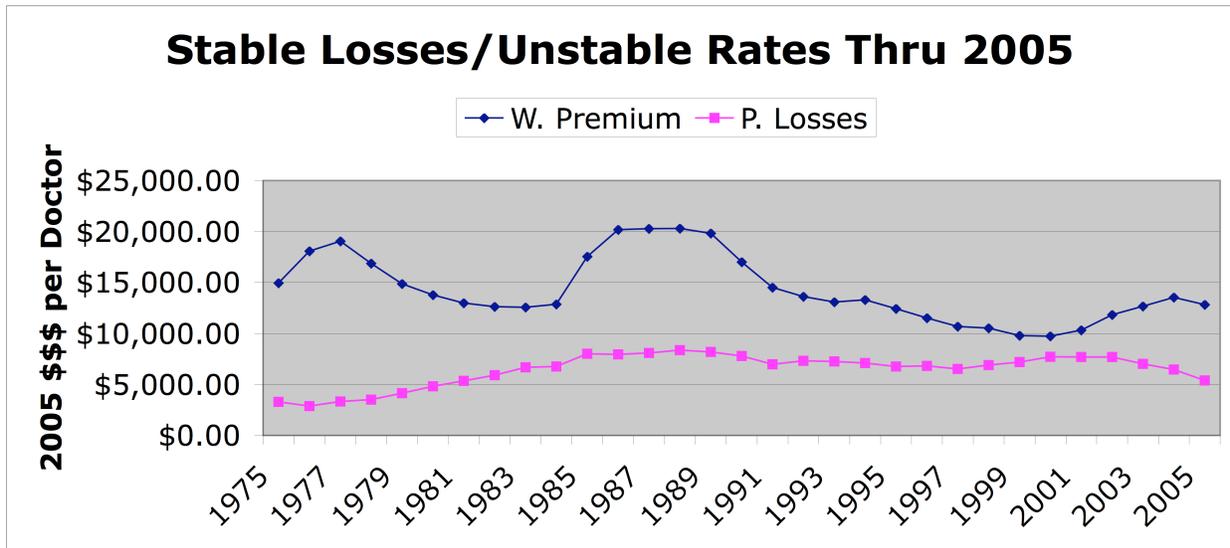
AIR tested two hypotheses advanced by the insurance industry: First, if large jury verdicts in medical malpractice cases or any other tort system costs were having a significant impact on the overall costs for insurers' and were therefore the reason behind skyrocketing insurance rates, then losses per doctor should be rising faster than medical inflation over time. Second, if lawsuits or other tort costs were 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 per doctor have risen almost precisely in sync with medical inflation. Moreover, contrary to what the insurance and medical lobbies alleged, the years 2001 through 2004 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 have been stable or dropping throughout this entire decade. 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. Only medical inflation and growth in the number of doctors correlate with the paid loss trends.

Second, while payouts per doctor closely track medical inflation, medical malpractice premiums are quite another thing. They have not tracked 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 of pricing during the cycle and changing interest rates, not by lawsuits, jury awards, the tort system or other causes. Moreover, medical malpractice insurance premiums rose much faster in this decade than was justified by insurance payouts. These hikes were similar to the rates hikes of the past "hard" markets, which occurred in the mid-1980s and mid-1970s. None were connected to actual increased payouts.

⁵ For a complete discussion of these remarkable insurance profits, see Property/Casualty Insurance in 2007: Overpriced Insurance, Underpaid Claims, Declining Losses and Unjustified Profits, 01/08/07, at http://www.consumerfed.org/pdfs/2007Insurance_White_Paper.pdf.

Exhibit 2



Sources:

Premiums and Losses from Special compilation of Annual Statement data by A. M. Best & Co.; Number of total doctors from US Census Bureau; 1976-79, 1988 and 1991 estimated as straight line growth between the years with data; Inflation Index: Bureau of Labor Statistics.

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.

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 2005 Dollars	Direct Losses Paid per doctor 2005 Dollars
1975	865,208	190,867	0.221	393,742	47.5	\$2,197.40	\$484.75	1975	\$14,951.56	\$3,298.35
1976	1,187,978	188,545	0.159	408,529	52	\$2,907.94	\$461.52	1976	\$18,073.97	\$2,868.53
1977	1,423,091	248,969	0.175	423,317	57	\$3,361.76	\$588.14	1977	\$19,061.78	\$3,334.85
1978	1,412,555	294,456	0.208	438,104	61.8	\$3,224.25	\$672.11	1978	\$16,862.08	\$3,515.01
1979	1,405,991	391,800	0.279	452,892	67.5	\$3,104.47	\$865.11	1979	\$14,864.68	\$4,142.26
1980	1,493,543	521,849	0.349	467,679	74.9	\$3,193.52	\$1,115.83	1980	\$13,780.32	\$4,814.89
1981	1,616,470	665,570	0.412	485,123	82.9	\$3,332.08	\$1,371.96	1981	\$12,990.70	\$5,348.83
1982	1,815,056	847,543	0.467	501,958	92.5	\$3,615.95	\$1,688.47	1982	\$12,634.33	\$5,899.62
1983	2,033,911	1,079,862	0.531	519,546	100.6	\$3,914.79	\$2,078.47	1983	\$12,577.12	\$6,677.56
1984	2,282,590	1,197,979	0.525	536,986	106.8	\$4,250.74	\$2,230.93	1984	\$12,863.67	\$6,751.28
1985	3,407,177	1,556,300	0.457	552,716	113.5	\$6,164.43	\$2,815.73	1985	\$17,553.68	\$8,018.01
1986	4,335,863	1,709,883	0.394	569,160	122	\$7,618.00	\$3,004.22	1986	\$20,181.47	\$7,958.73
1987	4,781,084	1,905,491	0.399	585,597	130.1	\$8,164.46	\$3,253.93	1987	\$20,282.50	\$8,083.55

1988	5,166,811	2,128,281	0.412	593193	138.6	\$8,710.17	\$3,587.84	1988	\$20,311.16	\$8,366.45
1989	5,500,540	2,273,628	0.413	600,789	149.3	\$9,155.53	\$3,784.40	1989	\$19,819.60	\$8,192.36
1990	5,273,360	2,415,117	0.458	615,421	162.8	\$8,568.70	\$3,924.33	1990	\$17,011.09	\$7,790.81
1991	5,043,773	2,423,418	0.480	634242	177	\$7,952.45	\$3,820.97	1991	\$14,521.08	\$6,977.05
1992	5,228,362	2,808,838	0.537	653,062	190.1	\$8,005.92	\$4,301.03	1992	\$13,611.33	\$7,312.43
1993	5,469,575	3,028,086	0.554	670,336	201.4	\$8,159.45	\$4,517.27	1993	\$13,094.02	\$7,249.16
1994	5,948,361	3,174,987	0.534	684,414	211	\$8,691.17	\$4,638.99	1994	\$13,312.74	\$7,105.78
1995	6,107,568	3,326,846	0.545	720,325	220.5	\$8,478.91	\$4,618.53	1995	\$12,428.04	\$6,769.66
1996	6,002,233	3,556,151	0.592	737,764	228.2	\$8,135.71	\$4,820.17	1996	\$11,522.62	\$6,826.82
1997	5,864,218	3,587,566	0.612	756,710	234.6	\$7,749.62	\$4,741.01	1997	\$10,676.38	\$6,531.51
1998	6,040,051	3,957,619	0.655	765,922	242.1	\$7,885.99	\$5,167.13	1998	\$10,527.68	\$6,898.04
1999	6,053,323	4,446,975	0.735	797,634	250.6	\$7,589.10	\$5,575.21	1999	\$9,787.70	\$7,190.37
2000	6,303,206	4,988,474	0.791	802,156	260.8	\$7,857.83	\$6,218.83	2000	\$9,737.93	\$7,706.77
2001	7,288,933	5,424,197	0.744	836,156	272.8	\$8,717.19	\$6,487.06	2001	\$10,327.70	\$7,685.55
2002	8,928,252	5,806,463	0.650	853,187	285.6	\$10,464.59	\$6,805.62	2002	\$11,842.28	\$7,701.59
2003	10,142,575	5,622,377	0.554	871,535	297.1	\$11,637.60	\$6,451.12	2003	\$12,659.95	\$7,017.85
2004	11,501,864	5,485,200	0.477	884,974	310.1	\$12,996.84	\$6,198.15	2004	\$13,545.88	\$6,459.99
2005	11,577,418	4,872,760	0.421	902,053	323.2	\$12,834.52	\$5,401.86	2005	\$12,834.52	\$5,401.86

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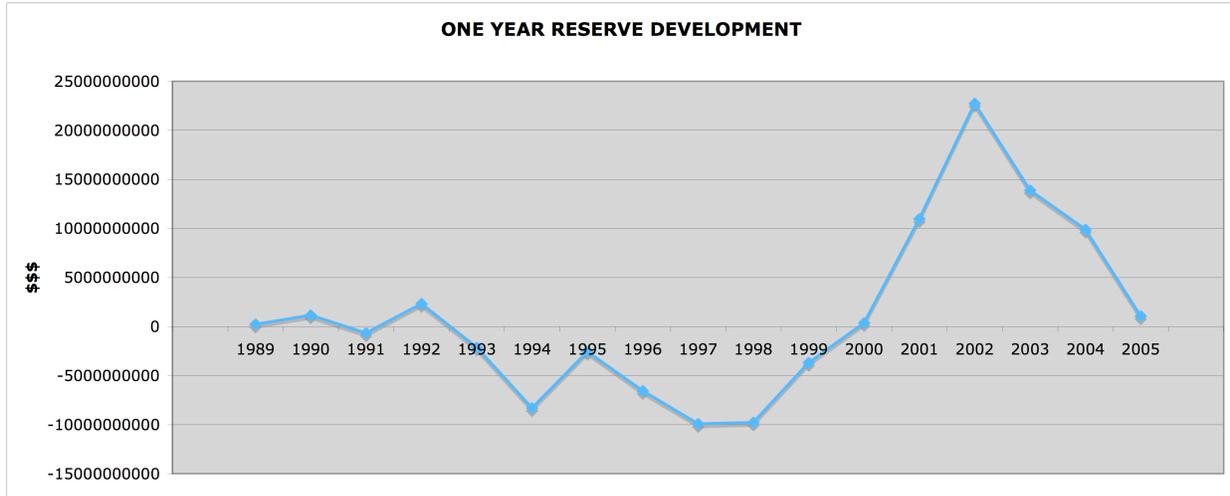
Paid Losses vs. Incurred Losses

In this report, AIR examines “paid losses.” Paid losses are what insurers actually pay out each year to people who are injured—all claims, jury awards and settlements—plus what insurance companies pay their own lawyers to fight claims. These are a far more accurate reflection of actual insurer payouts than what insurance companies call “incurred losses.” Insurers use “incurred losses” as the basis for rate hikes.

Incurred losses are not actual payouts. They include payouts but also reserves for possible future claims. Reserves include estimates of some claims they have received but also insurers’ estimates of claims that they do not even know about yet (called “Incurred but Not Reported” or “IBNR”). While incurred losses do exhibit more of a cyclical pattern similar to the pattern of premiums, observers know that this is because in hard markets, insurers will increase reserves as a way to justify price increases⁶. In other words, incurred losses are not reliable for trend purposes, as they will swing with the cycle because of the reserve activity, indicated in the

⁶ This may also be to offset profits. It is also true that reserves go up in hard markets because insurance executives make assumptions that tend to be more pessimistic when profits are low (just as they are more optimistic when profits are high during the soft markets – albeit even in soft markets medical malpractice reserves tend to be overstated).

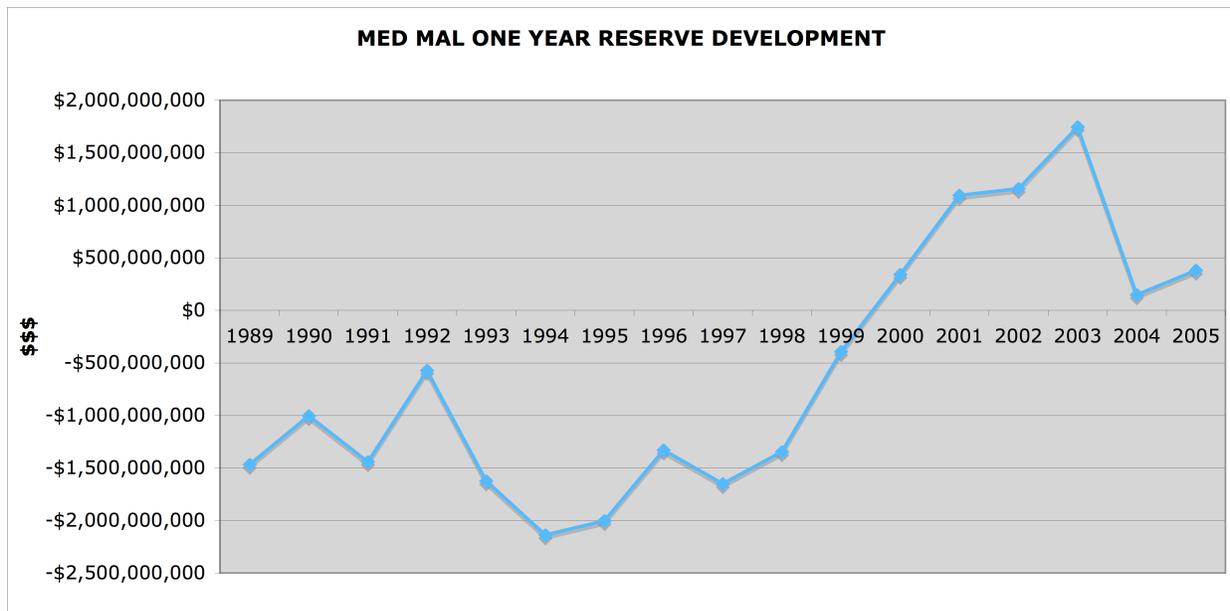
chart below. In 2002, during the latest hard market, additions to reserves for all property/casualty lines skyrocketed to as high as \$23 billion in 2002.



Source: Aggregate and Averages, A. M. Best and Co.

By the same token, insurers release reserves during the soft phase of the cycle as they are trying to gain market share and must show profits to keep rates down. Indeed, these data show that reserves were flat or down during soft market of the 1990s, dropping near the end of the soft phase when insurers were most likely to seek market share and they needed to justify low rates.

For medical malpractice insurance, this practice is even more extreme, as the following chart shows:



Source: Aggregates and Averages, A. M. Best and Co.

Reserve releases from previous soft markets have often exceeded \$1 billion in a year, representing under ten percent of overall reserves (although new additions in the current year often kept overall reserve dollars flat or even up). In terms of premiums, these releases were as much as over 30 percent, offering real opportunity for insurers to keep rates low. During the recent hard market, additions to reserves from prior years soared to as high as \$1.7 billion. The reserve increases in 2001 to 2004, the hard market years, could have accounted for 60 percent of the price increases witnessed by doctors during the period.

Happily, these over-reserving years now have primed the medical malpractice market for another soft market ahead, since these excesses will have to be released over the next few years.

The practice of over-reserving in hard markets by medical malpractice insurers was confirmed by a June 24, 2002, *Wall Street Journal* front page investigative article, finding that insurance company St. Paul, which until 2001 had 20 percent of the national med mal market, pulled out of the market after mismanaging its reserves.⁷ 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.

Conclusion

Like earlier *Stable Losses/Unstable Rates* studies, this updated version analyzes what medical malpractice insurers have taken in and what they've paid out over the last 30 years, including during this decade when doctors were hit with skyrocketing medical malpractice insurance rates.

Its findings are startling. While insurer payouts per doctor 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. This has been true for the last three decades and true for the last few years. Not only was there no "explosion" in lawsuits, jury awards or any tort system costs to justify the astronomical premium increases that doctors have been charged in recent years. These rate increases were rather driven by the economic cycle of the insurance industry, driven by declining interest rates and investments.

⁷ Christopher Oster and Rachel Zimmerman, "Insurers' Missteps Helped Provoke Malpractice 'Crisis,'" *Wall Street Journal*, June 24, 2002.