Medical Malpractice Insurance:
Stable Losses/Unstable Rates in Pennsylvania
January 16, 2003

Introduction and Summary of Findings

On January 16, 2003, President Bush appeared in Scranton Pennsylvania calling for severe restrictions on the legal rights of patients injured by medical malpractice. In formulating a solution to assist doctors who are being price-gouged with high medical malpractice rates, it is critical first to determine why physicians are suddenly being hit with skyrocketing insurance rates.

Now for the first time, Americans for Insurance Reform (AIR), a coalition of over 100 consumer groups around the country, has produced a comprehensive study of medical malpractice insurance in Pennsylvania, examining specifically what insurers have taken in and what they've paid out over the last 30 years. Similar to a national study that AIR conducted in October 2002, entitled *Stable Losses/Unstable Rates* (see http://www.insurance-reform.org), AIR has examined everything that Pennsylvania 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. This study makes two major findings similar to what AIR earlier observed on a national level, demonstrating that the causes of and solutions to this crisis lie not the tort system (i.e., capping damages) but with the business practices of the insurance industry itself:

- First, over the last 30 years, the amount that medical malpractice insurers have paid out in Pennsylvania, including all jury awards and settlements, has closely tracked the rates of medical inflation. Not only has there been no "explosion" in medical malpractice payouts at any time during the last 30 years in Pennsylvania, but payments (in constant dollars) have been extremely stable and virtually flat since the mid-1980s.

- Second, medical insurance premiums charged by insurance companies over the last 30 years in Pennsylvania have not corresponded to increases or decreases in payouts. Rather, premiums have risen and fallen in concert with the state of the economy —insurance premiums (in constant dollars) have increased or decreased in direct relationship to the strength or weakness of the economy, reflecting the gains or losses experienced by the insurance industry's market investments and their perception of how much they can earn on the investment "float" (which occurs during the time between

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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 have convinced medical lobbies in Pennsylvania and nationwide to advance 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. But the cause of the spike in rates is not the legal system; the cause is the insurance system.

In Pennsylvania, the insurance industry argues and worse, convinces surgeons and other physicians 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 Pennsylvania 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. This is precisely what striking West Virginia surgeons are demanding and are attempting to intimidate lawmakers into enacting.

As on the national level, insurance rates for doctors in Pennsylvania 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. News reports today are nearly identical to news reports during previous cycles. Compare, for example, the following two *Washington Post* stories, one from 1986 and the other from 2003:

> "Doctors and hospitals West Virginia have been saying for weeks that they would have to close their doors." *Washington Post*, May 24, 1986.
>
> "[D]ouble-digit increases in medical malpractice insurance premiums …are prompting doctors to flee states with the highest rates, refuse to perform high-risk procedures, retire early out of frustration or stage protests." *Washington Post,* January 5, 2003.

Today's rerun of these "old" stories is evidence of the economic cycle of the insurance industry at work in Pennsylvania as it is in the nation (explained below). Yet each of these periods has been followed by a wave of legislative activity not to reform insurance industry practices that cause these volcanic eruptions in premiums, but to restrict — over and over again — injured patients' rights to sue for medical malpractice.

One of the first states to react to this now third insurance "crisis" for doctors was Nevada. At the end of July 2002, Nevada enacted a $350,000 cap on non-economic damages for injured patients.

Within weeks of the law's enactment, two major insurance companies announced that despite the new law, they would not reduce insurance rates for the foreseeable future. Quite simply, this is because, as we show below, the legal system is largely irrelevant to the problem.

The Study

For the first time, AIR, under the *pro bono* 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 in Pennsylvania, examining specifically what insurers have taken in and what they've paid out, in constant dollars, over the last 30 years. AIR examined everything that Pennsylvania 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 represents the first major analysis exploring whether or not there is, as the insurance industry claims, an explosion in lawsuits, jury awards or tort system costs in Pennsylvania 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

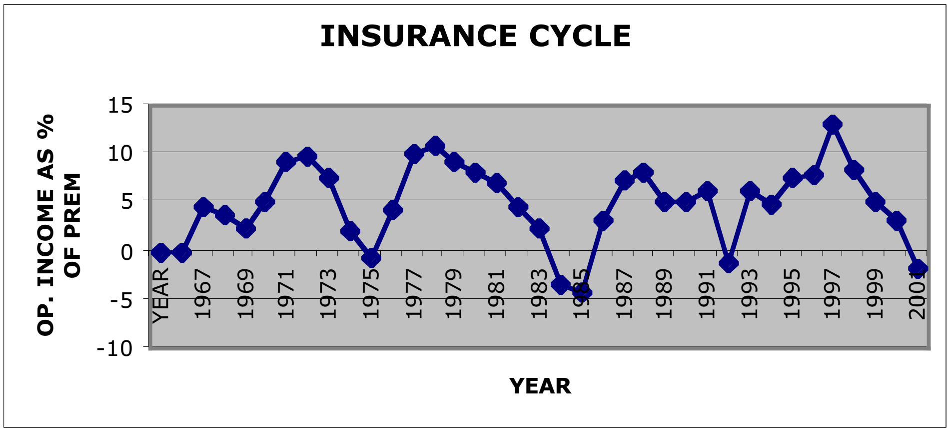
Insurers make most of their profits from investment income. During years of high interest rates and/or excellent insurer profits, insurance companies engage in fierce competition for premium dollars to invest for maximum return. Insurers severely underprice their policies and insure very poor risks just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

Exhibit 1. The Insurance Cycle



(The 1992 data point was not a classic cycle bottom, but reflected the impact of Hurricane Andrew and other catastrophes in that year.)

Prior to late 2000, the industry had been in a soft market since the mid-1980s. The usual six- to-ten year economic cycle had been expanded by the strong financial markets of the 1990s. 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 the last two years, the market turned 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 Pennsylvania 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 Pennsylvania doctors rather than decreasing interest rates and other economic factors, those losses should be reflected

[1] "…there 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.

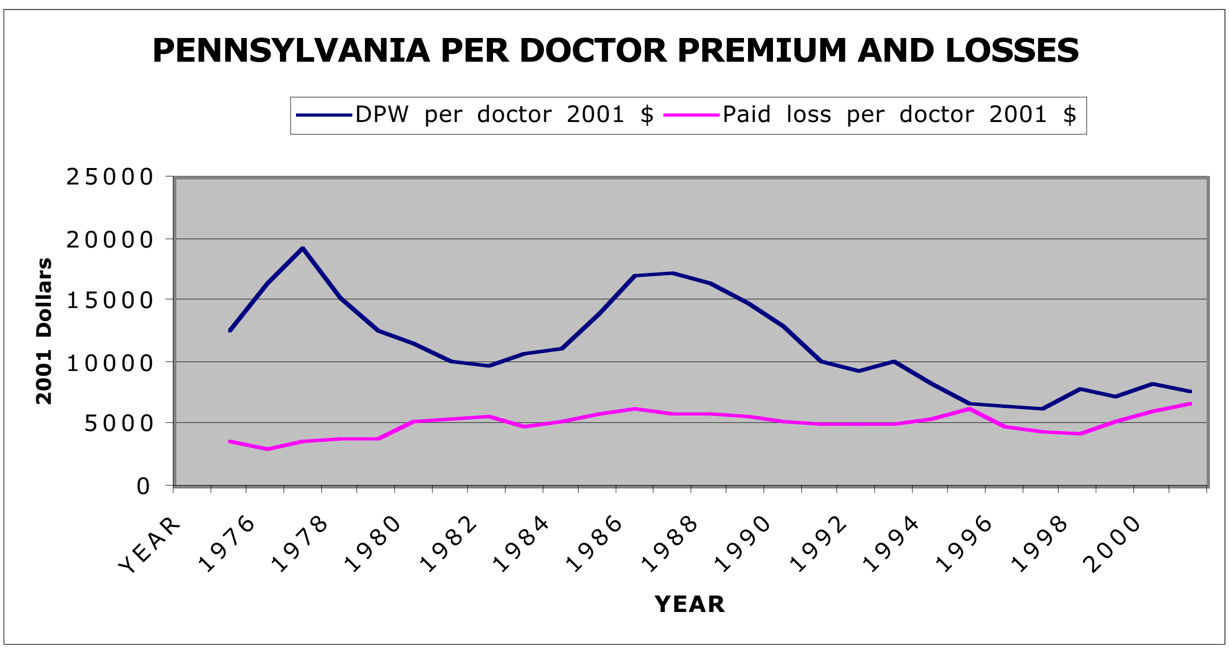
in steadily increasing rates, not in sharp ups and downs that might instead reflect the state of the economy, the well-documented insurance economic cycle (Exhibit 1), interest rates, the stock market or the level of insurers' investment income.

AIR finds both hypotheses are completely false. The data in Exhibits 2 and 3 below, are more than simply conclusive. They are "smoking guns" which should, once and for all, end the debate about the cause of these periodic medical malpractice crises in Pennsylvania. First, they show that since 1975, medical malpractice paid claims per doctor have tracked medical inflation very closely. In other words, payouts have risen almost precisely in sync with medical inflation, which should surprise the doctors who dutifully march off at the insurers' trumpet call to seek tort law changes. 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, 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.

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

Exhibit 2

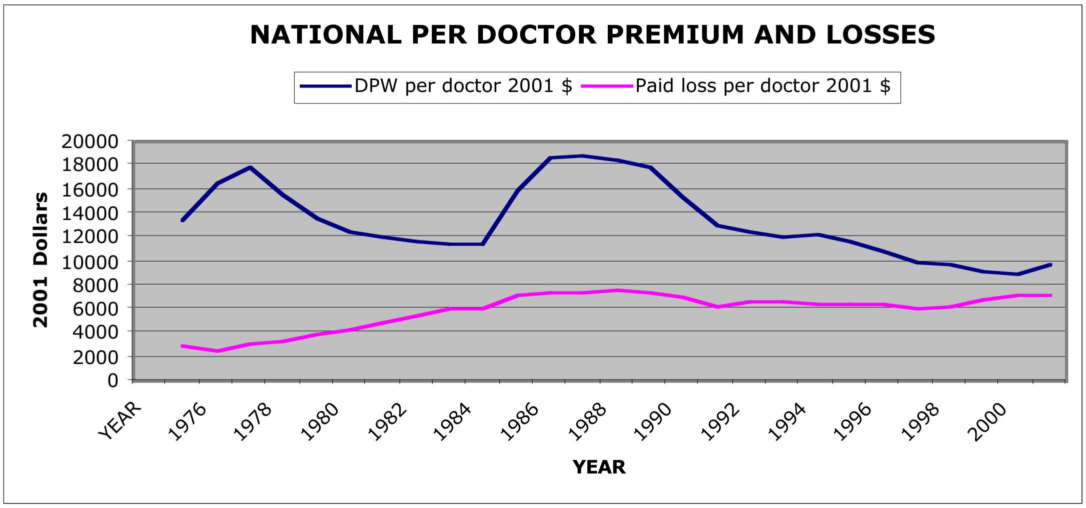


Sources:

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 (2001 Estimated)[2]; Inflation Index: Bureau of Labor Statistics, 1975 (1985 estimated).

Definitions:
"DPW" or **"Direct Premiums Written"** is the amount of money that insurers collected in premiums from doctors during that year.
"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]

In addition, it should be noted that the Pennsylvania experience closely tracks the national experience, as this chart reveals:



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 (2001 Estimated)[4]; Inflation Index: Bureau of Labor Statistics, 1975 (1985 estimated).

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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 Pennsylvania and 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.

Exhibit 3 – Pennsylvania Data

YEAR	Direct Prems Written	Direct Losses Paid	Loss Ratio	# doctors in PA	Medical Inflation (cpi-u)	DPW per doctor	PL per doctor	YEAR	DPW per doctor 2001 $	Paid loss per doctor 2001 $
1975	43,300,826	12,478,324	0.288	20026	47	2162	623	1975	12550	3617
1976	65,233,256	11,702,721	0.179	20690	52	3153	566	1976	16541	2967
1977	86,256,283	16,417,249	0.190	21354	57	4039	769	1977	19332	3680
1978	76,383,598	19,177,319	0.251	22019	61.8	3469	871	1978	15313	3845
1979	70,708,189	22,208,744	0.314	22683	67.5	3117	979	1979	12598	3957
1980	74,226,484	34,006,833	0.458	23347	74.9	3179	1457	1980	11580	5305
1981	75,443,326	41,069,439	0.544	24223	82.9	3115	1695	1981	10249	5579
1982	83,270,030	47,601,773	0.572	25099	92.5	3318	1897	1982	9784	5593
1983	102,532,965	47,628,770	0.465	25975	100.6	3947	1834	1983	10704	4972
1984	116,999,429	56,321,924	0.481	26851	106.8	4357	2098	1984	11130	5358
1985	162,048,623	67,784,173	0.418	27727	113.5	5844	2445	1985	14047	5876
1986	216,779,338	79,973,981	0.369	28346	122	7648	2821	1986	17101	6309
1987	237,626,420	81,127,665	0.341	28966	130.1	8204	2801	1987	17202	5873
1988	247,114,398	88,715,350	0.359	29585	138.6	8353	2999	1988	16440	5902
1989	245,635,918	93,451,416	0.380	30205	149.3	8132	3094	1989	14859	5653
1990	246,847,091	101,421,454	0.411	30824	162.8	7735	3178	1990	12962	5326
1991	219,420,588	109,695,138	0.500	31912	177	6649	3324	1991	10248	5123
1992	223,980,497	121,369,610	0.542	33001	190.1	6570	3560	1992	9429	5109
1993	264,243,328	131,718,360	0.498	34089	201.4	7512	3744	1993	10175	5072
1994	231,719,754	151,834,502	0.655	35178	211	6389	4187	1994	8261	5413
1995	197,102,672	182,595,939	0.926	36266	220.5	5435	5035	1995	6724	6229
1996	200,765,866	148,796,668	0.741	36831	228.2	5451	4040	1996	6516	4830
1997	204,621,253	142,598,162	0.697	37395	234.6	5472	3813	1997	6363	4434
1998	267,969,526	144,810,834	0.540	37960	242.1	7059	3815	1998	7954	4299
1999	258,553,453	190,152,065	0.735	38524	250.6	6711	4936	1999	7306	5373
2000	314,147,245	227,385,750	0.724	39089	260.8	8037	5817	2000	8407	6085
2001	305,278,687	268,807,752	0.881	39563	272.8	7716	6794	2001	7716	6794

Sources: Premiums Written (Net), Bests Aggregates and Averages, 2001 Edition

Number of Total NonFed Doctors: U.S. Bureau of the Census (data for 1975, 80, 85,90,95 and 99; other years Estimated)

Note that "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, insurers will increase reserves as a way to justify price increases. In fact, the current insurance "crisis" rests significantly on a jump (over a billion dollars) 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 the1980s, 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.

Conclusion

Stable Losses/Unstable Rates in Pennsylvania represents the first comprehensive report on medical malpractice insurance in that state, analyzing what 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. Medical insurance premiums have risen and fallen in relationship to the state of the economy while payouts over the last decade have approximately tracked the rate of medical inflation. Not only has there been no real increase in lawsuits, jury awards or any tort system costs in recent years, 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 other words, insurance companies in Pennsylvania and nationwide raise rates when they are seeking ways to make up for declining interest rates and investment losses.