



**American Enterprise Institute Medical Malpractice Report
Based on Fundamental Misunderstanding of Insurance Markets**

By J. Robert Hunter¹

On April 24, 2006, the American Enterprise Institute (AEI) published a report, “Faulty Studies from Center for Justice & Democracy are Stunting the Medical-Malpractice Debate,” by Messrs. Frank and Grace. In this report, the authors criticize work I did on two studies, “Stable Losses/Unstable Rates 2004” and “Insurance Crisis Officially Over” published in 2005 and 2006. The AEI authors wrongly conclude that increasing losses have been the primary driver of sharp medical malpractice rate increases in recent years, rather than the boom and bust insurance business cycle and the pricing and underwriting practices insurers employ during the cycle. (Insurers typically under-price policies and underwrite higher risks during the “soft” part of the insurance business cycle and significantly over-price them and cut back coverage during the “hard” end of the cycle.) In fact, the authors actually claim that an insurance business cycle does not exist and contend that I have used the wrong adjustments to show that there is a cycle. In this response, I will demonstrate that the business cycle and insurer pricing and underwriting practices, not insurer losses, have been the main reason for periodic sharp rate increases. I will also show that the cycle is well-established as a fact in academic and trade literature and that my adjustments are reasonable and valid.

The underlying reason that the AEI report is so fundamentally flawed is found in this statement, made on page 5:

The problem with AIR’s [Americans for Insurance Reform – for whom I wrote my studies] hypothesis is that an insurance cycle is not really a cycle at all, but rather a reaction to unpredictable shocks.

This astounding and uncorroborated statement is so deeply in error and so fundamental to their flawed findings that it must be dealt with first. Then I will comment on the rest of the errors the authors of the AEI report made in their assessment of my work.

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The first liability insurance crisis occurred in the mid 1970s when I was the Federal Insurance Administrator. The White House asked me to look into the crisis and to report back to them as to whether it was true that a claimed “explosion” of medical malpractice claims was causing the huge and sudden jump in premiums that doctors were experiencing.

My research immediately found that data was not available to answer this question. Therefore, working with the National Association of Insurance Commissioners (NAIC), we undertook a closed-claim study and also broke out medical malpractice insurance as a separate line in the Annual Statements of property/casualty insurers.

The closed claim study revealed no “explosion” of claims. We reported back to the White House that the problem seemed attributable to insurer economics and that the new medical malpractice line of data in the Annual Statement would enable us to monitor the situation over time. President Ford, as a result, wisely did not agree to request tort law change at that time.

When the second liability insurance crisis occurred in the mid 1980s, we had the data from the Annual Statements. It showed that the premiums had not risen from the time of the last crisis until the new crisis hit at which time premiums skyrocketed. The data also showed that claims had increased only slightly more than medical inflation consistently throughout the period. I developed a thesis that the economic cycle played a significant role in triggering these periodic crises. Again, there was no evidence of any claims explosion in the mid-1980s, but rather a consistent increase in claims over time roughly equal to inflation. However, premiums periodically exploded.

The NAIC undertook a major study of my thesis, publishing its findings in 1991.² The conclusion was that cycles are real and caused by some or all of three contributing factors:

1. Adverse shock losses that move insurers away from their target leverage ratios leading to supracompetitive (excessive) prices,
2. Changes in interest rates, and
3. Under-pricing in soft markets.

The report states that regulators see “considerable price cutting in soft markets which depletes surplus and increases the severity of the reversal when the market tightens.” This is particularly true in long-tail lines like medical malpractice.

At the time, I (and others) called for increased regulation to keep prices from being excessive during hard markets and inadequate during soft markets. The NAIC was cautious about the use of regulation, in part because it would have required insurers to

² “Cycles and Crises in Property/Casualty Insurance: Causes and Implications for Public Policy,” NAIC 1991.

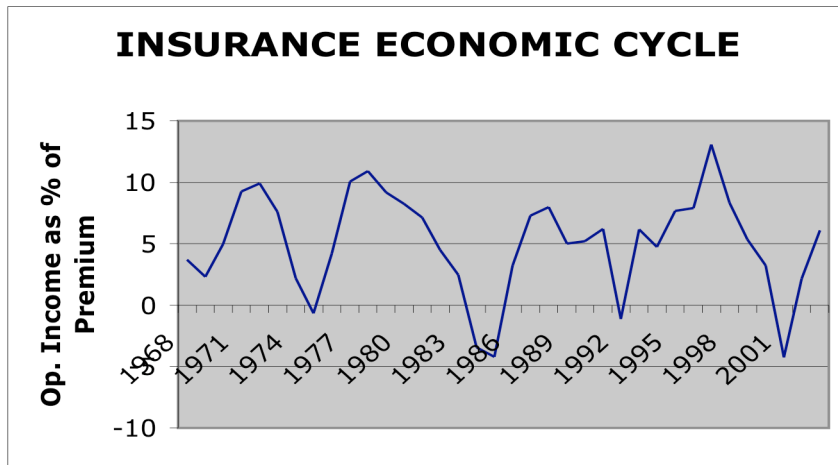
raise prices during the soft part of the cycle, a difficult political issue to be sure (but I think necessary to mitigate the damage of cyclical excesses).

The denial of the existence of an insurance business cycle by Messrs. Frank and Grace, perhaps the only two “world is flat” thinkers left in this debate, is astounding and fundamental to the other errors in thinking that pervade their AEI report. The existence of an insurance cycle is now widely accepted by insurers, brokers, regulators and most informed observers of the industry.

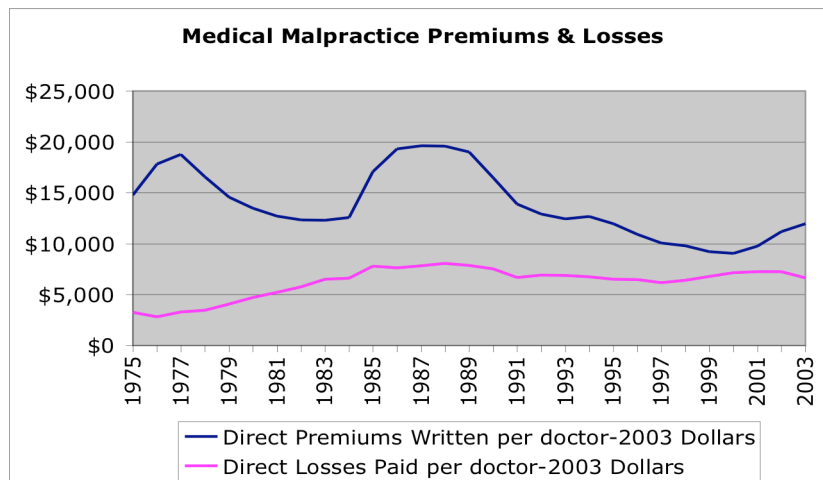
Now to some of the lesser errors in the AEI report:

Study 1 – Stable Losses

Both of my studies are based upon the fact that there is an economic cycle in the insurance industry. Indeed the first, “Stable Losses/Unstable Rates” documents the cycle in medical malpractice. Here is a chart from the report that shows the cycle dramatically for all property/casualty insurance (the 1992 low is not cyclical, but was triggered by the payment of losses after Hurricane Andrew).



The report also documented the medical malpractice cycle with a similar chart:



In the above chart, I added paid losses per doctor to show that the premium movement was cyclical while the loss movement was not.

The authors criticize my choice of growth factors and inflation, but offer no alternative calculation. The reason they offer no alternative calculation is simple: any such calculation would also show that the premium per doctor moves cyclically and the paid losses do not. Since the authors do not believe in the cycle, they can't show a calculation that undermines their primary error – the contention that there is no cycle.

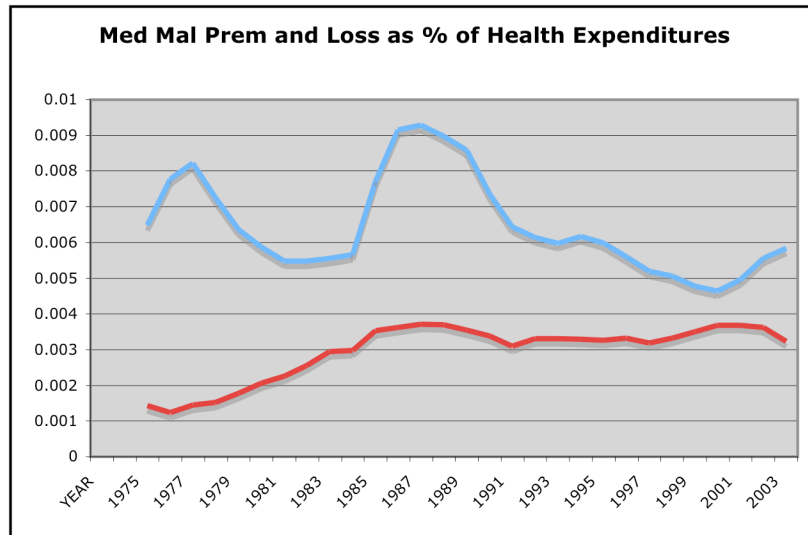
The authors compare my use of calculations based on the number of all doctors for the 1975 to 2003 period to growth in the number of surgeons for the 1999 to 2002 period and conclude I overstated the growth in the number of doctors. This mismatch of time and base is not an appropriate test. An appropriate test would compare a like base – all doctors – over a like period – 1975 to 2003. The authors fail to say what are the right adjustments to make or show the results with what they would claim are the proper adjustments.

More fundamentally, they criticize the use of a base of all doctors as including “retired doctors and others who have no need of insurance.” This is an error. Retired doctors do need insurance and are subject to suit for years after they retire. In fact, retiring doctors spend many thousands of dollars to purchase “tail” coverage to protect themselves during these years. In other words, they are insured, except in rare instances. I believe my choice of the doctor “base” is proper. If the AEI authors have a better base, they did not disclose it.

The authors also quibble with my use of the medical care price index and say that the CPI is “arguably more appropriate.” I disagree. These are medical injuries and require medical treatment. The use of the CPI would significantly understate the extent of medical inflation in recent years. Overall at least half of the payouts (settled claims, settled suits and verdicts) relate to medical treatment. To use the CPI to calculate medical inflation would be an error.

The authors gleefully point out that “Hunter’s study still found that real losses per doctor had more than doubled between 1975 and 2003.” This is true. But the authors fail to point out that that growth occurred between 1975 and 1985, not recently, and that 2003 real losses are less than 1985 losses. They also fail to point out that the Stable Losses report says just this at page 5, where I state that the real losses were “slightly higher than inflation from 1975 to 1985 and flat since.” They then accuse me of overstating the increase in losses (exactly the opposite of the point they claim I wanted to make – that losses have not skyrocketed) by using all available data (1975 to 2003 with an increase of double) instead of arbitrarily choosing the period 1976 to 2002 (with an increase of 157%). Had I done such a thing and shown lower loss increases, I should be criticized for “picking” end points in the series (and I am certain these authors would have done so). Since the AEI authors suggest arbitrary picking of data from a time series, I hereby severely criticize them.

Another test of the impact of medical malpractice insurance in America is to look at medical malpractice premiums as a percentage of health care expenditures. This approach eliminates the need to deflate the growth in premiums and losses by the growth in the number of doctors and by inflation as both the numerator and the denominator of the ratio (change in premiums – or losses – divided by change in health care expenditures) capture these effects. A chart of the medical malpractice insurance premiums and losses as a percentage of health care expenditures follows:



Appendix A contains the data underlying this chart.

The cycle in premiums is again revealed. Here, again, losses are up more than general health care cost increases between 1975 and 1985 and flat to down from 1985 to 2003. For the entire period, the average premium cost as a percentage of health care expenditures is 6.5 tenths of one percent and the losses are 2.9 tenths of one percent. As of 2003, premiums are at 5.8 tenths of one percent and losses are 3.2 tenths of one percent.

Clearly, medical malpractice is a trivial contributor to health care costs and losses are flat over the last twenty years in relation to health care costs.

Study 2 – Crisis Over

The second report, the “Insurance Crisis is Officially Over,” is also related to the widely accepted conclusion that an insurance economic cycle exists. This study was simply a statement of fact that the hard market part of the cycle, the crisis part of the cycle, with its huge rate increases, was over. Continuing to look reality in the face and deny it, the AEI authors doubt my finding. At the time the report was released, others questioned my conclusions too, but have long since changed their minds. Indeed the National Underwriter magazine, the leading insurance trade publication, did so. Below is

a quote from a February 6, 2004 editorial³ by the National Underwriter, the leading insurance trade publication, which recanted their earlier refusal to acknowledge the end of the hard insurance market:

I've had a good-natured, running argument this past year over whether the hard market is finally behind us with J. Robert Hunter—one of the leading gadflies laboring to keep the insurance industry honest.

Bob, director of insurance at the Consumer Federation of America in Washington, first declared the hard market over back in May 2003. I countered with an editorial headlined: "Hard Market Ain't Dead Yet."

My comments must have stuck in his craw, because he came back at me in November with an e-mail citing a speech by Insurance Services Office President Frank Coyne, who lamented that if the soft market is not already upon us, the hard market certainly is coming to a close. In a Nov. 26, 2003 editorial, I stuck by my guns, arguing that the market, while moderating, remained hard, with average price hikes still in the double-digits for most renewals.

Stubbornly keeping my feet to the fire, Bob thought for sure that he finally had me right where he wanted me after seeing our Jan. 26 edition. (He certainly is a faithful reader!) "Now that your cover title begins, 'After The Hard Market...' and you include items such as 'Property Rates Dip As Market Softens,' will you finally agree with me that the hard market is ending?"

All right, Bob, after careful consideration, I am prepared to at last conclude that the hard market is fading into the sunset!

This was not an easy admission.

So the overall crisis is over. How are we doing lately? It is a soft market. Below are price data from the last five quarters from the Council of Insurance Agents and Brokers:

	<u>1Q 2005</u>	<u>2Q 2005</u>	<u>3Q 2005</u>	<u>4Q 2005</u>	<u>1Q 2006</u>
Small Comm.					
Accounts	-5%	-5%	-5%	-3%	-2%
Mid-size Comm.					
Accounts	-9%	-10%	-8%	-5%	-3%
Large Comm.					
Accounts	-10%	-11%	-9%	-5%	-3%

³ Sam Friedman, Editor, National Underwriter Magazine, Property/Casualty Edition, February 6, 2004.

And for medical malpractice specifically:

	<u>1Q 2005</u>	<u>2Q 2005</u>	<u>3Q 2005</u>	<u>4Q 2005</u>	<u>1Q 2006</u>
Medical Malpractice	2%	2%	0%	0%	-1%

When I say the crisis is over, I refer to the sharp increases in prices. Are prices higher than they were a few years ago? Yes. When will we see increases again? Probably in a decade or so after years of stable prices and slowly rising losses catch up to the underwriters who today seek market share in long tail lines as interest rates rise. In the meantime real medical malpractice insurance premiums will decline again.

AEI concludes that my claim regarding the end of the crisis of sharp rate increases amounts to “enemy action.” Apparently I am an enemy because they don’t agree with my conclusion that there is an insurance cycle and that medical malpractice insurance is particularly impacted by the cycle because of its long-tail aspect. This charge of being an enemy is remarkable and, sadly, shows an extreme bias by the AEI authors.

Conclusion

Because of the authors’ lack of understanding of the American insurance market and other errors, their criticism of the two studies I worked on for Americans for Insurance Reform is unfounded. The fact that they show no data or analysis is both troubling and unprofessional.

APPENDIX A

YEAR	direct prems written (thousands)	direct losses paid (thousands)	Nat'l health care expend (millions of \$)	DPW/Expen	DLP/expen
1975	865,208	190,867	133,557	0.65%	0.14%
1976	1,187,978	188,545	152,952	0.78%	0.12%
1977	1,423,091	248,969	173,357	0.82%	0.14%
1978	1,412,555	294,456	195,253	0.72%	0.15%
1979	1,405,991	391,800	221,256	0.64%	0.18%
1980	1,493,543	521,849	254,872	0.59%	0.20%
1981	1,616,470	665,570	295,288	0.55%	0.23%
1982	1,815,056	847,543	332,051	0.55%	0.26%
1983	2,033,911	1,079,862	366,823	0.55%	0.29%
1984	2,282,590	1,197,979	404,026	0.56%	0.30%
1985	3,407,177	1,556,300	441,880	0.77%	0.35%
1986	4,335,863	1,709,883	473,915	0.91%	0.36%
1987	4,781,084	1,905,491	515,287	0.93%	0.37%
1988	5,166,811	2,128,281	576,586	0.90%	0.37%
1989	5,500,540	2,273,628	641,828	0.86%	0.35%
1990	5,273,360	2,415,117	717,342	0.74%	0.34%
1991	5,043,773	2,423,418	784,969	0.64%	0.31%
1992	5,228,362	2,808,838	852,548	0.61%	0.33%
1993	5,469,575	3,028,086	916,498	0.60%	0.33%
1994	5,948,361	3,174,987	966,011	0.62%	0.33%
1995	6,107,568	3,326,846	1,020,438	0.60%	0.33%
1996	6,002,233	3,556,151	1,072,626	0.56%	0.33%
1997	5,864,218	3,587,566	1,129,672	0.52%	0.32%
1998	6,040,051	3,957,619	1,195,552	0.51%	0.33%
1999	6,053,323	4,446,975	1,270,299	0.48%	0.35%
2000	6,303,206	4,988,474	1,358,510	0.46%	0.37%
2001	7,288,933	5,424,197	1,474,169	0.49%	0.37%
2002	8,928,252	5,806,463	1,607,942	0.56%	0.36%
2003	10,142,575	5,622,377	1,740,597	0.58%	0.32%
			Average	0.65%	0.29%

Premiums and Losses from A. M. Best and Co.

Health Expenditures from U.S. Department of Health & Human Services