Medical Malpractice Insurance: Stable Losses/Unstable Rates 2004

October 2004

Introduction and Summary of Findings

Over the last three years, this country has endured a series of protests, walk-outs and strikes by doctors protesting skyrocketing medical malpractice insurance rates for some high-risk specialties. The insurance industry and organized medicine have blamed the crisis on the legal system and have lobbied extensively for laws to limit compensation to injured patients.

A tremendous amount of fear and anger has been generated among doctors and patients alike due to rising malpractice insurance rates. But the question has always remained – have insurers charged rates that are justified by their claims experience, or is there another reason why they have raised rates so dramatically for doctors in the last three years?

Americans for Insurance Reform (AIR), a coalition of over 100 consumer groups around the country, has provided an answer to this question. *Stable Losses/Unstable Rates 2004* examines trends in medical malpractice insurance – both premiums and claims - over the past 30 years. AIR has found that the amount medical malpractice insurers have paid out, including all jury awards and settlements, directly track 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.

This new 2004 study makes two major findings:

- First, contrary to what the insurance and medical lobbies have alleged, the year 2003 saw no "explosion" in medical malpractice insurer payouts or costs to justify skyrocketing rate hikes. **In fact, rather than exploding, inflation-adjusted payouts per doctor have *dropped* for the last two years.** Payouts (in constant dollars) have been essentially flat or dropping since the mid-1980s.

- Second, **medical malpractice insurance premiums rose faster in 2003 than was justified by insurance payouts.** The price hikes, which began in 2001, are similar to the rate hikes of the past, which occurred in the mid-1980s and mid-1970s and were not connected to actual payouts either. Rather, they reflect a weakened economy and losses experienced by the insurance industry's market investments and their perception of how

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much they can 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.

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, “the 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 “tort reform” and insurance rates.

More recently, Weiss Ratings, an independent insurance-rating agency, 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. Weiss speculated that state regulation of insurance premium increases made the difference.[1]

Similarly, an August 2004 paper from the National Bureau of Economic Research found: “Surprisingly, there seems to be a fairly weak relationship between malpractice payments (for judgments and settlements) and premiums – both overall and by specialty.” “Past and present malpractice payments do not seem to be the driving force behind increases in premiums. Premium growth may be affected by many factors beyond increases in payments, such as industry competition and the insurance underwriting cycle.[2]

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, Weiss and NBER confirm, it will fail again.

The *Stable Loss/Unstable Rates 2004* 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 2003. 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.

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[1] Jyoti Thottam, “He Sets Your Doctor's Bill; A Chastened Insurer,” *Time Magazine*, June 9, 2003.

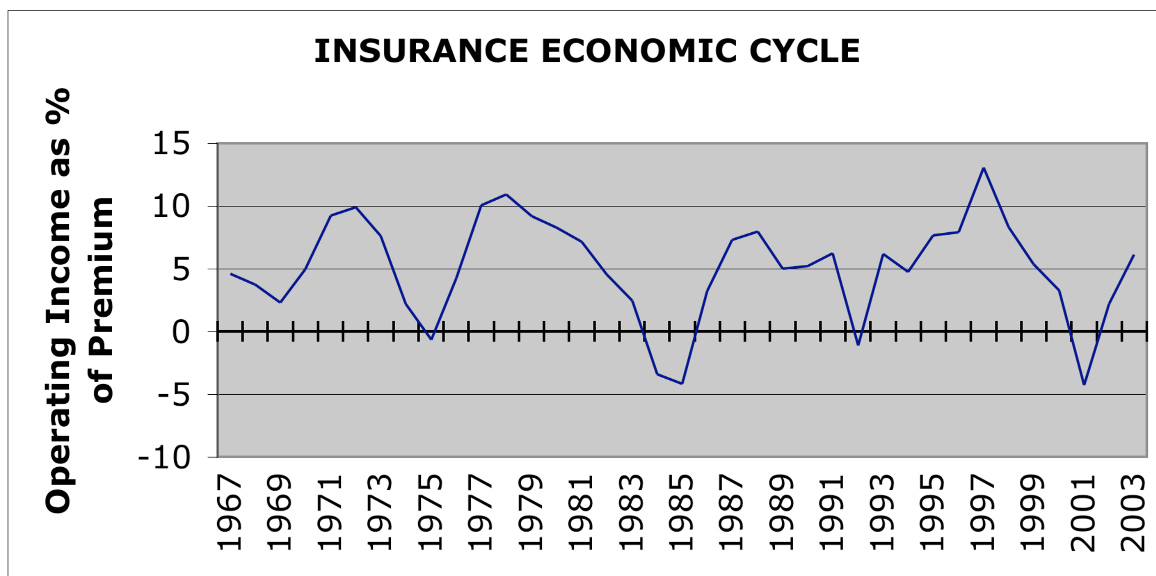
[2] Katherine Baicker & Amitabh Chandra, NATIONAL BUREAU OF ECONOMIC RESEARCH*, The Effect of Malpractice Liability on the Delivery of Health Care* (Aug. 2004), at 14 & 20.

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, beginning in 2001, the country started 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. (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.[3] 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 from 2001 through 2003 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 2003. 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 and 2003 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.

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.

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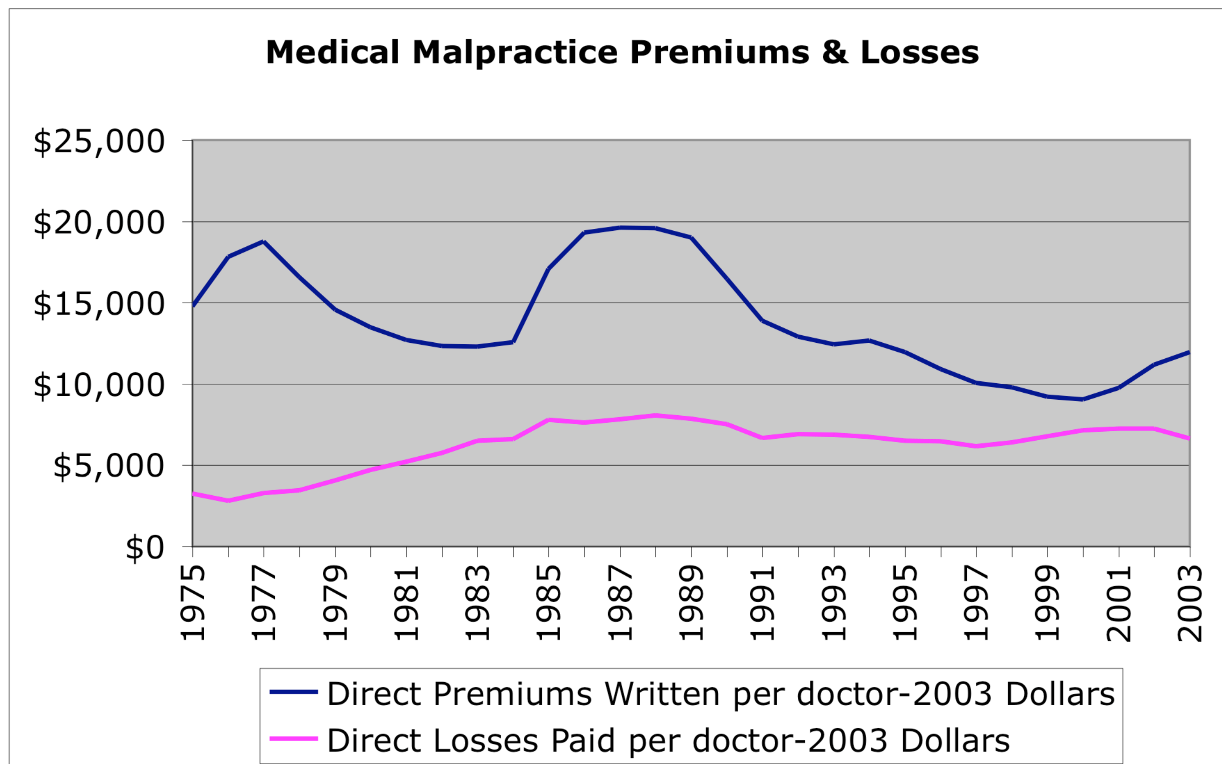
[3] "[T]here is clearly an opportunity now for companies to price gouge – and it's happening…. But I think companies are overreacting, because they see a window in which they can do it." Jeanne Hollister, consulting actuary, Tillinghast-Towers Perrin, quoted in, "Avoid Price Gouging, Consultant Warns,"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

Exhibit 2



Sources: A.M. Best and Co. special data compilation for AIR, reporting data for as many years as separately available (premiums and losses); American Medical Assoc. (number of non-federal doctors, 1975, 1980, 1985, 1986, 1990, 1992-2002; other years estimated); Bureau of Labor Statistics (CPI).[4] See Exhibit 3 for underlying data.

Definitions:

- **"Direct Premiums Written"** is the amount of money that insurers collected in premiums from doctors during that year.
- **"Direct Losses Paid"** 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.[5]

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[4] 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.

[5] "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 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

Exhibit 3

Year	Written Premiums (thousands)	Paid Losses (thousands)	Loss Ratio	Number of Doctors (Non-federal)	Medical Care Inflation (CPI-U)	Direct Premiums Written per Doctor	Direct Losses Paid per Doctor	Direct Premiums Written per Doctor-2003 Dollars	Direct Losses Paid per Doctor-2003 Dollars
1975	$865,208	$190,867	0.221	366,425	47.5	$2,361.21	$520.89	$14,793.63	$3,263.51
1976	$1,187,978	$188,545	0.159	381,000	52	$3,118.05	$494.87	$17,844.85	$2,832.17
1977	$1,423,091	$248,969	0.175	395,575	57	$3,597.53	$629.39	$18,782.87	$3,286.05
1978	$1,412,555	$294,456	0.208	410,151	61.8	$3,443.99	$717.92	$16,584.64	$3,457.17
1979	$1,405,991	$391,800	0.279	424,726	67.5	$3,310.35	$922.48	$14,594.96	$4,067.10
1980	$1,493,543	$521,849	0.349	439,301	74.9	$3,399.82	$1,187.91	$13,508.49	$4,719.91
1981	$1,616,470	$665,570	0.412	455,904	82.9	$3,545.64	$1,459.89	$12,728.37	$5,240.81
1982	$1,815,056	$847,543	0.467	472,507	92.5	$3,841.33	$1,793.72	$12,358.71	$5,770.92
1983	$2,033,911	$1,079,862	0.531	489,109	100.6	$4,158.40	$2,207.81	$12,301.59	$6,531.27
1984	$2,282,590	$1,197,979	0.525	505,712	106.8	$4,513.62	$2,368.90	$12,577.27	$6,600.97
1985	$3,407,177	$1,556,300	0.457	522,315	113.5	$6,523.22	$2,979.62	$17,104.06	$7,812.64
1986	$4,335,863	$1,709,883	0.394	547,222	122	$7,923.41	$3,124.66	$19,327.92	$7,622.12
1987	$4,781,084	$1,905,491	0.399	556,647	130.1	$8,589.08	$3,423.16	$19,647.27	$7,830.38
1988	$5,166,811	$2,128,281	0.412	566,072	138.6	$9,127.48	$3,759.74	$19,598.40	$8,072.85
1989	$5,500,540	$2,273,628	0.413	575,496	149.3	$9,557.91	$3,950.73	$19,051.81	$7,874.99
1990	$5,273,360	$2,415,117	0.458	584,921	162.8	$9,015.51	$4,128.96	$16,480.44	$7,547.78
1991	$5,043,773	$2,423,418	0.480	609,384	177	$8,276.84	$3,976.83	$13,916.31	$6,686.47
1992	$5,228,362	$2,808,838	0.537	633,846	190.1	$8,248.63	$4,431.42	$12,913.17	$6,937.35
1993	$5,469,575	$3,028,086	0.554	648,662	201.4	$8,432.09	$4,668.20	$12,459.73	$6,898.00
1994	$5,948,361	$3,174,987	0.534	661,960	211	$8,985.98	$4,796.34	$12,674.07	$6,764.89
1995	$6,107,568	$3,326,846	0.545	689,121	220.5	$8,862.84	$4,827.67	$11,961.82	$6,515.71
1996	$6,002,233	$3,556,151	0.592	717,335	228.2	$8,367.41	$4,957.45	$10,912.09	$6,465.10
1997	$5,864,218	$3,587,566	0.612	737,263	234.6	$7,954.04	$4,866.06	$10,090.03	$6,172.80
1998	$6,040,051	$3,957,619	0.655	757,865	242.1	$7,969.82	$5,222.06	$9,796.86	$6,419.19
1999	$6,053,323	$4,446,975	0.735	778,491	250.6	$7,775.71	$5,712.30	$9,234.05	$6,783.64
2000	$6,303,206	$4,988,474	0.791	793,211	260.8	$7,946.44	$6,288.96	$9,067.72	$7,176.36
2001	$7,288,933	$5,424,197	0.744	814,776	272.8	$8,945.93	$6,657.29	$9,759.20	$7,262.49
2002	$8,928,252	$5,806,463	0.650	831,645	285.6	$10,735.65	$6,981.90	$11,186.73	$7,275.26
2003	$10,142,575	$5,622,377	0.554	848,514	297.1	$11,953.34	$6,626.15	$11,973.46	$6,637.30

Sources: A.M. Best and Co. special data compilation for AIR, reporting data for as many years as separately available (premiums and losses); American Medical Assoc. (number of non-federal doctors, 1975, 1980, 1985, 1986, 1990, 1992-2002; other years estimated); Bureau of Labor Statistics (CPI).

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 as they did again after 2001, which this study shows. In fact, loss ratios are now the

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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.

lowest they have been since 1995. Otherwise, they tend to trend up as insurers cut premiums during the soft market.

Exhibit 3 shows this precise phenomenon of steadily increasing loss ratios from 1988 through 2000. 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

Stable Losses/Unstable Rates 2004 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 time period 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 stayed flat. In other words, insurance companies raise rates when they are seeking ways to make up for declining interest rates and market-based investment losses and reduction in interest rates.