WISCONSIN STATE LEGISLATURE COMMITTEE HEARING RECORDS

2005-06
(session year)

Assembly
(Assembly, Senate or Joint)

Task Force on Medical Malpractice (ATF-MM)

Sample:

Record of Comm. Proceedings ... RCP
- 05hr_AC-Ed_RCP_pt01a
- 05hr_AC-Ed_RCP_pt01b
- 05hr_AC-Ed_RCP_pt02

- *Appointments* ... *Appt*
- **

- *Clearinghouse Rules* ... *CRule*
- **

- *Committee Hearings* ... *CH*
- **

- *Committee Reports* ... *CR*
- **

- *Executive Sessions* ... *ES*
- **

- *Hearing Records* ... *HR*
- **

- *Miscellaneous* ... *Misc*
- **05hr_ATF-MM_Misc_pt11a**

- *Record of Comm. Proceedings* ... *RCP*
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United States General Accounting Office

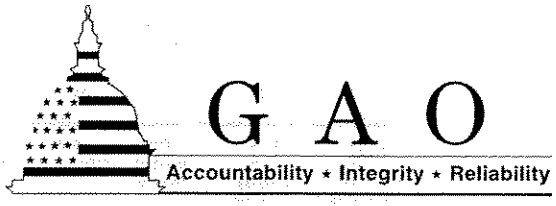
GAO

Report to Congressional Requesters

June 2003

MEDICAL MALPRACTICE INSURANCE

Multiple Factors Have Contributed to Increased Premium Rates



GAO-03-702

June 2003

MEDICAL MALPRACTICE INSURANCE

Multiple Factors Have Contributed to Increased Premium Rates

GAO Accountability · Integrity · Reliability

Highlights

Highlights of GAO-03-702, a report to congressional requesters

Why GAO Did This Study

Over the past several years, large increases in medical malpractice insurance premium rates have raised concerns that physicians will no longer be able to afford malpractice insurance and will be forced to curtail or discontinue providing certain services. Additionally, a lack of profitability has led some large insurers to stop selling medical malpractice insurance, furthering concerns that physicians will not be able to obtain coverage. To help Congress better understand the reasons behind the rate increases, GAO undertook a study to (1) describe the extent of the increases in medical malpractice insurance rates, (2) analyze the factors that contributed to those increases, and (3) identify changes in the medical malpractice insurance market that might make this period of rising premium rates different from previous such periods.

What GAO Recommends

GAO is not recommending executive action. However, to further the understanding of conditions in current and future medical malpractice markets, Congress may wish to consider encouraging the National Association of Insurance Commissioners and state insurance regulators to identify and collect additional, mutually beneficial data necessary for evaluating the medical malpractice insurance market.

www.gao.gov/cgi-bin/getrpt?GAO-03-702.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

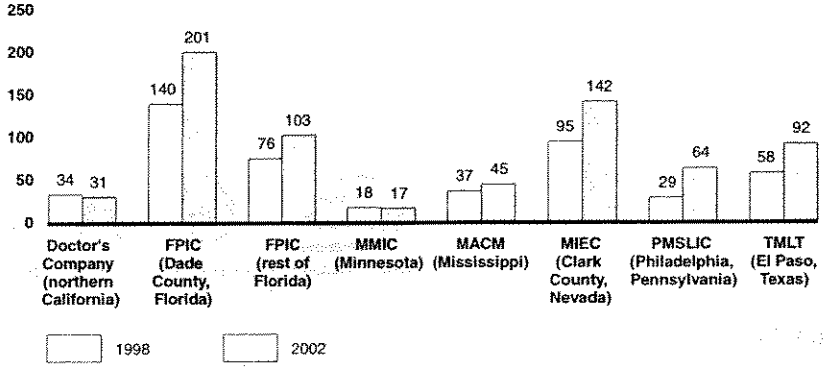
What GAO Found

Since 1999, medical malpractice premium rates have increased dramatically for physicians in some specialties in a number of states. However, among larger insurers in the seven states GAO analyzed, both the premium rates and the extent to which these rates have increased varied greatly (see figure).

Multiple factors, including falling investment income and rising reinsurance costs, have contributed to recent increases in premium rates in our sample states. However, GAO found that losses on medical malpractice claims—which make up the largest part of insurers' costs—appear to be the primary driver of rate increases in the long run. And while losses for the entire industry have shown a persistent upward trend, insurers' loss experiences have varied dramatically across our sample states, resulting in wide variations in premium rates. In addition, factors other than losses can affect premium rates in the short run, exacerbating cycles within the medical malpractice market. For example, high investment income or adjustments to account for lower than expected losses may legitimately permit insurers to price insurance below the expected cost of paying claims. However, because of the long lag between collecting premiums and paying claims, underlying losses may be increasing while insurers are holding premium rates down, requiring large premium rate hikes when the increasing trend in losses is recognized. While these factors may explain some events in the medical malpractice market, GAO could not fully analyze the composition and causes of losses at the insurer level owing to a lack of comprehensive data.

GAO's analysis also showed that the medical malpractice market has changed considerably since previous hard markets. Physician-owned and/or operated insurers now cover around 60 percent of the market, self-insurance has become more widespread, and states have passed laws designed to reduce premium rates. As a result, it is not clear how premium rates might behave during future soft or hard markets.

Medical Malpractice Premium Base Rates for Obstetricians and Gynecologists Quoted by Larger Insurers in 1998 and 2002 in the Seven States GAO Visited (Dollars in Thousands)



Source: GAO analysis of annual surveys by the *Medical Liability Monitor*

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Abbreviations

AMA	American Medical Association
CAP/MPT	Cooperative of American Physicians/ Mutual Protection Trust
CDI	California Department of Insurance
CPI	Consumer Price Index
DOI	Department of Insurance
FMA	Florida Medical Association
FPIC	First Professionals Insurance Company
JUA	Joint Underwriting Association
MACM	Medical Assurance Company of Mississippi
MIEC	Medical Insurance Exchange of California
MIIX	Medical Inter-Insurance Exchange
MLM	Medical Liability Monitor
MMIC	Midwest Medical Insurance Company
NAIC	National Association of Insurance Commissioners
NMIC	Nevada Mutual Insurance Company
NSCL	National Conference of State Legislatures
PIAA	Physician Insurers Association of America
PID	Pennsylvania Insurance Department
PMSLIC	Pennsylvania Medical Society Liability Insurance Company
SCPIE	Southern California Physicians Insurance Exchange
TMA	Texas Medical Association
TMLT	Texas Medical Liability Trust

GAO
Accountability • Integrity • Reliability

United States General Accounting Office
Washington, D.C. 20548

June 27, 2003

Congressional Requesters

Since the late 1990s, premium rates for medical malpractice insurance have increased dramatically for physicians in certain specialties and states.[1] These increases have raised concerns that many physicians will no longer be able to afford malpractice insurance and may be forced to curtail or discontinue providing services. These concerns have been heightened as some large insurers, faced with declining profits, have either stopped selling medical malpractice insurance or reduced their operations in a number of states. But disagreement exists over the causes of increased premium rates and what, if anything, should be done in response to the current situation. For example, some have argued for tort reform as a means of lowering certain awards in medical malpractice lawsuits and advocate legislative changes at the state level designed to place a cap on such awards. Others have argued for medical reforms as a means of reducing the incidence of medical malpractice or for insurance reforms as a way to moderate premium rate increases.

In response to these concerns, you asked us to determine the reasons behind the recent increases in some medical malpractice insurance rates.[2] Our specific objectives were to (1) describe the extent of the increases in medical malpractice insurance rates, (2) analyze the factors that have contributed to the increases, and (3) identify changes in the medical malpractice insurance market that may make the current period of rising premium rates different from earlier periods of rate hikes. We will also

[1]Medical malpractice lawsuits are generally based on tort law, which includes both statutes and court decisions. A tort is a wrongful act or omission by an individual that causes harm to another individual. Typically, a malpractice tort would be based on the claim that the health care provider was negligent, had failed to meet the acceptable standard of care owed to the patient, and thus had caused injury to the patient.

[2]Some health care provider associations and others have expressed concern over medical malpractice insurance premium rates for nursing homes and hospitals, but this topic is outside the scope of our report.

issue a related report that describes the effect of rising malpractice premiums on access to health care and related issues.[3]

Recognizing that the medical malpractice market can vary considerably across states, as part of our review we judgmentally selected a sample of seven states—California, Florida, Minnesota, Mississippi, Nevada, Pennsylvania, and Texas—in order to conduct a more in depth review in each of those states. Our sample contains a mix of states based on the following characteristics: extent of any recent increases in premium rates, status as a "crisis state" according to the American Medical Association, presence of caps on noneconomic damages, state population, and aggregate loss ratios for medical malpractice insurers within the state. Except where noted otherwise, our analyses were limited to these states. Within each state, we spoke to one or both of the two largest and currently active medical malpractice insurers,[4] the state insurance regulator, and the state association of trial attorneys. In six states, we spoke to the state medical association, and in five states, we spoke to the state hospital association. To examine the extent of increases in medical malpractice insurance rates in our sample states, we reviewed annual survey data collected by a private company.[5] To analyze the factors contributing to the premium rate increases in our sample states as well as nationally, we reviewed data provided by medical malpractice insurers to state insurance regulators, the National Association of Insurance Commissioners (NAIC),[6]

[3]For other related GAO products, see the list at the end of this report.

[4]We determined the largest insurers in 2002 based on premiums written for calendar year 2001.

[5]The *Medical Liability Monitor* annually surveys providers of medical malpractice insurance to obtain their premium base rates for three different specialties: internal medicine, general surgery, and obstetrics/gynecology.

[6]NAIC is a voluntary association of the heads of each state insurance department, the District of Columbia, and four U.S. territories. NAIC assists state insurance regulators by providing guidance, model (or recommended) laws and guidelines, and information-sharing tools.

and A.M. Best[7] on insurers within our sample states as well as the 15 largest writers of medical malpractice insurance nationally in 2001 (whose combined market share nationally was approximately 64.3 percent). We also spoke with officials from professional actuarial and insurance organizations and national trial attorney and medical associations and reviewed their testimonies before Congress. In addition, we analyzed data on medical malpractice claims collected by insurers, state regulators, and others in our sample states as well as nationally.

To analyze how the national medical malpractice insurance market has changed since previous periods of rising premium rates, we reviewed studies published by NAIC, reviewed state insurance regulations and tort laws, and spoke to the insurers and state insurance departments in our sample states. We also spoke to officials from national professional actuarial, legal, and insurance organizations. Appendix I contains a more detailed description of our methodology.

Results in Brief

Since 1999, medical malpractice premium rates for physicians in some states have increased dramatically. Among the seven states that we analyzed, we found that both the extent of the increases and the premium levels varied greatly not only from state to state but across medical specialties and even among areas within states. For example, the largest writer of medical malpractice insurance in Florida increased premium rates for general surgeons in Dade County by approximately 75 percent from 1999 to 2002, while the largest insurer in Minnesota increased premium rates for the same specialty by about 2 percent over the same period. The resulting 2002 premium rate quoted by the insurer in Florida was $174,300 a year, more than 17 times the $10,140 premium rate quoted by the insurer in Minnesota. In addition, the Florida insurer quoted a rate for general surgeons outside Dade County of $89,000 a year for the same coverage, approximately 51 percent of the rate it quoted inside Dade County.

[7]A.M. Best is a rating agency that provides current or prospective investors, creditors, and policyholders with independent analyses of insurance companies' overall financial strength, creditworthiness, ability to pay claims, and company activities.

Multiple factors have contributed to the recent increases in medical malpractice premium rates in the seven states we analyzed. First, since 1998 insurers' losses on medical malpractice claims have increased rapidly in some states. For example, in Mississippi the amount insurers paid annually on medical malpractice claims, or paid losses,[8] increased by approximately 142 percent from 1998 to 2001 after adjusting for inflation.[9] We found that the increased losses appeared to be the greatest contributor to increased premium rates, but a lack of comprehensive data at the national and state levels on insurers' medical malpractice claims and the associated losses prevented us from fully analyzing the composition and causes of those losses. For example, data that would have allowed us to analyze claim severity at the insurer level on a state-by-state basis or determine how losses were broken down between economic and noneconomic damages were unavailable. Second, from 1998 through 2001 medical malpractice insurers experienced decreases in their investment income[10] as interest rates fell on the bonds that generally make up around 80 percent of these insurers' investment portfolios. While almost no medical malpractice insurers experienced net losses on their investment portfolios over this period, a decrease in investment income meant that income from insurance premiums had to cover a larger share of insurers' costs. Third, during the 1990s insurers competed vigorously for medical malpractice business, and several factors, including high investment returns, permitted them to offer prices that in hindsight, for some insurers, did not completely cover their ultimate losses on that business. As a result of this, some companies became insolvent or voluntarily left the market, reducing the downward competitive pressure on premium rates that had existed through the 1990s. Fourth, beginning in 2001 reinsurance rates for medical malpractice insurers also increased more rapidly than they had in

[8]Paid losses are the cash payments insurers made in a given period, such as a calendar year, on claims reported during both the current and previous years. Incurred losses include the insurer's expected costs for claims reported in that year and adjustments to the expected costs for claims reported in earlier years. In Mississippi, insurers' incurred losses increased approximately 197.5 percent from 1998 to 2001, after adjusting for inflation.

[9]We adjusted for inflation using the consumer price index (CPI). The CPI is a measure of the average change over time in the prices consumers pay for a basket of goods and services. This report uses the CPI-U, which is meant to reflect the spending patterns of urban consumers and covers about 87 percent of the total U.S. population.

[10]In general, state insurance regulators require insurers to reduce their requested premium rates in line with expected investment income. That is, the higher the expected income from investments, the more premium rates must be reduced.

the past, raising insurers' overall costs.[11] In combination, all of these factors contribute to the movement of the medical malpractice insurance market through cycles of hard and soft markets--similar to those experienced by the property-casualty insurance market as a whole--during which premium rates fluctuate.[12] Cycles in the medical malpractice market tend to be more extreme than in other insurance markets because of the longer period of time required to resolve medical malpractice claims, and factors such as changes in investment income and reduced competition can exacerbate the fluctuations.

While the medical malpractice insurance market as a whole had experienced periods of rapidly increasing premium rates during previous hard markets in the mid-1970s and mid-1980s, the market has changed considerably since then. These changes are largely the result of actions insurers, health care providers, and states have taken to address increasing premium rates. Beginning in the 1970s and 1980s, insurers began selling "claims-made" rather than "occurrence-based" policies,[13] enabling insurers to better predict losses for a particular year. Also in the 1970s, physicians, facing increasing premium rates and the departure of some insurers, began to form mutual nonprofit insurance companies. Such companies, which may have some cost and other advantages over commercial insurers, now comprise a significant portion of the medical malpractice insurance market. More recently, an increasing number of large hospitals and groups of hospitals or physicians have left the traditional commercial insurance market and begun to insure themselves in a variety of ways—for example, by self-insuring. While such arrangements can save money on administrative costs, hospitals and physicians insured through these arrangements assume greater financial responsibility for malpractice claims than they would under traditional insurance arrangements and thus may face a greater risk of insolvency. Finally, since periods of increasing

[11]Reinsurance is insurance for insurance companies, which insurance companies routinely use as a way to spread the risk associated with their insurance policies.

[12]Some industry officials have characterized hard markets as periods of rapidly rising premium rates, tightened underwriting standards, narrowed coverage, and the withdrawal of insurers from certain markets. Soft markets are characterized by relatively flat or slow-rising premium rates, less stringent underwriting standards, expanded coverage and strong competition among insurers.

[13]Claims-made policies cover claims reported during the year in which the policy is in effect. Occurrence-based policies cover claims arising out of events that occurred but may not have been reported during the year in which the policy was in effect. Most policies sold today are claims-made policies.

premium rates during the mid-1970s and mid-1980s, all states passed at least some laws designed to reduce medical malpractice premium rates. Some of these laws are designed to decrease insurers' losses on medical malpractice claims, while others are designed to more tightly control the premium rates insurers can charge. These changes make it difficult to predict how medical malpractice premiums might behave during future hard and soft markets.

This report includes a matter that Congress may want to consider as it looks for ways to improve the ability of Congress, state insurance regulators, and others to analyze the current and future medical malpractice insurance markets. Specifically, Congress may want to consider encouraging NAIC and state insurance regulators to identify and collect additional data necessary to evaluate the frequency,[14] severity,[15] and causes of losses on medical malpractice claims.

We received comments on a draft of this report from NAIC's Director of Research. The Director generally agreed with the report's findings and matters for congressional consideration, and provided technical comments that we have incorporated as appropriate. The Director's comments are discussed in greater detail at the end of this letter.

Background

Nearly all health care providers, such as physicians and hospitals, purchase insurance that covers expenses related to medical malpractice claims, including payments to claimants and legal expenses. The most common physician policies provide $1 million of coverage per incident and $3 million of coverage per year. Today the primary sellers of physician medical malpractice insurance are the physician-owned and/or operated insurance companies that, according to the Physician Insurers Association of America, insure approximately 60 percent of all physicians in private practice in the United States. Other health care providers may obtain coverage through commercial insurance companies, mutual coverage arrangements, or state-run insurance programs, or may self-insure (take responsibility for claims themselves). Most medical malpractice insurance policies offer claims-made coverage, which covers claims reported during

[14]Claim frequency is the number of claims per exposure unit, such as a single general practitioner.

[15]Claim severity is the average loss per claim.

the year in which the policy is in effect. A small and declining number of policies offer occurrence coverage, which covers all claims arising out of events that occurred during the year in which the policy was in effect.

Medical malpractice insurance operates much like other types of insurance, with insurers collecting premiums from policyholders in exchange for an agreement to defend and pay future claims within the limits set by the policy. Insurers invest the premiums they collect and use the income from those investments to reduce the amount of premium income that would have been required otherwise. Claims against a policyholder are recorded as expenses, or incurred losses, which are equal to the amount paid on those claims as well as the insurer's estimate of future losses on those same claims. The liability associated with the portion of these incurred losses that have not yet been paid by the insurer is collectively known as the insurer's loss reserve. In order to maintain financial soundness, insurers must maintain assets in excess of total liabilities—including loss reserves and reserves for premiums received but not yet earned[16]—to make up what is known as the insurer's surplus. State insurance departments monitor insurers' solvency by tracking, among other measures, the ratio of total annual premiums to this surplus. Medical malpractice insurers generally attempt to keep their surplus approximately equal to their annual premium income.

Medical malpractice insurers establish premium base rates for particular medical specialties within a state and sometimes for particular geographic regions within a state. Insurers may also offer discounts or add surcharges for the particular characteristics of policyholders, such as claim histories or whether they participate in risk-management programs. The premium rates are based on anticipated losses on claims and related expenses, expected investment income, the need to build a surplus, and, for for-profit insurers, the desire to earn a reasonable profit for shareholders. In most states the insurance regulators have the authority to approve or deny proposed changes to premium rates.

[16]Insurers collect premiums in advance for coverage during a future period of time, and as that period of time passes, those premiums are "earned." Premiums related to periods of time yet to pass are considered "unearned" and are a liability on the books of the insurer.

For several reasons, accurately predicting losses on medical malpractice claims is difficult. First, according to a national insurer association we spoke with, most medical malpractice claims take an average of more than 5 years to resolve, including discovering the malpractice, filing a claim, determining (through settlement or trial) payment responsibilities, if any, and paying the claim.[17] In addition, some claims may not be resolved for as long as 8 to 10 years. As a result, insurers often must estimate costs years in advance. Second, the range of potential losses is wide. Actuaries we spoke with told us that individual claims with similar characteristics can result in very different losses for the insurer, making it difficult to predict the ultimate cost of any single claim. Third, the predictive value of historical data is further limited by the often small pool of relevant policyholders. For example, a relevant pool of policyholders would be physicians practicing a particular specialty within a specific state and perhaps within a specific geographic area within that state. In smaller states, and for some of the less common but more risky specialties, this pool could be very small and provide only a limited amount of data that could be used to estimate future costs.

Medical malpractice insurance is regulated by state insurance departments and subject to state laws. That is, insurers selling medical malpractice insurance in a particular state are subject to that state's regulations for their operations within that state, and all claims within that state are subject to that state's tort laws. Insurance regulations can vary across states, creating differences in the way insurance rates are regulated. For example, one state insurance regulator we spoke with essentially let the insurance market determine appropriate rates, while another had an increased level of review, including approving specific company rates on a case-by-case basis. NAIC assists state insurance regulators in developing these regulations by providing guidance, model (or recommended) laws and guidelines, and information-sharing tools.

In response to concerns over rising premium rates, physicians, medical associations, and insurers have pushed for state and federal legislation that would, among other things, limit the amount of damages paid out on medical malpractice claims. A few states have passed legislation with such limitations over the past several years, and federal legislation is pending. On March 13, 2003, the House of Representatives passed the Help Efficient,

[17]Estimates of some individual insurers we spoke with ranged from around 3 years to over 5 years.

Accessible Low-Cost, Timely Healthcare (HEALTH) Act of 2003, which includes, among other things, a limit on certain types of damages in medical malpractice claims. On March 12, 2003, a similar bill of the same name was introduced in the Senate, but as of June 2003, no additional action had been taken.

Both the Extent of Increases in Medical Malpractice Premium Rates and the Rates Themselves Varied across Specialties and States

Beginning in 1999 and 2000, medical malpractice insurers in our seven sample states increased their premium rates[18] for the physician specialties of general surgery, internal medicine, and obstetrics/gynecology faster than they had since at least 1992. These specialties were the only ones for which data were available, and 1992 was the earliest year for which we could obtain comprehensive survey data.[19] However, both the extent of these changes and the level of the premium rates insurers charged varied greatly across medical specialties, states, and even areas within states. From 1999 through 2002, one large insurer raised rates more for internal medicine than for general surgery, while another raised rates 12 times more for general surgery than for internal medicine. Changes in premium base rates among some of the largest insurers in each state ranged from a reduction of about 9 percent for obstetricians and gynecologists insured by one California company to an increase of almost 170 percent for doctors in the

[18]In this report, premium rates are the base rates insurers submit to state regulators along with a schedule of potential deductions or additions related to the particular characteristics of policyholders. The actual premium rate insurers charge individual policyholders varies from the base rate. We could not determine the extent to which the actual premium rates charged varied from the base rates, but among some of the insurers we spoke with, the actual premium rates ranged from about 50 to 100 percent of the base rates over the past several years. Some market observers and participants also told us that the discounts have decreased over the last several years.

[19]All premium rate information in this report is based on survey data collected by the *Medical Liability Monitor*, a newsletter that, among other things, publishes the results of its annual surveys of the premium rates of medical malpractice insurers. Comprehensive survey data was available for years 1992 to 2002. The surveys, which are sent to medical malpractice insurers, request premium rates for each state or smaller region for a standard amount of coverage in three specialties—internal medicine, general surgery, and obstetrics/gynecology. The *Medical Liability Monitor* selected these in order to have data representative of low-, medium-, and high-risk specialties. In the survey results for 1999 through 2002, all 50 states were represented in the rate information that companies provided. The premium rates collected in the survey are base rates that do not reflect the discounts or the additional amounts insurers charge, so actual premium rates can vary from the premium rates given in the survey.

same specialty in one area of Pennsylvania.[20] At the same time, premium rates for the same amount of coverage for the same medical specialty varied by a factor of as much as 17 among states—that is, the rate in one state was 17 times higher than the rate in a different state.

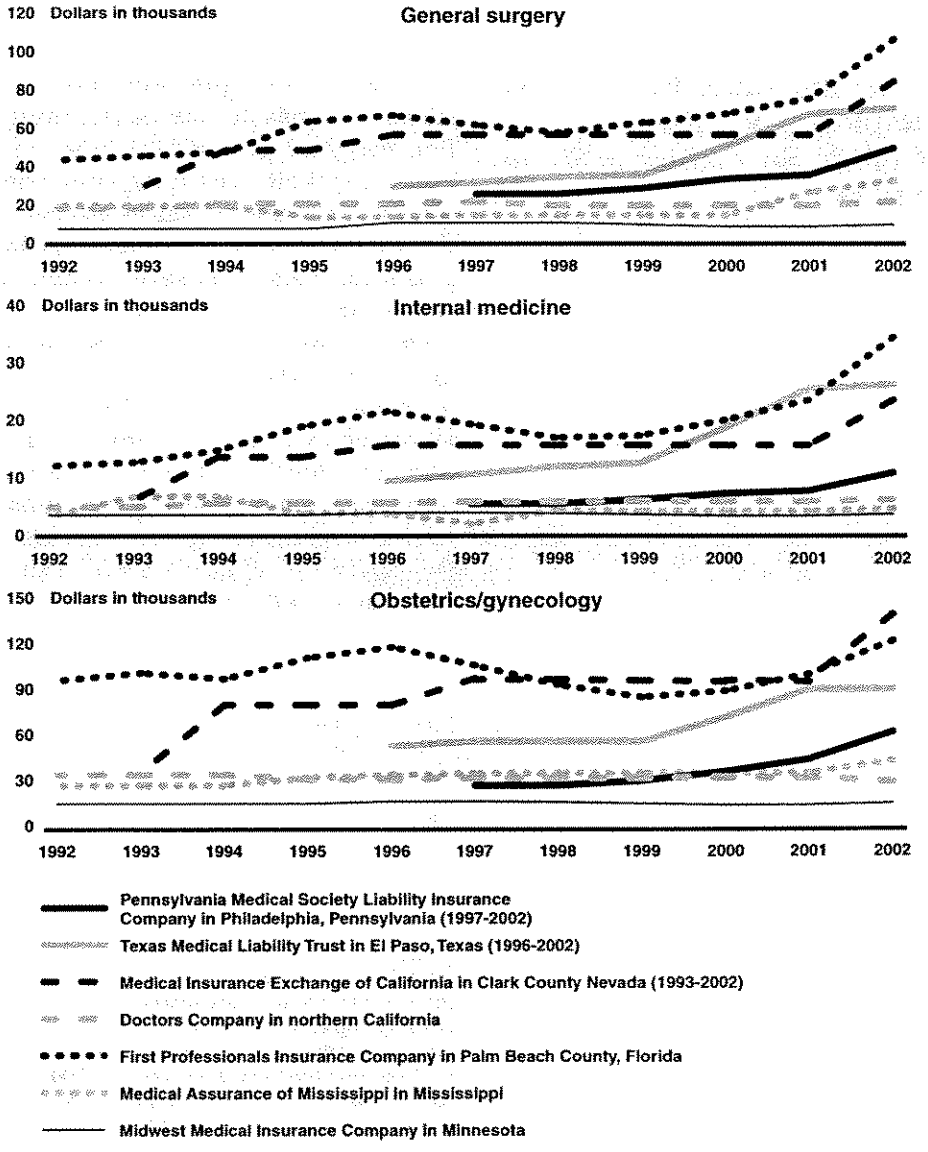
Premium Rates Have Grown Rapidly since 1998 for Certain Specialties in Some States

As figure 1 shows, premium base rates varied across our seven sample states from 1992 to 1998 but for most insurers remained relatively flat. Beginning in 1999 and 2000, however, most of these insurers began increasing their rates in larger increments. Many of the increases were dramatic, ranging as high as 165 percent, although some rates remained flat. Figure 2 shows the percentage increase in premium rates for the largest insurers in our seven sample states from 1999 through 2002.[21] In the Harrisburg area of Pennsylvania, for example, the largest insurer increased premium base rates dramatically for three specialties: obstetrics/gynecology (165 percent), general surgery (130 percent), and internal medicine (130 percent). At the same time, the consumer price index (CPI) increased by 10 percent. However, in California and Minnesota, premium base rates for the same specialties rose between 5 and 21 percent and in some cases fell slightly. The variations in the changes in premium base rates among our sample states appears to be consistent with the changes in states outside our sample, with insurers in some states raising premium rates rapidly after 1999 and insurers in other states raising them very little.

[20]In this report, premium rates shown for Pennsylvania include a surcharge for a mandatory professional liability catastrophe loss fund. Policies purchased from an insurer provide coverage up to a specific amount, and the loss fund then provides additional coverage. The amount required to be covered by insurers has been increasing and the amount covered by the loss fund has been decreasing. In 2002, insurers covered the first $500,000 of any claim, up to an annual limit of $1.5 million, while the loss fund covered an additional $400,000 per claim, up to an annual limit of $1.2 million.

[21]We determined the largest insurers in each of our seven sample states based on premiums written in 2001.

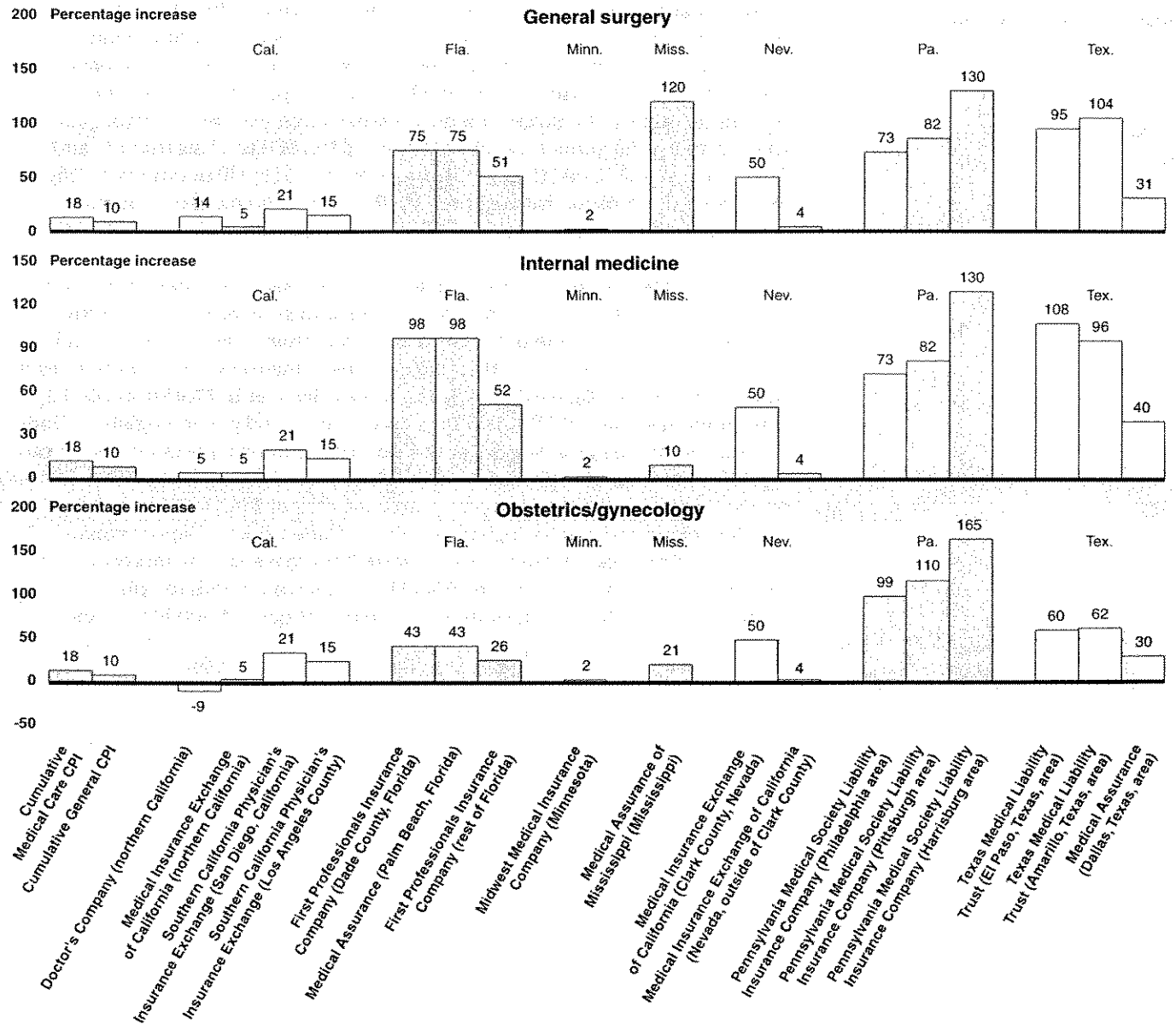
Figure 1: Premium Base Rates of the Largest Insurers in Seven Selected States for Three Medical Specialties, 1992–2002



Source: GAO analysis of annual surveys by the *Medical Liability Monitor*.

Note: Premium rates shown are annual premium rates for a claims-made policy with a cap of $1 million per incident and $3 million per year.

Figure 2: Percentage Changes in Premium Base Rates of the Largest Medical Malpractice Insurers in Seven Selected States for Three Medical Specialties, 1999–2002



Source: GAO analysis of annual surveys by the *Medical Liability Monitor.*

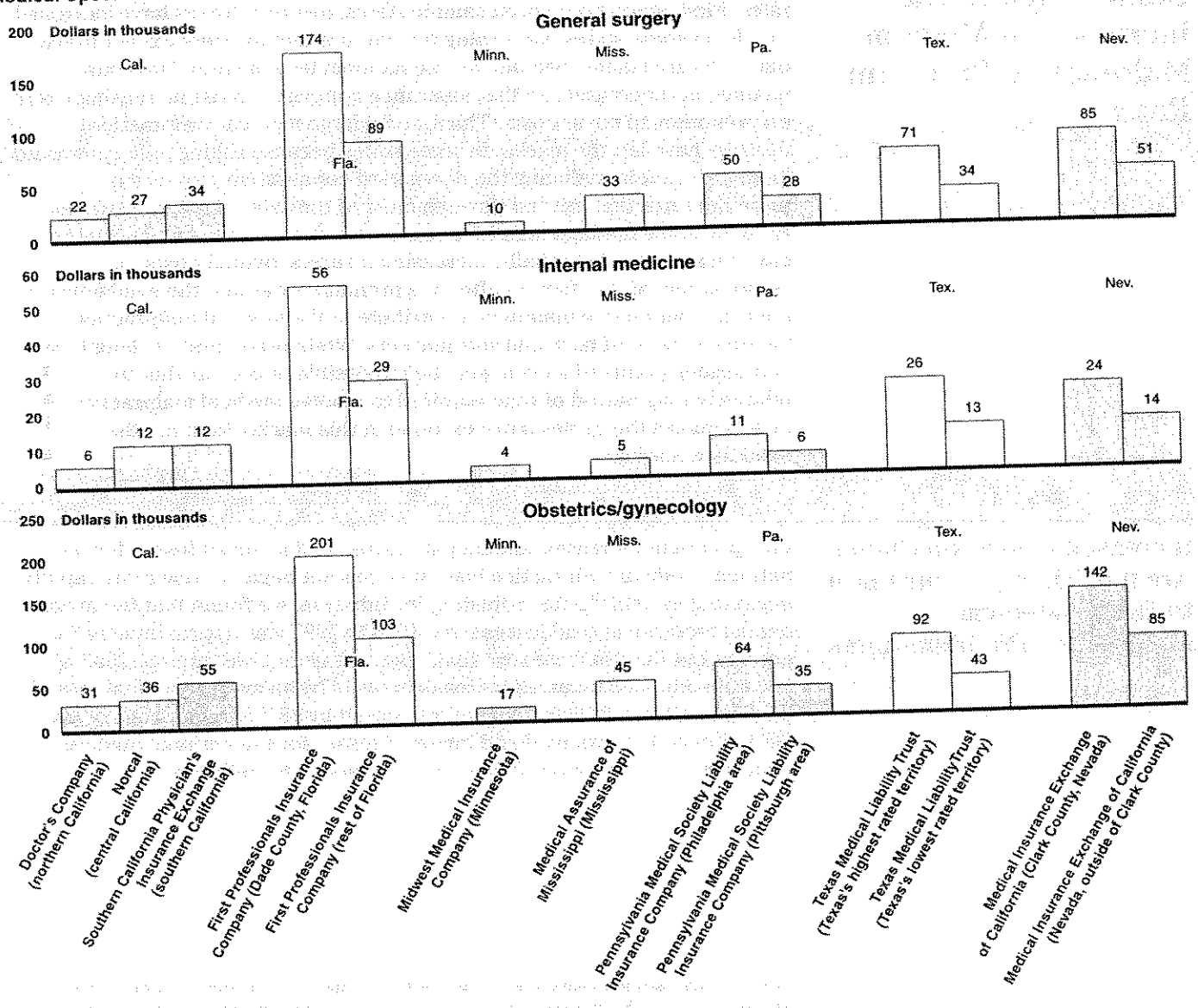
The Level of Premium Rates Also Varied across Specialties and States

We found that premium rates quoted by insurers in our seven sample states varied across medical specialties and states. According to some of the insurers and actuaries we spoke with, the differences in rates reflect the costs associated with medical malpractice claims against physicians in particular specialties. Specialties with a high risk of large or frequent losses on medical malpractice claims will have higher premium rates. For example, in 2002 the largest medical malpractice insurer in Texas quoted a base rate for the same level of coverage of $92,000 to obstetricians and gynecologists, $71,000 to general surgeons, and $26,000 to internists. Figure 3 shows the premium rates quoted by the largest medical malpractice insurers in our sample states for these three specialties.[22]

Premium rates quoted by insurers in our seven sample states for the same medical specialty also varied across states and geographic areas within states (see fig. 3). Some of the insurers and actuaries we spoke with told us that these variations also reflect differences in insurers' loss experiences in those venues. As figure 3 shows, the largest insurer in Florida quoted a premium base rate of $201,000 for obstetricians and gynecologists in Dade County, while the largest insurer in California quoted a premium based rate of $36,000 for similar physicians in northern California. Within Florida, the same large insurer quoted a premium base rate of $103,000 for obstetricians and gynecologists outside of Dade County—approximately 51 percent of the Dade County rate. Within Pennsylvania, the largest insurer quoted a premium base rate of $64,000 for doctors in Philadelphia—approximately 83 percent more than the rate it quoted outside the city.

[22]Not all of the insurers included in figs. 3 and 4 are the same, as data that would have allowed us to complete the same analyses for all of the insurers was not available.

Figure 3: 2002 Medical Malpractice Insurance Premium Base Rates of the Largest Insurers in Seven Selected States for Three Medical Specialties



Source: GAO analysis of annual surveys by the *Medical Liability Monitor*.

Note: Premium rates shown are annual premium base rates for coverage under a claims-made policy with a cap of $1 million per incident and $3 million per year.

Multiple Factors Have Contributed to the Increases in Medical Malpractice Premium Rates

Insurers' losses, declines in investment income, a less competitive climate, and climbing reinsurance rates have all contributed to rising premium rates. First, among our seven sample states, insurers' losses have increased rapidly in some states, increasing the amount that insurers expect to pay out on future claims. Second, on the national level insurers' investment income has decreased, so that insurance companies must increasingly rely on premiums to cover costs. Third, some large medical malpractice insurers have left the market in some states because selling policies was no longer profitable, reducing the downward competitive pressure on premium rates that existed through most of the 1990s. Last, reinsurance rates for some medical malpractice insurers in our seven sample states have increased substantially, increasing insurers' overall costs. In combination, all the factors affecting premium rates and the availability of medical malpractice insurance contribute to the medical malpractice insurance cycle of hard and soft markets. While predicting the length, size and turning points of a cycle may be impossible, it is clear that the relatively long period of time required to resolve medical malpractice claims makes the cycles more extreme in this market than in other insurance markets.

Increased Losses on Claims Are the Primary Contributor to Higher Medical Malpractice Premium Rates

Like premium increases, annual paid losses and incurred losses for the national medical malpractice insurance market began to rise more rapidly beginning in 1998.[23] After adjusting for inflation, we found that the average annual increase in paid losses from 1988 to 1997 was approximately 3.0 percent but that this rate rose to 8.2 percent from 1998 through 2001. Inflation-adjusted incurred losses decreased by an average annual rate of 3.7 percent from 1988 to 1997 but increased by 18.7 percent from 1998 to 2001. Figure 4 shows paid and incurred losses for the national medical malpractice market from 1975 to 2001, adjusted for inflation.

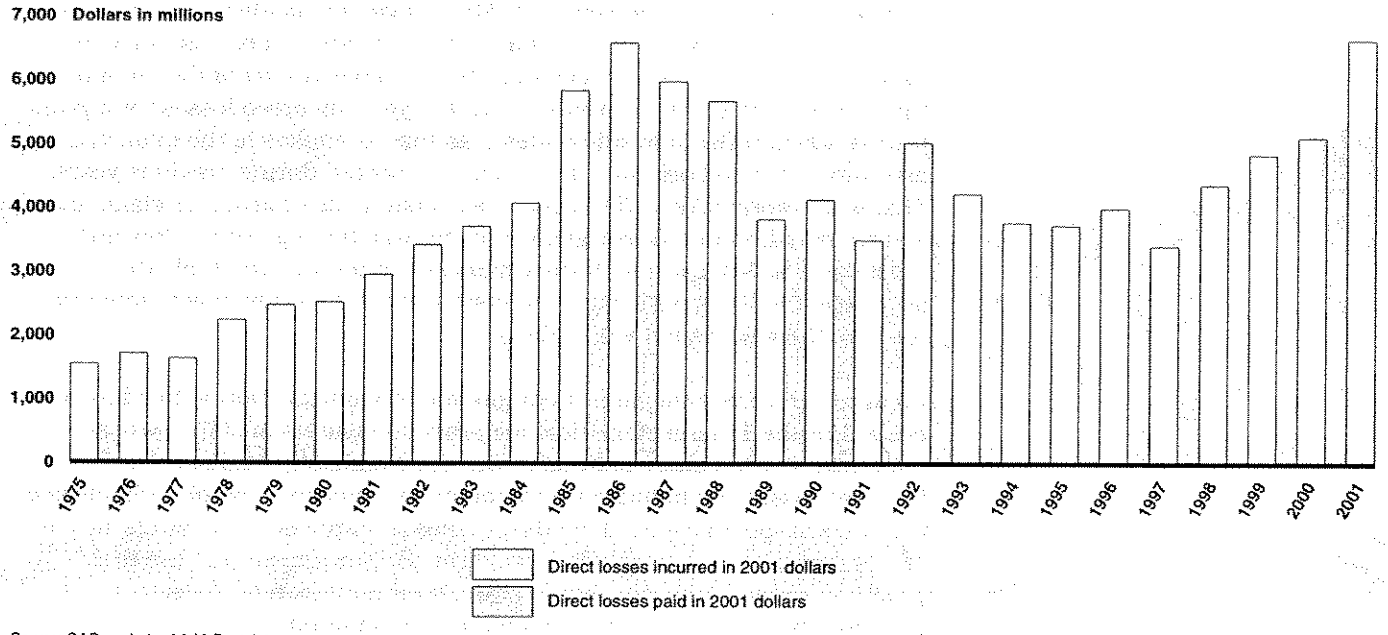
[23]Over the past several years, some large medical malpractice insurers in some states have become insolvent. Such insolvencies may have caused aggregate paid losses in those states to be understated to an unknown extent, because while the insurer may still be paying medical malpractice claims, they may no longer be reporting those payments to NAIC or state regulators.

Paid and incurred losses give different pictures of an insurer's loss experience, and examining both can help provide a better understanding of an insurer's losses.[24] Paid losses are the cash payments an insurer makes in a given year, irrespective of the year in which the claim giving rise to the payment occurred or was reported. Most payments made in any given year are for claims that were reported in previous years. In contrast, incurred losses in any single year reflect an insurer's expectations of the amounts that will be paid on claims reported in that year. Incurred losses for a given year will also reflect any adjustments an insurer makes to the expected amounts that must be paid out on claims reported during previous years. That is, as more information becomes available on a particular claim, the insurer may find that the original estimate was too high or too low and must make an adjustment. If the original estimate was too high, the adjustment will decrease incurred losses, but if the original estimate was too low, the adjustment will increase them.

Incurred losses are the largest component of medical malpractice insurers' costs. For the 15 largest medical malpractice insurers in 2001—whose combined market share nationally was approximately 64.3 percent—incurred losses (including both payments to plaintiffs to resolve claims and the costs associated with defending claims) comprised, on average, around 78 percent of the insurers' total expenses. Because insurers base their premium rates on their expected costs, their anticipated losses will therefore be the primary determinant of premium rates.

[24]According to at least one insurer, the best measure of the results from policies may be the ultimate paid losses on the claims reported that year, which insurers could compare to the premiums charged for the policies in question. However, as paid losses are not entirely known for at least 3 to 5 years after they claims are reported, such information is not completely available for the years 1998 through 2002.

Figure 4: Inflation-Adjusted Paid and Incurred Losses for the National Medical Malpractice Insurance Market, 1975–2001 (Using the CPI, in 2001 Dollars)

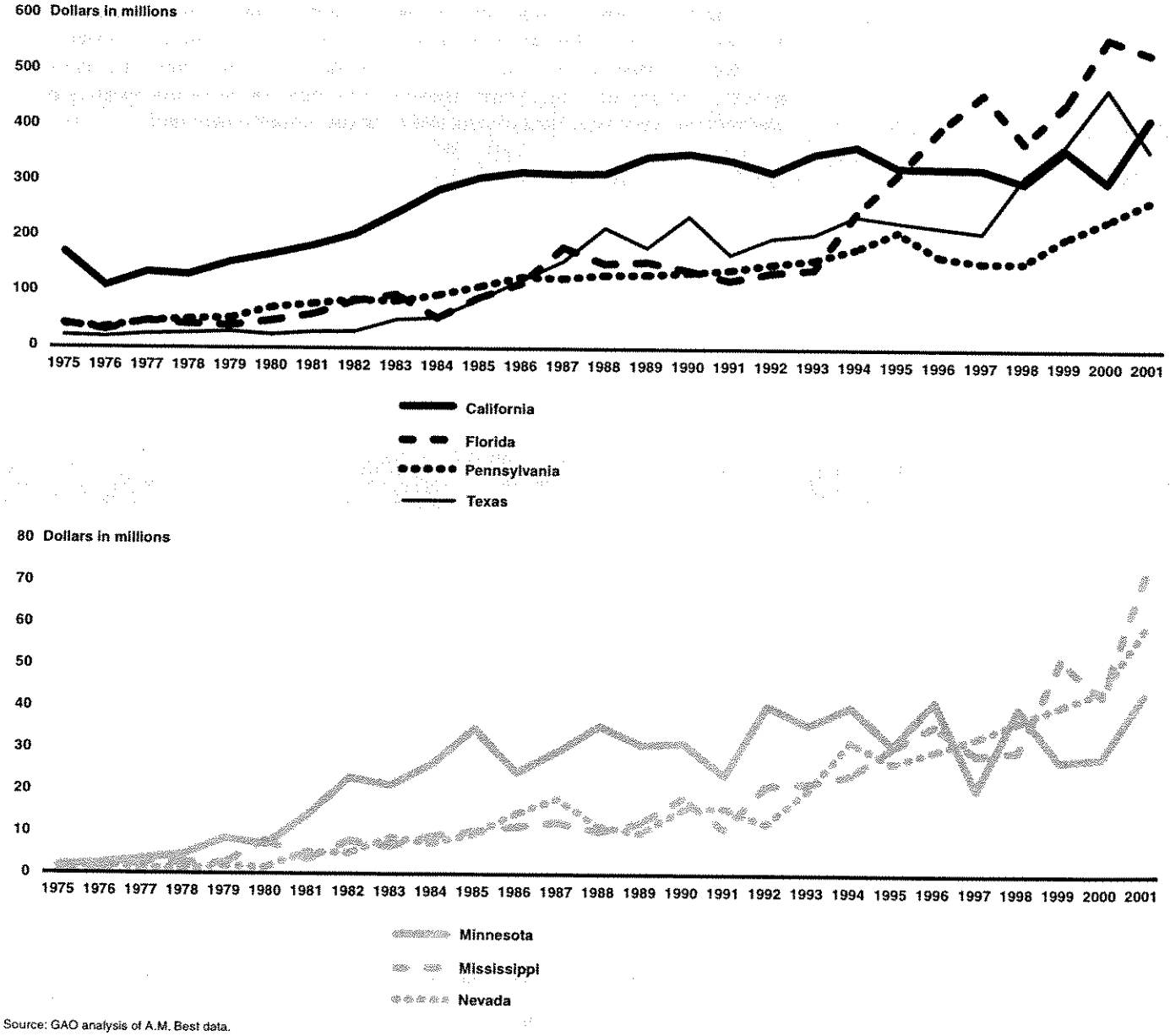


Source: GAO analysis of A.M. Best data.

The recent increases in both paid and incurred losses among our seven sample states varied considerably, with some states experiencing significantly higher increases than others. From 1998 to 2001, for example, paid losses in Pennsylvania and Mississippi increased by approximately 70.9 and 142.1 percent, respectively, while paid losses in California and Minnesota increased by approximately 38.7 and 8.7 percent, respectively (see fig. 5).[25] Because paid losses in any single year reflect primarily claims reported during previous years, these losses may not be representative of claims that were reported during the year the losses were paid.

[25]To better show annual changes in the states with smaller total losses, in both figs. 5 and 6 we have separated our seven sample states into two groups, those with smaller total losses and those with greater total losses.

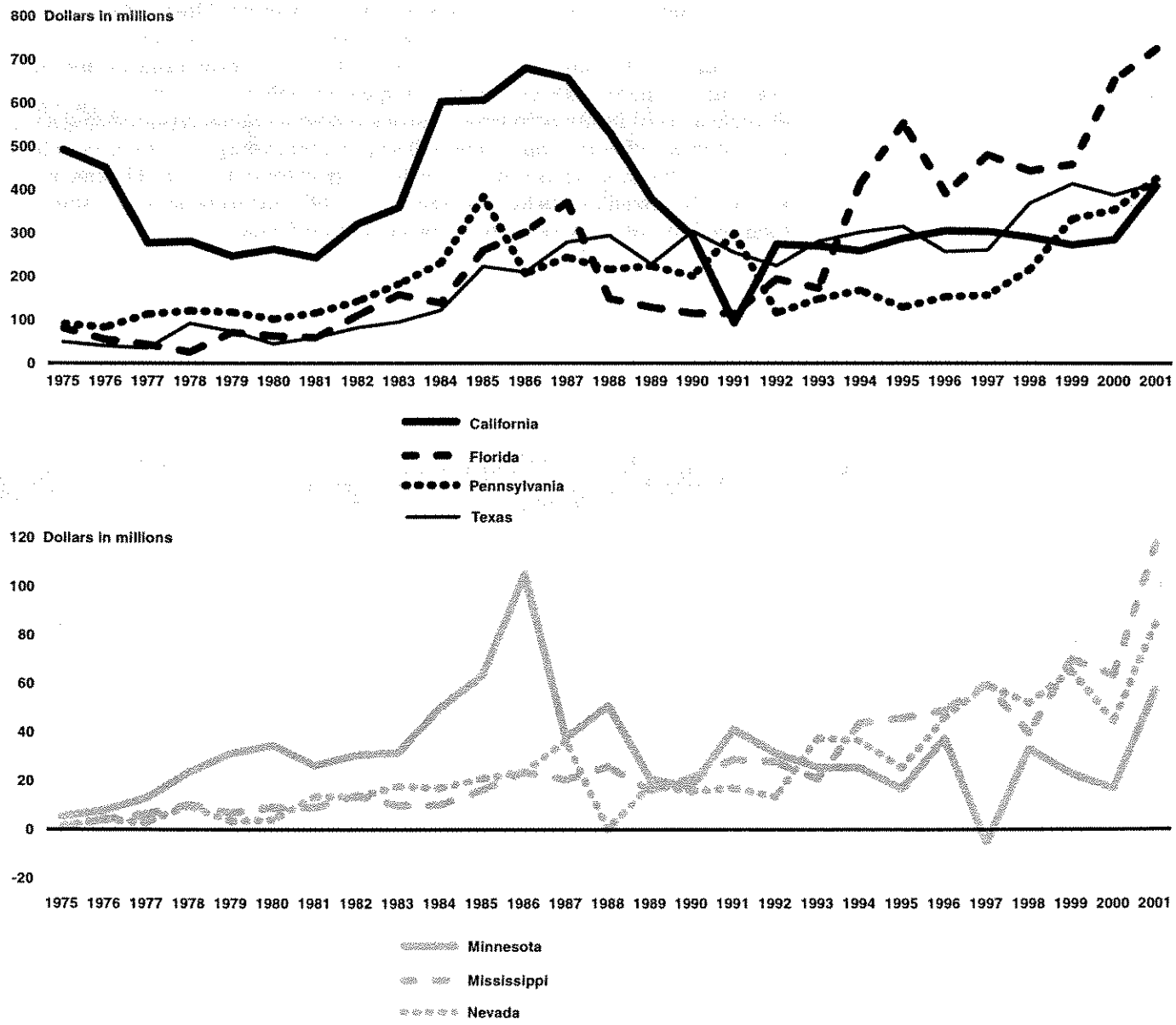
Figure 5: Inflation-Adjusted Aggregate Paid Losses for Medical Malpractice Insurers in Seven Selected States, 1975-2001 (Using the CPI, in 2001 Dollars)



Source: GAO analysis of A.M. Best data.

From 1998 to 2001, aggregate incurred losses increased by large amounts in almost all of our seven sample states. As shown in figure 6, the highest rates of increase in incurred losses over that period were experienced by insurers in Mississippi (197.5 percent) and Pennsylvania (97.2 percent). Even in California and Minnesota, states with lower paid losses from 1998 through 2001, insurers experienced increases in incurred losses of approximately 40.5 and 73.2 percent, respectively, over the same period. As noted above, incurred losses in any single year reflect insurers' expectations of future paid losses associated with claims reported in the current year—that is, claims that will be paid, on average, over the next 3 and one-half years (according to one industry association). And because insurers' incurred losses have increased recently, insurers are expecting their paid losses to increase over the next several years.

Figure 6: Inflation-Adjusted Aggregate Incurred Losses for Medical Malpractice Insurers in Seven Selected States, 1975-2001 (Using the CPI, in 2001 Dollars)



Source: GAO analysis of A.M. Best data.

Increased Losses Lead to Higher Premium Rates

According to actuaries and insurers we spoke with, increased paid losses raise premium rates in several ways. First, higher paid losses on claims reported in current or previous years can increase insurers' estimates of what they expect to pay out on future claims. Insurers then raise premium rates to match their expectations. In addition, large losses (particularly paid losses) on even one or a few individual claims can make it harder for insurers to predict the amount they might have to pay on future claims. Some insurers and actuaries we spoke with told us that when losses on claims are hard to predict, insurers will generally adopt more conservative expectations regarding losses—that is, they will assume losses will be toward the higher end of a predicted range of losses. Further, large losses on individual claims can raise plaintiffs' expectations for damages on similar claims, ultimately resulting in higher losses across both claims that are settled and those that go to trial. As described above, this tendency in turn can lead to higher expectations of future losses and thus to higher premium rates. Finally, an increase in the percentage of claims on which insurers must make payments can increase the amount that insurers expect to pay on each policy, resulting in higher premium rates. That is, insurers expecting to pay out money on a high percentage of claims may charge more for all policies in order to cover the expected increases.

Comprehensive Data on the Composition and Causes of Increased Losses Were Lacking

A lack of comprehensive data at the national and state levels on insurers' medical malpractice claims and the associated losses prevented us from fully analyzing both the composition and causes of those losses at the insurer level.[26] For example, comprehensive data that would have allowed us to fully analyze the severity of medical malpractice claims at the insurer level on a state-by-state basis did not exist. To begin with, data submitted by insurers to NAIC on the number of claims reported to insurers are not broken out by state. Rather, insurers that operate in a number of states report the number of claims for all their medical malpractice insurance policies nationwide. Also, while NAIC does collect data that can be used to measure the severity of claims paid in a single year (number of claims per state), NAIC began this effort only in 2000. As a result, we could not gather enough data to examine trends in the severity of paid claims from 1998 to 2002 at the insurer level. Similarly, comprehensive data did not exist that would have allowed us to analyze claim frequency on a state-by-state basis. As noted above, data that insurers submit to NAIC on the number of claims reported were not broken out by state prior to 2000. In addition, insurers do

[26]Some additional data on medical malpractice claims, not connected to individual insurers, were available and were analyzed in a separate report. See GAO-03-836.

not submit information on the number of policies in effect or the number of health care providers insured. Finally, medical associations we spoke with in our sample states had not compiled accurate data on the number of physicians practicing within those states. As a result, we could not analyze changes in the frequency of medical malpractice claims in our sample states at the insurer level.

Data that would have allowed us to analyze how losses were divided between settlements and trial verdicts or between economic and noneconomic damages were also not available. First, insurers do not submit information to NAIC on the portion of losses paid as part of settlements and the portion paid as the result of a trial verdict, and no other comprehensive source of such information exists. However, all eight insurers and one of the trial lawyers' associations we spoke with provided certain estimates about claims. The estimates of three insurers on the percentage of claims resulting in trial verdicts ranged from 5 to 7 percent. The estimates of four insurers and 1 state trial lawyers' association of the percentage of trial verdicts being decided in favor of the insured defendant ranged from 70 to 86 percent. The estimates of four insurers and one state trial lawyers' association of the portion of claims resulting in payment to the plaintiff ranged from 14 to 50 percent. Second, no comprehensive source of information exists on the breakdown of losses between economic damages, such as medical costs and lost wages, and noneconomic damages, such as compensation for pain and suffering. Several of the insurers and trial lawyers' associations we spoke with noted that settlement amounts are not formally divided between these two types of damages and that consistent, comprehensive information on trial judgments is not collected. Furthermore, while judgment amounts obtained at trial may be large, several of the insurers we spoke with said that they most often do not pay amounts beyond a policyholder's policy limits.[27] Data on the final amounts insurers pay out on individual judgments are not collected, although they are reported in the aggregate as part of paid losses in insurers' financial statements.

[27]Some insurers we spoke with told us that they can be liable for amounts beyond a policy's limits if the policyholder requests that the insurer settle with the plaintiff for an amount equal to or less than the policy limit, but the insurer takes the case to trial, loses, and a judgment is entered in an amount greater than the policy limits. Insurers in California, Florida, and Texas told us that payments beyond policy limits posed significant issues in their states.

While losses on medical malpractice claims increase as the cost of medical care and the value of lost wages rise, losses in some states have far outpaced such inflation. Insurance, legal, and medical industry officials we spoke with suggested a number of potential causes for such increases. These potential causes included a greater societal propensity to sue; a "lottery mentality," where a lawsuit is seen as an easy way to get a large sum of money; a sicker, older population; greater expectations for medical care because of improved technology; and a reduced quality of care and the breakdown of the doctor-patient relationship owing, for example, to factors such as the increasing prevalence of managed care organizations. While we could not analyze such potential causes for increased losses, understanding them would be useful in developing strategies to address increasing medical malpractice premium rates. That is, because losses on claims have such a profound effect on premium rates, understanding the reasons those losses have increased could make it easier to devise actions to control the rise in premium rates.[28]

Medical Malpractice Insurers' Investment Income Has Decreased

State laws restrict medical malpractice insurers to conservative investments, primarily bonds. In 2001, the 15 largest writers of medical malpractice insurance in the United States[29] invested, on average, around 79 percent of their investment assets in bonds, usually some combination of U.S. Treasury, municipal, and corporate bonds. While the performance of some bonds has surpassed that of the stock market as a whole since 2000, annual yields on selected bonds since 2000 have decreased steadily since then (table 1).

[28]State laws for resolving medical malpractice claims may also affect the extent to which losses increase in a particular state. The effect of state laws on losses and premium rates is discussed in greater detail in GAO-03-836.

[29]As reported by A.M. Best. These insurers included a combination of commercial companies and physician-owned nonprofit insurers. Some of these insurers sold more than one line of insurance, and changes in returns on investments might not be reflected equally in the premium rates in each of those lines.

Table 1: Annual Yields for Selected Bonds, 1995–2002, and Average Return on Investment Assets, 1997–2002, for the 15 Largest Writers of Medical Malpractice Insurance in 2001

	1995	1996	1997	1998	1999	2000	2001	2002
5-Year U.S. Treasury securities	6.38	6.18	6.22	5.15	5.55	6.16	4.56	3.82
10-Year U.S. Treasury securities	6.57	6.44	6.35	5.26	5.65	6.03	5.02	4.61
5-Year AAA-rated municipal bonds	4.57	4.41	4.34	3.97	4.18	4.72	3.63	3.16
10-Year AAA-rated municipal bonds	5.04	4.91	4.75	4.31	4.62	4.97	4.28	4.05
5-Year AAA-rated corporate bonds	6.71	6.49	6.52	5.61	6.17	6.96	5.24	4.45
10-Year AAA-rated corporate bonds	6.93	6.77	6.66	5.74	6.38	7.09	5.92	5.42
Average return on investment assets for 15 largest insurers	[a]	[a]	5.6	5.5	5.2	5.6	5.0	4.0[b]

Source: GAO analysis of data from A.M. Best, the Federal Reserve, and the Bond Market Association.

[a]Data for 1995 and 1996 were not readily available.

[b]Complete information was not available for the same companies in 2002. The 2002 average return on investment was estimated based on the average bond yield and the average ratio of the bond yield to the insurer's return on investment.

We analyzed the average investment returns of the 15 largest medical malpractice insurers of 2001 and found that the average return fell from about 5.6 percent in 2000 to an estimated 4.0 percent in 2002. However, none of the companies experienced a net loss on investments at least through 2001, the most recent year for which such data were available. Additionally, almost no medical malpractice insurers overall experienced net investment losses from 1997 to 2001.

Medical malpractice insurers are required by state insurance regulations to reflect expected investment income in their premium rates. That is, insurers are required to reduce their premium rates to consider the income they expect to earn on their investments. As a result, when insurers expect their returns on investments will be high, as returns were during most of the 1990s, premium rates can remain relatively low because investment income covers a larger share of losses on claims. Conversely, when insurers expect their returns on investments will be lower—as returns have been since around 2000—premium rates rise in order to cover a larger share of losses. During periods of relatively high investment income, insurers can lose money on the underwriting portion of their business yet

still make a profit. That is, losses from medical malpractice claims and the associated expenses may exceed premium income, but income from investments can still allow the insurer to operate profitably. Insurers are not allowed to increase premium rates to compensate for lower-than-expected returns on past investments but must consider only prospective income from investments.

None of the insurers that we consulted regarding this issue told us definitively how much the decreases in investment income had increased premium rates. But we can make a rough estimate of the relationship between return on investment and premium rates. When investment income decreases, holding all else constant, income from premium rates must increase by an equal amount in order for the insurer to maintain the same overall level of income. Thus the total amount of investment assets relative to premium income determines how much rates need to rise to compensate for lost investment income. Table 2 presents a hypothetical example. An insurer has $100,000 in investment assets and in the previous year received $25,000 in premium income, for a ratio of investment assets to premium income of 4 to 1. If the return on investments drops 1 percentage point and all else remains constant, the insurer must raise premium rates by 4 percent in order to compensate for the reduced investment income. If the return on investments drops by 2 percentage points, premium rates must rise by 8 percent to compensate.

Table 2: Hypothetical Example of How Premium Rates Change When the Return on Investments Falls

	Example 1	Example 2	Example 3
(a) Total investment assets	$100,000	$100,000	$100,000
(b) Original total premium income	$25,000	$25,000	$25,000
(c) Percentage point drop in return on investments	1%	2%	3%
(d) Drop in investment income [(a) x (c)]	$1,000	$2,000	$3,000
Total premium income required to make up for drop in investment income [(b) + (d)]	$26,000	$27,000	$28,000
Percentage increase in premium income required [(d) / (b) x 100]	4%	8%	12%

Source: GAO analysis.

Note: The examples given assume that all else holds constant and that the insurer must obtain the full amount of additional funds required in the following year, even though the insurer would earn interest on those funds and thus would not need to increase premium rates by the full amount. Such an assumption may overstate the extent to which premium rates must be increased. The examples also do not take into account the fact that insurers look prospectively at trends in interest rates when estimating their anticipated investment income. By not taking into account a downward trend in interest rates, such as the one that has existed since 2000, our examples may understate the needed increase.

This relationship can be applied to the 15 largest medical malpractice insurers—countrywide—from 2001. Data show that in 2001 the insurers' total investment assets were, on average, around 4.5 times as large as the amount of premium income they earned for that year. Applying the relationship established above and holding other factors constant, a drop of 1 percentage point in return on investments would translate into roughly a 4.5 percent increase in premium rates.[30] As a result, if nothing else changed, the approximately 1.6 percentage point drop in the return on investments these insurers experienced from 2000 through 2002 would have resulted in an increase in premium rates of around 7.2 percent over the same 2-year period.

[30]Insurers in states where it takes more time to resolve medical malpractice claims would be more affected by changes in interest rates than insurers in states where it takes less time to resolve claims.

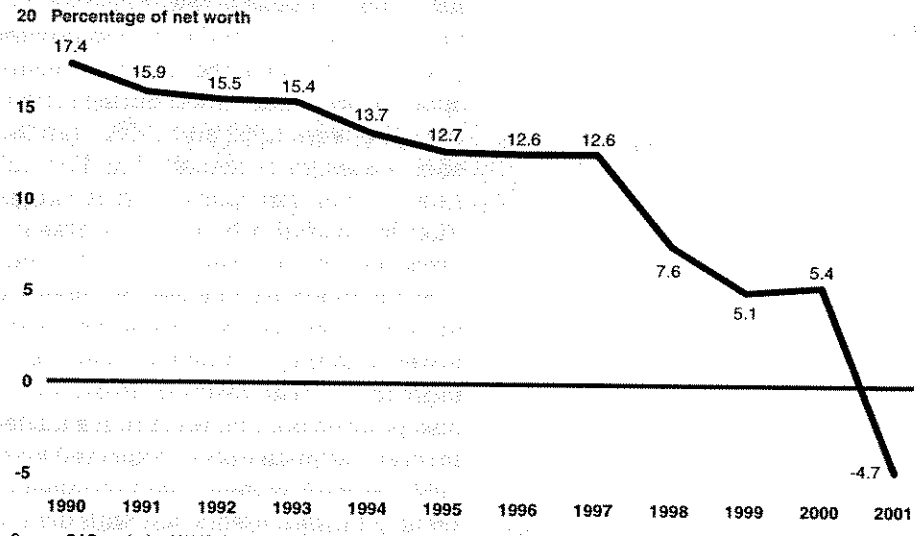
Downward Pressure on Premium Rates Has Decreased as Profitability Has Declined

Since 1999, the profitability of the medical malpractice insurance market as a whole has declined—even with increasing premium rates—causing some large insurers to pull out of this market, either in certain states or nationwide. Because fewer insurers are offering this insurance, there is less price competition and thus less downward pressure on premium rates. According to some industry and regulatory officials in our seven sample states, price competition during most of the 1990s kept premium rates from rising between 1992 and 1998, even though losses generally did rise. In some cases, rates actually fell. For example, during this period premium rates for obstetricians and gynecologists covered by the largest insurer in Florida—a state where these physicians are currently seeing rapid premium rate increases—actually decreased by approximately 3.1 percent. Some industry participants we spoke with told us that, in hindsight, premium rates charged by some insurers during this period may have been lower than they should have been and, after 1998, began rising to a level more in line with insurers' losses on claims. Some industry participants also pointed out that this pricing inadequacy was masked to some extent by insurers' adjustments to expected losses on claims reported during the late 1980s as well as their high investment income. For many insurers the incurred losses associated with the policies sold during the late 1980s turned out to be higher than the actual losses for the same policies, resulting in high levels of reserves. During the 1990s, as insurers eliminated these redundant reserves by adjusting their current loss reserves for these previous overestimates, current calendar year incurred losses fell and reported income increased. These adjustments, together with relatively high levels of investment income, allowed insurers to keep premium rates flat and still remain profitable.

Selling Medical Malpractice Insurance Has Become Less Profitable

Beginning in the late 1990s, medical malpractice insurers as a whole began to see their profits fall. Figure 7 shows the return on surplus—also called return on equity—for the medical malpractice insurance industry as a whole. Profitability began declining faster in 1998 and in 2001 dropped considerably even as premium rates were increasing in many states, resulting in a negative rate of return, or loss. Some of the factors pushing premium rates upward were also factors in insurers' declining profitability: higher losses on medical malpractice claims, higher reinsurance costs, and falling investment income.

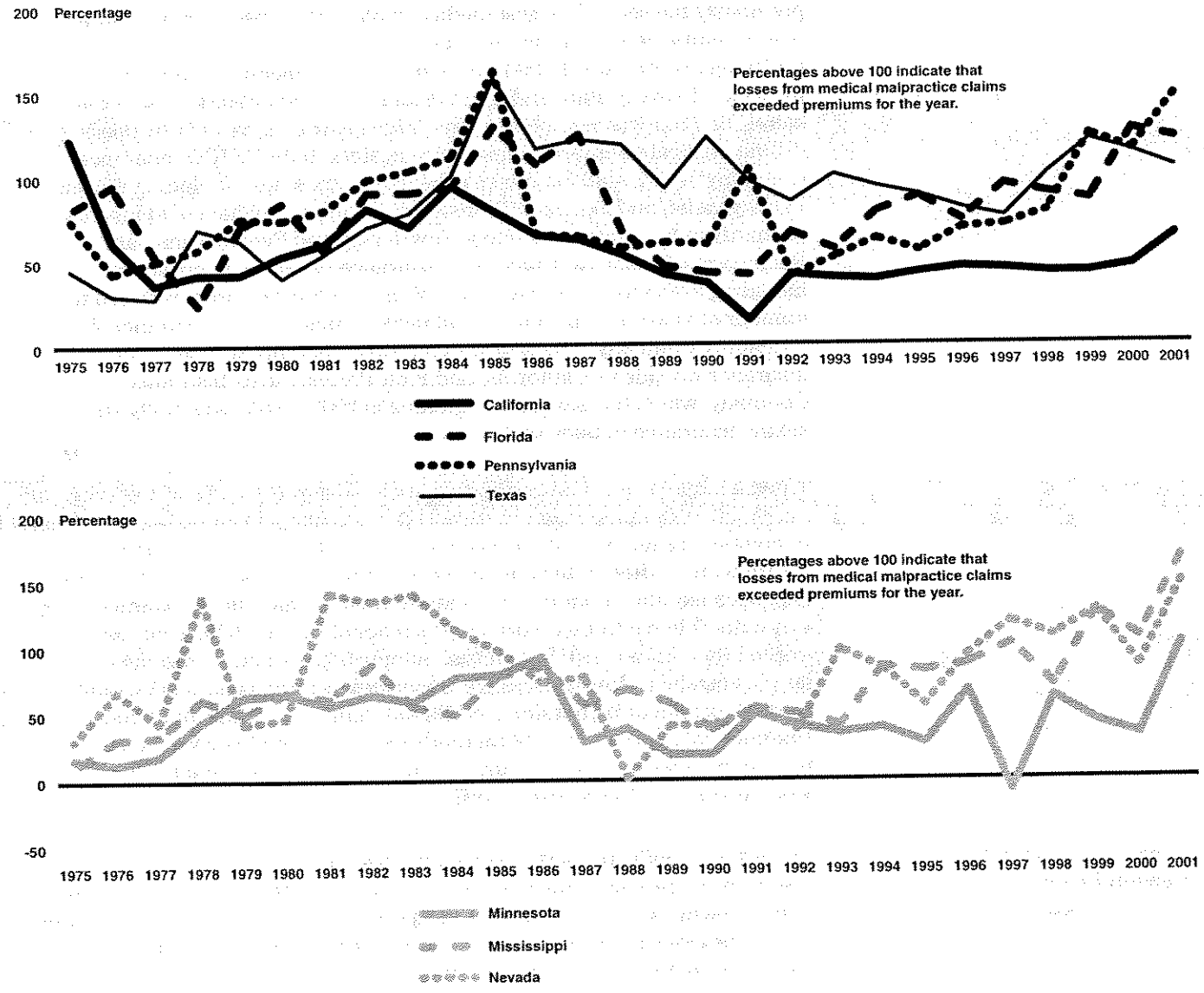
Figure 7: Net Profit or Loss as a Percentage of Net Worth for Medical Malpractice Insurance Companies Nationwide, 1990–2001



Source: GAO analysis of NAIC data.

Medical malpractice insurers in some of our sample states have experienced particularly low levels of profitability since around 1998 (see fig. 8). The loss ratio reported here is the ratio of incurred losses, not including other expenses (often referred to as loss adjustment expenses) related to resolving those claims, to the amount of premiums earned in a given year. Loss ratios above 100 percent indicate that an insurer has incurred more losses than premium payments, a sign of declining profitability. Loss ratios in all seven sample states have increased since 1998, and except for California, all had loss ratios of more than 100 percent for 2001.

Figure 8: Aggregate Incurred Losses as a Percentage of Premiums Earned for Medical Malpractice Insurers in Seven Selected States, 1975–2001



Source: GAO analysis of A.M. Best data.

Note: Incurred losses used in this figure do not include other expenses related to resolving claims or loss adjustment expenses.

As Profits Have Fallen, Insurers Have Left the Medical Malpractice Market

This declining profitability has caused some large insurers either to stop selling medical malpractice policies altogether or to reduce the number they sell. For example, beginning in 2002 the St. Paul Companies—previously the second-largest medical malpractice insurer in the United States—stopped writing all medical malpractice insurance because of declining profitability. In 2001, St. Paul had sold medical malpractice insurance in every state and was the largest or second-largest seller in 24 states. St. Paul was not alone. Other large insurers have also stopped selling medical malpractice insurance in since 1999: PHICO Insurance Company, which sold insurance primarily in six states, including Florida, Pennsylvania, and Texas; MIIX Insurance Company, which sold insurance primarily in five states, including New Jersey and Pennsylvania; and Reciprocal of America, which sold insurance primarily in six states, including Alabama, Mississippi, and Virginia. Other insurers reduced the number of states in which they sold medical malpractice insurance: SCPIE Indemnity Company, which in March 2003 essentially stopped selling insurance outside of California, and First Professionals Insurance Company, which has said that beginning in 2003 it will essentially stop selling insurance outside of Florida.

When a large insurer leaves a state insurance market, the supply of medical malpractice insurance decreases, and the remaining insurers may not need to compete as much on the basis of price. In addition, the remaining insurers are limited in the amount of insurance they can supply to fill the gap, because state insurance regulations limit the amount of insurance they can write relative to their surplus (the amount by which insurers' assets exceed their liabilities). For mutual, nonprofit insurers, increasing the surplus can be a slow process, because surplus must generally be built through profits or by obtaining additional funds from policyholders. Commercial insurers can obtain funds through capital markets, but even then, convincing investors to invest funds in medical malpractice insurance when profits are falling can be difficult.

Remaining Insurers Have Increased Prices to Reflect Expected Losses

According to industry participants and observers, as the competitive pressures on premium rates decreased, it appears that insurers were able to more easily and more quickly raise premium rates to a level more in line with their expected losses. That is, absent competitive pressure that may have caused insurers to keep premium rates at lower levels, which in hindsight were perhaps too low for the ultimate losses the insurers would have to pay, it appears that insurers were able to raise premium rates to match their loss expectations. As noted earlier, losses increased to a great

extent in some states, and thus some insurers may have increased premium rates dramatically.

While it appears clear that a reduction in price competition has allowed insurers to more easily and more quickly increase premium rates to a level more in line with insurers' expected losses, we identified at least three factors that seem to suggest that these premium rates are not inconsistent with expected losses. First, if the higher premium rates were above what was justified by insurers' expected losses, profitability would be increasing. But profits are not increasing, indicating that insurers are not charging and profiting from excessively high premium rates. Second, according to some industry participants we spoke with, physician-owned insurers have little incentive to overcharge their policyholders because those insurers generally return excess earnings to their policyholders in the form of dividends. Third, in most states the insurance regulators have the authority to deny premium rate increases they deem excessive. While the information that state regulators require insurers to submit as justification for premium rate increases varies across states, in general it includes data on expected losses.

Reinsurance Premium Rates Have Increased

A further reason for recent increases in medical malpractice premium rates in our seven sample states was that the cost of reinsurance for these insurers has also increased, increasing the total expenses that premium and other income must cover. Insurers in general purchase reinsurance, or excess loss coverage, to protect themselves against large unpredictable losses. Medical malpractice insurers, particularly smaller insurers, depend heavily on reinsurance because of the potential high payouts on medical malpractice claims.

Reinsurance industry officials and medical malpractice insurers we spoke with told us that reinsurance premium rates have increased for two reasons. First, reinsurance rates overall have increased as a result of reinsurers' losses related to the terrorist attacks of September 11, 2001. Second, reinsurers have seen higher losses from medical malpractice insurers and have raised rates to compensate for the increased risk associated with providing reinsurance to the medical malpractice market. Some insurers and industry participants told us that reinsurance premium rates had risen substantially since 1998, with the increases ranging from 50 to 100 percent. Other insurers told us that in order to keep their reinsurance premium rates down, they increased the dollar amount on any loss at which reinsurance would begin, essentially increasing the

deductible. Thus, while reinsurance rates may not have increased, the amount of risk the medical malpractice insurers carry did. One insurer estimated that while its reinsurance rates had increased approximately 50 percent from 2000 to 2002, this increase had resulted in only a 2 to 3 percent increase in medical malpractice premium rates.

The Medical Malpractice Insurance Market Moves through Hard and Soft Insurance Markets

All of the factors affecting premium rates and availability contribute to the length and amplitude of the medical malpractice insurance cycle. Like other property-casualty insurance markets, the medical malpractice market moves through cycles of "hard" and "soft" markets. Hard markets are generally characterized by rapidly rising premium rates, tightened underwriting standards, narrowed coverage, and often by the departure of some insurers from the market. In the medical malpractice market, some market observers have characterized the period from approximately 1998 to the present as a hard market. (Previous hard markets occurred during the mid-1970s and mid-1980s.) Soft markets are characterized by slowly rising premium rates, less stringent underwriting standards, expanded coverage, and strong competition among insurers. The medical malpractice market from 1990 to 1998 has been characterized as a soft market. According to a series of studies sponsored and published by NAIC in 1991, such cycles have been present in the property-casualty insurance market since at least 1926, and until the mid-1970s lasted for an average of approximately 6 years from the peak of one hard market to the next.[31] However, the cycle that began at the peak of the hard market in 1975 lasted for around 10 years. The current cycle has lasted for around 17 years—since 1985—and it is not yet clear that the current hard market has peaked.

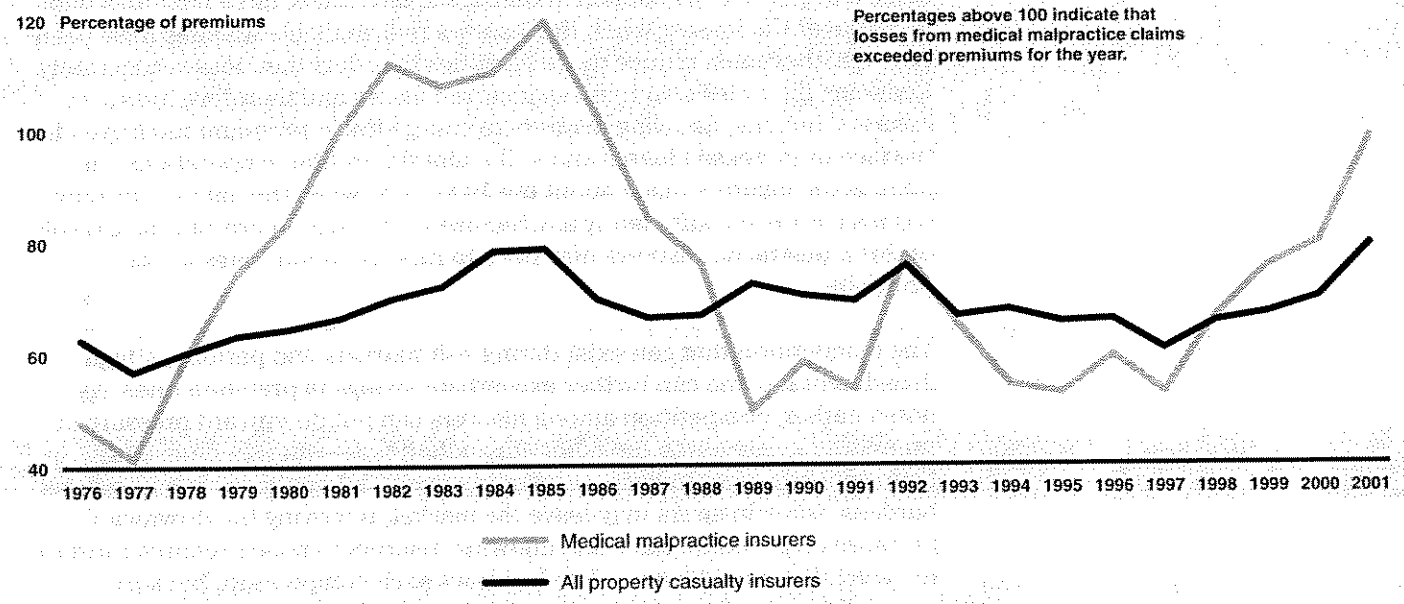
Cycles in the Medical Malpractice Market Tend to Be Volatile

The medical malpractice insurance market appears to roughly follow the same cycles as the overall property-casualty insurance market, but the cycles tend to be more volatile—that is, the swings are more extreme. We analyzed the swings in insurance cycles for the medical malpractice market and for the entire property-casualty insurance markets using annual loss ratios based on incurred losses (see fig. 9). Our analysis showed that annual loss ratios for medical malpractice insurers tended to swing higher or lower than those for property-casualty insurers as a whole, reflecting more extreme changes in insurers' expectations. Because premium rates

[31]National Association of Insurance Commissioners, *Cycles and Crises in Property/Casualty Insurance: Causes and Implications for Public Policy* (Kansas City, Mo.: 1991).

are based largely on insurers' expectations of losses, premium rates will fluctuate as well.

Figure 9: Incurred Losses as a Percentage of Premium Income for Medical Malpractice Insurers and Property-Casualty Insurers Nationwide, 1976–2001



Source: GAO analysis of A.M. Best and National Association of Insurance Commissioners data.

The medical malpractice insurance market is more volatile than the property-casualty insurance market as a whole because of the length of time involved in resolving medical malpractice claims and the volatility of the claims themselves. Several years may pass before insurers know and understand the profits and losses associated with policies sold in a single year. As a result, insurers may not know the full effects of a change in an underlying factor, such as losses or return on investments, for several years. So while insurers in other markets that do not have protracted claims resolutions can adjust loss estimates and premium rates more quickly to account for a change in an underlying factor, medical malpractice insurers may not be able to make adjustments for several years. In the interim, medical malpractice insurers may unknowingly be under- or over-pricing their policies.

When insurers do fully understand the effects of a change in an underlying factor, they may need to make large adjustments in loss estimates and premium rates. As a result, premium rates in the medical malpractice insurance market may move more sharply than premium rates in other lines of property-casualty insurance. For example, if insurers have been unknowingly overestimating their losses and overpricing their policies, as some insurers told us happened during the late 1980s, large liabilities build up to cover the losses. When the insurers realize their estimates have been too high, they must reduce those liabilities to reflect their losses accurately. Reducing liabilities also reduces incurred losses and therefore increases insurers' income, allowing insurers to charge lower premium rates even in the face of increased losses and still maintain profitable operations—a point some insurers made about the 1990s. But when the liability account has been reduced sufficiently and income is no longer increasing as a result of this adjustment, insurers may need to raise premium rates to stay profitable.

The competition that can exist during soft markets and periods of high investment income can further exacerbate swings in premium rates. As noted earlier, competition among insurers can put downward pressure on premium rates, even to the point at which the rates may, in hindsight, become inadequate to keep an insurer solvent. When the insurance market hardens, some insurers may leave the market, removing the downward pressure on premium rates and allowing insurers to raise premium rates to the level that would have existed without such competition. Because competition may have kept rates low, the resulting increase in premium rates that accompanies a transition to a hard market may be greater than it would have been otherwise.

According to some industry experts, periods of high investment income can bolster the downward pressure that exists during soft markets. That is, high investment income can contribute to the increased profitability of an insurance market. This profitability can, in turn, cause insurers to compete for market share in order to take advantage of that profitability, thereby forcing premium rates even lower. In addition, according to these industry experts, high investment income allows insurers to keep premium rates low for long periods of time, even in the face of increasing losses, because investment income can be used to replace premium income, allowing insurers to meet expenses. But if interest rates drop at the same time the market hardens (and reduced interest rates can be a contributor to the movement to hard market), insurers may have to increase premium rates

much more in a shorter period of time than they would have if investment income had not allowed premium rates to remain lower to begin with.

Predicting and Moderating the Cycle is Difficult

While the medical malpractice insurance market will likely move through more soft and hard markets in the future, predicting when such moves might occur or the extent of premium rate changes is virtually impossible. For example, the timing and extent of the unexpected changes in the losses that some researchers believe are responsible for hard markets are virtually impossible to predict. In addition, as we have seen, many factors affect premium rates, and it is just as difficult to predict the extent of any future changes these factors might undergo. While interest rates may be high during soft markets, it is not possible to predict how much higher they might be in the future and thus what effect they might have on premium rates. Predicting changes in losses on medical malpractice claims would be even harder, given the volatility of such losses. Further, some of the factors affecting premium rates, such as losses and competition, vary across states, and the effect of soft or hard markets on premium rates in one state could not be generalized to others. Finally, other conditions affecting premium rates have changed since earlier hard and soft markets, limiting our ability to make accurate comparisons between past and future market cycles.

Similarly, agreement does not exist on whether or how insurance cycles could be moderated. The NAIC studies mentioned above noted that the most likely primary causes of insurance cycles—changes in interest rates and losses—were not subject to direct insurer or regulatory control.[32] In addition, the studies also observed that underpricing by insurers during soft markets likely increases the severity of premium rate increases during the next hard market. But they did not agree on the question of using regulation to prevent such swings in premium rates. Such regulation could be difficult, for two reasons. First, because losses on medical malpractice claims are volatile and difficult to predict, regulators could have difficulty determining the appropriate level of premium rates to cover those losses. In addition, restricting premium rate increases during hardening markets could hurt insurer solvency and cause some insurers to withdraw from a market with an already declining supply of insurance.

[32]NAIC, *Cycles and Crises.*

The Medical Malpractice Insurance Market Has Changed since Previous Hard Markets

The medical malpractice insurance market as a whole has changed considerably since the hard markets of the mid-1970s and mid-1980s. These changes have taken place over time and have been the result primarily of actions insurers, health care providers, and state regulators have taken to address rising premium rates. For example, insurers have moved from occurrence-based to claims-made policies, physicians have formed mutual nonprofit insurance companies that have come to dominate the market, hospitals and groups of hospitals or physicians have increasingly chosen to self-insure, and states have passed laws designed to slow the increase in medical malpractice premium rates.

Beginning in the 1970s, Insurers Began Selling Claims-Made Rather Than Occurrence-Based Policies

In order to more accurately predict losses and set premium rates, in the mid-1970s most medical malpractice insurers began to change the type of insurance policy they offered to physicians from occurrence based to claims made. As we have noted, claims-made policies cover claims reported during the year the policy is in effect, while occurrence-based policies cover claims arising out of events that occurred during the year in which the policy was in effect. Because claims-made policies cover only reported claims, insurers can better estimate the payouts they will have to make in the future. Occurrence-based policies do not provide such certainty, because they leave insurers liable for claims related to the incidents that occurred during a given year, including those not yet reported to the insurer.

Claims-made policies can create difficulties for physicians needing or wanting to change insurers, however, because the physician rather than the insurer retains the risk of claims that have not yet been reported to the insurer. However, most companies today offer separate policies providing coverage for claims resulting from incidents that may have occurred but were not reported before the physician switched companies. The vast majority of policies in existence today are claims-made policies. In each of the seven states we studied, for example, the leading insurer's policies were predominantly (if not exclusively) claims-made. This change in the type of policy sold means that any changes to premium rates during future hard or soft markets may differ from such changes in previous such markets.