AMERICAN ACADEMY of ACTUARIES

Subcommittee on Health
Committee on Energy and Commerce
U.S. House of Representatives

Hearing on
"Harming Patient Access to Care:
The Impact of Excessive Litigation"

Statement of James Hurley, ACAS, MAAA
Chairperson, Medical Malpractice Subcommittee
American Academy of Actuaries

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1100 Seventeenth Street NW Seventh Floor Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948
www.actuary.org

INTRODUCTION

The American Academy of Actuaries appreciates the opportunity to provide comments on issues related to insurance and the availability and pricing of medical malpractice insurance. The Academy hopes these comments will be helpful as the subcommittee considers related proposals.

This testimony discusses some facts about medical malpractice financial results updated through 2001, contributing factors, and some common misconceptions about the results.

Then and Now

During the 1990s, the medical malpractice line of business experienced favorable operating results, and insurers competed aggressively. Healthcare providers shared in the benefit of improved loss experience and higher levels of investment income through lower charged premiums.

Recently, however, the cost of medical malpractice insurance has been rising. Rate increases have been precipitated in part by the growing size of claims, more frequent claims in some areas, and higher defense costs. The relation of increasing litigation and increased loss costs is clear, and the size of a median jury award rose to $1 million in 2000, a jump from $474,536 in 1996, according to a July 2002 Insurance Information Institute report.

From a financial standpoint, insurance industry medical malpractice results deteriorated in 1999 and 2000, and are expected to have continued to deteriorate in 2001. For all companies reporting to A.M. Best (an organization offering comprehensive data to insurance professionals), the combined ratio of 130 percent and 134 percent for the earlier two years, respectively, has deteriorated to 143 percent, per A.M. Best preliminary estimates. An operating ratio of 106 percent for the two earlier years, reflecting a loss of 6 cents on every dollar of premium written after considering underwriting and investment results, is expected to deteriorate when 2001 results become available. At these levels, 2001 results will be the worst they have been in 15 years or more, approximating levels of the mid-1980s.

Today, the loss environment has deteriorated, benefits of favorable reserve development appear to be gone, and the available investment income offset has declined. In fact, reserve liabilities may require increases to cover current ultimate loss obligations. All said, rates for both insurers and reinsurers need to increase to properly align with current loss and investment income levels. Companies failing to do this jeopardize their surplus base and financial health.

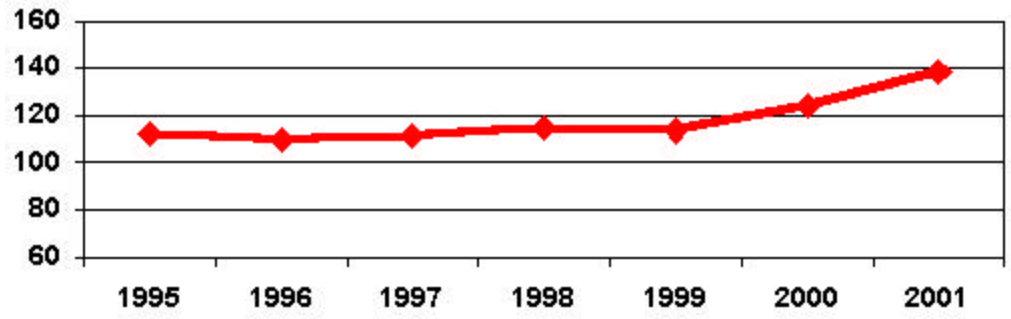
SOME FACTS

Because 2001 insurance industry A.M. Best data is not available, the following discussion is based on results of 30 companies (the 30-Group), primarily physician-owned and/or -operated medical liability insurers. These companies represent about one-third of the exposure reported to A.M. Best. Information is shown for the last seven years.

Results for these companies reflect a slight operating profit (a 96 percent operating ratio, or 4 percent net income relative to premiums) in 2000. However, the results deteriorated to a 10 percent operating loss (a 110 percent operating ratio) for 2001.

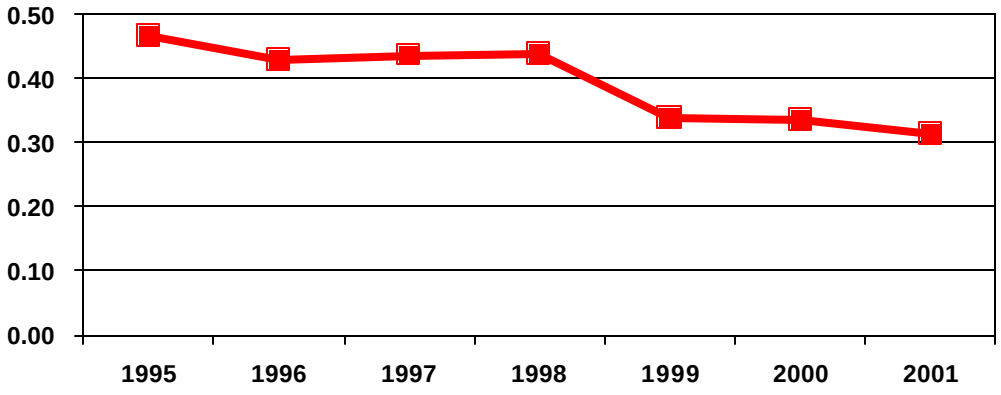
Following are discussion and charts summarizing the two key drivers of financial results and their effects on operating results and surplus.

CHART A: COMBINED RATIO



Driver #1 – Higher combined ratio (defined here as calendar year loss and all loss adjustment and underwriting expenses divided by premium earned). The combined ratio deteriorated by 10 points in 2000 and a further 14 points in 2001. The ratios were 124 percent and 138 percent in 2000 and 2001, respectively. The preceding five years reflect a rather stable 110-115 percent range. The driver in these results is the deterioration of the loss and loss adjustment expense ratio as the underwriting expense ratio remains relatively flat. The earlier years reflect the benefit of significant reserve reductions that have decreased and contributed to the deterioration observed.

CHART B: INVESTMENT INCOME AS PERCENTAGE OF PREMIUM DECLINES

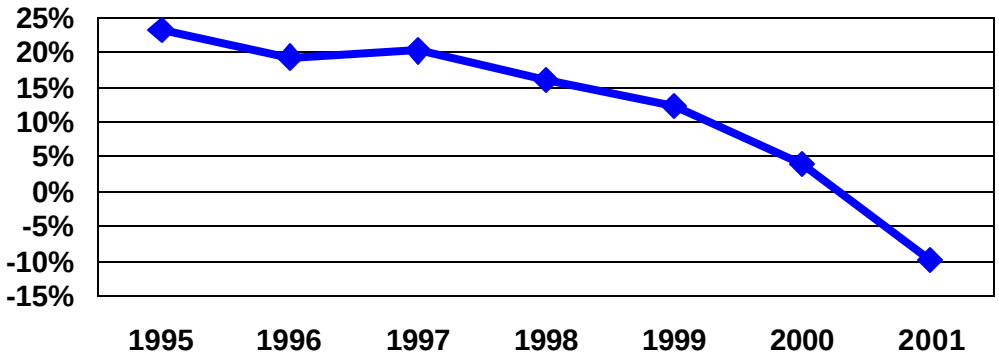


Driver #2 – Decreased investment income (shown here as pre-tax investment income divided by premium earned). As shown in Chart A, insurers generally spend more money on loss and expense than they collect in premium. This is possible because investment income offsets this underwriting loss. In Chart B, pre-tax

investment income is divided by earned premium to estimate the protection provided to offset an underwriting combined ratio in excess of 100 percent. As can be seen from Chart B, this statistic has declined over the measurement period from the mid-40s to the mid-30s, and, in 2001, to 31 percent. This "offset" will continue to decline in the future for two reasons. First, most invested assets are bonds and are affected by recently lower yields, a change that has not been fully felt in current investment income. Second, the premium base is growing due to increased rates, growth in exposure, or both. Invested assets are not increasing as rapidly as premium and, therefore, investment income as a percentage of premium will decline.

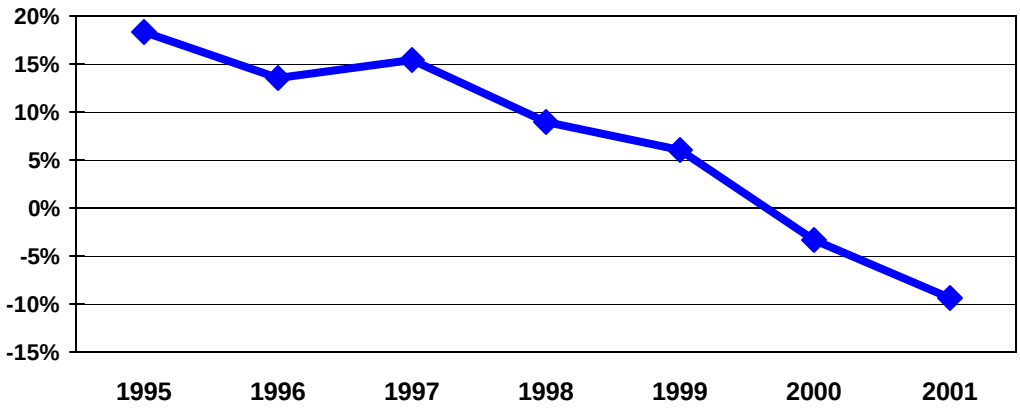
Effect #1 – Net operating income falls (shown in Chart C as a percentage of premium). Net operating income represents the net impact of the combined ratio and investment income ratio, adjusted for other income statement items (primarily policyholder dividends, miscellaneous other income, and federal income tax). The strong operating returns of the early years have been followed by the slight 2000 profit and 10 percent loss for 2001 described earlier.

CHART C: CALENDAR YEAR OPERATING RESULTS TURN NEGATIVE



Effect #2 –Surplus declines are shown in Chart D as a percentage change from one year to the next. Surplus increases through 1999, decreases slightly in 2000, and decreases more significantly in 2001. Surplus represents the capital base for these insurers, and its decline in 2000 and 2001 reduces the capacity to write new or renewing business prospectively, and/or absorb adverse loss developments on business written in prior years.

CHART D: SURPLUS CHANGE TURNS NEGATIVE



CONTRIBUTING FACTORS

There are several factors contributing to the financial results described above. It is probably best to note the factors contributing to the favorable results of the early and mid-1990s and then discuss the changes in these factors today.

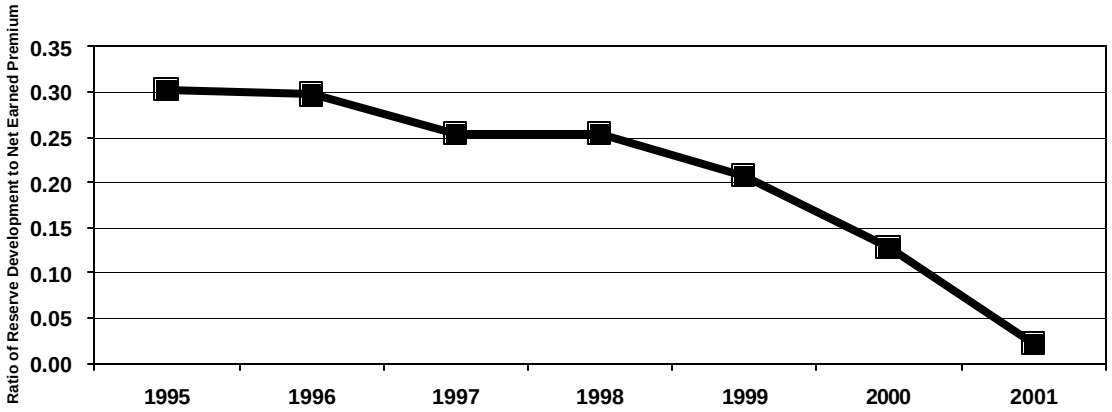
Factor #1: Throughout the 1990s, premium rates for the insurance industry as a whole were relatively flat or down in several states. Rates decreased toward the middle and end of the period in comparison to rates at the beginning of the decade. In many cases, rate decreases were a consequence of more significant discounts rather than changes to filed rates.

Factor #2: Loss-cost trends (the annual change in the frequency and severity of claims) during this time period were relatively low. Long-term indications suggest a low single-digit change, 3 percent to 5 percent, varying from state to state. This reflects a lower general economic inflationary environment, and, perhaps more importantly, an equally low medical inflationary index. Rates established at the beginning of the period contemplated higher trends. Companies responded to this emerging data in different ways. Some held rates stable and paid policyholder dividends or gave premium discounts. Some reduced filed rates. Others found they needed to increase rates modestly and tried to refine pricing models to improve the equity of their program costs. Many insurers employed combinations of these, with resulting increases in some programs and decreases in others, depending on specific facts and circumstances. However, in general, there was a decline in the adequacy of premiums in this period. Collected rates came into line with insurers' costs, but competitive actions pushed rates even lower in some jurisdictions.

Factor #3: Lower than expected loss-cost trends allowed reductions in loss reserves established in anticipation of trends more in line with historically higher levels. As experience emerged, loss reserves for prior years were reduced, contributing to very profitable calendar year results. This evidence emerged gradually as claims settled. Thus, the reductions occurred over a period of years. Loss reserve reductions for prior years lowered current calendar year loss ratios (and thus the combined and operating ratios) during the mid-to-late

1990s, as shown in Chart E. As is clear from the graph, loss reserve development for the 30-Group was not a factor in 2001. From a broader perspective, it appears that the medical malpractice line for the insurance industry as a whole is currently in a deficit position. For example, the industry as a whole had to increase reserves in 2000, and indications are that this also will have occurred in 2001. (Insurance industry results for 2001 are not yet available.)

CHART E: LOSS RESERVE DEVELOPMENT AS % OF PREMIUM NEUTRALIZED



Factor #4: During the 1990s, investment income returns produced a real spread between fixed income rates of return and economic inflation. In addition, the modest equity position of invested assets for the 30-Group combined with fixed income yields to produce significant investment gains, improving overall financial results. These gains increased the investment income ratio (see earlier graph) and improved the operating ratio.

Factor #5: Given the financial results of the early-to-mid-1990s, some companies considered expansion into new markets (although they may have had limited information to develop rates), became more competitive in existing markets, and offered more aggressive premium discounts. In most jurisdictions, "discounts" against the manual premium became common, reducing the actual premiums paid by health care providers. Reinsurers likewise reduced rates, competed and covered more exposure but often at lower rates. As a consequence, rates on a coverage year basis became less adequate.

Factor #6: Loss-cost trends, particularly claim severity, began to pick up toward the latter part of the 1990s. The number of large claims (sometimes very large) increased, but even basic limits analyses (eliminating the distortions of very large claims) began to move upward. This, coupled with the cumulative effect of the low loss-cost trend and rate activity in the earlier part of the decade, produced rate indications that were moving up significantly in many states. Insurers are moving to eliminate competitive discounts.

Factor #7: Aggregate loss reserve levels were reconciled to the lower loss-cost trends, resulting in no further reductions in 2001 (and for the insurance industry, requiring an addition to prior reserve levels). In fact, the upward loss-cost pressure noted above calls into question whether current reserve levels will be adequate to meet ultimate loss costs. Results to date for the 30-Group reflect little or no strengthening in the aggregate, although results vary on a company-by-company basis.

Factor #8: Rates of return on invested assets declined, and equity values fell. In addition to the fact that this affected interest earnings on existing assets, it also affected the expectation for investment earnings used to offset needed prospective premium levels. Rates established using an interest rate assumption of 6 percent rather than 7 percent were 3 to 4 percent higher (assuming no changes in other rate components) due to the multiplier effect of investment income. Moving to even lower yields compounds the impact.

Factor #9: Reinsurers' experience deteriorated as their results were affected by the increased claim severity and pricing changes in the early-to-mid-1990s. Since reinsurers generally cover the higher layers of exposure, their results were disproportionately impacted by claim severity increases. This, coupled with the broadly tightened reinsurance market after the events of September 11, 2001, caused reinsurers to substantially increase rates and tighten terms of reinsurance for medical malpractice.

FREQUENT MISCONCEPTIONS

In closing, it would be helpful to address some frequent misconceptions about the insurance industry and medical malpractice insurance coverage.

Misconception 1: "Insurers are increasing rates because of investment losses, particularly their losses in the stock market."

Investment income plays an important role in the overall financial results of insurers, particularly for insurers of medical professional liability, because of the long delay between payment of premium and payment of losses. Insurers have not suffered investment losses, but they have experienced a decline in their portfolio rates of return. The vast majority of invested assets are fixed-income instruments. Generally, these are purchased in maturities that are reasonably consistent with claim payments. Losses from this portion of the invested asset base have been minimal, although the rate of return available has declined. Equities are a much smaller portion of the portfolio (for this 30-Group, representing about 15 percent of invested assets). After favorable performance up through the latter 1990s, there has been a decline in the last few years, contributing to less favorable investment results and overall operating results. Thus, investment returns are still positive, but the rates of return have been adversely affected by equity declines and lower fixed income investment yields.

In establishing rates, insurers do not recoup investment losses. Rather, the general practice is to choose an expected prospective rate of return (e.g., 5 percent or 6 percent) and calculate a discount factor (usually producing a credit to rates on the order of 10 percent to 15 percent). This means the insurer is expecting to have an underwriting loss that will be offset by investment income. Since interest yields drive this process, when interest yields decrease, rates increase.

Misconception 2: "Companies operated irresponsibly and caused the current problems."

Financial results for medical insurers have deteriorated. Further, some companies made underwriting and rate decisions that have resulted in adverse financial results, including insolvencies. A significant portion of this adverse experience is emerging on business written in newly entered markets by companies that attempted to

expand in the mid-to-late 1990s. In addition, companies became too aggressive in discounting premiums for existing business.

Additionally, while one can argue about whether companies were imprudent in past pricing behavior, today's rate increases reflect a reconciliation of rates and current loss levels, given available interest yields. There is no added cost for past mispricing. Thus, although the competitive, soft market pricing delayed reconciliation of rates and loss levels, the "current problem" reflects current data.

Misconception 3: "Companies are reporting losses to justify increasing rates."

This is a false observation. Companies are reporting losses primarily because claim experience is worse than anticipated when prices were set. It is clear that companies, having gone through the 1990s reporting very profitable results, would not suddenly have decided that, in order to get more profits, they would report losses to increase rates. Further, several companies have suffered serious adverse consequences given these financial results, including liquidation or near liquidation. For example, the St. Paul Cos., formerly the largest writer of medical malpractice insurance, is now in the process of withdrawing from this market.

The Academy appreciates the opportunity to provide an actuarial perspective on these important issues and would be glad to provide the subcommittee with any additional information that might be helpful.