



Medical Malpractice Insurance: Stable Losses/Unstable Rates in Massachusetts

December 2004

Introduction and Summary of Findings

Over the last three years, some Massachusetts doctors, like many around the country, have experienced skyrocketing medical malpractice insurance rates. The insurance industry and organized medicine have blamed the crisis on the legal system and have lobbied extensively for laws to limit compensation to injured patients.

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

Americans for Insurance Reform (AIR), a coalition of over 100 consumer groups around the country including the New England Patients' Rights Group, Massachusetts Public Interest Research Group and the Massachusetts-based Center for Insurance Research, has provided an answer to this question. AIR has produced a comprehensive study of trends in medical malpractice insurance in Massachusetts – both premiums and claims – since 1990. AIR found that the amount medical malpractice insurers paid out, including all jury awards and settlements, closely tracked the rate of medical inflation. On the other hand, medical insurance premiums charged by insurance companies have not corresponded to increases or decreases in payouts. Rather, they have risen and fallen in sync with the state of the economy, reflecting gains or losses experienced by the insurance industry's market investments.

This study makes two major findings:

- First, contrary to what the insurance and medical lobbies have alleged, the last few years saw no “explosion” in medical malpractice insurer payouts or costs to justify skyrocketing rate hikes. **In fact, rather than exploding, inflation-adjusted payouts per doctor have *dropped* for each of the last three years.** Payouts (in constant dollars) have been essentially flat or dropping since 1990.
- Second, **medical malpractice insurance premiums rose faster over the last three years than was justified by insurance payouts.** The hike, which began in 2000, is not connected to actual payouts. Rather, it reflects a weakened economy and losses experienced by the insurance industry's market investments and their perception of how

much they can earn on the investment “float” (which occurs during the time between when premiums are paid into the insurer and losses paid out by the insurer) that doctors’ premiums provide them.

Background

Organized medicine and insurance companies in Massachusetts are advancing a legislative agenda to limit liability for doctors, hospitals, HMOs, nursing homes and drug companies that cause injury. State and federal lawmakers and regulators (and the general public) are being told by insurance and medical lobbyists that doctors’ insurance rates are rising due to increasing claims by patients, rising jury verdicts and exploding tort system costs in general.

The insurance industry argues and, worse, convinces doctors to believe that patients who file medical malpractice lawsuits are being awarded more and more money, leading to unbearably high losses for insurers. Insurers state that to recoup money paid to patients, medical malpractice insurers are being forced to raise insurance rates or, in some cases, pull out of the market altogether.

Since insurers say that jury verdicts are the cause for the current “crisis” in affordable malpractice insurance for doctors, the insurance industry insists that the only way to bring down insurance rates is to limit an injured consumer’s ability to sue in court.

Insurance rates for doctors have skyrocketed nationally twice before: in the mid-1970s and in the mid-1980s, each “crisis” occurring during years of a weakened economy and dropping interest rates. Each of these periods was followed by a wave of legislative activity to restrict injured patients’ rights to sue for medical malpractice. Insurance and medical lobbyists told legislators that changes in tort law were needed to reduce medical malpractice insurance rates.

However, history shows that the insurance industry has not cut, and has no plans to cut, insurance premiums as a consequence of tort restrictions. The American Insurance Association (AIA) and representatives of the American Tort Reform Association (ATRA) have already gone on record admitting this, with the AIA stating on March 13, 2002, “[T]he insurance industry never promised that tort reform would achieve specific premium savings.”

The Center for Justice & Democracy’s 1999 study, *Premium Deceit—the Failure of “Tort Reform” to Cut Insurance Prices*, found that tort law limits enacted since the mid-1980s did not lower insurance rates in the ensuing years. Some states that resisted enacting any “tort reform,” like Massachusetts, experienced low increases in insurance rates or loss costs relative to the national trends, while some states that enacted major “tort reform” packages saw very high rate or loss cost increases relative to the national trends. In fact, Massachusetts had no tort law changes in the 14-year period of study and had an increase in rate/loss cost of only 25.9%, less than 1.8% a year, well below general inflation. Massachusetts enjoyed the 10th lowest rate increase in the nation. In other words, there was no correlation between “tort reform” and insurance rates.

More recently, Weiss Ratings, an independent insurance-rating agency, found that between 1991 and 2002, states with caps on noneconomic damage awards saw median doctors’ malpractice

insurance premiums rise 48 percent – *a greater increase than in states without caps*. In states without caps, median premiums increased only 36 percent. Weiss speculated that state regulation of insurance premium increases made the difference.¹

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

The “liability insurance crises” of the mid-1970s and mid-1980s were ultimately found to be caused not by legal system excesses but by the economic cycle of the insurance industry. Just as these liability insurance crises were found to be driven by this cycle and not a tort law cost explosion as many insurance companies and others had claimed, the “tort reform” remedy pushed by these advocates failed.

As this study, Weiss and NBER confirm, it will fail again.

The 2004 Study

AIR, under the direction of actuary J. Robert Hunter (Director of Insurance for the Consumer Federation of America, and former Federal Insurance Administrator and Texas Insurance Commissioner), has produced a comprehensive study of medical malpractice insurance in Massachusetts, examining specifically what insurers have taken in and what they’ve paid out, in constant dollars, from 1990 through 2003. AIR examined everything that medical malpractice insurers have paid in jury awards, settlements and other costs over the last three decades, and compared these actual costs with the premiums that insurers have charged doctors, as well as with the economic cycle of the insurance industry.

This AIR study explores whether or not there is, as the insurance industry claims, an explosion in lawsuits, jury awards or tort system costs justifying an increase in insurance premium rates, or whether premium increases simply reflect the economic cycle of the insurance industry, driven by interest rates and investments.

The Insurance Industry’s Economic Cycle

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

But when investment income decreases – because interest rates drop or the stock market plummets or the cumulative price cuts make profits become unbearably low – the industry

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

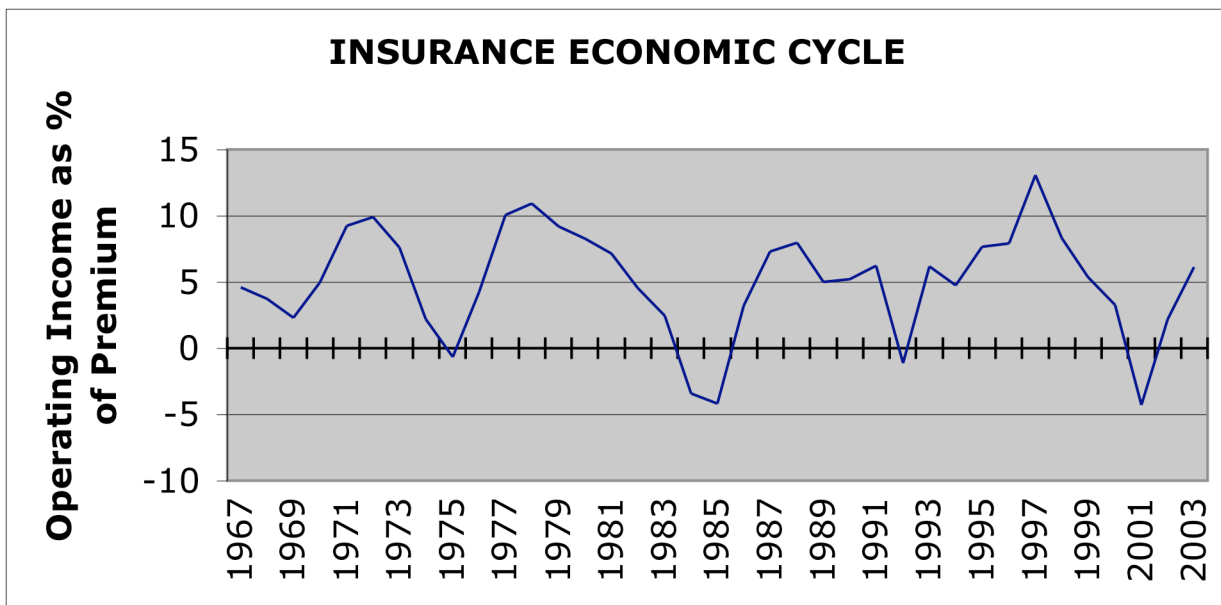
² Katherine Baicker & Amitabh Chandra, NATIONAL BUREAU OF ECONOMIC RESEARCH, *The Effect of Malpractice Liability on the Delivery of Health Care* (Aug. 2004), at 14 & 20.

responds by sharply increasing premiums and reducing coverage, creating a “hard” insurance market usually degenerating into a “liability insurance crisis.”

A hard insurance market happened in the mid-1970s, precipitating rate hikes and coverage cutbacks, particularly with medical malpractice insurance and product liability insurance. A more severe crisis took place in the mid-1980s, when most liability insurance was impacted. Again, beginning in 2001, the country started experiencing a “hard market,” this time impacting property as well as liability coverages with some lines of insurance seeing rates going up 100% or more.

The following Exhibit shows the national cycle at work, with premiums stabilizing for 15 years following the mid-1980s crisis. (The 1992 data point was not a classic cycle bottom, but reflected the impact of Hurricane Andrew and other catastrophes in that year.)

Exhibit 1. The Insurance Cycle



Prior to late 2000, the industry had been in a soft market since the mid-1980s. The strong financial markets of the 1990s had expanded the usual six- to ten-year economic cycle. No matter how much they cut their rates, the insurers wound up with a great profit year when investing the float on the premium in this amazing stock and bond market. (The “float” occurs during the time between when premiums are paid into the insurer and losses paid out by the insurer – *e.g.*, there is about a 15 month lag in auto insurance and a 5 to 10 year lag in medical malpractice.) Further, interest rates were relatively high in recent years as the Fed focused on inflation.

But in 2000, the market started to turn with a vengeance and the Fed cut interest rates again and again. This took place well before September 11th. The terrorist attacks sped up the price increases, collapsing two years of anticipated increases into a few months and leading to what

some seasoned industry analysts see as gouging.³ However, the increases we are witnessing are mostly due to the cycle turn, not the terrorist attack or any other cause. This is a classic economic cycle bottom.

Smoking Guns

AIR tested two hypotheses advanced by the insurance industry: First, if large jury verdicts in medical malpractice cases or any other tort system costs are having a significant impact on the overall costs for insurers, and are therefore the reason behind skyrocketing insurance rates, then losses per doctor should be rising faster than medical inflation over time. Second, if lawsuits or other tort costs are the cause of rate increases for doctors – rather than decreasing interest rates and other economic factors – those losses should be reflected in rate increases in line with such losses, not in ups and downs that instead reflect the state of the economy, the well-documented insurance economic cycle (Exhibit 1), interest rates, the stock market or the level of insurers' investment income.

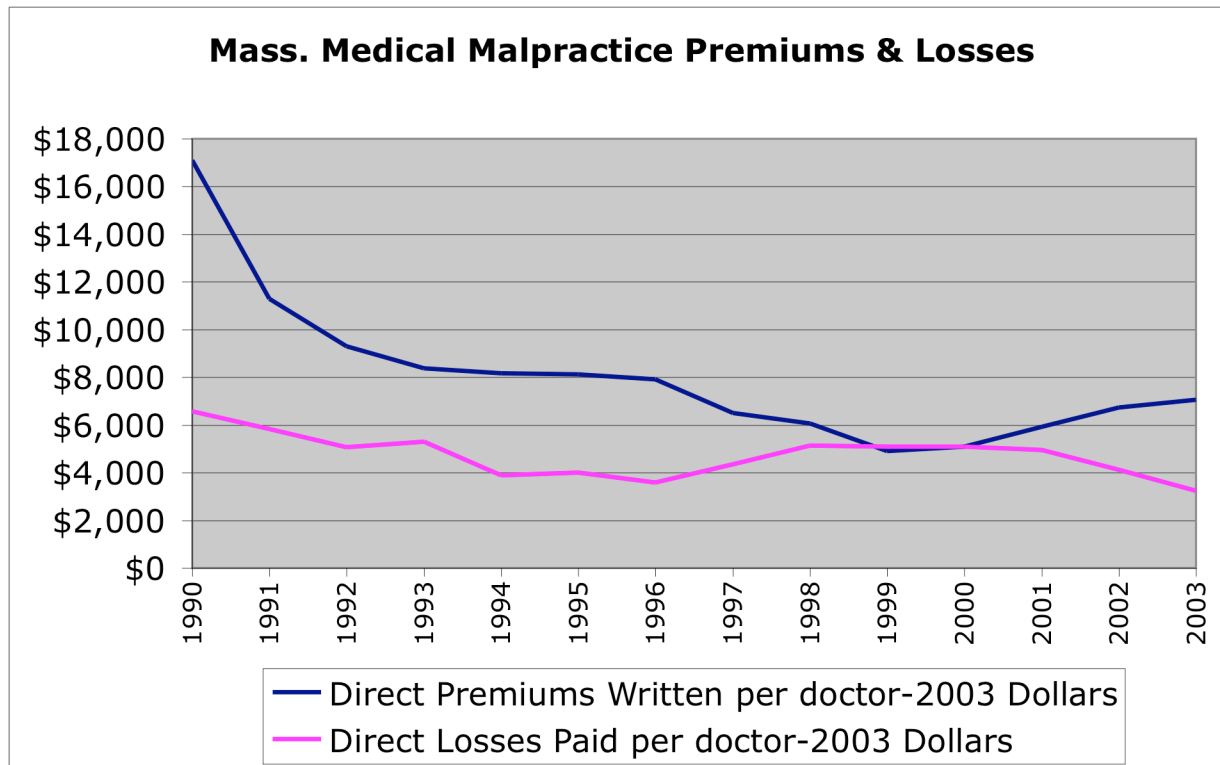
AIR finds both hypotheses are completely false, demonstrated by Exhibits 2 and 3 below. First, these charts show that since 1990, medical malpractice paid claims per doctor have closely tracked medical inflation. In other words, payouts have risen no faster than medical inflation and have, in fact, generally risen more slowly than inflation. Moreover, contrary to what the insurance and medical lobbies have alleged, the years from 2001 to 2003 saw no “explosion” in medical malpractice insurer payouts or costs to justify sudden rate hikes. In fact, rather than exploding, inflation-adjusted payouts per doctor *dropped each year* from 2001 to 2003. These data confirm that neither jury verdicts nor any other factor affecting total claims paid by insurance companies that write medical malpractice insurance have had much impact on the system's overall costs over time.

Second, while payouts track medical inflation, medical malpractice premiums are quite another thing. They do not track costs or payouts in any direct way. Since 1990, the data show that in constant dollars, per doctor written premiums – the amount of premiums that doctors have paid to insurers – dropped steadily throughout the 1990s and only began rising in 2000-2001, in line with the insurers' economic cycle, which is driven by such factors as insurer mismanagement and changing interest rates, not by lawsuits, jury awards, the tort system or other causes. Moreover, medical malpractice insurance premiums rose in each of the last three years even though insurance payouts were dropping steadily.

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

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

Exhibit 2



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

Definitions:

- **“Direct Premiums Written”** is the amount of money that insurers collected in premiums from doctors during that year.
- **“Direct Losses Paid”** is what insurers actually paid out that year to people who were injured – all claims, jury awards and settlements – plus what insurance companies pay their own lawyers to fight claims.⁵

⁴ We calculate the paid losses on a per doctor basis to remove from the trend we are studying the effect of the ever increasing number of doctors in America. We acknowledge that the number of doctors includes a certain number of doctors that are retired or otherwise not in the medical malpractice system, but since we are interested in overall loss trends over time, and since the percentage of doctors in that category should not vary much year to year, this fact should not significantly impact our results.

⁵ “Paid losses” are a far more accurate reflection of actual insurer payouts than what insurance companies call “incurred losses.” Incurred losses are not actual payouts. They include payouts but also reserves for possible future claims – e.g., insurers’ estimates of claims that they do not even know about yet. While incurred losses do exhibit more of a cyclical pattern, observers know that this is because in hard markets, as we are currently experiencing, insurers will increase reserves as a way to justify price increases. In fact, the current insurance “crisis” rests significantly on a jump in loss reserves in 2001. Historically, reserves have been later “released” to profits during the “softer” market years. For example, according to a June 24, 2002, *Wall Street Journal* front page investigative article, St. Paul, which until 2001 had 20 percent of the national med mal market, pulled out of the market after mismanaging its reserves. The company set aside too much money in reserves to cover malpractice claims in the 1980s, so it “released” \$1.1 billion in reserves, which flowed through its income statements and appeared as profits. Seeing these profits, many new, smaller carriers came into the market. Everyone started slashing prices to attract

Exhibit 3

Year	Written Premiums	Paid Losses	Loss Ratio	Number of Doctors (Non-federal)	Medical Care Inflation (CPI-U)	Direct Premiums Written per Doctor	Direct Losses Paid per Doctor	Direct Premiums Written per Doctor-2003 Dollars	Direct Losses Paid per Doctor-2003 Dollars
1990	\$201,292,998	\$77,239,742	0.384	21,475	162.8	\$9,373.36	\$3,596.73	\$17,105.81	\$6,563.81
1991	\$148,858,278	\$76,847,648	0.516	22,111	177	\$6,732.32	\$3,475.54	\$11,300.40	\$5,833.80
1992	\$135,304,375	\$73,795,737	0.545	22,746	190.1	\$5,948.49	\$3,244.34	\$9,296.67	\$5,070.45
1993	\$133,686,196	\$84,424,372	0.632	23,526	201.4	\$5,682.49	\$3,588.56	\$8,382.66	\$5,293.74
1994	\$140,195,848	\$66,827,914	0.477	24,144	211	\$5,806.65	\$2,767.89	\$8,176.10	\$3,897.35
1995	\$153,652,355	\$75,502,332	0.491	25,467	220.5	\$6,033.39	\$2,964.71	\$8,129.34	\$3,994.63
1996	\$157,602,065	\$71,299,023	0.452	25,950	228.2	\$6,073.30	\$2,747.55	\$7,907.00	\$3,577.12
1997	\$136,481,322	\$91,259,489	0.669	26,546	234.6	\$5,141.31	\$3,437.79	\$6,511.02	\$4,353.65
1998	\$134,557,791	\$113,824,106	0.846	27,228	242.1	\$4,941.89	\$4,180.41	\$6,064.58	\$5,130.11
1999	\$116,055,249	\$120,491,973	1.038	28,062	250.6	\$4,135.67	\$4,293.78	\$4,903.07	\$5,090.51
2000	\$127,016,055	\$127,362,712	1.003	28,457	260.8	\$4,463.44	\$4,475.62	\$5,084.69	\$5,098.57
2001	\$156,948,527	\$131,298,071	0.837	28,905	272.8	\$5,429.81	\$4,542.40	\$5,913.47	\$4,947.02
2002	\$190,817,297	\$116,598,269	0.611	29,474	285.6	\$6,474.09	\$3,955.97	\$6,734.78	\$4,115.26
2003	\$212,152,958	\$97,542,469	0.460	30,043	297.1	\$7,061.64	\$3,246.76	\$7,061.64	\$3,246.76

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

A Word About Loss Ratios

Loss ratios are the percent of premiums that insurers pay out in claims. These ratios will drop during hard market years reflecting sudden rate hikes, as they have since 1999. In fact, loss ratios are now the lowest they have been since 1996. Otherwise, they tend to trend up as insurers cut premiums during the soft market.

Exhibit 3 shows this precise phenomenon of increasing loss ratios from 1990 through 1999. This simply demonstrates the insurance cycle at work, which is the point of this study. Insurers did not respond to higher loss ratios during these years by raising rates because they were making significant money from investments. In fact, during the soft market, insurers are expected to take a larger underwriting loss (a combined loss ratio over 100 percent) than during the hard market as they benefit from more investment income during these times. As we show, when this income drops, insurers will then raise rates and loss ratios will also drop. This is indeed what is now happening.

customers. From 1995 to 2000, rates fell so low that they became inadequate to cover malpractice claims. Many companies collapsed as a result. St. Paul eventually pulled out, creating huge supply and demand problems for doctors in many states. Christopher Oster and Rachel Zimmerman, "Insurers' Missteps Helped Provoke Malpractice 'Crisis,'" *Wall Street Journal*, June 24, 2002.

Conclusion

Stable Losses/Unstable Rates in Massachusetts analyzes what medical malpractice insurers have taken in and what they've paid out over the last 14 years, including jury awards, settlements and other costs. Its findings are startling. While insurer payouts track the rate of medical inflation, medical insurance premiums do not. Rather, they rise and fall in relationship to the state of the economy. Not only has there been no "explosion" in lawsuits, jury awards or any tort system costs at any time over the last fourteen years, but the astronomical premium increases that some doctors have been charged during insurance "crises" are in exact sync with the economic cycle of the insurance industry, driven by interest rates and investments. In 2000, rates began to spike, but payouts dropped. In other words, insurance companies raise rates when they are seeking ways to make up for declining interest rates and market-based investment losses and reduction in interest rates.