



Medical Malpractice Insurance: Stable Losses/Unstable Rates in North Carolina (April 2003)

Introduction and Summary of Findings

On April 8, 2003, some doctors in North Carolina are staging a rally to protest high malpractice insurance rates in the state. In formulating a solution to assist doctors who are being price-gouged, it is critical first to determine why some physicians may be experiencing high insurance rates.

Now for the first time, Americans for Insurance Reform (AIR), a coalition of over 100 consumer groups around the country, has produced a comprehensive study of medical malpractice insurance in North Carolina, examining specifically what insurers have taken in and what they've paid out over the last 30 years. Similar to a national study that AIR conducted in October 2002 entitled, *Stable Losses/Unstable Rates* (see <http://www.insurance-reform.org>), AIR has examined everything that North Carolina 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. This study makes two major findings similar to what AIR earlier observed on a national level, demonstrating that the causes of and solutions to this "crisis" lie not with the tort system (*i.e.*, capping damages) but with the business practices of the insurance industry itself:

- First, over the last 18 years, the amount that medical malpractice insurers have paid out, including all jury awards and settlements, has approximately tracked rates of medical inflation. When measured in constant dollars, the average payout per doctor rose somewhat from the mid-1970s to the mid-1980s, but was approximately stable from the mid-1980s through 2001. In other words, medical malpractice claims payments (in constant dollars) have been flat when examined for the last decade.
- Second, medical insurance premiums charged by insurance companies over the last 30 years in North Carolina have not corresponded to increases or decreases in payouts. Rather, premiums have risen and fallen in concert with the state of the economy — insurance premiums (in constant dollars) have increased or decreased in direct relationship to the strength or weakness of the economy, reflecting the gains or 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.

Background

The nation's insurance companies have convinced medical lobbies in North Carolina and nationwide to advance a legislative agenda to limit liability for doctors, hospitals, HMOs, nursing homes and drug companies that cause injury. Federal and state lawmakers and regulators (and the general public) are being told by medical and insurance lobbyists that doctors' insurance rates are rising due to increasing claims by patients, rising jury verdicts and exploding tort system costs in general.

As on the national level, insurance rates for doctors in North Carolina skyrocketed before, particularly in the mid-1980s, a "crisis" precipitated by a weakened economy and dropping interest rates. News reports today are nearly identical to news reports during the previous cycle. Compare, for example, the following two *Washington Post* stories, one from 1986 and the other from 2003:

"Doctors and hospitals...have been saying for weeks that they would have to close their doors." *Washington Post*, May 24, 1986.

"[D]ouble-digit increases in medical malpractice insurance premiums...are prompting doctors to flee states with the highest rates, refuse to perform high-risk procedures, retire early out of frustration or stage protests." *Washington Post*, January 5, 2003.

Today's rerun of these "old" stories is evidence of the economic cycle of the insurance industry at work in North Carolina as it is in the nation (explained below). Yet each of these periods has been followed by a wave of legislative activity not to reform insurance industry practices that cause such volcanic eruptions in premiums, but to restrict — over and over again — injured patients' rights to sue for medical malpractice.

One of the first states to react to the current insurance "crisis" for doctors was Nevada. At the end of July 2002, Nevada enacted a \$350,000 cap on non-economic damages for injured patients. Within weeks of the law's enactment, two major insurance companies proclaimed that they would not reduce insurance rates for at least another year to two, if ever. Several insurers then filed for rate increases.

In Mississippi, lawmakers enacted a cap on medical malpractice verdicts in October 2002. Four months later, surgeons still could not find affordable insurance and many Mississippi doctors were still limiting their practice or walking off the job in protest. In January 2003, Ohio enacted a cap on compensation for patients injured by medical malpractice. Almost immediately, all five major medical malpractice insurance companies in Ohio announced they would not reduce their rates. One insurance executive predicted his company would seek a 20 percent rate increase.

Quite simply, this is because, as we show below, the legal system is largely irrelevant to the problem.

The Study

For the first time, AIR, under the *pro bono* 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 North Carolina, examining specifically what insurers have taken in and what they've paid out, in constant dollars, over the last 30 years. AIR examined everything that North Carolina 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 represents the first major analysis exploring whether or not there is, as the insurance industry claims, an explosion in lawsuits, jury awards or tort system costs in North Carolina.

The Insurance Industry's Economic Cycle

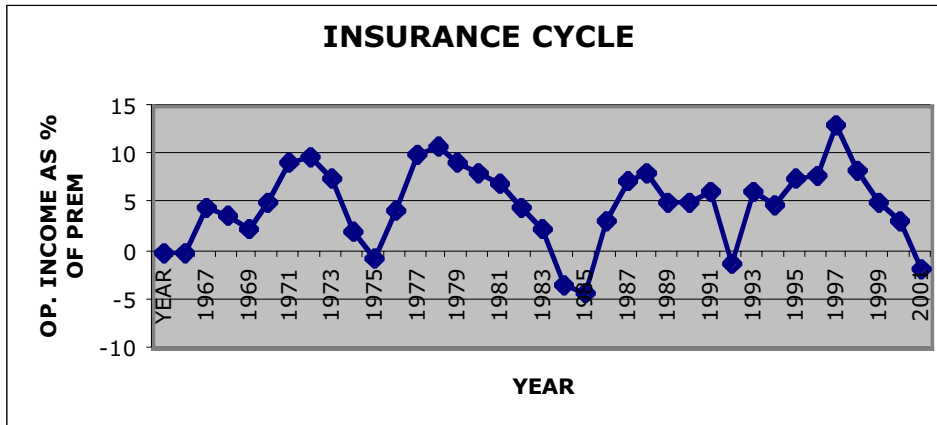
Insurers make most of their profits from investment income. During years of high interest rates and/or excellent insurer profits, insurance companies engage in fierce competition for premium dollars to invest for maximum return. Insurers severely underprice their policies and insure very poor risks just 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 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, in 2002, the country is 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. This graph reflects the experience of the entire property/casualty industry (not just medical malpractice insurance) and reports operating income (underwriting results plus investment returns on insurance reserves) as a percentage of premiums.

Exhibit 1. The Insurance Cycle



(The 1992 data point was not a classic cycle bottom, but reflected the impact of Hurricane Andrew and other catastrophes in that year.)

Prior to late 2000, the industry had been in a soft market since the mid-1980s. The usual six- to-ten-year economic cycle had been expanded by the strong financial markets of the 1990s. 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 the last two years, the market turned 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.¹ However, the increases we are witnessing are mostly due to the cycle turn, not the terrorist attacks 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 North Carolina insurers, then losses per doctor should be rising faster than medical inflation over time.
- Second, if lawsuits or other tort costs have been the cause of any rate increases for North Carolina doctors rather than decreasing interest rates and other economic factors, those

¹ “...there 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.

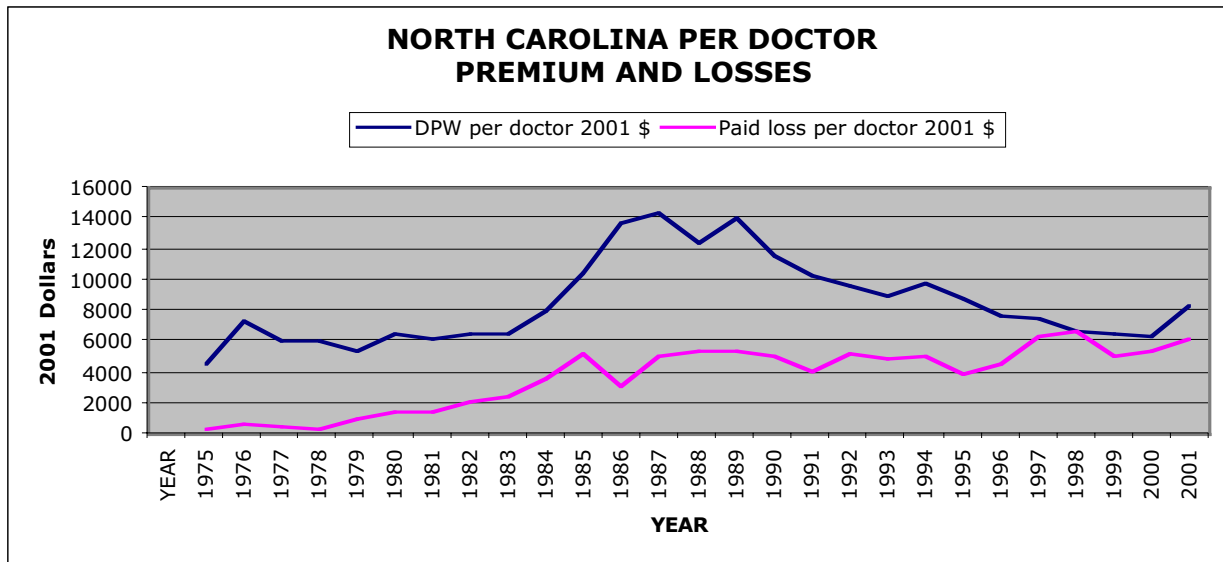
losses should be reflected in steadily increasing rates, not in sharp ups and downs that might instead reflect the state of the economy, the well-documented insurance economic cycle (Exhibit 1), interest rates, the stock market or the level of insurers' investment income.

AIR finds both hypotheses are false. The data in Exhibits 2 and 3 below are more than simply conclusive. They are “smoking guns” which should, once and for all, end the debate about the cause of periodic medical malpractice “crises” in North Carolina. First, they show that the average payout per doctor rose somewhat from 1976 to 1983, but was stable to slightly down between 1984 and 2001. In other words, medical malpractice claims payments (in constant dollars) have been flat over the last decade, which should surprise surgeons and other doctors who dutifully march off at the insurers' trumpet call to seek tort law changes.

Second, medical malpractice premiums are quite another thing. They do not track costs or payouts in any direct way. The data show that in constant dollars, per doctor written premiums — the amount of premiums that doctors have paid to insurers — have gyrated almost precisely with the insurer's economic cycle, which is driven by such factors as insurer mismanagement and changing interest rates, not by lawsuits, jury awards, the tort system or other causes.

In sum, the results of AIR's analysis of data from 1975 to 2001, illustrated in Exhibits 2 and 3, are startling; North Carolina premiums rise and fall with the economic cycle, as illustrated in Exhibit 1, but losses paid do not.

Exhibit 2



Sources:

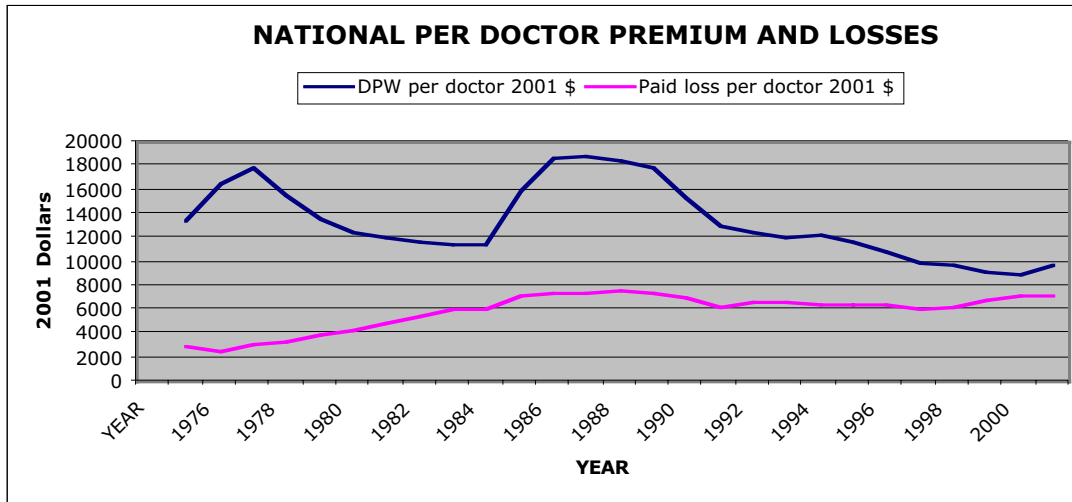
Premiums Written (Net), Bests Aggregates and Averages, 2001 Edition, A.M. Best and Co., special data compilation for AIR, reporting data for as many years as separately available; U.S. Bureau of the Census, 1975 (2001 Estimated); Inflation Index: Bureau of Labor Statistics, 1975 (1985 estimated); Number of Total NonFed Doctors: U.S. Bureau of the Census (data for 1975, 80, 85, 90, 95 and 99; other years Estimated)

Definitions:

“DPW” or “Direct Premiums Written” is the amount of money that insurers collected in premiums from doctors during that year.

“Paid losses” 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.²

In addition, it should be noted that the North Carolina experience closely tracks the national experience, as this chart reveals:



² 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 North Carolina and 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.

Exhibit 3 – North Carolina Data

YEAR	loss ratio	# doctors in NC	Medical Inflation (cpi-u)	Direct Premiums Written per doctor	Paid Losses per doctor	Direct Premiums Written per doctor 2001 \$	Paid Losses per doctor 2001 \$
1975	0.084	7005	47	786	66	4562	385
1976	0.100	7475	52	1388	139	7283	730
1977	0.091	7945	57	1256	114	6009	545
1978	0.061	8414	61.8	1363	83	6017	368
1979	0.180	8884	67.5	1341	241	5419	975
1980	0.216	9354	74.9	1776	383	6468	1394
1981	0.229	9753	82.9	1909	438	6281	1440
1982	0.327	10151	92.5	2241	733	6609	2161
1983	0.371	10550	100.6	2382	885	6459	2399
1984	0.444	10948	106.8	3118	1384	7964	3535
1985	0.501	11347	113.5	4381	2195	10529	5276
1986	0.221	11776	122	6140	1358	13730	3036
1987	0.350	12205	130.1	6846	2395	14355	5021
1988	0.433	12634	138.6	6338	2744	12476	5400
1989	0.390	13063	149.3	7662	2991	13999	5465
1990	0.432	13492	162.8	6945	2998	11637	5024
1991	0.390	14183	177	6704	2612	10332	4026
1992	0.537	14874	190.1	6714	3608	9635	5177
1993	0.552	15564	201.4	6619	3651	8965	4945
1994	0.514	16255	211	7550	3878	9761	5014
1995	0.443	16946	220.5	7122	3155	8811	3904
1996	0.588	17719	228.2	6422	3775	7678	4512
1997	0.843	18491	234.6	6512	5489	7572	6383
1998	1.012	19264	242.1	5905	5975	6654	6732
1999	0.762	20036	250.6	6018	4584	6551	4990
2000	0.849	20809	260.8	6134	5210	6416	5450
2001	0.751	21581	272.8	8368	6281	8368	6281

Sources:

Premiums Written (Net), Bests Aggregates and Averages, 2001 Edition, A.M. Best and Co., special data compilation for AIR, reporting data for as many years as separately available; U.S. Bureau of the Census, 1975 (2001 Estimated); Inflation Index: Bureau of Labor Statistics, 1975 (1985 estimated); Number of Total NonFed Doctors: U.S. Bureau of the Census (data for 1975, 80, 85, 90, 95 and 99; other years Estimated)

Note that “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 (over a billion dollars) in loss reserves in 2001 – which is accompanied by a similar jump in premiums nationally.

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 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 North Carolina represents the first comprehensive report on medical malpractice insurance in that state, analyzing what insurers have taken in and what they’ve paid out over the last 30 years, including jury awards, settlements and other costs. Its findings are startling. Medical insurance premiums have risen and fallen in relationship to the state of the economy while payouts have approximately tracked the rate of medical inflation. Not only has there been no real increase in lawsuits, jury awards or any tort system costs in recent years, but the astronomical premium increases that some doctors have been charged during periodic insurance “crises” over this time period are in exact sync with the economic cycle of the insurance industry, driven by interest rates and investments. In other words, insurance companies in North Carolina and nationwide raise rates when they are seeking ways to make up for declining interest rates and investment losses.