Medical Malpractice Insurance: Stable Losses/Unstable Rates in West Virginia

January 2003

Introduction and Summary of Findings

In January, 2003, approximately two dozen surgeons in West Virginia went on strike protesting 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 physicians are suddenly being hit with skyrocketing 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 West Virginia, 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 West Virginia 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 the tort system (i.e., capping damages) but with the business practices of the insurance industry itself:

- First, over the last 10 years, the amount that medical malpractice insurers have paid out, including all jury awards and settlements, has approximately tracked the rates of medical inflation. When measured in constant dollars, the average payouts per doctor rose from 1976 to 1991, but fell sharply between 1992 and 1999. In other words, medical malpractice claims payments (in constant dollars) have been essentially flat over the last decade.

- Second, medical insurance premiums charged by insurance companies over the last 30 years in West Virginia 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 them.

Background

The nation's insurance companies have convinced medical lobbies in West Virginia 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. But the cause of the spike in rates is not the legal system; the cause is the insurance system.

In West Virginia, the insurance industry argues and worse, convinces surgeons and other physicians 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 West Virginia 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. This is precisely what striking West Virginia surgeons are demanding and are attempting to intimidate lawmakers into enacting.

As on the national level, insurance rates for doctors in West Virginia have skyrocketed twice before: in the mid-1970s and in the mid-1980s, each "crisis" occurring during years of a weakened economy and dropping interest rates. News reports today are nearly identical to news reports during previous cycles. Compare, for example, the following two *Washington Post* stories, one from 1986 and the other from 2003:

> "Doctors and hospitals in West Virginia 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 such as one underway in West Virginia." *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 West Virginia 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 these volcanic eruptions in premiums, but to restrict — over and over again — injured patients' rights to sue for medical malpractice. Indeed, in 1986, West Virginia enacted a "cap" on non-economic compensation and limited joint and several liability for doctors.

One of the first states to react to this now third 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 announced that despite the new law, they would not reduce insurance rates for the foreseeable future. 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 West Virginia, 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 West Virginia 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 West Virginia 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

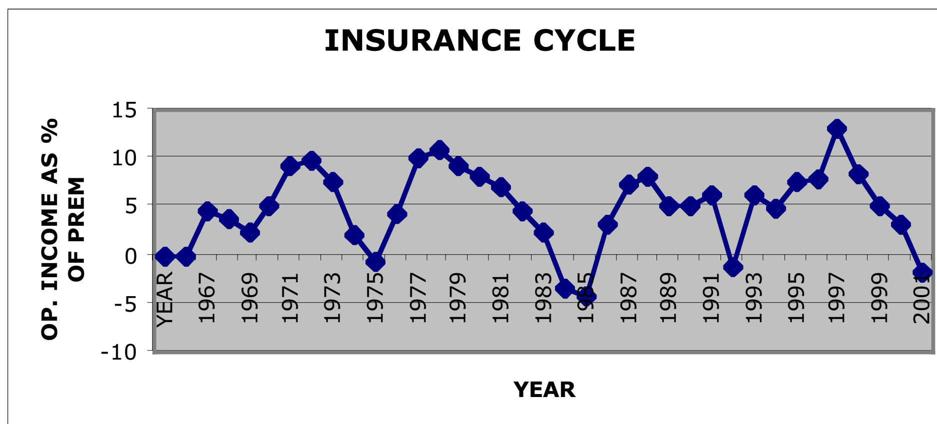
Insurers make most of their profits from investment income. During years of high interest rates and/or excellent insurer profits, insurance companies engage in fierce competition for premium dollars to invest for maximum return. Insurers severely underprice their policies and insure very poor risks just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

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 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 West Virginia insurers and are therefore the reason behind skyrocketing insurance rates, then losses per doctor should be rising faster than medical inflation over time.

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[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.

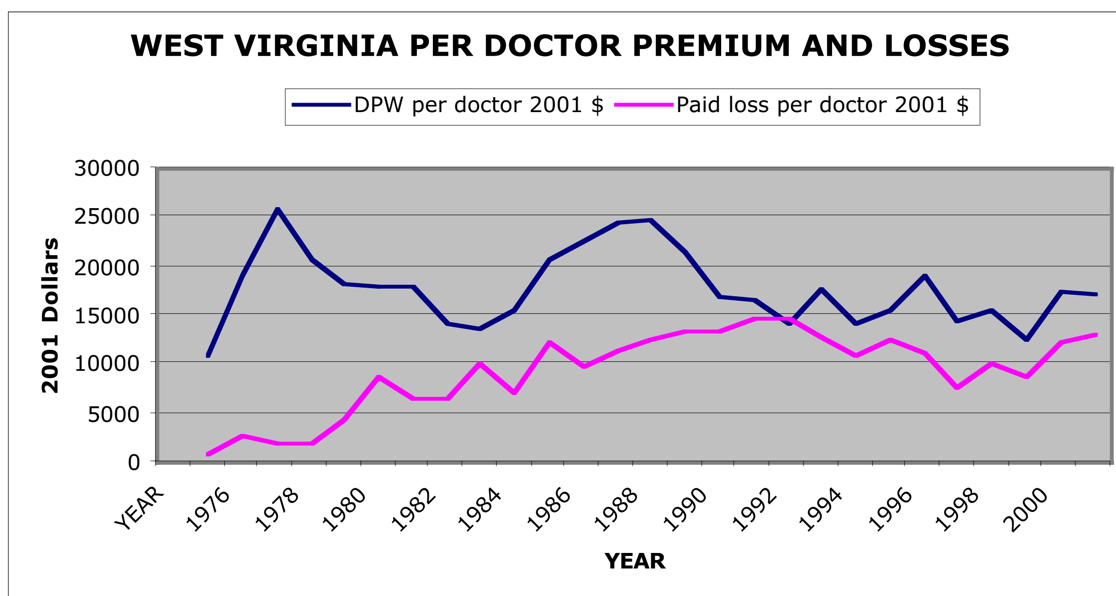
Second, if lawsuits or other tort costs are the cause of rate increases for West Virginia doctors rather than decreasing interest rates and other economic factors, those losses should be reflected in steadily increasing rates, not in sharp ups and downs that might instead reflect the state of the economy, 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 these periodic medical malpractice crises in West Virginia. First, they show that since 1991, medical malpractice paid claims per doctor have tracked medical inflation very closely. In fact, while the average payouts per doctor rose from 1976 to 1991, they fell sharply between 1992 and 1999. In other words, between the beginning and end of the last decade, payouts have risen almost precisely in sync with medical inflation, which should surprise striking 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. Since 1975, the data show that in constant dollars, per doctor written premiums — the amount of premiums that doctors have paid to insurers — have gyrated almost precisely with the insurer's economic cycle, which is driven by such factors as insurer mismanagement and changing interest rates, not by lawsuits, jury awards, the tort system or other causes. In constant dollars, the average premium paid per doctor in West Virginia was $25,000 in 1978, $25,000 again in 1989 and presumably headed back there today. However, the average premium paid per doctor was sharply down in early 1990s and flat between 1994 up to 2001.

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

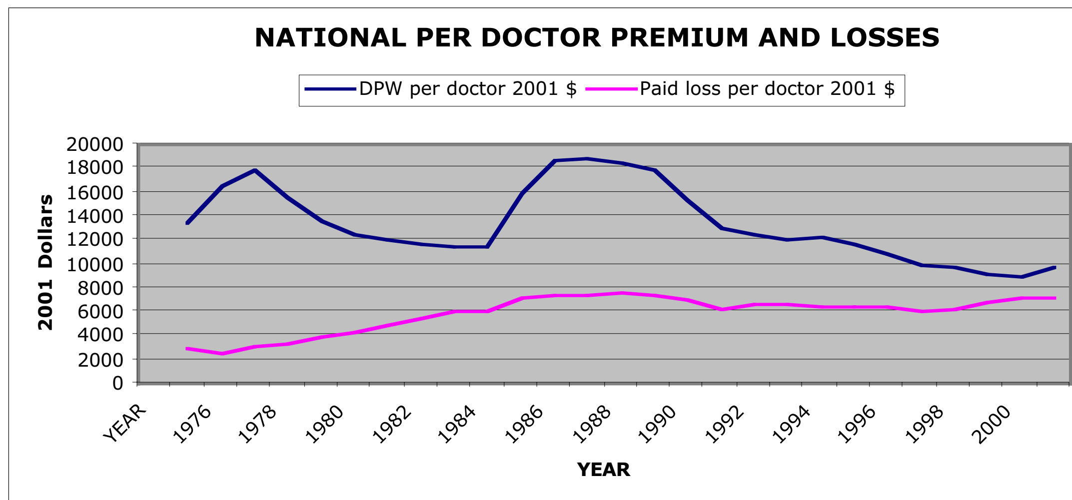
Exhibit 2



Sources:
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)[2]; Inflation Index: Bureau of Labor Statistics, 1975 (1985 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.[3]

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



Sources:
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[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 West Virginia 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 – West Virginia Data

YEAR	Loss ratio	Number of doctors in West Virginia	DPW per doctor	Paid losses per doctor	YEAR	DPW per doctor **2001 $**	Paid loss per doctor **2001 $**
1975	0.083	2230	1877	156	1975	10894	907
1976	0.144	2333	3639	523	1976	19093	2744
1977	0.078	2436	5439	423	1977	26031	2024
1978	0.095	2539	4667	442	1978	20600	1950
1979	0.247	2642	4502	1113	1979	18196	4498
1980	0.489	2745	4968	2430	1980	18093	8850
1981	0.361	2860	5476	1979	1981	18021	6512
1982	0.463	2975	4848	2244	1982	14298	6619
1983	0.746	3089	5012	3738	1983	13591	10136
1984	0.459	3204	6122	2811	1984	15638	7180
1985	0.586	3319	8675	5083	1985	20851	12217
1986	0.434	3333	10110	4386	1986	22606	9808
1987	0.469	3347	11686	5480	1987	24503	11492
1988	0.506	3360	12634	6395	1988	24866	12586
1989	0.627	3374	11728	7357	1989	21429	13443
1990	0.782	3388	10115	7913	1990	16949	13260
1991	0.879	3500	10815	9506	1991	16669	14652
1992	1.027	3612	9974	10242	1992	14313	14697
1993	0.718	3724	13087	9391	1993	17726	12720
1994	0.781	3836	10919	8530	1994	14116	11029
1995	0.801	3948	12598	10093	1995	15586	12487
1996	0.595	4042	15890	9459	1996	18996	11308
1997	0.534	4136	12482	6663	1997	14514	7748
1998	0.653	4229	13842	9044	1998	15597	10190
1999	0.681	4323	11636	7922	1999	12667	8624
2000	0.703	4417	16599	11661	2000	17363	12198
2001	0.750	4511	17283	12955	2001	17283	12955

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.

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 the1980s, 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 West Virginia 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 over the last decade 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 timeperiod are in exact sync with the economic cycle of the insurance industry, driven by interest rates and investments. In other words, insurance companies in West Virginia and nationwide raise rates when they are seeking ways to make up for declining interest rates and investment losses.