Testimony of
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Consumer Federation of America

Before the
Subcommittee on Health
of the House Committee on Energy and Commerce

Regarding Medical Malpractice Insurance Rates

July 17, 2002

Good morning. I am Travis Plunkett, legislative director for the Consumer Federation of America. CFA is a non-profit association of more than 290 organizations founded in 1968 to advance the consumer interest through advocacy and education. Ensuring the provision of fairly priced and adequate insurance has been one of our core concerns since CFA's inception.

I would like to thank Chairman Bilirakus, Ranking Member Brown and the other members of the Subcommittee for the opportunity to offer our comments on this extremely important issue. For the third time in less than thirty years, Congress and state legislators across the country are grappling with the problem of fast-rising medical malpractice rates. Insurers insist that a sharp increase in large, unwarranted jury verdicts is to blame for the crisis. As a result, lawmakers on this Subcommittee and in a variety of states are considering legislation to place further limits on the legal rights of Americans who have been harmed or killed by medical malpractice.

But research by actuary and CFA Director of Insurance J. Robert Hunter shows that insurers are pointing fingers when they should be looking in the mirror. It is the "hard" insurance market and the insurance industry's own business practices that are largely to blame for the rate shock that physicians have experienced in recent months. CFA has found that:

- Medical malpractice rates are not rising in a vacuum. Commercial insurance rates are rising overall.
- The rate problem is caused by the classic turn in the economic cycle of the industry, sped up--but not caused by--terrorist attacks.
- Insurers have under-priced malpractice premiums over the last decade. It would take a 50 percent rate hike to increase inflation-adjusted rates to the same level as existed ten years ago.
- Further limiting patients' rights to sue for medical injuries would have virtually no impact on lowering overall health care costs. Medical malpractice insurance costs as a proportion of national health care spending are miniscule, amounting to less than 60 cents per $100 spent.
- Insurer losses for medical malpractice have risen slowly in the last decade, by just over the rate of inflation.
- Malpractice claims have not "exploded" in the last decade. Closed claims—which include claims where no payout was made-- have remained constant, while paid claims have averaged just over $110,000.
- Medical Malpractice profitability over the last decade has been excellent, at just over 12 percent, despite a decline in profits in the last two years.

I. Putting Medical Malpractice Insurance Rates into Context: Insurer Practices and the Insurance Cycle

A. Commercial Insurance Rates Overall Are Rising

To put price increases in insurance anywhere in America today into context, you have to be aware of a general tendency toward higher rates nationally. According to data released by the

Council of Insurance Agents (CCIA) and Brokers,[1] commercial premiums are increasing quickly. According to estimates made by CFA based upon the CCIA data for the 12-month period ending December 31, 2001, average prices rose as follows:

Small Commercial Accounts	+21%
Mid-size Commercial Accounts	+32%
Large Commercial Accounts	+36%

The worst hit are, not surprisingly, "terrorist target" risks, such as skyscrapers. According to the CCIA survey, CFA calculates the average increases over the last year by line of insurance as:

Business Interruption	+30%
Construction	+46%
Commercial Cars	+28%
Property	+47%
General Liability	+27%
Umbrella Liability	+56%
Workers' Compensation	+24%

Interestingly, the broad rate increases are occurring even when terrorism is excluded. The market shows all the earmarks of a classic cycle bottom, which is discussed in some detail below.

B. <u>There is a Classic "Hard" Cycle Nationally--with Prices Rising Accelerated by the Events of September 11th</u>

Insurance is a cyclical business. This is particularly true in the medical malpractice insurance business. In the mid-1970s, the country experienced the first liability insurance crisis. In this case, the crisis was particularly acute in product liability insurance and medical malpractice insurance.

At the mid-70s cycle low, the industry's rate of return was "2.6% in 1975," rose "to 19.7% in 1977, a gain of almost 17 points in the course of only two years. The industry's rate of return then fell by more than 17 points over the next 7 years to 1.9% in 1984, the nadir of that soft market. During the subsequent hard market, profits once again shot up…to 15.4%" (by 1987).[2]

The mid-1980s crisis was in commercial liability generally, hitting municipalities, day care centers, environmental liability, medical malpractice and many other liability risks and lines. *Time* magazine had a cover story called "Sorry America, Your Coverage is Cancelled."

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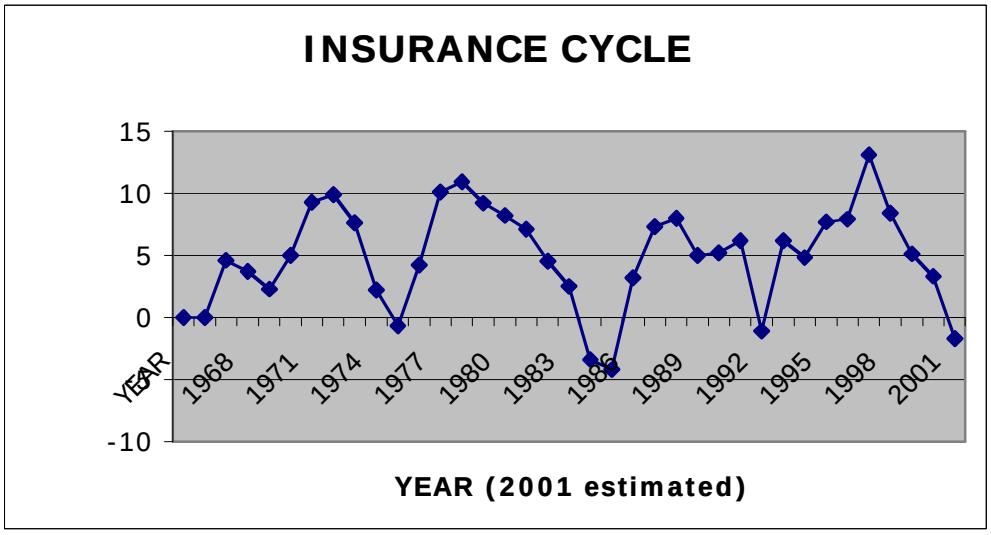
[1] 4th Quarter 2001 Survey, released January 2002.

[2] <u>Cycles and Crises in Property/Casualty Insurance: Causes and Implications</u>, edited by Cummings, Harrington and Klein, NAIC, 1991. Page 11.

Two charts below show the cyclical nature of insurance.[3] The first chart, "Insurance Cycle" shows the operating income as a percentage of premium from 1967 to 2001. The operating income of the industry falls below zero four times on the chart – in 1975, in 1984 and 1985, in 1992, and in 2001 (the last number estimated by CFA).



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

The 1975 and mid-80s bottoms were both classic cycle bottoms with very sizeable price increases and coverage availability problems immediately following the bottom. Consider the mid-80s cycle turn: between 1977 and 1984, insurance premiums had "…actually declined (by) 4.4%…from 1984 to 1987, net premiums written increased 63.3%…"[4]

The price increases in this cycle turn began in late 2000.[5] The rate of change was accelerating upward before September 11th. The terrorist attacks sped up the price increases into what some seasoned industry analysts see as gouging.[6] Many examples of unjustified price increases have surfaced in the last few months.[7] [8]

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[3] Both of these charts use data from A. M. Best and Co., Aggregates and Averages, 2001 edition for all years except 2001, where CFA made estimates of the results based on current information.

[4] Cycles and Crises in Property/Casualty Insurance: Causes and Implications, edited by Cummings, Harrington and Klein, NAIC, 1991. Page 8.

[5] "The Big Question For 2002: Will Hard Market Last Long?" By Sean F. Mooney, National Underwriter, January 7, 2002 edition.

[6] "…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, in, "Avoid Price Gouging, Consultant Warns," National Underwriter, January 14, 2002.

[7] "As Insurers Hike Prices, State Regulators Consider Reducing Regulatory Authority," Consumer Federation of America, December 5, 2001.

[8] "We've seen premiums go up as much as 40-70 percent," says [Jenny] Jones [CEO of Elkins/Jones insurance brokerage]. She points out that commercial buildings which now pay five or six cents per square foot for insurance need to budget for costs to go up to as much as seven or eight cents a foot. She says the increases could be across the board for all types of properties. Single family housing developers could be sharply affected, she notes, citing

Gouging usually does occur as the cycle turns.[9] The evidence is very strong that what we are experiencing is a classic underwriting cycle turn into a "hard," from a prolonged "soft," market.

According to the National Association of Insurance Commissioners, "…underwriting cycles may be caused by some or all of the following factors:

1. Adverse loss shocks…unusually large loss shock…may lead to supra-competitive prices.
2. Changes in interest rates…
3. Under pricing in soft markets…"[10]

Prior to September 11th, the industry had been in a soft market since the late 1980s. The usual six to ten year economic cycle had been expanded by the amazing stock market of the 1990s. No matter how much they cut their rates, the insurers wound up with a great year when investing the float on the premium in this amazing 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). 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 Federal Reserve cut interest rates again and again. Item 2 above had occurred well before September 11th.

Item 3 above, the low rates, were also apparent. The chart, "Insurance Cycle," shows the operating profit drop from about 13% of premium in 1997 to about 3.5% of premium in 2000.

So, before September 11th, the cycle had turned, rates were rising and a hard market was developing. An anticipated price jump of 10% to 15% in 2001 was predicted by CFA and confirmed by the Insurance Information Institute.

Item 1, the shock loss was all that was missing. September 11th provided that in an achingly painful way.

However, the increases are mostly due to the cycle turn. The price increases were sped up by the terrorist attack, collapsing two years of anticipated increases into a few months, but the bulk of the increases are not related to pricing for terrorism, per se. This is a classic economic cycle.

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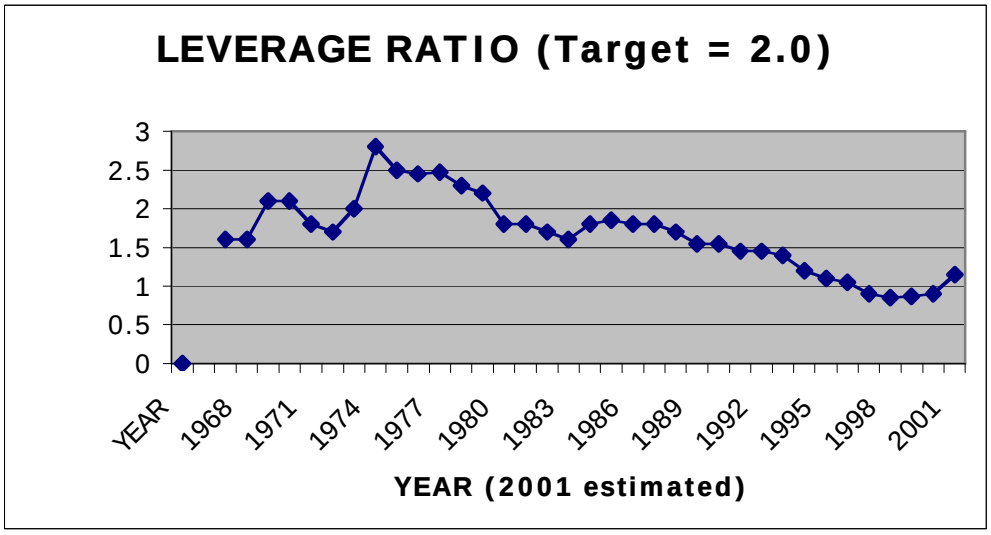
one homebuilder whose liability premium doubled at the November 11 renewal." "Large Insurance Premium Increases in 2002 as September 11 Ricochets Through Industry, Expert Advises," Business Wire, January 3, 2002.

[9] "To be sure, the market began firming in 2000. But the Sept. 11 terrorist attacks sent insurance prices skyrocketing far beyond the estimates of increases that earlier were being attributed to a normal hard cycle." "Year in Review," Business Insurance, December 24, 2001.

[10] Cycles and Crises in Property/Casualty Insurance: Causes and Implications, edited by Cummings, Harrington and Klein, NAIC, 1991. Page 339.

The question we hear a lot of debate about is how long the hard market can last. Given the amazing inflow of capital, can the prices hold for long? While the jury is still out on that question, there are some factors that make it seem likely that the hard market will be brief. They include:

- The capital inflow in excess of the after-tax terrorism loss,
- The relatively overcapitalized position of the industry as shown in the chart, "Leverage Ratio," below,
- The availability of alternative risk mechanisms to the larger client risks, the insureds with the biggest price hikes,
- The pattern of risk managers blaming insurers, not the terrorism event, for renewal problems, and shopping for better deals.[11]



A "leverage ratio" is the ratio of net premiums written (i.e., after reinsurance) to the surplus, the amount of money the insurer has to back up the business; assets less the liabilities. Surplus is not reserves, which are liabilities set up to cover claims. The leverage ratio has always been the key measure of insurer strength.

The rule of thumb used for decades by insurance regulators and other experts in determining solidity is the so-called "Kenny[12] Rule" of $2 of premium for each $1 of surplus as safe and efficient use of capital. Some now say that this rule is antiquated, given the new level of catastrophe possible, but new ways of spreading the risk, such as securitizing it, may offset this. CFA still believes a 2:1 ratio is safe. But even those proposing a lower ratio do not go below 1.5:1. The NAIC uses a 3:1 ratio as the standard for determining if an individual insurer warrants solvency inspection.

When the cycle turned in the mid-70s, the premium/surplus ratio was as high as 2.8 to 1. This was a dangerously high average ratio since many insurers exceeded the 3:1 NAIC problem

[11] "Risk Managers Blame Insurers for Renewal Woes," National Underwriter, January 14, 2002
[12] Named after a famous insurance financial writer, Roger Kenny.

ratio. When the mid-80s cycle turned, the ratio was as high as 1.8 to 1 – a relatively safe level. In today's cycle turn, CFA projects the ratio for 2001 year-end to be about 1.2 to 1, extremely safe and, indeed, overcapitalized.

II. The Facts About Medical Malpractice Claims and Losses

As the lengthy explanation above demonstrates, the practices of the insurance industry itself are to largely to blame for the wildly gyrating business cycle of the last thirty years. Each time the cycle turns from a soft to a hard market the response by insurers is predictable: they shift from inadequate under-pricing to unconscionable over pricing, cut back on coverage and blame large jury verdicts for the problem. It is particularly appalling to see a crisis caused by insurer action being blamed, by the very insurers that caused the problem, on others. Insurers seem to expect legislators and the American public to swallow the dubious line that trial lawyers have managed to time their million-dollar jury verdicts to coincide precisely with the bottom of the insurance cycle three times in the last thirty years. Medical malpractice insurance rates are now rising fast. Insurers tell the doctors it is the fault of the legal system and urge them to go to state legislatures or to Congress and seek restrictions on the rights of their patients. Physician associations, unfortunately, are only too willing to accept this faulty logic.

Although rates are obviously now increasing, medical malpractice insurance losses are not "exploding" and have actually declined by one significant measure. CFA's Director of Insurance, J. Robert Hunter, conducted an actuarial analysis of medical malpractice insurance using the most recent insurance data available from the National Association of Insurance Commissioners and A.M. Best and Company. He found the following:

1. **Inflation-adjusted medical malpractice premiums have declined by one -third in the last decade**. Exhibit A shows that the average medical malpractice premium per doctor barely climbed from $7,701 in 1991 to $7,843 in 2000, an increase of 1.9 percent. Rates in constant 2000 dollars have declined by 32.5 percent, when the medical care services Consumer Price Index is taken into consideration, It would take a rate increase of 48 percent to bring premium rates in 2000 back to the 1991 price level. This chart points to insurer pricing practices (e.g. under-pricing during a soft market followed by a sharp increase in premiums as the market has hardened) as a key culprit in the rate shock that many physicians are now experiencing.

2. **Medical malpractice as a percentage of national health care expenditures are a fraction of the cost of health care in this nation. Over the last decade, for every $100 of national health care costs in the United States, medical malpractice insurance cost 66 cents. In the latest year (2000) the cost is 56 cents, the second lowest rate of the decade.** Exhibit B shows that malpractice premiums as a share of health costs have declined from .95 percent in 1988 to .56 percent in 2000. Medical malpractice insurance is actually an amazing value as it covers all medical injuries for about one-half of one percent of all health costs. Moreover, this chart shows that proposals to further limit patients' rights to sue for medical injuries have little, if any, value in terms of lowering

overall health care costs. The maximum potential savings of eliminating all rights for injured patients to seek legal redress would be under 60 cents on a $100 medical bill.

3. **There is no "explosion" in the severity of medical malpractice claims** . Only about one in four persons who bring a claim (24.6%) get any payment at all. Each closed claim in America—which includes all million-dollar verdicts—averaged only $27,824 for the decade ending December 31, 2000. This includes costs for insurer defense and claims adjustment. The figures over the decade showed no growth in average paid claim. If one looks at average payout just for claims with payments (as opposed to all closed claims) the average loss was $112,987. This includes costs for defense of claims settled, adjudicated or otherwise closed with no payment, thereby overstating the cost per claim paid. (See Exhibit C**.)**

4. **Medical malpractice insurance losses have risen very slowly .** Incurred losses, including loss adjustment expense (LAE) has risen by one-half of one percent over the last decade on a per-capita basis more than medical inflation. (See Exhibits A and C.) Furthermore, Exhibit D shows that medical malpractice losses haven't come anywhere close to approaching or exceeding premiums, as they did in the early 1980s. In other words, losses have increased on a fairly regular, predictable basis, like most goods and services subject to inflation. The problem, as pointed out in 1 above, is that premiums have not kept up with losses.

5. **Medical Malpractice profitability over the last decade has been excellent.** Despite a decline in profitability in the last three years, the average return on net worth for medical malpractice lines was still a handsome 12.3% over the last decade. (See Exhibit E.)

III. Solutions

Both the states and Congress must act to deal with the true source of the malpractice insurance price increases: insurer pricing practices and the volatile insurance cycle. As usual with insurance issues, state regulators must take the lead. CFA has called on the National Association of Insurance Commissioners to thoroughly investigate rate hikes in both personal and property/casualty lines and to consider a number of specific reforms to freeze or rollback unwarranted rate hikes and to prevent rate shock in the future. States can also take steps to spur private market development of increased insurance alternatives (such as captive insurance companies, risk retention groups, purchasing groups and the creation of new mutual insurance companies) and to increase the availability of insurance through public resources (such as joint underwriting associations and insurance facilities.)

The states could also act to provide relief to the medical specialists, such as obstetricians and neurologists, who bear the brunt of medical malpractice costs. The problem, from an insurance point-of-view, is that the risk is too concentrated on too few providers. The highest risk patients, who have illnesses or conditions where a slight provider error can cause grave harm or death, are usually "referred up" from general practitioners and internists to specialists. For example, only the very worst risks of all bad backs in a particular state end up being treated by

neurosurgeons. Yet a few neurosurgeons bear the full cost of these risks; none of the risk is borne by referring physicians. This risk should be spread somewhat, because non-specialist physicians benefit financially from this structure (lower risk patients are less costly in malpractice terms.) States should consider requiring insurers to impose a "high-risk referral" fee on all physicians, that could then be adjusted upward for risk depending on the class of practitioner and used to lower insurer costs in the highest-risk classes.

Congress could act to address rising malpractice rates by creating a national reinsurance facility. All insurers writing medical malpractice would be members of the facility. Members would cede the premiums and claims over a set catastrophic amount to the facility. The facility would take all risk over this retention and would charge an actuarially-based premium for this coverage. The premium would NOT be allowed to fluctuate downward during the economic cycle of the medical malpractice insurance market, thereby serving to stabilize the premium cycle as well as make insurance more readily available through spreading the cost of large injuries to a national base. The reinsurance plan would have to be administered by a federal agency—the Department of Health and Human Services is probably the best bet—but there would be no taxpayer funding. Cost of premiums and of program administration would be paid out of the premiums ceded to the facility. HHS would utilize the data generated on these catastrophic claims to report to Congress on ways to decrease medical errors and malpractice.

There have been three medical malpractice crises, in the mid-1970s, the mid-1980s and currently. This appears to be (so far) the mildest of the three events in terms of price increases and coverage unavailability, even with the withdrawal of malpractice insurer St. Paul from the market.

The crises are caused by the economic cycle of the insurance industry. The cost of claims has been relatively flat, of the order of $110,000 per claim closed with payment and under $30,000 per claim closed when those claims closed without payment are included in the averages (as they must be since the adjustment expense for such claims is included in the data).

Thus, in order to control the periodic malpractice insurance rate flare-ups, the cycle must be controlled. This requires the discipline of a regulator to do a very difficult thing, keep prices somewhat higher than competition would dictate during the "soft" phase of the cycle and escrow the excess to help when the "hard" phase sets in.

The "hard" phase is related to reinsurance becoming unavailable or high priced. This is why a national reinsurance facility makes sense. Further, if the facility is regulated by the federal government, the government would have incentives to make sure that rates remained actuarially sound and stable throughout the cycle and would be able to use the data on large claims for risk reduction research.

IV. Conclusion

A lot is at stake in this debate. The 1999 report regarding medical errors by the Institute on Medicine (IOM) demonstrates that far too many Americans face the serious possibility of an

injury, or even death, due to medical mistakes in the hospital. Using the IOM's low estimate of 44,000 deaths per year, medical errors are the eighth leading cause of death in this country, ahead of breast cancer and AIDS. The IOM's high-range estimate of 98,000 deaths a year would make medical errors the fifth leading cause of death, more than all accidental deaths.[13] Of course, some medical errors are directly attributable to physician negligence and some are not, but the IOM report clearly demonstrates the serious implications of rolling back the legal rights of Americans who have been harmed or killed by malpractice. If Congress gets it wrong, the pain and suffering incurred by many families across the country will only increase.

Before this Committee rushes through tort reform legislation, I urge you to get the facts. As the evidence I've presented you with today shows, insurers have only themselves to blame for the predicament they—and physicians and patients throughout the country—face.

[13] *To Err is Human, Building a Safer Health System,* Institute of Medicine, National Academy of Sciences; November, 1999.

EXHIBIT A: MEDICAL MALPRACTICE PREMIUMS 1991-2000

YEAR	U.S.A. NUMBER OF DOCTORS	U.S.A. MEDICAL MALPRACTICE PREM EARNED (in thousands)	AVERAGE MED MAL PREMIUM PER DOCTOR U.S.A.	MEDICAL CARE SERVICES CPI-U 7/1 OF YEAR	MED MAL AVERAGE PREMIUM AT 2000 DOLLARS
1991	631400	4862170	7700.62	176.1	11614.33
1992	652100	5138395	7879.77	189.7	11032.50
1993	670300	5174055	7719.01	202.6	10119.30
1994	684400	5931898	8667.30	212.6	10828.01
1995	720300	6080639	8441.81	223.5	10031.97
1996	737800	5992394	8121.98	231.9	9302.27
1997	756700	5917038	7819.53	238.7	8700.74
1998	777900	6195047	7963.81	246.5	8580.88
1999	797600	6155241	7717.20	254.6	8050.62
2000	812800	6375401	7843.75	265.6	7843.75
1991 to 2000 PERCENT CHANGE				50.8	-32.5
RATE INCREASE REQUIRED TO BRING 2000 TO 1991 PRICE LEVEL					48.10%

Sources:
Doctors USA: Statistical Abstract of the United States
Earned Premiums: NAIC Report on Profit By Line By State
Medical Care Services Inflation: Bureau of Labor Statistics

EXHIBIT B: RATIO OF MEDICAL MALPRACTICE PREMIUM COSTS TO NATIONAL HEALTH CARE EXPENDITURES

YEAR	DIRECT PLUS ASSUMMED MEDICAL MALPRACTICE PREMIUMS EARNED[14]	NATIONAL HEALTH EXPENDITURES[15]	MEDICAL MALPRACTICE PREMIUM AS A % OF HEALTH COSTS
1988	$5322	$562,000	0.95%
1989	5379	623,900	0.86
1990	5157	699,400	0.74
1991	5015	766,800	0.65
1992	5127	836,500	0.61
1993	5367	898,500	0.60
1994	5896	947,700	0.62
1995	6207	993,700	0.66
1996	6190	1,042,500	0.59
1997	6402	1,092,400	0.59
1998	6559	1,146,000	0.57
1999	6703	1,211,000	0.55
2000	7360	1,311,000	0.56
TOTAL	**$56,062**	**$8,463,400**	**0.66%**

[14] Best's Aggregates and Averages, 1998 and 2001 Editions. Figures in millions of dollars. Using direct plus assumed slightly overstates the size of medical malpractice premiums.
[15] U.S. Department of Health and Human Services web site.

EXHIBIT C: MEDICAL MALPRACTICE CLAIMS BY AMERICANS 1991-2000

YEAR	Claims closed with Payment	Claims closed without Payment	USA Number of Doctors	Claims w/ pay per 100 Doctors	Total claims closed per 100 Doctors	Percent of total claims With payment	Paid losses and LAE Expense (000)	Average Loss for all Claims closed	Average Loss for paid claims only
1991	30841	75348	631400	4.9	16.8	29.0	3089412	29093.52	100172.24
1992	31079	82737	652100	4.8	17.5	27.3	3270128	28731.71	105219.86
1993	32821	87728	670300	4.9	18.0	27.2	3438042	28519.87	104751.29
1994	31147	92788	684400	4.6	18.1	25.1	3696608	29826.99	118682.63
1995	31237	94180	720300	4.3	17.4	24.9	3903960	31127.84	124978.71
1996	30522	92888	737800	4.1	16.7	24.7	3641179	29504.73	119296.87
1997	24326	79178	756700	3.2	13.7	23.5	2560484	24738.02	105257.09
1998	17835	67094	777900	2.3	10.9	21.0	2488737	29303.74	139542.30
1999	10419	50363	797600	1.3	7.6	17.1	1192560	19620.28	114460.12
2000	3035	22280	812800	0.4	3.1	12.0	204248	8068.26	67297.53
TOTAL	243262	744584	7241300	3.4	13.6	24.6	27485358	27823.53	112986.65

EXHIBIT D: PREMIUMS EARNED AND LOSSES INCURRED 1976-2000

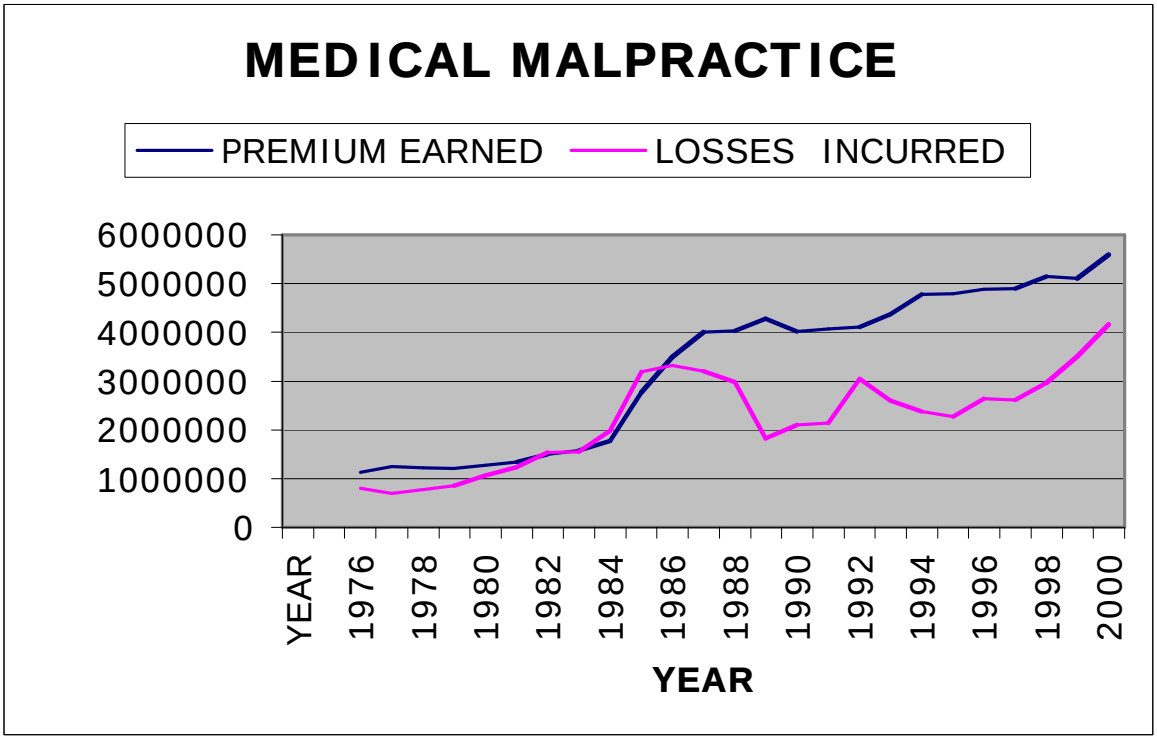


EXHIBIT E: MEDICAL MALPRACTICE INSURANCE PROFITABILITY 1991-2000

PROFITABILITY DATA --
RETURN ON NET WORTH

YEAR	NATIONAL RETURN
1991	15.9
1992	15.5
1993	15.3
1994	13.7
1995	12.7
1996	12.6
1997	12.6
1998	7.6
1999	5.1
2000	5.4
Average ROR	12.3

Source: Profitability By-Line, By-State, National Association of Insurance Commissioners, 2000 Edition.