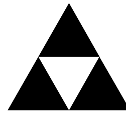

AMERICAN ACADEMY *of* ACTUARIES

March 14, 2005

The Honorable Nathan Deal
Chairman, Subcommittee on Health
U.S. House Energy and Commerce Committee
Washington, DC 20515

Dear Chairman Deal:

This letter serves as a response to your request for written responses to questions posed by Members of the Subcommittee following the February 10, 2005 hearing on "Current Issues Related to Medical Liability Reform." As a member of the Medical Malpractice Subcommittee of the American Academy of Actuaries[1], I was pleased to testify at that hearing. We offer these responses to your questions.

From: The Honorable Joe Barton

1. **Do you believe that, over time, well-crafted federal tort reforms will stabilize the medical liability insurance market and help avoid the kind of wild increases in medical liability premiums we are experiencing now?**

   We believe that well-crafted federal tort reforms will help stabilize the medical liability insurance market and help reduce the likelihood of the sudden, large rate increases that have occurred in the recent past. The Academy subcommittee's observations on tort reforms and other related matters are discussed starting on page nine of our written testimony. A copy of the relevant section is attached for your convenience. One clarifying point on collateral source is that evidence of collateral source benefits should be admissible in court and subrogation against the recipient of a medical liability payment should be prohibited. These approaches help to increase the impact on claim costs.

[1] The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification, and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

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2. **Would medical liability reform, such as a limit on “pain and suffering” awards reduce medical liability insurance premiums?**

   There can be no assurance that rates will be reduced, particularly immediately, after adoption. However, it is a certainty that if claim costs are reduced, or the rate of increase in claim costs is reduced, then rates will be lower than they otherwise would be. The immediate impact on rates will depend on the provision(s) passed, applicability of provisions to cases filed before the effective date of the reform, and whether the pre-reform rate levels of each insurance company are adequate. For example, if an insurance company’s indicated premium rate change is +25 percent pre-reform, and the estimated premium savings from tort reform is 10 percent, healthcare providers would not see a 10 percent savings on their next insurance bill but a net premium increase of approximately 15 percent. Referring to recent actions in Texas, three significant medical malpractice insurers writing physician coverage in Texas have reduced their rates citing the passage of Proposition 12. According to published reports, the largest writer reduced rates first by 12 percent and then by a further five percent; a second writer has proposed reducing rates by 14 percent and a third by five percent. In addition, a large insurer of hospitals has reduced rates by 15 percent.

3. **Some have proposed that caps on insurance premiums could solve the problems facing the medical liability insurance marketplace. What do you believe would be the consequences of such caps?**

   In our opinion, placing caps on insurance premiums will not solve the problems. We believe caps on insurance premiums will lead to more disruption in the marketplace, are likely to reduce the willing and available underwriting capacity for all types of health care providers, and could push more exposure into the alternative risk market (ARM). Some ARM mechanisms (e.g., captives, trusts, etc.) can save administrative costs and some may cost more, but none change the underlying claim costs that are driving higher premiums. While many physician specialty insurers would continue to write business, their financial health could be eroded by caps on insurance premiums and, over some period of time, physicians, in particular, may have trouble finding coverage. In summary, caps on insurance premiums have the potential to, relatively quickly, increase availability problems in addition to the current affordability issues.

4. **Are the premiums being charged today by most insurers sufficient to cover losses or do you expect that they will continue to increase?**

   In general, but subject to variation by jurisdiction, rates look to be sufficient to cover claim costs, defined as at least breaking even on the basis of total operating results. In most jurisdictions claim costs appear to have stabilized, meaning rates will increase at more modest levels than in the recent past in order to keep pace with inflationary trends underlying medical liability payouts and administrative costs. In the jurisdictions where the claim costs have not stabilized, rate increases will likely be more sizeable as insurance companies adjust premium rates to adequate levels. Most jurisdictions rates have been adjusted to reflect a perceived stabilizing claim environment and appear reasonably sufficient to generate a break-even result. In others, the claim costs do not appear to have stabilized and, thus, rates require larger

adjustments in response.

From: The Honorable Charles W. Pickering

What are the two most important provisions of MICRA that we must enact to make a difference?

The two most important Medical Injury Compensation Reform Act or MICRA provisions are the $250,000 non-economic cap on a per occurrence basis and collateral source reform, including admission as evidence in court and no subrogation by health plans, etc. against the recipient of a medical liability payment. It is, however, the full package of reforms, including the other provisions, that makes MICRA have the impact it does.

Thank you for involving actuaries in this important public policy issue. Please feel free to contact us through Greg Vass, Senior P/C Policy Analyst, at 202-223-8196 if we can be of further assistance.

Sincerely,

James D. Hurley ACAS, MAAA
Member, Medical Malpractice Committee

Kevin Bingham, ACAS, MAAA
Chairperson, Medical Malpractice Subcommittee

Attachment: Excerpt from American Academy of Actuaries' Medical Malpractice Subcommittee testimony before House Energy and Commerce, Subcommittee on Heath. February 10, 2005.

TORT REFORM

Some states enacted tort reform legislation after previous crises and in response to the current circumstances as a compromise between affordable health care and an individual's right to seek recompense. The best known is the Medical Injury Compensation Reform Act or MICRA, California's tort reform package. Since MICRA's implementation in 1975, California has experienced a more stable marketplace and lower premium increases than have most other states.

Tort reform has been proposed as a solution to higher loss costs and surging rates. Many are suggesting reforms modeled after California's MICRA, although some have cautioned against modifying the MICRA package. The Academy, which takes no position for or against tort reforms, has previously reviewed and commented on this subject. Based on research underlying the issue, we observe the following:

- A coordinated package of tort reforms is more likely than individual reforms to achieve savings in malpractice losses and insurance premiums.
- Key among the reforms in the package is a cap on non-economic awards (on a per-event basis and at some level low enough to have an effect, such as MICRA's $250,000) and a mandatory collateral source offset rule.
- Such reforms may not assure immediate rate reductions, particularly given the size of some increases currently being implemented. The actual effect, including whether or not the reforms are confirmed by the courts, will not be immediately known.
- These reforms are unlikely to eliminate claim severity (or frequency) changes but they may mitigate them. The economic portion of claims is not affected if a non-economic cap is enacted. Thus rate increases still will be needed.
- These reforms should reduce insurer concerns regarding dollar awards containing large, subjective non-economic damage components and make the loss environment more predictable.
- Poorly crafted tort reforms could actually increase losses and, therefore, rates.

FREQUENT MISCONCEPTIONS

In closing, it might 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."

As we have pointed out, 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. The vast majority of invested assets are fixed-income instruments. Generally, these are purchased in maturities that are reasonably consistent with the anticipated future payment of claims. Losses from this portion of the invested asset base have been minimal, although the rate of return available has declined.

Stocks are a much smaller portion of the portfolio for this 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. Investment returns are still positive, but the rates of return have been adversely affected by stock declines and more so by lower fixed income investment yields.

In establishing rates, insurers do not recoup investment losses. Rather, the general practice is to choose an expected prospective investment yield and calculate a discount factor based on historical payout patterns. In many cases, the insurer expects to have an underwriting loss that will be offset by investment income. Since interest yields drive this process, when interest yields decrease, rates must increase.

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

Financial results for medical liability insurers have deteriorated. Some portion of these adverse results might be attributed to inadequate knowledge about rates in newly entered markets and to being very competitive in offering premium discounts on existing business. However, decisions related to these actions were based on expectations that recent loss and investment markets would follow the same relatively stable patterns reflected in the mid-1990s. As noted earlier, these results also benefited from favorable reserve development from prior coverage years. Unfortunately, the environment changed on

several fronts — loss cost levels increased, in several states significantly; the favorable reserve development ceased; investment yields declined; and reinsurance costs jumped.

While one can debate whether companies were prudent in their actions, 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 there was some delay in reconciling rates and loss levels, the current problem reflects current data.

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

This is a false observation. Companies are reporting financial losses primarily because claim experience is worse than anticipated when prices were set. Several companies have suffered serious adverse consequences given these financial results, including liquidation or near liquidation. Phico, MIIX, Frontier, and most recently, the Reciprocal of America, are all companies forced out of the business and in run-off due to underwriting losses. Further, the St. Paul Cos., formerly the largest writer of medical malpractice insurance, has withdrawn from this market. One reason for this decision is an expressed belief that the losses are too unpredictable to continue to write the business.

The Subcommittee 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.