May 8, 2006

The Honorable William Frist
United States Senate
Washington, DC 20510

Dear Senator Frist:

On behalf of the American Academy of Actuaries'[1] Medical Malpractice Subcommittee, we offer the following actuarial perspective on issues related to patient access to health care and, in particular, the availability and pricing of medical malpractice insurance. As Congress considers medical malpractice liability reform (S. 22 and S. 23), the subcommittee wishes to clarify certain issues in the current debate to aid Congress in addressing problems related to the availability and pricing of this insurance.

DETERMINING RATES

Ratemaking is the term used to describe the process used by insurance companies and their actuaries to determine the premium indicated for a particular coverage. In the insurance transaction, the insurer assumes the financial risk associated with a future, contingent event in exchange for a fixed premium. The true cost of the coverage is not known at the time of the transaction. The company must estimate that cost, determine a price for it, and be willing to assume the risk that the cost may differ, perhaps substantially, from the estimate. It is a fundamental principle of ratemaking that the rate charged reflects the estimated cost of the future events that will occur during the policy period, not what has been paid or is going to be paid on past coverage. It does not reflect money lost on prior investments or costs that exceeded estimates from past policies. In short, a rate is a reflection of future costs.

In general, the actuarial process used to estimate costs for medical malpractice insurance starts with historical claim, adjusting, and defense costs, projected to future dollar levels. It incorporates provisions for all other operating expenses (e.g., administrative expenses, premium taxes, commissions, etc.), the time value of money, and an appropriate provision for risk and profit associated with the insurance transaction.

The inherent risk characteristics of the various types of insurance coverage make some lines of insurance more predictable than others. For example, costs, and therefore rates, for automobile physical damage coverage are more predictable than those of medical malpractice coverage

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

because automobile insurance has a higher frequency of claims with consistently low severity. In contrast, medical malpractice insurance generally produces infrequent claims with a much higher average value and a significantly wider range of possible outcomes. There is also a significant amount of time between the occurrence of an event, the report of a claim, and its final disposition. This delay, due to the interaction between the insurance and legal systems, averages from three to five years and adds to the uncertainty in estimating the ultimate costs of coverage and, consequently, premiums.

RATES DO NOT RECOUP PAST INVESTMENT LOSSES

Ratemaking is a forward-looking process. State insurance laws and actuarial standards of practice prohibit recoupment of past investment losses in rates. Future investment income, based on reasonably expected investment yields, does have an impact on rates. Rates reflect a credit for the time value of money associated with the collection of premium dollars today and the payout of claims in the future. Medical malpractice insurers often expect an underwriting loss (costs before investment yields exceed premium) that will be offset by investment income.

Insurers are restricted in their investment activity due to state insurance regulation and competition in the market. The 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. Capital losses from this portion of the invested asset base have been minimal.

A decrease in investment yields puts upward pressure on premiums. The reverse is also true; an increase in investment yields, as the Board of Governors of the Federal Reserve System's recent series of rate increases demonstrates, puts downward pressure on premiums. A one percent change in interest rates can be translated into a premium rate change of two to four percent in the opposite direction.

TORT REFORMS

Tort reforms like those suggested in S. 22 have been proposed as a possible solution to higher claim costs and surging rates. Reforms modeled after California's Medical Injury Compensation Reform Act (MICRA) are intended to alleviate some of the financial pressure on the medical malpractice insurance system. Those outlined in S. 22, of course, would apply to claims filed at both the state and federal levels. The Subcommittee, which takes no position for or against tort reform measures, offers the following observations:

- A coordinated package of reforms is more likely to achieve savings in malpractice claims and insurance premiums than an individual reform such as a cap on pain and suffering, or non-economic damages, only.
- While a cap on non-economic awards could substantially reduce claim costs (on a per-event basis, and at a level low enough to affect many claims, such as MICRA's $250,000) other tort reform elements, such as an evidence-based collateral source offset with no right of subrogation, are also important.
- Such tort reforms may not assure immediate rate reductions. However, due to recent improvements in the adequacy of rate levels, a meaningful reform package is more likely to increase competition and reduce the frequency and size of rate changes. A full understanding

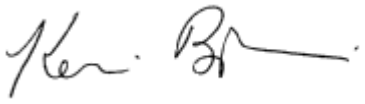
and reflection (in rates) of the long-term impact of such legislation will likely emerge as actual loss experience develops under the applicable reforms.

- These reforms are unlikely to reduce the severity (or frequency) of all claims, but they may mitigate them and add some stability over a number of years. Since the economic portion of claims would not be affected if a non-economic cap is enacted, rate increases, probably at lower levels than otherwise, are still likely over the long term.
- These reforms should reduce concerns about large dollar awards containing significant subjective, non-economic damage components, making the claim environment more predictable.

In general, reforms that bring stability and increase the predictability of future claims will allow insurers and their actuaries to better estimate future costs. That will tend to make insurers more willing to write policies they might otherwise avoid, making coverage more available. Affordability of coverage is a complex issue that goes beyond actuarial science and ratemaking. However, increased stability in rates may allow other economic forces to better adjust, thereby improving affordability.

Thank you very much for your consideration. Please do not hesitate to contact me or Lauren Pachman, the Academy's Casualty Policy Analyst, at 202-223-8196 if you have any questions or would like additional information. We invite you to visit our website at www.actuary.org, which contains copies of our prior testimony to Congress and other valuable information.

Sincerely,



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American Academy of Actuaries