ATTACHMENT 23

FROM: GAO Report June 2003
Medical Malpractice Insurance
Multiple Factors Have Contributed to
Increased Premium Rates.

deductible. Thus, while reinsurance rates may not have increased, the amount of risk the medical malpractice insurers carry did. One insurer estimated that while its reinsurance rates had increased approximately 50 percent from 2000 to 2002, this increase had resulted in only a 2 to 3 percent increase in medical malpractice premium rates.

The Medical Malpractice Insurance Market Moves through Hard and Soft Insurance Markets

All of the factors affecting premium rates and availability contribute to the length and amplitude of the medical malpractice insurance cycle. Like other property-casualty insurance markets, the medical malpractice market moves through cycles of "hard" and "soft" markets. Hard markets are generally characterized by rapidly rising premium rates, tightened underwriting standards, narrowed coverage, and often by the departure of some insurers from the market. In the medical malpractice market, some market observers have characterized the period from approximately 1998 to the present as a hard market. (Previous hard markets occurred during the mid-1970s and mid-1980s.) Soft markets are characterized by slowly rising premium rates, less stringent underwriting standards, expanded coverage, and strong competition among insurers. The medical malpractice market from 1990 to 1998 has been characterized as a soft market. According to a series of studies sponsored and published by NAIC in 1991, such cycles have been present in the property-casualty insurance market since at least 1926, and until the mid-1970s lasted for an average of approximately 6 years from the peak of one hard market to the next.[31] However, the cycle that began at the peak of the hard market in 1975 lasted for around 10 years. The current cycle has lasted for around 17 years—since 1985—and it is not yet clear that the current hard market has peaked.

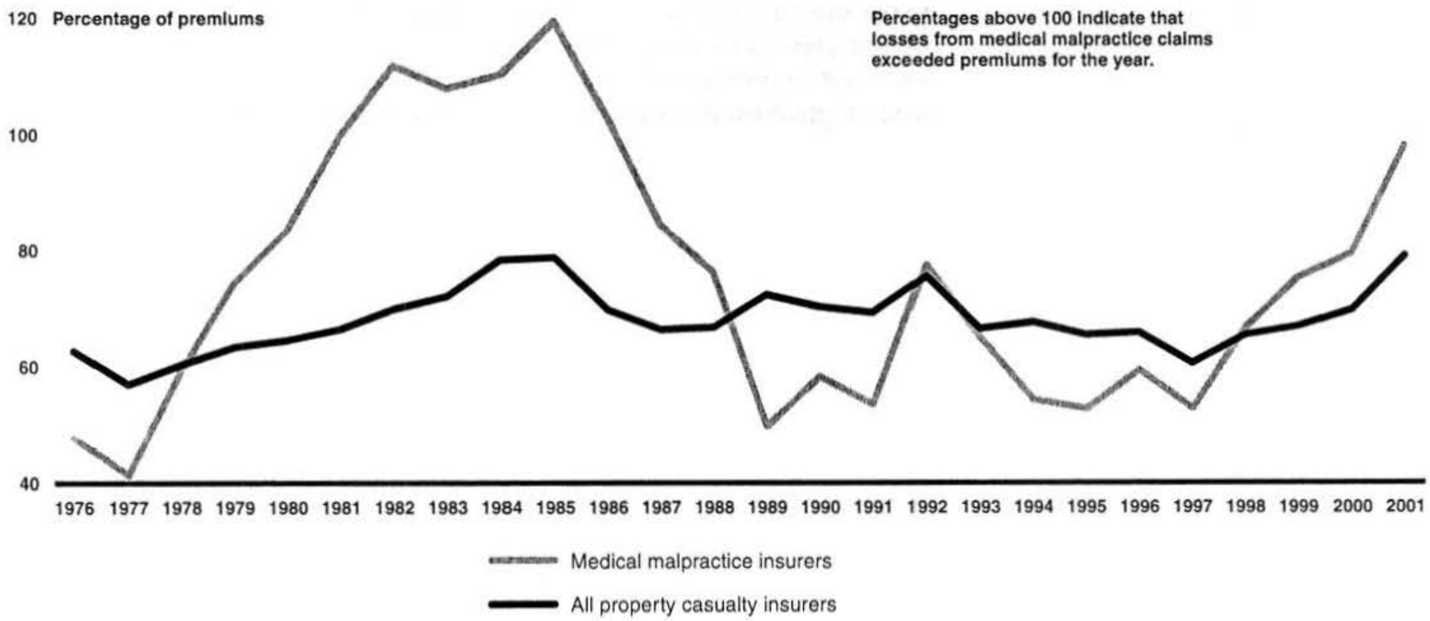
Cycles in the Medical Malpractice Market Tend to Be Volatile

The medical malpractice insurance market appears to roughly follow the same cycles as the overall property-casualty insurance market, but the cycles tend to be more volatile—that is, the swings are more extreme. We analyzed the swings in insurance cycles for the medical malpractice market and for the entire property-casualty insurance markets using annual loss ratios based on incurred losses (see fig. 9). Our analysis showed that annual loss ratios for medical malpractice insurers tended to swing higher or lower than those for property-casualty insurers as a whole, reflecting more extreme changes in insurers' expectations. Because premium rates

[31] National Association of Insurance Commissioners, *Cycles and Crises in Property/Casualty Insurance: Causes and Implications for Public Policy* (Kansas City, Mo.: 1991).

are based largely on insurers' expectations of losses, premium rates will fluctuate as well.

Figure 9: Incurred Losses as a Percentage of Premium Income for Medical Malpractice Insurers and Property-Casualty Insurers Nationwide, 1976–2001



Source: GAO analysis of A.M. Best and National Association of Insurance Commissioners data.

The medical malpractice insurance market is more volatile than the property-casualty insurance market as a whole because of the length of time involved in resolving medical malpractice claims and the volatility of the claims themselves. Several years may pass before insurers know and understand the profits and losses associated with policies sold in a single year. As a result, insurers may not know the full effects of a change in an underlying factor, such as losses or return on investments, for several years. So while insurers in other markets that do not have protracted claims resolutions can adjust loss estimates and premium rates more quickly to account for a change in an underlying factor, medical malpractice insurers may not be able to make adjustments for several years. In the interim, medical malpractice insurers may unknowingly be under- or over-pricing their policies.

When insurers do fully understand the effects of a change in an underlying factor, they may need to make large adjustments in loss estimates and premium rates. As a result, premium rates in the medical malpractice insurance market may move more sharply than premium rates in other lines of property-casualty insurance. For example, if insurers have been unknowingly overestimating their losses and overpricing their policies, as some insurers told us happened during the late 1980s, large liabilities build up to cover the losses. When the insurers realize their estimates have been too high, they must reduce those liabilities to reflect their losses accurately. Reducing liabilities also reduces incurred losses and therefore increases insurers' income, allowing insurers to charge lower premium rates even in the face of increased losses and still maintain profitable operations—a point some insurers made about the 1990s. But when the liability account has been reduced sufficiently and income is no longer increasing as a result of this adjustment, insurers may need to raise premium rates to stay profitable.

The competition that can exist during soft markets and periods of high investment income can further exacerbate swings in premium rates. As noted earlier, competition among insurers can put downward pressure on premium rates, even to the point at which the rates may, in hindsight, become inadequate to keep an insurer solvent. When the insurance market hardens, some insurers may leave the market, removing the downward pressure on premium rates and allowing insurers to raise premium rates to the level that would have existed without such competition. Because competition may have kept rates low, the resulting increase in premium rates that accompanies a transition to a hard market may be greater than it would have been otherwise.

According to some industry experts, periods of high investment income can bolster the downward pressure that exists during soft markets. That is, high investment income can contribute to the increased profitability of an insurance market. This profitability can, in turn, cause insurers to compete for market share in order to take advantage of that profitability, thereby forcing premium rates even lower. In addition, according to these industry experts, high investment income allows insurers to keep premium rates low for long periods of time, even in the face of increasing losses, because investment income can be used to replace premium income, allowing insurers to meet expenses. But if interest rates drop at the same time the market hardens (and reduced interest rates can be a contributor to the movement to hard market), insurers may have to increase premium rates much more in a shorter period of time than they would have if investment income had not allowed premium rates to remain lower to begin with.

Predicting and Moderating the Cycle is Difficult

While the medical malpractice insurance market will likely move through more soft and hard markets in the future, predicting when such moves might occur or the extent of premium rate changes is virtually impossible. For example, the timing and extent of the unexpected changes in the losses that some researchers believe are responsible for hard markets are virtually impossible to predict. In addition, as we have seen, many factors affect premium rates, and it is just as difficult to predict the extent of any future changes these factors might undergo. While interest rates may be high during soft markets, it is not possible to predict how much higher they might be in the future and thus what effect they might have on premium rates. Predicting changes in losses on medical malpractice claims would be even harder, given the volatility of such losses. Further, some of the factors affecting premium rates, such as losses and competition, vary across states, and the effect of soft or hard markets on premium rates in one state could not be generalized to others. Finally, other conditions affecting premium rates have changed since earlier hard and soft markets, limiting our ability to make accurate comparisons between past and future market cycles.

Similarly, agreement does not exist on whether or how insurance cycles could be moderated. The NAIC studies mentioned above noted that the most likely primary causes of insurance cycles—changes in interest rates and losses—were not subject to direct insurer or regulatory control.[32] In addition, the studies also observed that underpricing by insurers during soft markets likely increases the severity of premium rate increases during the next hard market. But they did not agree on the question of using regulation to prevent such swings in premium rates. Such regulation could be difficult, for two reasons. First, because losses on medical malpractice claims are volatile and difficult to predict, regulators could have difficulty determining the appropriate level of premium rates to cover those losses. In addition, restricting premium rate increases during hardening markets could hurt insurer solvency and cause some insurers to withdraw from a market with an already declining supply of insurance.

[32]NAIC, *Cycles and Crises.*