

Groundhog Day!

Do You See Your Shadow?

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In the movie “Groundhog Day” with Bill Murray, each day keeps repeating itself, much to the ire of the lead character. Every day is the same until he’s able to break the cycle by “getting it right.”

While not exactly the same each time, the medical malpractice insurance cycle causes similar angst to those who haven’t been able to “get it right” in the past. This article highlights the steps you can take to break free from this cycle and protect yourself and your practice or facility from the potential (and likely) market change in the coming years.

Why should we start thinking about a transition in the market cycle from soft (falling or steady prices) to hard (rapidly rising prices)? Simply put: because it hasn’t happened yet! There are other compelling reasons as well. Notably, recent health reform efforts have raised medical malpractice as an issue again, and new federal or state-level reform efforts will probably stem from this resurgent interest. Equally as important, physicians are currently dealing with far too many regulatory and reimbursement pressures. Planning now will help you prevent one more pressure later.

While this may not be the bold prediction you might be hoping for, the only forecast we will make is that the market is more likely to cycle higher before moving lower.

“Cycle” logically challenging

A few factors associated with the last hard medical malpractice insurance market included rising premiums, increasing claim severity and/or frequency, decreasing premium capacity (the number of policies or amount of premium the industry as a whole is able to write), a down economy and decreasing investment returns. Each of these contributing factors surfaced again early in this decade, compounding upon one another to create the most recent medical malpractice insurance crisis.

Market capacity

Many experts in the insurance industry believe the last true hard market started between 2000 and 2002. The timing of the previous hard market in medical malpractice in the upper Midwest is easily linked to the exit of St. Paul Companies in 2002. Although less significant, a number of smaller regional players (e.g., PHICO) also exited this market, adding to system-wide stress.

These changes led to a classic supply-and-demand problem. With fewer insurance companies available or willing to offer medical malpractice policies, prices naturally increased. What were the reasons behind the exit of numerous market participants? Increasing claims severity and frequency, as well as decreasing investment income were commonly cited reasons.

Claims

An analysis of the medical malpractice insurers’ financials during the early and mid-1990s shows strong investment income and conservative reserving.¹ For the most part, insurers found themselves with high levels of reserves when losses did not develop as expected. These factors played a role in drawing new entrants seeking quick returns in the market, while also causing some carriers to modify their underwriting and reserving policies in order to maintain market share and profitability.

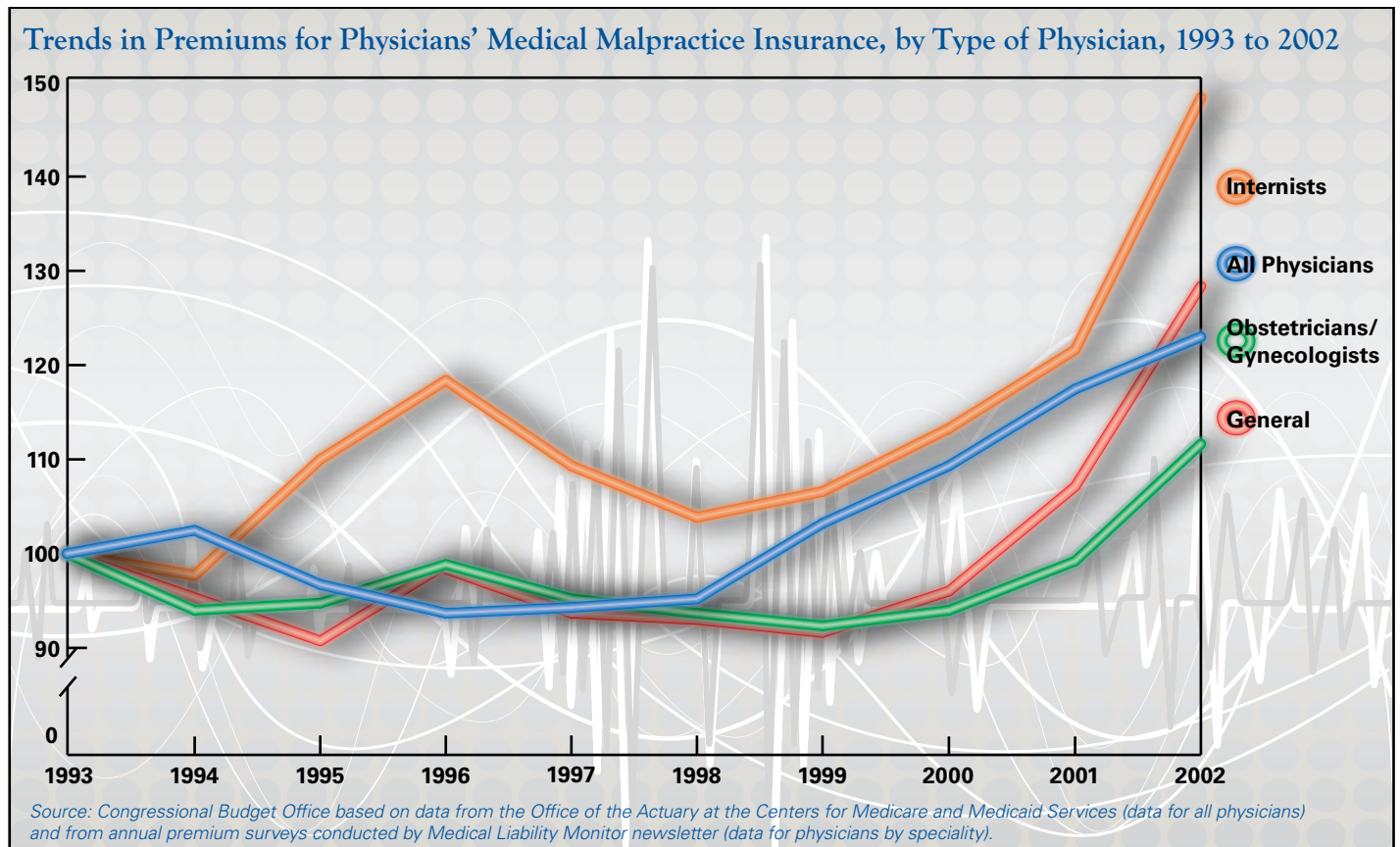
As these trends converged, they were met by 2 other variables needed to quickly turn a market cycle from soft to hard: rising claim severity and frequency. Research shows that the median malpractice award, whether via a jury or settlement, doubled



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in real terms between 1990 and 2001.² Claims frequency through the 1990s also tracked upward at a steady pace.³ A third leg to the frequency and severity stool is the impact they have had on reinsurance costs. As both of these trends caused increasing losses, reinsurers demanded higher prices for their services.

With decreasing investment returns, increasing claim severity and frequency, and downward pressure on prices, the perfect storm for market turmoil was at hand. What followed was a rapid and significant increase in premiums⁴ after the exit of significant market players when substantially worse claims experiences developed and profits evaporated.



Two other points must be noted here. First, tort reform, particularly in the form of state caps on damages, was less developed than it currently is. Second, the Institute of Medicine had only recently issued its sentinel report, "To Err is Human," highlighting the nearly 98,000 preventable deaths due to medical errors every year. Providers, and the industry as a whole, were only in the initial stages of the patient safety movement.

Good times here to stay?!

An exact date is impossible to pinpoint, but the previous hard market transitioned to the current soft market between 2005 and 2006. Since this time, larger risks have seen a decline in premiums ranging from 5% on the low end, to 40% in exceptional cases. Smaller risks have experienced modest decreases, or flat rates, because many have grown during this

time, expanding their exposure. Regardless of these trends, it is important to keep in mind that each business is unique and medical malpractice premiums depend on loss history, industry and unique exposures.

Claim frequency and severity

The last few years have seen a gradual decline in the factors that have previously led to a hard market. According to Chad Karls, Principal and Consulting Actuary with Milliman, the single most important factor in the transition to a soft market has been the reduction in claim frequency that began between 2003 and 2005.⁵ However, Karls also goes on to confirm what many in the industry are now seeing – that claim frequency has either plateaued or is trending upward. Claim severity, a close cousin of frequency, did not see the decline that frequency did and has continued to move upward at a moderate pace.

Great taste but less filling?

Since the start of the millennium, many states have enacted some type of tort reform in an effort to retain providers by lowering malpractice costs. Malpractice reforms can include modifications to the collateral source rule and joint and several liability, but limits on damages that can be awarded are the most common. According to the American Medical Association, approximately 30 states have some cap on damages in medical malpractice cases, although the exact number is in flux as caps undergo constitutional challenges.⁶

For example, Illinois recently exited the list of states with malpractice damage caps when the Illinois Supreme Court overturned the state's 5-year-old, non-economic cap on damages. Georgia's \$350,000 non-economic cap on damages met the same fate this year when it was overruled unanimously by the Georgia Supreme Court. Some other states with caps at risk include:

- Nebraska – a total cap of \$1.75 million successfully withstood one test, but is once again being challenged in the case of *Melvins v. Great Plains Regional Medical Center*.
- Kansas – the case of *Miller v. Johnson* seeks to overturn the state's total cap on non-economic damages of \$250,000.
- Missouri – total cap on non-economic damages of \$350,000 has also withstood one test, but is again under attack in the case of *Klotze v. Shapiro* and *Metro Heart Group of St. Louis*.

The positions of 2 other Midwestern states should also be noted. Iowa law does not cap medical malpractice damages, while South Dakota has a \$500,000 cap on non-economic damages.

The different legal, political and judicial climates of each state make it difficult to extrapolate trends from these recent decisions and challenges. However, it is virtually guaranteed that any tort reforms favorable to the medical malpractice interests of doctors and hospitals will be challenged.

The recent healthcare reform debate has largely ignored the issue of medical liability, and the final bill does not address tort reform at the federal level, but rather provides \$50 million in grants for states to experiment with reforms. The lack of a comprehensive plan to address medical liability ensures that incremental change will be the status quo for the foreseeable future.

The patient safety movement

Since the beginning of the decade, both the public and private sector have made significant headway in promoting patient safety. Although slower than in the last few years of the 1990s, the Agency for Healthcare Research and Quality (AHRQ), a division of Health and Human Services, reports that the overall quality of healthcare improved 1.5% between 2000 and 2005.⁷ The government, as the largest purchaser of healthcare services, continues to push providers to improve quality and outcomes by linking payments to success in these areas. Pay-for-performance initiatives and an expanding list of "never-events" (e.g., wrong-site surgery) are just a few ways that reimbursements to physicians and hospitals are placed at risk if basic quality levels are not met.

Hospitals, insurance carriers and other private parties have also made strides in promoting patient safety. Healthcare entities have refined sterilization procedures and installed special materials to reduce the spread of infection. Providers have created care pathways and checklists to promote consistency, and the majority of insurance carriers offer patient safety consulting and electronic resources to aid insureds in addressing risks.

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New kids on the block...Will they hang tough?

In recent years, the number of medical malpractice options for healthcare providers and facilities has grown. New companies have entered the market and current carriers have augmented their reach and offerings. As with many industries, the medical professional liability market has also seen a wave of consolidations. The current high level of market capacity pits

established, stable insurance carriers against startups. While competition in our economy is generally seen as a good thing, there are potential drawbacks to the current situation.

The risk is that new entrants to the market will fail to underwrite sufficiently to cover the long tail of medical malpractice claims. On average, these claims take years longer to resolve than most other insurance claims. Many things are subject to change from the time an insurer sets a premium to the time an alleged negligent act occurs, to the point a claim is made and ultimately resolved. Claims frequency and severity, as well as investment income, are subject to rapid swings and are capable of financially crippling an insurer.

Carriers who are thinly capitalized, or who failed to adequately underwrite their exposures, are always at significant risk. Rather than straining for low premiums to generate business, the ideal insurer works to maintain stable pricing for its insureds. Commenting on the philosophy of a stable, specialized carrier, W. Stancil Starnes, CEO of ProAssurance, stated, "It is more important than ever that we remain very adequately reserved, and if we walk away from inadequate rates, that we are in a position to fulfill the promises we make to our insureds, which, in our long-term business, will have to be met four or five or six years from now."

Thriving through market cycles

Reviewing the business practices of both successful and unsuccessful carriers over the last 15 years reveals habits that most likely lead a medical malpractice carrier through a market cycle. Not surprisingly, appropriate risk pricing is one of the strongest indicators of a carrier's success and stability. Historically, malpractice insurers do not make a profit from

underwriting. Rather, these carriers most frequently generate positive income from investment returns and other activities. In other words, insurers can do everything correctly, but if they simply do not charge enough, they are destined to fail.

An additional sign of carrier stability is a conservative investment strategy and a focus on principal preservation. Prior to the most recent sharp decline in the stock market, a number of carriers had added exotic investment products, including mortgage-backed securities, to their portfolios in a misplaced analysis of risk versus reward. Carriers who place conservation of policyholders' premiums above the potential for a quick profit will weather market turmoil better than their competitors.

Carriers who specialize in medical malpractice will also weather changes in the market cycle better than those who write many different lines of insurance. Some insurance carriers write many lines of business, such as professional liability, business, automobile and general liability, while others restrict their scope. Carriers who focus primarily on professional liability do not have the option to exit a line of business in order to focus their resources on offering other products. Rather, these carriers must maintain a long-term, conservative focus to maintain the viability of their business. The point of insurance is to have someone (the insurance company) there to help you when no one else is. These carriers are forced to live that principle every day.

A final common characteristic of successful carriers is that they each maintain a sufficiently high level of capitalization. Unexpected events can rapidly deplete the resources of any business, a fact exacerbated by the uniqueness of medical

Then

- Increasing claim frequency and severity
- Decreasing investment returns
- St. Paul Companies, PHICO and a number of other small regional players exited the market
 - Some new entrants to the market sought quick returns by aggressively seeking market share
- Reinsurance costs increased rapidly
- Some state tort reforms present, but still developing



malpractice risks. Whether it's due to size, recent entry in the marketplace or lack of underwriting and reserving discipline, the carriers who have failed to grow their financial position will be the first hurt by the turn toward a hard market cycle.

You DO NOT have to repeat the same day (market cycle) again

Those who cannot learn from history are doomed to repeat it.
~ George Santayana

By now, it should be clear that there are steps a provider can take to prepare for a likely change in the medical malpractice insurance market. Some of these steps include:

- Work with a broker who has experience with the nuances of medical malpractice. Medical professional liability is a complex, detail-intensive area of insurance.
 - Your broker should read policies and be able to compare forms to find the right fit for your needs.
- Find a carrier partner who specializes in your industry.
 - Your carrier should understand the importance of a doctor's reputation and be committed to fully defending that reputation when appropriate.
- Work with someone who considers more than one category of risk.

¹ Kenneth E. Thorpe, "The Medical Malpractice 'Crisis': Recent Trends and the Impact of State Tort Reforms." *The Journal of Health Affairs*, January 21, 2004

² L. Bartholomew, "Using PIAA Data: A Valuable Resource." Physician Insurers Association of America

³ Thorpe, citing data reported by the St. Paul Companies

⁴ Information retrieved from: www.cbo.gov/doc.cfm?index=4968&type=0 on March 24, 2010, 10:45am

⁵ As discussed in the webcast "State of the Medical Professional Liability Market: What Brokers, Doctors and Hospitals Need to Know." February 10, 2010

⁶ American Medical Association report "Caps on Damages," retrieved on March 19, 2010 at 1:30pm, www.ama-assn.org/ama1/pub/upload/mm/378/capsdamages.pdf

⁷ "AHRQ Annual Highlights, 2008" retrieved from: www.ahrq.gov/about/highlt08.htm

- You deserve more than just a policy review once a year for the premiums you pay.
- Risk management encompasses more than making sure you have the right policies in place. Your broker should help you evaluate human capital, financial, operational, regulatory and general compliance issues and other areas of risk unique to healthcare.
- Never forget that 2/3 of all business risks are uninsurable. You need to work proactively to address these.

Looking forward...

While it's not possible to predict the future, it's almost certain that the market will turn hard sooner rather than later. Historically, downturns in the economy have been followed by increased litigation and hardening insurance markets. For example, 3 years after unemployment spiked near 10% in 1982, medical professional liability claims frequency increased as well. A similar spike has followed other soft markets that coincided with a weak economy. Additionally, current market pricing does not appear sustainable. Low prices, driven in part by new entrants to the marketplace, will not generate profits to compensate for worse-than-expected losses if claims frequency and/or severity turn sharply worse. Providers and brokers now need to plan for the possibility of rising medical malpractice insurance premiums and a scarcity of quality coverage.

Now

- Depressed economy
- Large risks have seen accumulated decreases in premiums ranging from 5%-40% (in exceptional cases) and smaller risks have seen modest decreases to flat rates (except for those that have grown in size)
- Beginning uptick in claim frequency and continued trend in increasing claim severity
- Many states have enacted tort reform, but these laws will continue to be challenged
- New companies are entering the market again and new forms of risk transfer are more readily available (e.g., risk retention groups and various captive structures)

