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Connexion™

Up, up and away

Malpractice insurance costs continue to soar

Editor's note: Next issue, MGMA Connexion *will examine what some states are doing to curb the malpractice crisis.*

As in the 1975-76 medical malpractice insurance crisis, health care providers now are receiving nonrenewal notices from their insurance carriers or receiving exorbitant premium increases to renew their policies. With profit margins already strained, medical groups and provider organizations that provide malpractice insurance for their physicians and surgeons under a master policy are particularly hard hit. The only real difference today is that despite the number of carriers that have voluntarily withdrawn from the market or been forced out of business by state regulators, more than 75 companies remain willing to entertain new applications.

Entertain is the key word. With the voluntary departure of The St. Paul Cos. and the forced closure of Frontier, Reliance, PHICO and others, the remaining underwriters are being deluged with applications. They summarily reject those submitted on other carriers' forms or not properly completed. Applicants that do not fit a carrier's stringent underwriting criteria are similarly treated.

Standard risk underwriters generally review new applications presented on their forms by groups that:

- Are largely claims-free;
- Practice in moderate- to low-risk specialties;
- Meet tightened underwriting requirements; and
- Have limited prior-acts exposure.

In other words, the remaining preferred risk carriers are selective. Medical groups get a double whammy as carriers increase their base rates and reduce group practice discounts.

More and higher hurdles to clear

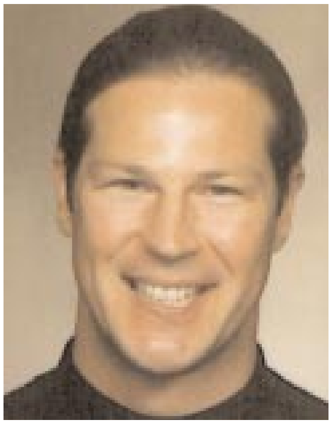
Underwriters make applicants jump over multiple hurdles before offering premium quotations. They scrutinize every submission to find a reason to surcharge or, worse, say no. The selection process often starts with the rejection of obstetricians, teleradiologists and high-risk surgical specialties. Large hospitals and nursing homes are on many carriers' "no" lists.

The chosen ones must clear several other barriers:

- Many carriers previously willing to accept submissions from brokers designated by applicants now turn away presentations unless a broker appears on an approved list;

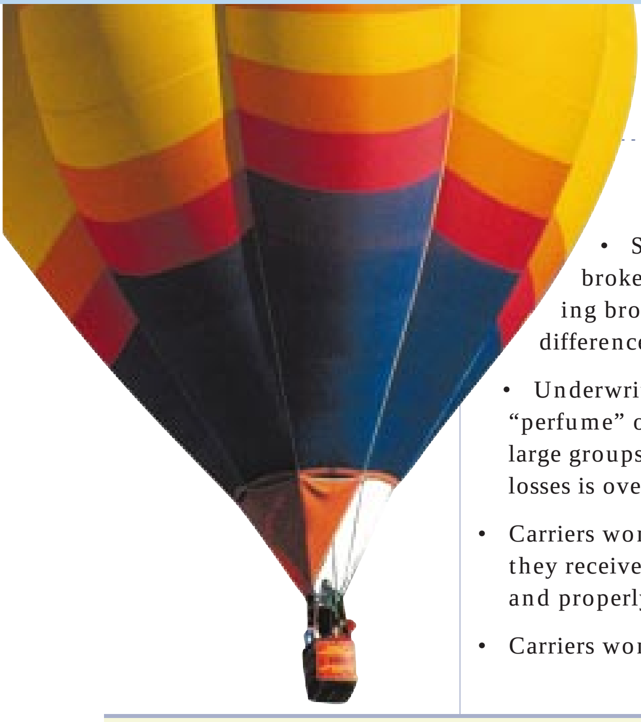
With the voluntary and involuntary departure of several companies, the remaining underwriters are being deluged with applications.

By Richard Mortimer Jr.



about the author

Richard Mortimer Jr., president, Brea Calif. division HealthCare Professionals' Insurance Services of Brown & Brown, Inc.
rick@hcpinsurance.com



- Some carriers have reduced broker commission rates, prompting brokers to add fees to recover the difference;
- Underwriters no longer follow the "perfume" of the premiums paid by large groups if the stench of historical losses is overwhelming;
- Carriers won't look at submissions until they receive application forms completed and properly signed;
- Carriers won't take an applicant's word about prior losses. They want written verification from the previous carrier even if there have been no losses;
- Large group practices and independent practice organizations, preferred provider organizations and managed care organizations are now asked to provide financial statements; financially shaky applicants are shunned; and
- Prior-acts coverage for high-risk specialties may not be available; if it is, it's pricey.

Insurers' actions

Here's a sampling of the actions taken by some of the leading malpractice underwriters:

- **The St. Paul Cos.** — In a May 14, 2001, press release, St. Paul affirmed its commitment to serving physicians and surgeons "as long as it can do so profitably." St. Paul closed 2000 with a 138 percent combined ratio for malpractice liability. At the end of the first quarter of 2001, its ratio climbed to 170.8 percent, up from 115.4 percent for the first quarter of 2000. On Dec. 12, 2001, the company announced its departure from the medical malpractice market after more than 65 years — on the heels of an estimated $1 billion malpractice underwriting loss. With about 7 percent of the market, St. Paul's withdrawal left about 42,000 doctors and allied health professionals uninsured.
- **CNA** — In late 2001, the company placed a moratorium on new business in nine Western states and raised renewal premiums 70 percent to 100 percent in many states. It announced a $1.6 billion underwriting loss for calendar year 2001 and maintains its moratorium.
- **SCPIE** — This once doctor-owned California carrier, now a publicly traded national company, placed a moratorium on new submissions from non-California applicants to give it time to review its pricing and underwriting structure.
- **GE/Medical Protective** — MedPro is one of the few carriers looking for growth. However, after being inundated with new submissions, on Dec. 1, 2001, MedPro declined to offer premium quotations for applications requesting effective dates in 2002.
- **NORCAL** — On Dec. 7, 2001, NORCAL stopped offering premium quotations for applications requesting effective dates in 2002. NORCAL returned to business as usual at the start of 2002 but stringently underwrites every submission.
- **Evanston** — This surplus-lines carrier has a solid track record of staying in the market during soft and hard market cycles and is trying to keep up with the increased demand. Like others, it has raised rates and tightened underwriting. The company no longer offers prior-acts coverage to new applicants.
- **Professional Underwriters Liability Insurance Co.** — PULIC, a non-standard, surplus-lines risk underwriter like Evanston, underwrote hundreds of last-minute requests for Jan. 1, 2002, effective dates. Like Evanston, the company is trying to keep pace with increased demand. It is unwilling to provide prior-acts coverage.
- **Interstate** — In mid-December 2001, this surplus-lines carrier stopped quoting submissions with 2002 effective dates. In February, Interstate announced a 60-day moratorium and in March exited the physicians and surgeons medical malpractice arena altogether.
- **Farmers** — Considered a silent plodder by many, Farmers' tight underwriting criteria continue. It is reviewing its pricing structure while attempting to respond to the increased demand for premium quotations and make sense of the market's rapid collapse and its 152% combined loss ratio for 2001.
- **The Doctors' Co.** — TDC anticipated the market decline and tightened its underwriting standards in early 2001. Deluged by new applications, TDC is cautiously accepting some while it reviews its pricing structure and new business appetite.

And the list goes on...

Medical groups get a double whammy as carriers increase their base rates and reduce group practice discounts.

History since the last crisis

Those in the industry more than 25 years will remember that the 1975-76 malpractice crisis was triggered when Travelers and other dominant commercial carriers either stopped writing malpractice insurance or raised their prices beyond affordability. In response, physicians helped push through tort reform legislation in California, New York and other populous states. They formed their own insurance companies and brought prices down by issuing claims made instead of the traditional occurrence-type policies. Commercial carriers took almost 15 years to acknowledge the financial success of the "bedpan mutuals" and reenter the market.

Insurance companies are not immune to the laws of supply and demand. The past 15 years clearly demonstrate that an abundance of unused underwriting capital vying for market share keeps prices down despite adverse loss experience. The supply side started to become saturated in the late 1980s after many commercial underwriters realized that physician-owned companies were accumulating vast amounts of surplus, even though their underwriting results were at break-even or marginally profitable levels. Because malpractice claims have long settlement periods, carriers have shown underwriting losses while continuing to build surpluses by investing loss reserves and retaining after-tax proceeds. The insurance business calls this cash-flow underwriting.

Few expected interest rates to drop to pre-1970 lows or that the stock market would stay in a prolonged nose-dive. Virtually all property/casualty insurance carriers face intense pressure to make up the resulting cash flow shortfall by improving their underwriting results. Prior to Sept. 11, 2001, the general insurance industry was moving into "hard market" mode — with medical malpractice just one piece of the insurance mechanism needing a price hike. The terrorist attacks served as the catalyst for double-digit rate increases. However, irrespective of Sept. 11's impact on the insurance world, rates needed to rise.

Loss ratios are climbing — why?

The combination of decreases in investment income and increased severity of lawsuits, coupled with the rising costs of reinsurance, most likely will make medical malpractice a difficult market for underwriters for the foreseeable future, according to a recently published study. In that study, malpractice insurers compared ratios of indemnity, settlement and underwriting expenses to net premiums written, which have been steadily increasing. Starting with 1995, the combined ratio increased from 96.4 percent on net written premiums of $4.8 billion to approximately 118 percent on $6.3 billion in 2000.[1]

Malpractice underwriters can make a profit when their combined ratio of operating expenses and losses is below 115 percent. In 2001 the combined ratio was 143 percent. Even with significant rate increases, estimates are that the 2002 ratio will remain in the red at 122 percent.[2]

There are mixed signals as to why loss ratios are climbing. One reason may be that insurer reserve deficiencies grew to $1.7 billion in 2000.[1] Some blame the rise on an unexpected increase in the frequency of claims filed against health care providers.

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Others say that increasing severity — that is, the average claim amount — is to blame. A recent report indicated that the average jury verdict increased 7 percent to $800,000 from 1998-99, and the average settlement rose from $500,000 to $650,000 — a 30 percent increase.[3]

Some industry analysts believe the rise in overall reserves may have more to do with declining interest rates and a depressed stock market than actual claims frequency or severity. They look at it this way: Loss ratios are based on claims paid, plus reserves for claims reported, plus reserves for claims incurred but not reported. A carrier can avoid paying taxes on an underwriting profit by increasing reserves. The money saved is then invested. The decline in investment income caused by external economic factors can be partially, if not totally, recouped by increasing the amount invested. Reserves can be boosted by reserving for incidents reported that might not become claims. This increases frequency. When reserves on incidents and reported claims go up, the per-claim severity obviously increases.

What's next?

The bottom line: Buyers who want coverage will find it increasingly difficult to find quality underwriters willing to compete for their business at 1990s prices. Quality means well-established, financially sound carriers. Only in extreme circumstances should any buyer, large or small, purchase malpractice insurance from a carrier rated below B+ by A.M. Best.

Competition exists, even in a hard market. The turmoil will begin to calm when premium increases wash away the carriers' red ink.

notes

1. Lawsuits up, investment returns down: Medical malpractice industry facing tough future, says Conning & Company. Kitchen Public Relations 2001:1, May 17.
2. Tyrpin TE. Old problems still haunt P-C industry. National Underwriter 2002; Jan. 28:25.
3. Flaherty M. Malpractice payouts, premiums rising. Physicians Financial News 2001; Dec 15:1-12.

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