

# MEDICAL MALPRACTICE INSURANCE



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## ***Introduction***

Recent protests by doctors about the cost of medical malpractice insurance reflect a growing problem which is affecting access to healthcare and adversely impacting the quality of that care, prompting urgent calls for medical liability reform.

The lack of affordable insurance is leading doctors to retire prematurely, relocate their practices to non-litigious areas, practice without insurance or drop risky procedures. According to the American Medical Association (AMA), the medical liability situation has reached crisis point in at least 18 states and a crisis is looming in many others (Exhibit 1). Trauma centers and specialist practices, like obstetrics and gynecology, are increasingly under threat. In Pennsylvania, 18.6 percent of obstetricians/gynecologists (ob/gyns) have dropped obstetrics, while in West Virginia nearly one in five has stopped.<sup>1</sup> Also under pressure are the nation's hospitals, nursing homes and other healthcare facilities, which are being forced to close or reduce the range of services they can offer to the communities they serve.

## ***History of the Problem***

The medical malpractice insurance crisis did not appear overnight and is not the first of its kind. Previous crises occurred in the early 1970s and the 1980s. Various efforts were made to ease the explosion in claims costs at that time. Aggressive campaigns to reform state laws governing medical liability lawsuits began in the 1970s. Every state except West Virginia passed some reforms. California's Medical Injury Compensation Reform Act (MICRA), enacted in 1975, which caps non-economic damages, is considered a model law, as discussed later.

Other steps, like increased diagnostic testing, improved peer review and better communication between doctors and patients also had a positive impact. While the number of claims dropped, however, the size of claims in dollars has continued to grow. In response to the lack of available capacity, many doctors formed their own malpractice insurance companies to provide coverage. These companies now write about half of all the medical malpractice insurance in the US.

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<sup>1</sup> *American College of Obstetricians and Gynecologists (ACOG), January 16, 2003.*

### ***Economic and Financial Implications***

Rising medical malpractice costs are inflicting real pain on patients, doctors and insurers. Insurers are paying out significantly more in claims than they collect in premiums. In 2002, the medical malpractice combined ratio, a key measure of profitability, reached an estimated 165 compared with 106.1 for all lines combined (Exhibit 2). This means that medical malpractice insurers last year paid out \$1.65 in losses and associated expenses for every dollar they collected in premiums. In contrast, insurers during the mid-1990s collected roughly the same amount in premiums as they paid out in claims and expenses. The increasing severity of claims has directly contributed to the deterioration in insurers' results. Insurance Information Institute calculations based on data from AM Best indicate that medical malpractice underwriting losses skyrocketed from \$289.3 million in 1996 to \$3.0 billion 2001, an increase of \$2.7 billion, or 938 percent in just 5 years (Exhibit 3). Over the same period, premium earned by med mal insurers rose 16.8 percent, while losses and expenses rose by 68.9 percent (Exhibit 4).

### ***Skyrocketing Losses Lead to Higher Insurance Costs***

Many insurers have scaled back their exposure to the medical malpractice market and, in some cases, exited the market completely. Insurers that remain have imposed significant rate increases in order to cover their costs. Consequently, medical malpractice insurance premiums are rising rapidly.

The intensity of the country's medical malpractice problem varies by state, with those experiencing crises seeing the largest increases. According to the AMA, states where conditions are described as critical for medical malpractice insurance are Arkansas, Connecticut, Florida, Georgia, Illinois, Kentucky, Mississippi, Missouri, Nevada, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Texas, Washington and West Virginia. Doctors alone spent \$6.3 billion last year to obtain coverage, while hospitals and nursing homes spent additional billions of dollars.<sup>2</sup> OB/GYNs are among the specialists that have been most seriously affected by rate increases due to their vulnerability to lawsuits. Medical Liability Monitor newsletter reports that ob/gyns' rate

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<sup>2</sup> *Confronting the New Health Care Crisis: Improving Health Care Quality and Lowering Costs by Fixing Our Medical Liability System*, prepared by US Department of Health and Human Services, July 24, 2002.

increases averaged 19.6 percent in 2002. General surgeons also saw their rates increase by 25 percent on average, while for internists the average cost of coverage rose 24.7 percent. A recent nationwide survey from the Council of State Neurosurgical Societies showed that neurosurgeons, another high-risk group, were hit with an average premium increase of 63 percent from 2000 to 2002. As a result, as many as 43 percent plan to, or are considering, restricting their practice.

Exhibit 5 illustrates the enormous difference in premiums paid by doctors in three different specialties: obstetrics/gynecology, surgery and internal medicine.

### ***Escalating Tort and Litigation costs***

The US tort system is the most expensive in the industrialized world and this high cost inevitably translates into higher liability insurance premiums for policyholders. Latest data from consulting firm Tillinghast puts the cost of the US tort system at \$205 billion in 2001, or 2.0 percent of the nation's gross domestic product, compared with 1.3 percent in 1970, and 0.6 percent in 1950 <sup>2</sup> (Exhibit 6). The ratio of tort costs to GDP dropped in the 1990s but is expected to increase again in the next few years. Tort costs were \$721 per US citizen in 2001, compared with a cost of just \$12 in 1950.

Tillinghast's data also shows that medical malpractice tort costs are skyrocketing. From 1990 to 2000, medical malpractice tort costs rose by 140 percent, more than double the 60 percent increase in medical costs generally over the same period (Exhibit 7). The tort system is also highly inefficient, returning only 46 cents on the dollar to claimants. In its breakdown of costs, Tillinghast found that just 22 cents of the tort dollar goes to litigants for their actual economic losses and 24 cents to compensate for pain and suffering. Of the remaining 54 cents, 19 cents pay for claimants' attorney fees, 14 cents for defense costs and 21 cents for administrative costs (Exhibit 8).

Added to the rising cost of going to court in the US, is the fact that the median award in medical malpractice liability suits is climbing sharply. The latest statistics from Jury Verdict Research show that from 1995 to 2001, the median jury award in medical malpractice litigation doubled to \$1 million, from \$500,000. From 1999 to 2001 alone, the median award rose by 43 percent (Exhibit 9). The mean (average) award from 1995 to 2001 rose from \$2.0 million to \$3.9 million, an increase of 95 percent. Medical

negligence in childbirth resulted in the highest median award. There is also a continuing trend toward larger verdicts. JVR data shows that 54 percent of all medical malpractice awards now are over \$1 million, compared with just 36 percent between 1995 and 1997. Plaintiff recovery rates in medical malpractice are also on the rise to 39 percent in 2001, from 29 percent in 1996.

Doctors say run-away jury awards and increased litigiousness are key drivers of the medical liability insurance crisis. A nationwide survey conducted last year by Harris Interactive revealed that malpractice litigation was a number one concern among doctors.<sup>3</sup> Some 76 percent of doctors surveyed said their concerns about malpractice litigation have hurt their ability to provide quality care to patients. That fear of litigation has also caused many to practice defensive medicine, which in turn increases healthcare costs. Nearly four out of five doctors (79 percent) surveyed said they have ordered unnecessary tests, while 74 percent have referred patients to specialists more often than they would have based solely on professional judgment.

American consumers too, are increasingly concerned about the severity of medical liability lawsuits. A Health Care Liability Alliance (HCLA) survey released last June found that Americans agree that litigation is one of the primary factors behind rising medical costs and reduced access to care.

### ***Rising Healthcare Costs***

Another factor that is directly linked to the problem is healthcare costs. Healthcare costs have been rising for several years and a jump of as much as 15 percent is forecast for 2003. Litigation against doctors, hospitals and nursing homes, pharmaceutical and medical device manufacturers threaten to push these costs still higher. Indeed, excessive litigation is one reason why healthcare spending in the US reached a record \$1.4 trillion in 2001, an 8.7 percent increase over 2000. According to the Department of Health and Human Services (HHS) this was the fifth consecutive year of growth in healthcare expenditure (Exhibit 10). Health spending grew more than three times faster than the 2.6 percent nominal rate of growth in the economy in 2001, and averaged \$5,035 per person

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<sup>3</sup> *Harris Interactive Survey conducted for Common Good, of 300 practicing physicians, 100 hospital administrators and 100 nurses interviewed in March 2002.*

in 2001, compared to \$4,672 in 2000. HHS economists say the health share of gross domestic product (GDP) increased to 14.1 percent in 2001 from 13.3 percent in 2000 (Exhibit 11). Yet a reduction in healthcare costs would enable more Americans to obtain insurance. Today a staggering number of Americans – nearly 40 million – are uninsured. An HHS report suggests that healthcare costs could be reduced by 5 percent to 9 percent if unreasonable awards for non-economic damages were limited. It estimates this would save \$60 billion to \$108 billion in healthcare costs each year, thus lowering the cost of health insurance and allowing an additional 2.4 to 4.3 million Americans to obtain insurance.

### ***A Changing Insurance Market***

Decisions by many insurers to reduce their exposure to, or withdraw completely from, the medical malpractice market has caused a massive contraction in capacity and is another factor that has driven up premiums.

The St. Paul Companies, which until recently was the largest writer of medical malpractice in the US, announced in December 2001 that it was exiting the market because underwriting losses threatened its solvency. The company also announced a \$900 million write-off stemming mainly from its medical malpractice book. St. Paul insured some 40,000 physicians (about 6 percent of that market), 72,000 other healthcare professionals and 750 hospitals and other facilities.

In August 2002, New Jersey regulators approved the restructuring of Lawrenceville, New Jersey-based MIIX Insurance Co, a medical malpractice insurer that covered some 37 percent of New Jersey doctors. Under the reorganization, regulators have given conditional approval to a new company, MIIX Advantage Insurance Co. Regulators had placed MIIX Group in solvent run-off in May 2002, after learning that the company's surplus had dropped \$128 million between September and December 2001.

The collapse of Pennsylvania-based PHICO and Reliance, and New York-based Frontier Insurance Group has added to the market's capacity woes.

### *Current Market Structure*

Today's medical malpractice insurance market is a mix of traditional insurers, provider-owned groups (physicians and hospitals) and alternative risk transfer entities. They serve a changing customer market. Physicians accounted for 52 percent of estimated medical malpractice premiums in 1999, followed by hospitals at 32 percent, according to Conning & Co. Allied health care, nursing homes and managed care organizations make up the remainder.

A.M. Best reports a total of 335 companies wrote \$6.1 billion in net medical malpractice premiums in 2001, an 8.7 percent increase on the \$5.6 billion net premiums written in 2000. Premium growth was flat during much of the 1990s (Exhibit 4), although there were variations year-on-year. In the last five years of the decade, net premiums written grew at an average rate of just 1.5 percent, compared with 2.5 percent growth for all lines. In 2000, the top five groups accounted for 33 percent of the medical malpractice market, and the top five states were New York, California, Florida, New Jersey and Illinois, which between them accounted for 44.6 percent of the market. Alternative risk transfer options, such as self-insurance, pooling and even the formation of offshore captives, are becoming increasingly popular and given the current crisis, this segment of the market is expected to grow further.

### ***Medical Malpractice Reform***

#### ***California Case Study—The MICRA Experience***

California has had a \$250,000 cap on noneconomic damages since 1975 when the Medical Injury Compensation Reform Act (MICRA) took effect. The Act has helped stabilize the medical malpractice environment in the state, making the coverage more affordable than in many other states. MICRA has seven major elements: a collateral source rule which requires that juries be told when plaintiffs have other sources of compensation for their injuries, a cap of \$250,000 on noneconomic awards such as compensation for pain and suffering, and periodic payments rather than a lump sum for awards of more than \$50,000. It also requires lawsuits generally to be filed within three

years of the injury, includes a specific scale for attorneys' fees, requires that plaintiffs' attorneys give 90 days advance notice to the defendant of their intention to file suit, and stipulates that contracts for medical services may include provisions for binding arbitration.

### *Impact of MICRA Reforms*

A General Accounting Office report on medical malpractice published in December 1986 singled out the reforms enacted in California as among the most effective in moderating increases in the cost of insurance and the size of awards. According to Jury Verdict Research data, the median jury award in medical malpractice litigation in California in the period 1997 to 2002 is \$402,500, significantly lower than other states with no reforms. It compares with an award median for the period 1996 to 2001 of \$1 million in New York, \$806,750 in Florida and \$840,000 in Pennsylvania, for example (Exhibit 12). In addition, the frequency of million dollar plus medical malpractice awards in California is considerably lower than in other states (Exhibit 13). California's doctors also pay significantly less for their liability insurance than their colleagues in other states. The AMA reports that since 1976, medical liability premiums across the US have increased three times faster than in California. It puts the savings to Californians at more than \$1 billion a year. According to the HHS, states with limits of \$250,000 or \$350,000 on noneconomic damages experienced an average premium increase of just 12 percent to 15 percent in 2001, compared with a 44 percent increase for states with no caps on noneconomic damages.

### *The Effects of Reforms on Loss Costs and Premium Costs*

The historical record clearly shows that reforms, particularly caps on noneconomic damages, result in lower losses. Simple common sense would predict this outcome, which is confirmed by critical studies. Even recent reforms produce lower costs within a few years.

It has been suggested that lower costs do not translate into lower premiums, because a median number of states with some reform have experienced premium increases. There are several difficulties with the argument. One is that according to those making this case, most states have passed reforms only recently. For a long-tail line like medical

malpractice, it may take a minimum of five years for states in which caps have only been recently introduced to see the resulting affect on premiums, and even longer to repair the balance sheets of insurers hit by very large payouts not envisaged when the policies were written years earlier.

It is also likely that for states with recent caps, the medical liability situation had reached a crisis point in order for the reforms to stand a chance of being passed. Further, there is typically an understandable rush to file lawsuits as reforms appear about to take effect, which results in costs that will be carried forward for many years. It is therefore not surprising if the introduction of caps on noneconomic damages does not result in an immediate reduction in premium costs. Also, many of the caps used to arrive at a median are in fact up to \$1 million.

In California, as noted earlier, it is clear that the \$250,000 cap on noneconomic damages has had a measurable impact on claim payments and insurance costs over time (Exhibit 12). Analysis by the Pennsylvania Medical Society shows that between 1985 and 1998, major medial professional liability reforms substantially reduced loss costs. According to its findings, states with six major medical professional liability reforms saw a 91 percent increase in loss costs during the period, while states with only one reform had an increase of 252 percent (Exhibit 14).

Almost always, the main argument against reform appears to be that the financial problems in the medical malpractice line are caused by poor investment returns and a cyclical insurance market, rather than by rising costs. As has been stated above, while very low interest rates do play a role, they do not alter the fact that loss costs are a central part of insurance prices. Even those that argue that premiums go up in states where caps have been introduced also present data showing that claims payouts do in fact drop. Again, this is supported by basic common sense: the more expensive a product is to produce, the more it will cost.

### ***Investment Facts***

Common stock accounts for only about 20 percent of the insurance industry's invested assets. Bonds are still the mainstay of insurer investments (Exhibit 15). This is fortunate

since the S&P 500 index declined 23 percent in 2002, making it the worst year for the US equity market since 1974.

For most of the 1990s when the bull market and higher interest rates generated higher earnings on securities, investment income did help to offset underwriting losses for medical malpractice insurers. At the same time, the introduction of managed care in the early 1990s initially kept healthcare costs down. This pushed the cost of insurance significantly lower, and policyholders benefited. As investment returns have shrunk, according to III and AM Best statistics, medical malpractice investment gains as a percentage of net earned premiums fell to 19 percent, or \$1.1 billion in 2001, down from 27.6 percent, or \$1.5 billion in 2000 (Exhibit 16). In the eight-year period from 1994 to 2001, medical malpractice insurers averaged an annual investment gain of 26.9 percent, compared with just 17.6 percent for all lines during the same period (Exhibit 17). Since then, with claims costs spiraling and interest rates continuing to fall, insurers raised rates and tightened underwriting standards. As the figures shown earlier indicate, medical malpractice insurers achieved an underwriting profit in only two of 12 years from 1990 through 2001. Over the same period, net premium earned rose 44 percent, but losses and expenses rose by more than 100 percent.

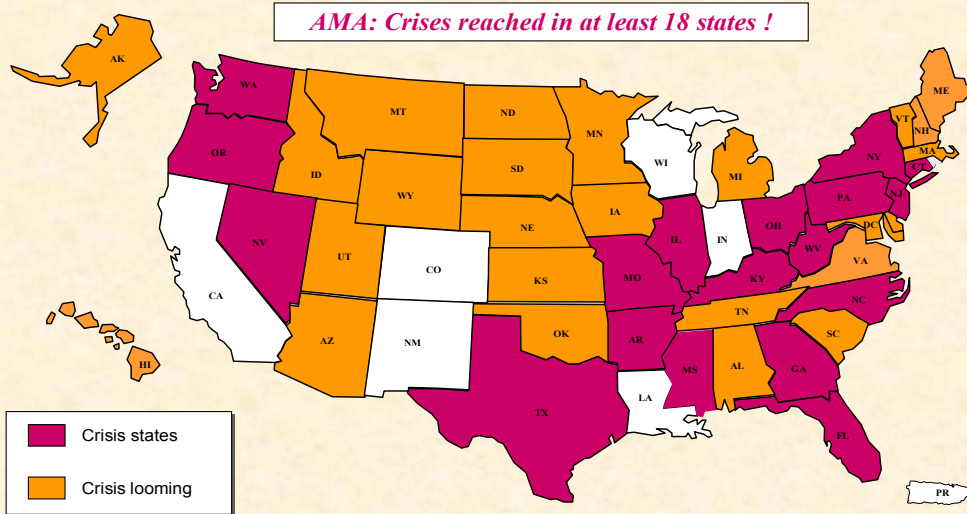
Following our report are 17 tables which illustrate the medical malpractice insurance problem, as discussed above.

For additional information, see:

- Insurance Information Institute, [www.iii.org](http://www.iii.org)
- American Medical Association, [www.ama-assn.org](http://www.ama-assn.org)
- A.M. Best, [www.ambest.com](http://www.ambest.com)
- Conning & Co., [www.conning.com](http://www.conning.com)
- Tillinghast-Towers Perrin, [www.tillinghast.com](http://www.tillinghast.com)
- Medical Liability Monitor, [www.medicalliabilitymonitor.com](http://www.medicalliabilitymonitor.com)
- U.S. Bureau of Labor Statistics, [www.bls.gov](http://www.bls.gov)
- Jury Verdict Research, [www.juryverdictresearch.com](http://www.juryverdictresearch.com)
- Department of Health and Human Services, [www.hhs.gov](http://www.hhs.gov)

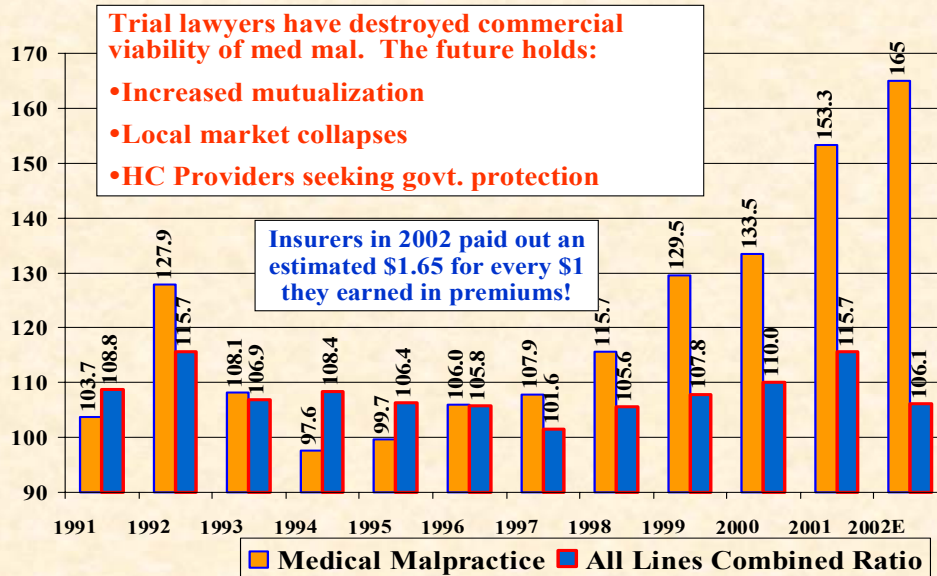
- Pennsylvania Medical Society, [www.pamedsoc.org](http://www.pamedsoc.org)
- Medical Society of the State of New York, [www.mssny.com](http://www.mssny.com)
- New Jersey Medical Society, [www.msnj.org](http://www.msnj.org)
- Health Care Liability Alliance, [www.hcla.org](http://www.hcla.org)
- Hospital and Healthsystem Association of Pennsylvania, [www.haponline.org](http://www.haponline.org)
- Americans for Insurance Reform, [www.insurance-reform.org](http://www.insurance-reform.org)
- Consumer Federation of America, [www.consumerfed.org](http://www.consumerfed.org)
- Center for Justice and Democracy, [www.centerjd.org](http://www.centerjd.org)
- Physicians Insurers Association of America, [www.thepiaa.org](http://www.thepiaa.org)
- American College of Obstetricians and Gynecologists, [www.acog.org](http://www.acog.org)
- Georgia Board for Physician Workforce, [www.gbpw.georgia.gov](http://www.gbpw.georgia.gov)

## Medical Crises across the US



Source: American Medical Association, March 2003

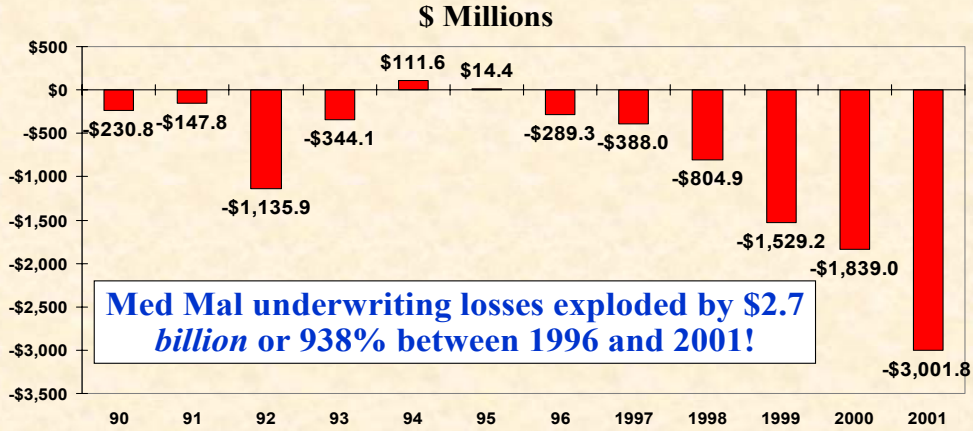
## Medical Malpractice Combined Ratio



Source: AM Best, Conning, Insurance Information Institute

# Medical Malpractice: Underwriting Losses

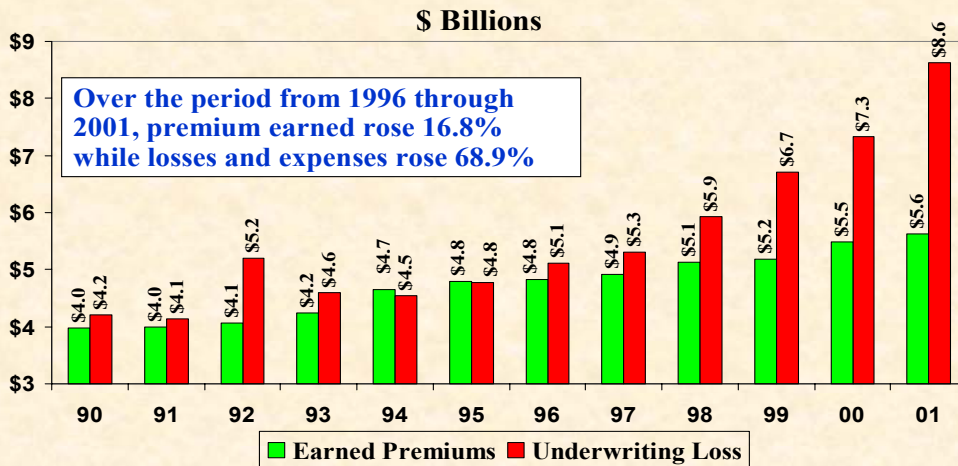
Exhibit 3



Source: Insurance Information Institute calculations based on data from A.M. Best.

# Medical Malpractice: Losses & Expenses Paid vs. Premiums Earned

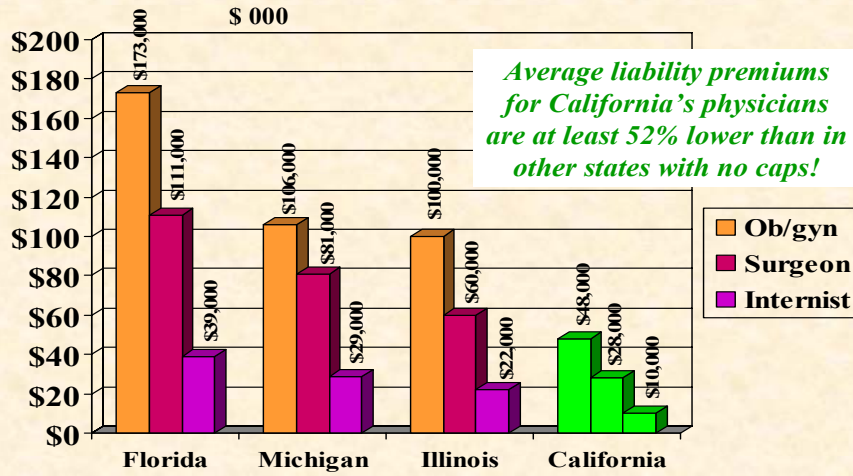
Exhibit 4



Source: Computed from A.M. Best data by the Insurance Information Institute

## Annual Premiums in 2001 By Specialty Compared to California

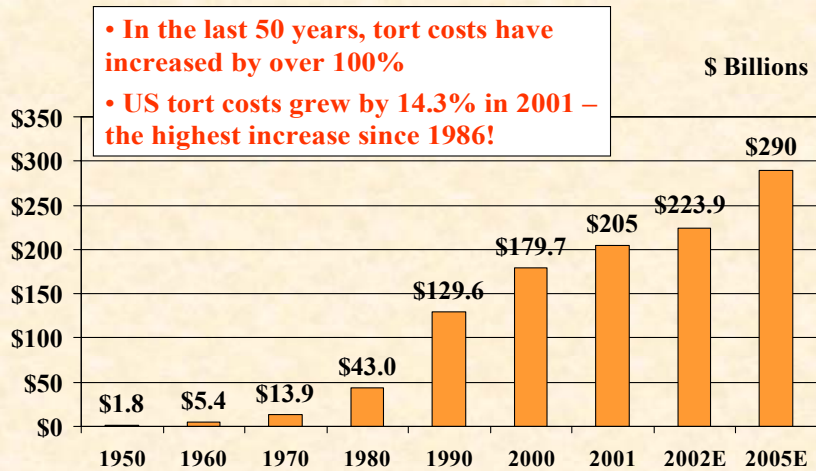
Exhibit 5



Source: Medical Liability Monitor

## US Tort Costs 1950-2001

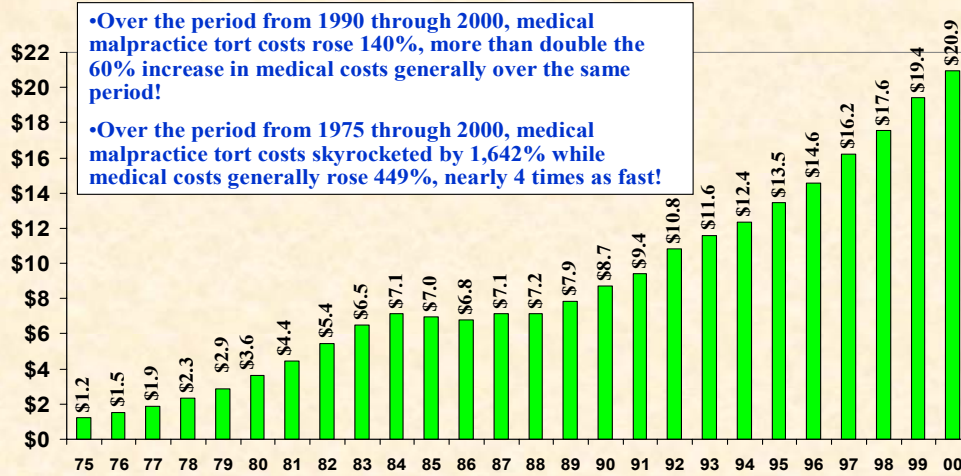
Exhibit 6



Source: Tillinghast-Towers Perrin

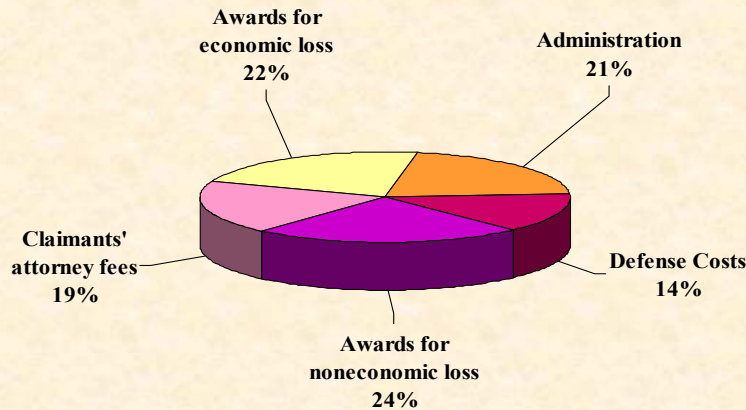
# Medical Malpractice: Tort Cost Growth is Skyrocketing

\$ Billions



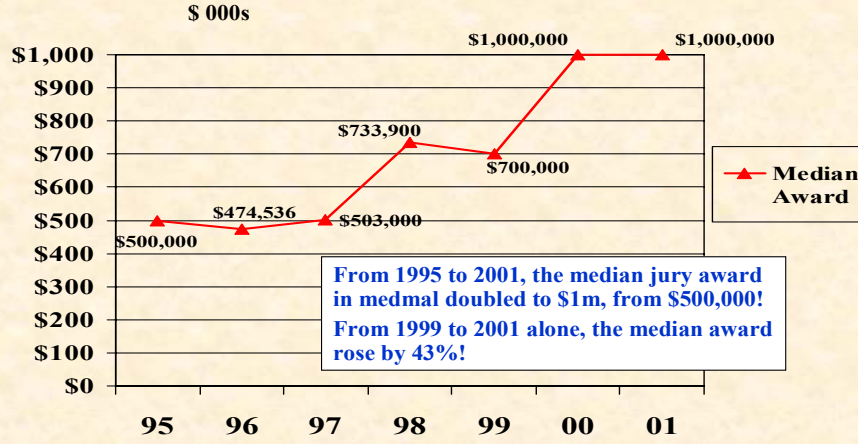
Sources: Tillinghast-Towers Perrin, US Bureau of Labor Statistics, Insurance Information Institute

# Where Tort Cost Goes



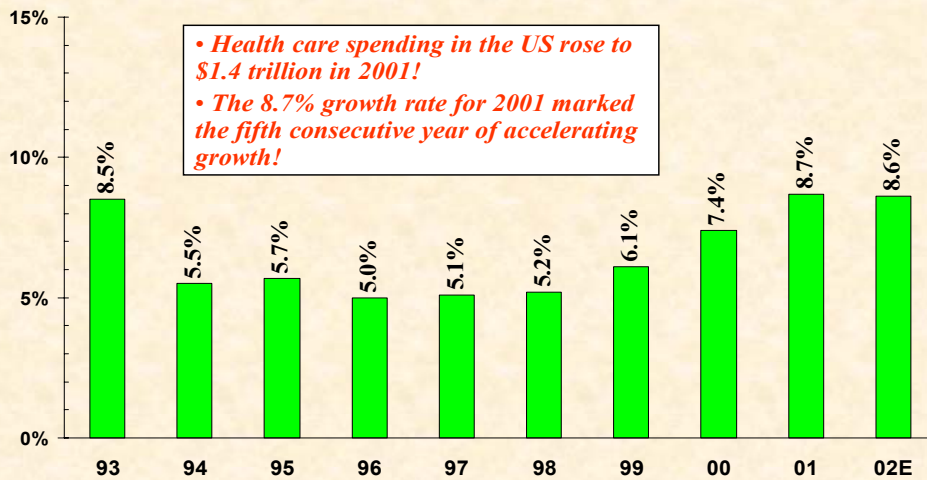
Source: Tillinghast-Towers Perrin

## National Jury-Award Median in Medical Malpractice Cases



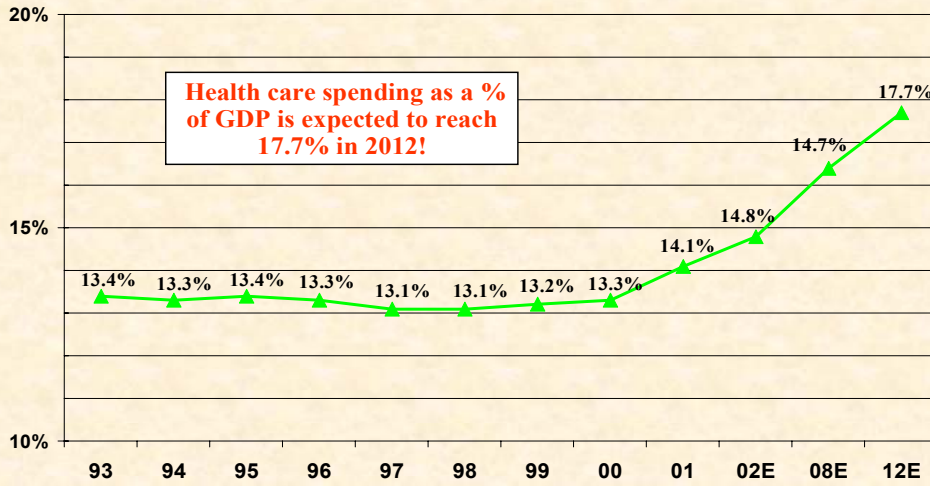
Source: Jury Verdict Research

## National Health Care Costs



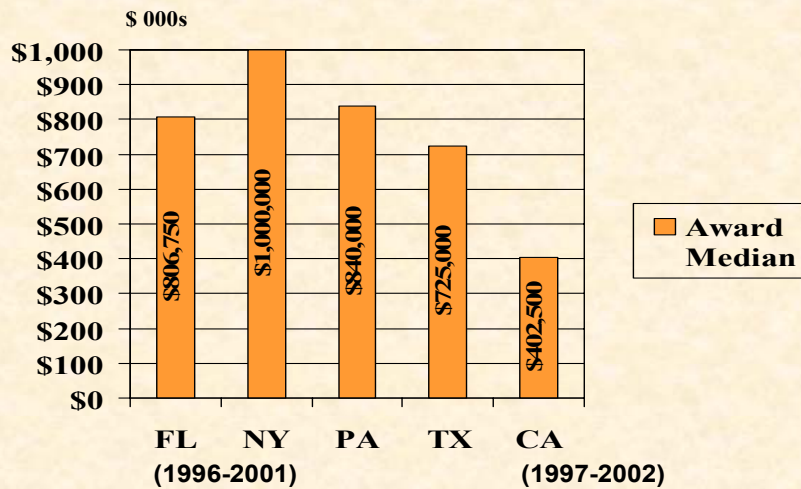
Source: Department of Health and Human Services

## National Health Care Expenditure as % of GDP



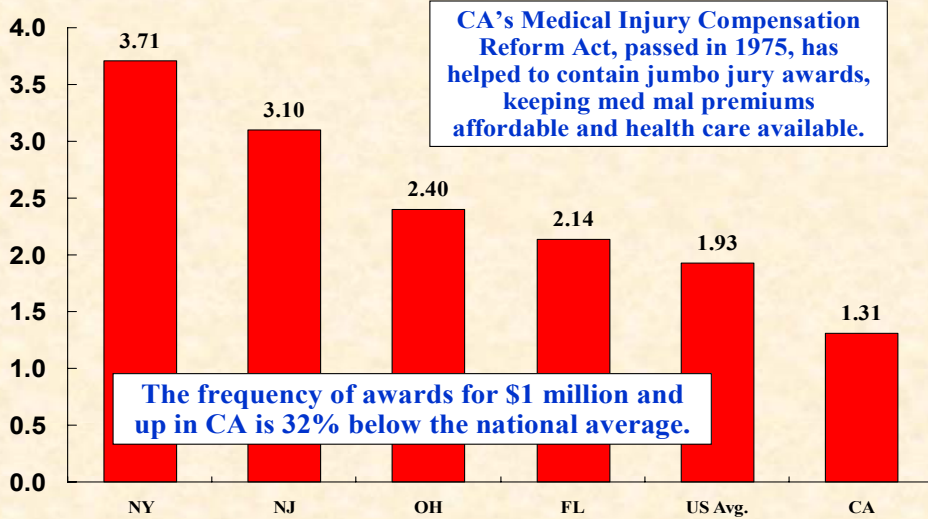
Source: Department of Health and Human Services

## Median Med Mal Jury Awards 1996-2002



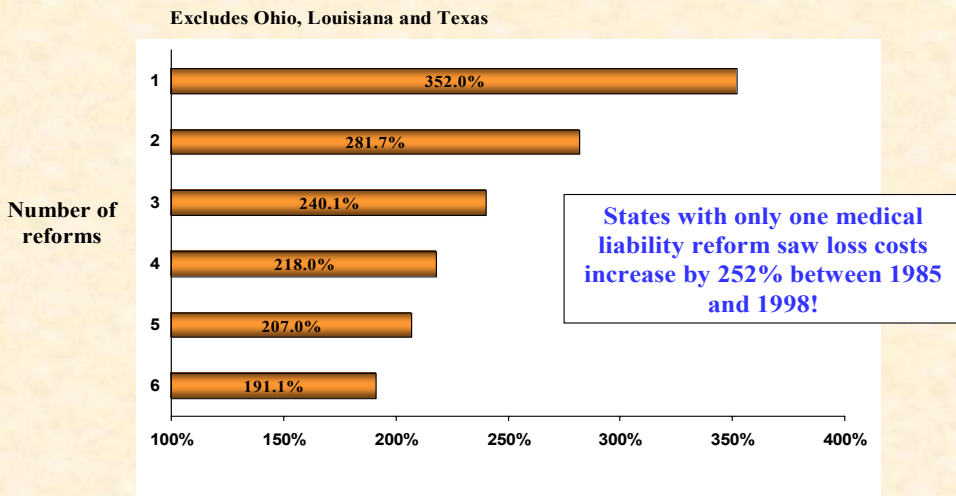
Source: Jury Verdict Research

### *Frequency of \$1 Million + Jury Verdicts (Per 1,000 Doctors)*



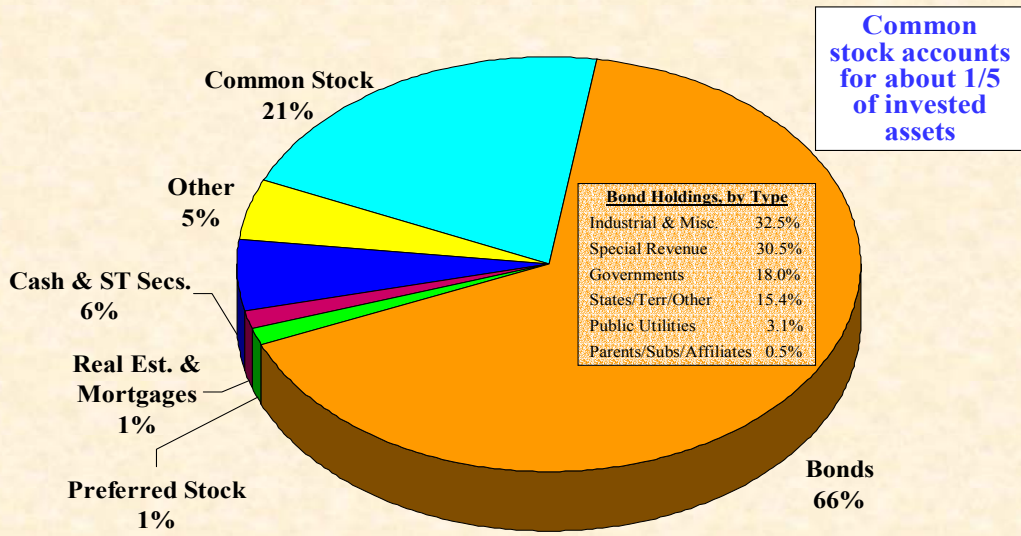
Source: Jury Verdict Research, American Medical Association, Insurance Information Institute.

### *Loss Cost Changes by Number of Major Reforms by State 1985-1998*



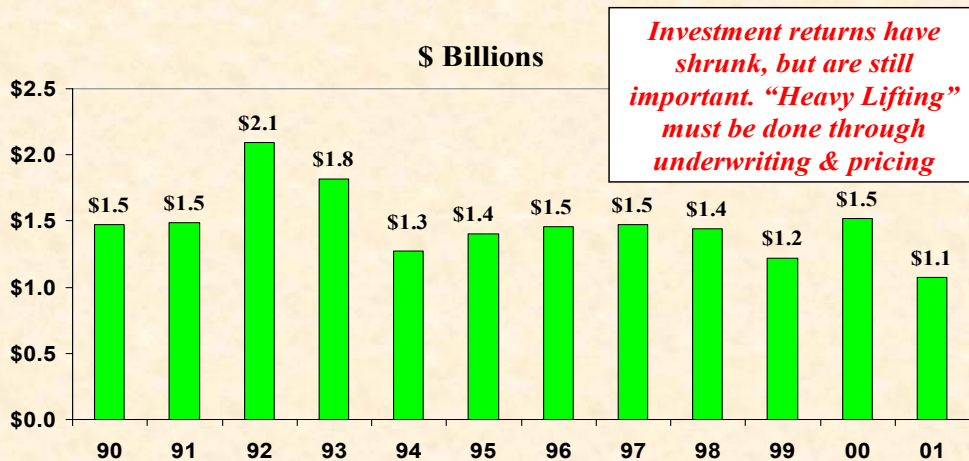
Source: Pennsylvania Medical Society

## *P/C Industry Investments, by Type (as of Dec. 31, 2001)*



Source: A.M. Best, Insurance Information Institute

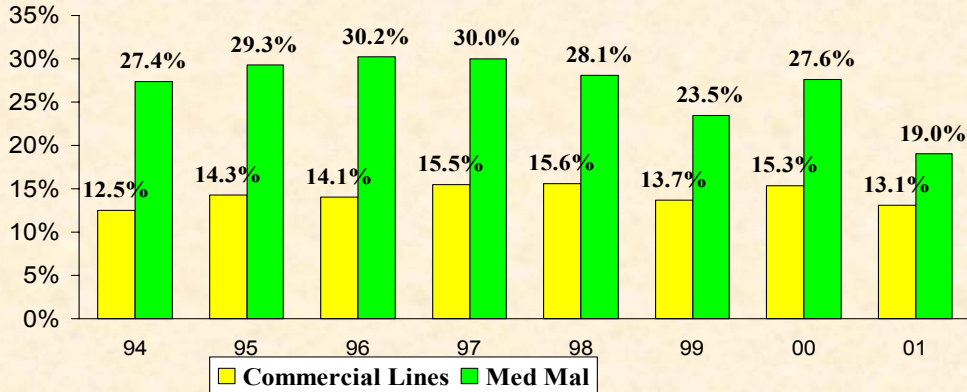
## *Medical Malpractice Investment Gain\**



\*Imputed from investment gain data as a % of net earned premium. Investment gains consists primarily of interest, dividends and realized capital gains and losses.  
Source: A.M. Best; Insurance Information Institute estimate

## Investment Gain: Med Mal vs. All Commercial Lines\*

*Investment returns have shrunk, but are still important. "Heavy Lifting" must be done through underwriting & pricing*



\*As a % of net earned premium. Investment gains consists primarily of interest, dividends and realized capital gains and losses.

Source: A.M. Best; Insurance Information Institute estimate