MEDICAL LIABILITY
MONITOR
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ANNUAL RATE SURVEY ISSUE

OCTOBER 2014 VOL 39, NO 10

METHODOLOGY

RATE REPORT PRESENTS STATE-BY-STATE VIEW OF CHANGING MARKET

In this issue, we bring you our 24th *Annual Rate Survey*. This issue provides a continuing overview of changing rates for physicians' medical professional liability insurance. It is a snapshot in time, reporting rates effective July 1, 2014.

It is a picture we paint state by state, county by county because where physicians practice largely determines the premiums they pay. This is because insurers base their rates on the aggregate claims experience in a particular geographic area. Because state insurance departments may regulate rates, state tort reforms can affect the cost and patient compensation funds may influence the total premium, it is impossible to project a common national picture.

Each year, we survey the major writers of liability insurance for physicians. We ask for manual rates for specific mature, claims-made specialties with limits of $1 million/$3 million—by far the most common limits. These are the rates reported unless otherwise noted.

We report on three specialties to reflect the wide range of rates charged: internal medicine, general surgery and obstetrics/gynecology.

With the exception of Medical Protective, Princeton and Physicians' Reciprocal Insurers, all rates shown were volunteered by their respective companies. Those companies' rates published herein were obtained through inde-

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THE SLINKY EFFECT

WITH MEDICAL PROFESSIONAL LIABILITY INSURANCE RATES CONTINUING TO - SLOWLY AND STEADILY - DECLINE DURING THIS MOST RECENT SOFT MARKET, IT APPEARS IT WILL TAKE SEVERAL MORE YEARS BEFORE THE MARKET HARDENS AND RATES ACCELERATE UPWARD

by Chad C. Karls, FCAS, MAAA
Annual Rate Survey Editor

During the past six years of Medical Liability Monitor *Annual Rate Surveys*, we have offered various, whimsical metaphors to describe the unusual nature of the modern medical professional liability (MPL) insurance market. We've characterized it as everything from a hard chocolate candy bar with a soft center to a sailboat listlessly drifting on a becalmed sea.

This year—as MPL companies' rates continue to slowly erode—we see the market behaving similar to the iconic Slinky. Not so much the spiral spring toy invented by Richard James in the 1940s as the stop-and-go highway traffic pattern transportation experts have dubbed "the Slinky Effect."

It's a Long Road that has No Turning

Like most old Irish sayings, "It's a long road that has no turning" is both an expression of hope and a sigh of frustration. It can mean "things can't go on in the same way forever." Eventually there is always a turn, a change for the better (or worse). But it can also mean "It's a long, boring road without variety in it."

Both meanings can apply to the recent MPL market, which has been going along the same straight path of lower rates, lower levels of written premium—and yet healthy profits—for nearly a decade.

This begs the question: *How long does an anomalous trend have to continue—year after year—before it stops being anomalous?* No one in the industry believes the current situation can continue forever. Eventually something will happen to cause a turn in the road. Either rates will eventually, if slowly, drop so far as to become unsustainable or some unexpected, unpredictable Black Swan event will spark a sudden rush to raise rates aggressively.

And, yes, this past decade's market has also become anxiously tedious, despite its historically high annual profits. Never has a winning streak engendered so much ambivalence.

Every year we search for indications that a 'turn ahead' sign is on the horizon—rising frequency, higher severity—something, anything to reveal the inevitable return to normal is about to happen. It's simply not intuitive—nor is it likely, based on historical precedent—for any property-and-casualty (P&C) insurance sector to make so much profit while rates fall and consolidation shrinks the customer base. Yet, according to a May 2013 special report in A.M. Best, MPL results have been outpacing the entire P&C composite for many years now.

Significant Changes from Last Year's Annual Rate Survey Results

In this market, the slightest changes can appear significant. We note that 84 percent of 2014 respondents indicated a non-renewal rate of less than one percent, a 20 point increase from last year.

Supporting our belief that frequency has bottomed and may have started to inch upwards, only four percent of respondents

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to last year's *Survey* saw an increase in frequency, and 16 percent saw a decrease during the previous two years. This year, not a single respondent reported a decrease in frequency during the last 24 months, and nearly three times as many (11 percent) experienced an increase.

Also, almost three times as many respondents to this year's *Survey* (11 percent in 2014 vs. 4 percent in 2013) indicated they had refined their underwriting approach beyond specialty and territory to include such additional factors as age, gender, procedure or visit volume.

Finally, the percentage of respondents saying reinsurance costs have increased during the past few years dropped 11 percent this year, indicating a continued soft reinsurance market.

The Last 10 Years vs. the Previous 20

To understand why many in the industry are anxious about the future, it's useful to consider how very different things were during the first years of the previous decade and earlier. As we turned the corner into the 21st Century, MPL companies were reeling from a string of significant losses. Two of the largest players—The St. Paul Companies and Farmers Insurance—withdrew from the market, as did many other smaller companies, voluntarily or otherwise.

The companies that remained stepped on the gas, racing to raise rates as much as 100 to upwards of 200 percent between 2000 and 2004. After peaking around 2006, rates began to moderate and have been in a slow and steady decline ever since.

Also declining for seven straight years has been overall direct written premium, which dropped by almost $2.5 billion between 2006 and 2013 (a 20 percent reduction) with 2014 expected to further that decline. To put this into perspective, consider that during the entire 35-year history of the modern MPL industry, no other period of decreasing premiums has lasted for more than two years, and the greatest consecutive-year premium reduction was just 7 percent.

In 2010 the MPL industry's operating ratio reached its lowest point, 56 percent—based on a Milliman analysis of 38 of the largest MPL writers, using statutory data obtained from SNL Financial—a 44 percent pre-tax profit for the industry based on the composite.

By 2013, that ratio had risen to 70 percent, driven primarily by deteriorating rate levels and lower reserve releases. During the same period, underwriting expense ratios continued to inch up, while investment income tapered down. Combine these trends with stubbornly low rates and reduced written premium, and we see the industry's operating profits have declined—slightly, but definitely—each year since 2010. Despite this, profits remain high by historical standards.

Three Core Factors Keep Profits High

MPL Profits have remained healthy for the

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Subscriptions: Annual subscription rate $399, which includes monthly issues and the Annual Rate Survey. Subscriptions are available at www.mlmonitor.com or by calling 312-944-7900.

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pendent research and are believed to be accurate.

The rates reported should not be interpreted as the actual premiums an individual physician pays for coverage. They do not reflect credits, debits, dividends or other factors that may reduce or increase premiums. Rates reported also do not include other underwriting factors that can increase premiums.

States without compensation funds, by far the largest group, are reported first. Patient compensation fund states are grouped at the end of the survey.

In patient compensation fund states, physicians pay surcharges that range from a modest percentage to more than the base premium. Also, limits of coverage can differ in these states, which is noted with each PCF state.

When we contact survey participants, we ask them to provide data on all the states in which they actively market to physicians. We only report rates for companies that maintain filed and approved rates for each state in which they sell medical professional liability insurance. We try to capture the leading, active writers in each state, but every writer may not be included.

In comparing this year's report with previous reports, it is evident that the market is always changing. Many companies formerly included no longer sell physicians' malpractice insurance in certain states, do not currently entertain new business, have withdrawn from this line of insurance or no longer exist. The companies shown were available for business as of July 1, 2014.

We estimate that this survey represents companies that comprise 65 to 75 percent of the market; as such, it is the most comprehensive report on medical professional liability rates available.

The expanded rate report could not have been completed without the cooperation of the many people who work in the companies surveyed. Their cooperation is invaluable in providing this information to all who have an interest in medical professional liability.

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past eight years—despite rates and written premium levels that continue to creep downward—for three primary reasons: **1.** Frequency continues to be exceptionally low on a historical basis; **2.** Indemnity severity has remained flat the past several years; and, perhaps most significantly, **3.** Reserve releases have fueled the industry's operating results.

MPL companies have to be wondering how long the profitable results will continue. Of even more concern is the specter of some sudden, game-changing event that will render the last few years of low rates and high profits a true historic anomaly.

Chart No. 1

Overall Average Rate Change by Range

Range	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
> +100%	0.0%	0.0%	0.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
+70.0 to +99%	0.6	0.0	0.6	0.0	0.1	0.0	0.0	0.0	0.0	0.0
+50.0 to +69.9%	0.7	0.0	0.4	0.0	0.1	0.0	0.0	0.0	0.0	0.0
+25.0 to +49.9%	6.5	2.3	0.5	0.6	0.0	0.0	0.3	0.1	0.3	0.0
+10.0 to +24.9%	28.5	5.6	5.9	1.2	1.9	0.8	4.8	0.2	2.4	0.1
+0.1 to +9.9%	29.3	22.6	8.2	5.6	5.7	13.4	9.4	14.8	11.0	12.1
0.0%	24.0	46.6	53.1	49.9	54.2	67.0	55.1	59.2	57.6	65.0
-9.9 to -0.1%	8.4	15.1	21.0	20.8	22.1	14.9	27.8	15.7	17.2	16.9
-19.9 to -10.0%	2.1	5.1	6.5	15.6	12.0	3.6	2.2	7.9	7.8	2.2
-29.9 to -20.0%	0.0	1.3	2.3	5.2	3.7	0.3	0.2	2.0	2.6	1.1
< -30.0%	0.0	1.4	0.0	1.1	0.2	0.0	0.1	0.1	1.2	2.6

Two of the three factors that have contributed to the recent run of healthy profits—the sudden fall-off and continued low levels of claim frequency as well as stable indemnity severity—remain largely unexplained.

Proponents of tort reform claim the success of their efforts in enacting caps on noneconomic damages are the reason frequency and indemnity severity are down. Advocates of patient safety initiatives and better risk management say it is because healthcare workers have become more cautious, employing pre-operation checklists and other risk mitigating tactics.

The truth is no one knows with certainty which factors may have led to the significant decline in claim frequency. It is likely the result of a combination of tort reform, patient safety advancements, better medical care and—perhaps—some other causal factor or factors we cannot discern. And since no one knows why frequency fell, no one knows when—or if—it might revert back towards historical levels.

There are two looming wildcards that could have a substantial effect on claim frequency as well as severity: **1.** Full implementation of the Affordable Care Act and the unknown consequences thereof, as well as **2.** The movement afoot to undo the various tort reform measures enacted across the U.S. during the past decade.

The potential impact to claim frequency from the Affordable Care Act has been discussed and debated in numerous forums since its passage in March of 2010. Opinions vary widely on its expected effect. In the short term, it seems to us that tens of millions of people now having greater access to healthcare will lead to more patients seeking more care. That, in turn, is likely to result in more medical misadventures and, ultimately, more MPL claims.

Efforts across the country to reverse the various tort reform measures could also have a significant impact. This debate is best encapsulated by the impending ballot-box battle in California known as Proposition 46. Next month, California voters will decide whether or not to modify their state's 1975 Medical Injury Compensation Reform Act's (MICRA) cap on noneconomic damages, raising the cap from its current level of $250,000 to $1.1 million effective Jan. 1, 2015. If that were to occur, the prospect of higher payouts is likely to encourage more lawsuits, raising frequency in the state. California is large and populous, often a bell-weather of national trends. If the state's long-standing, noneconomic damage cap—often held out by proponents of tort reform as a model—is significantly modified, additional momentum might build in other states to overturn or raise their caps. Some states, such as Florida, Illinois, New Hampshire, Missouri and Georgia, have already done so.

Internal Medicine saw an average rate reduction of 1.6 percent. General Surgery had a 1.3 percent total drop this year, while OB/Gyns saw their rates fall by 1.7 percent overall.

We cannot know at this point what the consequences of a fully implemented Affordable Care Act or the results of California's ballot initiative will be. The one thing we do know for certain is that the third major factor propping up profits—past reserve releases—will not continue to fuel profitability on a calendar-year basis forever.

Because of the three-to-five year payment lag, it is only during the past several years that companies have begun to completely see the impact of the lower reported frequency on actual claim payments. This has allowed the industry to continue benefitting from favorable reserve releases, which have nevertheless started to somewhat diminish.

Historically, favorable calendar-year reserve development has continued two or three years past the point when reserves were subsequently found to be adequate. So if levels are considered precisely adequate now, history suggests, we will see favorable reserve development on a calendar-year basis for the next few years, followed by adverse development—at least for the older coverage years in subsequent calendar years.

Another, somewhat less impactful, factor is the slow decline of investment income and realized capital gains. The Milliman MPL specialty company composite investment gain ratio of 21 percent in 2013 was down from 2010's decade-long high of 27 percent. The realized capital gain ratio hit its high of 6 percent of net earned premium, also in 2010, and ended 2013 at 2 percent.

All of these factors have been chipping away at the industry's profitability, contributing to uncertainty about the adequacy of current rates. Nevertheless, companies continue to aggressively compete for business—in part by lowering their rates, principally through scheduled credits. One company will lower its rates and others will follow suit, creating the Slinky effect mentioned earlier.

Those who played with a Slinky as a child (and who didn't?) will remember how the bundle of spiraled metal would walk down a flight of stairs, one step after another. The individual coils would—slowly and steadily—move forward one after the other until such point where the pile of coiled metal remaining behind became too light to hold its position and would—quickly and suddenly—spring forward, setting-up another cycle of the slow-and-steady descent to the next step.

In the Slinky Effect, as it is used to describe traffic, a leading car slows down from normal highway speed to, for example, 45 miles per hour. The next car in line must then slow down to at least 44 to increase the spacing in order to avoid the chance of hitting the slowing car in front of it. The third car then must slow to 43 or less. Some 40 cars later, what started out as a momentary 10-mile-per-hour reduction in speed has resulted in a number of cars backed up and going nowhere.

This frustrating effect always feels as if it's the other cars' fault, even though each car has, perhaps unwittingly, participated in creating the delay by slowing down just a little more than the car in front of it. Finally and mercifully, the traffic jam ends and the cars begin to speed up again, but this time the change in speed occurs much more quickly, to the point where many cars will actually go beyond the speed limit and even beyond their normal driving speed. For some, this may be to make up for lost time; for others, it may be the result of releasing the frustration that was built up during the slow, painful decline in speed. For still others, they may speed simply because they can, as the road and other drivers allow, and may even encourage it through their actions.

Could it be that today's multi-billion dollar MPL market can be modeled, not with advanced actuarial Monte Carlo stochastic simulation techniques, but rather with a toy from the 1940s that can still be purchased at Toys"R"Us for $4.99? As has been witnessed during the course of many years, the MPL industry's rates tend to—slowly and steadily—decline in soft markets for an extended period of time, until the point at which the hard market finally arrives and companies respond by—quickly and suddenly—increasing rates for a brief period of time.

Rate Results from the Survey: the Numbers, Please...

The rate change results of the most recent *Annual Rate Survey* show basically the same story we have seen repeated since 2008. Overall rates fell slightly, by an average of 1.5 percent in 2014, a little less than 2013's 1.9 percent average drop. This is the seventh-straight year that rates have fallen, dropping 13 percent overall since 2008, an average annual fall-off of 1.9 percent. Rates rose only minimally in the two preceding years, 2006 and 2007, rising less than one percent in each. So, in effect, the current soft market on rates has been going on for nearly a decade.

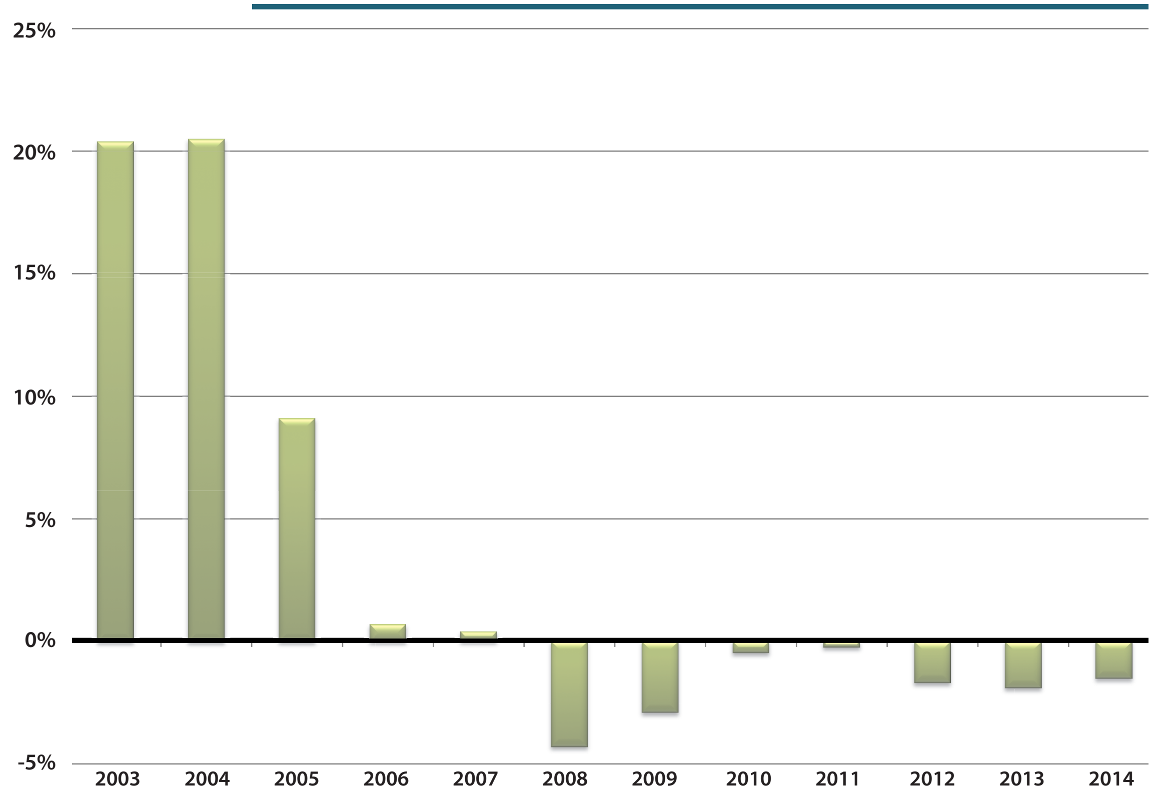
Internal Medicine saw an average rate reduction of 1.6 percent. General Surgery had a 1.3 percent total drop this year, while OB/Gyns saw their rates fall by 1.7 percent overall.

While most rate reductions were on the small side, rate drops in excess of 30 percent were seen in Nevada and Texas. Nevada showed a hefty overall average rate decrease of 34.8 percent, while Texas' overall average rate decreased 9.6 percent. There were only two companies reporting rates in Nevada and as a result the large reduction noted above may be somewhat skewed.

Overall, a majority of rates did not change—up or down—in

Chart No. 2

Overall Average Rate Change (2003 - 2014)



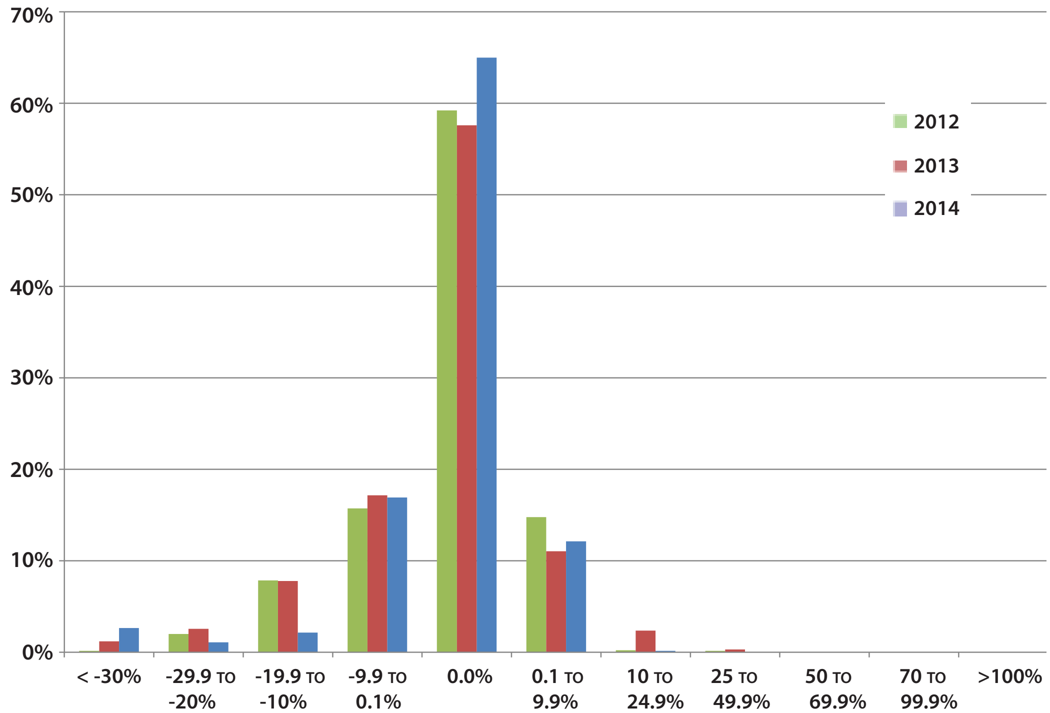
2014. Sixty-five percent of all manual rates stayed the same, a 7.4 point increase from the percentage that did not budge in 2013. As they have since 2006, rate declines significantly outnumbered, and were generally more severe, than rate increases.

For the tenth-straight year, most increases were in the 0.1 to 9.9 percent range (12.1 of the 12.2 percent of total increases), a slight increase from the 11 percent of all increases residing in that range last year. A scant 0.1 percent of rates increased in the 10 to 24.9 percent increase range, significantly lower than 2012's 2.4 percent rise for this range. There were no rate increases in any of the larger ranges this year, whereas a very small 0.3 percent of 2013 rates increased in the 25 to 49.9 percent range.

Bar Chart No. 2 (on page 4) shows the percentage of reported rate changes in the *Survey* from 2003 through 2014; Chart No. 3 (at right) illustrates the distribution of rate changes for the years 2012-2014.

Chart No. 3

Distribution of Rate Changes by Range (2012 - 2014)



There was also little change in the size and nature of rate changes regionally, although there were some anomalies worth pointing out in each of the four regions—Northeast, West, Midwest and South.

Massachusetts saw the largest drop in the Northeast region, down 4.9 percent. As mentioned earlier, Nevada's massive 34.8 percent drop in rates in the West was driven by just two companies. In the Midwest, Missouri registered a 5.2 percent drop in rates, while the South's average was pulled down by Texas' nearly 10 percent drop (9.6 percent).

As has been witnessed during the course of many years, the MPL industry's rates tend to—slowly and steadily—decline in soft markets for an extended period of time, until the point at which the hard market finally arrives and companies respond by—quickly and suddenly—increasing rates for a brief period of time.

On a regional basis, the Northeast was once again the only area of the U.S. to see an average increase in rates: an underwhelming 0.1 percent, lower than last year's 0.7 percent regional increase. New Hampshire (which had last year's second highest increase in the Northeast) led its cohort this year, with a 3.4 percent rise in rates, followed by Maine with its 2.7 percent increase (slightly less than Maine's 3 percent rise last year). New York, which showed the highest rate increase last year, had the second largest decrease in 2014—down 3.1 percent. Connecticut had no change in rates. Rhode Island, which showed no increase last year, increased its rates 1.7 percent in 2014; Vermont's 1.9 percent rise was a reduction from 2013's 3.1 percent increase. New Jersey was down 0.1 percent this year, compared with a 0.8-percent decrease in 2013, and Pennsylvania had a significantly smaller decrease in 2014 (0.7 percent) when compared to last year's 8.4 percent drop for the Keystone State.

The Western states experienced a 4.1 percent average rate decrease, a noticeably larger fall than the 1.2 percent drop recorded in 2013. As mentioned above, Nevada's freakishly large 34.8 percent fall in rates, based on only two reporting companies, distorts the West's overall average. If Nevada is taken out of the picture, the West would have only a 1.5 percent drop in rates (still the largest average decrease for the four regions). Utah and Hawaii tied for second place with rates for both states dropping 5 percent. This was the same as last year for Utah, but a much larger rate drop for Hawaii, which had no change—up or down—last year. Wyoming, which showed no rate change in 2013, took third place this year, with a 4.6-percent cut in rates. Colorado followed with a 3.8-percent drop, a slightly larger decrease when compared to last year's 3.4 percent fall in rates. Montana, which had no change last year, was down 1.2 percent. Idaho was the only state to show an increase in the West this year, with rates rising 1.3 percent, an increase from 2013's 1.6-percent reduction in rates. There were no rate changes reported this year in Alaska, Arizona, California, New Mexico, Oregon or Washington.

The Midwest, which experienced the largest average rate decrease last year, came in second behind the West for 2014 with an average 0.7-percent drop, far lower than last year's 3.6 percent average decline. This year, only one state in the Midwest showed a substantial rise in rates (Indiana, at 4.5 percent) and only one had a significant drop (Missouri, with a decline of 5.2 percent). Illinois had a modest 1.2 percent rise in overall rates, while Ohio had a noteworthy decline of 2.9 percent. The remaining four states showing declines were all at 2 percent or less (Kansas, down 1.8 percent; South Dakota, down 1.7 percent; Michigan, down 0.9 percent; and Wisconsin, 2-percent lower than last year). Four states showed no change in rates (Iowa, Minnesota, Nebraska and North Dakota), up from three states last year.

The South, which had 0.7 percent average rate drop overall in 2013, came in with another 0.7-percent drop in 2014. Also similar to last year, nine Southern states and the District of Columbia showed no change in rates, but this year it was a different list.

In 2014 Alabama, Arkansas, Delaware, Florida, Georgia, Mississippi, North Carolina, South Carolina and West Virginia were the no-change states. Once again Texas showed the largest drop in rates, but this year's 9.6-percent drop is nearly double the state's 4.9-percent decline in 2013. Kentucky, which had no change last year, saw a small increase of 1.2 percent. Louisiana had a 2-percent decline in 2014, slightly less than the state's 2.6 percent drop last year. Maryland had no change last year and a small increase (1.3 percent) in 2014. Oklahoma, which had no change in 2013, saw its rates decline about one half a percent (0.6 percent) in 2014. After no change last year, Tennessee had a 2.5-percent decline in rates this time around. Virginia, which showed no change last year, had just under a 1-percent (0.9) rise in rates.

In it's most recent 'MPL Segment Review' report, A.M. Best estimated a net undiscounted reserve redundancy of $3.5 billion for the MPL industry as a whole. Taking this estimate relative to the industry's premium suggests that there is another one-and-a-half to two years of reserve releases at the same level as has been released of late. This implied time period would be extended if the reserve releases are proportionally reduced as the perceived overall redundancy begins to wane.

Noteworthy Responses, Quotes from the 2014 Annual Rate Survey

As usual, the written comments to the *Survey* exposed many of the issues insurers are most concerned about.

Last year's major concerns focused on market consolidation, the rise of accountable care organizations (ACOs), the impact of the ongoing implementation of electronic medical records (EMRs) and competitors who may be driving down rates to unsustainable levels in an attempt to increase their share in a shrinking market. This year was no different. Some of the comments we found most revealing and interesting are:

• In assessing an ACO's risks, one respondent indicated the major underwriting consideration to be "the ability to insure all aspects of the risk," while another respondent indicated the major underwriting considerations were "capitalization, care coordination, data quality on their pricing and motivations of providers."

• Concerning the continued roll out of the Affordable Care Act, several *Survey* respondents echoed the sentiment presented by a respondent, who wrote: "More patients with access to regular healthcare and a relatively constant supply of physicians in the short run will lead to greater patient frustration and dissatisfaction with waiting times and appointments."

• Comments on the implementation of EMRs ran from one end of the spectrum to the other. They ranged from the positive, "It should enhance the entire file management process," to the negative, "EMRs appear to impact productivity and have a large learning curve upon initial implementation which may impact patient care," to the inconclusive, "Too soon to say."

• Some of the other concerns *Survey* respondents expressed in their comments include, "… the increased use and responsibility of healthcare extenders … the aggregation of physicians into larger groups, hospital employment or similar arrangements … and the formation of ACOs" as well as "telehealth/telemedicine" and "tort reform challenges … smaller share of practitioners in private practice and MPL company expense ratio issues."

• Many respondents continue to see, "Hospital acquisition of physician practices" as the biggest threat to their market share.

In addition to those listed above, there were also several respondents this year who expressed frustration with the soft market and the actions of others, reporting that "Incumbent carriers will do 'whatever it takes' to renew business" and "We are seeing rate reductions as well as additional crediting from our competitors." In other words, why is it that the other cars always create the traffic jam I'm now caught up in when I had nothing to do with creating it?

Conclusion

In its most recent "MPL Segment Review" report, A.M. Best estimated a net undiscounted reserve redundancy of $3.5 billion for the MPL industry as a whole. Taking this estimate relative to the industry's premium suggests that there is another one-and-a-half to two years of reserve releases at the same level as has been released of late. This implied time period would be extended if the reserve releases are proportionally reduced as the perceived overall redundancy begins to wane.

If the industry continues to release reserves beyond the point at which reserve levels are later deemed precisely adequate—as has been the P&C industry's history—that, too, would extend the time period of expected reserve releases implied by A.M. Best's estimate.

So long as the industry's calendar-year, reserve-release-supported financial results remain strong, one can expect continued slow and steady weakening in rate levels.

While the expectation is that this current soft market will continue for the foreseeable future, there are some indications that the back-up of cars is starting to slowly build, though we are likely to continue to apply the brakes and slow down for several more years before reaching the end of the soft market's traffic jam. Once we do reach the end, will we react the way frustrated drivers tend to and stomp on the accelerator to make up for lost time?

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