MEDICAL LIABILITY
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ANNUAL RATE SURVEY ISSUE

OCTOBER 2010 VOL 35, NO 10

METHODOLOGY

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

In this issue, we bring you our 20th Annual Rate Survey. This survey provides a continuing overview of changing rates for physicians' liability insurance. It is a snapshot in time, reporting rates effective July 1, 2010.

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, all rates shown were volunteered by their respective companies. Medical Protective has historically opted not to participate in the Rate Survey; the company's rates published herein were

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NOW HARD & CRUNCHY ON THE OUTSIDE

COULD STRONG FINANCIALS BE HIDING A MARKET THAT'S GROWING SOFT WITHIN?

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

Two years ago, the Medical Liability Monitor Rate Survey roundup bore the title "Soft... with a Hard, Crunchy Center." Sort of like a Snickers candy bar left out in the sun too long.

The point was that—although the medical professional liability (MPL) market had undoubtedly continued to "soften" in 2008 from a rate perspective—the underlying improvement in the loss-cost environment, most notably in claims frequency, had lent the market a "hard, crunchy center" that firmed up the industry's core financial health.

At first glance, the results from the 2010 Rate Survey would suggest the same title might remain applicable today. Rates for 2010 indicate a market that remains "soft" or perhaps "flat," with 67 percent of all rates holding at last year's levels. In addition, all of the thirty-two companies responding to the survey characterized the current market as either "softer" (53 percent) or "the same" (47 percent) when compared with last year. Yet despite this "soft" market, the industry's operating results and balance sheet remains strong.

From a distance this might paint a picture of an industry that is placid and not very exciting—maybe even a little boring. Only slightly lower rates suggest a market that is continuing to soften, but at a slower pace—perhaps even a market that is beginning to stabilize in advance of an upcoming hard market in the near future.

But a closer look reveals a frisson of anxiety that belies the calm and suggests there may be tougher times ahead for the industry before things actually do begin to get better. Going beyond the survey, there are data sets as well as some intriguing indicators to suggest claim frequency may be increasing. Defense costs per claim are definitely going up, and many of the comments made by individual respondents to the 2010 MLM survey suggest there is a growing uncertainty in the market prompted by certain trends and events.

Even the industry's strong operating results the past few years may be a less than reliable indicator of the industry's core operating fundamentals. The release of past loss reserves have acted to, in some sense, artificially inflate the industry's profits in 2010, just as an increase in the use of schedule credits may be hiding an overall drop in rates that is more severe than this year's miniscule 0.5-percent average manual rate decrease would indicate.

Hence the title of this year's MLM Rate Survey Roundup. Rather than the deceptively soft market with a hard, crunchy center of two years ago, the results of the 2010 Rate Survey suggest a market that is deceptively firm, with a softness within that should concern the industry—sort of like a chocolate-dipped, peanut-encrusted ice cream bar left out in the sun too long.

What is a "Soft" Market?

It is important to consider exactly what is meant in this case by a "soft" market before going any further, particularly given the industry's results during the latter half of this past decade. Does it mean a market that is really "bad" or one that is just "less good?" Any discussion of the state of the MPL industry in 2010 must take into account the unprecedented and remarkably good financial results that have occurred in the recent past.

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NOW HARD & CRUNCHY ON THE OUTSIDE

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From a pricing perspective, the market does indeed appear to be soft, although perhaps less so than in the past two years. Rates have been down or flat (increasing less than 1 percent when they increased at all) every year since 2006 (see Chart A on page 3 for a look at what rates have done since 2003). Rates were up substantially in 2003 to 2005 but have fallen—less dramatically than they rose, but consistently—the last three years in a row.

An A.M. Best report that came out earlier in the year showed that net premiums written for the industry dropped every year from 2006 through 2009, with the expectation that 2010 will continue this pattern. Using industrywide net written premium as a proxy for rates, in the past 30 years we have not had three years in a row where the industry's overall rates have declined. That would argue the market is indeed "soft," at least when we confine the definition of "soft" to declining rate levels.

On the other hand, from 2006 to 2009, the industry's combined ratio was less than 100 percent every year, again with the expectation that 2010 will continue this pattern as well. That means for four—and likely five—years in a row the industry made a profit from underwriting alone. Compare these recent results to the observation that during the prior 25 years, the industry's combined ratio was less than 100 percent only twice before. Certainly, such unusually strong underwriting results have had a very strong and positive effect on the industry's balance sheet.

Thus, once we get past rates, if we include a second criteria in the definition of "soft" as being a market with poor financial results, then the market does not *appear* "soft" at all. Despite five straight years of weakening rate levels—and despite a weakened economy that is having a negative effect on many other sectors—the MPL industry is heading into 2011 in a position of relative financial strength.

As has been penned in this and many other industry publications during the past several years, one of the biggest factors that has resulted in the industry's current financial health has been the precipitous and, quite possibly, universal fall-off in claims frequency that occurred generally between 2002 and 2004. This significant reduction in claims frequency has, for the most part, continued into 2010. But for how long?

Recently we have seen a number of data sets where claim frequency is beginning to show indications that it is increasing of late—not so strongly that we are suggesting this trend is universal, nor that the magnitude of the increase would return it to 2002 and prior levels—but there does appear to be enough evidence that suggests this observation is more than just an

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obtained through independent 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 will be 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 July 1, 2010.

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

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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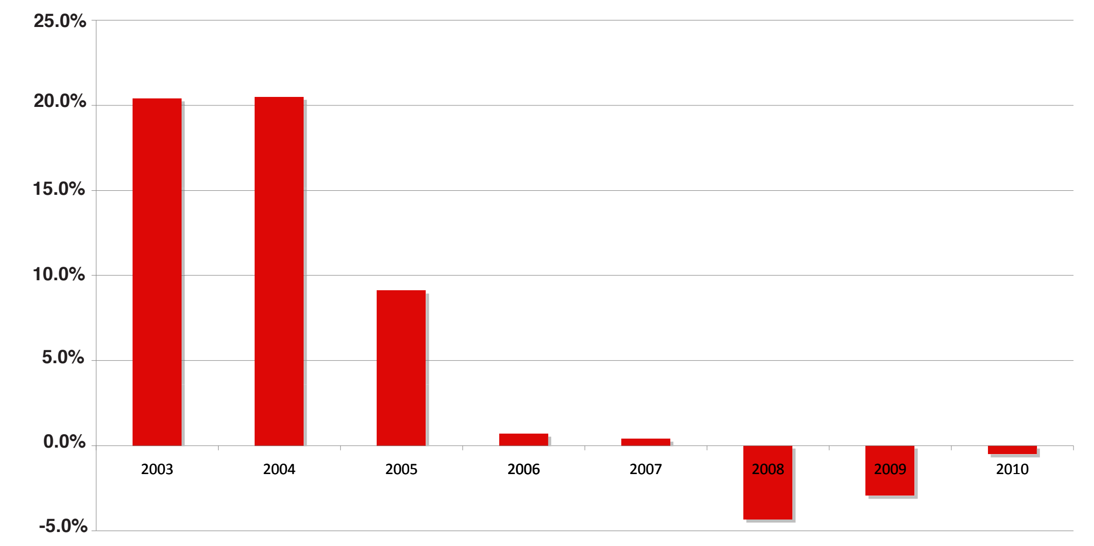
Chart A

Overall Average Rate Change



anomaly. Certainly it is something we are going to keep an eye on. Part of the difficulty with this issue is that since no one knows with certainty why frequency has fallen so sharply in the first place, the signs or events that might announce its return to higher levels could be difficult to see until significant increases are already upon us.

Do Economic Conditions Have an Impact on Frequency?

One external factor that many people in the industry have suggested over the years that might have an effect on claim frequency is the general state of the economy; more specifically, the unemployment rate. Given the current state of economy, and in particular, the focus of late on the nation's unemployment rate, it seems appropriate to comment on any possible relationship between that and the MPL industry.

Earlier this year, my colleagues and I attempted to discern if there was any relationship between the overall state of the economy and MPL claim frequency. Specifically, we tried to determine if a relationship could be demonstrated between an unusually high U.S. unemployment rate and a higher level of MPL claim frequencies. In order to do so, we had to go back as far as the early 1980s to find a time period during which the unemployment rate was as high as what it is today. With the unemployment rate plotted across the years, we then overlaid the St. Paul Companies' countrywide physician and surgeon claim frequencies during that same time period.

An initial comparison of the two rates showed only a loose relationship, at best, between rising unemployment and claim frequency. This prompted the question, "What if frequency is not dependent upon unemployment rates at a specific, given time? What if claim frequency rates are related to—but lag—the unemployment rate?" We experimented using different lag times, and it turned out that incorporating a three-year delay into the comparison revealed a relationship that was both compelling and consistent. The regression-based fitted St. Paul claim frequency followed closely the unemployment rate, with a 1-percent change in unemployment associated with a one-third of 1-percent change in frequency. The U.S. unemployment rate hit 10 percent in 1982; three years later, St. Paul's nationwide claim frequency spiked.

This does not mean that claim frequency is destined to spike again in October of 2012—three years after unemployment in the U.S. first hit 10 percent during the current cycle. Many factors are different today. Unemployment benefits are more generous and consistent. And absent a solid theory explaining what factors may have prompted the recent frequency drop, we cannot say whether current trends in frequency are still as tied to the unemployment rate as they might have been in the early '80s, based on our analysis.

It does, however, seem prudent to consider that the current economic environment could put some upward pressure on frequency, resulting in a small or even moderate bounce. In light of this evidence, the small pockets of frequency increases we have seen lately should not be quickly dismissed as aberrations. Any increase in frequency should be watched closely, particularly as pricing continues to soften.

Numbers Please... Results from the Survey

The rates collected as part of this year's MLM Rate Survey tell a story of pricing that continues the softening trend of the past few years, although at a slower pace.

The total number of reported rate decreases in 2010 was 168—or just under 19 percent of the total number of changes. No change was reported for 597 (67 percent) of all reported rates, and 126 rates saw an increase—just slightly more than 14 percent. The overwhelming majority of all increases (95 percent) was less than 10 percent.

Of the manual rate increases reported on the survey for this year, the magnitude of such increases ranged from less than 1 percent to as high as 10 percent. About two-thirds of all reported manual rates remained the same, significantly higher than last year's 437 or 54 percent, further supporting the contention of fifteen respondents (47 percent) that the market was more "flat" than "soft."

Nearly 20 percent (18.8 percent) of all filed rates were lowered within this past year, a nearly 20 point drop in the percentage of decreasing rates from 2009. Specifically, for 2010 there were 133 reported decreases between 0.1 and 9.9 percent; 32 reported decreases between 10 and 19.9 percent; and three reported decreases between 20 and 29.9 percent.

As with the increases, those in the top bracket were few—only three—all in one state, and clustered around the bottom of the range. Individual decreases ranged from the infinitesimal—0.20 percent (General Surgery) in Illinois to a high of 23.11 percent (Internal Medicine) and 23.12 percent (General Surgery and OB/Gyn) in Tennessee.

Chart B (located on page four) shows the percentage of reported rate changes in the survey for every year from 2003; Chart C (located on page five) illustrates the distribution of rate changes for the years 2008-2010. This year, there were no reported increases in excess of 24.9 percent and, in fact, none over the seven 10.3 percent rate increases we saw in New York State. In 2009 there were only 63 rate increases, but 16

Chart B

Overall Rate Changes by Year

Range	2003	2004	2005	2006	2007	2008	2009	2010
> +100%	1.2%	2.2%	0.0%	0.0%	0.6%	0.0%	0.0%	0.0%
+70.0 to +99%	1.1	4.1	0.6	0.0	0.6	0.0	0.1	0.0
+50.0 to +69.9%	3.7	3.7	0.7	0.0	0.4	0.0	0.1	0.0
+25.0 to +49.9%	26.8	14.8	6.5	2.3	0.5	0.6	0.0	0.0
+10.0 to +24.9%	31.4	34.9	28.5	5.6	5.9	1.2	1.9	0.8
+0.1 to +9.9%	13.1	22.5	29.3	22.6	8.2	5.6	5.7	13.4
0.0%	20.3	13.2	24.0	46.6	53.1	49.9	54.2	67.0
-9.9% to -0.1%	2.3	4.7	8.4	15.1	21.0	20.8	22.1	14.9
-19.9 to -10.0%	0.0	0.0	2.1	5.1	6.5	15.6	12.0	3.6
-29.9 to -20.0%	0.0	0.0	0.0	1.3	2.3	5.2	3.7	0.3
< -30.0	0.0	0.0	0.0	1.4	0.0	1.1	0.2	0.0

(nearly 2 percent) were increases of 11 percent or more, and two were more than 50 percent. So although there were more than twice as many increases this year when compared to last, their overall impact is somewhat reduced by their consistently small size.

Regionally, the Northeast saw a 1.06-percent average rise in rates; the West a 1.45-percent average drop; the Midwest a 0.12-percent average increase; and the South a 1.38-percent average drop. Eighteen states and the District of Columbia, more than a third of the total, had no increases or decreases. Six states, all in the South or Midwest (Florida, Illinois, Iowa, Maryland, Missouri and Texas) had rate increases or decreases of less than 0.5 percent.

The South had the most states with no change in rates—eight. The Northeast had three, the West four and the Midwest three.

An Increase in the Use of Scheduled Credits Masks the Full Decline

Carriers increased their use of scheduled credits in 2010, with nearly 20 percent reporting they have added new credits. These adjustments lower the actual charged rates further beyond the manual rates discussed in the previous section. Thus, a reported 0.5-percent overall average reduction in manual rates could, in fact, be a 3- or 4-percent actual reduction when scheduled credits are figured into the mix, closer to the overall average decline rate of the previous two years.

Not only did 19 percent of the companies add new credits during 2010, all of the companies but one reported they did not restrict the use of any previously offered credits, with one company having it both ways—saying they had both introduced a new credit or credits and restricted others.

Among the new credits added were medical society discounts, an expansion of claims-free credits and a credit for part-time OB/Gyn practitioners. Twenty-five percent of all respondents say they offer a credit for providers who use electronic medical records.

Eighty-one percent of all respondents said they monitor the use of credits, but only 66 percent claimed to reflect credits in their manual rates, suggesting that upwards of a third of all companies do not adjust their manual rates to reflect credits.

"Anything Is Possible"

When asked to comment on the likelihood of various future events or trends, one respondent wrote in the comments section "Anything is possible." That seems to sum up the feeling of uncertainty that appears to bubble beneath the surface of this seemingly placid 2010 survey report.

Although the numbers tell part of the story, the written responses in the survey's individual comments section provide additional insight as to where the market might be headed. Several people predicted additional consolidations within the market, with others saying there would be an increase in self-insurance and captives. Concerns were expressed regarding competitor behaviors, the possible unintended consequences of healthcare reform, and the trend of providers consolidating their coverage under the umbrella of hospitals.

Concern Over Competitors' Actions

A solid majority (56 percent) expressed concerns with the actions of competitors. Comments such as "We are seeing additional crediting from our competitors"; "Competitors are blatantly misclassifying and/or charging below loss costs"; and "Competitors are discounting rates up to 20 percent" give a voice to these concerns and buttressed the argument that credits are being used increasingly more liberally.

But is a general concern with competitor behavior justified? Respondent answers to the survey are at odds on this point.

While 56 percent said they are "concerned" over their competitors' behavior in the market, the vast majority of respondents say their own companies have done nothing to cause any concern by either expanding eligibility requirements (94 percent) or by relaxing their underwriting guidelines (91 percent). Three companies (9 percent) admit that they have loosened underwriting guidelines some and only two (6 percent) say they have expanded eligibility.

If the concern about competitor actions is justified, these responses must not be correct. And if the responses are correct, then the anxiety over competitor actions must be overblown. Which is it? Probably a little of both.

Healthcare Reform and the MPL Industry

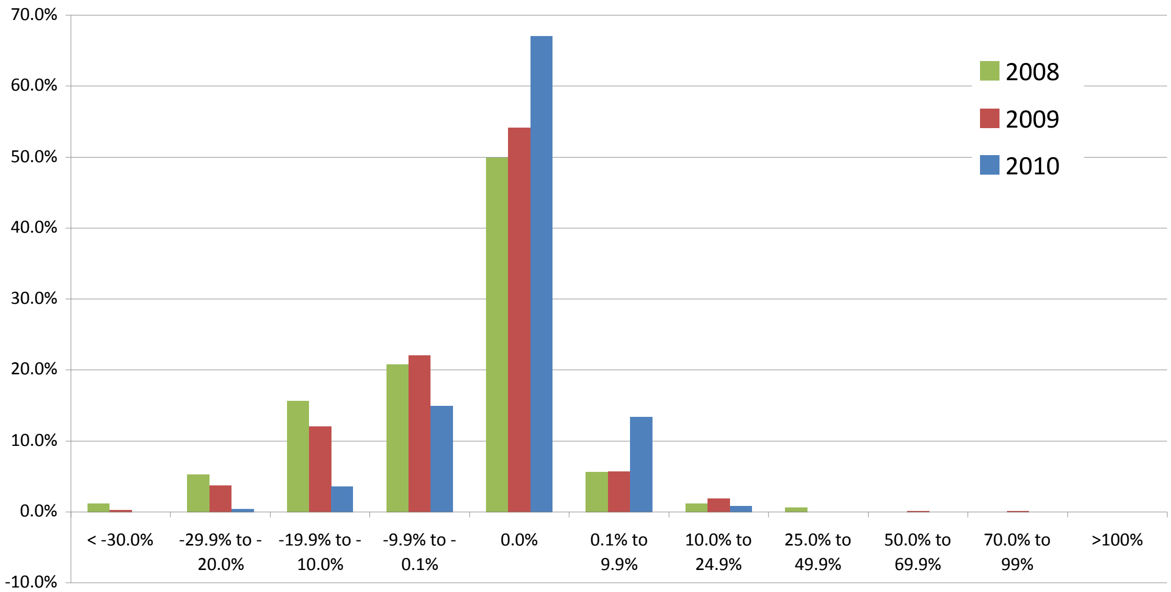
Surprisingly, respondents exhibited little concern over the potential effects of this year's Patient Protection & Affordability Act healthcare reforms on the MPL industry.

Only 10 respondents out of the 32 (31 percent) believe it will increase either frequency or severity; 60 percent believe it will have either no effect (41 percent) or say they do not know (19 percent); two respondents believe healthcare reform will actually reduce frequency and/or severity.

Perhaps the most cogent responses are from those who say they do not know. For if nothing else, the healthcare reform bill increases uncertainty. Nobody knows for sure whether 45 million more people

Chart C

Distribution of Rate Changes 2008 - 2010



suddenly obtaining medical coverage is going to strain the healthcare provider system to the point where professional liability claims increase. In any case, it seems that it must be acknowledged that healthcare reform will—at the least—put additional strain on a system for which future capacity concerns had already been predicted.

If these capacity concerns come to fruition, it is difficult to envision many scenarios under which this will be good for MPL . In any event, the passage of healthcare reform will definitely have a disproportionate impact across individual states. The average national percentage of people in the U.S. with no healthcare coverage is currently about 15 percent, but ranges widely from state to state.

Massachusetts, with its "universal" healthcare law on the books for several years, still has 5.5 percent of its citizens without coverage—far below the national average, but still not zero. Perhaps a 94.5 percent coverage rate is as "universal" as healthcare coverage can get. But as many as 15 states are currently above the national average, with Texas significantly so, at 25 percent; one out of every four people in the state has no healthcare coverage. New Mexico, Louisiana and Florida are each close behind.

It seems reasonable to expect that if more people begin seeing healthcare providers it will result in an increase in claim frequency—if not necessarily severity. In any case, it is safe to say that healthcare reform is one of the factors leading to greater uncertainty about the future of the MPL industry.

Physicians, Other Providers Obtaining Coverage from Hospitals/ACOs

One concern that was voiced several times by survey respondents was the possibility of "increased use of self-insurance and captives" and the related trend of "hospitals purchasing practices and rolling the physicians' exposure into their self-insureds programs." This seemed to be of particular concern to the survey respondents, one of whom predicted that "large groups of healthcare providers [will] feel that the profits enjoyed by their insurers should be experienced by themselves."

Another potential threat along these lines not mentioned directly in the survey is a "new/old" idea that is beginning to be explored in the healthcare community—Accountable Care Organizations—or ACOs. The healthcare industry is currently exploring how ACOs could help to deliver better services more efficiently and at a lower cost. Healthcare reform is expected to accelerate the use of ACOs as more pressure is put on providers to cut costs. Although the main thrust of ACOs is to replace fee-for-service with an incentivized system of rewards and penalties designed to make the delivery of healthcare services more uniform and efficient, it could speed the migration of providers into large self-insured groups.

Something similar to ACOs was attempted in the early 1990s and failed to work as promised. ACO advocates argue that the technology data and process management tools needed to make the system work did not exist 20 years ago, but do now. Even so, incentives will have to be aligned among many different groups within the healthcare provider universe—doctors, patients and payors—to make the cost-cutting ideas behind ACOs work as promised this time around.

Looking Ahead to the Next Few Years

Does the low-level sense of uncertainty and general anxiety that appears to be peeking out beneath the placid exterior of today's MPL market have any basis? We believe it does, and the industry is in for some challenging, but manageable, times during the next two to three years. Defense costs per claim are going up; frequency is showing definite signs of increasing in certain markets; pricing remains flat, at best, and most likely softer than reported manual rates would indicate.

All of this must be kept in perspective with an appreciation of recent history. In the early part of the decade just ending, companies more than doubled their rates as claim frequency fell off the table. Today we are seeing a slow-motion version of the same phenomenon—but in reverse. Rates are slowly, but inexorably, falling each year while claims and expenses move at the same pace, but in the opposite direction.

Underwriting profits may prove to be difficult to come by—particularly if reserve releases begin to decline—during this time frame but, for most companies, the level of surplus accumulated during the recent past will provide solid support through the soft market. Ultimately, the uncertain consequences of healthcare reform—including greater movement to self-insurance, fallout from ACOs and other trends—will become clearer or at least "less uncertain" over time. And the economy is certain to improve eventually—"right?"

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