

The Medical Malpractice Market

From National Dominance to Regional Focus

IF YOU'RE NOT A DOCTOR, you wouldn't notice it. But if the same thing happened to your home, your car, or your health insurance, you'd notice. Big time.

In 2002 and 2003, several medical malpractice insurers across the country increased their rates by 20 percent to 40 percent each year. Underlying the countrywide rate hikes were state rate filings that varied dramatically by state, with some increases exceeding 80 percent in the so-called crisis states. Furthermore, depending on the physician's area of practice, certain specialties such as OB/GYNs, emergency room physicians, and neurosurgeons have seen their rates double or triple.

Five publicly traded medical malpractice liability insurers—FPIC Insurance Company, APCapital, NCRIC Group, ProAssurance, and SCPIE Holdings—announced during their 2003 year-end earnings calls that they expect to raise rates by 10 percent to 25 percent during calendar year 2004. While this is still significant from the perspective of physicians and hospitals purchasing coverage, it appears that there will be fewer “outlier” states receiving exorbitant rate increases than were seen in recent years. The moderation is largely driven by the significant rate activity since 2001 that has helped push rates closer to adequate levels in many states.

The current hard insurance market, which started in early 2001, has been driven by a number of factors, including rising loss trends, higher jury awards, adverse development on prior accident-year loss reserves, reduced carrier capacity (cessation of medical malpractice underwriting at St. Paul in 2002 and Farmers in 2003, and various insolvencies), a hardening reinsurance market, declining investment returns, and the varying success of tort reform packages in multiple states. The current crisis represents the third medical malpractice crisis in the past 30 years. The original medical malpractice crisis occurred in the mid- to late-1970s, followed by another crisis in the mid-1980s.

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While industry practitioners hope that the next competitive market underwriting cycle won't be as damaging as previous “soft” markets, the current environment does create exciting business opportunities for fiscally prudent medical malpractice insurers with strong balance sheets. As

the industry has already seen in early 2004, there are companies looking to capitalize on the current difficult times facing some medical malpractice insurers by acquiring renewal rights to large medical liability books of business.

For example, on March 4, 2004, ProAssurance disclosed in its Form 8-K (a document required by the SEC to announce certain significant changes in a public company) the acquisition of OHIC Insurance Co.'s renewal rights for the physician, hospital, and health care facility business

in Indiana, Illinois, Kansas, Kentucky, and Wisconsin. ProAssurance also noted that policy renewals will be strictly underwritten using ProAssurance guidelines and rates, and will not include a transfer of prior liability for policies written by OHIC.

A quick comparison of OHIC and ProAssurance 2002 direct-written premium (DWP) illustrates that ProAssurance wrote almost \$41 million more business in these five states (See Fig. 1.).

ProAssurance's premium writings exceed those of OHIC in four of the five states in which they operate. The key observation here is that ProAssurance is not diversifying for diversification's sake—a phenomenon common in the 1990s (PIE Mutual, Frontier, PHICO, and many solvent insurers) thanks to a diversification rallying cry led by rating agencies.

Rather, ProAssurance is adding to its *current* knowledge base, growing its book in areas with which it's already familiar. Instead of expanding rapidly into non-core states, as occurred frequently in the 1990s, ProAssurance appears to be sticking to its knitting. It's following through on its strategy by leveraging its current strengths and expertise (underwriting, rates, and claims staff). This is especially



true in Illinois and Indiana, where it already has significant premium volume.

At the time of this transaction, OHIC stated that its intent is to focus on policyholders in its home state of Ohio, which represented 59 percent of OHIC's 2002 DWP. At that level, Ohio represents a state with the critical mass necessary to underwrite and handle claims effectively, efficiently, and with the right level of hands-on knowledge. This compares to the largest of the five states transferred to ProAssurance, Wisconsin, which represents only 6 percent of OHIC's 2002 DWP.

On March 9, 2004, OHIC also announced that it was in discussions with another company to sell its medical-liability book of business in Wyoming, further increasing its focus on Ohio. Although Wyoming constituted a less significant 6 percent of OHIC's book of business in 2002, this also represented 44 percent of the Wyoming market in 2002. It'll be interesting to keep a close watch on this developing situation, particularly since the Doctors Co. and AIG are the No.2 and 3 players in the Wyoming market, behind OHIC with 32 percent and 11 percent of the market, respectively.

A quick review of the top 10 medical malpractice writers in the United States further illustrates that there are no dominant national players left in the medical malpractice arena since the exit of St. Paul. The market is led by insurers that focus on niche markets in blocks of contiguous or strategic core states where they've developed deep underwriting and claims handling expertise.

MLMIC Group, the largest writer in 2002 based on net-written premiums of \$923 million, is composed of three writing companies: MLMIC, Princeton, and OHIC, that focus heavily on the states of New York (95 percent of the company's DWP), New Jersey (65 percent of the company's DWP), and Ohio (59 percent of the company's DWP before the aforementioned transactions). Medical Protective, the second largest writer owned by GE Global Insurance, wrote a significant amount of business in Texas (17 percent of DWP) and Ohio (16 percent of

FIGURE 1 2002 DIRECT WRITTEN PREMIUM (000s)

State	MLMIC		Proassurance		
	OHIC	TOTAL	Pronational Ins. Co.	Medical Assur.	Red Mountain
Illinois	4,811	18,333	17,335	178	820
Indiana	5,453	41,925	754	41,171	—
Kansas	2,540	2,591	—	2,591	—
Kentucky	5,700	6,323	5,986	250	87
Wisconsin	9,795	—	—	—	—
5 States	28,299	69,172	24,075	44,190	907
CW	151,597	433,983	164,029	267,239	2,715
Illinois	3%	4%	11%	0%	30%
Indiana	4%	10%	0%	15%	0%
Kansas	2%	1%	0%	1%	0%
Kentucky	4%	1%	4%	0%	3%
Wisconsin	6%	0%	0%	0%	0%
5 States	19%	16%	15%	17%	33%

DWP).

Moving down the list of top 10 writers, a pattern appears of companies with market shares in excess of 70 percent in certain states, including companies that focus almost exclusively on single states such as California and Illinois. OHIC's recent actions support my belief that successful malpractice companies that succeed in the future will tend to focus on a limited number of states. That's where they've developed the critical mass and expertise to truly act locally at all stages of the claim-settling process: handling the initial complaint, discovery, depositions, and settlement discussions. And if they have to go to trial, they're armed with a deep-seated knowledge of the important case precedents that apply to the venue.

Other strong forces will exert pressure on medical malpractice writers to sell their renewal rights in non-core states, consider opportunities to be acquired by stronger companies, investigate merger opportunities, place moratoria on business in certain states, and exit challenging markets. Here are a few of them:

- Pressure from rating agencies to maintain sound financial leverage ratios. (Net-written premium to surplus ratio < 1.0, noting that a number of companies stated in their year-end earnings calls that a higher ratio such as 1.25 should be used by rating agencies, given that rate

increases drive the increase in NWP, not exposure growth; loss reserves to surplus < 2.0; risk based capital ratio > 3.0);

- Rating agency downgrades (MLMIC downgraded twice in 2003, APCapital downgraded in 2004);

- Pressure from reinsurers to increase risk retention levels. (All five publicly traded medical malpractice insurers discussed risk retention levels on their year-end earnings calls, with most retentions doubling);

- The dramatic reduction in reinsurance recoverables noted by multiple companies at year-end 2003, driven by favorable large-loss case reserve development, with some of these costs shifting back to the company through revised actuarial assumptions in the retained layers;

- The impact of large jury awards on the surplus of smaller companies, where a single catastrophic award could impair surplus;

- The continuation of "unexpected and unprecedented increases in prior-year loss severity," as noted by MIIX in its 2002 10-K (a company's annual report, filed with the Securities and Exchange Commission) and its recent delay in providing 2003 information. This could result in further adverse reserve development for companies that are already in a highly leveraged surplus position;

- Pressure from investment analysts to

focus on core medical malpractice business while exiting non-core lines of business (APCapital exiting workers' compensation and health care insurance; SCPIE exiting health care business and assumed reinsurance);

■ Pressure from rating agencies and the investment analyst community to return to underwriting profitability (target combined ratio under 100 percent).

ProAssurance stated the following in its 2003 10-K regarding merger and acquisition opportunities:

"We have successfully acquired and integrated companies and books of business in the past and believe our financial size and strength make us an attractive acquirer. The current professional liability climate may also provide us with the opportunity to undertake additional mergers or acquisitions of companies or books of business within or adjacent to our states of operation. We continually evaluate these opportunities to leverage our core underwriting and claims expertise."

ProAssurance's statement—focused on

leveraging "core underwriting and claims expertise"—summarizes ingredients that are key to the successful operation of a medical malpractice writer. Medical malpractice, unlike other lines of business, requires a tremendous amount of state-specific expertise in order to defend and settle highly emotional cases (death of an infant, paralysis, disfigurement) where the public—especially jurors, finds it easy to feel the emotional pain of the grieving family.

Often, this expertise is required down to the individual county level, where loss costs can vary dramatically. (In Florida, for instance, rates for physicians in Dade and Broward counties are almost double the rates in Clay and Duval counties.) In addition, hot-button issues that are critical in one state, such as third-party bad faith claims in Florida, won't be an issue in states where third-party bad faith claims aren't allowed.

In the end, it could be that only a handful of companies will drive the medical malpractice market in the years to come. These companies will be the insurers that price business appropriately,

stick to their underwriting guidelines (meaning they're willing to walk away from poorly priced accounts), understand the venues in which they do business, handle claims aggressively and effectively, and are reserved conservatively and consistently.

Vick Adamo, chief operating officer of ProAssurance, may have said it best on the company's Feb. 23, 2004, year-end earnings call:

"We cannot mortgage the future by charging less than the adequate premium rate."

Amen. Although this may appear like motherhood and apple pie, one must ask why the medical malpractice industry has dramatically missed the mark on a number of occasions during the past century. If this time around is different, then medical malpractice insurers that truly understand the above principle will continue to grow and prosper.

More important, insurers that charge adequate premium rates will improve their financial strength, allowing them to provide sound, stable, and innovative coverage options to health care providers for many years to come. ●

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