

THE EVIDENCE



Noneconomic Damage Caps Help Reduce Malpractice Insurance Premiums

By Richard S. Biondi and Arthur Gurevitch

It's said that bad things come in threes, and it looks as if medical malpractice crises are no exception. We are now officially entrenched in the third crisis since the mid-1970s. And if the first crisis was marked by the withdrawal of the Argonaut Insurance Co. from the malpractice market in 1975, then the current crisis may be said to have been highlighted by the December 2001 decision of St. Paul's to exit the market, followed by PHICO, Reliance, Frontier, and MIIX.

Several things have changed in the malpractice environment over the past 25 years. Most notably, the mid-1970s crisis led to a dramatic shift from commercial insurance companies to self-insurance and medical society-owned mutual insurance companies. The malpractice crisis of the mid-1980s resulted in significant tort reforms: many states updated joint-and-several liability laws, tightened statutes of limitations, modified collateral source rules, provided for period payment of damage

awards, and limited contingency fees.

Much of the debate in the current crisis centers around the limitation of noneconomic damages, the so-called caps on pain and suffering. Under this reform, juries would be required to quantify economic damages (such as lost wages and medical expenses) and noneconomic damages. Most of the current proposals allow awarding of the full economic damages but limit noneconomic damages to a maximum predetermined amount, typically \$250,000.

As evidence of the effectiveness of noneconomic damage caps, proponents point to California's 1975 Medical Injury Compensation Reform Act (MICRA), which introduced numerous malpractice reforms including the imposition of a \$250,000 cap on pain and suffering. It's clear that malpractice premiums are significantly and dramatically lower in California than in many other comparable states.

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tice market is due to insurance company mismanagement and the drop in stock market returns.

■ Malpractice claims are increasing at the rate of medical inflation while the spikes in premium are driven by an insurance cycle.

We don't doubt that there's an insurance cycle, that stock market returns and bond yields have fallen, and that there have been some mismanaged malpractice companies. However, in this article, we've tried to determine the extent to which the malpractice insurance market is loss-driven and if it follows sound economic principles. Rather than use piecemeal, anecdotal data, we chose to quantify malpractice effects across states and over time.

One of the best sources of malpractice claims data is the National Practitioner Data Bank (NPDB). The NPDB was established in 1990 to aid physician credentialing organizations by

FIGURE 1 Growth in NPDB Malpractice Losses

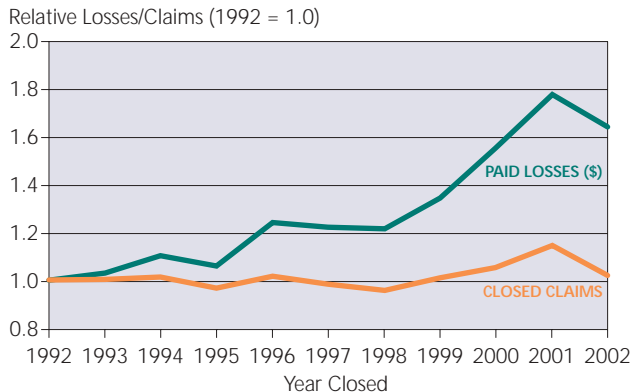
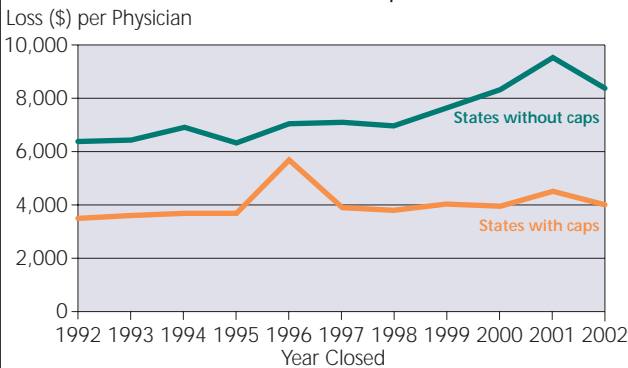


FIGURE 2 Average Loss per Physician in States With and Without Caps



For example, according to *Medical Liability Monitor*, an obstetrician in Los Angeles had an annual premium of about \$60,588 in 2002, while OB's in New York City and Miami paid \$89,317 and \$201,376, respectively.

Opponents of noneconomic caps, which include trial lawyers and so-called consumer advocates, contend that:

■ There is no malpractice claims crisis. In fact, they say, claims have not risen dramatically in the late 1990s.

■ Noneconomic caps and other tort reforms have no effect on premiums and presumably no effect on claims. Accordingly, they argue, California's lower malpractice rates are a consequence not of tort reform but of subsequently imposed insurance regulations.

■ The dramatic increase in malpractice premiums, the widespread unavailability of coverage, and the withdrawal (voluntary or otherwise) of insurance companies from the malprac-

FIGURE 3 Malpractice Claims per Physician in States With and Without Caps

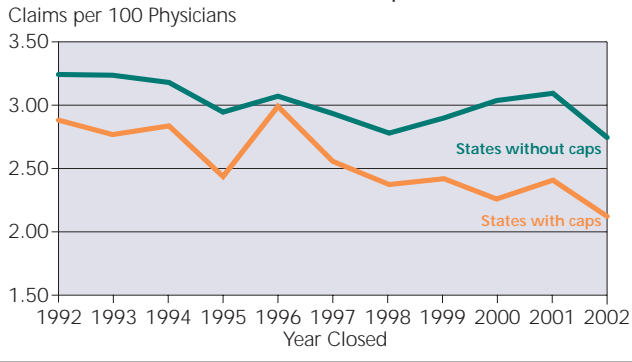


FIGURE 4 Differential in Loss per Physician in States With and Without Caps

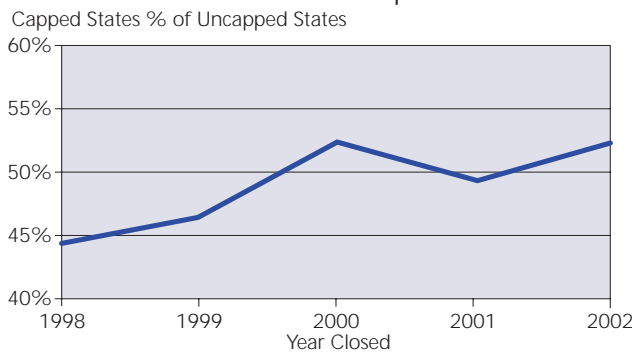


FIGURE 5 Malpractice Premium per Physician in States With and Without Caps

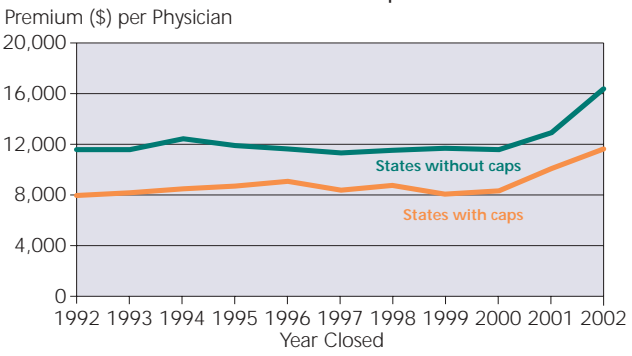
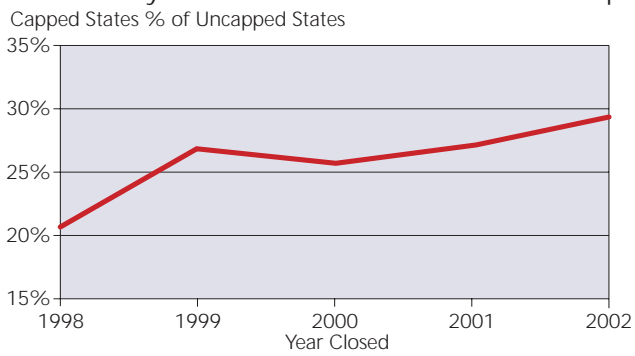


FIGURE 6 Differential in Malpractice Premium per Physician in States With and Without Caps



collecting data on malpractice claims and disciplinary actions against physicians. Most NPDB data are confidential; however, the NPDB releases unidentifiable claims data in the form of a Public Use Data File. Because of the legal mandate to report claims, the NPDB contains information on nearly every paid claim against physicians.

Working with the NPDB Public Use Data File, we approached our thesis by asking the following basic market questions:

1 Do claims data support the existence of a malpractice crisis?

Both the number of malpractice claims and the dollars of paid loss have grown since 1992, as fig. 1 clearly shows. Most noticeable is the dramatic jump in total paid losses at the end of the 1990s. We contend that this malpractice “crisis” is a reasonable label for a sustained 25 percent jump in payments over a two-year period!

2 Do tort reforms affect malpractice payments?

A more detailed look shows that malpractice losses are not uniformly high in every state. Fig. 2 shows that states with noneconomic damage caps have much lower NPDB losses per physician than do states without caps. Indeed, losses per physician in states with caps averaged 46 percent lower than states without caps.

3 Why do noneconomic damage caps have such a significant effect on per physician losses?

In general, caps on noneconomic damages apply only to verdicts and not specifically to settlements. Only a small minority of payments, perhaps as few as 5 percent, are made as a result of verdicts. However, a settlement is negotiated on the basis of the estimated cost of a claim as if it were to go to a verdict. Thus, if the cost of verdicts is reduced due to a cap, it follows that the cost of settlements will be reduced proportionately.

Second, noneconomic damages make up a surprisingly large percentage of total malpractice costs. Publicly available closed claim data from Texas and Florida (the NPDB doesn’t distinguish between economic and noneconomic damages) indicate that noneconomic damages compose over two-thirds of the total cost of claims payments.

Third, caps generally apply to the total noneconomic damages for each medical malpractice occurrence, regardless of the number of physician and/or hospital defendants. So, for example, if \$1 million of noneconomic damages are awarded to a claimant from an occurrence involving three physician defendants, it’s assumed that the entire \$1 million, not the allocated amounts to each of the three physician defendants, would be capped.

Fourth, noneconomic damage caps may have a secondary effect of reducing the frequency of malpractice cases. In an efficient economic environment, certain suits currently in the system might not be brought to court if the potential reward to the plaintiff—and the plaintiff’s attorney—is too low. Fig. 3 shows that claim frequency is reduced by more than 15 percent in states with caps on noneconomic damages.

Finally, in addition to reducing the overall level of malpractice payments, tort reforms also reduce the growth rate of loss-

es (inflation or “trend”). Since 1998, the average losses per physician in non-tort-reform states increased at an average annual rate of 6.8 percent, while the annual increase in states with reforms has been 3.0 percent.

In contrast, during this period the consumer price index (CPI) increased at a 2.6 percent annual rate, and the medical CPI increased 4.2 percent per year. As a result of the different growth rates, the differential between losses for physicians in states with noneconomic caps and those in states without caps has grown from 44 percent to more than 52 percent since 1996 (fig. 4).

4 Do tort reforms affect malpractice premiums?

As an index of the total malpractice premium in each state, we examined the aggregate annual statement malpractice written premium (as reported by Thompson Financial Insurance Solutions) divided by the number of physicians in each state. This index lumps together hospital and physician premium. However, it should provide a reasonable estimate of malpractice premium growth, indexed to adjust for changes in the physician population.

Fig. 5 clearly shows that the premium in states with noneconomic caps is lower than in states without caps. The increase in premium didn't begin until after losses increased; it took insurance companies 18 to 24 months to process new claims data and to promulgate new rates (undoubtedly due to the filing and approval process).

The premium differential between states with caps and those without caps has also increased during the span of this most recent crisis (fig. 6). As with losses, it appears that tort reform has a relatively stronger impact as losses increase.

Note also that the premium differentials in fig. 6 are somewhat lower than the loss differentials shown in fig. 4. Is this because malpractice insurers are ripping off the insureds and pocketing the tort reform savings?

We don't think so. The premiums shown in fig. 6 include defense costs (LAE) and overhead costs. These costs do not decrease (or decrease less) as the result of noneconomic damage costs. Therefore, we would expect that the premium differential would track the loss differential but not be quite as extreme.

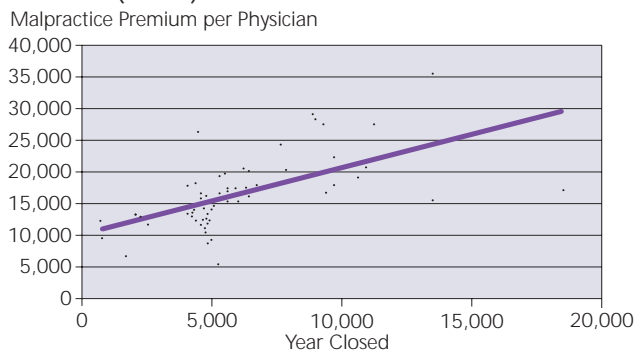
5 Are malpractice premiums rationally based on losses?

We have thus far shown that there has been a relatively sudden and dramatic increase in malpractice costs (a “crisis”) and that states with noneconomic damage caps have lower claims and lower premiums than states without caps. But what of the more basic argument, that malpractice insurance is a (fundamentally) competitive market with market forces determining the rates?

Fig. 7 shows premium as a function of losses in 2002. The strong relationship shows that as losses increase, so does premium. Therefore, any type of reform that decreases losses should have a corresponding effect on premium.

Interstate data unequivocally support the premise that caps on noneconomic damages are an effective means of reducing malpractice costs. Noneconomic caps reduce malpractice payments, and malpractice payments are highly correlated with medical malpractice premiums.

FIGURE 7 Relationship Between Loss and Premium (2002)



In general, factors that bring down losses, including tort reforms, get translated into premium savings regardless of an economic or insurance cycle.

1 2002 occurrence rates, LA - SCPIE, Miami - FPIC, NYC - MLMIC. From *Medical Liability Monitor*.
 2 The NPDB does not distinguish economic and noneconomic damages.
 3 As reported by Thompson Financial Insurance Solutions.

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