MEDICAL LIABILITY
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ANNUAL RATE SURVEY ISSUE

OCTOBER 2012 VOL 37, NO 10

METHODOLOGY

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

In this issue, we bring you our 22nd *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, 2012.

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 Independent Nevada Doctors Insurance Exchange, all rates shown were volunteered by their respective companies. Those companies' rates published herein were obtained

CONTINUED ON PAGE 2

BECALMED & BEWILDERED

WHEN WILL THE MEDICAL PROFESSIONAL LIABILITY MARKET BREAK OUT OF THE DOLDRUMS, BEGIN TO HARDEN?

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

The medical professional liability (MPL) market has behaved enigmatically, to say the least, during the past five years. Ever since we began writing the Executive Summary to the Medical Liability Monitor *Annual Rate Survey* in 2008, we have been asking the same question: What is the true nature of this strange and seemingly contradictory MPL business environment? One must consider any market strange that continues to exhibit increasingly weak rate levels and investment returns while turning in impressively strong financial performances year after year. How does that work? And how does it keep working?

Is it a "soft" market on the surface only? Is it hard and strong at its center? That is what we suggested in the Executive Summary to the *Annual Rate Survey* in 2008. We compared the market then to a piece of chocolate left out in the sun too long. Or is this market really just the opposite? Is it hard on the outside—"crunchy"—but hiding a deceptively soft and softening core? This is what we thought might be the case back in 2010. Or perhaps, as we asked rhetorically last year, has the MPL sector found its way into a "new normal?"—one characterized by a market that can remain forever vibrant and profitable even as rates and premium continue to decline year after year?

Although some in the industry may have hoped fervently that this last theory would prove true, most believed it was wishful thinking. If rates continue to fall, the industry's financial results will eventually become insupportable and therefore unacceptable. As painful as that scenario is to contemplate, it might prove to be the industry's one and only path back to a truly "hard" market—one characterized by rising rates, higher amounts of premium *and* strong, sustainable financials. Based on history, the MPL industry's current strong financial results may have to hit bottom before rates can begin to rise again.

In this year's Executive Summary to the *Annual Rate Survey*, we discuss:

- How the MPL market got to this strange, enigmatic place;
- The contradictory state of the industry today and the growing anxiety revealed in the responses to this year's *Annual Rate Survey* Questionnaire;
- The details about which rates fell or rose, where and with a comparison to last year's movement; as well as
- Our take on how long it may be before the market begins to truly harden, and why we believe the financial results will have to become untenable before any real change can take place.

Where We've Been Lately

As we discussed in last year's Executive Summary, from a top-line perspective, the MPL market has been growing softer every year since at least 2006. That trend continues.

Rates have fallen repeatedly, and are down another 1.7 percent this year (see Chart No. 1 on page 3). Although this is a small drop, indicating a market that has been essentially "flat" since 2010, 1.7 percent is a bigger reduction than some may have anticipated. It is larger than the miniscule 2010 and 2011 rate reductions, which were a scant 0.5 and 0.2 percent, respectively. This year's larger drop in rates dims

CONTINUED ON PAGE 2

WILL THE MARKET EVER HARDEN?

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hopes that a hard market could be just around the corner.

Adding more fuel to the argument that the market is truly "soft," the aggregate drop in direct written premium has reached nearly 20 percent since 2006, falling year after year from its all-time high of $12.5 billion. Beginning in 2007, it dropped steadily to slightly more than $10 billion by 2011. This is sobering when one considers that direct written premium had fallen for two consecutive years only once previously, and then for a total reduction of only seven percent. It has now fallen nearly 20 percent during five consecutive years, and will most certainly show another drop in 2012 for an unprecedented six straight years of decline.

These facts alone would typically be more than enough to consider this MPL market as soft as they come.

But—and this is a big but—the industry's financial results have never been as strong during this same period where rates and direct written premium have fallen. The MPL sector's combined ratio after dividends will likely hover around a still very healthy 90 percent in 2012, and has remained well under 100 percent every year since 2006.

If rates continue to fall, the industry's financial results will eventually become insupportable and therefore unacceptable. As painful as that scenario is to contemplate, it might prove to be the industry's one and only path back to a truly hard market.

These healthy financial results for MPL are due to a confluence of several positive factors, some of which could be seen as temporary, fortuitous and/or artificial. Positive influences include the sudden and unexpected drop in claims frequency, which fell—precipitously and in some ways, mysteriously—to a point where the industry's claims frequency is now approximately half of what it was a decade ago.

Indemnity severity trends have remained manageable lately with most indications in the low single digits. Lower claims frequency and modest claim severity trends working together have resulted

CONTINUED ON PAGE 3

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METHODOLOGY

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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 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, 2012.

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 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.

CONTINUED FROM PAGE 2

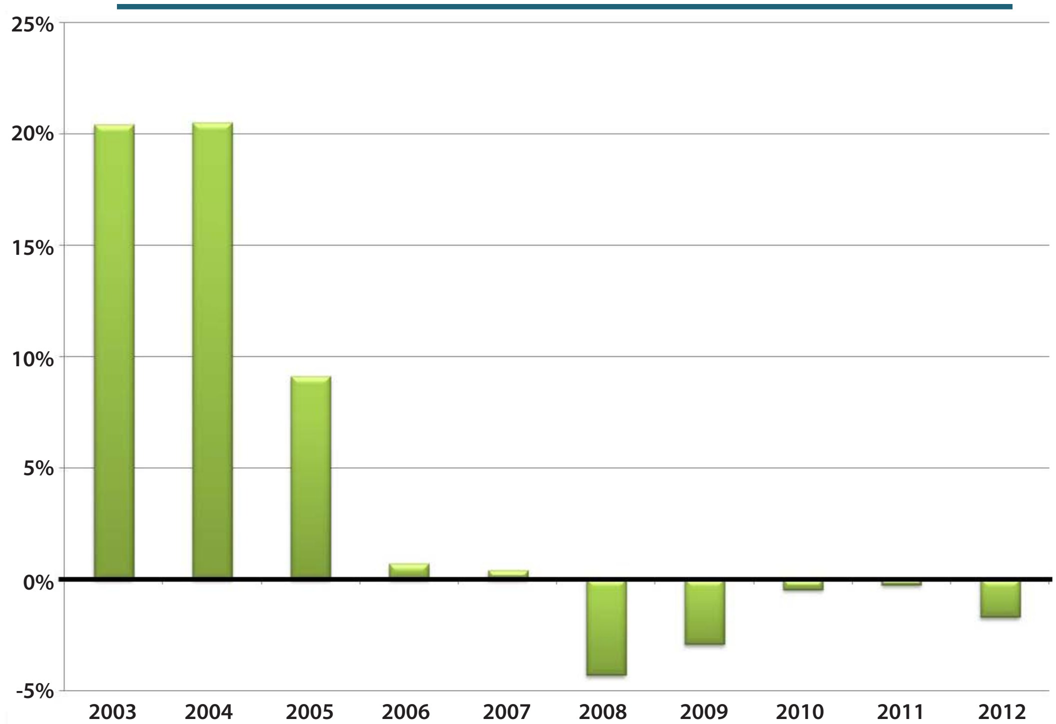
in significant releases of prior-year reserves, which have served to fatten the MPL's bottom line.

Favorable calendar-year reserve development, it is important to note, does not necessarily mean current reserves are redundant. As we noted earlier this year, "a review of calendar-year development segregated by 'Schedule P' year shows that favorable calendar-year reserve development has historically continued two to three years past the point at which reserves were later found to be adequate." Also, while frequency remains historically low, some companies have seen a modest rise in frequency lately. Finally, while indemnity severity trends have proven relatively benign of late, the average cost to defend claims has risen sharply since 2005.

The bottom line is that while revenues have been declining, several other factors—most notably, claims frequency—have served to contribute to a market that nevertheless remains quite profitable. This has been the case for several years, and we are beginning to have some difficulty coming up with new ways of describing what appears to be a becalmed and static market.

Chart No. 1

Overall Average Rate Change



It is difficult to take the position that positive financial results are not good, but the results may be masking structural issues that are slowly eating away at the MPL sector's longterm health. That seems to be the underlying fear expressed in the responses to this year's *Annual Rate Survey* Questionnaire.

The numbers from this year's survey, with only a few exceptions, are so close to last year's numbers that there is almost nothing new to say. There seems to be only one real question on everyone's mind: when will this market harden again?

Last year we concluded that the market was indeed soft, and getting softer, adding the following: "[Positive financial results] have lulled the industry into a kind of dozing complacency. Companies are willing to sit and wait out the current becalmed environment, hoping that next year will show a market beginning to firm up… one of the strongest forces in human nature is inertia—the inclination to do nothing until circumstances or events force us to act. As long as financial results continue to stay strong, the industry is unlikely to address the growing weakness at the MPL market's core." What we couldn't say with any degree of certainty last year was when the market would begin to harden again.

The bottom line is that while revenues have been declining, several other factors—most notably, claims frequency—have served to contribute to a market that nevertheless remains quite profitable. This has been the case for several years.

This year, we believe we have an actuarially precise answer to that question supported by historical data and analysis, to wit: the MPL market will only begin to harden several years after the sector's financial results become unacceptable. And due to the factors mentioned above that are propping up the market's financial performance (lower frequency and the release of prior years' reserves) it will likely be several years before financial results actually become truly and undeniably "unacceptable."

That is the good and the bad news in a nutshell. And, yes, there is good news.

The good news is that the MPL sector will not disappear down a rabbit hole of ever-decreasing, insupportable rates. We believe there will be a hard market again. A smaller one, perhaps, with fewer companies and fewer customers, but there will be an MPL industry and it will be profitable for those who learn to navigate the new landscape. The bad news is that it may take precisely a little more than a few or several, but likely less than many years for us to get there.

We will discuss the data and the analysis that leads us to this conclusion later. But first, let's take a few moments to mine the *Annual Rate Survey* data for some of the important, current information it has to tell us about the MPL market today.

Results from the 2012 Rate Survey: *The Numbers Please...*

A majority of rates did not change at all in 2012. In fact, 59.2 percent of manual rates stayed the same this year, a 4.1 point increase over the percentage that did not budge in 2011. And, as they have since 2006, rate declines significantly outnumbered and were generally more severe than rate increases, although both increases and decreases hovered near zero.

Chart No. 2

Overall Average Rate Change by Range

Range	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
> +100%	1.2%	2.2%	0.0%	0.0%	0.6%	0.0%	0.0%	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	0.0	0.0
+50.0 to +69.9%	3.7	3.7	0.7	0.0	0.4	0.0	0.1	0.0	0.0	0.0
+25.0 to +49.9%	26.8	14.8	6.5	2.3	0.5	0.6	0.0	0.0	0.3	0.1
+10.0 to +24.9%	31.4	34.9	28.5	5.6	5.9	1.2	1.9	0.8	4.8	0.2
+0.1 to +9.9%	13.1	22.5	29.3	22.6	8.2	5.6	5.7	13.4	9.4	14.8
0.0%	20.3	13.2	24.0	46.6	53.1	49.9	54.2	67.0	55.1	59.2
-9.9 to -0.1%	2.3	4.7	8.4	15.1	21.0	20.8	22.1	14.9	27.8	15.7
-19.9 to -10.0%	0.0	0.0	2.1	5.1	6.5	15.6	12.0	3.6	2.2	7.9
-29.9 to -20.0%	0.0	0.0	0.0	1.3	2.3	5.2	3.7	0.3	0.2	2.0
< -30.0%	0.0	0.0	0.0	1.4	0.0	1.1	0.2	0.0	0.1	0.1

In 2012, 25.7 percent of all rate changes were downward, a 4.6 point decline when compared with the 30.3 percent of all adjusted rates that fell in 2011.

By comparison, only 15.1 percent of all rate changes were increases, essentially flat when compared with the 14.5 percent registered for 2011 and the 14.2 percent of all adjusted rates that rose in 2010. As has been typical for the past six years, the great majority of increases in 2012 were in the 0.1 to 9.9 percent increase range (13.5 percent), an increase over the 9.4 percent of all increases that lived in that range last year. Only 0.2 percent of rates increased in the 10 to 24.9 percent range, and 1.4 percent increased in the 25 to 49.9 percent range. [Chart No. 2 (above) shows the percentage of reported rate changes in the survey from 2003 through 2012 by range, and Chart No. 3 (at right) illustrates the distribution of rate changes for the years 2010-2012. —*ed.*]

Ninety-eight percent of all rate increases were in the 0.1 to 9.9 percent range, while one percent could be found in the 10 to 24 percent and 25 to 49.9 percent ranges each.

A little more than 61 percent of all manual rate decreases fell into the lowest 0.1 to 9.9 percent range, a little more than 30 percent fell into the next higher range of 10 to 19.9 percent, and eight percent fell into the 20 to 29.9 percent range. A miniscule 0.4 percent of the rate reductions landed in the greater than 30 percent range.

There was also little change in the size and nature of rate changes regionally. The Northeast was once again the only area of the United States to see an average increase in rates: 1.09 percent. This time it was Vermont leading the pack in the Northeast with a 4.11 percent rise in rates. It was followed by New Hampshire (which had shown the highest increase in 2011) with a rise in rates of 3.11 percent. Pennsylvania was the only other Northeast state to see an increase greater than one percent (1.27), while Connecticut, Maine, Massachusetts, New Jersey, New York and Rhode Island all had no change or only fractional increases.

The Western states experienced a 3.14 percent average drop, significantly larger than 2011's 0.7-percent average decrease for the region. Utah led the field with an 8.39 percent rate reduction, with Arizona coming in second at 7.55 percent, a slightly larger average rate reduction than last year. Other Western states showing significant average rate reductions in 2012 include: California (5.14 percent), Oregon (6.16 percent), Washington (5.11 percent) and Wyoming (6.27 percent). Alaska, Colorado, Hawaii, Montana, New Mexico and Nevada all showed no change in rates or decreases of less than three percent.

Chart No. 3

Distribution of Rate Changes by Range (2010 - 2012)

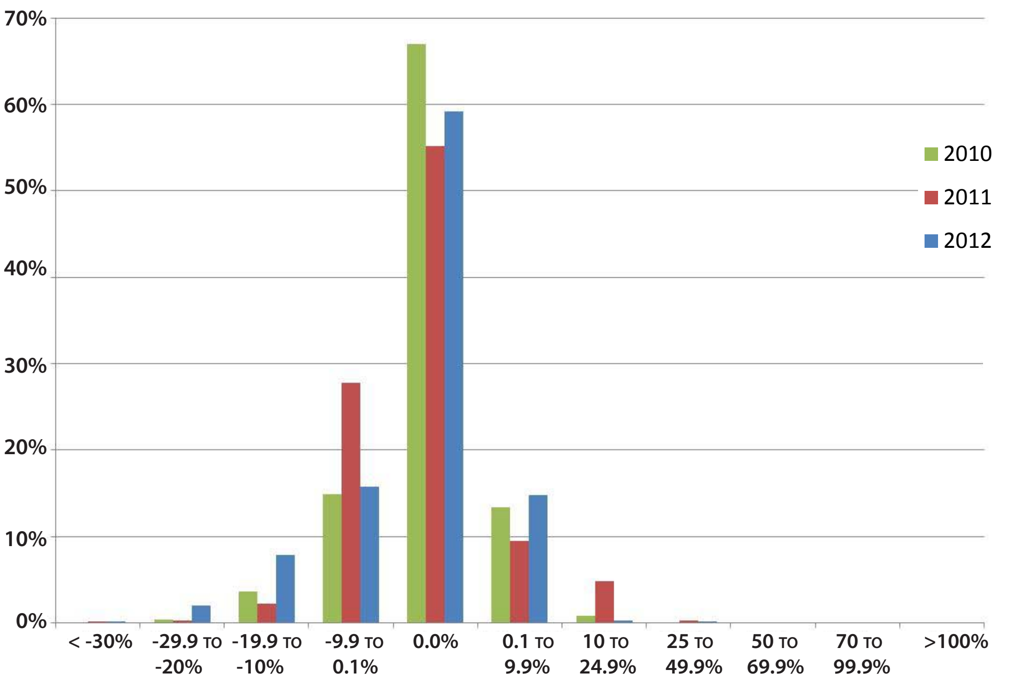
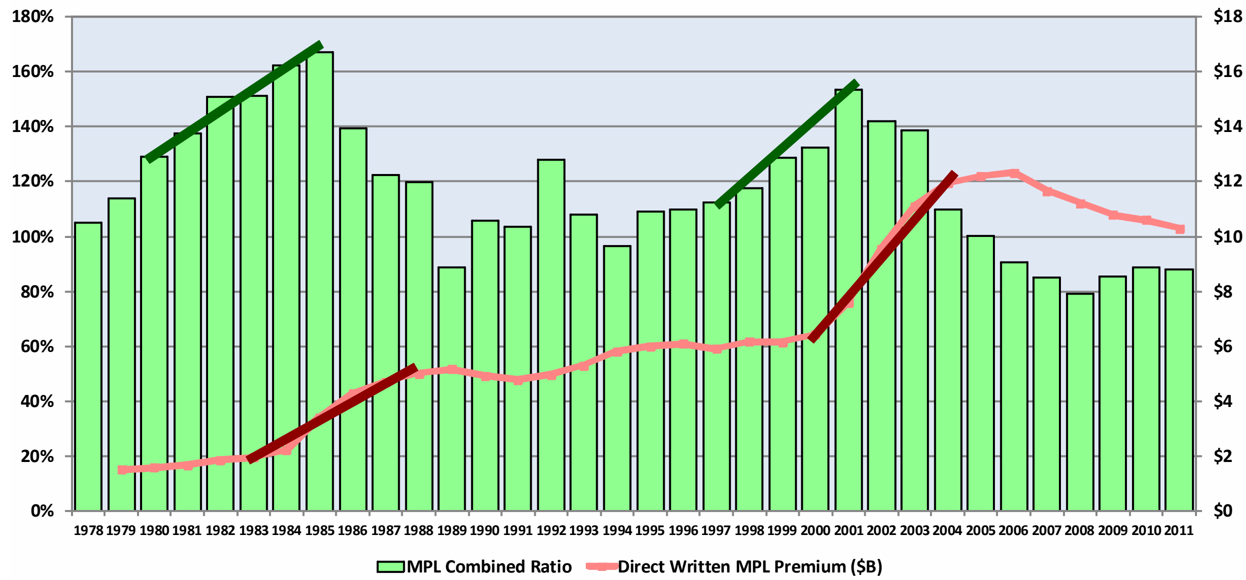


Chart No. 4

Combined Ratio & Direct Written Premium (1978 - 2011)



At 3.52 percent, the Midwest experienced the largest average decrease and was once again the most volatile region. Only two states (Iowa and Minnesota) showed no change in rates. North Dakota had the steepest drop in rates at 9.81 percent, followed closely by Kansas with an 8.89 percent average reduction. Both Michigan and South Dakota had rate declines of more than five percent (5.01 and 5.34, respectively), with the remaining states all coming in with rates that fell less than five percent. Illinois and Wisconsin had the smallest rate drops, at 0.91 and 0.90 percent, respectively.

The South, which showed the second-largest average decline last year at 1.9 percent, had the smallest at 0.26 percent. Six of the Southern states (Alabama, Arkansas, Mississippi, North Carolina, South Carolina and Tennessee) showed no change in rates. Florida experienced the largest movement in rates, a 4.54-percent reduction.

New Questions & Noteworthy Responses from the 2012 Annual Rate Survey Questionnaire

Once again, carriers acknowledged an increase in their use of schedule credits in 2012. The percentage of companies increasing their use of credits went up from 29 to 37 percent.

Last year we noted that only 11 percent of companies had introduced new credits, and suggested that companies might be running out of ideas for new credits. We spoke too soon. This year the percentage of companies introducing new credits shot up to 30 percent. Asked to describe their new offerings, individual responses ranged from credits based on claims history to a credit for completing a company-approved loss prevention/risk management course or activity to one company providing credit for "meaningful use" of an EMR system. Credits, as we note every year, serve to reduce the actual charged rates beyond those collected in this survey. So a reported 1.4 percent overall average reduction in manual rates like this year's could actually be a 2.5 to four percent or more percent actual reduction when schedule credits are figured into the mix.

> Last year we noted that only 11 percent of companies had introduced new credits, and suggested that companies might be running out of ideas for new credits. We spoke too soon. This year the percentage of companies introducing new credits shot up to 30 percent.

The number of respondents reporting they were "concerned about trends in underwriting guidelines used by competitors" dropped slightly in 2012, from 36 to 30 percent, indicating that two companies, at least, are less worried by the issue this year than last. But whether that is because they have become more trusting of their competition or have begun lowering their own guidelines is unknown. When asked to explain their concerns more specifically, respondents pointed to the following: risk retention groups and their lack of state oversight, the trend toward offering free death-disability-retirement tails, excessive discounting and the use of scheduled credits to obtain business.

A new question on this year's survey involved Accountable Care Organizations (ACOs). Only two respondents said they had written coverage for ACOs, but there was no shortage of opinion when asked what considerations might be paramount when considering an ACO as a prospective client. Respondents wrote that when considering an ACO, they would take into account the following: "ownership," "credentialing, patient loads [and] services," "[the] ACO's responsibility to coordinate care among specialties," "being able to bundle several types of coverage together and assessing the exact insurance needs of an ACO," and "non-MPL exposures… lack of clarity of liability under different policies," among other comments.

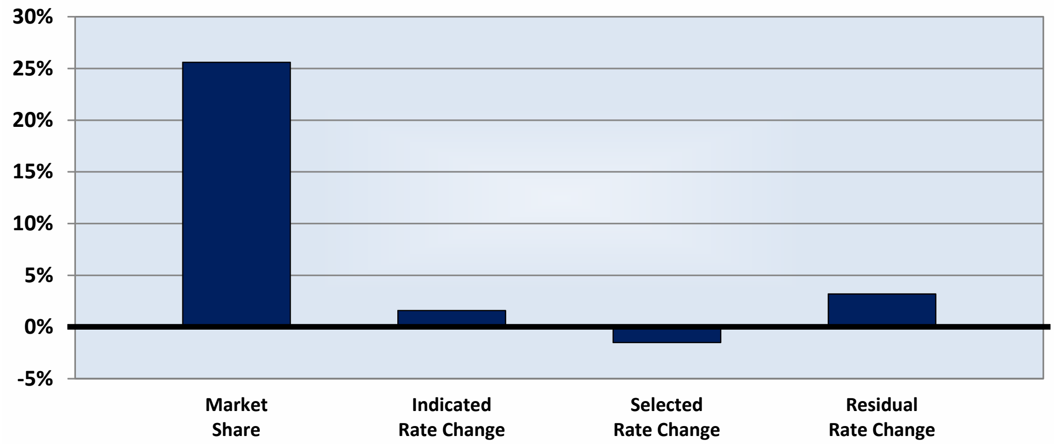
This suggests there is a lot of thought and some trepidation when it comes to writing coverage for these new organizations. That anxiety is understandable when one considers that ACOs are still an evolving creature that could ultimately cannibalize certain parts of the MPL market.

Provider and insurer consolidation remains a hot topic and major concern among MPL professionals, as evidenced by the responses. Question No. 15 on the Questionnaire asked, "Do you believe there will be additional consolidation in the marketplace?" Seventy-four percent of respondents said "yes," only 11 percent said "no," and one respondent each said "N/A," "possible," "employment of physicians by hospital," or left the answer blank.

In fact, several respondents left written comments to this question, even though the survey did not ask for any, indicating how concerned the industry is about this issue. Comments included: "The Supreme Court upholding the Affordable Care Act will lead to additional consolidation," "Additional carrier consolidation and hospitals will continue to form strategic alliances," "Especially hospital/physician integration," "Employment of physicians by health systems," "There will most likely be additional company consolidations in the future," "May continue to see trend of national carriers acquiring regional carriers," "This has only just begun and we will see much more. National healthcare reform will accelerate the pace of consolidation," and "More mergers/and some [companies] will go out of business."

Chart No. 5

Current Market Participants Rate Filing Info
10 Company Composite 2010 - 2011



When Will the Market Harden?

As noted earlier, we believe the market will begin to harden only after the financial results become unacceptable, which could take several years. Once that happens, it may take another few years before the industry reacts with firming rates. This is what the historical data suggests.

Chart No. 4 (see page 5) shows the relationship between the industry's combined ratio and the dollar amount of direct written premium from 1978 to 2011. The combined ratio spiked to unacceptably high levels twice during that period—from 1980 to 1985, and again from 1997 to 2001—as indicated by the diagonal green lines at the top of the bars representing those years. Both periods were followed three years later by sharp increases in the industry's direct written premium, as indicated by the red lines overlaid on the line charting the dollar amount of direct written MPL premium growth. Note that the green and red lines are almost exactly parallel, although separated by three years.

The good news is that the MPL sector will not disappear down a rabbit hole of ever-decreasing, insupportable rates. We believe there will be a hard market again. A smaller one, perhaps, with fewer companies and fewer customers, but there will be an MPL industry and it will be profitable for those who learn to navigate the new landscape.

The next question that presents itself then is: Why three years? Why not one? Or two? Or five? The answer seems to be that given the volatility inherent in this business, it takes that long for the industry to truly believe higher rates will be necessary to remain profitable in the face of increased costs.

The last time the market began to harden was in 2001, three years after the combined ratio began to rise precipitously in 1998. With this most recent hard market, we decided to go back and look at how rates were being decided during this time period. Specifically, we collected 32 rate filings from the largest national carrier at the time, The St. Paul Companies, that were filed to be effective between Jan. 1, 1999 and Jan. 1, 2002. For each of those filings we compared the actuarially indicated rate change to the rate change that was ultimately filed by the company and found that, on average, the indicated rates were nearly 33 percent higher than the filed rates. One assumes that despite the changing conditions in the market and a rising combined ratio, competitive pressures conspired to keep rates lower than they might have otherwise been.

When we look at the current market (see Chart No. 5, above), a similar survey of current market participants suggests that the difference between the actuarially indicated rates and the filed rates is much smaller at around three percentage points. While we are comparing a composite of current market participants with the former single largest carrier, the difference in the "residual rate indication" suggests that it's going to take a few years for that differential to approach the levels that immediately preceded the last hard market.

Conclusion

The current MPL market seems stuck in a becalmed sea of soft rates, meager investment returns and rising defense costs, but the impetus to take the oars and row itself out of the doldrums is dampened by the superior financial results the industry has been able to post.

This has been the story for the past five or six years, and is likely to continue for a few more. Exactly how many years it will take to before the financials will become unacceptable is difficult to predict. What we can say with some degree of confidence is that when we do reach that point, it will likely be another few years before the market begins to truly harden again.

Chad C. Karls is a Principal and Consulting Actuary in the Milwaukee office of Milliman, Inc., specializing in medical professional liability insurance. He was the editor of the 2008, 2010 and 2011 Annual Rate Surveys as well.