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ANNUAL RATE SURVEY ISSUE

OCTOBER 2011 VOL 36, NO 10

METHODOLOGY

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

In this issue, we bring you our 21st *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, 2011.

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 *Annual Rate Survey*; the company's rates published herein were

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FROM CRUNCHY CANDY TO SIMMERING FROGS

WAITING AND HOPING FOR A HARDENING MARKET AS THE MARKET TRENDS SLOWLY, STEADILY SOFTER

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

Three years ago, in the 2008 *Annual Rate Survey*, we characterized the medical professional liability (MPL) market as being similar to a sun-drenched chocolate candy—hard and crunchy on the inside despite a seemingly soft exterior. The point was that while lower rates may have made the MPL market appear soft, its core underlying cost structure provided for financial results that remained remarkably strong. Signs of weakness, we wrote then, were superficial and deceptive.

Two years later, we turned that metaphor on its head for the 2010 Medical Liability Monitor *Annual Rate Survey*, suggesting the market might actually be starting to soften at its core, beneath its hard outer shell of profitable results.

Many in the industry remained optimistic during the past year as the market has continued to demonstrate growing signs of weakness, choosing to stay with the "glass-half-full" philosophy we endorsed in 2008. There were sets of hard data supporting that optimism then, but conflicting indicators have since made all of us question the very definition of a soft market. Can we call a market "soft" when it is consistently profitable, year after year?

The expected underwriting results for 2011 may not be as stupendously good as they were during the 2006 to 2010 period, after rates shot up and frequency fell through the floor, but they will likely still be good—very good, in fact.

The hard truth is the market has been sending decidedly mixed signals of late, looking healthy from a profits point of view, but soft—or flat, at best—when looked at from the angle of rates. Last year, rates—and therefore direct written premium—fell yet again, as it has every year since 2006, but the MPL insurance industry had one of its best years in 2010 from a financial perspective.

So it remains difficult for anyone to say we are really in a traditionally defined soft market, one with declining rates and unprofitable results. The negative effects of clearly declining rate levels have been minimized or masked by historically low frequency. Perhaps, as some have suggested, we are at the beginning of some "new normal," an MPL market with different rules from the past, a gravity-free environment where profits stay forever buoyant despite the drag of lower rates year after year. Sadly, we believe this opinion is off the mark.

The MPL insurance market does appear to be slowly and steadily getting softer, despite its stubborn and resilient profitability. The increased anxiety bubbling under the surface and expressed in the comments in response to the 2011 *Annual Rate Survey* questionnaire lead us to believe that this is the most likely, if inconvenient, truth. The other, more comforting interpretation—that we are in some new kind of MPL market environment—is, in our view, not the case.

The effects of the soft market on profitability are indeed being masked by the release of past reserves. This may have lulled some in the industry into a dozing complacency. Some companies may be willing to sit and wait out the current becalmed environment, hoping that next year will show a market beginning to firm up or, at the very least, no worse than the past year.

Too often, we tend to not take action until circumstances or events force us to act.

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FROM CRUNCHY CANDY TO SIMMERING FROGS

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In other words, as long as financial results continue to stay strong, the industry is unlikely to address the growing weakness at the market's core. It will take drastic change to spark any kind of industry-wide response—a sharp rise in frequency, for example.

A sharp rise in frequency, however, cannot be predicted with any degree of certainty, since no one knows for certain why frequency fell so sharply in the first place. Nevertheless, there have been occasional, but definite, signs that frequency is beginning to tick upwards. Its magnitude is nothing like the sharp decline we saw in the middle years of the previous decade, but any consistent rise in frequency, regardless of size, is going to have a negative effect on financial results in today's fragile rate environment.

As the softer rate environment enters its sixth year, there is increasingly less room for any bad news in this market. And yet bad news may be around the corner. While indemnity-severity trends have remained manageable of late, defense costs are definitely increasing at a much quicker pace. Further, industry trends toward provider consolidation could build to flood levels as President Barack Obama's Patient Protection & Affordable Care Act begins to take root, destabilizing the market even further.

Absent some kind of completely unpredictable and positive influence, we believe the industry will continue to get slowly weaker, with rate levels remaining soft for the next few years.

Because rather than being like a chocolate candy that is either hard or soft at its center, the industry in 2011 may be more like the metaphorical Boiling Frog—the one that sits and waits while the temperature of the water slowly rises. Legend and business metaphor has it that a frog will jump to safety if put into a pot of boiling water, but that it will stay in the pot and allow itself to get cooked if the heat is turned up very, very slowly. Currently, we believe the MPL market's dial is set to a low simmer—manageable and even acceptable in the short term—yet consistently, if slowly, moving toward a time when the heat will reach a boil.

How Did We Get Here?

That rates have been falling consistently for the past several years is not in dispute. The only questions seem to be: *When exactly did they start to fall? And how much have they really dropped?*

Although the *Annual Rate Survey* only noted a drop of 0.5 percent in 2010, MarketScout and the Council of Insurance Agents & Brokers (CIAB) estimated rate drops that were three to six times as steep—1.7 percent and 3.2 percent, respectively—for 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 as of July 1, 2011.

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.

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average drop of 1.8 percent when you factor in the *Annual Rate Survey* estimate (see Chart A: "Estimated Rate Change for MPL in 2010," at right).

Compared to 2005 levels, rates are estimated to have fallen cumulatively by 7 percent (*Annual Rate Survey*), 12 percent (CIAB) and nearly 30 percent (MarketScout) for an average fall-off of approximately 16 percent. The *Annual Rate Survey* suggests there were slight upticks in rates during 2006 and 2007 (0.7 and 0.4 percent, respectively), while MarketScout and CIAB show rates beginning their downward trajectory in 2006.

This year, the *Annual Rate Survey* suggests a drop-off in rates of 0.2 percent, slightly less than last year's 0.5 percent, and lower than the 3- to 4-percent drops registered by the *Survey* during the previous two years (see Chart B: "Overall Average Rate Change by Year," on page 4). As we have noted in the past, the actual percentage could be higher when credits are taken into account, although the issue of credits is even less clear than it was in 2010 (as discussed further in the section on credits, below).

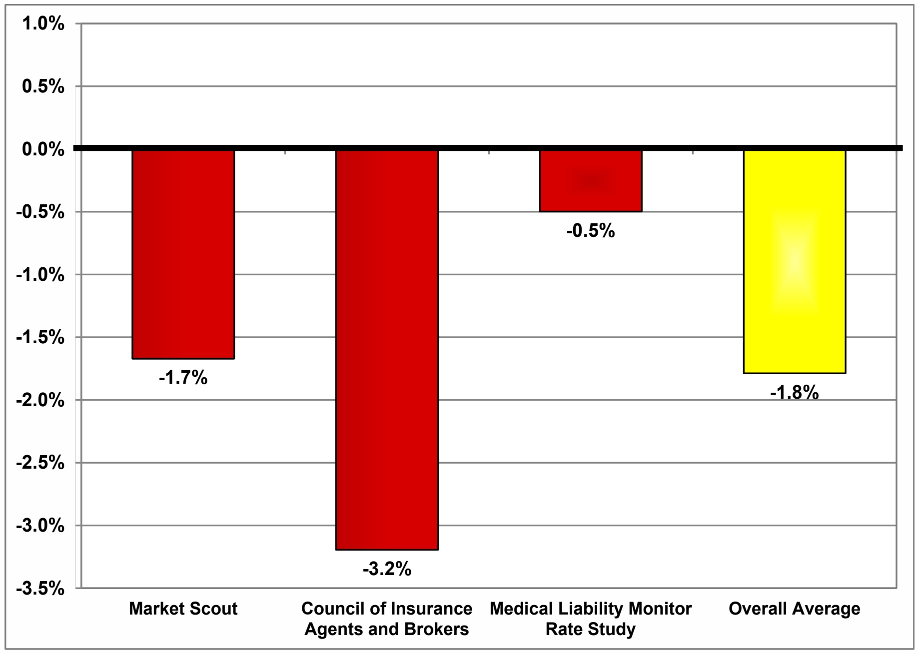
These declining rate levels over the past five years have produced a significant drop in the industry's direct written premium levels. From a high of nearly $12.5 billion in 2006, the industry's premium has fallen by nearly 15 percent, or $2 billion, to approximately $10.5 billion in 2010. That is a substantial decline, considering that during the past 30 years no period of decreasing premiums has endured for longer than two years, and the highest consecutive-year premium reduction was 7 percent. In other words, strictly from a top-line, direct written premium perspective, the industry has been mired in a soft market that has lasted more than twice as long and been twice as deep as any previous soft market.

These dimensional references would, on the surface, normally indicate a market that is in even worse shape financially than the soft market of the late 1990s. Instead, as noted above, the industry had one of its strongest operating results ever in 2010, and will probably do almost as well this year.

The industry's combined ratio was approximately 90 percent last year and has been consistently under 100 percent every year since 2006 (and is expected to be so again this year). This is stunning when you realize that combined ratios have only been below 100 percent during two different years in the 28 years prior to 2006. But the industry's strong operating results the past few years may not be a reliable indicator of the industry's core or longterm strength. The release of past loss reserves has been acting to artificially inflate the industry's profits, just as an increase in the use of schedule credits this year and last may be hiding an overall drop in rates that is more severe than the *Annual Rate Survey* estimates of an 0.2 and 0.5 percent decline would indicate.

Chart A

Estimated Rate Change for MPL in 2010



> 'Strictly from a top-line, direct written premium perspective, the industry is mired in a soft market that has lasted more than twice as long and been twice as deep as any previous soft market.'

Use of Schedule Credits Masks the Full Decline

As they did in 2010, MPL insurance carriers increased their use of schedule credits in 2011, with nearly 30 percent of the respondents to the *Annual Rate Survey* questionnaire acknowledging an increase in their use of credits this year and none reporting any decrease.

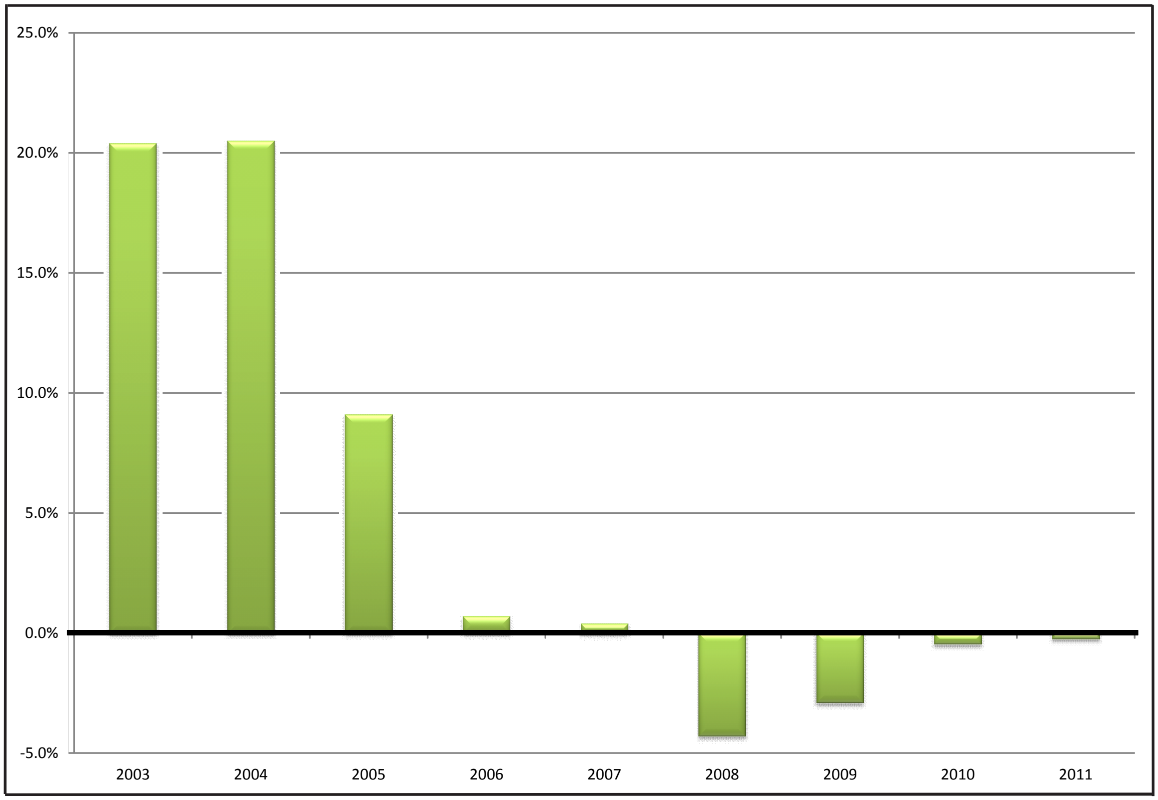
Three of the 28 companies that responded to the questionnaire (11 percent) introduced new credits during the past year; this is in addition to the nearly 20 percent of companies that added new credits the previous year, suggesting that this particular strategy for attracting insureds may be coming to the natural end of its tether, as there are only so many classes of credits possible before you begin to run out of them.

Credits, as we noted last year, work to lower the actual charged rates beyond the manual rates filed with the states. A reported 0.2 percent overall average reduction in manual rates could, in fact, be a 2- to 4-percent actual reduction when schedule credits are figured into the mix, closer to the overall average decline seen in 2008 and 2009 when credits were not being offered quite as freely.

When asked, "Are you concerned about competitors' underwriting guidelines?," more than one-third of this year's respondents said "yes," and pointed to the use of schedule credits as well as under-

Chart B

Overall Average Rate Change by Year



writing policies when commenting on competitor actions they find irresponsible. Examples of what respondents find concerning include: "More credits, less restrictive coverage"; "Competitors are discounting up to 40 percent"; "Irresponsible pricing"; "No application required in some cases"; "Discounts of 20 to 30 percent"; and "More premium reduction without justification other than competing on price."

Six companies (21 percent) reported that they have modified coverage in the past year, and 21 (75 percent) report they have not; one company did not answer. However, a full 50 percent reported they have added new coverage or coverages.

Perhaps the most insightful response to the question of expanding underwriting eligibility is from the respondent who wrote, "I'd rather not [expand underwriting guidelines]," suggesting that the temptation to do so is being resisted at the company, so far.

With the market remaining competitive, there seems to be little appetite for restricting new business. When asked about the prospects of targeting new business for expansion in certain specialties, territories or states in 2011, one respondent answered in the affirmative by writing, "Yes, Yes, Yes," which could be read as quite possibly the most enthusiastic response to an *Annual Rate Survey* question in its history, but likely means that the target for expansion is going on in all three areas at once for that company this year: specialties, territories and states.

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

According to MPL insurance filings made with the states, 55 percent of manual rates did not change at all in 2011, somewhat less than the nearly two-thirds that remained firmly at the same level in 2010. And like last year, the great majority of those that did change adjusted downward.

Only 15 percent of all rate changes were increases, essentially the same as the 14 percent of all adjusted rates that rose in 2010, while two times as many (30 percent) decreased this year—a 67 percent increase from the 19 percent of reported manual rates that experienced decreases in 2010. For both increases and decreases, most were in the lowest range of 0.1 to 9.9 percent.

Rate increases in the range of 0.1 to 9.9 percent made up two-thirds of total increases. Rate increases in the next range of 10 to 24.9 percent contributed one-third of that total, and a scant 2 percent fell into the 25 to 49 percent increase.

Chart C: "Overall Average Rate Change by Range," on page 5, shows the percentage of reported rate changes in the *Survey* for every year from 2003; Chart D: "Distribution of Rate Changes by Range," on page 6, illustrates the distribution of rate changes for the years 2009-2011.

More than 90 percent of all manual rate decreases fell into the 0.1 to 9.9 percent range. A little more than 7 percent were in the next range of 10 to 19.9 percent, and miniscule numbers fell into the next two ranges—20 to 29.9 and greater than 30 percent—0.6 and 0.3 percent, respectively.

Regionally, the Northeast saw a 1.5 percent average rise in rates, led by New Hampshire's 3-percent increase; the Western states had a 0.8 percent average drop, with Arizona showing the largest decrease at 5.3 percent; the Midwest experienced a 1.1 percent average decrease, although evidencing more volatility amongst the states within this region; the South enjoyed a 1.5 percent average drop, helped along by Mississippi's 11.4 percent decrease.

Sixteen states and the District of Columbia had no increase or decrease in reported rates. Five states (New Jersey, Illinois, Iowa, Florida and South Carolina) had rate decreases of less than 0.5 percent.

Worrisome Trends from the Survey

As is always the case, the numbers tell only part of the story. Certain trends are difficult to quantify with currently available data. Trends such as the migration of independent physicians toward becoming employees of hospitals or large healthcare groups, as well as additional consolidation, seemed to loom large and be more on the minds of those who responded to this year's *Survey* questionnaire versus the previous year.

Provider & Insurer Consolidation

When the Patient Protection & Affordable Care Act was initially made public, there were only seven pages out of 906 that seemed to directly impact medical professional liability at all, and as a result, the industry's initial reaction was to more or less discount its potential impact on the market. But both anecdotal evidence from clients and comments left on the *Survey* in response to the open-ended question, "What do you view as the biggest threat to your market share?," indicate companies are now very concerned with several troubling indirect effects that the Patient Protection & Affordable Care Act are having on the industry.

The most prevalent of these complaints is a version of "Hospitals or healthcare groups employing physicians" or "Buying practices" or "Physicians becoming employees of hospitals and healthcare groups," any and all of which can lead to former insureds obtaining their MPL coverage through their new employer. Half of all respondents mention this as the chief threat to their market share.

Chart C

Overall Average Rate Change by Range

Range	2004	2005	2006	2007	2008	2009	2010	2011
> +100%	2.2%	0.0%	0.0%	0.6%	0.0%	0.0%	0.0%	0.0%
+70.0 to +99%	4.1	0.6	0.0	0.6	0.0	0.1	0.0	0.0
+50.0 to +69.9%	3.7	0.7	0.0	0.4	0.0	0.1	0.0	0.0
+25.0 to +49.9%	14.8	6.5	2.3	0.5	0.6	0.0	0.0	0.3
+10.0 to +24.9%	34.9	28.5	5.6	5.9	1.2	1.9	0.8	4.8
+0.1 to +9.9%	22.5	29.3	22.6	8.2	5.6	5.7	13.4	9.4
0.0%	13.2	24.0	46.6	53.1	49.9	54.2	67.0	55.1
-9.9 to -0.1%	4.7	8.4	15.1	21.0	20.8	22.1	14.9	27.8
-19.9 to -10.0%	0.0	2.1	5.1	6.5	15.6	12.0	3.6	2.2
-29.9 to -20.0%	0.0	0.0	1.3	2.3	5.2	3.7	0.3	0.2
< -30.0%	0.0	0.0	1.4	0.0	1.1	0.2	0.0	0.1

Several additional respondents mentioned "captives," "risk retention groups and/or risk purchasing groups" as the greatest threat, and another specifically mentioned Accountable Care Organizations (ACOs)—all of which are basically different ways of saying the same thing: Companies are very concerned that the market itself will shrink as their former customers become their competitors. Based on our experience, this is the largest concern on the minds of our clients, and it is a serious threat to market share and the future viability of the industry.

In addition to the threat of physicians migrating into larger healthcare delivery systems, the second most cited concern from respondents related to the additional consolidation within the current MPL market that is expected in the future. The past few years have been witness to a number of mergers and acquisitions within this market, with several larger transactions taking place. Based on the responses to this year's *Survey* questionnaire, this consolidation trend is expected to continue.

> 'Companies are very concerned that the market itself will shrink as their former customers become their competitors. Based on our experience, this is the largest concern on the minds of our clients as well, and it is a serious threat to market share and the future viability of the industry.'

Bottoming Frequency & Rising Defense Costs

Other trends not mentioned in response to the *Survey* questionnaire remain concerns as well.

Although we cannot yet say with certainty that frequency has universally started to rise again, in our view, it has definitely bottomed out and is beginning to bounce upward slightly for some clients. Similar to what we noticed in 2010, we are seeing frequency increases in about one-third of our data sets. This also means that we are not seeing signs of increase in the other two-thirds of the data sets, which by and large are exhibiting flat-frequency indications this year over last.

The Closed With Indemnity (CWI) ratio—the number of claims that end with an indemnity payment compared with the total number of claims closed—appears to be holding steady for most data sets. There have been a few indications that suggest a rise in this metric of late, and as a result it is being monitored closely by a number of companies.

Indemnity cost trends have also remained very manageable during the past several years—rising, but generally only by the low single digits.

We see a definite rising trend in the cost to defend claims. This trend has been increasing significantly, perhaps universally, during the past several years, often in the high single digit range.

There are several possible reasons for this rise in defense costs:

• Claims are more complex. A number of claims managers have commented that the types of cases being brought today are medically and, at times, legally more complex than in the past. This explanation seems plausible enough, although one might expect this has been a continually evolving trend—not unique to the past few years—during which time the average cost to defend a claim has increased at a much faster rate.

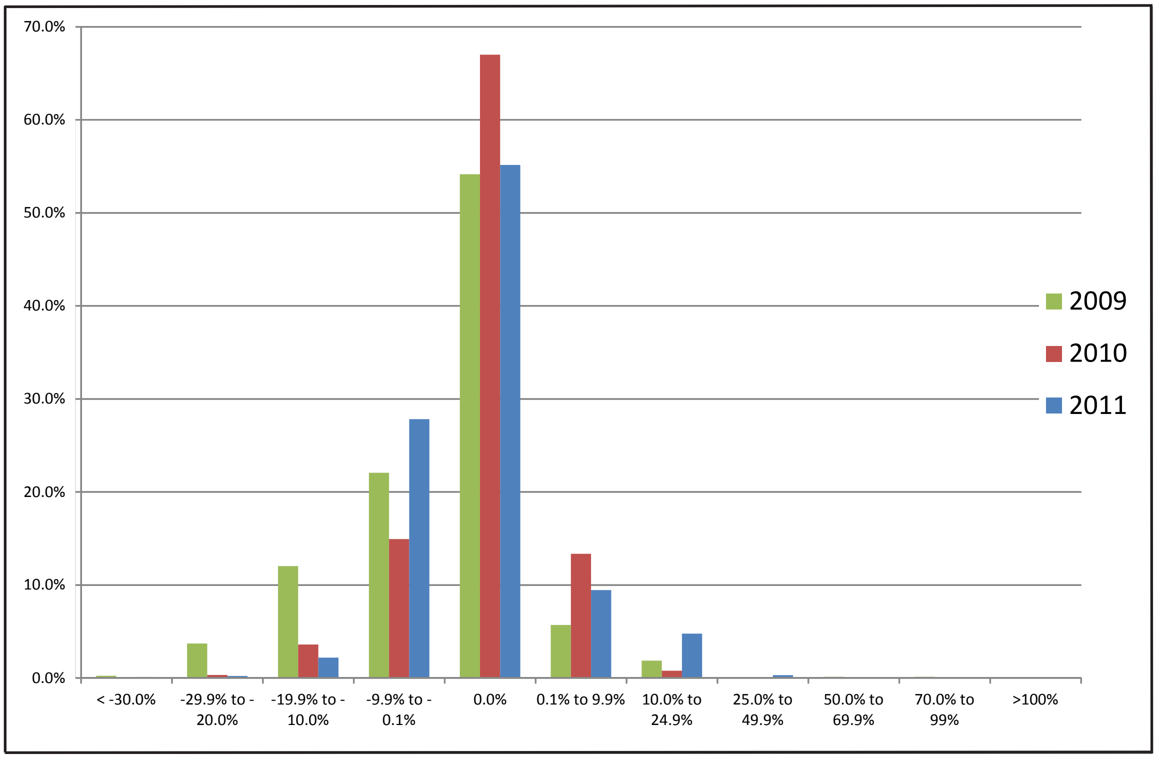
• Plaintiffs' costs have gone up, causing plaintiff attorneys to be more selective about which cases they are taking, thus making each individual case more of a "must-win" situation. This increases plaintiffs' costs for expert witnesses, medical animation technology, etc. This has increased costs for the defense as well, as they have to spend more money if they want to win the case.

- There are more people working fewer claims on the defense side. With the falloff in claims frequency, the industry has more available staff and more time to pursue the defense of claims. Since the claims personnel and defense counsel have more time to work the case harder, perhaps they are actually working the cases harder.

This last reason is only a theory and difficult to substantiate, but it makes sense. Frequency has dropped off substantially since 2003, but insurance companies have not let many people go. An insurance company that might have had 10 people working 1,500 claims in-house in 2003 might now have the same number of people handling only 750. We suspect that will increase the defense costs per claim. If it leads to lower indemnity payments, however, it could be an expense well worth incurring.

Chart D

Distribution of Rate Changes by Range



Looking Ahead

As with the job market and the economy in general, it will likely be a few years before things start to turn around and the MPL market hardens. Others will project rosier scenarios for the near future, but we do not believe the underlying facts support a quick turnaround on rates. Profitability will come under some pressure as past reserves eventually run their course.

> 'It's probably going to be several years before things start to turn around and the MPL market hardens. Others will project rosier scenarios for the near future, but we do not believe the underlying facts support a quick turnaround on rates. Profitability will come under some pressure as past reserves eventually run their course.'

Insurance companies offering MPL coverage might want to begin thinking outside the box in their quest to protect and expand both market share and profits in the future. At the very least, rather than watching and hopeful waiting, they might want to look at technology solutions, more imaginative marketing such as a la carte service offerings or other ways to maintain market share and profitability in the face of a shrinking and increasingly more competitive market.

Fortunately, the industry is starting from a place of strength in terms of expertise and finances as it rouses itself to address these challenges. We are optimistic that the industry will respond accordingly, and the heat resulting from this extended soft market will remain relatively low.

In the end, the Boiling Frog metaphor—so beloved by business consultants everywhere—turns out to be a canard. A real frog will not just sit and wait to get cooked. According to Professor Douglas Melton of the Harvard University Biology Department, the frog will always jump.

If you put a frog in a pot of water and slowly heat it up, Professor Melton assures us, the frog "will jump before it gets hot. They don't sit still for you."

We don't think the MPL industry will sit still and wait to get cooked, either. **MLM**

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