The Reserving Practices and Record Profits of Large Medical Malpractice Insurers

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AMERICAN ASSOCIATION *for* JUSTICE

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ABSTRACT

This report analyzes the financial performance of the 10 largest medical malpractice insurers in the United States. The report finds the following:

- Insurers reported extremely high levels of profit. The average profit margin for the top ten medical malpractice insurers was twice as high as the average profit margin of the 50 most profitable Fortune 500 companies. Only one Fortune 500 company had a profit margin that matched the average for the top 10 medical malpractice insurers.

- Insurers have systematically overestimated their losses in recent years. The widely-reported medical malpractice insurance "crisis" was significantly overblown.

- Insurers underestimated profits in recent years. Revisions in projected losses also mean profits from prior years were even higher than thought.

- Current record-level profits will ultimately be even higher. The trend of overestimating losses will almost certainly continue, meaning the profits reported this year will be revised upwards.

- Medical negligence laws were passed under false pretences. Overblown reported losses were used by the insurance industry to justify new measures restricting the rights of those injured by medical negligence.

- The principal victims of the insurance company behavior have been doctors. Doctors saw their premiums rise dramatically in response to what would turn out to be systematically overestimated losses. The high profits and burgeoning reserves of the medical malpractice insurance companies were made on the backs of the very doctors they were supposed to serve.

INTRODUCTION

During the early part of the last decade, many academics, insurance industry executives and policymakers were concerned with an apparent medical malpractice insurance crisis. The "crisis" appeared in the form of dramatic increases in physicians' malpractice insurance premiums. News stories highlighted price hikes as high as 600 percent in one year.[1]

In hindsight, it has become clear that despite the predominant storyline at the time, the crisis was not caused by an upswell of litigation. Claims severity – the average amount paid in medical malpractice claims – did increase during this time, as to be expected when such claims largely constitute medical costs that are subject to high levels of inflation. However, claims severity increased gradually, and not in a manner that would explain a sudden spike in claims costs. Moreover, claims frequency – the number of medical malpractice claims insurers were having to pay – actually decreased.

Over several years during which the crisis only worsened, insurance company losses – what they paid out – remained stable, while premiums skyrocketed. On the other hand, investment returns dropped and insurers made less money investing the premiums they took in.

It has long been suggested that variations in investment income and other insurance market dynamics constitute an insurance cycle that regularly results in periods of dramatic premium increases. Past crises occurred in the 1970s and 1980s. In essence, when market conditions cause insurers to make less money, they must offset the drop in revenue by increasing premiums.

Academic research has now largely concluded that litigation was not the principal driver of the malpractice crisis. There is also agreement that the crisis was caused by many factors – increased claims costs, the insurance cycle and the poor business decisions that fueled it.[2]

The inadequacy of this explanation is that it attributes a dramatic effect to factors that were themselves experiencing only mild change. Somehow we are supposed to believe they came together in a perfect storm to cause extreme consequences.

There is another explanation that, thanks to the vagaries of insurance industry bureaucracy, is only coming into view now. There never was a crisis at all, at least in the sense that the insurance industry never really had a justifiable reason to suddenly and dramatically raise premiums. Insurance companies did so in part to cover decreases in investment income. But they also did so to deliberately create an atmosphere of crisis, provoking doctors into pushing for tort reform.

The insurance companies did this by systematically overestimating their future losses to justify massive increases in current premiums. Looking back we can now see exactly what those future losses actually turned out to be. Because unlike most lines of insurance, medical malpractice claims can take several years to conclude, the actual losses take years to fully show up on the books. But if one does look back, it quickly becomes clear that for several years the insurers cried wolf and rode a wave of political and public sentiment towards tort reform.

Today, there is no question that losses were significantly overestimated for the best part of a decade. Still, no insurer or industry trade group has ever stepped up to admit that the extreme premium increases were overblown. The insurance industry cried wolf, and everybody believed them.

SOARING PROFITS

Despite a deep recession that decimated Americans' bank accounts, corporate America has done remarkably well. Fortune described corporate America's escape from the recession as an "epic resurgence," and noted that earnings for the Fortune 500 jumped by 335 percent in 2010 - the second largest leap in history.[3]

The insurance industry has been front and center of this recovery, and is enjoying the best operating margins in more than two decades. The property/casualty industry made $35 billion in after tax profit in 2010 – a 1,000 percent increase in just two years. In addition, the industry also sits on a record-breaking surplus of $557 billion.[4]

But these remarkable numbers do not come close to the profit margins enjoyed by the medical malpractice insurance industry. The average profit margin for the top 10 medical malpractice insurers was twice as high as the average profit margin of the 50 most profitable Fortune 500 companies. In fact, only one Fortune 500 company could match the average profit margin of the biggest medical malpractice insurers.[5] The insurer enjoying the highest level of profit was ProAssurance, which recorded an astonishing profit margin of over 100 percent – nearly twice as high as the most profitable Fortune 500 company. And as extraordinary as these numbers are, they almost certainly underestimate the actual profits that these companies are making.

Table 1. Insurance Company Profit Margins – 10 Largest Medical Malpractice Insurers (2010 Profits as a Percentage of Revenue)[6]

Rank	Insurance Company	Total Profit/Loss	
1	Medical Liability Mutual Insurance Company	49.0%	$291,676,000
2	Medical Protective (Berkshire Hathaway)	31.7%	$101,366,000
3	Doctors Company	65.9%	$346,639,000
4	ProAssurance	103.6%	$124,303,000
5	Lexington (AIG)	58.8%	$154,518,000
6	Continental Casualty	38.4%	$180,719,000
7	Physicians' Reciprocal Insurance	(8.2%)	$(29,860,000)
8	ProMutual	53.7%	$188,401,000
9	ISMIE	19.5%	$40,855,000
10	MAG Mutual	33.2%	$75,525,000
	Average	**44.6%**	
	Total Profit		**$1,474,142,000**

Lexington, the medical malpractice unit of insurance giant AIG, reported an outstanding profit margin of nearly 60 percent even as the company as a whole was being bailed out with taxpayer funds. Alabama-based ProAssurance saw its already record-breaking profits jump an additional 25 percent in 2010, and used the money to acquire a rival company, American Physicians Group, the second largest medical malpractice insurer in Texas.[7] Similarly, The Doctors Company put its profits into acquisitions, taking over American Physicians Capital, the third rival it had consumed in three years.[8]

Taken as a whole, the top 10 medical malpractice insurers have made enormous profits. The average profit of these companies is higher than 499 of the companies in the Fortune 500. And these numbers very likely underestimate the actual profits these companies are making.

WHEN A LOSS IS NOT A LOSS

In the insurance industry, a loss is not necessarily a loss. When an insurer reports profits and losses for a particular year, it does not do so based upon actual money it has paid out to injured drivers, patients, workers or other claimants. This does not necessarily mean that insurers are deliberately motivated to mislead. Insurers do not know with absolute certainty how much they are eventually going to have to pay out because they cannot see into the future. Insurance premiums are collected in the present, but insurance claims are paid months, or even years in the future.

In the case of some types of insurance, such as auto insurance, the relatively large number of cases and the relatively short time frame until nearly all of the claims are paid – often within just a year – means that insurers can be more certain how much they are going to pay out. What makes medical malpractice insurance different from other lines of insurance is that there are relatively few cases, there is wide variation in the ultimate cost of claims, and it can frequently take more than five years for cases to work their way through the claims process.

"Losses" That Are Never Paid

When an insurance company reports losses for a particular year, it relies upon an educated guess about future losses based upon new claims opened and the history of previous claims. This educated guess is called an incurred loss. An incurred loss is used for accounting purposes and does not represent money paid out. An incurred loss should not be compared to a paid loss, which is money paid out.

As the years pass, these incurred losses are updated as more and more claims are closed with or without payment. After one year, the insurer has paid a few claims and has a better idea what the ultimate paid losses will be, so it revises its incurred losses for the previous year. After four years most, but not all, of the cases have worked their way to a conclusion. Eventually, the incurred and paid losses will converge as the information comes in and the cases are closed.

People unfamiliar with the insurance industry are often surprised to learn that when an insurer reports its profits for a particular year, it does so based upon these incurred losses, not upon any money that it has actually paid out. In fact, this "loss" is actually set aside in reserves, collecting interest, until the time it is paid out. Indeed, in many cases this money never actually gets paid out. Thus, paradoxically, it's possible that a company can "lose" money year after year while the company's net worth continues to grow.

Hiding Losses and Profits

Broadly speaking, insurers are quite good at estimating how much will eventually be paid out, and this is what the actuarial science is all about. Estimating too low can have catastrophic consequences that can lead to insurer insolvency. When insurers estimate too low they have to revise their incurred losses upwards. This is called negative reserve development. So if in 2005 a company says that it believes it will have to pay out $1 million for that year, but then in 2006 it realizes that it will have to pay out $1.1 million for 2005, it means that projected losses have gone up for that year and the effect on the company's bottom line is negative.

On the other hand, when companies revise downward how much they are going to have to pay out, it is called positive reserve development. So if in 2005 a company believes it will have to pay out $500,000, but instead puts away $1 million, it will likely record a huge loss the first year, but then revise its losses downwards in subsequent years. In 2006, it would revise losses to $900,000, in 2007 to $800,000, and so on until the values match up. The discrepancy from year to year will not look inconsistent with what is after all an estimate, and few will ever bother looking back over a long time period. Even if someone did raise a red flag, as we attempt to here, the insurance company is unlikely to be troubled by news that appears on the surface to be half a decade old.

Why Hide Profits?

But why would an insurance company ever do such a thing? Insurance companies are by their very nature risk-averse, and especially in times of perceived crisis they may want to put away extra funds. Of course, this could make a crisis self-fulfilling as extra reserving causes premiums to rise, which increases the sense of crisis and makes insurance increasingly scarce as insurers refuse to take on new policyholders. Third, it is possible that a company does not want to appear to be making excessive profits. Finally, it is possible that some kind of political agenda is served by appearing to lose great sums of money.

What They Said Then, What They Say Now

One can begin to understand how loss development works by looking at ISMIE's reserving practices over the last several years. ISMIE is the largest medical malpractice insurer in Illinois and was a force behind the 2005 reforms that placed severe new restrictions on victims of medical negligence.

In a 2008 memo, ISMIE Chair Harold L. Jensen, MD credited these new restrictions by saying, "ISMIE has seen real improvement in our loss experience, which has allowed us to lower premiums by an average of 5.2 percent in 2006, allocate dividends to ISMIE's loyal policyholders two years in a row, and temporarily lift ISMIE's moratorium on new policyholders. But the Illinois market could deteriorate once again if medical lawsuits reforms are overturned by the state's high court this fall."[9]

Table 2. ISMIE Reserving Practices 2004-2009[10]

	What They Said Then	What They Say Now	Difference
2004	$201,612,000	$158,584,000	-21.34%
2005	$208,502,000	$172,515,000	-17.26%
2006	$187,290,000	$152,856,000	-18.39%
2007	$187,106,000	$158,293,000	-15.40%
2008	$179,742,000	$167,107,000	-7.03%
2009	$174,767,000	$165,808,000	-5.13%
		Average Revision	**-14.09%**

"What They Said Then" represents incurred losses for 2004 in 2004. "What They Say Now" represents incurred losses for 2004 reported in 2010.

In 2004, a year before the new tort reform measures were passed, ISMIE said that it would have to pay out $202 million for that year. By 2009, ISMIE revised this amount downwards to $159 million, or a drop of 21 percent. This is an enormous change by any standard and is the difference between a company making a good profit versus one that is taking a huge loss and in crisis. Keep in mind also, any claims for that year are unaffected by any tort reform measures because they happened before the new law came into effect.

In 2005, the year that ISMIE was lobbying for these new protections against injured patients, ISMIE claimed even higher incurred losses of $209 million. Doctors protested in their white coats, and local news channels bemoaned skyrocketing insurance rates. It turns out that now ISMIE believes that it will only have to pay out $173 million for that year, even though the law did not impact these claims either.

The next year, 2006, "thanks to these tort reform efforts," ISMIE said that it would only have to pay out $187 million. It gave rebates to doctors and lowered premiums slightly. In fact, ISMIE now says that it is going to pay out slightly more for years where tort reform was in effect. While Dr. Jensen of ISMIE may suggest that tort reform allowed the lowering of rates and the payment of rebates to doctors, the truth is that ISMIE charged its own doctors too much to begin with, fomented a crisis atmosphere and then gave back the overcharged money years later.

In February 2010, the Illinois Supreme Court overturned the state's medical malpractice cap. Not surprisingly, ISMIE was quick to voice its disappointment. Dr. Jensen stated, "Since passage of the Illinois reform law, patient access to health care has expanded, frivolous lawsuits have ebbed and malpractice rates have leveled off or decreased for many doctors. This is practical proof the law is working." In fact, the stabilizing of malpractice rates had more to do with ISMIE's drastic overstating of predicted losses. Dr. Jensen went on to warn that the company had "been down this path before," which would suggest Illinois physicians get ready for the prospect of increasing premiums built upon the fiction of overstated losses once again.[11]

Revisions Tell the True Story

There is nothing inherently wrong or dishonest about revising estimates of what will eventually be paid out. Usually there are some years that have a positive reserve development and some years that have a negative development and these should be distributed more or less randomly, showing no systematic pattern.

Table 3. Average Six-Year Revision of Incurred Losses

Rank	Insurance Company	Average Revision
1	Medical Liability Mutual Insurance Company	-10.90%
2	Medical Protective (Berkshire Hathaway)	-24.52%
3	Doctors Company	-24.74%
4	ProAssurance	-15.63%
5	Lexington (AIG)	-10.19%
6	Continental Casualty	-8.57%
7	Physicians' Reciprocal Insurance	6.74%
8	ProMutual	-26.29%
9	ISMIE	-14.09%
10	MAG Mutual	-21.35%
	Average	**-14.95%**

Average revision represents the average percentage change from the original incurred loss of each year from 2004-2009 to the 2010 estimate for those same years.

In the six years since the apparent beginning of the most recent medical malpractice crisis, companies have been routinely grossly overestimating what their losses would be, and then revising them downwards in later years. Amongst the top 10 companies over the last five years, the estimated final payout has dropped by an average of 15 percent for each of the last six years.

This pattern is widespread. Nine of the top 10 insurers have experienced positive reserve developments (meaning projected payouts have gone down), while eight of the top 10 have experienced double digit positive reserve developments.
The picture painted by insurers during the medical malpractice crisis has proven

to be something of a sham. The originally reported incurred losses have proven to be very poor predictors of the actual losses eventually paid. At first they claimed huge losses, but now they are saying that the losses were not so bad. These revisions are the difference between large losses and large profits.

When a medical malpractice insurer is claiming to lose large sums of money, there is very little reason to take them at face value because the last decade has not been the nightmare the insurers had claimed it to be. The insurance industry and its apologists are unlikely to acknowledge that the medical malpractice crisis was significantly overblown, nor are they likely to publicize any errors they may have made. And most significantly, they are certainly not likely to lift draconian restrictions on the rights of those injured by medical negligence - restrictions that were put into place under seemingly false pretenses.

PROFITS WERE ALWAYS SOARING

If insurance companies' updated estimates now show that their losses are not as bad as anticipated, it also stands to reason that their net profits would also improve. Nine of the top 10 insurers experienced positive reserve developments, so their initial estimates of profits were low, and in some cases very low.

It is impossible to calculate exactly how much profits would have been different given these new updated values because an exact calculation involves more than just substituting one number for another. However, it is possible to get an idea how much profits should have been.

How Much Did They Really Make?

An analysis of The Doctors Company, one of the most vociferous tort reform proponents, helps to illustrate how this is done. In 2006, The Doctors Company earned $505 million in premiums and a further $67 million in investments. For that same year, they incurred $286 million in losses. When all was said and done, The Doctors Company came away with a whopping 50 percent profit.

However, this tells only half the story. In fact, the situation is even better for The Doctors Company. In 2010, after four years seeing how losses panned out, it decided its original estimate of $286 million was high and dropped its estimated losses 34 percent to $188 million. Thus, years after the fact, when no-one was paying much attention, The Doctors' Company's estimated 50 percent profit for 2006 actually turned out to be closer to 70 percent, an astonishing margin of profit for any corporation.

Below is a table indicating estimated revisions to profits over the last two years. These are not the profits for those years, but simply the amount of revision upwards or downwards.

Table 4. Recalculating Profits
(2009 Profits as a Percentage of Revenue, as reported and as revised)

Rank	Insurance Company	2009 Profit as Reported in 2009	2009 Profit Revised One Year Later	One Year Revision in 2009 Profit
1	Medical Liability Mutual Insurance Company	+15.9%	+23.3%	+7.4%
2	Medical Protective (Berkshire Hathaway)	+35.5%	+36.0%	+0.5%
3	Doctors Company	+26.9%	+31.1%	+4.2%
4	ProAssurance	+79.4%	+78.4%	-1.0%
5	Lexington (AIG)	+52.0%	+64.4%	+12.4%
6	Continental Casualty	+19.5%	+19.5%	0%
7	Physicians' Reciprocal Insurance	-15.0%	-14.3%	-0.7%
8	ProMutual	+90.6%	+95.5%	+4.9%
9	ISMIE	+13.3%	+17.5%	+4.2%
10	MAG Mutual	+37.5%	+42.2%	+4.7%
	Average	**+35.6%**	**+39.4%**	**+3.7%**

As can be seen by the table above, in just one year profits were revised upwards by nearly 4 percent. As the years go on, the profits for 2009 will continue to be revised upwards. The same dynamic will apply to other years. These profits will accumulate every year, but will never be reported as profits. They will remain merely as revisions to incurred losses. Without delving into thousands of pages of dense annual statements, no one but the companies themselves will ever know just how much money they really made.

CONCLUSION

Most of the top 10 medical malpractice insurers are likely over-reserved. Their incurred losses exceed estimated losses by double digit percentage points. These companies have been incurring high losses and then adjusting them downwards.

Insurers will undoubtedly state that this assessment does not take into account the complexities of the turbulent medical malpractice insurance market and the vast array of actuarial assumptions that they have to make. But the data provided by the insurance companies themselves are damning. Their Annual Statements indicate extraordinarily high profits, and wildly overinflated initial estimates of losses.

When past payment trends are compared with current incurred losses, it becomes obvious that this trend will very likely continue. Thus, the record-level profits reported in the first section will almost certainly prove to be even higher. The question is, will anyone be paying any attention then, or will there be a new "crisis" filled with heated rhetoric and misplaced blame?

Doctors are paying too much for their medical malpractice premiums, restrictive tort reform laws are being passed under false pretenses, and those injured by medical negligence are seeing their ability to seek remedy restricted. Meanwhile, the medical malpractice insurance industry is reaping all of the benefits.

APPENDIX: GLOSSARY

Incurred Losses
Losses which have happened and will cause claims to be made. See also Paid Losses.

Negative Reserve Development
The result of an upward revision of incurred losses, which increases the reserves necessary to meet all liabilities. See also Positive Reserve Development.

Paid Losses
Losses which have actually been paid out. See also Incurred Losses.

Positive Reserve Development
The result of a downward revision of incurred losses, which reduces the reserves necessary to meet all liabilities. See also Negative Reserve Development.

Reserves
The amount kept by an insurance company representing all its liabilities.

Surplus
The amount by which an insurer's total assets exceed all its liabilities.

END NOTES

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