November 24, 1992
ILR 92-I

Speaker H. Craig Moody
House of Representatives
State Capitol Building
Salt Lake City, Utah 84114

Subject: Medical Malpractice Insurance

Dear Speaker Moody:

At your request, we examined the medical malpractice insurance information provided, and reviewed recent trends in the rates, claims, and dividends. Although the information is correct, it does not accurately reflect the condition in the medical malpractice insurance industry. We are specifically concerned with the comparison provided by outside parties, of gross premiums earned with net losses paid (see attachment A). We believe this comparison gives the inaccurate impression of high premiums and relatively small losses, which does not appear to be the case.

To provide a more accurate comparison, we have compared net premiums earned to net losses incurred (this is a projected figure). The difficulty with any analysis of the medical malpractice insurance industry is understanding that premiums earned in one year, fund losses that take years to identify and process. For example, some malpractice claims are not reported for several years after the medical service has been provided, and these may require years of litigation before losses are fully paid. Any comparison of net premiums earned to net losses paid within the same accounting period is not accurate unless all the claims have been made and all the losses have been paid for that premium period. Consequently, the industry projects the losses to be paid from each premium period and this projection which is updated annually is called net losses incurred.

This report will first detail our concerns with the malpractice information you received and the provided to us. Secondly, we identify current conditions in Utah's medical malpractice insurance industry. Finally, we provide information concerning dividends paid.

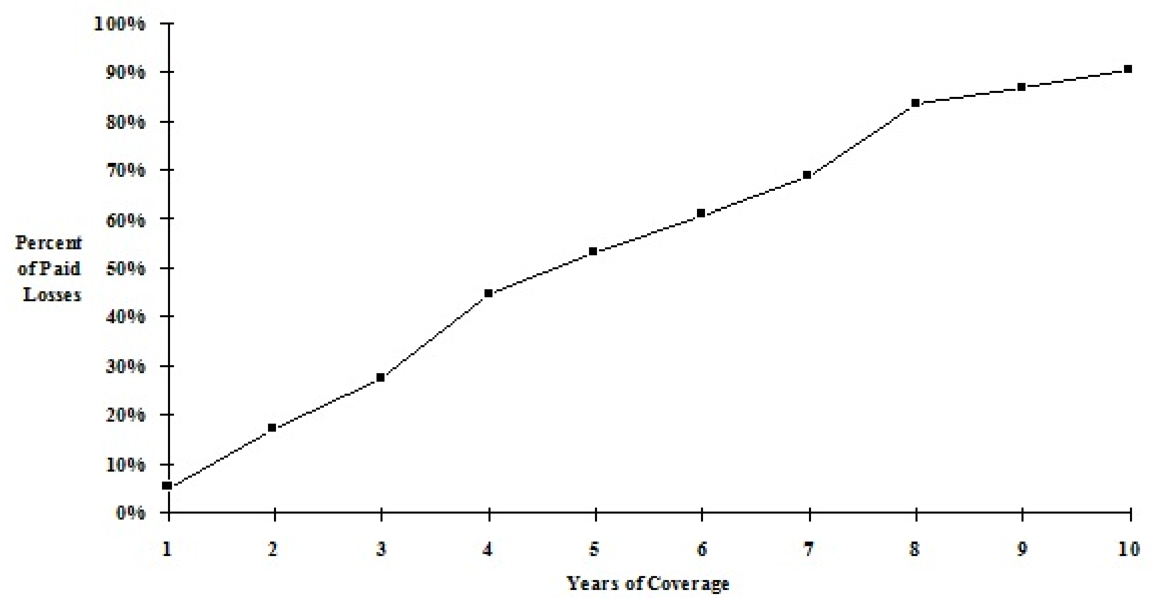
Concerns With Information Provided

The data provided on medical malpractice insurance premiums and losses from 1979-1991 is technically correct, but the comparison of gross premiums earned to net losses paid is inappropriate for several reasons. First, it is not appropriate to compare a gross figure with a net figure. The malpractice information provided compares gross premiums earned with net losses paid. The gross premium figure represents all premiums earned during the given year. However, net premiums earned represent the premium available after a significant portion of the insurance has been sold to other companies (reinsurance ceded) to share the liability. In our analyses of one company that represents over 70% of the Utah market, we found that gross premiums earned average 26% or about $4.7 million per year more than net premiums earned, over the last five years. The net losses paid does not consider reinsurance ceded. Therefore, the comparison of gross premiums earned to net losses paid is inappropriate.

A second reason why the information provided is not an appropriate comparison is that the amount of net losses paid in one year does not include all the losses to be covered by the annual premium. Losses take years to identify and to litigate. Consequently, premiums received during any one year are intended to cover losses that may not be reported or paid for many years in the future. The following figure identifies what percent of the net losses incurred is paid (on average) during each of the first ten years of coverage.

Figure 1

Average Percent of Incurred Losses Paid
During the First Ten Years of Coverage



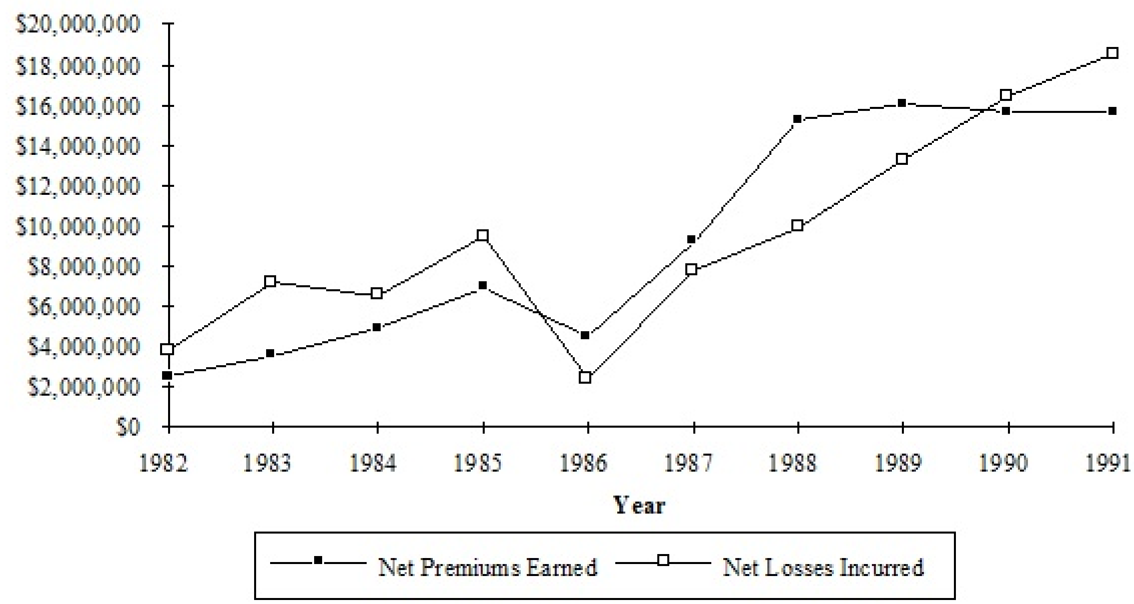
This figure indicates that on the average there is a steady payment of claims over the ten- year period. But, even after ten years, the full projected amount of losses has not been paid. For example, the 1991 incurred losses were projected at $18.6 million, but only $800,000 (4 percent) was paid in the first year. In comparison, of the $3.8 million estimated 1982 losses, $3.5 million (92 percent) had been paid as of 1991. Consequently, the information you provided (comparing gross premiums earned to net losses) was an unfair comparison because it mixed an accrual-based analysis with a cash-based analysis.

Existing Conditions in the Industry

In our opinion, the premiums earned for medical malpractice insurance in Utah are not excessive. From 1982 through 1985 net losses incurred were greater than net premiums earned. It is difficult to predict the amount of losses that will be incurred during a given year. Consequently, the amount of the incurred loss is constantly changing. The following figure identifies net premiums earned and net losses incurred from 1982-1991 for Utah's largest medical malpractice company. (This company accounts for over 70 percent of Utah's medical malpractice policies)

Figure II

**Comparison of Net Premiums Earned
with Net Losses Incurred**



The graph shows that the lines criss-cross each other, with premiums earned being less than losses incurred sometimes, and greater at other times. Premiums can be adjusted annually to correct any increases or decreases in the amount of losses incurred, but it takes years for the effects to show up. This lag time is what causes the lines on the graph to criss-cross. If incurred losses are greater than expected, then premiums must be increased to cover the additional expense.

Total net premiums earned during the ten-year period shown in the figure above amount to $94.3 million compared to $95.3 million of total net incurred losses. Consequently, the company is projecting one million dollars more in paid losses than in earned premiums. However, over the same ten- year period, the company had only paid out $39.3 million in net losses. As a result, projected incurred losses of $56 million are yet to be paid on future claims and litigation. Consequently, the company invests a portion of the net premium earnings each year and has reported earning several million dollars per year in interest on the income statement. Some of the premium or investment earnings are needed to cover operating expenses, overhead, dividends and unallocated loss expenses and are not included in net premium earnings. Without a more in-depth review we cannot comment on these expenses . Some of the earned premium must be kept in reserve to cover unallocated loss expenses.

The cost of medical malpractice insurance for specialties has increased significantly over the years. The rates are based on the number of malpractice claims and the severity of the claims. In Utah, premium rates are relatively low because there isn't as much malpractice litigation as in other areas of the nation. We compared Utah's rates to those of some of the surrounding western states and found the medical malpractice premiums for specialties in Utah are favorable.

Dividends Are Appropriate

Medical malpractice insurance may be sold by mutual companies. The policyholders are owners of the mutual companies. If there is no occurrence of malpractice, some of the base premium may be refunded to the policyholder. This is allowed according to state law. The company represented in this report paid dividends to policyholders for four of the last ten years. The dividend payments average about $1.7 million per each of the four years. Dividends are only paid if there is a positive net income and a surplus in the capital account. As stated above, dividends are not included in the net premium earnings. The amount of dividends paid cannot exceed the net income. They are awarded on a graduated scale to deserving policyholders based on low incidence of malpractice. The payment of dividends must be outlined and a detailed plan submitted to the insurance commissioner for approval.

We hope this letter provides you with the information needed. Please recognize the survey work has been done quickly and without complete resolution. If you have any questions or need additional information, please let us know.

Sincerely,

Wayne L. Welsh
Auditor General

Attachment A