



AMERICAN ACADEMY *of* ACTUARIES

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July 31, 2002

The Honorable Michael Bilirakis  
Chairman, Subcommittee on Health  
Committee on Energy and Commerce  
U.S. House of Representatives  
2125 Rayburn H.O.B.  
Washington, DC 20515

Dear Chairman Bilirakis:

Thank you again for inviting me to testify before the Subcommittee on Health on July 12, 2002, regarding the availability and pricing of medical malpractice insurance. I hope my testimony on behalf of the American Academy of Actuaries' Medical Malpractice Subcommittee was helpful in your deliberations.

A number of issues were raised in questions by Subcommittee members, and I would like to offer clarification on several of those points. I would therefore appreciate the opportunity to submit the following comments for the written record of the hearing:

1. In response to a question from Congressman Brown, Ms. Townsend responded that it would reduce losses and premiums if a single payer system existed in the states or across the country, like the CAT (automobile catastrophic medical )Fund operates in Pennsylvania. A specific reference was that the CAT Fund only pays \$500 per claim for defense.

The reason the CAT Fund pays only \$500 per claim for defense is because the CAT Fund is an excess program above a primary insurance carrier. Under this scheme, the primary insurance carrier pays for all the defense costs. The CAT Fund does not defend the claim; as a general rule, it monitors the case only and hence has little or no defense costs.

2. It was also suggested by the Consumer Federation of America that a single nationwide reinsurance facility should be created and while, at first blush, this sounds like a good idea, there are several examples at the state level where this has been tried – some have been reasonably successful; some have not. The Pennsylvania CAT Fund is an example of a reinsurance facility that is planned to be eliminated. (Over time, it has covered retentions as low as \$100,000 when it began, and currently \$500,000 with a specified upper limit on its coverage.) The CAT Fund was

3. run on a cash basis (pay-as-you-go with no reserves) and has accumulated an unfunded liability of in excess of \$1 billion. Some other state-based excess programs have been operated on an accrual basis but usually have limits or caps on damages to protect their financial viability. As is frequently the case with these types of programs, what sounds good in concept requires significant detailed investigation to review and resolve the many issues related to implementation and operation.

Such a proposal does not address the level and unpredictability of medical malpractice liability.

4. Based on a question from Congressman Greenwood, Mr. Plunket responded that investment income affects reserves for medical malpractice. Reserves are determined based on an analysis of a company's loss exposure. Investment income has nothing to do with this analysis except to the extent that companies discount their reserves. It is generally known that only a handful of insurers engage in this practice.
5. Several observations were made about St. Paul's financial results and decision to cease writing medical malpractice coverage. Congressman Brown questioned their reasons. He and Congressman Stupak implied a link to losses on Enron holdings and Congressman Stupak noted reserve reductions of some \$1 billion over the 1991-1997 period. Dr. Anderson observed that St. Paul withdrew after an approximate \$1 billion loss in 2001 and this was due to the belief that medical malpractice pricing was too unpredictable.
  - A. It is not logical that investment losses would cause St. Paul to cease writing medical malpractice, any more than it would cause them to cease writing other lines of business. It was their view of the inherent risk in medical malpractice losses and pricing that distinguished medical malpractice from other lines. In fact, published statements from St. Paul representatives indicated they felt losses were too unpredictable to risk shareholder capital.
  - B. Regarding the reserve reductions in the early to mid 1990s, most companies writing medical malpractice in the late 1980s and early 1990s were reducing reserves during the

mid to late 1990s because lower than projected loss levels were emerging. (Sustained lower economic and medical cost trends contributed to this lower loss level.) These reductions conformed with insurance accounting, generally accepted accounting principles (GAAP) and, for publicly traded companies, SEC requirements, including clear disclosures of these reductions. Given the favorable emerging loss experience, St. Paul and the other companies were required to take reserves down. In fact, the IRS challenged several companies for not adjusting reserves downward fast enough.

C. Toward the end of the 90s, loss trends had begun to accelerate, eliminating the favorable development on reserves. In addition, St. Paul had two other issues. First, the company wrote some volume of nursing home business that experienced significantly deteriorating loss experience toward the end of the 90s. More important, St. Paul completed the acquisition of MMI in 1999. In 2000 and 2001, St. Paul identified significant reserve deficiencies in this company; a major source of the required reserve strengthening and loss in 2001. Again, the reporting of losses on a timely basis is required under all applicable accounting rules.

6. There have been several inferences that the reason for these problems is insurance accounting. Reserve requirements are no different under insurance accounting or GAAP accounting. St. Paul and the other companies would be required to report timely adjustments to reserves, up or down, under any relevant accounting standards. The problem is not in the accounting standards; it is in the unpredictability of the loss levels.

Thank you very much for your consideration. Please do not hesitate to contact me or Greg Vass, the Academy's Senior Casualty Policy Analyst, at 202-223-8196 if you have any questions or would like additional information.

Sincerely,  
James Hurley, ACAS, MAAA



Chairperson, Medical Malpractice Subcommittee  
American Academy of Actuaries

cc: The Honorable Sherrod Brown