THE INSURANCE HOAX:

HOW DOCTORS AND PATIENTS PAY FOR THE HUGE EARNINGS OF MEDICAL MALPRACTICE INSURERS

ONE OF A SERIES OF REPORTS FROM THE AMERICAN ASSOCIATION FOR JUSTICE ON MEDICAL NEGLIGENCE

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Executive Summary

This report is one of a series from the American Association for Justice (AAJ) highlighting the issue of medical negligence. AAJ previously released *Medical Negligence: A Primer for the Nation's Health Care Debate*, which examined relationships between medical malpractice, patient safety and access to health care. *The Truth About "Defensive Medicine"* debunked claims that the threat of liability drives up the cost of health care.

This report delves deeper into the medical malpractice insurance industry itself and analyzes the financial performance of the 10 largest medical malpractice insurers in the United States. The report's primary sources of data are 2008 Annual Statements filed by the insurance companies themselves with state insurance departments and the National Association of Insurance Commissioners (NAIC).

The report finds the following:

- **Insurers reported extremely high levels of profit.** The average profit of the 10 companies was higher than 99 percent of the Fortune 500 companies and 35 times higher than the Fortune 500 average for the same time period.

- **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 have also revised upwards profits from prior years.

- **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.

Soaring Profits

The "medical malpractice crisis" of the earlier part of this decade has long since ended and has been quietly replaced by a period of extremely robust profits. The insurance industry and many politicians have been crediting tort reform for bringing an end to the crisis, but profits are strong across the board. In states both implementing "reforms," usually in the form of restricting the rights of victims of medical negligence, and those without any reforms at all, profits are booming.

Insurance Industry Profits Beat Fortune 500

The Insurance Information Institute (III) acknowledges that these are good times and show the best operating margins in the last twenty years, surpassing even the boom years of the early and mid 1990s.[1] But just how high are these profits and how do they compare to the economy as a whole? Below is a table of the total profits as a percentage of revenue, reported by the ten largest insurers themselves in their Insurance Expense Exhibits (part II, Line 11, column 42), to the National Association of Insurance Commissioners (NAIC).

As can be seen, these profitability numbers are extremely impressive by almost any standard. The percentages range from 5.9 percent for Physicians Reciprocal Insurance, a percentage that beats 64 percent of the Fortune 500, to 74.8 percent, a number that beats 99.8 percent, or all but one company of the Fortune 500. In fact, the *average* of the top 10 beats all but five, or 99 percent, of the Fortune 500 for 2008.[2] And as extraordinary as these numbers are, they almost certainly underestimate the actual profits that these companies are making.

Table 1. Insurance Company Profits – 10 Largest Medical Malpractice Insurers[3]

Rank	Insurance Group or Company Name	Total Profit/Loss
1	Medical Liability Mutual Insurance Company	6.1%
2	Medical Protective (Berkshire Hathaway)	28.7%
3	Doctors Company	20.7%
4	Lexington (AIG)	67.3%
5	Continental Casualty (CAN)	27.0%
6	ProAssurance	74.8%
7	Physicians' Reciprocal Insurance	5.9%
8	ISMIE	23.2%
9	ProMutual	27.7%
10	MAG Mutual	30.3%
	Average	**31.2%**

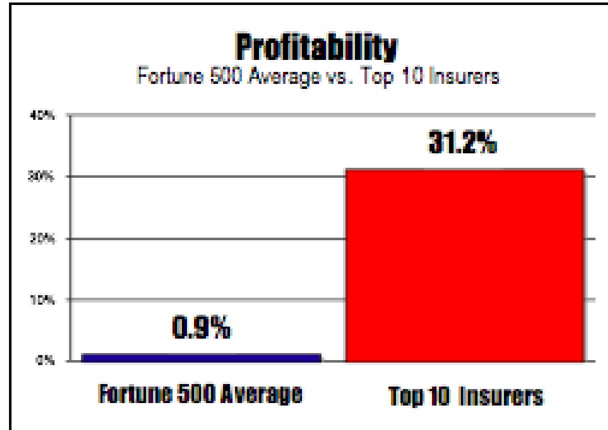
Highlighted companies are for-profit stock companies

It is particularly interesting to note that Lexington's malpractice unit, which is a division of AIG, reported impressive profits even as the company as a whole was being bailed out with taxpayer funds. According to the Fortune 500 listing, AIG reported revenues of approximately

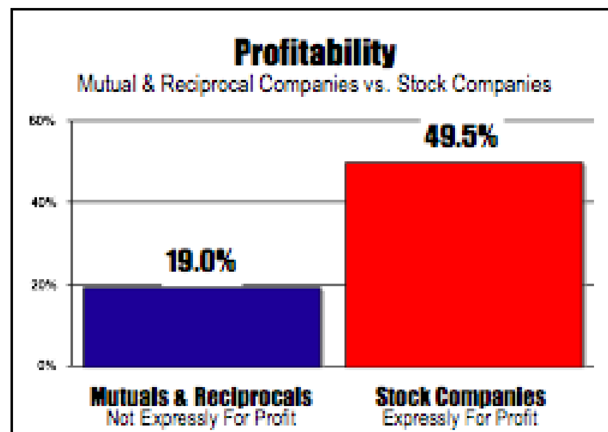
$11.1 billion while losing $99.3 billion, generating a staggering loss of -894.2 percent. Meanwhile, its medical malpractice unit was doing its share to keep the company afloat, generating an outstanding total profit of 67.3 percent.

Alabama-based ProAssurance announced in early 2009 that its profits had exceeded analyst estimates by 89 percent, and that 2008 was the most successful in company history.[4]

To put these numbers into an even greater context, it is useful to further compare these profitability numbers to those of the Fortune 500. As has been widely reported, 2008 was a year of worldwide recession marked by extremely low levels of profitability and a large number of companies reporting huge losses. Fortune described it as "the worst year ever for the country's largest publicly traded companies."[5] At the same time, however, profits at the top 10 medical malpractice insurers were 35 times higher than the Fortune 500 average.[6]



Also interesting is the discrepancy between companies that are beholden to shareholders (stock companies), and thus expressly for-profit, and those that are not beholden to shareholders (mutual and reciprocal companies). The four stock companies, which, taken together, represent 21 percent of the medical malpractice insurance market, turned a profit of almost 50 percent in 2008. To put this in some perspective, only one Fortune 500 company in 2008 surpassed this level of profit and no Fortune 500 companies surpassed this level of profit in 2007. It is definitely a very good time to be a for-profit medical malpractice insurer.



But beyond this, it's curious that even non stock companies—companies that are supposed to exist just to serve the needs of the policyholders—are generating huge profits as well. The 19.0 percent average profit is greater than 475 of the Fortune 500 companies. This begs the question: why would they be so profitable? Mutuals have no external shareholders to pay dividends to and thus usually do not attempt to maximize profits. Of course some profits may be necessary for re-investment purposes and to grow and sustain the organization, but profits higher than 95 percent of the Fortune 500 seem a bit excessive. It might be possible that some of these companies might be planning to demutualize at some point in the future; that is, go private and sell stock. In 2008, for example, ProAssurance acquired PICA group through a sponsored demutualization.[7]

And these profits have occurred across the board, regardless of whether tort reform has occurred or not. The largest company in the country, MLMIC, does nearly all of its business in New York, which has no caps at all. Medical Protective, a division of Warren Buffet's Berkshire Hathaway and the second largest insurer, sells more premium in Pennsylvania than any other state. The Keystone State has dodged major tort reform efforts and does not limit damages to those injured by medical negligence. The most profitable company, ProAssurance, does business in 22 states, but of all states, its largest share is in Alabama, which does not cap damages at all.

Taken as a whole, then, 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. The next sections will show that 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 really 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 means that insurers can be more certain how much they are going to pay out, often within just a year. In the case of medical malpractice and some other types of insurance, there is much more variability. There are relatively few cases, there is wide variation in the ultimate cost of claims, and it takes around seven years for most of the 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, more or less, paid out. "More or less" because paid losses does not necessarily mean the check has been written and cashed. Large verdicts can be reduced and insurers can often recoup losses through subrogation.

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 through. 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 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.

Also, since profits are calculated based upon these predictions, an insurer could, in theory, simply say it was going to pay out less than it really thought, making it appear more profitable than it actually is. In a very simplistic example, imagine the unscrupulous *Fly By Night* insurance company collected $1,000,000 in premiums but it believed that it would eventually have to pay $2,000,000 in claims. Imagine also that these claims would eventually make the company insolvent. But Fly By Night, being unscrupulous, reports that it will only be on the hook for $500,000, incurs that as a loss, and claims an impressive profit of 50 percent.[8]

The flip side of the *Fly By Night* scenarios is the case where the insurer says that it is will pay out more that it actually will. Imagine for some reason that an insurance company wants to "hide" its profits. *Furtive Mutual Insurance Company* knows that it will probably have to pay out $500,000 in claims, but it puts away $1,000,000 instead and reports a huge loss. So the first year it incurs a loss of $1 million, the second $900,000, the third $800,000 and so on until the values match up. A few years from now, nobody will think to go back and double check what *Furtive Mutual* had been saying, and even if they do it will be old news. When companies revise downward how much they are going to have to pay out, it is called ***positive reserve development***. It is a positive development in that the losses go down, thus helping the company's bottom line.

Why Hide Profits?

But why would *Furtive Mutual* ever do such a thing? What benefit could it possibly realize? Wouldn't its stock take a beating? There are several reasons why such things could happen. First, not all companies issue stock; in fact, six of the top 10 insurance companies are organized as either mutuals or reciprocals, and are not beholden to shareholders. Second, 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 skyrocket, 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 be losing great sums of money.

That the Physicians Insurers Association of America (PIAA), the trade association of the medical malpractice insurance industry, has a political agenda is not something the group tries to hide. They regularly produce reports playing up the importance of legislation that restricts the rights of those affected by medical negligence. Recently, the group suggested that recent improvements in the industry were due to tort reform and that without it the industry risked another crisis. As Lawrence Smarr, president of the PIAA stated, "Unfortunately, the biggest pressure facing the industry—namely rising litigation costs—

remains unrestrained in most states."[9] It is with these facts in mind that it is interesting to look back at the reserving practices of the top 10 medical malpractice insurance companies.

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."[10]

Table 2. ISMIE Reserving Practices 2004-2007[11]

	What They Said Then	What They Say Now	Difference
2004	$201,610,000	$165,100,000	-18.11%
2005	$208,501,000	$171,007,000	-17.98%
2006	$187,289,000	$167,008,000	-10.83%
2007	$187,106,000	$180,336,000	-3.62%
		Average Revision	-12.63%

"What They Said Then" represents incurred losses for 2004 in 2004.
"What They Say Now" represents incurred losses for 2004 in 2008.

In 2004, a year before the new tort reform measures were passed, ISMIE said that it would have to pay out $201.6 million for that year. By 2008, ISMIE revised this amount downwards to $165.1 million, or a drop of 18.1 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 claims of patients seeking remedies for medical negligence, ISMIE claimed even higher incurred losses of $208.5 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 $171.0 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 $187.3 million. It gave rebates to doctors and lowered premiums slightly. But it turns out these estimates were still high, and now they've dropped them another 10.8 percent. If you look closely, you will notice, however, that ISMIE now says that it is going to pay out basically the same amount for each of those three years, and actually a bit more in 2007, even though the effects of tort reform are in full 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.

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 Five-Year Revision Of Incurred Losses[12]

Rank	Group/Company Name	Average Revision
1	Medical Liability Mutual Insurance Company	-4.0%
2	Medical Protective (Berkshire Hathaway)	-23.1%
3	Doctors Company	-14.5%
4	Lexington (AIG)	-34.4%
5	Continental Casualty (CNA)	-2.9%
6	ProAssurance	-23.1%
7	Physicians' Reciprocal Insurance	6.6%
8	ISMIE	-9.4%
9	ProMutual	-13.1%
10	MAG Mutual	-17.2%
	Average	-13.5%

Average revision represents the average percentage change from the original incurred loss of each year from 2003-2007 to the 2008 estimate for those same years.

What the above chart indicates is that over the last five years, companies have been routinely grossly overestimating what their losses would be at the beginning, and then revising them downwards in later years. And this is not even the total revision. Amongst the top ten companies over the last five years, the estimated final payout has dropped by an average of 13.5 percent for each of the last five years.

This pattern is widespread. Nine of the top 10 insurers have experienced positive reserve developments (meaning projected payouts have gone down), while six of the top 10 have experienced double digit positive reserve developments. In the case of Lexington/AIG, it now says that its average estimated losses for each of the last five years are 34.4 percent lower than its initial estimates.

Revisions Tell the True Story

Initial incurred losses over the last several years have been very poor at predicting the actual losses eventually paid. 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. 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.

There is one exception. As has been widely reported, Physicians Reciprocal Insurance has had several bad years and has experienced an average *negative* reserve development of

6.6%. The situation has become so dire, in fact, that PRI has been declared insolvent.[13]

The danger, however, is not that other companies will be following PRI into insolvency; rather, the real danger is that PRI's problems will draw attention away from the fact that other insurers are gouging their doctors and reaping huge profits. PRI was the *only* company in the top ten to experience negative loss reserve development and the attention that PRI is receiving will likely play into the hands of those seeking to perpetuate a crisis atmosphere for political gains.

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 Lexington, a division of AIG, helps to illustrate how this is done. In the year 2006, between *claims made* and *occurrence* (two different types of medical malpractice insurance), Lexington/AIG earned $511.9 million in premiums. This is about 10 percent of Lexington's total, and Lexington is just one part of AIG. For that same year, they incurred $313.9 million in losses. It also made an investment gain of $157.9 million, so when all was said and done, Lexington/AIG came away with a whopping 61.3 percent profit in its medical malpractice unit.

In fact, the situation is even better for Lexington/AIG. In 2008, after a couple of years seeing how losses panned out, it decided its original estimate of $313.9 million was high and dropped its estimated losses 32.6 percent to $211.4 million. The difference between $313.9 and $211.4 million is $102.5 million, and this represents approximately 20 percent of the $511.9 million Lexington/AIG earned in premiums that year. Thus, given the revisions in losses to the 61.3 percent profit it made in 2006, its profit for that year is actually closer to 81.3 percent.

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 For The Last Two Years

Rank	Company	Profit Change	
		1 Year	2 Year
1	Medical Liability Mutual Insurance Company	+9.3%	+8.1%
2	Medical Protective (Berkshire Hathaway)	+4.0%	+7.8%
3	Doctors Company	+3.2%	+4.8%
4	Lexington (AIG)	+10.2%	+20.0%
5	Continental Casualty (CNA)	-0.6%	+1.2%
6	ProAssurance	+1.1%	+65.4%
7	Physicians' Reciprocal Insurance	+10.1%	-10.9%
8	ISMIE	+3.0%	+8.4%
9	ProMutual	+4.2%	+6.8%
10	MAG Mutual	+6.1%	+12.0%
	Average Change	+5.1%	+12.4%

As can be seen by the table above, the medical malpractice insurance industry did much better over the last couple of years than it reported in either 2007 or 2006. The values range from a -10.9 percent revision to profits for Physicians Reciprocal Insurance to a +65.4 percent revision for ProAssurance. In 90 percent of the cases reported here, profits were revised upwards. Typically, the revision upwards was +5.1 percent for 2007 and +12.4 percent for 2007.

It cannot be stressed enough how large the profits medical malpractice insurers are reaping. Already a good year, 2007 profits were 5.1 percent higher than originally reported. When you consider that the average for the Fortune 500 was just 6.2 percent for that year, you begin to see just how large these numbers are.

Disguising Profits

As previously shown, the profits insurers reported in 2008 were extremely good, especially considering the year was marked by recession. Is it possible, however, that they actually made more money than they reported? Is the 31.2 percent industry average for the top 10 masking even more robust profits?

It is possible to look at a company's actual paid losses (not incurred losses) for the past decade and analyze the trends. This test, usually called a ***Paid Loss Development Method***, is usually used to see whether a company's reserves are sufficient. This report, however, does not attempt to understand whether or not they are sufficient. With years and years of obvious over-reserving and the scaling back of estimates of ultimate payouts, that does not seem to be a problem.

Insurance companies are required by the National Association of Insurance Commissioners (NAIC) to file ***Loss Reserve Development*** information in Schedule P, Part II of their annual statements. These data amount to a history of their reserving practices over the last decade. While an insurer's underlying actuarial assumptions are not completely knowable, it is possible to find a historical pattern to their payments, project these payments forward, and compare them to current reserve levels. This process is described in the appendix and the following table summarizes the results.

Table 5. Estimated Claims vs. Actual Incurred Losses

Company	Estimated Claims Payment	Actual Incurred Losses	Over/Under Estimate
1. MLMIC	$6,354,529,083	$7,773,981,000	+22.3%
2. Medical Protective/Berkshire	$1,711,016,215	$2,423,641,000	+41.6%
3. Doctors Company	$2,181,521,685	$2,127,893,000	-2.5%
4. Lexington/AIG	$1,317,156,363	$1,240,981,000	-5.8%
5. Continental/CNA	$1,681,502,298	$1,854,329,000	+10.3%
6. ProAssurance	$949,087,246	$1,410,074,000	+48.6%
7. Physicians Reciprocal	$1,765,295,396	$2,130,012,000	+20.7%
8. ISMIE	$1,403,768,783	$1,713,223,000	+22.0%
9. ProMutual	$1,933,204,863	$1,745,787,000	-9.7%
10. MAG Mutual	$795,513,952	$1,143,067,000	+43.7%
		Average	**+19.1%**

To illustrate what these results mean, take ProAssurance as an example. Recall that above, ProAssurance has already reported a 2008 profit of 74.8 percent. Recall also that this profit could end up being higher or lower in the end because of the nature of incurred losses. Looking at the data above shows that ProAssurance has incurred losses of $1.41 billion to

cover payments for claims made over the last 10 years. Remember, these are not all actual losses paid; a large portion of these are funds sitting in reserves, collecting interest, waiting to eventually get paid. ProAssurance's history of actual paid claims, however, makes it quite likely that the company will only have to pay out a total of $949 million. This means that ProAssurance likely has about 50 percent more in reserves than it is actually going to pay out. Their doctors, who have been complaining about skyrocketing premiums, are being victimized by their own insurance company.

In future years, ProAssurance will likely revise their incurred losses even further downwards, and therefore their eventual profits will be significantly higher than the large profits they have already reported.

Record-Level Profits Will Increase

Seven of the top 10 insurers are likely over-reserved, and each of these seven has incurred losses that exceed estimated losses by double digit percentage points. Taken as a whole, the reserve adequacy test shows the top 10 to be over-reserved by about 19.1 percent.

This fits very well with what is already known about incurred losses over the last several years. As this report illustrates, the information provided by these companies shows that they have been incurring high losses and then adjusting them downwards. 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 still. The question is, will anyone be paying any attention then, or will there be a new "crisis" filled with heated rhetoric and misplaced blame?

Insurers will undoubtedly state that the paid loss development method is incomplete and 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. They will also state that the incurred loss development method is better given that medical malpractice claims take many years to develop. This is tantamount to saying that future claim payments will differ significantly from the historical patterns. This may be true, but recall that these same insurers have been doing a remarkably bad job predicting ultimate paid losses with their initial incurred losses. Recall also that in each of the last five years, the insurers have been systematically revising downwards what they will ultimately have to pay out. So it seems that using history, as indicated in the insurance companies' own reported actually paid losses, as a guide, is probably more reliable than these hidden actuarial assumptions that in many cases seem suspiciously affected by the surrounding political environment.

Conclusion

The data provided by the insurance companies themselves are damning. Their 2008 Annual Statements indicate (1) extraordinarily high profits, (2) that their initial estimates of losses over the last several years were wildly inflated, (3) their profits over the last several years have been much higher than initially reported, and (4) this pattern is likely to continue, with reported record profits actually underestimating ultimate actual profits.

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

Appendix: Methodology

This report analyzes the 2008 performance and reserving practices of the 10 largest medical malpractice insurance companies in the United States as reported by the National Association of Insurance Commissioners (NAIC). The report's primary sources of data are 2008 Annual Statements filed by the insurance companies themselves with state insurance departments and the NAIC.

The insurers analyzed include companies such as Lexington Insurance Company, a division of insurance giant AIG, and Medical Protective, a division of Warren Buffet's Berkshire Hathaway. These companies issue stock, are owned by investors, and exist to generate profits. These companies tend to have operations that are either regional or national in scope.

It also includes mutual and reciprocal companies, which are not explicitly organized to generate profits and are beholden to their policyholders, who in this case are doctors. Moreover, these companies tend to limit their operations to one or just a few states. Mutuals include the country's largest medical malpractice insurer, Medical Liability Mutual Insurance Company (MLMIC), which operates predominantly in New York, and ISMIE, the county's eighth largest, which operates primarily in Illinois. Reciprocal interinsurance exchanges operate very similarly to mutuals and include The Doctors Company, the country's third largest medical malpractice insurer. While the analysis is limited to the top 10, these companies account for almost half (46.4 percent) of the medical malpractice insurance market.[14]

The *paid loss development method* is normally used to test if current reserves are sufficient to meet future claims; that is, to determine if insurers have reserved enough to remain solvent. In this case, however, the intent is to determine if current reserves are excessive. This section outlines the basics of the test. It is not intended to explain in detail how the values are calculated, but anyone familiar with actuarial science and insurance accounting will be able to follow the reasoning.

First, cumulative paid net claims and expenses data for claims made and occurrence for the medical malpractice lines (Schedule P, Part 3F, Sections 1 and 2) were combined into a single table for each company. Then load factors were calculated and a load factor table was created. The load factors were then averaged to develop average payments. Three and five year averages were then also created to give more weight to recent years. This process yielded the set of multipliers that were used to estimate future payments.

Current cumulative payments through year-end 2008 were then taken from Column 10 of Schedule P, Part 3F, Sections 1 and 2, and the multipliers were used to create development factors to bring the claims to 10 years of maturity. These estimated claims payments were then compared to the actual payments incurred and the percentage difference was calculated.

It is often argued that a different method, the *incurred loss development method*, should be used in lines with long tails such as medical malpractice. This use of the paid loss versus the incurred loss development methods remains controversial and has been the subject of debate in the actuarial community. It is far beyond the scope of this paper to discuss the pros and cons of each method. Suffice it to say, the incurred loss method is explicitly rejected here because it relies upon “soft” data. It employs in its calculations case reserves, which are themselves estimates, to estimate ultimate losses; that is, it uses estimates to estimate estimates. Given that section two of this study demonstrated how poor the predictive validity of insurer estimates have been generally, the study uses the paid loss development, which, despite potential limitations, produces better results.

Appendix: Glossary

Claims Made
Type of medical malpractice insurance policy which offers insurance for any claim made during the term of the policy, even if the incident occurred before the policy start date. See also *Occurrence*.

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

Loss Reserve Development Method
An actuarial method that uses reserves to analyze trends.

Mutual Insurance Company
An insurance company whose policyholders are also its owners. See also *Reciprocal Insurance Company*.

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

Occurrence
Type of medical malpractice insurance policy which offers insurance for incidents that occurred during the term of the policy, even if the claim is reported after the term of the policy. See also *Claims Made*.

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

Paid Loss Development Method
An actuarial method that uses actual paid losses rather than reserves to analyze trends.

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

Reciprocal Insurance Company
An insurance company whose policyholders agree to insure one another. See also *Mutual Insurance Company*.

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.

[1] *Medical Malpractice Insurance & The Insurance Cycle: Medical Professional Liability & the P/C Insurance Industry*, Insurance Information Institute (III), http://www.iii.org/media/presentations/medmal/.
[2] *Fortune 500*, CNNMoney.com, http://money.cnn.com/magazines/fortune/fortune500/2008/full_list/index.html. Percentages for Fortune 500 companies reported as profits as a percentage of revenue.
[3] From insurer annual reports, Insurer ExpenseExhibits (IEE) Part II Allocation to Lines of Business Net of Reinsurance. Row 11, Column 42. Profits reported as a percentage of revenue.
[4] *ProAssurance Far Surpasses Profit Estimate in Fourth Quarter*, Medical Liability Monitor, March 2009.
[5] Dan Strumpf, *Exxon Mobil Overtakes Wal-Mart to Top Fortune 500*, ABC News, http://abcnews.go.com/Business/Economy/wireStory?id=7374943.
[6] *Fortune 500*, CNNMoney.com, http://money.cnn.com/magazines/fortune/fortune500/2008/full_list/index.html. Revenue and profits for the top 500 were summed, with percentages being reported as the total summed profits as a percentage of the total summed revenue.
[7] *ProAssurance to Acquire Podiatrists' PICA Group*, Presidio Insurance News, http://www.presidioinsurance.com/news/?p=333.
[8] Obviously much more goes into the calculation of profits and losses. There are a number of expenses, taxes, investments and other things that go into the calculation of the bottom line. This example is merely illustrative.
[9] *PIAA Warns That Without Tort Reform, Medical Malpractice Insurance Industry Return to Profitability Likely to be Short Lived*, Business Wire, September 14, 2006, http://www.accessmylibrary.com/coms2/summary_0286-17627522_ITM.
[10] *ISMIE Mutual Maintains Current Insurance Rates for 2nd Year Running*, ISMIE Press Release, http://illinoisdeservesthetruth.typepad.com/home/files/ISMIE_2008_rates.pdf.
[11] From insurer annual reports, Insurer ExpenseExhibits (IEE) Part II Allocation to Lines of Business Net of Reinsurance. Row 11, Column 42.
[12] *Id.*
[13] Gale Scott, *Big N.Y. Malpractice Insurer is Bust*, Crain's New York Business, May 20, 2009.
[14] *Property and Casualty Insurance Industry, 2008 Top 25 Companies by Countrywide Premium*, National Association of Insurance Commissioners (NAIC), http://www.naic.org/documents/research_premium_by_LOB.pdf.