REPORT OF THE

OFFICE OF THE AUDITOR GENERAL

TO THE

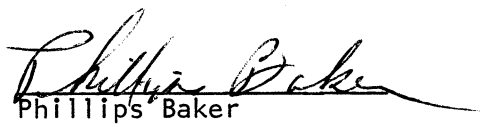
JOINT LEGISLATIVE AUDIT COMMITTEE

265.2

THE MEDICAL MALPRACTICE INSURANCE CRISIS IN CALIFORNIA

DECEMBER 1975

Respectfully submitted,



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SUMMARY

The current medical malpractice insurance crisis in California has evolved over many years and is attributable to the actions of many facets of our society including the doctors, the insurance companies, the various regulatory bodies, the legal profession and court system, and the general public.

The insurance companies which provided medical malpractice insurance in California over the last 15 years will ultimately experience estimated losses of $400 million in excess of premiums collected for this coverage and earnings from the investment of these premiums held until loss payments are made.

The current high, and escalating, costs and the shrinking availability of medical malpractice insurance is due to the many variables associated with this type of insurance and the extended periods for which insurers are liable.

The highest rates to be in effect for medical malpractice insurance on January 1, 1976, in California, will be approximately $4,800 per year for general practitioners and between $24,500 and $36,000 for the highest-rated specialists.

In our opinion recent legislation enacted in California may have a beneficial effect on malpractice rates in the future but will have limited immediate impact. Possible solutions for legislative actions which should have an immediate effect are included in this report. Our conclusions are as follows.

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3. Legislation be enacted which will place a per claim limitation on the liability of insurance companies and provide that the State will be liable for settlement in excess of this limitation. 37

4. Legislation be enacted requiring the availability of medical malpractice insurance on a claims-made basis through private insurance carriers. 37

5. Legislation be enacted which will require medical malpractice insurers to implement nondiscriminatory rate making procedures. Items to be considered in arriving at resulting rates should include:

   - High volume practices vs low volume practices
   - Urban physicians vs rural physicians
   - High risk physicians vs low risk physicians
   - High risk specialty vs low risk specialty 38

6. Amend Section 800(c) of part (5) of the Business and Professions Code to provide that contents of any central file, pertaining to an individual physician, maintained by the Board of Medical Quality Assurance be made available to any insurance company which has received an application for malpractice insurance from that physician

INTRODUCTION

In response to Assembly Concurrent Resolution No. 83 of the Regular Session of the 1975-76 California Legislature, we have reviewed the subject of malpractice insurance underwriting and claims as it affects physicians and surgeons in California. An interim report was submitted to the Legislature on September 10, 1975.

The primary function of malpractice insurance for physicians is to protect their assets in the event a claim for malpractice is settled in favor of a patient. As such, this insurance is a proper business cost of physicians to be passed on to their patients.

Medical malpractice insurance becomes an item of public concern when the cost of this insurance passes the point where it can reasonably be expected to be absorbed by patients, or when this insurance is not available to protect both the physician and the public.

The medical malpractice insurance crisis in California is not a recent occurrence. The problems of availability and affordability date back at least to 1946. Less serious crises have surfaced on several occasions since 1946, with the current crisis being the most severe.

The crisis is real and multi-faceted. The causes of the current situation are equally complex. The doctors, Department of Insurance, insurance companies, legal profession, courts, jury system, and the people of the State of California have all contributed to the current crisis.

During 1975 the California Legislature devoted a tremendous amount of time and resources to the study of the medical malpractice insurance crisis. We have reviewed the resulting legislation.

In conducting this study we have contacted major insurance carriers in the State which have written medical malpractice insurance over the last 15 years. We have reviewed and analyzed available documentation, including annual statements filed with the Insurance Commissioner, supporting premium income and loss data maintained by these companies.

In addition to the insurance companies, we have contacted representatives of the California Medical Association, the California Trial Lawyers Association, the California Department of Insurance, insurance brokers, plaintiffs' and defense attorneys, judges, and various consultants. Booz-Allen Consulting Actuaries were contracted to assist in this study. Their report is included as Appendix A of this report.

We received excellent cooperation and support from all parties contacted during the study.

I. MEDICAL MALPRACTICE INSURANCE IS A BUSINESS EXPENSE FOR THE PHYSICIANS WHICH IS PASSED ON TO THEIR PATIENTS AS A COST OF PROVIDING MEDICAL SERVICES, AND HAS HISTORICALLY BEEN A SMALL PERCENTAGE OF A PHYSICIAN'S GROSS INCOME.

A. The Average 1975 Cost Of Medical Malpractice Insurance Per Physician-Patient Contact For Northern California Ranges From $0.53 To $11.54 For $1,000,000/$3,000,000 Policy Limits.

- Table 1 on the following page uses a nationwide average number of patient visits produced per year by individual office-based physicians using statistics from the American Medical Association's Profiles on Medical Practice for 1974. The average annual physician-patient contact was used to determine the average cost for physician-patient contact for medical malpractice insurance.

- Rates shown in Table 1 are the highest group plan rates in Northern California at this time, and include a 322 percent increase as of May 1, 1975. Another group plan carrier in Northern California increased rates 350 percent effective November 1, 1975, but these rates are less than those used in calculating Table 1.

B. The American Medical Association's 1973 Profiles On Medical Practice Show That, For 1971, Professional Liability Insurance Nationwide Accounted For 1.2 Percent Of Physicians' Gross Income.

- During the period 1971 through 1975, medical malpractice insurance rates have increased approximately 338 percent in Northern California resulting in an increase in the percent of physicians' gross income going for medical malpractice insurance.

C. Physicians Are Not Able to Pass The Increased Cost Of Medical Malpractice Insurance Premiums On To Their Fixed-Fee Schedule Patients, Such As Medi-Cal.

- The State Department of Health will have to take this additional physician cost into consideration in determining rates paid for Medi-Cal beneficiaries.

TABLE 1

AVERAGE MEDICAL MALPRACTICE INSURANCE
COST PER PHYSICIAN-PATIENT CONTACT
FOR NORTHERN CALIFORNIA
FOR YEARS 1973 AND 1975

Medical Specialty	1973 Policy Limit $100,000/ 300,000	1973 Average Visit Cost	1973 Policy Limit $1,000,000/ 3,000,000	1973 Average Visit Cost	1975* Policy Limit $100,000/ 300,000	1975* Average Visit Cost	1975* Policy Limit $1,000,000 3,000,000	1975* Average Visit Cost	Cost Increase Over 1973	Cost Increase Over 1973
General Practice:										
Annual Premium	$ 652	$0.07	$ 983	$0.11	$ 3,168	$0.35	$ 4,772	$0.53	$0.28	$0.42
Average Number of Annual Patient Visits	8,944		8,944		8,944		8,944			
Surgery:										
Annual Premium	$2,070	$0.34	$3,120	$0.51	$10,052	$1.66	$15,148	$2.50	$1.32	$1.99
Average Number of Annual Patient Visits 1/	6,061		6,061		6,061		6,061			
Obstetrics-Gynecology:										
Annual Premium	$3,105	$0.49	$4,676	$0.74	$15,076	$2.40	$22,704	$3.61	$1.91	$2.87
Average Number of Annual Patient Visits 1/	6,289		6,289		6,289		6,289			
Anesthesiology:										
Annual Premium	$3,105	$1.58	$4,676	$2.38	$15,076	$7.66	$22,704	$11.54	$6.08	$9.16
Average Number of Annual Patient Visits 1/	1,968		1,968		1,968		1,968			

* The 1975 premium figures are for the county medical societies with the highest premiums.

1/ A patient may be seen more than once for each surgery or anesthesia application.

II. PHYSICIANS ARE NOT REQUIRED BY LAW TO HAVE MEDICAL MALPRACTICE INSURANCE TO PRACTICE MEDICINE IN CALIFORNIA. INDICATIONS ARE THAT A LARGE PERCENTAGE OF PHYSICIANS ARE CONSIDERING PRACTICING WITHOUT MEDICAL MALPRACTICE INSURANCE COVERAGE.

A. Only A Relatively Few California Physicians Practiced Medicine Without Medical Malpractice Insurance In Past Years.

- It is apparent from testimony before a legislative committee that an ever increasing number of physicians are, or are contemplating, practicing medicine without medical malpractice insurance.

- Comments from the Senate Committee on Insurance and Financial Institutions public hearing of October 14, 1975 are as follows:

> ...our survey now reveals that at least 10 percent of physicians in District 13 of Los Angeles County Medical Association, are now without insurance. Our surveys also indicate that this number will markedly rise, perhaps even as high as 50 percent.
>
> ...we've made a few telephone calls around the State to try and get an estimate on this and quite obviously most physicians will not advertise the fact that they're not going to purchase insurance in today's market. But it would appear to -- twenty to twenty-five percent of the physicians in the State, largely the primary care physicians, and they feel that they will do a little bit of self-insurance....
>
> I think physicians are looking at this (lack of medical malpractice) in a sense as Russian Roulette. They'll put away the premium for a year or two as a defense fund. And the first time they're hit with a large claim, they'll simply declare bankruptcy and leave. This is a hell of a way to look at it, but this is what many of them feel they're forced into at this point.

III. PHYSICIANS' PURCHASE OF MEDICAL MALPRACTICE INSURANCE THROUGH GROUP PLANS SPONSORED BY MEDICAL SOCIETIES MAY HAVE CONTRIBUTED TO THE CURRENT MALPRACTICE CRISIS IN CALIFORNIA BY RESTRICTING THE AVAILABILITY OF MEDICAL MALPRACTICE INSURANCE.

A. Group Plans Represented By Insurance Brokers Have In Past Years Used Their Leverage Successfully To Obtain Lower Rates From Other Insurance Companies When Their Current Insurance Carriers Quoted Higher Rates Which They Deemed Necessary.

- Approximately 50 percent of the office-based physicians in California currently purchase medical malpractice insurance through group plans sponsored by county medical societies. (See Appendix A)

- Group plans have been insured by the following insurance companies:

	From	To
Northern California		
American Mutual Liability Insurance Co.	1946	1973
Argonaut Insurance Co.	1973	present
Travelers Insurance Companies	1973	present
Southern California		
Pacific Indemnity Co.	1963	1970
Hartford Accident & Indemnity Co.	1970	1974
Phoenix Insurance Co. (A subsidiary of Travelers)	1974	present

- Since 1965 there have been at least 17 companies writing medical malpractice insurance in California. Currently there are only three insurance companies writing the bulk of medical malpractice with one carrier "making every effort to withdraw from the medical malpractice market".

B. Numerous Documents In The Files Of The Department Of Insurance Indicate That The Insurance Brokers And Medical Societies Had Knowledge In Past Years That Rate Increases Were Justified To Support The Program. (See Appendix C)

IV. THE BOARD OF MEDICAL EXAMINERS HAS BY DEFAULT LEFT THE POLICING OF THE MEDICAL PROFESSION TO THE TORT SYSTEM, AND IN SOME INSTANCES THE INSURANCE INDUSTRY.

A. The Board Of Medical Examiners Is Responsible For Enforcing The Medical Practice Act Of The Business And Professions Code. This Act Prescribes The Licensing Procedures For Physicians And Empowers The Board To Monitor Licensees To Assure That Their Professional Conduct And Quality Of Medical Care Meet Prescribed Standards.

- A report of the Office of the Auditor General entitled, "Disciplining of Physicians by the Board of Medical Examiners" (236.1) was released on August 11, 1975. The report included the following findings:

  - The Board of Medical Examiners has not promptly investigated and resolved alleged violations of the Medical Practice Act by physicians. In most cases the physicians had an unrestricted license to practice medicine until the effective date of the board's final order. The report includes numerous examples of lengthy delays in completing disciplinary actions.

  - The Board has not made full and prompt use of malpractice insurance reports to identify physicians who may be practicing in an incompetent or grossly negligent manner.

  - The Board has not issued regulations requiring reports from state-licensed hospitals on physicians whose hospital privileges have been limited or terminated.

B. The Court System, Through Punitive Damage Awards, Has Had An Effect On Policing The Medical Profession. The Following Quotes Have Been Extracted From The Court's Opinion In The Gonzales v Nork Case In Which The Court Awarded $2 Million In Punitive Damages.

  - The evidence in this record refers to the "token requirements of the legal licensing agencies" as inadequate to set standards for and police the medical profession.

  - The need for deterrence is obvious, because the failure of the medical profession to discipline itself has been recently remarked.

  - Licensing of persons to practice medicine in itself "furnishes no continuing control with respect to a

physician's professional competence and therefore does not assure the public of quality patient care. The protection of the public must come from some other authority..."

- In this case the other authority is the Court. The beneficial effect of malpractice litigation in improving medical performance has been established by evidence in this case.

C. Two California Medical Malpractice Carriers Who Have Provided Coverage To Doctors On An Individual Basis Instead Of Group Plans Through Medical Societies Have Been Able To Write Their Malpractice Insurance Relative To The Risk Of The Individual Applicant Physician And Have Experienced Better Loss Frequency Results Than Group Program Carriers.

- Some of the criteria used by these companies to determine the relative risks of each physician included:

  1. Number of claims.
  2. Severity of claims.
  3. Specialty.
  4. School of graduation.
  5. Whether or not board certified.
  6. Whether doctor used drugs or alcohol.
  7. How large his patient load is.

- By restricting the procedures which physicians may perform and still have medical malpractice insurance these insurance companies have effectively limited the practice and potential for malpractice of the physicians insured.

V. THE RESULTS OF A SURVEY OF PHYSICIANS, CONDUCTED AS A PART OF THIS REVIEW, INDICATE THAT MOST DOCTORS WOULD SUBMIT MALPRACTICE CLAIMS TO BINDING ARBITRATION, WOULD JOIN A MUTUAL INSURANCE GROUP FORMED BY DOCTORS, AND HAVE NOT RECLASSIFIED THEIR PRACTICE BECAUSE OF HIGH INSURANCE COSTS.

A. A Questionnaire Was Sent To 540 California Office-Based Physicians Selected At Random By The California Medical Association, From Its Directory Of Members, To Determine Doctors' Attitudes On Specific Aspects Of The Medical Malpractice Crisis.

- The following data was compiled from 274 responses to the questionnaire. The survey requested yes or no answers to the following questions.

1. Would you be willing to submit claims to binding arbitration?

	Number Responding	Percentage
Yes	251	91.6%
No	9	3.3%
Undecided	14	5.1%
Total	274	100.0%

2. Would you join a mutual insurance group formed by doctors?

	Number Responding	Percentage
Yes	165	60.2%
No	63	23.0%
Undecided	46	16.8%
Total	274	100.0%

3. Have you reclassified your practice for insurance purposes?

	Number Responding	Percentage
Yes	48	17.5%
No	195	71.2%
Undecided	31	11.3%
Total	274	100.0%

- Information was requested from the physicians on any malpractice claims filed against them, the year the incident occurred, the year the incident was filed and the final disposition of the claim. The response data appeared to be based on memory rather than a record review and therefore possible misstatements seemed likely. However, the data showed a significant increase in both the number of claims filed and the amount per claim filed in the years 1970-74 compared to all earlier years.

VI. THE DEPARTMENT OF INSURANCE HAS CONTRIBUTED TO THE CURRENT MEDICAL MALPRACTICE CRISIS BY NOT FULFILLING STATUTORY REQUIREMENTS TO ASSURE THAT THE RATES FOR MEDICAL MALPRACTICE INSURANCE ARE ADEQUATE.

A. The Department Of Insurance Has Failed To Require Medical Malpractice Insurance Carriers To Charge Adequate Rates, As Required By Statute, Even Though Documentation Was Provided To The Department That Such Rates Were Grossly Inadequate.

- Section 1852 of the California Insurance Code defines the statutory responsibilities for the Department of Insurance if rates are excessive, inadequate, or unfairly discriminatory. The criteria to determine inadequate rates are:
  - Such rate is unreasonably low for the insurance provided, and
  - The continued use of such rate endangers the solvency of the insurer using same, or unless
  - Such rate is unreasonably low for the insurance provided and the use of such rate by the insurer using same has, or if continued will have, the effect of destroying competition or creating a monopoly.
- A preponderance of documentation in the files of the Department of Insurance was reviewed regarding the inadequacy of rates being charged by insurance companies for medical malpractice insurance. Some of the comments are as follows:
  - A report to the Insurance Commissioner, dated February 1970, states:

    > Although we have tried to do so, we have been unable to get a commitment...that they will continue to offer malpractice insurance in California after October 1, 1970. They feel they have lost a lot of money, and unless their present rate structure improves this experience, they say they do not wish to continue to irritate the profession with continued rate increases which the company may consider necessary.

  - A letter to the Department of Insurance, dated December 1972, states:

    > The feeling of those coordinating the program is that any substantial rate increase would not be acceptable to the members. Since our review of experience and trends indicates a substantial increase, we agreed not to quote [new rates] and thereby not prejudice the doctors' ability to negotiate with another carrier in any way.

  - See appendix C for additional documentation.

B. Failure Of The Department Of Insurance To Act On These Inadequate Rates Has Resulted In Significant Losses To Insurance Companies Writing Medical Malpractice Insurance In California, And The Restricted Availability Of Medical Malpractice Insurance In California.

- An actuarial study included as a part of this report (Appendix A) states:

> California medical malpractice is estimated to ultimately produce a net loss of approximately $400,000,000 to the insurance industry for coverage provided during the period 1960 through 1974
>
> There are few insurance companies providing medical malpractice insurance in California

- The following statement is from a questionnaire sent to an insurance company during the course of this review, regarding their experience in the medical malpractice insurance line in California.

> To the extent that we have withdrawn from the California market, the decision was not a particularly recent one and resulted essentially because competitors proposed rates which we believed were too low for us to meet for the business which we were then writing. Since then our premium writings elsewhere have totally absorbed our capacity to undertake new programs, largely as a result of necessary rate increases.

- Availability of medical malpractice insurance in California was further reduced when the Department of Insurance recently declared two insurance companies statutorily insolvent and placed them in conservatorship.

C. The Department Of Insurance Has Knowledge Of What Constitutes An Adequate Pure Premium For Medical Malpractice Insurance By Having Knowledge Of Adequate Loss And Loss Expense Reserves.

- The Department of Insurance can calculate the estimated loss and loss expense reserves of an insurance company for medical malpractice insurance by using actuarial methods.

- The pure premium for medical malpractice insurance is the estimated amount necessary to pay all present and future loss and loss expenses resulting from claims of a given policy year, and can be determined from the loss and loss expense reserve calculation.

- With knowledge of the pure premium for malpractice insurance, the Department of Insurance can regulate medical malpractice rates in California.

D. The Department of Insurance Recently Took Action To Reduce Proposed Medical Malpractice Insurance Rates Which Were Deemed Excessive But No Action Was Taken When Rates Were Inadequate.

- The Department of Insurance issued a Notice of Non-Compliance for excessive rates pursuant to Section 1858.1 of the California Insurance Code.

- The proposed rate increase by the insurance carrier was for 485 percent, to be effective January 1976, while the Department of Insurance calculation indicated a rate increase of 297.5 percent which is subject to negotiation with the company.

- In prior years, the Department of Insurance had knowledge that medical malpractice insurance rates were inadequate, but failed to take action to insure the solvency of insurance companies and the availability of medical malpractice insurance in California.

VII. THE DEPARTMENT OF INSURANCE FAILED TO MAKE AND PROMULGATE RULES AND REGULATIONS FOR THE ESTABLISHMENT OF ADEQUATE RESERVES BY INSURANCE COMPANIES THUS INDIRECTLY CONTRIBUTING TO THE MEDICAL MALPRACTICE CRISIS.

A. Section 923.5 Of The Insurance Code, Which Became Effective In 1970, Requires The Department Of Insurance To Make And Promulgate Rules And Regulations For The Establishment Of Adequate Loss And Loss Expense Reserves.

- Loss and loss expense reserves are the best estimate of an insurance company's potential liabilities which will result from having insured risks.

- If loss and loss expense reserves established by an insurance company are inadequate, they must be increased to assure funds will be available to pay all claims and related expenses.

- If the surplus of an insurer is not at least equal to the minimum paid in capital requirements to transact business in California, after covering reserve deficiencies, a company will be declared statutorily insolvent and placed in conservatorship unless additional capital is invested in the company.

B. The Department Of Insurance Did Not Promulgate Rules And Regulations For The Establishment Of Loss And Loss Expense Reserves Until October 1975.

- A Department of Insurance internal memorandum, dated February 1, 1973, states:

> Liability Reserves -- Longtail
> (Medical Malpractice, etc.)
>
> The adoption of a principle and promulgation of regulatory language has been talked about for a long time now, but we do not seem to be getting it off the ground.
>
> Please make this a matter of first priority in order that the initial stages of exposing the principle to actuaries and others interested in this subject occurs this month. You will recall that we were shooting for getting this under way during January, but now January has slipped past.

- On October 17, 1975 the Department of Insurance issued proposed rules and regulations for the establishment of loss and loss expense reserves.

- The response of insurance companies surveyed in November 1975 was unanimous that no such rules or regulations had been established by the Department of Insurance for loss and loss expense reserves as required by the Insurance Code.

- On November 26, 1975 the Insurance Commissioner stated he had promulgated rules and regulations because public hearings were conducted on the proposed regulations of October 17, 1975. However, these rules and regulations have still not been implemented.

C. The Department Of Insurance Issued An Order On September 10, 1975 Placing Two Insurance Companies, Which Were Writing Medical Malpractice Insurance, In Conservatorship.

- Based on data provided by one of the insurance companies the Department estimated that this company had a loss reserve deficiency at year-end 1973 of about $9 million. The Department of Insurance concluded that the company had underestimated their reserve requirements because the method used was not "calculated on any sound actuarial basis" and was "uniformly rejected throughout the insurance industry as unsound".

- The company with the reserve deficiency was a subsidiary company. The parent company had an investment of $4 million in the subsidiary and was therefore also declared insolvent.

- If the Department of Insurance had implemented statutorily required rules and regulations, the medical malpractice insurance carriers in California would have had knowledge of unacceptable reserving practices and could have taken corrective action, with the result that two California insurance companies may not have been declared statutorily insolvent.

VIII. THE DECLINE IN THE STOCK MARKET, COUPLED WITH THE VIRTUALLY UNLIMITED INVESTMENT AUTHORITY OF INSURANCE COMPANIES AND THE INVESTMENT PORTFOLIO VALUATION PROCEDURES ADOPTED BY THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, HAS RESULTED IN A SEVERE STRAIN ON THE FINANCIAL SOLVENCY OF THE LIABILITY INSURANCE INDUSTRY, WHICH MAY BE A GREATER CRISIS THAN MEDICAL MALPRACTICE INSURANCE.

A. Except For Regulations Limiting The Maximum Amount Which An Insurance Company May Invest In The Common And Preferred Stock Of A Single Corporation, A Solvent Liability Insurance Company May, After Three Years Of Operation, Invest All Excess Funds In Common And Preferred Stock.

- The investment portfolios of the seven companies which we reviewed were made up of approximately 70 percent bonds and 30 percent preferred and common stock. Approximately 84 percent of the funds invested were provided by policyholders.

- Common stocks may not be prudent investments for the liability insurance industry. Investable funds of policyholders, with the possible exception of medical malpractice insurance, may not remain with the companies for a sufficient period of time to minimize the risks inherent with stock investments.

- Consideration of liquidity in the investment portfolio would reduce investment risk. Reduction of investment risk would reduce potential insolvency of liability insurance companies resulting from moves in the prices of common and preferred stocks.

B. The Investment Portfolio Valuation Procedures Of The Liability Insurance Industry Do Not Reflect The True Value Of Investments And Permit The Conditions Of The Economy To Have a Roller Coaster Effect On The Financial Integrity And Solvency Of The Companies.

- Common and preferred stocks are valued at market. Unrealized gains and losses resulting from increases and decreases in the market value of stocks still owned by the companies are reflected in the surplus of the companies. This affects not only the solvency of the companies but also the amount of business which a company may write because one of the most important restrictions placed on insurance companies by the Department of Insurance is the allowable ratio between surplus and premiums written.

- Bonds owned by these companies are valued at amortized cost. As a result changes in their market value are not reflected in the surplus of companies. However, if the companies were forced into the position of

having to dispose of bonds during a prolonged period of declining values such as exists today, they would suffer severe and previously unrecognized losses.

C. Declines In The Stock Market Have Reduced The Financial Integrity And Solvency Of The Liability Insurance Industry And Reduced The Availability Of Medical Malpractice Insurance By Reducing The Capacity Of The Companies To Write Policies.

- During the five-year period of 1969 through 1974, unrealized losses from common and preferred stock investments reduced the surplus of seven insurance companies which we reviewed by approximately $118 million, or 36 percent of their surplus.

- Fluctuations in the market value of bonds are not reflected in the surplus of liability insurance companies. Bond value information was provided to us by five of these companies writing medical malpractice insurance in California. From this information we have estimated that if bonds were valued at market on September 30, 1975, the investments, and therefore the surplus, of these companies would have been reduced by $444 million which would effectively force the companies into statutory insolvency.

D. The Financial Integrity And Solvency Of The Liability Insurance Industry May Be A Greater Crisis Than Medical Malpractice.

- In November 1975, the Insurance Commissioner of the State of California and casualty liability insurance companies surveyed stated the most pressing issue facing the industry today is "the financial integrity and solvency of the industry". Some of the comments added were:

> Medical malpractice is merely a symptom of the disease. Inflation, increased litigation and liberal courts make it virtually impossible to price insurance adequately.
>
> Product liability insurance is a significant example of where we have growing concern.

- Medical malpractice insurance is estimated to approximate only two percent of the liability insurance written in the United States.

- Medical malpractice insurance is included in "miscellaneous liability" insurance when reported by insurance companies. Other lines of insurance included in miscellaneous liability are: owners', landlords' and tenants'; manufacturers' and contractors'; elevator; product; owners' or contractors' protective and/or contractual; storekeepers' liability.

- Based on growth in earned premiums by stock insurance companies between 1964 and 1973, miscellaneous liability insurance did not grow the greatest as shown below:

Growth in Earned Premiums by
Stock Companies Between 1964 and 1973

Miscellaneous Liability	Homeowners Multiple Peril	Commercial Multiple Peril	Ocean Marine	Inland Marine	Auto Liability	Auto Physical Damage
+157%	+184%	+677%	+164%	+129%	+125%	+149%

- The Insurance Commissioner of the State of California and industry executives surveyed stated they would be willing to participate in a task force to improve the availability of casualty-liability insurance, predictability of rates, and securing the solvency of the industry.

- Generally, the executives agreed that the stock market and valuation procedures have been contributing problems. They cite inadequate rates, however, as the chief cause of the industry condition. Further, they say any changes that would occur to the California Code regarding restricted investment authority, not adopted by other states, might make California an unattractice state in which to compete.

NOTE: The effects of the investment policies of insurance companies, the valuation of these investments in conformance with Department of Insurance guidelines, and fluctuations of the stock market are discussed in greater detail in Appendix B of this report.

IX. STOCK MARKET LOSSES HAVE NOT BEEN INCLUDED IN ESTABLISHING MEDICAL MALPRACTICE INSURANCE PREMIUMS, BUT INDIRECTLY HAVE CONTRIBUTED TO THE MEDICAL MALPRACTICE INSURANCE CRISIS.

A. A Review Of The Investment Portfolios And Their Effect On The Financial Condition Of Seven Liability Insurance Companies, That Have Written Or Are Writing Medical Malpractice Insurance In California, Shows That Stock Market Losses Have Not Been Included In Medical Malpractice Insurance Premiums.

- As a composite these companies have experienced from all lines of liability insurance underwriting losses for a five-year period ending December 31, 1974 of 1.8 percent.

- For calendar year 1974 the loss was 13.5 percent.

- The net operating results of these composite companies show an after-tax profit equivalent to a 3.88 percent compounded rate of return on the average stockholder's investment after absorbing the 1.8 percent underwriting loss for the five-year period.

B. Indirectly, Unrealized Stock Market Losses Eroded The Availability Of Liability Insurance, Particularly Medical Malpractice, A Company Can Write.

- The capacity of insurance a company may write is in proportion to its surplus.

- Large underwriting losses for medical malpractice insurance resulted in limited availability of malpractice insurance because of its unpredictability.

- Unrealized losses in common and preferred stock investments still owned by the composite companies as of December 31, 1974 eliminated 36 percent of their surplus based on operating results for the five-year period.

X. LEGAL COSTS FOR SETTLEMENT OF MEDICAL MALPRACTICE CLAIMS IN CALIFORNIA OVER THE PAST 15 YEARS CONSTITUTE APPROXIMATELY 42 PERCENT OF THE TOTAL CLAIM COSTS.

A. Of The Total Projected Claim Cost Of $900 Million, Legal Costs For Plaintiffs And Defense Attorneys Are Estimated To Be $378 Million, Or 42 Percent Of the Total.

- Disposition of the total claim cost is estimated on the assumption that recently passed legislation will have no effect on future claim costs, and is as follows:

Disposition of Claim Cost Dollars
For Medical Malpractice Insurance
1960 Through 1974
(In Millions of Dollars)

	Claims Paid	Claims To Be Paid	Total Claim Cost	% Of Award	% Of Total Claim Cost[1/]
Indemnity to Plaintiffs	$110	$385	$495	66%	55%
Plaintiffs' Legal Fees	56	196	252	34%	28%
Total Award to Plaintiffs	$166	$581	$747	100%	83%
Defense Legal Cost	28	98	126		14%
Other Claim Cost	6	21	27		3%
Total Claim Cost	$200	$700	$900[2/]		100%

- Attorney contingency fees for medical malpractice cases range from 25 percent to 50 percent, with 33-1/3 percent representing the average fee. The California Trial Lawyers Association stated that this was the best figure available and was used to project total plaintiffs' legal costs. Defense legal costs consume approximately 14 percent of the total claim cost dollar.

- Plaintiffs' attorney fees are calculated on the amount of the award after deducting direct costs incurred in connection with prosecution or settlement of the claim, and can result in the plaintiff's attorney receiving more than the 34 percent of the award shown above.

1/ Legal costs were not related to total premiums collected for medical malpractice insurance due to the inadequacy of rates charged for the 15-year period 1960 through 1974.

2/ See Appendix A.

- Approximately one-half of the medical malpractice claims filed are settled with no indemnity payment, which means that plaintiffs' attorneys working on a contingency fee basis received no compensation for their services in those cases.

- Approximately $84 million has been paid in legal costs on closed claims for cases settled between 1960 and 1974, and it is estimated that an additional $294 million will be expended for future claims for the above 15-year period.

Combined Legal Costs
(In Millions of Dollars)

	Claims Paid	Claims To Be Paid	Total	Percent of Legal Cost
Plaintiffs' Legal Fees	$56	$196	$252	67%
Defense Legal Cost	28	98	126	33%
Total Legal Costs	$84	$294	$378	100%

XI. RECENTLY ENACTED LEGISLATION MAY, IN THE LONG RUN, REDUCE THE AWARDS GRANTED IN MEDICAL MALPRACTICE CLAIMS AND MAY ULTIMATELY HAVE A BENEFICIAL EFFECT ON MALPRACTICE INSURANCE RATES. HOWEVER, THIS LEGISLATION WILL HAVE LITTLE IF ANY IMMEDIATE IMPACT ON THE CURRENT MEDICAL MALPRACTICE INSURANCE CRISIS.

The primary provisions of both Assembly Bill 1 and Senate Bill 24 of the Second Extraordinary Session of the 1975 California Legislature are of such nature that (1) the effects will depend upon interpretations and applications by the courts and administrative bodies, or (2) the basic data necessary to make reliable projections using analytical methods is not available.

Therefore, in order to determine the probable effects of this legislation, the following were contacted, by surveys and interviews: the Department of Insurance, insurance companies providing medical malpractice insurance, insurance brokers, plaintiff and defense attorneys active in the field of medical malpractice, the California Trial Lawyers Association, and the California Medical Association.

A. The Board Of Medical Quality Assurance Was Established To Replace The Board Of Medical Examiners With Expanded Membership And Added Responsibilities And Authority.

- In the long-term the strengthening of the regulatory board for physicians may reduce malpractice insurance rates by identifying and eliminating the small percentage of practitioners who are incompetent and contribute disproportionately to the spiraling cost of malpractice premiums.

- The immediate impact on medical malpractice rate setting will be minimal since any actions taken by the Board will not affect acts which have already occurred.

B. Limitations Have Been Imposed On The Percentages Which Plaintiffs' Attorneys May Charge As Contingency Fees In Medical Malpractice Suits.

- The limitations which have been imposed on attorney contingency fees in medical malpractice cases are:

  40 percent of the first $50,000 net amount recovered by the claimant

  33-1/3 percent of the next $50,000 net amount recovered by the claimant

  25 percent of the next $100,000 net amount recovered by the claimant

  10 percent of any amount over $200,000 net amount recovered by the claimant.

- We applied these percentages to all indemnity payments which we reviewed for the 15-year period 1960 through 1974. The average contingency fee allowable would have been 36 percent.

- Unless the amount of medical malpractice settlements continue to increase in the future there will be little if any effect on medical malpractice insurance rates as a result of limitations imposed on attorney contingency fees.

C. Awards For Noneconomic Losses On Medical Malpractice Cases Are Limited To A Maximum Of $250,000.

- The seven major medical malpractice insurance carriers which were reviewed paid 32 settlements in excess of $250,000 during the 15-year period 1960 through 1974. These settlements included economic and noneconomic losses. From the information developed it is not possible to determine what the exact reductions would have been had these limitations been in effect. A schedule of these payments is shown below.

Claims Paid in Excess of $250,000
During the Period 1960 through 1974

Year of Payment	Number of Claims	Amount Paid	Amount Paid In Excess of $250,000
1968	1	$ 300,000	$ 50,000
1970	3	829,000	79,000
1971	2	748,000	248,000
1972	1	350,000	100,000
1973	11	3,638,000	888,000
1974	14	7,143,000	3,643,000
Total	32	$13,008,000	$5,008,000

- The number of large settlements per year has been increasing over the last three years. However, the new statutory limits on the amounts which may be awarded for noneconomic losses may have an effect on future medical malpractice insurance rates.

D. The Statute Of Limitation Provision Requires Legal Action Be Started No Later Than Three Years After The Date Of Injury Or One Year After Discovery Of Injury, Except In Cases Of Fraud Or Intentional Concealment, Or Unintentional Foreign Objects Left In The Body.

- Individuals contacted projected minimal effects on claim costs resulting from this limitation. It is therefore unlikely that there will be any reductions in medical malpractice insurance premiums until the effects are demonstrated.

E. Courts Will Allow Periodic Payments Rather Than Lump Sum Settlements For Awards In Excess of $50,000 For Future Damages With Unused Balances Returned To The Insurer Upon Termination Of Need.

- This provision has the potential to ultimately reduce medical malpractice insurance premiums, but it is not anticipated that premiums will be reduced until savings to the insurance companies have been demonstrated.

F. Other Sources Of Compensation Such As State, Federal, Or Private Disability Plans May Be Introduced Into Evidence And Taken Into Consideration In Determining The Amounts Of Awards.

- There will be no immediate decrease in medical malpractice insurance rates as a result of this provision because there is no requirement that collateral source benefits be offset against judgments.

G. Before Care Is Provided, A Physician May Require Patients To Contractually Agree To Binding Arbitration Of Any Disputes Over Medical Care.

- The consensus of opinion among individuals contacted is that patients may feel that they are being coerced into signing an arbitration contract since they are not usually in a bargaining position when visiting the doctor. It is therefore anticipated that the constitutionality of this provision will be challenged.

XII. DOCTOR-OWNED INSURANCE COMPANIES AND THE JOINT UNDERWRITING ASSOCIATION WILL ASSURE THE AVAILABILITY OF MEDICAL MALPRACTICE INSURANCE, BUT WILL HAVE LITTLE EFFECT ON AFFORDABILITY OF THIS INSURANCE, AND THEREFORE WILL NOT RESULT IN A SOLUTION TO THE CURRENT MEDICAL MALPRACTICE INSURANCE CRISIS.

A. The Department Of Insurance Has Authorized Two Doctor-Owned Insurance Companies Which Will Provide Short-Term Relief In The Reduction Of Medical Malpractice Insurance Rates Through The Vehicle Of Claims-Made Policies.

- Claims-made policies differ from occurrence policies in that claims-made premiums are based on claims reported during a one-year period that the policy is in force. The occurrence policy covers any claim arising as a result of an incident during the year of coverage and reported in future years.

- Claims-made policies provide a more accurate method for pricing medical malpractice insurance.

- In order to obtain the initial capitalization required to write medical malpractice insurance by the doctor-owned companies, it will be necessary for the companies to collect from their policyholders a substantial capital contribution as well as the first year's premium.

- A claims-made policy will have a lower premium in the first year than the occurrence policy. However, when the required capital contribution is added to the claims-made first year premium, the total cost to the doctor will approximately equal the occurrence policy premium.

- The capital contribution made by the doctors may not be tax deductible which will result in an additional drain on doctors' resources.

- Premiums on a claims-made policy will eventually approximate those charged for an occurrence policy.

- The claims-made policy ratemaking procedures will result in the necessity to purchase the "Tail Coverage" (i.e., those claims on a policy year which will be reported in future years) in the final year and could result in considerable cost to the physician.

- Several attempts to form doctor-owned companies in other states resulted in financial failure.

B. The Joint Underwriting Association (JUA) Was Created By The Legislature To Assure The Availability Of Medical Malpractice Insurance.

- The JUA is composed of all insurance carriers writing liability insurance in California, excluding ocean marine insurance. The JUA will provide medical malpractice insurance in the event it is unavailable from private insurance carriers.

- Policies issued through the JUA will be on a claims-made basis which is the same as the doctor-owned companies.

- The Insurance Commissioner has verbally recommended to physicians that the JUA be used only as a "last resort".

XIII. A CALIFORNIA MEDICAL MALPRACTICE INSURANCE STUDY PREPARED BY BOOZ, ALLEN CONSULTING ACTUARIES, FOR THE OFFICE OF THE AUDITOR GENERAL, STATE OF CALIFORNIA.

Booz, Allen Consulting Actuaries was contracted to assist in this study in accordance with requirements of Assembly Concurrent Resolution No. 83.

Basic data for their study and resulting report was provided to the actuaries by the Office of the Auditor General.

Their report is included in its entirety as Appendix A of this report.

The actuaries, in their projection of 1976 premium rates in Section IV of their report (Appendix A), used Insurance Services Office data rather than actual premium rates in California.

In our opinion these rates do not reflect California experience. The highest rates to be in effect January 1, 1976 in California, by the three largest carriers, will be approximately $4,800 per year for general practitioners (representing 51 percent of physicians) while the highest-rated specialists will be between $24,500 and $36,000. The actual rates of the highest-rated specialists will depend on the outcome of the Order of Non-Compliance filed by the Department of Insurance against a Southern California carrier discussed on page 20 of our report.

Surcharges may be added to rates based upon an individual's claims history.

POSSIBLE SOLUTIONS FOR LEGISLATIVE CONSIDERATION

The following are offered as possible solutions to provide for the application of more precise actuarial methods to price medical malpractice insurance, place limitations on the losses which both doctors and insurers should reasonably be expected to absorb, and assure the continuing availability of medical malpractice insurance for the benefit of all concerned.

1. Legislation be enacted which will require all physicians practicing in California to be covered by malpractice insurance.

BENEFITS

THIS WILL ASSURE ALL CITIZENS THAT FUNDS WILL BE AVAILABLE TO COMPENSATE THEM FOR LOSSES IN THE EVENT THEY BECOME VICTIMS OF MEDICAL MALPRACTICE.

2. Legislation be enacted which will require insured physicians to pay the first $1,000 of each malpractice claim. In addition, all physicians be required to post bonds or securities with the Board of Medical Quality Assurance in an amount sufficient to assure these payments.

BENEFITS

THIS WILL PLACE THE RESPONSIBILITY FOR SETTLEMENT OF "NUISANCE CLAIMS" WITH THE PHYSICIANS AND SHOULD ACT AS AN INDUCEMENT FOR PHYSICIANS TO IMPROVE THE PHYSICIAN-PATIENT RELATIONSHIP.

3. Legislation be enacted which will place a per claim limitation on the liability of insurance companies and provide that the state will be liable for settlement in excess of this limitation.

BENEFITS

THERE ARE RELATIVELY FEW EXCEPTIONALLY LARGE MEDICAL MALPRACTICE SETTLEMENTS, BUT THEIR RATE OF OCCURRENCE HAS BEEN INCREASING AND INSURERS MUST PROVIDE FOR THEIR EVENTUALITY IN ESTABLISHING RATES. THIS WILL ENABLE INSURERS TO DISCOUNT THIS EVENTUALITY AND REDUCE THEIR RATES ACCORDINGLY.

4. Legislation be enacted requiring the availability of medical malpractice insurance on a claims-made basis, through private insurance carriers.

BENEFITS

ONE OF THE MOST VEXING PROBLEMS OF MEDICAL MALPRACTICE INSURANCE IS THE LONG PERIOD, OR "TAIL", OVER WHICH AN INSURER MAY BE HELD LIABLE. THIS WILL ELIMINATE THE "TAIL" AND ASSOCIATED PROBLEMS.

5. Legislation be enacted which will require medical malpractice insurers to implement nondiscriminatory rate making procedures. Items to be considered in arriving at resulting rates should include:

- High volume practices vs low volume practices
- Urban physicians vs rural physicians
- High risk physicians vs low risk physicians
- High risk specialty vs low risk specialty.

BENEFITS

THIS WILL ASSURE THAT DOCTORS IN LOW RISK PRACTICES ARE NOT SUBSIDIZING THE HIGH RISK DOCTORS.

6. Amend Section 800(c) of part (5) of the Business and Professions Code to provide that contents of any central file, pertaining to an individual physician, maintained by the Board of Medical Quality Assurance be made available to any insurance company which has received an application for malpractice insurance from that physician or any physician currently insured by the requesting insurance company.

BENEFITS

IN ORDER FOR INSURANCE COMPANIES TO ARRIVE AT NONDISCRIMINATORY RATES IT IS MANDATORY THAT THEY HAVE ACCESS TO PERTINENT DATA.

California Medical Malpractice Insurance Study

a report prepared by

Booz, Allen Consulting Actuaries
Newport Beach, California
a division of Booz, Allen & Hamilton, Inc.

for the

Office Of The Auditor General
State of California

December 5, 1975

BOOZ · ALLEN CONSULTING ACTUARIES
A DIVISION OF BOOZ · ALLEN & HAMILTON Inc.

660 NEWPORT CENTER DRIVE
NEWPORT BEACH, CA 92660
(714) 640-4900

December 5, 1975

Joint Legislative Audit Committee
State of California
Sacramento, California 95814

Dear Committee Members:

We have completed our work on the California Medical Malpractice Insurance Study and a copy of our final report is attached.

We appreciate this opportunity to work for the Office of the Auditor General of the State of California and look forward to being of service in the future.

Very truly yours,

R.W. Beckman

R. Woody Beckman
Fellow, Casualty Actuarial Society
Member, American Academy of Actuaries

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TABLE OF EXHIBITS

INTRODUCTION

This report is responsive to our assignment arising out of Assembly Concurrent Resolution #83 relative to medical malpractice insurance. The report is based on a number of estimates and assumptions that are identified herein.

It is the nature of medical malpractice insurance, due to the time required to discover and settle claims, to require estimates and assumptions in projecting and evaluating claim experience. That fact does not, however, undermine the basic conclusions drawn in the course of our study:

- Premiums paid by California doctors for medical malpractice insurance have increased significantly over the past fifteen years, but have not kept pace with increasing claim costs.
- The current malpractice crisis has been caused in part by poor pricing by the insurance industry, for premiums have increased erratically while claim cost increases have been relatively steady.
- The current malpractice crisis has been caused in part by a shortage of insurance companies offering malpractice insurance coverage.
- The insurance industry has collected more premium than it has paid in claims for medical malpractice insurance written in California over the past fifteen years, but future claim payments on past coverage will ultimately result in a severe net loss to the industry.

- Income on invested premium funds will alleviate the situation to some extent for the industry, but the net loss will remain severe.

- The medical profession in California over the past fifteen years has paid an inadequate amount for its medical malpractice insurance coverage.

- The average premium in 1976 is expected to be about five times higher than the 1974 average.

The following sections support the foregoing conclusions, and provide a measure of detail.

Information has been collected from companies who have had experience writing a large portion of the malpractice insurance in California, and from this large sample we have estimated statewide results. Data used in the study has been provided or verified by the Auditor General for the most part, but our assumptions and conclusions have been independently developed. Information has also been collected from the California Medical Association, the California Insurance Department, individual physicians, the Assembly Select Committee on Medical Malpractice and various published sources.

Our analysis has been restricted to claims that have been settled and paid. In this way, we have avoided the difficulties associated with evaluating claim reserving practices of insurance companies. However, some estimates and assumptions have been necessary and are identified herein.

I. THERE ARE FEW INSURANCE COMPANIES PROVIDING MEDICAL MALPRACTICE INSURANCE IN CALIFORNIA

1. Group Plans Now Provide Insurance For More Than 50% Of The Office-Based Doctors Practicing In California

- There are approximately 28,000 office-based physicians practicing in California in 1975.
- Four group plans have been in operation for several years, each covering a specific geographic part of California, and collectively insuring about 15,000 doctors (see Exhibit I following this page).
- All doctors covered under group plans have been apprised of substantial rate increases in 1975 or 1976, and at least two carriers are issuing only three-month policies.
- Doctors not included in the group plans are either insured with another company or are uninsured.

2. There Are No Insurance Companies Writing A Significant Number Of Individual Doctors As Of October, 1975

- Only three companies have been a major factor during the last year.
- One company voluntarily withdrew from the medical malpractice market.

EXHIBIT I

State of California
MEDICAL MALPRACTICE INSURANCE AVAILABILITY

Carrier	Approximate Number Of Insured	Geographic Area	Recent Action	Other Comments
A. Group Plans				
1) Travelers Insurance Co.	6,900	Covers all Southern California counties except San Diego, Imperial & Riverside	486% rate increase announced and being challenged by insurance department	Doctor-owned company planned
2) CNA (Continental National)	1,200	Covers Riverside, Imperial, San Diego Counties	190% rate increase announced, issuing three-month policies	
3) Argonaut Insurance Co.	3,400	Covers San Francisco, Alameda, Contra Costa, Marin, Shasta, Solano, Siskiyou, Trinity Counties	Rate increases up to 320% in May, 1975, issuing three-month policies, making no commitment for long-term coverage	Doctor-owned Medical Insurance Exchange of California established
4) Travelers Insurance Co.	3,500	All Northern California counties except above	341% rate increase announced	Doctor-owned company planned
B. Largest Individual Carriers				
1) Imperial	3,500	Statewide	Placed under conservatorship by California insurance commissioner effective September 24, 1975 Policies not being renewed	A subsidiary of Signal Insurance Company Preferred risk carrier
2) Pacific Indemnity (Chubb Corp)	2,500	Southern California	Stopped renewing policies effective January 1, 1975	Preferred risk carrier
3) Signal	500	Statewide, provides excess rate coverage	Placed under conservatorship by California insurance commissioner effective September 24, 1975 Policies not being renewed	High risk carrier

Sources:
- Assembly Select Committee on Medical Malpractice, Preliminary Report, June, 1974, see Appendix, Exhibit C.
- Professional Liability Newsletter, September, 1975, July, 1975, February, 1975.
- Best's Insurance News Digest, Property/Liability Edition, September 29, 1975.

- Two companies were placed under conservatorship by the California insurance commissioner on September 24, 1975.

- Other companies insure some doctors, either as individuals or as part of groups such as hospital employees and the American College of Obstetricians and Gynecologists.

3. Doctor-Owned Companies Are Being Organized To Provide Insurance

- Insurance companies to be owned by doctors are being organized to sell insurance in several areas of the State.

- The California Medical Association and the American Medical Association have been contemplating establishing companies to offer insurance or reinsurance.

II. CALIFORNIA MEDICAL MALPRACTICE IS ESTIMATED TO ULTIMATELY PRODUCE A NET LOSS OF APPROXIMATELY $400,000,000 TO THE INSURANCE INDUSTRY FOR COVERAGE PROVIDED DURING THE PERIOD 1960 THROUGH 1974

The aggregate statewide medical malpractice insurance experience over the fifteen-year period of 1960 through 1974, subject to the stated assumptions which include a continuation of historical trends, is estimated as follows:

. Revenue	
- Premium	$450,000,000
- Investment income	100,000,000
- Total	$550,000,000
. Disbursements	
- Claims paid through 1974	$200,000,000
- Claims to be paid after 1974	700,000,000
- Expenses	50,000,000
- Total	$950,000,000
. Net loss to insurance industry	$400,000,000

1. Total California Medical Malpractice Revenues For Insurance Issued During The 1960 Through 1974 Period Are Estimated To Be $550,000,000

(1) Insurance Premiums For The 1960 Through 1974 Period Are Estimated To Total $450,000,000

. During the fifteen years from 1960 through 1974 the number of office-based doctors practicing in California increased from 21,000 to 28,000, all of whom are assumed to have purchased medical malpractice insurance.

. Doctors in the study are generally those in the medical society programs, and it is assumed that their medical malpractice insurance characteristics are the same as other insured doctors.

. Based on the above assumptions, insurance premiums of about $450,000,000 were collected for the years 1960 through 1974 (see Exhibit II following this page).

. The estimated premium is intended to reflect total limits medical malpractice insurance as actually purchased.

2. Investment Income On Insurance Issued During The 1960 Through 1974 Period Is Estimated To Ultimately Total $100,000,000

. Insurance companies are able to invest premiums collected less expenses that must be paid.

. Invested premiums are held for an average of about five years before claims must be paid.

EXHIBIT II

State of California
ESTIMATED INSURANCE COMPANY
REVENUE

Calendar Year	Doctors In California (000)	Doctors In Study (000)	Study Percentage (%)	Earned Premiums ($000)	Premium Per Doctor ($)	Premium Increase (%)	Investment Income ($000)
1960	21	4	19	$ 9,000	$ 400	-	$ 2,000
1961	22	4	18	10,000	500	25	2,000
1962	22	4	18	10,000	500	0	2,000
1963	23	10	43	9,000	400	-	2,000
1964	23	11	48	9,000	400	0	2,000
1965	24	12	50	10,000	400	0	2,000
1966	24	13	54	11,000	500	25	3,000
1967	25	15	60	13,000	500	0	3,000
1968	25	17	68	19,000	800	60	5,000
1969	25	18	72	33,000	1,300	63	8,000
1970	26	15	58	46,000	1,800	38	11,000
1971	26	14	54	55,000	2,100	17	13,000
1972	27	14	52	60,000	2,200	5	14,000
1973	27	22	81	60,000	2,200	0	14,000
1974	28	21	75	73,000	2,600	18	17,000
Totals	368	194	53%	$427,000	$ 16,600	550%	$100,000

- Invested premiums are assumed to earn 5% compound interest, before federal income taxes, which is probably high for the early years and low for the later years, for the five-year holding period.

- Investment income is allocated to the year the premium was collected although the income is earned over a five-year period.

2. Insurance Companies Are Estimated To Ultimately Pay A Total Of Approximately $950,000,000 For Claims And Operating Expenses For The Malpractice Insurance Coverage Sold From 1960 Through 1974 In California

(1) Claim Payments Through 1974 Are Estimated To Total $200,000,000

- Statewide estimates of claim payments were developed in the same way that premiums were estimated (see Exhibit III following this page).
- Claim payments are largely from the 1960's and include only a small amount from the 1970's because of the slow claim settlement process.
- Claim payments include actual payments on closed claims during the 1960 through 1974 study period, and include the insurance companies' claim settlement expenses that can be charged to a specific claim (for example, fees for outside counsel and investigation).
- A large number of all malpractice claims are settled with no payment to the claimant although the corresponding claim settlement expenses average more than $1,000 per claim.

(2) Future Claim Payments Are Estimated To Total Approximately $700,000,000

- Future claim payments are projected based on actual claim payment patterns by year, and are not dependent on company or other claim estimates, but do assume a continuation of historical patterns.
- Medical malpractice claims are reported over many years (see Exhibit IV following Exhibit III)

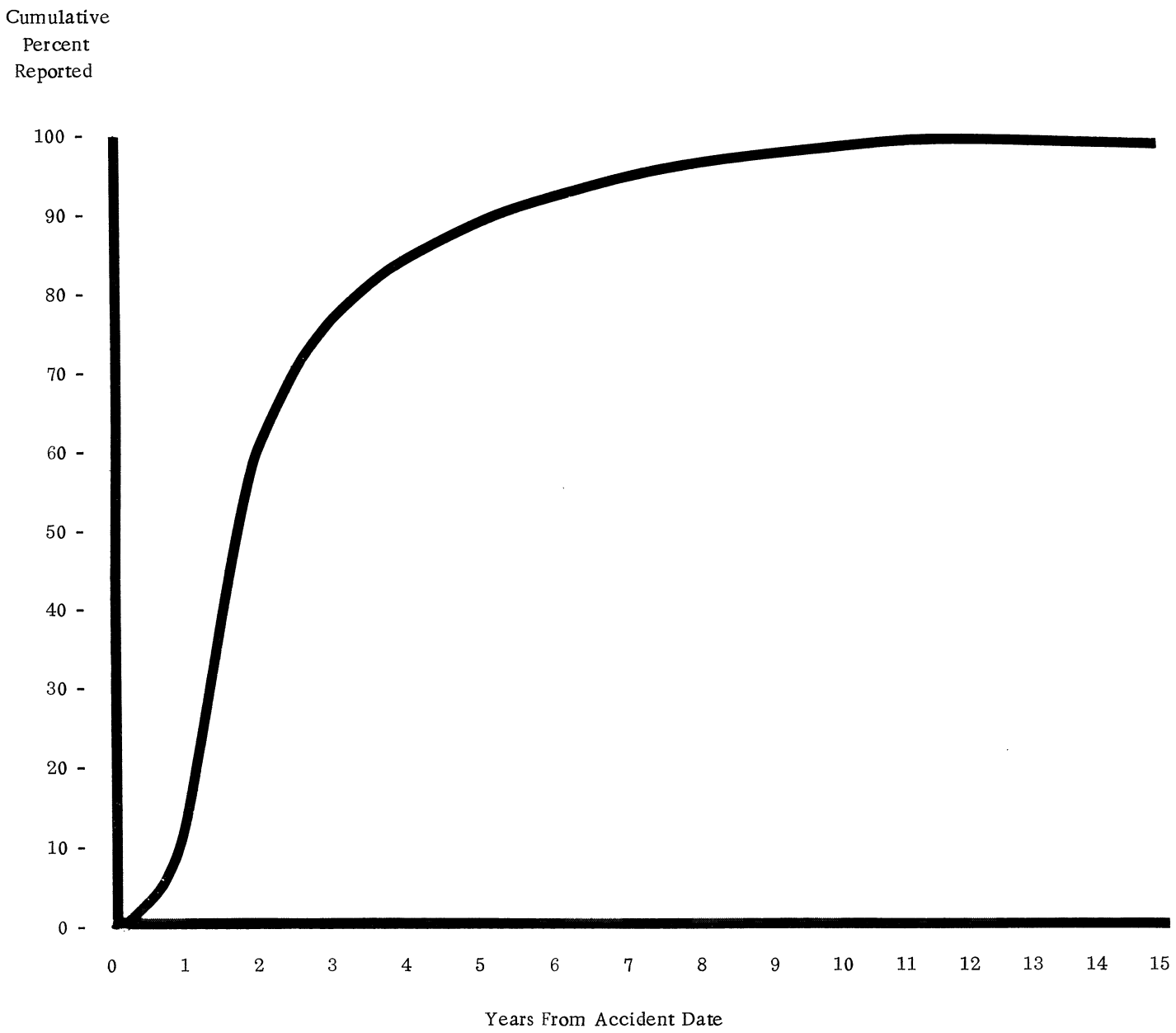
EXHIBIT III

State of California
ESTIMATED INSURANCE COMPANY
DISBURSEMENTS

Calendar Year	Claims Paid ($000)	Claims Incurred ($000)	Claims Per Doctor ($)	Claim Increase (%)	Expenses Paid ($000)
1960	$ 9,000	$ 9,000	$ 400	-	$ 1,000
1961	7,000	7,000	300	-	2,000
1962	10,000	10,000	500	67	2,000
1963	11,000	12,000	500	0	1,000
1964	14,000	16,000	700	40	1,000
1965	16,000	22,000	900	29	2,000
1966	23,000	26,000	1,100	22	2,000
1967	24,000	35,000	1,400	27	2,000
1968	21,000	45,000	1,800	29	3,000
1969	20,000	58,000	2,300	28	5,000
1970	17,000	75,000	2,900	26	7,000
1971	13,000	96,000	3,700	28	8,000
1972	4,000	127,000	4,700	27	9,000
1973	1,000	162,000	6,000	28	9,000
1974	-	213,000	7,600	27	11,000
Totals	$190,000	$913,000	$34,800	1,800%	$65,000

EXHIBIT IV

State of California
REPORTED CLAIMS



- About 15% of claims resulting from medical procedures in a year are reported during that year.

- About 35% of claims are reported in the second year.

- About 20% of claims are reported in the third year.

- About 10% of claims are reported in the fourth year.

- About 20% of claims are reported after the fourth year.

. There is a long delay in paying the average medical malpractice claim (see Exhibit V following this page) because of both slow reporting and often lengthy litigation.

- Less than 5% of claim dollars are paid in the year of the incident.

- About 5% of claims are paid in the second year.

- About 10% of claims are paid in each of the third through eighth years.

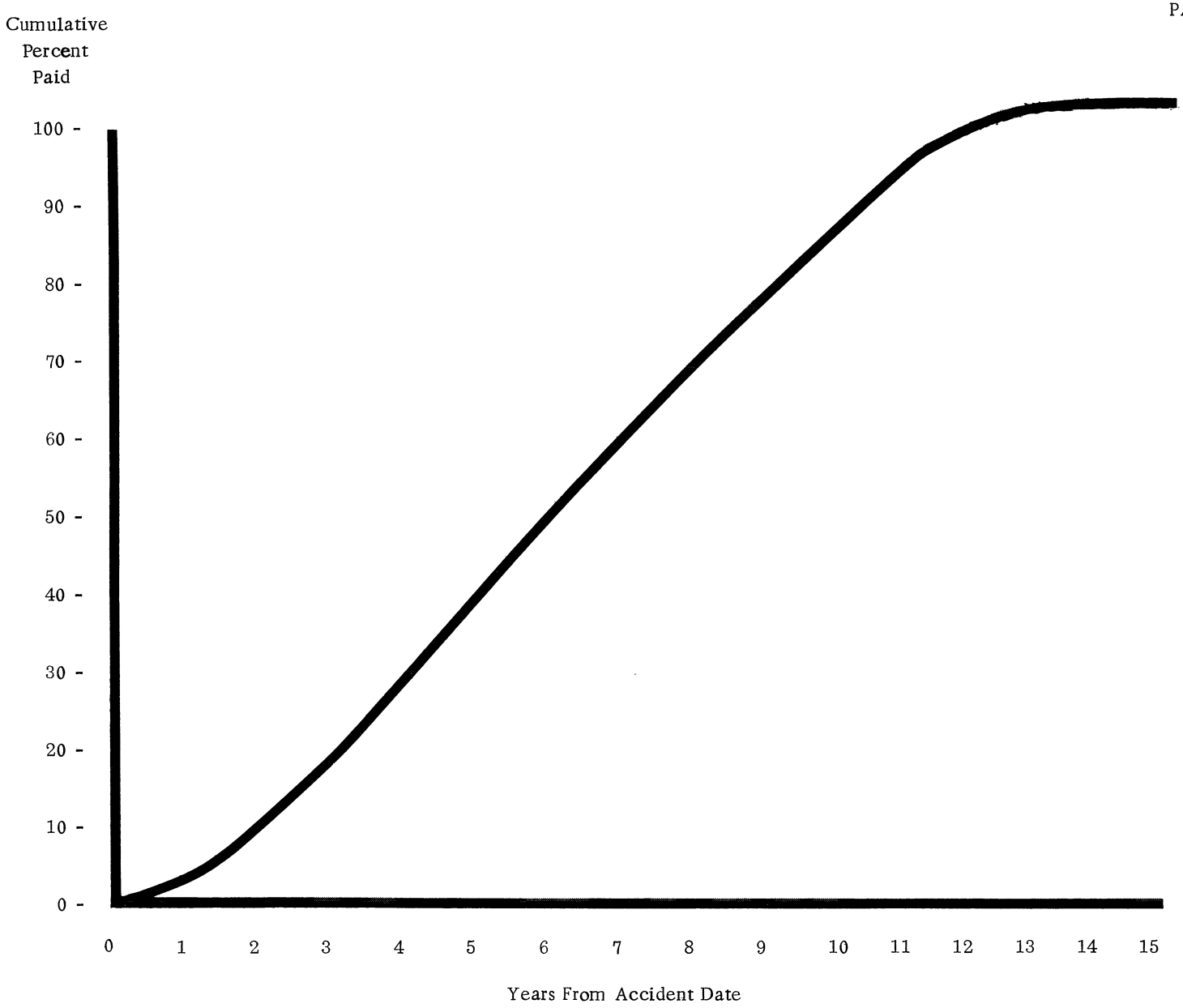
- About 30% of claims are paid after the eighth year.

(3) Expenses Are Estimated To Total $50,000,000

. Expenses include commissions, premium taxes and company overhead, but exclude claim settlement expenses that are included with claim payments.

EXHIBIT V

State of California
PAID CLAIMS



- Expenses are assumed to be 15% of premiums, which is somewhat lower than most other liability insurance, but reflects the heavy concentration in group plans with commissions of 6% or less.

III. PREMIUMS PAID BY CALIFORNIA DOCTORS HAVE INCREASED SIGNIFICANTLY OVER THE PAST FIFTEEN YEARS BUT HAVE NOT KEPT PACE WITH INCREASING CLAIM COSTS

1. Premium Increases Have Been Erratic But Have Averaged About 15% Per Year

- Premium per doctor has increased from $400 in 1960 to $2,600 in 1974 (see Exhibit II).
- The fifteen-year increase is 550%, or an annual increase of 14%.

2. Claim Cost Increases Have Been Relatively Steady At About 25% Per Year

- Claim costs per doctor have increased from $400 in 1960 to $7,600 in 1974 (see Exhibit III).
- The fifteen-year increase is 1,800%, or an annual increase of 23%.

3. Large Premium Increases Have Been Announced For 1975 And 1976, But, Once An Adequate Premium Level Is Reached, Annual Premium Increases In Future Years Should Be About 25% Assuming A Continuation Of Historical Rates Of Claim Cost Increases

- Premium increases of up to 500% have been announced for the group plans in California.

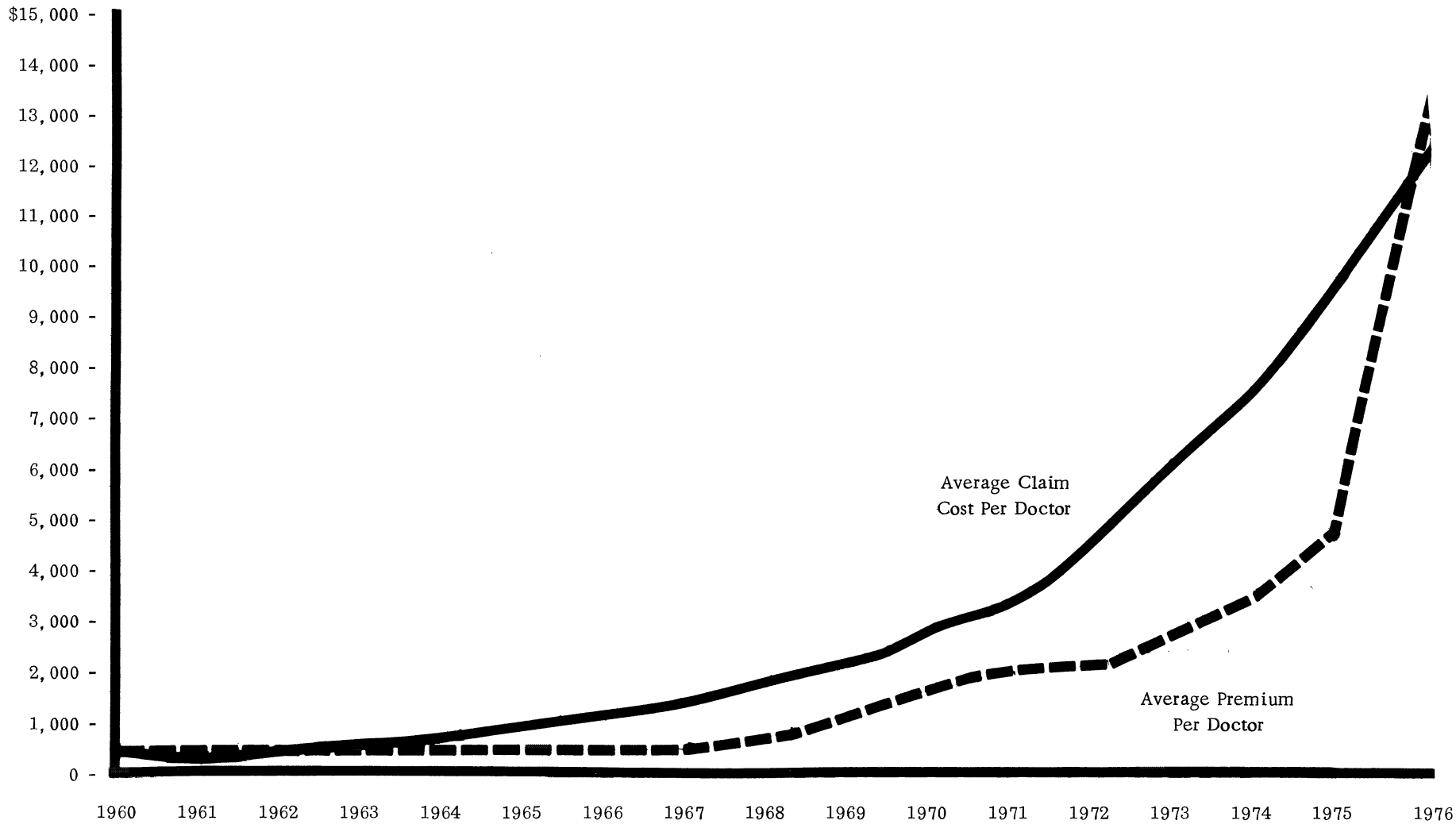
- These premium increases result primarily from previous ratemaking error, whereby the insurance was underpriced, and only partially from recent increases in claim costs (see Exhibit VI following this page).

- For California as a whole, significant premium increases are needed to adequately charge for current insurance coverage.

- Future premium increases should follow claim cost increases which over the last fifteen years have increased about 25% per year.

EXHIBIT VI

TOTAL STATE OF CALIFORNIA
MEDICAL MALPRACTICE INSURANCE



IV. PREMIUMS PAID BY CALIFORNIA DOCTORS IN 1976 ARE PROJECTED TO BE ABOUT FIVE TIMES THE AMOUNT PAID IN 1974

1. The Average Premium For 1976 Is Estimated At $14,000, Which Is More Than Five Times Higher Than The $2,600 Average In 1974

- The average claim cost per doctor is projected to be $12,000 in 1976, based on a continuation of the current trend of nearly 25% per year.
- About 15% is added to cover insurance company expenses.
- Investment income is a significant factor and should produce a return to the insurer of approximately 20%.

2. Premium Rates Vary Substantially By Doctor Specialty And Somewhat By Location, Reflecting Differences In Claim Costs

Analysis of claim costs by specialty and location should be based on the largest body of data available to minimize the impact of random fluctuations. Accordingly, the indicated 1976 premiums shown on Exhibit VII, following this page, are based on the ISO's nationwide distribution of doctors by specialty. Any geographic area with a different distribution of doctors would have a different schedule of indicated 1976

EXHIBIT VII

State of California
RELATIVE INSURANCE COST
BY MEDICAL SPECIALTY

Classification	Proportion Of Doctors	Premium Relationships Indicated by ISO Study	Indicated 1976 Premium
Physicians - no surgery	51%	$ 100	$ 6,000
Physicians - minor surgery or assisting in major surgery on own patients (5% or less)	15	180	11,000
Ophthalmologists	2	200	13,000
Proctologists	*	250	16,000
Cardiologists - including catheterization, but not including cardiac surgery	9	290	18,000
Anesthesiologists	4	300	19,000
Urologists	1	310	20,000
Otolaryngologists - plastic surgery	1	390	25,000
Otolaryngologists - no plastic surgery	1	440	28,000
Cardiac surgeons	*	460	29,000
Obstetricians - gynecologists	5	480	31,000
Plastic surgeons	*	520	33,000
Surgeons - general - specialists in general surgery	6	550	35,000
Orthopedists	3	760	48,000
Thoracic surgeons	1	840	53,000
Vascular surgeons	*	940	60,000
Neurosurgeons	1	970	62,000
Total	100%	220 (average)	$ 14,000

* Less than 1%

Source: Insurance Services Office -- Physicians and surgeons countrywide excluding Texas, policy years ending 1969 - 1972

premiums. The ISO analysis is based on the assumption that each medical specialty should bear the full costs of settling its malpractice claims.

- A general practitioner who performs no surgery is estimated to pay an average premium of about $6,000 for medical malpractice insurance protecting him against all claims arising from his 1976 practice.

- A general surgeon is expected to pay a corresponding average of about $35,000 in 1976.

- A neurosurgeon (the highest-rated class) is expected to pay a corresponding average of about $62,000 in 1976.

- The new doctor-owned companies are able to offer significantly lower premiums by providing coverage only for claims reported in 1976.

- Analysis indicates that there has historically been about a 20% differential in the State with Northern California claim costs being about 10% lower than the statewide average while Southern California is about 10% higher.

V. RECENT LEGISLATION INCLUDES SOME REFORMS THAT COULD EVENTUALLY REDUCE MEDICAL MALPRACTICE COSTS

Although it is beyond the scope of this study to analyze and evaluate legislative reform, recent legislation has the potential to reduce both the high medical malpractice costs and the 25% annual trend. However, this legislation must be supported by the courts and recognized by juries if there is to be a reduction in medical malpractice costs. The major features of this legislation include the following:

- Option for periodic payment of future damages at the request of either the plaintiff or the defendant when future damages exceed $50,000.
- Statute of limitations of one year after date of discovery with a few exceptions.
- Schedule for attorney's contingent fees.
- Limitation of $250,000 for non-economic loss.
- Recognition of collateral sources for defraying economic loss.

EFFECTS OF INVESTMENTS AND THEIR VALUATION ON THE FINANCIAL INTEGRITY AND SOLVENCY OF THE LIABILITY INSURANCE INDUSTRY AND RATES OF THE INDUSTRY, PARTICULARLY MEDICAL MALPRACTICE

December 19, 1975

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INTRODUCTION

In order to determine whether investment losses had been included in the setting of doctors' medical malpractice insurance rates, we reviewed the investment portfolios and their effect on the financial condition of seven liability insurance companies that have written or are writing doctors' medical malpractice insurance in California.

Because these companies have experienced underwriting losses for a five-year period ending December 31, 1974, we have concluded that investment losses could not have been included in determining insurance premiums.

Due to the potential for investment income to insurance companies from the investment of medical malpractice insurance premiums prior to payments to claimants, and the need to be competitive in order to obtain a share of the insurance business, the insurance companies may have intentionally charged inadequate rates for medical malpractice insurance. The inadequacy may have been caused by the anticipation that a portion of the investment income would offset the insurance losses. However, unrealized losses from common and preferred stock investments negated the potential investment income earned and the insurance companies may now have to charge adequate rates for insurance without consideration of investment income.

The potential insolvency of these companies as a composite has been brought about primarily by inadequate insurance rates, common and preferred stock investments made with policyholders' funds, and the procedures used for valuing the investment portfolio.

As the solvency of the entire casualty-liability insurance industry may be affected, a more detailed study of the financial condition, considering valuation procedures and review of investment authority, may be in order.

Effects of Valuation Procedures for Common and Preferred Stocks on the Financial Condition of the Liability Insurance Industry.

Unrealized losses from common and preferred stock investments of fire and casualty (liability) insurance companies have directly eroded the financial position of these companies. Future rate increases without the injection of new capital will further erode the financial condition of these companies temporarily, and will result in increased risks to policyholders due to the necessity to increase loss and loss expense reserves for prior years' insurance sold, particularly medical malpractice, at grossly inadequate rates.

The Insurance Commissioner of the State of California has adopted, for use by insurance comapnies that issue medical malpractice insurance policies, the "Valuation Procedures for Bonds and Stocks" issued by the Securities Valuation Office of the National Association of Insurance Commissioners. This requires that bond investments be carried at amortized book value while common and preferred stock investments are carried at market value.

Annual changes in market value of common and preferred stock investments still owned are then recognized by the insurance companies as if the investments had actually been disposed of by increasing or decreasing their surplus accordingly. No consideration is given to changes in the market value of bond investments.

In liability insurance companies, which include those that issue medical malpractice insurance, surplus is technically referred to as policyholders' surplus (PHS). PHS, therefore, consists of all capital and surplus invested in the insurance company by the stockholders plus miscellaneous other special surplus funds, all of which have the effect of being invested in the business by the stockholders.

PHS is one of the most critical measures of the solvency of an insurance company. To the extent PHS is less than the minimum required capital to do business in California, the company will be declared insolvent by the Insurance Commissioner and put into conservatorship. Also, PHS is used to establish various ratio tests to

determine the risk to policyholders. Among the 11 solvency test ratios, the most commonly used test is the ratio of net insurance premiums written to PHS. Presently, the Insurance Commissioner considers, as a rule of thumb, a ratio of $3 to $1 acceptable. However, this ratio has deteriorated since it was $1 to $1 in the mid-40s, $2 to $1 in the 60s, and $3 to $1 in 1974. Liability insurance companies may consider this increase a more prudent maximization of their PHS. However, the increase in premiums written results in less stated PHS available to cover losses due to inadequate rates, which increases the chances of statutory insolvency because of the increased leverage.

As a composite, for those companies we have analyzed which issue or have issued medical malpractice insurance for doctors in California, this ratio was $4.30 to $1 as of December 31, 1974.

In addition to the deterioration of the ratio of net insurance premiums written to PHS, PHS may be reduced to zero if further declines in the market values of common and preferred stock investments owned by these companies occur, even though present market values are in excess of historical cost. Increases in premiums will further deteriorate the ratio of net insurance premiums written to PHS and expose policyholders to greater risks, at least on a temporary basis due to the necessity to increase loss reserves for prior years' insurance sold, particularly medical malpractice, at grossly inadequate rates.

The financial solvency of liability insurance companies as a composite, that have written or are writing medical malpractice in California, is in jeopardy. Further, this condition may affect the entire liability insurance industry. On August 11, 1975, A. M. Best Co. announced that 24 percent of 1,000 liability insurance comapnies have been downgraded because of massive underwriting and stock market losses in 1974. This was the largest number of reduced ratings in the liability insurance industry since the Depression Era. A. M. Best Co. is considered the primary rating service for the liability insurance industry. Industry officials state that the "Best" rating affects their banking costs, clientele, and various other factors important to the viability of their companies.

On September 10, 1975, the Insurance Commissioner of the State of California found two insurance companies of seven we have reviewed to be insolvent. These companies have been ordered to stop writing or renewing any insurance policies. The Insurance Commissioner has informed us that another insurance company in our review has been requested to restrict writing of riskier lines of insurance, such as medical malpractice insurance.

In discussions with the Insurance Commissioner, we were told that if the market value of common and preferred stock investments owned by the companies declared statutorily insolvent were to materially increase, the companies would no longer be found to be insolvent.

In November 1975, in response to a questionnaire sent to the Insurance Commissioner of the State of California and Casualty Liability Insurance Companies, the consensus of opinion regarding the most pressing issues facing the liability insurance industry today was "the financial integrity and solvency of the industry". Some of the comments added were:

> Medical malpractice is merely a symptom of the disease. Inflation, increased litigation and liberal courts make it virtually impossible to price insurance adequately.
>
> Product liability insurance is a significant example of where we have growing concern.

Solvency of Liability Insurance Companies and Bond Investment Valuation Procedures.

By definition, solvency is defined as "able or sufficient to pay all legal debts". In liability insurance, particularly medical malpractice, all legal debts are not paid for a number of years.

Nonetheless, the California Insurance Code recognizes these liabilities today and makes no allowance for the fact that the funds necessary to meet these liabilities do not have to be disbursed immediately. If funds are not provided immediately to cover these future liabilities, the insurance company in the absence of adequate PHS will be declared statutorily insolvent and placed into conservatorship.

Bond investments made by insurance companies are carried at their amortized book value as opposed to their actual market value. This procedure was established in the mid-1930s, due to the Great Depression which resulted in an economic crisis. At that time, bonds were defaulting or their value was declining precipitously. Had this procedure not been established, many liability insurance companies may have been declared statutorily insolvent because prior to that time bonds were recorded at market value. At that time, it was recognized that the insurance business was on a "going concern basis" and "bonds were purchased for income, not capital appreciation".

To show the effect of what would have happened as of September 30, 1975, to five insurance companies if bonds were carried at market value as are common and preferred stocks, we have created the following table:

Effect to PHS If Bonds Were Carried At Market Value for a Composite of Five Liability Insurance Companies Who Have or Are Writing Medical Malpractice in California as of September 30, 1975[1/]
(In Thousands of Dollars)

9/30/75 Estimated PHS	Estimated Reduction to PHS if Bond Investments Were Carried at Market Value at 9/30/75	Estimated PHS at 9/30/75 if Bonds Carried at Market Value
$524,605	$(444,429)	$80,176

1/ Source of information was response to questionnaire sent to companies. Certain figures were given as estimates and no attempt was made to audit them. Figures include parent and subsidiary companies which may write insurance in states other than California and which may include parent companies investments in subsidiary companies.

From the above table it is obvious that if bond investments of insurance companies were valued the same way as common and preferred stocks, the potential for statutory insolvency would be great. Regardless, the availability of insurance would be greatly reduced without the injection of new capital or the discounting of all future loss and loss expense reserves.

Preferred Stocks Versus Bonds and Common Stocks as Investments.

Preferred Stock is assured by a corporation's charter of dividends before any are paid on the common and usually also have preference in distribution of assets.

Bonds are a written, interest-bearing certificate of debt with the promise to pay on a specific date, generally paying interest semi-annually.

Common Stock represents equity ownership of a business which includes participation in profits which may be paid out in the form of dividends.

Although each are unique types of investment vehicles and may contain unique provisions, common stocks are usually the only type bought for capital appreciation as well as growth of income.

Preferred stocks normally are bought for income because of certain tax advantages. Bonds are usually bought for income and offer a specified maturity date. Generally, the market value of bonds and preferred stocks tend to approximate each other since their market value is usually determined by the current level of interest rates.

The market value of preferred stocks of the composite of seven liability insurance companies we reviewed as of December 31, 1974 was $20 million less than their cost. If such investments were recorded at book value as bonds are carried at amortized book value, the PHS of the companies would be increased $20 million as of December 31, 1974.

Characteristics of the Ratemaking Process of Liability Insurance Companies.

The liability insurance industry, through actuarial science, estimates the losses from a given line of insurance. Further, it is permitted to include for ratemaking purposes the expenses necessary to pay these losses, including administrative expenses, taxes, clerical expenses and a reasonable profit.

Characteristics of Medical Malpractice Insurance Premiums as Opposed to Other Lines of Liability Insurance and Its Effects on Investments.

Medical malpractice insurance premiums, as with other liability insurance premiums, are collected in advance for the period of coverage.

The insurance comapnies may invest the premiums prior to their need to be paid to individuals making claims for damages.

However, medical malpractice insurance premiums remain with the liability insurance companies much longer than other lines of liability insurance such as fire, automobile and bodily injury. This is because of the number of years it takes to discover the injury and/or the time to complete the claims settlement process which is generally prolonged by litigation.

The following table illustrates the potential investment earnings to liability insurance companies from the use of premiums prior to their payment:

Potential Investment Earnings Available to Liability Insurance Companies from $1.00 of Insurance Premium Written Prior to Payment to Claimants

Type of Liability Insurance	Estimated Time Premiums Invested	Estimated Pre-Tax Earning Rate	Amount $1.00 Invested Will Provide Compounded Annually 2/
Fire	11 months	5%	$.03
Auto and bodily injury	1 year 1 month	5%	.04
Medical malpractice	5 years	5%	.22

2/ Insurance premiums written are recorded in an unearned premium account and are amortized daily until the expiration of the insurance period. Certain expenses are immediately paid for by the insurance companies which result in the temporary use of PHS. Therefore, we estimate that only 75 cents of each dollar are available for investment for auto and fire and 80 cents for medical malpractive.

The long period of time between collection of medical malpractice insurance premiums and the payment of claims provides the potential for more investment income than for other lines of liability insurance, and simultaneously permits the accumulation of significant cash reserves. The accumulation of these cash reserves permits the opportunity for liability insurance companies writing malpractice insurance to consider higher risk-reward investments such as common stocks which otherwise might not have been purchased, or in the same degree as would have been invested with fire or auto premiums.

The Investment Portfolio of the Liability Insurance Industry as of December 31, 1973.

The following table illustrates the size of the entire liability insurance industry investment portfolio and the amount of money which was provided by policyholders:

Investment Portfolios of 913 Fire and Casualty Insurance Companies and Other Selected Financial Data as of December 31, 1973

Total Investment Portfolios	PHS	Loss Reserves and Unearned Premiums 3/
$44.9 billion	$14.1 billion	$32.8 billion

3/ Source of data: "The Erosion in the Financial Position of Fire and Casualty Companies", prepared by Theodore J. Newton, Jr., Analyst, Blyth Eastman Dillon. However, per footnote 2/ on page 22, we calculated unearned premium reserve at 75 percent of the figure reported by Mr. Newton.

The leverage potential in the liability insurance industry is significant. For every dollar of PHS, $3.18 was invested. Therefore, policyholders provided $2.18 to insurance companies which was directly invested. Pre-tax investment income to the insurance companies at an assumed five percent earning rate would provide a potential 16 percent annual return to the companies. This does not consider the compounding of investment income or the potential for increases or decreases from changes in the market value of common stocks owned. However, loss reserves and unearned insurance premiums more accurately represent total funds provided by policyholders. Therefore, policyholders' funds actually permitted $2.33 as available for investment in addition to PHS.

The leverage, while providing for potential earnings to the companies, also creates a solvency risk to the industry should the value of common and preferred stocks owned decline. As of December 31, 1973, the value of common and preferred stock investments owned by these companies was $16.2 billion. The ratio of common and preferred stock investments owned to PHS was $1.15 to $1.00. A 10 percent reduction in the market value of common and preferred stocks owned would reduce the PHS of these companies by 11-1/2 percent.

The Risks of the Liability Insurance Industry.

The only inherent risk of the liability insurance industry should be the inability to accurately estimate the losses and expenses necessary to pay claims. To the extent these losses are underestimated, the loss is absorbed by the stockholders, not the policyholders.

As a means to offset these risks, provide additional profits and attract capital, the liability insurance industry makes investments.

The Risks of Valuing Common and Preferred Stocks at Market Value.

The recognition of annual changes in the market value of common and preferred stocks permits a roller-coaster effect on PHS.

When the general prices of securities rise, the liability insurance industry recognizes this by increasing their PHS accordingly. The Insurance Commissioner also recognizes this and has stated he would not question an insurance company writing new insurance business and incurring added insurance risks. However, because this is not permanent-type capital, a decline in the market value the following year would result in deterioration of the financial condition of the insurance companies as determined by one of the solvency measures used by the Insurance Commissioner.

Over the years, this procedure has permitted liability insurance companies to take on insurance risks without having invested permanent capital. However, when common and preferred stocks experience sharp and continued decline such as has been experienced recently, a possibility exists that many liability insurance companies could be declared insolvent even though the actual market value of the common and preferred stock investments is greater than their historical cost. Such a possibility exists today, because the regulation regarding investment in

common and preferred stocks does not consider the negative leverage effect this procedure could have on the industry.

Limitation of Investment Risk for Liability Insurance Companies

Section 1190 of the California Insurance Code requires minimum paid-in capital to be invested in certain securities, or in deposit in a national or state bank. The minimum paid-in capital in California for multiple lines companies is $1 million. Common and preferred stocks are not eligible for purchase under this requirement.

However, investments over the $1 million minimum requirement are considered excess investments and common and preferred stocks are eligible. Therefore, subject to regulations regarding the maximum amount invested in the common and preferred stock of a single corporation, a statutorily solvent liability insurance company may, after three years of operation, invest all excess funds in common and preferred stocks. Thus, it is permissible to use policyholders' funds for these investments and subject them to the investment risk which could result in the insolvency of the insurance company due to fluctuating economic conditions.

The Financial Position of Liability Insurance Companies That Have Written or Are Writing Medical Malpractice Insurance in California.

The question of investment losses being included in rates for medical malpractice or any other type of liability insurance for the period 1970 through 1974 is best answered by the financial results of these companies.

Analysis of the Financial
Results of a Composite of Insurance
Companies That Have Written or Are Writing
Medical Malpractice and Other Lines of Liability
Insurance in California for the Period 1970-74
(In Thousands of Dollars)

Net premiums written (from all lines)	$3,749,614
Net premiums earned	$3,652,967
Statutory pre-tax underwriting income (loss) reported	$ (92,827)
Pre-tax underwriting rate of return (loss)[4/]	(1.8%)
Pre-tax net investment income (loss)[5/]	$ 285,157
Reported net income (loss) after tax	$ 78,997
Common stocks dividends paid	$ 108,849
Average policyholder surplus	$ 376,765

4/ Rate determined by calculation of: (1) ratio of combined losses and loss of adjustment expenses incurred to earned premiums; and (2) ratio of underwriting expenses incurred to written premiums.

5/ Certain insurance programs, primarily workmen's compensation, may be issued with participation clauses. This results in the payment of dividends to policyholders as a profit share if there are any. During the 1970-74 period, $122,297,000 of such dividends were declared and paid with pre-tax net investment income.

The statutory underwriting losses reported are not indicative of actual losses incurred. Statutory insurance accounting recognizes all expenses paid in a year as chargeable to earned premiums while insurance companies do not actually earn all premiums written in the current year. The reported 1.8 percent rate of loss above was adjusted for this.

The insurance companies analyzed show a five-year composite loss from underwriting although profits would have been permissible under the ratemaking process. Further, the overall after-tax profit reported,

which includes investment earnings, underwriting and all other operations, is equivalent to a 3.88 percent compounded rate of return on PHS for the five-year period.

The operating results of these companies demonstrates that a windfall or excessive profit was not earned by these companies. However, these results do not clearly reflect the severe financial strain which has been put on these companies and how the leverage of their investment portfolio may result in their insolvency.

Effects on Policyholders Surplus 1970-74
Due to Unrealized Losses from
Common and Preferred Stock Valuations
of Composite Liability Insurance Companies That Have
Written or Are Writing Medical Malpractice Insurance in California
(In Thousands of Dollars)

Policyholders surplus 1/1/70	$290,944
Add: Reported net income after tax 1970-74	78,997
Capital paid in by stockholders 1970-74	2,082
Net surplus adjustments 1970-74	62,546
Deduct: Net other miscellaneous adjustments 1970-74	(1,816)
Common stock dividends paid 1970-74	(108,849)
Estimated policyholders' surplus 12/31/74 (without consideration of unrealized losses from common and preferred stock)	$323,904
Actual policyholders' surplus reported 12/31/74	206,147
Unrealized losses from common and preferred stocks 1970-74	$117,757

Due to unrealized losses from common and preferred stock investments owned by casualty insurance companies, approximately $118 million, or 36.4 percent of PHS, has been eliminated, although the actual market

value of common and preferred stocks are 10 percent greater than historical cost as of December 31, 1974.

Effects on PHS

The liability insurance industry's capacity to write insurance and the policyholder's measure of safety was materially affected in 1974 as demonstrated below:

Ratio of Net Premiums Written to PHS
of Composite Liability Insurance Companies
Who Have Written or Are Writing Medical
Malpractice Insurance in California
(In Thousands of Dollars)

Year	Net Premiums Written (NPW)	PHS	Ratio NPW/PHS
1970	$611,489	$306,672	2:0 to 1
1971	702,014	398,516	1:8 to 1
1972	756,156	513,041	1:5 to 1
1973	798,658	459,449	1:7 to 1
1974	881,296	206,147	4:3 to 1
5-Year Average	$749,923	$376,765	2:0 to 1

The unrealized losses from common and preferred stocks in 1974 amounted to approximately $109 million, or 43 percent of the reduction in PHS in 1974. However, the current market value as of December 31, 1974 of common and preferred stocks was 10 percent greater than their historical cost.

More serious than the capacity to write new business is the risk of further market value declines of common and preferred stocks in the composite liability insurance companies investment portfolio.

Another 20 percent decline in the market value of these securities would reduce PHS by 35 percent as illustrated in the tables below.

Effects on PHS of Composite
Liability Insurance Companies If
Market Value of Common and
Preferred Stocks Decline

Investment Portfolio of Composite
Liability Insurance Companies 12/31/74
(In Thousands of Dollars)

Description of Securities	Actual Cost	Market Value	Rate of Return from Investments before Taxes & Expenses	
			Cost	Market
Bonds[6/]	$ 916,863	$ 922,064	6.62%	6.58%
Preferred stocks	77,363	57,468	8.22%	9.67%
Common stocks	252,108	306,363	3.26%	2.82%
Total	$1,246,334	$1,285,895	5.91%	5.72%

6/ Bonds are carried at amortized book value in column stated "Market Value".

As of December 31, 1974, the PHS of the composite liability insurance companies was approximately $206 million. To determine the risks further market value declines will have on PHS, it is necessary to determine the dollars invested at market value in relation to PHS. This percentage can then be multiplied by assumed declines in market value of common and preferred stocks to determine the reduction to PHS.

	Dollars Invested at Market Value in Relation to PHS	Reduction to PHS Assuming Declines in Market Value of Common and Preferred Stocks of: 10%	20%	30%
Bonds (amortized Book value)	$4.47			
Preferred stocks	.28	2.80%	5.60%	8.40%
Common Stocks	1.49	14.90%	29.80%	44.70%
Total Investment Portfolio	$6.24	17.70%	35.40%	53.10%

Further declines in the market values of common and preferred stocks owned may result in the insolvency of certain liability insurance companies in our composite.

In addition to the investment risk because of the valuation procedures used, the insurance companies have the risk of not having estimated their future claims correctly.

As of December 31, 1974, the composite liability insurance companies had approximately $991 million of estimated future claims to be paid from insurance sold and policyholders surplus of $206 million. The ratio of estimated claims to PHS is $4.81 to $1. Therefore, if the future claims are underestimated by ten percent, PHS will be reduced by 48 percent.

The solvency of the composite liability companies as of December 31, 1974, is in jeopardy. The leveraged investment and estimated claims position may result in the financial collapse of some of these companies. Further, it is necessary to review the financial position of the entire liability insurance industry as this condition may affect the entire industry.

Liquidity of Investment Portfolio not Considered in Determining Solvency of Liability Insurance Companies

While the solvency position of the composite liability insurance companies is in jeopardy, no test has yet been made to determine the liquidity or the ability of the companies to meet their current financial obligations. Further, the California Code does not adequately consider this nor require liquidity of investments with policyholders' funds of companies who are statutorily solvent.

The test the liquidity of the composite liability insurance companies we have created a ratio of liquidity to policyholder funds provided to the companies for the years 1970-74 as illustrated below:

Five-Year Average
Liquidity Composite of Liability Insurance
Companies Who Have or Are Writing Medical
Malpractice Insurance from
January 1, 1970 through December 31, 1974
(In Thousands of Dollars)

(A) Cash on Hand	+	(B) Investments Owned Due in One Year	=	(C) Liquidity	(D) Estimated Claims to be Paid Plus Unearned Premiums	(E) Liquid Funds to Estimated Claims
$83,251		$755,894		$839,145	$4,702,292	.18¢ for every $1

Liquidity Composite of
Liability Insurance Companies
As of December 31, 1974

$25,937	$316,620	$342,557	$1,260,837	.27¢ for every $1

As illustrated above, the composite liability insurance companies improved their liquidity or ability to meet estimated claims measurably. However, since there are no guidelines it is not possible to judge if this is adequate.

(A) Cash in checking accounts or on deposit.
(B) Investment with a maturity date of 1 year or less from December 31.
(C) Calculation of liquid investments a company could raise on short notice without being subject to major losses.
(D) Loss and loss expense reserves plus unearned premiums as of December 31.
(E) Amount of liquid cash a company has available to meet estimated future liabilities.

Consideration of liquidity in the investment portfolio will reduce investment risk. Reduction of investment risk will reduce potential insolvency because of moves in the prices of common and preferred stocks of the composite liability insurance companies.

The State Pooled Money Investment Account (PMIA), which does not have authority to purchase common and preferred stocks, but does invest in various short-term liquid investments, has produced a rate of return in excess of two broadly used inflation indexes as illustrated below:

Comparison of the Consumer Price Index (CPI), and Wholesale Price Index (WPI) to the State of California PMIA and Various Short-term Money Market Instruments Between 1960 and 1974

CPI Compounded Average Growth Rate 1960-74	WPI Compounded Average Growth Rate 1960-74
3.81%	3.41%

Weighted Average Annual Earning Rate of the PMIA for Fiscal Years 1961-62 through 1973-74

5.15%

Average Rate of Return Offered by Various Money Market Instruments taken from Historical Federal Reserve Data from July, 1961 through January, 1974

Federal Funds	Prime Commercial Paper 4-6 Months	Prime Bankers Acceptances 90 Days	Negotiable Certificates of Deposit 90 Days	3-5 Year Government & Federal Agency Securities
5.04%	5.36%	5.12%	5.46%	5.21%

As demonstrated from the above table, the PMIA and various other short-term money market instruments produced a rate of return in excess of broadly used inflation measures. In addition, the short-term money market instruments generally would not subject investment portfolios to volatile fluctuations normally associated with the valuation procedures of the liability insurance industry.

CONCLUSIONS

- Our evaluation of seven malpractice insurance carriers in California indicates their financial condition has undergone serious erosion over the last five years and as a composite, currently face statutory insolvency.

- The carriers reviewed have, over the last five years, shown a composite loss of 1.8 percent from underwriting operations for all lines of liability insurance.

- The liability insurance carriers must increase premiums in order to improve their underwriting results. However, any increases in premiums without the injection of new capital will, on a temporary basis, increase risks to policyholders and further erode the financial condition of these carriers due to the necessity to increase loss reserves for prior years' insurance sold, particularly medical malpractice, at grossly inadequate rates.

- The availability of medical malpractice insurance is being affected because the California Insurance Commissioner issued cease and desist orders effective September 10, 1975, precluding two companies which we have reviewed from writing any new policies or renewing any current policies due to insolvency and has advised another company we reviewed to restrict the writing of high risk lines of insurance, such as medical malpractice insurance.

- The virtually unlimited investment authority to acquire common and preferred stocks investments and lack of prudent liquidity requirements for the investment portfolio have contributed to the current plight of the liability insurance industry.

- The portfolio valuation procedures of the liability insurance industry do not reflect the true value of investments and permits unrelated conditions occurring in the economy to affect the financial condition of the industry.

- The recent decline in the stock market has reduced the capacity of insurance a company may write, has contributed to the statutory insolvency of at least two companies and in general reduced the financial integrity and solvency of the liability insurance industry although companies may have sufficient resources to meet all estimated current liabilities for several years.

EXCERPTS FROM SELECTED DOCUMENTS IN THE FILES OF THE DEPARTMENT OF INSURANCE WHICH SHOW KNOWLEDGE OF INADEQUATE RATES OR RESTRICTED AVAILABILITY OF MEDICAL MALPRACTICE INSURANCE

- Internal memorandum to Insurance Commissioner, dated December 20, 1967, resulting from a public hearing of the Senate Subcommittee of General Research Studying Malpractice Liability:

  > ...a general practitioner, related the difficulties he had experienced in obtaining malpractice insurance and stated that insurers were only interested in providing such coverage as an accommodation in connection with the acquisition of the physician's entire insurance business.
  >
  > ...Chairman of the Malpractice Study Committee for a group in Los Angeles, stated that she had conducted a survey of insurance carriers which showed that malpractice insurance was not readily available. She said that carriers had told her that they didn't make money on malpractice and merely offered it as a service to their good customers.
  >
  > ...was the last witness and he read from an Airgram which advised that the open market in London (for malpractice insurance) was no longer available because of the high awards against practitioners in recent weeks.

- Report from a Medical Association to the Insurance Commissioner, dated February 12, 1970:

  > Although we have tried to do so, we have been unable to get a commitment from...that they will continue to offer malpractice insurance in California after October 1, 1970. They feel they have lost a lot of money, and unless their present rate structure improves this experience, they say they do not wish to continue to irritate the profession with continued rate increases which the company may consider necessary. Also, no one has reported success in bringing to the market from any carrier, at any price, a contract approaching CMA and Northern California specifications. All possibilities of so attracting a large carrier have not been exhausted, but if next year no carrier is willing and able to cover 12,000 doctors in Southern California, something will need to be done. One proposal is that CMA seek legislation which would require casualty companies as a condition for licensure in California to participate in a

- Letter from the Department of Insurance to the State Attorney General, dated July 31, 1973:

> ...Statistical data showing the rising costs of malpractice claims and inadequacy of premiums for medical malpractice over a period of years.

- Internal memorandum to the Department of Insurance, dated December 10, 1973:

> ...bid to take over the...account with only a 30% rate increase seems hard to believe. From the attached report...you will see that at least a 100% increase was indicated.

The memorandum goes on to state:

> ...in one or two years this could again be an explosive situation should they decide to increase the rates drastically or pull out.

- Memo from a broker to the Department of Insurance, dated November 28, 1973:

> ...is really playing with fire by holding its rates on upper specialties (board or non-board). Our statistics...show that even at new...rates they won't support themselves.

pool which would provide malpractice coverage. The casualty carriers would probably oppose such legislation.

- Magazine article, dated November 17, 1972, in The National Underwriter, entitled "Actuary Eyes Rating, Other Problems of Professional Liability on Doctors":

> This group contract began...in 1946, in a crisis similar to the recent one. Insurance carriers were leaving the northern California field because of what were then considered large awards, and underwriting losses.

The article goes on to state:

> The crisis in the late 60's and continuing to some extent now is much worse than it was in 1946. It appears to be part of a nationwide sociological phenomenon, and I agree with much that has been said about the reasons -- the shortage of doctors; changing doctor-patient relationships; the growing numbers and growing expertise of plaintiff attorneys specializing in malpractice; the rapid emergence of new drugs and new procedures; the tendency to blame doctors for things going wrong, the increasing liberality in court decisions, and the contingency fee system, among perhaps others.
>
> This phenomenon expresses itself in rate increases and decreasing availability of market,....

- Letter from an insurance company to the Department of Insurance, dated December 27, 1972:

> ...I am now in a position to tell you confidentially that indications are we will retire from this coverage at expiration of the current policy year...We have had discussions with representatives of the societies... The feeling of those coordinating the program is that any substantial rate increase would not be acceptable to the members. Since our review of experience and trends indicates a substantial increase, we agreed not to quote and thereby not prejudice the doctors' ability to negotiate with another carrier in any way. I understand they have retained...to try to find them another carrier. We also agreed that we would not announce our decision at this time.

State of California

Memorandum

To : Mr. Richard B. Howard
Office of the Auditor General
925 L Street, Suite 750
Sacramento, CA 95814

Date: February 2, 1976

From : **Department of Insurance**
1407 Market St., San Francisco 94103

FEB - 3 1976

Subject:

Mr. George Spaeth has reported his telephone conversation with you last Friday regarding a memorandum I had given to the staff members of the Auditor General's office who called on the Insurance Commissioner several months ago to review his records in connection with your offices's study of medical malpractice insurance. I do not recall at this time with whom I had a general discussion regarding the confidentiality of some of the records we would make available to your staff. At any rate, I did furnish your office with a memorandum advising that we would make all of our records available to you subject to your respecting the confidentiality of most of the work papers in possession of Mr. Clarence Atwood and Mr. Robert Cook.

I have been concerned for some time about the likelihood of a breach of confidentiality based on some of the conversations your staff has had with members of our Los Angeles Office and also based on some references in the preliminary report issued by your office. Management Memorandum No. 13, which Mr. Spaeth mentioned to you, lists the records which are public. We call your attention specifically to Section 2, which lists the confidential records in possession of the Insurance Commissioner. If you need any further clarification, please do not hesitate to call.

ANGELE KHACHADOUR
Chief Counsel
(415) 557-0763

AK:hcr

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
Secretary of State
State Controller
State Treasurer
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
California State Department Heads
Capitol Press Corps