

SURVIVAL: IT'S MORE THAN A NUMBERS GAME

BY RICHARD B. LORD AND STEPHEN J. KOCA

Medical professional liability (MPL) insurers are in the midst of enormous change in the healthcare market, but there has been little more than a ripple in insurers' financial results over the past several years. And 2014 was no exception.

Most metrics last year only inched up or down from their previous year's marks, providing little hint of what lies ahead. The sector's strong, some would say enviable, financial results have buffered insurers from the ongoing upheaval, and for some insurers they are providing the wherewithal to overcome whatever may befall them in the future.

While financial strength will still be important, the forces now sweeping through the healthcare market will also call for agility and diversification. It's a call that MPL insurers have heard before, but this time the call is fueled by market forces that go beyond mere prompts to diversify.

Last year, MPL insurers extended their run of profitability, ending the year with a combined ratio of 92% and marking the ninth consecutive year when the metric was less than insurers' theoretical breakeven point of 100%. Only a few points worse than the previous year's result, the ratio remains in line with results of the past five years. During this time, the ratio bounced around, after bottoming just below 80% in 2008 but then rising to, and hovering in, the high 80s to low 90s since then.

The 92% combined ratio gave insurers a profit of \$0.08 before investment income for every dollar of coverage they wrote. But as in years past, this profit stemmed from releases of reserves for prior accident years, which have offset companies' current estimates of losses on policies written in 2014.

Without the reserve releases, which accounted for approximately 20 points, insurers' aggregate combined ratio would have been

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112%, a figure that is fairly consistent with the past four to five years (Figure 1). Compared with the broader property and casualty insurance industry—which has posted combined ratios in the range of 96% to 108% in recent years, including a two- to three-point boost from reserve releases—ratios in the MPL segment are, comparatively, much better.

Hard to ignore

And while profitability has been considerably better for MPL insurers when compared with the broader property and casualty market, premiums have been under severe pressure for nearly a decade. Last year, premiums fell 4.5% from the 2013 level, the largest year-over-year decrease in the past eight years. Over this time, premiums have withered to \$8.2 billion and are at their lowest point since 2002, the advent of the last hard market (Figure 2).

The nearly decade-long decline in premiums is the longest stretch of year-over-year declines in the past 30 years and far exceeds its closest rival, which petered out after only two years in the late 90s. At that time, rates quickly became inadequate, prompting the market to harden.¹ But even now, after eight years of waning premiums, there is only spotty evidence that rates are inadequate. This is because of the huge reduction in frequency that took place during the early to mid-2000s and left insurers in an advantageous position, and the fact that premium is leaving the commercial insurance marketplace as physicians continue to leave private practice to affiliate with hospitals and large medical groups.

But the insurers' reprieve isn't going to last forever. Over the past 10 years, physician insurers have seen their markets dwindle, as more physicians shutter the doors of their independent practices and seek employment at hospitals or large medical groups, in an attempt to



stave off the rising operating costs and flagging incomes.

With the implementation of the Patient Protection and Affordable Care Act (ACA) and its renewed focus on lowering health-care costs while improving quality, the exodus of physicians from independent practices is likely to continue, if not accelerate, and cause a further contraction in the physician-insurers' traditional exposure base.

This trend is fairly well defined, but the ground is still shifting for MPL insurers in ways both foreseen and unforeseen. One example is the influx of individuals into the healthcare system, which has been in line with many estimates, but their demand—or, rather, their lack of demand—for the services of primary care physicians has been somewhat unexpected. Many had speculated that as individuals became insured, they would seek the services of primary care physicians, potentially increasing their exposures.

In reality, primary care physicians haven't felt the severe crunch for services; instead, hospitals have observed an increase in emergency room (ER) visits. The reason may stem from the payment structure of many individual policies, which have copays for primary care visits or require full payment because of deductibles but do pay for ER visits. This unforeseen demand for ER services could increase hospitals' exposures while leaving physicians' exposures relatively unchanged.

What one hand taketh away, the other giveth

The ACA has indeed triggered a contraction in the MPL market, but it may also offer MPL insurers that are willing and able to adjust to the new landscape a way out of the impending cutthroat competition that is likely to ensue as the soft market deepens.

One dominant feature of the new landscape is the accountable care organization (ACO), a network of doctors, hospitals, and other healthcare providers charged with coordinating patient care in an effort to improve quality, while also reducing costs. Like health maintenance organizations (HMO), a primary care physician is at the heart of the patient's care with ACOs.

While ACOs are far from a new concept, their numbers have ballooned since the ACA, climbing from 164 a year and a half after the enactment of the law² to slightly more than 606, as of 2014.³

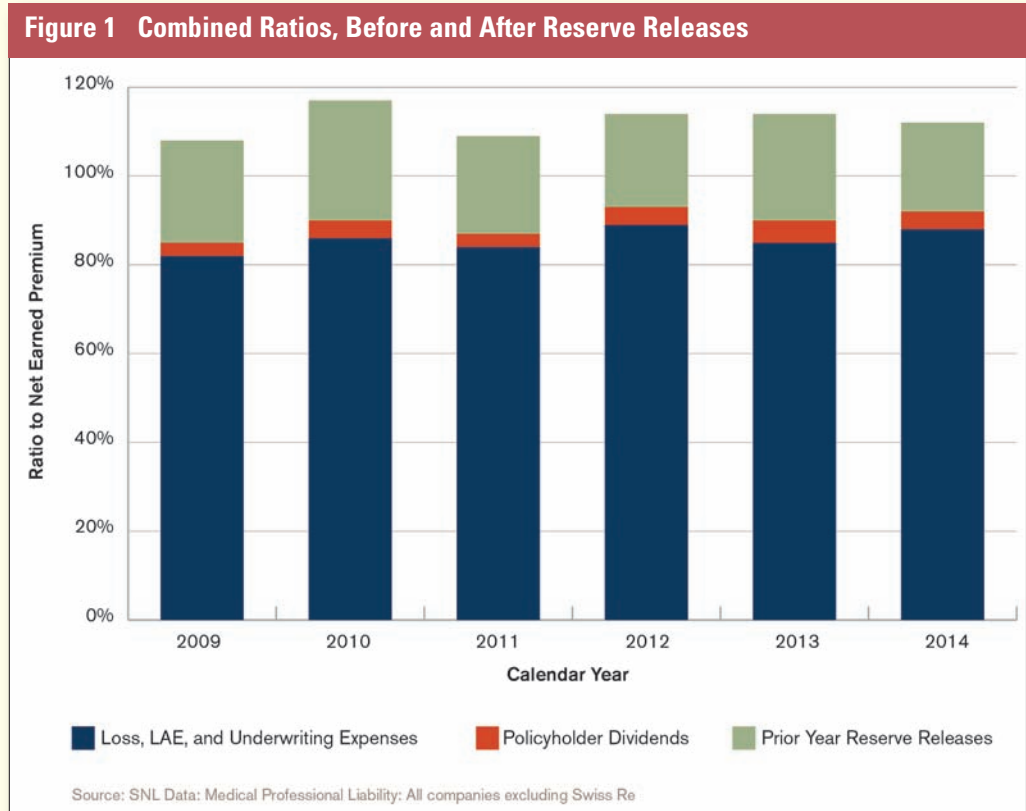
Despite this growth, their success is far from assured. This is because the

current healthcare system is highly fragmented, and treatment protocols are largely decided by independent-minded physicians who have considerable leeway in managing a disease. Now they must adapt to a new system whose processes are being reconfigured to conform to the goals of ACOs. Under ACOs, healthcare providers will be expected to coordinate care and adhere more closely to quality standards.⁴

As part of this transition, physicians will most likely need informational tools that help them in safely integrating services across the spectrum of care, while also keeping up to date on best practices. This development opens the door for MPL insurers that, until now, have only provided continuing education. Now they can step in to bridge the risk-information gap. This strategy would allow them to maintain or, in some cases, to establish relationships with physicians who are now employed at hospitals or working in large medical groups.

Forward-looking MPL insurers can also partner with self-insured hospitals or large medical groups that do not have expertise in underwriting MPL for physicians. Some have started to focus on providing risk or claims management services for physician risk as a way of establishing or maintaining client relationships. Whether the services involve preventing a claim against a physician or devising strategies to defend against a claim, insurers have started to redeploy their expertise and target hospital systems or large medical groups that have not had the resources or desire to develop these specialized skills, which can contain claims costs and help to solidify the hospital's relationship with its physicians.

By unbundling services, MPL insurers have started to shift their focus from providing risk transfer mechanisms, whose results can often be volatile, to risk-related services whose revenue streams are



likely to be more predictable. This shift may be only the first step in insurers' transformation, which could involve developing products and services that are more relevant to the changing healthcare landscape.

As an alternative, some MPL insurers may also choose to pursue more traditional options that involve streamlining processes for providing fronting arrangements to institutions in states that require coverage placement with a licensed insurer, or providing excess MPL coverage to hospital systems or large medical groups.

A storied past

And while the road ahead is uncertain, fortune has indeed shone on MPL insurers since 2003, when insurers first began to see a decrease in claims frequency. It took another four years before they realized the change wasn't an anomaly but, instead, a sea change in their baseline frequency. Over the intervening years, insurers have benefited from this sudden, unprecedented, and unexpected plunge in frequency, which resulted from the confluence of several factors and has underpinned insurers' abilities to release reserves for the past nine years.



At the same time, severity of losses has risen steadily, though not precipitously. The combination of somewhat predictable increases in severity and a much lower baseline for frequency has paved the way for MPL insurers' long run of profitability. Recently, however, there has been increased activity in very large claims, which has raised some concern, but the still relatively low numbers of claims of this magnitude make it difficult to determine if the observed jump in mega-awards is an aberration or a developing trend.

One conspicuous source that might provide an explanation is a weakening of tort reforms, but reversals for the most part haven't happened. Of the 32 states that have enacted caps on noneconomic damages, more than two-thirds remain in place or have had only minor alterations. And the plaintiff lawyers' challenge to California's landmark tort reform, enacted some 40 years ago and a bellwether for reform in other states, was rebuffed this past November in a voter referendum. One point of interest, however, is that even states with traditionally strong tort reform laws have not been entirely shielded from an increase in claims severity, because many of the large awards are often the result of anticipated high costs for future medical care or other

Figure 2 Historical MPL Net Earned Premiums



related items that typically do not fall within the scope of the damage caps.

Even so, the continual pressure on claims severity, MPL insurers' relentless decline in premium, and ongoing changes in the broader healthcare market have made for decidedly unsettled times. Standing in place goes against the grain of a rapidly changing market and ignores the opportunities that lie ahead. Survival, indeed the future, is likely to go to those insurers that not only have the financial resources to weather the transition, but also the foresight and the agility to develop the products that support the next generation of healthcare providers. Unlike prior calls for diversification, this time market forces are driving change. Agility as much as financial strength may define who will survive.  

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