



COMMONWEALTH OF PENNSYLVANIA  
INSURANCE DEPARTMENT  
1326 STRAWBERRY SQUARE  
HARRISBURG, PA 17120

THE COMMISSIONER

DATE: July 8, 2005

TO: All Interested Parties

FROM: Diane Koken   
Insurance Commissioner

SUBJECT: **Additional Medical Malpractice Basic Insurance Capacity**

In accordance with Section 711 of Medical Care Availability and Reduction of Error (Mcare) Act (the "Act" or "Act 13"), the Pennsylvania Insurance Department conducted a study to determine whether sufficient "additional basic insurance capacity" in the medical malpractice insurance marketplace exists to allow a step-up of the statutorily based limit in 2006. Prior legislative efforts to phase out Mcare included more modest step-ups in basic limits of \$50,000 or \$100,000. Act 13 contemplates a \$250,000, or 50%, step-up. Act 13 also recognized the need for consumers to have access to a comprehensive and high quality health care system. As evidenced by the requirement for this review, as well as the premium abatements in 2003, 2004 and 2005, the importance of Mcare and medical malpractice liability insurance in general to health care access in the Commonwealth has been recognized by the General Assembly and Governor Rendell. Having completed our study, we have concluded that a variety of current marketplace factors illustrate that sufficient additional basic insurance capacity is presently lacking.

**Introduction**

On March 20, 2002, the General Assembly of the Commonwealth of Pennsylvania passed Act 13. Section 711 of Act 13 provides for the continued reduction of excess medical malpractice coverage limits available under the Mcare Fund. According to the Act, the mandatory medical malpractice primary coverage limits are scheduled to increase (with corresponding decreases in the Fund coverage limits) in 2006, subject to a study regarding the availability of additional basic insurance coverage capacity (pursuant to section 745(a) of the Act). Unless it is found, pursuant to section 745(a), that additional basic insurance coverage capacity is not available, basic primary limits will increase in 2006 from current levels of \$500,000 per occurrence to \$750,000 per occurrence. Thus, if it is determined that there is not additional capacity available to permit the increase in the basic limits, the limit will remain at \$500,000, and a market capacity study will be conducted again in two years.

## Analysis

The term “capacity” is not defined in the Act, but for purposes of the study, was generally understood to mean the amount of insurance the medical malpractice insurance industry is able to write, as dictated by marketplace limitations or availability of capital. Thus, in being charged with determining whether there is “additional basic insurance coverage capacity available,” we necessarily looked to determine whether there is sufficient additional capacity to effectuate a step-up in the limits in light of the current status of the marketplace in Pennsylvania.

In accordance with the Act, an independent actuarial firm, Pricewaterhouse Coopers, LLP (“PwC”), was retained to analyze the basic insurance coverage capacity in the marketplace. PwC’s report, entitled “Study of the Availability of Additional Basic Insurance Coverage Capacity Pursuant to Section 745(a)(2) of Act 13” (the “PwC Report”), is dated June 30, 2005. A data call was also issued by the Department to 121 licensed companies, risk retention groups (“RRGs”) and excess and surplus lines (E&S) providers to assist the Department and PwC with the subject analysis.

As further supported by the PwC Report, the Department made a number of observations significant to the determination as to whether sufficient additional basic insurance capacity presently exists. Some of the more significant findings include:

- In the past six years, there has been a significant change to the landscape of the Pennsylvania medical malpractice insurance market. A significant portion of the current Top 20 market share is provided by insurers that did not exist in 1999. The most significant components of the increase relates to the increased use of Risk Retention Groups (RRGs) and the JUA. RRGs and the JUA wrote a combined share of 33% in 2004, as compared to a combined share of only 3% in 1999. When alternative markets grow materially, it is clear that the traditional commercial market is either not interested or is unable to write the business, and that must be an element in any evaluation of capacity.
- There has been significant growth in non-traditional insurer market share, while traditional insurance arrangements have decreased dramatically. Traditional insurers lost over half of their market share from 1999 to 2004. Use of RRGs, whose insureds do not have guaranty fund protection, has increased dramatically and now comprises over 27% of the 2004 market share. The JUA has also grown significantly relative to its negligible market share of 1999, now representing 6% of the market. In 2004, excess & surplus lines insurers represented roughly 11% of the market share, more than double their 5% market share in 1999. Qualified self-insurance comprises the majority of the remaining market share and remains about 5% of the total market. Again, the use of the JUA, RRGs, and qualified self-insurance may be considered indicative of a lack of basic insurance capacity. Since E&S insurers typically provide a market for difficult-to-insure risks, changes in the E&S market share may also be indicative of changes in the willingness of the traditional insurance market to insure certain risks.
- The increased market share of “PA-only” insurers may imply less ability to sustain increased risk in a volatile market. The market share of “PA-Only” insurers and self-insurers nearly doubled over the period 1999 to 2004, from roughly 32% to 62%, respectively. The most

significant components of the increase are for RRGs and the JUA, whose combined market share increased from 3% in 1999 to 33% in 2004. Insurers and self-insurers with a heavy concentration in Pennsylvania will be impacted differently by a change in the mandatory basic limits of insurance than those insurers with limited exposure to Pennsylvania medical malpractice, whose more diversified medical malpractice portfolios provide a greater degree of “insulation” to the volatility of any given state. Thus, while the data did show some willingness by certain carriers to increase basic capacity at this time, the ability of the PA-Only companies to sustain the required increase may be less than companies with established track record for insuring (or reinsuring) the risk in this higher layer.

- Higher than average combined ratios implies a potential lack of desire for non-PA-only companies to increase business here. The combined ratio provides a measure of the loss, loss adjustment expense, and other expense costs relative to each dollar of premium. The Pennsylvania combined ratios tend to be higher than the national average and those of other “large” states. With the exception of 2004, Pennsylvania combined ratios are higher than the regional (New York, New Jersey, Maryland, and Ohio) average. The position of combined ratios of Pennsylvania relative to other states or national averages may provide an indication of a company’s willingness to commit additional surplus to Pennsylvania business over business in other states.
- The ratio of adjusted capital to authorized control level risk-based capital (“ACL Ratio”) for “PA only” medical malpractice insurers is lower than the national average. The ACL Ratio is used as a measure of the sufficiency of the company’s surplus. Ratios of 200% or more represent a level at which no regulatory action is required for a company, according to standards promulgated by the National Association of Insurance Commissioners. A comparison of risk-based capital ratios can provide insight into the relative strength of companies currently providing medical malpractice insurance in Pennsylvania and, in turn, their ability to withstand a change in the mandatory basic limits of insurance. The average ACL Ratio of companies whose medical malpractice portfolio is concentrated in Pennsylvania is lower than the national average for companies writing medical malpractice. Pennsylvania medical malpractice insurers appear to be less well capitalized than an “average” company providing medical malpractice insurance coverage. An increase in the basic limits of insurance will create the requirement for additional capital to maintain the current ACL ratio. This could be a significant stressor for the Pennsylvania companies that are, on average, comparatively more aggressively capitalized.
- Higher premium-to-surplus ratios indicate an already higher degree of overall leverage. The premium-to-surplus ratio is used as a measure of financial strength or to indicate the degree to which a particular insurance company is leveraged. A comparison of premium-to-surplus ratios of companies providing medical malpractice insurance in Pennsylvania versus medical malpractice writers in other states may indicate whether there is a relatively higher or lower degree of leverage within the Pennsylvania medical malpractice market. Since increasing the mandatory basic limits of insurance will increase the associated basic premium, such a change would put an additional strain on existing surplus. The gross premium-to-surplus ratio for “PA only” companies is substantially higher than a national average. This degree of leverage exposes these “PA only” companies to a relatively higher degree of reinsurance credit risk.

- RRG's ACL and premium to surplus ratios are exposed to greater credit risk. "PA only" RRG's ACL ratios averaged roughly 250% in 2004, but that also varied significantly by RRG. RRGs also have higher premium-to-surplus ratios, on both a net and on a gross basis. On average, it appears that the RRGs are less well capitalized, place greater demands on their surplus, and thus are likely exposed to reinsurance credit risk to a relatively greater degree than the average "PA only" traditional insurer or other medical malpractice writers in general. These RRGs have significant current market share.
- Pennsylvania medical malpractice appears to be less profitable for insurers as compared to other "large" states and other regional states, which would likely impact an insurer's willingness to commit surplus to new or expanded medical malpractice coverage.
- Data call responses acknowledged concerns over reinsurance availability and cost resulting from a limit step-up. Certain carriers noted the difficulty of obtaining reinsurance, with additional concern raised over the unknown costs associated with reinsurance purchasing. The RRG for one large health system specifically noted that reinsurance costs and volatility pose significant burdens on the health system. Another carrier stated that anticipated reinsurance costs may force it to reduce its current book of insured health care providers. Another insurer with relatively significant market share observed that obtaining reinsurance to sustain increased capacity would be difficult and could result in a reduced level of overall Pennsylvania insured exposure.

## **Conclusion**

The Department's and PwC's review of the capacity issue illustrates that, while there have been improvements in the marketplace from a capacity standpoint since the passage of Act 13, the available information does not allow a finding of sufficient additional capacity to allow a step-up in the basic insurance limit at this juncture. To the contrary, because of the relatively new entries into the Pennsylvania market and the volatility of the financial results appurtenant to this market, additional seasoning is required. As contemplated by Act 13, an additional two years to study developing marketplace trends, RRG stability, and the positive effects of Act 13 in general should enable the Department to determine whether a step-up in the basic insurance limit is appropriate.