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DATE: July 20, 2007

TO: All Interested Parties

FROM: Randolph Rohrbaugh
Deputy 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 2008.

In July 2005, Commissioner Diane Koken issued her finding that a variety of current marketplace factors illustrated that sufficient additional basic insurance capacity was lacking at that time. Specifically, she found that 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 continuing premium abatement programs, the importance of Mcare and medical malpractice liability insurance to health care access in the Commonwealth has continually been recognized by Governor Rendell and the General Assembly.

In light of the Department's and PricewaterhouseCoopers' ("PwC") review and analysis of the capacity, it cannot be definitively found that additional basic insurance coverage is presently available and as such for calendar year 2008, the respective limits of coverage for the primary market and Mcare shall remain unchanged.

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 ("Fund"). According to the Act, the mandatory medical malpractice primary coverage limits were 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).

Commissioner Koken's 2005 conclusion that additional basic insurance capacity was lacking at that time prompted this additional study. Under 711(d)(3), "... the

Commissioner shall conduct a study every two years until the Commissioner finds that additional basic insurance capacity is available, at which time the Commissioner shall increase the required basic insurance coverage in accordance with this paragraph.” Therefore, the Commissioner’s charge after the July 1, 2005 study prompted by Section 745(a) is somewhat different in that basic insurance coverage can only be increased upon an affirmative finding that additional basic insurance coverage is available.

Analysis:

Like Commissioner Koken, we note that the term “capacity” is not defined in the Act. However, for purposes of this study as well, the term 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, 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 July 12, 2007. A data call was also issued by the Department to 114 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 significant observations include:

- A significant portion of the current Top 20 market share is provided by insurers that did not exist in 1999. The Top 20 insurers in Pennsylvania in 2006 wrote 73% of the direct written premium. Those same insurers wrote 70% of 2004’s direct written premium but only 34% of the direct written premium in 1999. The most significant components of the market changes from 1999 to 2004 relate to the increased use of RRGs, which are not protected by the Pennsylvania Property and Casualty Insurance Guaranty Association, and the Joint Underwriters Association (“JUA”). RRGs and the JUA wrote a combined share of 34% in 2006, as compared to a combined share of only 4% in 1999.
- The market share of all RRGs, arguably the most cost effective means for providing coverage, has grown since 2004, and currently comprises 30% of the current market share. This may be indicative of a continued lack of basic insurance coverage capacity. Several RRGs cited concerns about the increased costs to the insureds and a few expressed significant concerns about the need to

increase surplus to support the higher premium volume and increased volatility associated with a higher level of coverage. Insureds of RRGs do not have access to the protection afforded by the Pennsylvania Property and Casualty Insurance Guaranty Association.

- 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 may provide a greater degree of “insulation” to the volatility of any given state.
- Because of the existence of Mcare coverage above the \$500,000 basic limits, and the fact that 65% of the 2006 medical malpractice market is represented by insurers or self-insurers that wrote almost exclusively in Pennsylvania, the primary market is likely not providing meaningful amounts of direct primary limits above \$500,000.
- In reviewing the ratio of Adjusted Capital to Authorized Control Level Risk-Based Capital for “PA-only” insurers (the “ACL Ratio”), PwC observed that the average “PA-only” RRG had an above average ACL Ratio in 2002, dropping through 2005 and then rising sharply in 2006 to nearly 800%. The market share of RRGs should also be considered when assessing trends in the RRG ACL ratio over time. It was noted that ACL ratios vary widely from one RRG to another – from a minimum of under 25% to well over 1000% for 2006. It is noteworthy that in 5 of the last 7 years, RRGs’ ACL Ratio was below the average.
- The gross premium-to-surplus ratio for “PA-only” companies is higher than a national average, largely driven by RRGs. The RRGs are a large portion of Pennsylvania’s market share and typically cede a large amount of their direct and assumed risk, causing them to have a relatively high gross premium-to-surplus ratio. The degree of leverage may expose these “PA-only” companies to a relatively higher degree of credit risk.
- On average, it appears that the RRGs are less well capitalized and may be exposed to credit risk to a relatively greater degree than the average and as indicated, “PA-only” traditional insurer or other medical malpractice writers in general. These RRG insurers have significant current market share.
- It appears that the decreasing “PA-only” net written premium-to-surplus ratio is being driven by the RRGs. Although the ratios by RRG vary widely, the average net premium-to-surplus ratio of the “PA-only” RRGs reached a high of nearly 2.0 in 2003 and has decreased to 0.9 in 2006, which is slightly higher than the “PA-only”.

- Information from the Administrative Office of Pennsylvania Courts indicates that the average number of cases filed has decreased 38% statewide compared with the pre-Act 13 years 2000 to 2002, providing indications of a possible long-term reduction in claim frequency. However, the extent to which a reduction in the number of claims will result in a reduction in the total cost is difficult to estimate reliably given the long-tailed nature of medical professional liability.
- Recent data compiled by Jury Verdict Research (JVR) indicates that the severity of awards continues to increase nationally, and that median award severities are generally higher in Pennsylvania relative to the national average.
- During the period of this study, Mcare's phase-out continued with the transfer of responsibility for section 715 claims from the Mcare Fund to the primary market.
- As a professional liability line of insurance, medical malpractice liability insurance is a long tailed line. Since many of the reforms vital to this line (e.g., Act 13 Reforms, Venue Reform, Certificate of Merit) were expected to require 3 to 5 years of "seasoning" until their benefits were fully realized, it remains difficult to project the extent to which these reforms have improved the capacity of this market, as influenced by credible changes in loss experience, stability and predictability.

Conclusion:

While there is little question that there have been improvements in the marketplace from a capacity standpoint since the passage of Act 13, the available information does not allow for a finding of additional basic insurance capacity to allow a step-up in the basic insurance limits at this juncture. To the contrary, because of the still relatively new entries into the Pennsylvania market and the volatility of the financial results appurtenant to this market, Commissioner Koken's finding that additional seasoning is required, continues to apply. 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, is needed for the Department to determine whether a step-up in the basic insurance limits is appropriate.