



Deflating the Med Mal Bubble

By Brian S. Kern, Esq. (3/08)

The NJ Department of Banking and Insurance (DOBI) has released two proposals that, if passed, may help the medical malpractice insurance industry avoid its next crisis.

The first proposal, N.J.A.C. 11:27-11 would finally give DOBI the necessary authority to monitor both the reserve positions and reinsurance agreements that medical malpractice insurance companies have in place. The proposal includes strong language aimed at certain companies, noting that the “(Department) has found that on occasion some insurers do not establish reserves at the amount or within the range recommended by the actuary...”

N.J.A.C. 11:27-12, is designed to ensure that company board committees have sufficient independence from their companies to promote responsible decision-making. Standards would be set to mirror those adopted by the National Association of Insurance Commissioners (NAIC), and under the proposal, “Codifying these requirements for medical malpractice insurers will better ensure that these insurers operate in a financially sound manner.”

Could more regulation be the solution? To be sure, the continuing medical malpractice crisis in New York has demonstrated that strict price controls do not work, and market forces cannot be ignored. However, competition in New Jersey has again heated up and has entered what is known as a “soft market,” a term that essentially describes too much supply. New regulations could stem the flow of companies with limited resources that are willing to battle in a finite marketplace, with the view of a short-term profit. Put another way, the regulations could keep the medical malpractice insurance availability bubble from over-inflating.

Medical malpractice insurance bubbles have unique attributes because investors come in a variety of forms, and investment risk can be transferred to individual physicians in the form of “capital contributions.” Imagine any other business that requires its future customers to provide the initial financing, *interest free!* This “start-up” company model re-emerged when competition fled the market after its last collapse. The trend is exacerbated by the proliferation of risk retention groups (RRGs), which, too, require capital contributions, but have added risk because they are formed under federal charter, which allows them to circumvent state filing requirements and precludes their participation in state guaranty associations if they become insolvent.

While these models can thrive in hard markets, they are particularly vulnerable to soft markets, as sound underwriting can yield to the more immediate and pressing need for growth. Start-up companies and RRGs are inherently more susceptible to adverse selection, and usually compete for the highest risk physicians. When markets are oversupplied for too long, premiums drop to unsustainably low levels, compounding the problem.

Navigating soft markets becomes increasingly difficult when companies mask underlying financial problems with marketing schemes. For example, physicians with occurrence policies should welcome dividend payments, unless they are used solely to convey a false sense of security. DOBI's proposed new regulations should help physicians measure the financial strength or weakness of these companies, without reliance on what may be nothing more than a misleading marketing scheme.

Long-term financial strength is especially important when considering a medical malpractice carrier because of the time lapse between the time when premium is collected and the time claims are paid. The industry relies heavily on actuarial predictions, based on market trends, to determine how much premium will be needed to pay future claims. As history has taught us though, actuarial predications can be based as much in art as in science.

After years of increasing trends in claim severity and frequency, actuaries have lately noted a sharp decline in the number of claims filed. Combined with the multiple rounds of substantial premium increases and sporadic tort reform in recent years, investors have become bullish. However, some experts are now warning that increased competition is leading to a new round of irresponsible pricing which may, yet again, jeopardize future ability to pay claims.

Top industry actuaries and analysts have outlined four key concerns with the current market: 1) that inexperienced companies may mistakenly rely upon current trends, and not reserve properly for future claims (for which current premiums are to be collected); 2) that a continued drop in claim frequency is unsustainable, and if trends reverse course, companies may be inadequately reserved; 3) that tort reform has been and may continue to be successfully challenged, calling into question the reliability of current data; and 4) that too much market supply will not last forever, and that the weakest carriers must ultimately fail.

If the DOBI proposals are not adopted, it will remain up to an industry, often lacking the necessary tools and authority to enforce its own guidelines, to police itself. Though the market may suffer select casualties now, proactively eliminating the weakest will have far less impact than reactively addressing a collapse of the entire system later.

DOBI is accepting written comments on its proposals until May 2, 2008. For more information on the financial status of your carrier, physicians can write to DOBI, or contact their independent consultants.

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