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REPEAT OFFENDERS:

HOW THE INSURANCE INDUSTRY MANUFACTURES CRISES AND HARMS AMERICA

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Summary/Key Findings

The property/casualty insurance industry is one of the most important industries in the nation. Every person and business in America needs insurance. Yet for the past 35 years, policyholders have been victims of this industry's little understood economic cycle, created by anti-competitive (yet legal) underwriting practices, unique and opaque accounting policies, and virtually unchecked power when it comes to regulation of insurance rates.

The industry's economic cycles lead to what are known as "hard" and "soft" insurance markets, particularly for commercial insurance; there have been three full cycles in the past 35 years, with soft markets characterized by stable or low rates (good for policyholders but disliked by the insurance industry) and hard markets, characterized by sudden and astronomical rate hikes for policyholders. These hard markets lead to sometimes devastating "liability insurance crises."

While the existence of this self-made cycle is clear to insurance industry insiders, insurers often publicly deny the cycle's existence while their lobbyists try to take advantage of skyrocketing rates to push for so-called "tort reform." However, insiders know that hard markets have never been caused by jumps in claims, lawsuits or tort system costs. That is why these cycles are national in scope and occur in every state irrespective of a state's tort law and why enactment of so-called "tort reform" has done nothing to prevent them. Unfortunately, public officials tend to turn to medical and insurance lobbyists for explanations rather than to objective experts and data.

This country has been in a "soft" insurance market since 2006, with rates stable and dropping in every state whether or not "tort reforms" have been enacted. However, since early 2011, the insurance industry has been trying to push the country into a new hard market.

Hurricane Irene in late August 2011, which was greatly hyped by the Weather Channel but wasn't nearly the catastrophe that was expected, has been used by insurance industry representatives to push the country into a new hard market. This is despite the fact that the industry is perfectly able to handle those claims in addition to having stored away excess profits for decades so that today, it is in an all-time safe position. Creation of a hard market now would be purely for the purpose of price-gouging buyers of insurance, particularly commercial lines insureds.

Over the last few months in particular, industry executives – including unregulated foreign reinsurers – have been boldly declaring to the entire industry that it is time to end the soft market (including pressuring their own competitors to start raising rates), setting the stage for a new liability insurance crisis in this country.

KEY ACCOUNTING FACTS ABOUT THE INDUSTRY'S FINANCIAL CONDITION

Losses: Insurers' unique accounting practices allow them to identify "losses" that are really not losses at all. To an insurance company, the word "loss" is short for the term "incurred loss," which includes "incurred but not reported" (IBNR) losses. When a company has an "incurred loss," this does not mean the insurer has actually paid out this money. This figure includes *estimates of future claims that they do not even know about yet*. It is *this* figure that insurers file with state insurance departments when seeking rate hikes. History shows that during hard markets, insurers vastly overstate their incurred losses by increasing reserves (money set aside to pay them) despite experiencing no increase in payouts or any trend suggesting large future payouts. This "over-reserving" seems often to be politically-inspired, used by insurers as a way to show poor income statements, which in turn is used to justify imposition of large premium increases. In sum, when an insurance representative uses the term "loss" (whether in filings with state authorities, lobbying lawmakers or talking to the news media), they do not mean an actual loss; they mean an "incurred loss," a figure that is highly susceptible to manipulation and exaggeration, especially during hard markets.

Premiums and Claims: Insurers make their money primarily from investment income, investing the premium dollars they receive from policyholders. Rarely do insurers achieve an underwriting profit (i.e., when premiums taken in are more than "losses" and underwriting expenses). In many lines of insurance, an underwriting profit would produce a wildly excessive overall profit because the investment yield on the "float" (between the time they collect the premium and pay the loss) is so great. During "soft market" periods, which cover most years, insurers compete heavily for premium dollars to invest. Because of competition, insurers keep rates low – sometimes too low. Therefore, most of the time they do not try to have, nor expect to have, an "underwriting profit." It makes economic sense for them to compete for premium dollars to invest even though they may lose money on claims and expenses. But also, when an insurer talks about "underwriting profit" or says they have an "underwriting loss" (or when they use terms like "combined ratio" to measure losses and expenses per dollar of premium), it is important to remember that insurer calculations are based on "incurred losses." As explained above, this does not mean money the insurer has actually paid out. This figure includes estimates of future claims that they do not even know about yet, which can be (and are, during hard markets) wildly exaggerated.

Surplus: Today, the industry has been suggesting that it is in financial trouble as a result of weather events in 2011. However, surpluses today – the extra cushion insurers hold in addition to the amount they have set aside to pay estimated future claims – put the industry in an all-time safe financial position, far safer than required, and one might even say that today, the industry is overcapitalized. Given these circumstances, the creation of a hard market now would be purely for the purpose of price-gouging buyers of insurance, particularly commercial lines insureds.

HOW LAWS AND LACK OF OVERSIGHT MAKE THE SITUATION WORSE

With few exceptions, state insurance departments have neither the authority nor the funding to exercise proper control over insurance industry pricing.

Because the industry is exempt from anti-trust laws under the federal McCarran-Ferguson Act, it can collude on important components of insurance prices, an anti-competitive practice that is illegal for other industries. For example, as we are seeing right now, at cycle bottoms immediately preceding a hard market, insurance companies will pressure their own competitors to stop competing for premium dollars and to raise rates and reserves as an entire industry.

GOVERNMENTAL ACTION IS NEEDED

For the property/casualty insurance industry, creation of hard markets and phony liability crises have paid off and will pay off again unless lawmakers take responsible, remedial steps immediately to reign in the power and control the abuses of the property/casualty insurance industry.

1. Data disclosure: With rare exceptions, laws today do not force even licensed property/casualty insurance companies to disclose meaningful information to state authorities that could substantiate or refute their allegations about the financial health of the industry or the impact of the U.S. civil justice system. The need for data disclosure is urgent.

2. States must repeal anti-competitive laws and enact stronger regulation and oversight. State insurance departments must take a far more active role controlling insurance rates; insurance departments must receive needed support for proper oversight over the industry. State regulators must carefully review any requests for price increases in this emerging hard market.

3. Congress should repeal the federal anti-trust exemption; at a minimum, the new Federal Insurance Office must review its impact. The federal McCarran-Ferguson Act exempts the insurance industry from anti-trust laws, allowing the industry to collude on important components of insurance prices, an anti-competitive practice that is illegal for other industries. At a minimum, the newly created Federal Insurance Office (FIO), established by Title V of the Dodd- Frank Wall Street Reform and Consumer Protection Act, should include a review of the harm done to consumers by the anti-trust exemption of the McCarran-Ferguson Act in the report it is preparing for Congress in 2012, as well as collect data on the impact of the Act on policyholders, particularly commercial policyholders.

REPEAT OFFENDERS:

HOW THE INSURANCE INDUSTRY MANUFACTURES CRISES AND HARMS AMERICA

Americans for Insurance Reform

Introduction

Imagine an industry that sold a product which every person and business in America needed. This product was so important that the industry could literally threaten the economy of a state by pulling its product out. The seller of this product was accountable to no federal agency and regulated only by very weak state agencies. It was also exempt from anti-trust laws so the entire industry, including so-called “competitors,” could use the same collusive pricing agencies to help determine the product’s price – price fixing that would land others in jail. Other laws permitted it to keep its financial data secret, enabling it to routinely mislead lawmakers, regulators and members of the media about its financial condition. This secrecy allowed it to create phony “crises” to help promote its own legislative agenda, padding its bottom line at the expense of everyday Americans.

Sounds incredible. Yet this industry exists in America - although it’s not the “too big to fail” banks or other industries receiving attention from the “99 percent movement,” even though it should. This is the U.S. property/casualty industry, which supplies everything from auto and homeowners insurance to medical malpractice insurance for doctors to liability insurance for small businesses and local governments. Three times in the last 35 years, the insurance industry has created liability insurance “crises,” making insurance unaffordable or, in some cases, unavailable at any price for many businesses and professions. Each time this has happened

(called a “hard market”), the insurance industry has tried to cover up its own mismanaged underwriting by blaming the legal system for its sudden, astronomical premium increases. Like clockwork, following these rate hikes have been frenetic calls for legislative limits on victims’ rights to sue, with state lawmakers viewing the “crisis” as an isolated problem rather than indicative of a broader national problem caused by the cyclical nature of the insurance business. And all indications are that this industry is about to create a new hard market, hitting policyholders with volcanic price increases and once again, creating another potentially devastating liability insurance crisis in this country.¹

Discussions and analysis by industry insiders make clear that hard markets are caused by a combination of the industry’s own boom and bust economic cycle, anti-competitive (yet legal) underwriting practices, unique and opaque accounting policies, and virtually unchecked power when it comes to regulation of insurance rates. What is also clear from these discussion, as well as from the lessons of history, is that our legal system, tort laws, judges, juries and injured victims have nothing whatsoever to do with creating these “hard markets,” even though they are routinely blamed for political effect.

This study attempts to expose the industry’s predictable cycle and the reasons behind it, to explain why hard markets are created, as well as to show that they are not driven by tort law cost explosions as insurance companies and others claim. Because of the disconnect between hard markets and tort laws, “tort reform” remedies pushed by these advocates have been colossal failures and will fail once again to prevent what the industry is now threatening. Only effective insurance reforms and oversight, which are called for at the end of this study, can stop these cyclical insurance crises, now and for future years to come.

Hard Markets, Soft Markets, Insurance Cycles and “Crises” – A Short Explanation

To understand these insurance cycles, one must start with the basis premise that insurers make their money primarily from investment income, investing the premium dollars they receive from policyholders. Specifically, they invest the “float” that occurs during the time between when premiums are paid into the insurer and losses paid out by the insurer —*e.g.*, there is about a 15 month lag in auto insurance, while there is a 5 to 10 year lag in medical malpractice.

As a corollary to this, rarely do insurers achieve an underwriting profit (i.e., when premiums taken in are more than “losses” and underwriting expenses). In many lines of insurance, an underwriting profit would produce a wildly excessive overall profit because the yield on the “float” is so great. During “soft market” periods, which cover most years, insurers compete heavily for premium dollars to invest. Because of competition, insurers keep rates low – sometimes too low. Therefore, most of the time they do not try to have, nor expect to have, an “underwriting profit.” It makes economic sense for them to compete for premium dollars to invest even though they may lose money on claims and expenses.

¹ Chad Hemenway, “Commercial Soft Market Has Ended, Says MarketScout,” *National Underwriter*, December 6, 2011.

Table 1 clearly illustrates this point, that is, this industry has hardly ever had an underwriting profit, occurring *in only 7 of the last 44 years*.

TABLE 1

UNDERWRITING GAIN/LOSS

1967	-1.1%	1982	-10.1%	1997	-2.2%
1968	-2.3%	1983	-12.4%	1998	-6.3%
1969	-3.8%	1984	-18.8%	1999	-8.6%
1970	-1.4%	1985	-18.8%	2000	-10.7%
1971	2.4%	1986	-10.0%	2001	-16.4%
1972	2.8%	1987	-5.4%	2002	-8.9%
1973	0.0%	1988	-5.9%	2003	-1.3%
1974	-6.1%	1989	-10.1%	2004	0.4%
1975	-8.8%	1990	-10.0%	2005	-1.6%
1976	-3.8%	1991	-9.2%	2006	7.6%
1977	1.6%	1992	-16.0%	2007	4.1%
1978	1.7%	1993	-7.7%	2008	-4.9%
1979	-1.5%	1994	-9.0%	2009	-0.1%
1980	-3.6%	1995	-6.8%	2010	-2.1%
1981	-6.5%	1996	-6.5%		

Source: *Best's Aggregates and Averages*, 2011 Edition.

Yet over this same period, despite almost always having an underwriting loss, the property/casualty industry prospered. As shown in Table 2, insurers' surplus - the extra cushion insurers hold in addition to the amount they have set aside to pay estimated future claims - rose by a factor of almost 40!

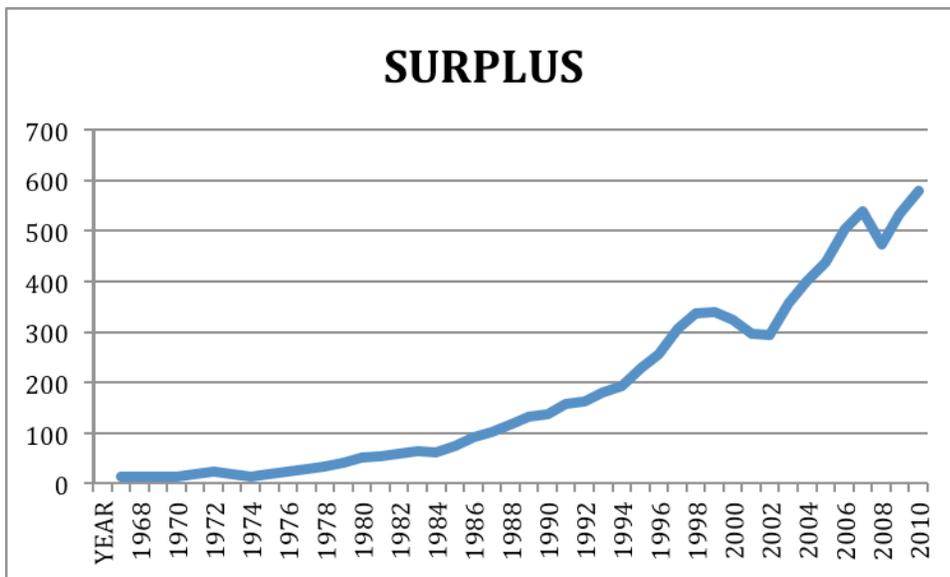
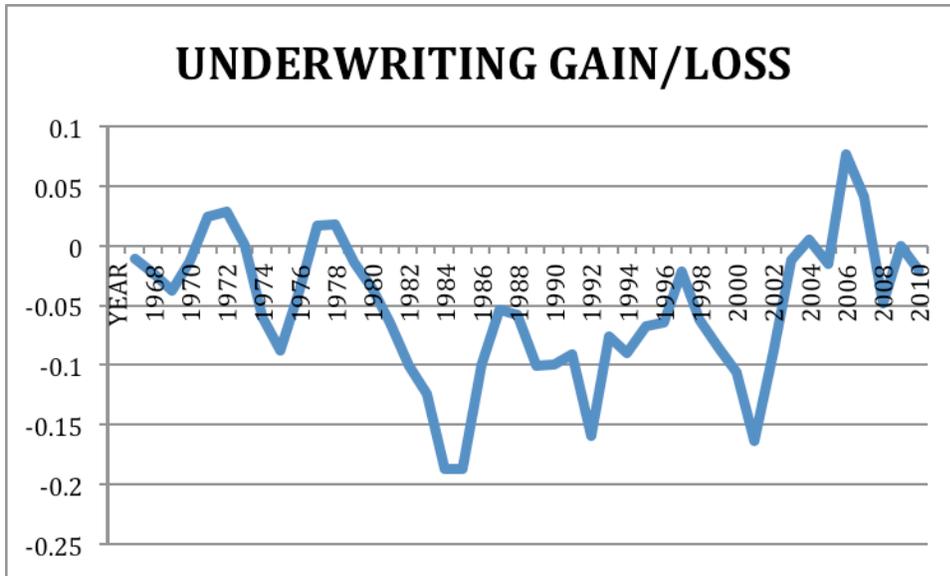
TABLE 2

SURPLUS BY YEAR (BILLIONS)

1967	\$15	1982	\$60	1997	\$308
1968	\$16	1983	\$66	1998	\$339
1969	\$14	1984	\$64	1999	\$340
1970	\$15	1985	\$76	2000	\$326
1971	\$19	1986	\$94	2001	\$298
1972	\$24	1987	\$104	2002	\$295
1973	\$21	1988	\$118	2003	\$358
1974	\$16	1989	\$134	2004	\$402
1975	\$20	1990	\$138	2005	\$438
1976	\$25	1991	\$159	2006	\$504
1977	\$29	1992	\$163	2007	\$540
1978	\$35	1993	\$182	2008	\$473
1979	\$42	1994	\$193	2009	\$534
1980	\$52	1995	\$230	2010	\$580
1981	\$54	1996	\$256		

Source: *Best's Aggregates and Averages*, 2011 Edition.

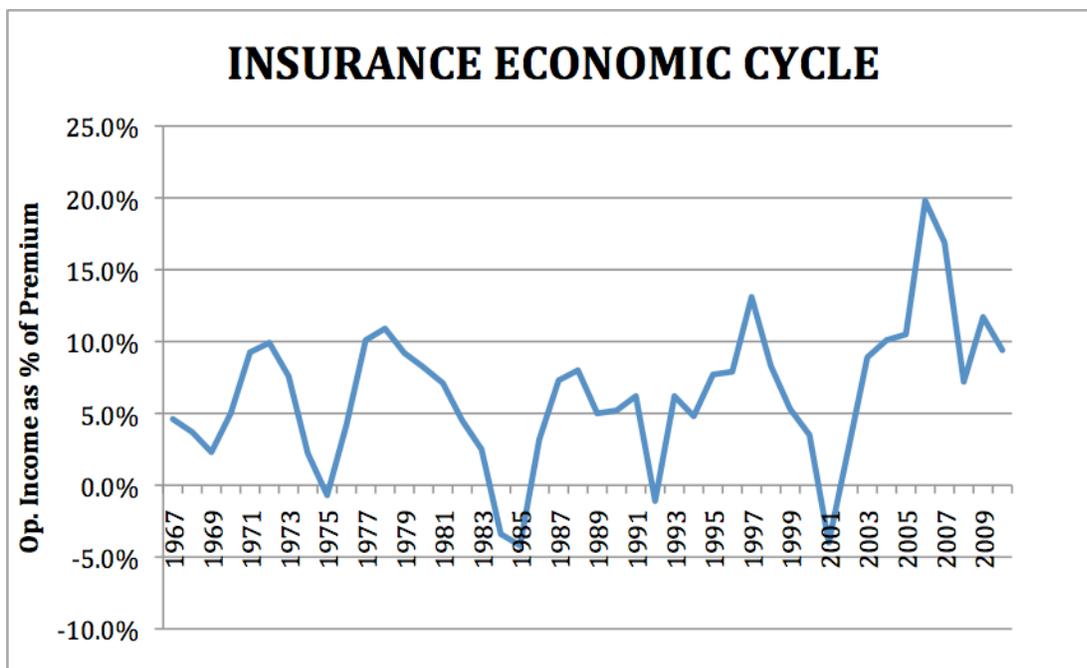
Graphing these data shows how this industry massively prospers while saying it is “suffering” losses.



The insurance “cycle” comes into play, as follows. As noted above, during years of high interest rates and/or excellent insurer profits, insurance companies engage in fierce competition for

premiums dollars to *invest* for maximum return.² This results in competitive *underpricing* of policies, when rates rise less than inflation. This is called the “soft market,” the duration of which is typically around six to ten years. However, when investment income decreases because interest rates drop, the stock market plummets and/or cumulative price cuts make profits unbearably low, the industry responds by sharply increasing premiums and reducing coverage, creating a “hard market.” For policyholders, a “liability insurance crisis” may result. These hard market periods last about three to four years.

The country experienced a hard insurance market in the mid-1970s, particularly in the medical malpractice and product liability lines of insurance. A more severe crisis took place in the mid-1980s, when most liability insurance was impacted. Again, from late 2001 through 2006, a “hard market” took hold, primarily in the property and medical malpractice lines. Each of these periods was followed by a soft phase. In fact, we have been in such a soft market period since 2006, as will be explained more fully below. The following chart shows this economic cycle at work.



(The 1992 data point was not a classic cycle bottom, but reflected the impact of Hurricane Andrew and other catastrophes in that year.)

It is critical to note the following. First, this cycle is national in scope and occurs in every state irrespective of a state’s tort law. Second, to justify sudden rate requests, insurers will argue that

² This is particularly true with regard to commercial insurance, like liability insurance for businesses or malpractice insurance. The personal lines market, like auto and homeowners insurance, is not as competitive because of the lack of knowledge of consumers and the resulting inertia in the marketplace.

“losses” are increasing. To those not familiar with how the industry works, the term “loss” suggests that companies are paying out more money. This is not true.

To an insurance company, the word “loss” is short for the term “incurred loss,” which includes “incurred but not reported” (IBNR) losses. When a company has an “incurred loss,” this does not mean the insurer has actually paid out this money. This figure includes *estimates of future claims that they do not even know about yet*. It is *this* figure that insurers file with state insurance departments when seeking rate hikes.

The money the insurers set aside for claims is called “reserves.” During hard markets, history shows that insurers can vastly (and unnecessarily) overstate their IBNR and other unpaid “losses” and increase reserves despite no increase in payouts or any trend suggesting large future payouts. This over-reserving phenomenon seems often to be politically-inspired, used by insurers as a way to show poor income statements, which in turn is used to justify imposition of large premiums increases, which as will be shown below, drives the push for laws to permanently reduce insurers’ payouts to policyholders – so called “tort reform.” During subsequent soft markets, these reserves often are then released through income statements as profits, as they are actually not needed to pay future claims (and never were). Releasing this money has another advantage: during the soft phase of the cycle, insurers must show profits in order to keep rates down, so they can try to gain market share. Releasing reserves helps them do that.

While the existence of this self-made cycle is clear, insurers often publicly deny the cycle’s existence while their lobbyists are trying to take advantage of the hard market and skyrocketing rates to push for “tort reform.” However, insurance insiders tell a very different story than do their lobbyists. For example, W.R. Berkley CEO William R. Berkley recently remarked in an interview:

Basically we’ve been in the business now for 38 years. It’s a cyclical business; we’ve been through three complete cycles going on to the fourth... [T]he cornerstone of succeeding and surviving in this business is understanding how to take advantage of those changes in the cycle and paying attention to what to do and what are the signs that give you the signals.³

Similarly, *Business Insurance* magazine published a White Paper in 2010 entitled “Hard Market Game Plan: Steps Risk Managers Need to Take Before Rates Rise.”⁴ The purpose of the White Paper is to show that any business can prepare for the very predictable periodic hard market, the arrival of which one business insider termed “the evil day.” In fact, this document is essentially a flat out admission that hard markets are not caused by jumps in claims, lawsuits or the tort system, which are not even mentioned in the document, but rather by insurer economics, for which businesses can plan.

³ Phil Gusman, “Berkley: Market Is Hardening; Good Companies Can Seize Opportunities,” *National Underwriter*, December 7, 2011.

⁴ “Hard Market Game Plan; Steps Risk Managers Need to Take Before Rates Rise,” *Business Insurance*, Crain Communications (2011).

Some of the more interesting statements found in this 2010 White Paper are:

Experts differ on when commercial insurance market will finally harden, but one thing they agree on is that a hard market will arrive ... eventually. And if past market turns are anything to go by, the next market turn will likely be abrupt and severe.⁵

The past two market cycles have featured long pricing slides followed by sharp upswings, said Michael Davis, president and CEO of Risk International Services Inc. in Fairlawn, Ohio. ... "I think when it happens, it's going to be really painful," Mr. Davis said.⁶

"It's not a question of if the market is going to harden, but when it's going to harden," Mr. [Jim] Rubel [of Lockton Cos., LLC] said. "When it does, I think it will harden with a vicious whip."⁷

"Redundancies now have been largely harvested," according to Dave Bradford, Executive VP of Advisen. [In other words, insurers "sow" or significantly grow their reserves during hard markets, resulting in poor-looking balance sheets to support extreme rate hikes, and then "harvest" or release these excessive or redundant reserves during soft markets, as we are in now, having never needed them in the first place.]⁸

In sum, insurers' unique accounting practices allow them to identify "losses" that are really not losses at all and to manipulate their reserves in order to justify requests for large and sudden rate hikes. All indications are that we are about to enter such a period very soon.

How Certain Laws Allow for the Creation of the Insurance Cycle

To understand how the property casualty insurance industry can create these hard and soft markets, it is necessary to start with one key observation: in 1944, Congress passed the McCarran-Ferguson Act, a law that exempts the insurance industry from anti-trust laws⁹ and allows the industry to collude on important components of insurance prices, an anti-competitive practice that is illegal for other industries. For example, at cycle bottoms immediately preceding a hard market, insurance companies will pressure their own competitors to stop competing for premium dollars and to raise rates and reserves as an entire industry. The exemption has also allowed creation of an industry-controlled, for-profit company called the Insurance Services Office, Inc. (ISO), which presents rate data to state insurance departments on behalf of the insurance companies using their services. State insurance departments often approve rates based on ISO data, which then are used by many insurance companies in their pricing models. Many companies use the ISO-selected classification and territories, further reducing competition.

⁵ *Id.* at 2.

⁶ *Id.* at 3.

⁷ *Id.* at 12.

⁸ *Id.* at 9.

⁹ 15 U.S.C. 1012-1015. The U.S. Supreme Court has held that insurance companies may not boycott their insureds by agreeing to deny them coverage entirely. *St. Paul Fire & Marine Inc. Co. v. Barry*, 438 U.S. 531 (1978).

While exempting the industry from anti-trust laws, Congress also prohibited any federal regulation of insurance.¹⁰ The job of regulating insurance companies has been left to the states. Most state insurance departments have weak or non-existent authority over insurance rates through prior approval or rejection of requests for rate increases. State insurance departments universally lack adequate investigators, auditors and other professionals, preventing them from recommending appropriate insurance rates and coverage. In other words, with few exceptions, state insurance departments have neither the authority nor the funding to exercise proper control over insurance industry pricing.

As for reinsurance, which insurance companies carry to spread their risk (a sort of lay-off bookie arrangement), the situation is even worse. Not only is there no federal regulation, but state insurance departments do not at all regulate rates and terms of coverage in reinsurance contracts. State reinsurance regulation is focused only on assuring the solvency of the reinsurer. States do not require foreign reinsurers, like Swiss Re or Lloyd's of London, to be licensed to do business in the United States. They require only that the foreign reinsurer maintain some security in the United States to back up its obligations, such as a U.S. trust fund or a letter of credit. And states have no data collection requirements for foreign reinsurers.¹¹

Given this poor oversight as well as the anti-trust law exemption, the insurance industry has been able to create liability insurance "crises" three times in the last 35 years, making insurance unaffordable or, in some cases, unavailable at any price for many businesses and professions.

The History of Hard Markets and Insurance Crises

Hard Market - Mid-1970s

"Like measles in a nursery, doctors' strikes seem to be erupting all across the nation. What the doctors are protesting is the skyrocketing cost of their malpractice insurance premiums."
"Malpractice - Doctors in Revolt," Newsweek cover story, June 9, 1975

The first liability insurance crisis in this country occurred in the mid 1970s, when co-author J. Robert Hunter was the Federal Insurance Administrator. To provide a sense of what was happening in the country, the *Washington Post* editorialized on November 3, 1976:

[I]t is becoming increasingly apparent that liability insurance - or the lack of it - is becoming a national problem.... Local governments are finding that it is increasingly difficult or expensive to buy insurance covering their police departments. And because of the price now placed on it, many small companies are dropping the product liability

¹⁰ 15 U.S.C. 1012-1015. Title V of the 2010 Public Law 111 – 203, the Dodd-Frank Wall Street Reform and Consumer Protection Act, allows the Federal Insurance Office to collect insurance data. However, the law maintains exclusive state regulation over "insurer's rates, premiums, underwriting, [and] sales practices."

¹¹ See, e.g., *The Liability Insurance Crisis*, Hearings Before the Subcomm. On Economic Stabilization of the House Comm. On Banking, Finance and Urban Affairs, 99th Cong., 2nd Sess. 83 (1986)(Statement of Mindy Pollack, Assistant General Counsel, Reinsurance Association of America). See also, Joanne Doroshow and Adrian J. Wilkes, *Goliath: Lloyd's of London in the United States*, Center for Study of Responsive Law (1988), pp. 27-30.

insurance they thought they needed ... The real beneficiaries of this litigation explosion have been the lawyers.

As the *Newsweek* cover story indicates,¹² doctors were hit hard with skyrocketing insurance rates. Insurers quickly blamed what they believed was occurring in the country – a “litigation explosion.” They demanded huge rate hikes from state regulators and convinced lawmakers that the only way to bring rates under control was to limit the legal rights of injured victims, i.e., insurer payouts. In fact, insurers learned during this period that state regulators would give away the store in rate increases. They also learned that they could easily take political advantage of the situation by asking state lawmakers to limit victims’ rights. For example, during this period California enacted the Medical Injury Compensation Reform Act, or MICRA, which among other things placed a \$250,000 cap on non-economic damages for malpractice victims.¹³ Pennsylvania enacted a law immunizing all Pennsylvania municipalities from most kinds of liability suits and limiting liability for even catastrophic events to \$500,000 per occurrence.¹⁴

Yet it turns out that there never was a “litigation explosion.” After insurers abandoned the medical and product manufacturer lines, the federal government decided to review the situation and not simply accept the insurer’s assertions that litigation was “exploding.” Hunter was part of the inter agency working group formed to look into the crisis and to report back specifically as to whether a claimed “explosion” of medical malpractice claims was causing the huge and sudden jump in premiums that doctors were experiencing.

Hunter’s research immediately found that data was not available to answer this question. Insurers did not have such data. Therefore, working with the National Association of Insurance Commissioners (NAIC), they undertook a closed-claim study. The closed claim study revealed that there was no “explosion” of claims and that there was no justification for the insurer actions. The group concluded that the insurers had panicked from lack of data. They reported back to the White House that the problem seemed attributable to insurer economics and negotiated with the NAIC to create a new medical malpractice line of data in insurers’ Annual Statements to enable them to monitor the situation over time.

However, the political lessons learned by the insurance industry were clear: by blaming lawyers and litigation for a crisis that the industry itself had manufactured, the industry could obtain major changes in tort laws – basically, gravy to their bottom line. Their clients – businesses and

¹² See, e.g., “Malpractice - Doctors in Revolt,” *Newsweek*, June 9, 1975 (“Like measles in a nursery, doctors’ strikes seem to be erupting all across the nation. What the doctors are protesting is the skyrocketing cost of their malpractice insurance premiums.”).

¹³ See Cal. Civil Code §3333.2.

¹⁴ 42 Pa. Cons. Stat. §§ 8501-8538. Notably, this cap continues to have tragic consequences for Pennsylvania victims. Recently, a Philadelphia area jury awarded \$14 million to a young woman who had to have her leg amputated while still a high school student, when a school bus plowed into a group of students. Pennsylvania’s \$500,000 liability cap means the judge must ignore the jury (whose award included \$3 million so she can get things like prosthetics) and reduce the award to the cap – if she’s lucky. As the *Associated Press* wrote, “The \$500,000 cap applies to all awards stemming from a single incident. And seven others have sued over injuries from the crash. If the cap is upheld, Zauflik could be left to share the \$500,000 with any others who win damage awards.” “Pa. jury awards \$14M for school bus crash that cost teen her leg when driver struck students,” *Associated Press*, December 5, 2011.

doctors – were more than happy to go along. It is a political strategy that worked in the 1970s, and carried them through the next 35 years.

Soft Market – 1978-1984

*The industry's problems were due to price cuts taken
"to the point of absurdity" in the early 1980s.
Had it not been for these cuts, there would not be
'all this hullabaloo' about the tort system."*
**Maurice R. Greenberg, AIG President and CEO
Business Insurance, 1986**

The country then entered a six-year soft-market phase. During these years, insurers lowered prices “to the point of absurdity”¹⁵ and insured poor risks around the nation just to get the premium dollars to invest, taking advantage of the ultra-high interest rates of the early 1980s. This period was characterized by such risky underwriting as retroactively insuring the MGM Grand Hotel for fire risk *months after it had burned down in a fire*, so the policy actually covered a known event.¹⁶

However, eventually, these astonishing price cuts became unbearable. Combined with dropping interest rates and investment income, insurance insiders signaled to the industry that the soft market period had to end. The industry needed to raise rates quickly and sharply. The following quotes from industry insiders and trade publications tell some of the story leading up to the next hard market, particularly how the industry pressured all competitors within the industry to stop competing for premium dollars and to coordinate rate hikes. It also shows how the industry again started taking advantage of the situation to press for “tort reform”:¹⁷

October 5, 1984: A survey by the leading trade publication, the *National Underwriter* (NU), concluded that “a tightening of the property and casualty insurance market in the United States is underway” but that “an across-the-board approach to raising rates was not being used.” Rather “an account by account review will determine future pricing” according to the executive contacted by NU.¹⁸

December 14, 1984: St. Paul, then the nation's largest medical malpractice insurer, told NU that “there is not a malpractice crisis around the corner” and that any problem in the medical malpractice insurance field “can be dealt with through rate adequacy, improved risk management, more intensive underwriting practices, and improved claims handling ability and strategy.”¹⁹

¹⁵ Greenwald, “Insurers Must Share Blame: AIG Head,” *Business Insurance*, March 31 1986, p. 3.

¹⁶ *The Liability Insurance Crisis*, Hearings Before the Subcomm. On Economic Stabilization of the House Comm. On Banking, Finance and Urban Affairs, 99th Cong., 2nd Sess. 83 (1986)(Testimony of J. Robert Hunter).

¹⁷ Quotes can be found at National Insurance Consumer Organization, “Crisis Creation Chronology” (1986) (on file with authors).

¹⁸ *National Underwriter*, October 5, 1984, pp. 1, 74.

¹⁹ *Id.*, December 14, 1984, p. 40.

December 21, 1984: At the National Association of Insurance Commissioner's annual meeting, there was no mention of any problems with the civil justice system, NU indicates. Yet in the same edition of the NU, it was reported that the Insurance Information Institute (III) would be launching a massive new advertising and public relations effort "to market the idea that there is something wrong with the civil justice system in the United States."²⁰

February 4, 1985. The President of ISO, Dan McNamara, told the ISO annual meeting, "The need for significant premium increases, especially for commercial lines, is absolute for the next three years," *Business Insurance* reports.²¹

May 1985: ISO in conjunction with the National Association of Independent Insurers released "1985 a Critical Year," which proclaimed that "the brutal price war of the last six years is over," and that "significant premium increases are needed especially for the current commercial lines products."²² (p. 5)

Hard Market – 1985-1988

During the prior six years, these companies increased doctors' malpractice premiums some 300 percent. Yet the number of claims against doctors had not gone up, the amount paid out by insurance companies had not increased, and the number of frivolous claims had not increased.
Michael Hatch, Commerce Commissioner of Minnesota, Interviewed on ABC's Nightline, 1989.

By mid-1985, major companies were pressuring their competitors to start raising rates again, to reduce or cancel coverage for policyholders and to use these events to start pressing for major limits on the legal rights of everyday Americans, so-called "tort reform." The following quotes are instructive:²³

June 10, 1985: Aetna President William O. Bailey told the National Association of Insurance Brokers (NAIB), "clearly another round of price increases is absolutely necessary for the business" and that "the time is right to start engaging in some serious efforts for tort reform," according to *Business Insurance*. Crum & Foster Chairman John K. Lundberg told the NAIB that "a lot of people are going to go without insurance."²⁴

June 18, 1985: GEICO Chairman John J. Byrne told the Casualty Actuaries of New York, "it is right for the industry to withdraw and let the pressures for reform build in the courts and in the state legislatures," the *Journal of Commerce* reports. According to the

²⁰ *Id.*, December 21, 1984, pp. 1, 2, 46.

²¹ *Business Insurance*, February 4, 1985, p. 16.

²² *National Underwriter*, May 1985, p. 5.

²³ Quotes can be found at National Insurance Consumer Organization, "Crisis Creation Chronology" (1986) (on file with authors).

²⁴ *Business Insurance*, June 10, 1985, p. 3.

Journal of Commerce, Mr. Byrne told the actuaries that “the insurance industry should quit covering doctors chemical manufacturers and corporate officers and directors.”²⁵

June 28, 1985: Only six months after the NAIC annual meeting at which no mention was made of a “civil justice crisis,” NU reports that talk of “civil justice system abuses” dominates the NAIC mid-year meeting.²⁶

September 6, 1985: NU reports, “the quick reversal in underwriting standards has been shocking.” An NU review notes that “we have received reports of major markets placing moratoriums on all new business;” that medical malpractice insurance is “rapidly becoming hard to find;” and that in general liability “what has occurred ... is a return to basic ISO rating subject to a minimum 20% surcharge...”²⁷

Indeed by early 1986, the hard market was in full swing. Manufacturers, municipalities, doctors, nurse-midwives, day-care centers, non-profit groups and many other commercial customers of liability insurance, found themselves in the midst of a “crisis.” Insurance rates were skyrocketing, up 300 percent or more for some. Many could not find coverage at any price. The situation received extensive media attention, such as *Time Magazine*’s March 1986 cover story entitled, “Sorry, Your Policy is Cancelled.”²⁸

Notably, this hard market stopped at no state boundary. It occurred whether or not a state had placated the industry during the prior hard market and stripped victims of their legal rights. For example, Pennsylvania municipalities were again hit with rate hikes even though the state had severely capped their liability at \$500,000.²⁹ In California, which had capped non-economic damages for injured patients at \$250,000 with no inflation adjustment (MICRA), doctors saw their rates jump as well.³⁰

Not surprisingly, study after study that examined the property/casualty insurance industry found that the “insurance crisis” was a self-inflicted phenomenon caused by the mismanaged underwriting practices of the industry itself, leading *Business Week* magazine to explain:

²⁵ *Journal of Commerce*, June 18, 1985, p. 10A.

²⁶ *National Underwriter*, June 28, 1985, p. 1.

²⁷ *Id.*, September 6, 1985, pp. 8, 82.

²⁸ George J. Church, “Sorry, Your Policy Is Canceled,” *Time Magazine*, March 24, 1986.

²⁹ Pennsylvania Local Government Comm. Hearing on Municipal Liability Insurance, September 24, 1985, *Report, Recommendations and Summary of Testimony* (1985).

³⁰ “MICRA was enacted in 1975. However, premiums continued to rise. By 1988, twelve years after the passage of MICRA, California medical malpractice premiums had reached an all-time high – 450% higher than 1975, when MICRA was enacted. During the mid 1980s, California malpractice premiums increased by more than 20% annually. Insurance companies argue that premiums continued to increase after MICRA’s passage because of court challenges to the law; the California Supreme Court upheld the damage cap in 1985. Despite that ruling, however, malpractice premiums in California increased more dramatically in 1986 than any year since the passage of MICRA. Between 1985, when the cap was upheld, and 1988 [when voters passed Prop. 103, a strong insurance regulatory law], malpractice premiums soared 47%.” *Consumer Watchdog, How Insurance Reform Lowered Doctors’ Medical Malpractice Rates in California and How Malpractice Caps Failed* (2003), found at <http://www.consumerwatchdog.org/resources/1008.pdf>.

Even while the industry was blaming its troubles on the tort system, many experts pointed out that its problems were largely self-made. In previous years the industry had slashed prices competitively to the point that it incurred enormous losses. That, rather than excessive jury awards, explained most of the industry's financial difficulties.³¹

The Ad Hoc Insurance Committee of the National Association of Attorneys General concluded after studying the "crisis" in 1986:

The facts do not bear out the allegations of an "explosion" in litigation or in claim size, nor do they bear out the allegations of a financial disaster suffered by property/casualty insurers today. They finally do not support any correlation between the current crisis in availability and affordability of insurance and such a litigation "explosion." Instead, the available data indicate that the causes of, and therefore solutions to, the current crisis lie with the insurance industry itself.³²

State commissions in New Mexico, Michigan and Pennsylvania reached similar conclusions.³³ Insurance industry executives also admitted this internally. As noted earlier, in 1986, Maurice R. Greenberg, then President and Chief Executive Officer of American International Group, Inc., told an insurance audience in Boston that the industry's problems were due to price cuts taken "to the point of absurdity" in the early 1980s. Had it not been for these cuts, Greenberg said, there would not be 'all this hullabaloo' about the tort system."³⁴

But to the public and to lawmakers, insurers told a different story. On March 19, 1986, the *Journal of Commerce* reported that the Insurance Information Institute (III) was beginning a \$6.5 million nationwide advertising campaign designed in III's words to, "change the widely held perception that there is an insurance crisis to a perception of a lawsuit crisis."

It is no coincidence that the American Tort Reform Association (ATRA) was formed around this time, representing hundreds of U.S. and foreign corporations in their bid to overhaul civil liability laws at the state and national levels. In his 1995 report for the Washington-based group Essential Information, John Gannon found nearly 40 ATRA members were insurance companies or insurance-related organizations and six ATRA directors worked for insurance companies or law firms that frequently represented insurers.³⁵ *Legal Times* also reported that, "most of [ATRA's] funding comes from large corporate donors. Insurance firms ... are each good for \$50,000 or \$75,000, one unnamed lobbyist familiar with the Association told the publication."³⁶

³¹ "What Insurance Crisis?" *Business Week*, January 12, 1987.

³² Francis X. Bellotti, Attorney General of Massachusetts, et al., *Analysis of the Causes of the Current Crisis of Unavailability and Unaffordability of Liability Insurance* (Boston, Mass.: Ad Hoc Insurance Committee of the National Association of Attorneys General, May 1986).

³³ See, e.g., New Mexico State Legislature, *Report of the Interim Legislative Workmen's Compensation Comm. on Liability Insurance and Tort Reform*, November 12, 1986; Michigan House of Representatives, *Study of the Profitability of Commercial Liability Insurance*, November 10, 1986; Insurance Comm. Pennsylvania House of Representatives, *Liability Insurance Crisis in Pennsylvania*, September 29, 1986.

³⁴ Greenwald, "Insurers Must Share Blame: AIG Head," *Business Insurance*, March 31 1986, p. 3.

³⁵ John Gannon, *Tort Deform - Lethal Bedfellows*, Essential Information, 1995, pp. 23-25.

³⁶ "Proponents of Reform," *Legal Times*, April 17, 1995, cited in Ken Silverstein, *Smoke & Mirrors*, Public Citizen Congress Watch, 1996, p. 11.

Insurance industry print ads started running in media outlets, with such misleading headlines as *The Lawsuit Crisis is Bad for Babies*, *The Lawsuit Crisis is Penalizing School Sports* and *Even Clergy Can't Escape the Lawsuit Crisis*, appearing in *Readers' Digest*, *Time* and *Newsweek*, as well as in Sunday magazine supplements.³⁷ In 1986, Congressman John J. LaFalce (D-N.Y.) asked the III to submit information to Congress to back up the “clergy” ads, for example. During 1986 congressional hearings, LaFalce announced:

The information they gave us would lead us to conclude that there are only about a dozen of these religious malpractice cases pending throughout the country, and that the only one that has gone to trial was dismissed in favor of the defendant. In other words, ... at the time these ads were run, the insurance industry had not yet paid out one cent pursuant to any court judgment in any of these cases. Yet, they form an integral part of its national advertising campaign.³⁸

Insurance companies and other insurance trade associations complemented the III campaign with their own ads. For example:

Johnson & Higgins ran several ads in 1985 and 1986. One that appeared in the *Wall Street Journal* on November 19, 1985, stated, “the mounting wave of losses, which last year cost insurers more than \$116 for every \$100 of premium taken in, has forced insurers to act defensively. Most have stopped offering pollution insurance entirely and have cut back on other vital liability coverages ... Nothing has done more to create this ominous situation than the field day plaintiffs are having in court.”³⁹

Aetna ran a series of ads in 1987. One contained a pull-quote that read, “Somehow we’ve managed to create a [civil justice] system that makes good people behave badly.” The ad blamed the civil justice system for the fact that “insurers, whose reasons for being in business is to pool risks so that they are affordable, start looking for reasons not to take risks.”⁴⁰

Just as in the mid-1970s, state legislatures, regulators, and voters in ballot initiative states, were again told by business and insurance lobbyists (and their PR firms) that the only way to bring down insurance rates was to make it more difficult for injured consumers to sue in court. For example:

At a 1986 meeting of National Association of Insurance Commissioners, Iowa’s commissioner, William D. Hager, remarked, “The insurance industry has argued for some time that insurance rates and availability are predicated upon the high costs associated with the expanding tort system. It should clearly follow, therefore, that

³⁷ Herbert, “\$6.5 Million In Ads Targets Lawsuit Crisis,” *Journal of Commerce*, March 19, 1986, p. 1.

³⁸ *The Liability Insurance Crisis*, Hearings before the Subcomm. on Economic Stabilization of the Comm. on Banking, Finance and Urban Affairs, House of Representatives, 99th Cong., 2d. Sess., Part 1, July 23, 1986, p. 2.

³⁹ Stephen Daniels, “The Question of Jury Competence and the Politics of Civil Justice Reform: Symbols, Rhetoric, and Agenda-Building,” 52 *Law & Contemp. Prob.* 261 (1989).

⁴⁰ *Ibid.*

insurance rates will decrease and the availability improve with the advent of legislative reforms of the tort system.”⁴¹

Iowa’s Attorney General Tom Miller asserted in 1986, “Reforms are needed to reduce tort liability in the state and consequently cut spiraling insurance rates.”⁴²

A spokesman for the Texas Medical Association promised in 1986, “If significant tort reform is passed next year, there will be an immediate stabilization of premiums.”⁴³

In its March, 1987 newsletter, the Association for California Tort Reform, announced, “[D]oes significant reform mean lower insurance premiums? Yes!”

Ralph Gaines, Jr., a spokesman for the Alabama Civil Justice Reform Committee, said in 1987, “rigorous and meaningful tort reform will go a long way to reduce rates in insurance premiums.”⁴⁴

In New York in 1986, just months after state lawmakers responded once to the insurance crisis by enacting major “tort reforms,” Minority Leader Clarence D. Rappleyea (R-Norwich) called for even more changes -- complete elimination of joint and several liability and a \$250,000 cap on “non-economic damages -- saying these measures were still needed “to ease the liability insurance crisis.”⁴⁵

To garner support for Florida’s Amendment 10, the unsuccessful 1988 ballot initiative that would have capped noneconomic damages at \$100,000, the Florida Medical Association argued that “the cap was a necessary tradeoff to stop spiraling insurance rates.”⁴⁶

Doctors in Montana and their insurers said in 1988, “if tort reform is enacted to make the system more predictable, insurance rates will stabilize or drop.”⁴⁷

In a November 7, 1988, editorial entitled “Prepare for the backlash,” the *National Underwriter*, an insurance trade publication, bluntly conceded, “Let’s face it. The only reason tort reform was granted in many states is because people accepted our argument that it was needed to control soaring insurance rates.”

Threats and intimidation by reinsurers were an additional driving force behind the liability insurance crisis of the mid-1980s. Evidence gathered by over a dozen state attorneys general for

⁴¹ Kenneth Reich, “Insurers told rate cuts must precede more legal reform” *Los Angeles Times*, December 14, 1986.

⁴² Scott Sonner, “Miller calls for liability reform,” *UPI*, February 21, 1986.

⁴³ *UPI*, October 24, 1986.

⁴⁴ Dana Beyerle, “Civil liability law reform urged,” *UPI*, April 7, 1987.

⁴⁵ “Tort Reform, Banks on NY Insurance Agenda,” *Journal of Commerce*, January 22, 1987.

⁴⁶ Stephen Koff, “Voters deal hard blow to limits on liability,” *St. Petersburg Times*, November 9, 1988.

⁴⁷ Mike Dinnison, “In rural areas, doctors are delivering sad message to mothers-to-be,” *Los Angeles Times*, May 1, 1988.

an anti-trust⁴⁸ class action filed in 1988, and settled in 1995, found that a number of insurance and reinsurance companies had helped cause the insurance crisis by restricting coverage to commercial customers and raising prices, creating an atmosphere intended to coax states into enacting “tort reform.”⁴⁹ According to the anti-trust complaint, Lloyd’s of London became the locus of meetings and discussions for a coordinated industry effort to raise commercial insurance rates, abandon certain lines of coverage, change the standard terms of coverage used by the majority of the industry and enact “tort reforms.”⁵⁰

The influence of reinsurers over rates was effective even over doctor-owned mutual insurance companies, which account for more than half the medical liability insurance in this country and should be independent of the profit considerations that motivate pricing decisions by the rest of the industry:

In 1985 testimony before the Maryland Governor’s Task Force on Maryland Mutual Society’s request for a 70 percent rate increase for OB/GYNs (when a 10 percent reduction was justified), the company’s president stated, “In order to keep [reinsurers’] participation on cover we had to accede to some strong suggestions from the reinsurers to beef up the rate charged to the OB’s and it might be relevant to point out Med Mutual is...the only company in the state writing OB’s.”⁵¹

In 1987, after heavy lobbying by the Medical Mutual Society, Maryland’s legislature passed a bill to limit collateral source payments in medical malpractice cases. According to Maryland Delegate Lawrence Wiser, in early August 1987, John Spinella, then of Medical Mutual, was asked why there was little rate reduction as a result of the new collateral source law. Spinella replied that there would not be much rate impact because Medical Mutual still had to pay the same premiums to their London reinsurers.⁵²

In Arizona in April 1987, the Mutual Insurance Company of Arizona (MICA) announced medical malpractice rate increases averaging 36 percent across the board, with some as high as 50 percent, despite a whopping \$38 million surplus, up 23 percent from 1985. MICA said the surplus was needed to maintain a 1:1 premium/surplus ratio, which it claimed was required by the Arizona Department of Insurance (DOI). DOI director Dave Childers, however, denied that his department had ever required such a premium/surplus

⁴⁸ The U.S. Supreme Court has held that insurance companies may not boycott their insureds by agreeing to deny them coverage entirely. *St. Paul Fire & Marine Inc. Co. v. Barry*, 438 U.S. 531 (1978).

⁴⁹ *In re Insurance Antitrust Litigation*, MDL No. 767, No. C-88-1688 [CAL] (N.D. Cal.); *The State of Texas v. Insurance Services Office, Inc., et al*, No. 439089 (Tex. Dist. Ct., Travis Co., 53rd Jud. Dist., filed March 22, 1998). See also, “Final Approval Given To Insurance Antitrust Settlement,” *Mealey’s Litigation Reports*, April 18, 1995; “Ten States Announce They Will Join Antitrust Suits,” *Insurance Antitrust & Tort Reform Report*, June 15, 1986; Joanne Doroshow and Adrian Wilkes, *Goliath: Lloyd’s of London in the United States*, Center for Study of Responsive Law (1988), text accompanying n. 74-77; pp. 69-95.

⁵⁰ *In re Insurance Antitrust Litigation*, MDL No. 767, No. C-88-1688 [CAL] (N.D. Cal.); *The State of Texas v. Insurance Services Office, Inc., et al*, No. 439089 (Tex. Dist. Ct., Travis Co., 53rd Jud. Dist., filed March 22, 1998).

⁵¹ *The Liability Insurance Crisis*, Hearings Before the Subcomm. On Economic Stabilization of the House Comm. On Banking, Finance and Urban Affairs, 99th Cong., 2nd Sess. 83 (1986)(Testimony of J. Robert Hunter) (Exh. I, Sheet 1).

⁵² Telephone Interview by Joanne Doroshow with Delegate Lawrence Wiser, October 13, 1987.

ratio.⁵³ Six months later, during a subcommittee hearing of the Governor's Committee in Medical Malpractice Insurance in Arizona, Woody Beckman, MICA's actuary, implicated the reinsurance industry as responsible for both the high surplus and the premium increases. According to task force member Jim Roush, staff director of Fairness and Accountability in Insurance Reform, "There were...several legislators in attendance who remember, as I do, that it was a whole new defense of the surplus and certainly the first time any of us had heard of any linkage to the reinsurance market..."⁵⁴

Some of the threats directed at lawmakers at that time were quite brash. In 1985, attorney Jeff Johnson of the U.S. law firm LeBoeuf, Lamb, Leiby and MacCrae⁵⁵ – Lloyd's U.S. counsel – told Alaska state legislators:

If you change your tort laws in Alaska, you will have a market here when the rest of the United States will not. Lloyd's is pulling out of the United States as a reinsurer – they have already pulled out of Connecticut, New York and New Jersey – and they're continuing to pull out of more states.⁵⁶

As a result, Alaska's Director of Insurance, John George, proceeded to tell Alaska's Defense Council, "Lloyd's is threatening to pull out of the United States, in fact they are pulling out of the States one by one, but they will stay in Alaska if we enact tort reform. If we all work together we might be able to steam roller this legislation."⁵⁷ (Alaska responded by enacting a broad "tort reform" bill.)

Meanwhile, Lloyd's was also telling the U.S. Congress that America's tort system was to blame for the company's underwriting losses. U.S. Representative John LaFalce (D-NY) noted:

Both American reinsurance companies and the foreign reinsurers, or alien reinsurers, in particular the Lloyd's of London market, argue that they were more severely hit in terms of declining profitability in 1984 and 1985, than the primary insurers. The major reason given by these reinsurance groups for their declining profitability is the so-called explosion in tort litigation.⁵⁸

⁵³ Letter from Jim Roush, Staff Director, Fairness and Accountability in Insurance Reform to Joanne Doroshow, Center for Study of Responsive Law, October 8, 1987.

⁵⁴ *Ibid.*

⁵⁵ LeBoeuf, Lamb, Greene and MacCrae is the firm's current name.

⁵⁶ *The Liability Insurance Crisis*, Hearings Before the Subcomm. On Economic Stabilization of the House Comm. On Banking, Finance and Urban Affairs, 99th Cong., 2nd Sess. 83 (1986)(Testimony of J. Robert Hunter)(Exh. I, sheet 3)(Excerpt from Report of Casualty Insurance Colloquium held for Alaska State Legislators by the Insurance Industry, September 17, 1985)(Statement by Jeff Johnson).

⁵⁷ Summary of Casualty Insurance Colloquium held for Alaska State Legislators by the Insurance Industry (September 17, 1985)(Statement from summary of presentation of John George, Director of Insurance, State of Alaska).

⁵⁸ *The Liability Insurance Crisis*, Hearings Before the Subcomm. On Economic Stabilization of the House Comm. On Banking, Finance and Urban Affairs, 99th Cong., 2nd Sess. 83 (1986)(Statement of Hon. John J. LaFalce, Chairman of Subcomm.).

Yet when a U.S. Senator sought statistics on Lloyd's payouts on U.S. claims, Lloyd's would not supply this information.⁵⁹ And despite its threats, Lloyd's never pulled out of the United States. In fact, within two years, desperately in need of U.S. business, Lloyd's representatives began attempting to smooth over any evidence of withdrawal and minimize their earlier intimidation of U.S. companies and public officials.⁶⁰

During this period, great pressure was brought to bear on state legislatures to enact so-called "tort reforms" after being told by insurance companies and others that this was the only way to reduce skyrocketing insurance rates. Lawmakers in some 46 states succumbed to this pressure and passed many so-called "tort reforms." A summary list of laws passed during this period can be found in Appendix A of the Center for Justice & Democracy study, *Premium Deceit: The Failure of "Tort Reform" To Cut Insurance Prices*.⁶¹

In 1989, as a new soft market phase was beginning, Michael Hatch, then Commerce Commissioner of Minnesota, released an investigation of two malpractice insurers including the country's then largest, St. Paul. Hatch found that during the prior six years, these companies had increased doctors' malpractice premiums some 300 percent. Yet the number of claims against doctors had not gone up, the amount paid out by insurance companies had not increased, and the number of frivolous claims had not increased either. In response to a question by ABC's *Nightline* as to how this could happen, Hatch responded, "Because they had the opportunity to do it. There was a limited market. People need coverage. The companies knew they had a corner on it, and they raised their rates accordingly."⁶²

Indeed, there was never any evidence in any area of claims "exploding" in the mid-1980s, but rather a consistent increase in claims over time roughly equal to inflation. However, premiums had exploded.⁶³

The National Association of Insurance Commissioners undertook a major study of what happened, publishing its findings in 1991 in a document called "Cycles and Crises in Property/Casualty Insurance: Causes and Implications for Public Policy." NAIC concluded that these cycles were real and caused by some or all of three contributing factors:

1. Adverse shock losses that move insurers away from their target leverage ratios leading to supracompetitive (excessive) prices,
2. Changes in interest rates, and

⁵⁹ Letter from R. Hazell to Sen. John Danforth, Chairman of the Senate Comm. On Commerce, Science and Transportation, April 2, 1986.

⁶⁰ See, e.g., "Lloyd's Forecast is Bullish," *Journal of Commerce*, September 8, 1987.

⁶¹ See, *Premium Deceit: The Failure of "Tort Reform" to Cut Insurance Prices*, Center for Justice & Democracy (1999), found at <http://centerjd.org/system/files/PremiumDeceit.pdf>

⁶² *Nightline*, February 14, 1989 (Discussion of medical malpractice insurance premiums with Ted Koppel (ABC), St. Paul Companies spokesperson David McDonell, Minnesota Department of Commerce Commissioner Michael Hatch and Dr. Christopher Foley; taped segment with James Walker (ABC), Dr. Donald Gehrig, St. Paul Companies spokesperson Timothy Morse, Hatch, McDonell, and insurance actuary Martin Simons).

⁶³ For national premium and claims data in the medical malpractice line, for example, see *True Risk: Medical Liability, Malpractice Insurance and Health Care*, Americans for Insurance Reform (2009), found at <http://www.insurance-reform.org/TrueRiskF.pdf>, p. 14 and Exh. A.

3. Under-pricing in soft markets.

The report stated that regulators saw “considerable price cutting in soft markets which depletes surplus and increases the severity of the reversal when the market tightens.” This is particularly true in what are called “long-tail” lines like medical malpractice, which has about a 5 to 10 year lag between when premiums are paid into and losses paid out by the insurer.

At the time, co-author Hunter (and others) called for increased regulation to keep prices from being excessive during hard markets and inadequate during soft markets. The NAIC was cautious about this type of recommendation, in part because it would have required insurers to raise prices during the soft part of the cycle. This would be a difficult political step to take to be sure – yet necessary to mitigate the damage of cyclical excesses. However, with the exception of California’s 1988 voter initiative, Prop. 103,⁶⁴ this type of insurance rate regulation was not enacted in states following the devastating hard market of the 1980s.

Soft Market – 1988-2001

“[M]any tort reform advocates do not contend that restricting litigation will lower insurance rates, and I’ve never said that in 30 years.”

**ATRA General Counsel Victor Schwartz
Liability Week, 1999**

For the next 13 years or so, rates stabilized and availability improved everywhere. The strong financial markets of the 1990s expanded the usual six- to 10-year soft market phase of the cycle. No matter how much insurers cut their rates, the insurers wound up with a great profit year when investing the float on the premium in this amazing stock and bond market. Further, interest rates were relatively high as the Fed focused on inflation. Notably, this improvement occurred whether or not a state had enacted so-called “tort reform.” As then Washington Insurance Commissioner Dick Marquardt put it in a 1991 report, it was “impossible to attribute stable insurance rates to tort-law changes or the damage cap. (Rates also improved in states that didn't pass tort reform.)”⁶⁵

An interesting political phenomenon occurred during this prolonged soft market: the “tort reform” movement’s principal justification for “tort reform” – spiking insurance rates – evaporated. This led to some interesting admissions by representatives of this movement. For example, as noted earlier, towards the end of this soft market period, the Center for Justice & Democracy published a 1999 study called *Premium Deceit – the Failure of “Tort Reform” to Cut Insurance Prices*. The study was the first-ever look at 14 years of property/casualty insurance price trends nationwide. The study found that the enactment of laws that restrict injured victims’ rights to go to court had no impact on rates. States with little or no tort law restrictions experienced approximately the same changes in insurance rates as those states that enacted severe restrictions on victims’ rights.

⁶⁴ See, Consumer Watchdog, “Proposition 103 – Main Provisions and Status,” found at <http://www.consumerwatchdog.org/feature/proposition-103-main-provisions-and-status>

⁶⁵ “Health-Care Reform – Bush’s Insurance-Cap Plan A Proven Failure,” *Seattle Times*, May 16, 1991.

When asked to comment on these findings, Sherman Joyce, president of the American Tort Reform Association told *Liability Week* on July 19, 1999, “We wouldn’t tell you or anyone that the reason to pass tort reform would be to reduce insurance rates.” ATRA General Counsel Victor Schwartz told the same publication, “[M]any tort reform advocates do not contend that restricting litigation will lower insurance rates, and ‘I’ve never said that in 30 years.’” And when the Center for Justice & Democracy reissued *Premium Deceit* in 2002, Debra Ballen, American Insurance Association executive vice president, responded in a March 13, 2002 news release, “Insurers never promised that tort reform would achieve specific savings.” In other words, these spokespeople essentially confirmed *Premium Deceit*’s conclusions, in striking contrast to the industry’s heated “tort reform” rhetoric during both of the prior two hard markets. It was not to last.

In 2000, the market started to turn again with a vengeance as the Fed cut interest rates again and again. The prolonged soft market was finally about to end.

Hard Market – 2002 – 2006

“A decade of short-sighted price slashing led to industry losses of nearly \$3 billion last year. I don’t like to hear insurance-company executives say it’s the tort [injury-law] system – it’s self-inflicted,” says Donald J. Zuk, chief executive of Scpie Holdings Inc., a leading malpractice insurer in California.”
Wall Street Journal, 2002

On September 11, 2001, the cycle was already about to turn. The terrorist attacks sped up the advent of the hard market, collapsing two years of anticipated price increases into a few months. Some seasoned industry analysts saw this as gouging. Indeed, said one insurance consultant, “[T]here is clearly an opportunity now for companies to price gouge – and it’s happening.... But I think companies are overreacting, because they see a window in which they can do it.”⁶⁶ Another put it this way: “A simple way of saying it is that adversity breeds opportunity. That’s probably a little too crass. But that’s the way capital looks at it.”⁶⁷ Indeed, by 2002, a new insurance “hard market” was underway, this time impacting property as well as liability coverages, especially the medical malpractice lines of insurance, with rates going up 100% or more.

In addition, in 2001, one of the country’s largest medical malpractice insurance companies, St. Paul, pulled out of the medical malpractice insurance market, creating significant supply and demand problems in some states. According to a June 24, 2002, *Wall Street Journal* front-page investigative article, St. Paul, with a 20 percent share of the national market, pulled out after having mismanaged its underwriting and reserves during the prior soft market period. A few smaller companies took St. Paul’s lead and collapsed. The head of a leading medical malpractice

⁶⁶ Jeanne Hollister, consulting actuary, Tillinghast-Towers Perrin, quoted in, “Avoid Price Gouging, Consultant Warns,” *National Underwriter*, January 14, 2002.

⁶⁷ Joseph B. Treaster, “Insurers’ Outlook (Unexpectedly) Good, Despite Big Claims,” *New York Times*, December 17, 2001.

insurer described problems in the med mal insurance market: “I don’t like to hear insurance-company executives say it’s the tort [injury-law] system – it’s self-inflicted.”⁶⁸

As one insurance industry insider also put it in 2001: “The [medical malpractice insurance] market is in chaos.... Throughout the 1990s ... insurers were ... driven by a desire to accumulate large amounts of capital with which to turn into investment income. Regardless of the level of ... tort reform, the fact remains that if insurance policies are consistently underpriced, the insurer will lose money.”⁶⁹

But again, policymakers were not listening to experts like this, who were explaining what was now a very familiar pattern. Instead, federal and state lawmakers and regulators (and the general public) once again turned to medical and insurance lobbyists for an explanation as to why doctors’ insurance rates were rising. The lobbyists had one explanation: exploding tort system costs. The industry argued and, worse, convinced doctors to believe that patients who filed medical malpractice lawsuits were being awarded more and more money, leading to unbearably high “losses” for insurers. Insurers stated that to recoup money paid to patients, medical malpractice insurers were being forced to raise insurance rates or, in some cases, pull out of the market altogether.

However, as many studies showed, this was false. For example, Americans for Insurance Reform 2007 analysis of medical malpractice claims and premiums showed the following:⁷⁰

Inflation-adjusted payouts per doctor failed to increase between 2001 and 2004, a time when doctors’ premiums skyrocketed.

Medical malpractice insurance premiums rose much faster in the early years of 2000’s than was justified by insurance payouts.

At no time were increases in premiums connected to actual payouts.

During this same period, medical malpractice insurers vastly (and unnecessarily) increased reserves (used for future claims) despite no increase in payouts or any trend suggesting large future payouts. The reserve increases in the years 2001 to 2004 could have accounted for 60 percent of the price increases witnessed by doctors during this period.

Indeed, according to A.M. Best, reserves were “redundant” (i.e. excessive) between 2002 to 2004.⁷¹ In those years, insurers told lawmakers that they needed to raise rates dramatically for doctors in order to pay future claims. It wasn’t true. But as explained earlier, as reserves went up, so did rates.

⁶⁸ Christopher Oster and Rachel Zimmerman, “Insurers’ Missteps Helped Provoke Malpractice ‘Crisis,’” *Wall Street Journal*, June 24, 2002.

⁶⁹ Charles Kolodkin, “Medical Malpractice Insurance Trends? Chaos!,” International Risk Mgmt. Institute (September 2001).

⁷⁰ *Stable Losses, Unstable Rates*, Americans for Insurance Reform (2007) found at <http://www.insurance-reform.org/StableLosses2007.pdf>.

⁷¹ A.M. Best, “Solid Underwriting Undercut by MPLI’s Investment Losses,” *Best’s Special Report*, April 27, 2009.

In a 2005 study of the 15 leading medical malpractice insurance companies,⁷² former Missouri Insurance Commissioner Jay Angoff found that during the period 2000-2004 the amount the major medical malpractice insurers collected in premiums more than doubled, while their claims payments remained essentially flat. The report also found that many insurers substantially increased their premiums while their claims payouts were decreasing, and that some insurers also reduced projections of their ultimate payouts while increasing their premiums. Specifically, the insurers increased their net premiums by 21 times the increase in their net claims payments. In addition, Angoff's report found that the leading malpractice insurers accumulated record amounts of surplus--the extra cushion insurers hold in addition to the amount they have set aside to pay estimated future claims--during the prior three years.

To say medical malpractice insurers did well during this period would be an understatement. Despite their lobbying position that medical malpractice claims and lawsuits were making it difficult for them to survive, these companies thrived. In fact, they did so well during this hard market that, while every other sector in the economy began suffering through a global economic crisis, medical malpractice insurers had "a very good" 2008.⁷³ This came "after posting record profits in 2007."⁷⁴ A 2009 study by Americans for Insurance Reform found that by every measure, medical malpractice insurer profits were *higher* than the rest of the property casualty industry, which itself had been remarkably profitable during the period.⁷⁵

AIR also found, once again, that states that had resisted enacting severe restrictions on injured patients' legal rights during the prior two hard markets experienced rate changes similar to those states that had enacted severe restrictions on patients' rights, i.e., there was no correlation between "tort reform" and insurance rates for doctors.⁷⁶

But because rates were so high for doctors and hospitals everywhere, and coverage unavailable for some, doctors threatened to leave states or give up medicine entirely and were told to blame juries, judges and injured patients. Trade and business associations conveyed that message to lawmakers and the public everywhere in campaigning for more so-called "tort reform." For example:

The American Medical Association (AMA) announced in March 2002 that it planned to lobby lawmakers and courts in at least 25 states and mount an ad campaign that raised public support for "tort reform." In explaining the AMA's position, President Richard Corlin claimed that limits on injured patients' rights to sue were needed because "[m]any practitioners, both generalists and specialists, just can't afford the liability premiums, forcing them to retire early, limit their practice or relocate."⁷⁷

⁷² Jay Angoff, *Falling Claims and Rising Premiums in the Medical Malpractice Insurance Industry*, Center for Justice & Democracy (2005) found at <http://centerjd.org/system/files/ANGOFFReport.pdf>

⁷³ A.M. Best, "Solid Underwriting Undercut by MPLI's Investment Losses," *Best's Special Report*, April 27, 2009.

⁷⁴ *Ibid.*

⁷⁵ See, *True Risk: Medical Liability, Malpractice Insurance And Health Care*, Americans for Insurance Reform (July 2009) found at <http://insurance-reform.org/pr/090722.html>.

⁷⁶ *Ibid.*

⁷⁷ Simon Avery, "Doctors vow tort reform to reduce insurance costs," *Associated Press*, March 11, 2002. See also, "AMA: To Campaign For Malpractice Tort Reform," *American Health Line*, March 13, 2002.

In January 2002, the American Association of Health Plans (AAHP) and the Physician Insurers Association of America (PIAA) announced that as co-chairs of the American Tort Reform Association's (ATRA) Medical Liability Committee they would "work at the state and federal level to educate opinion leaders on the consequences of frivolous lawsuits on health care access and quality."⁷⁸

ATRA announced in December 2001 that "[s]ome physicians in parts of eastern Pennsylvania have already abandoned their practices because of skyrocketing insurance premiums, opting to retire early or move to states where premiums cost much less. Pennsylvania, like other states where malpractice insurance rates have soared in the absence of meaningful civil justice reforms, is facing a physician shortage crisis. Legislators in Pennsylvania's General Assembly have promised to address liability reform in January to help keep their doctors from leaving the state."⁷⁹

Dave Golden, director of commercial lines at the National Association of Independent Insurers, argued: "If insurance companies can spend less defending themselves and the doctors they insure in court, the cost of doing business and practicing medicine in West Virginia can return to normal levels. Otherwise, doctors will continue to flee and turn to states where the litigation climate and insurance rates are more palatable."⁸⁰

In a March 2003 policy paper called "Doctors on Strike," Bruce Bartlett, wrote, "Recently, there have been numerous press stories about doctors striking to protest high medical malpractice premiums. This is just the most obvious evidence that something is fundamentally wrong with the nation's tort liability system. A number of reports suggest that the cost is growing out of control, imposing a de facto tax on all Americans that is slowing economic growth and investment, while doing little for those suffering real harm. ... But the cost of compensating people for these problems has been going up rapidly without any evidence that the underlying causes are increasing.

During this period, Congress was heavily pressured by some political forces, including President George W. Bush, to enact federal medical malpractice litigation limits. The U.S. Senate considered such bills at least five times between 2003 and 2006, but rejected them decidedly each time.⁸¹ However, many state lawmakers once again succumbed to the same pressure and did enact state "tort reform" laws, focusing heavily on limiting the rights of patients injured by medical negligence. In Texas, for example, voters were coaxed into voting to change their own state constitution to allow their own rights to be stripped away. The insurance industry and

⁷⁸ "AAHP Partners with Physicians to Fight for Medical Malpractice Reform; AAHP to Co-Chair American Tort Reform Association's Medical Liability Committee," *PR Newswire*, January 10, 2002.

⁷⁹ American Tort Reform Association, "Insurance Rate Hikes Force Pennsylvania Doctors To Close Doors," December 19, 2001, found at <http://www.atra.org/alert.fl.ml?aid=7265>.

⁸⁰ "Tort Reform Necessary To Quell WV Medical Malpractice Crisis," *PropertyandCasualty.com News*, December 14, 2001.

⁸¹ The Senate failed to invoke cloture on 7/09/03 (S.11); 2/24/04 (S.2061); 4/07/04 (S.2207); 5/08/06 (S.22 and S.23). Most bills of these would have imposed hard non-economic damages caps of \$250,000; some applied only to certain types of malpractice; some allowed a limited stacking of damages depending on the number of defendants. See, Dana Milbank, "Take Two of These and Call Us Next Year," *Washington Post*, May 9, 2006.

regulators made loud promises at the time that if this happened and “caps” on damages were passed, insurance companies would lower insurance rates for doctors. Caps were indeed enacted. Yet, immediately thereafter, major insurers requested rate *hikes* as high as 35 percent for doctors and 65 percent for hospitals.⁸² As reported in the *Houston Chronicle*:

House lawmakers sent a stern message to insurance companies Thursday: Medical malpractice lawsuit reforms passed last year were meant to help doctors - not boost profits. Republicans and Democrats who supported the legislation suggested that lawmakers might consider mandatory rate rollbacks if doctors don't get significant rate relief Texas Medical Liability Trust is the only major carrier to agree to reduce rates. Others have tried to raise rates. About 60 percent of Texas doctors have not seen a rate decrease, the commissioner said.⁸³

Of course, rates failed to drop because the country was still in the midst of a severe “hard market.” Rates were not coming down for anyone – yet.

Soft Market – 2006-2011

“We are all competing more aggressively with more capital for a pie that keeps shrinking,” he said, explaining why the market is not hardening. ‘It’s going to take outside forces. ... I think a natural disaster, a natural property disaster, could be a causative event that could turn the market.’”

**Nick Cortezi, CEO, All Risks,
Insurance & Financial Advisor, 2010.**

According to A.M. Best, after reaching a high of 14.2% in 2003, medical malpractice premium growth began dropping again, decreasing by 6.6% nationally in 2007, and an additional 5.3% in 2008.⁸⁴ The growth of insurance pure premiums⁸⁵ or loss costs,⁸⁶ as compiled by the Insurance Services Office (ISO) showed the same trend. Loss costs, or pure premiums, are the component of insurance rates that should be affected by verdicts, settlements, payouts, or so-called “tort reform.” It is the largest part of the premium dollar for most lines of insurance. According to the ISO,⁸⁷ the same cyclical pattern was at work, with the biggest increases between 2002-2005,

⁸² E.g. Darrin Schlegel, “Some Malpractice Rates to Rise Despite Prop. 12,” *Houston Chronicle*, Nov. 19, 2003; Darrin Schlegel, “Malpractice Insurer Fails in Bid for Rate Hike,” *Houston Chronicle*, Nov. 21, 2003; (October 2003 rate filing from Texas Medical Liability Insurance Association (JUA) to Texas Department of Insurance).

⁸³ Jim Vertuno, “House takes insurance firms to task over malpractice rates,” *Houston Chronicle*, April 23, 2004.

⁸⁴ “Solid Underwriting Undercut by MPLI’s Investment Losses,” *Best’s Special Report*, A.M. Best, April 27, 2009.

⁸⁵ “Pure premium” is a term used interchangeably with “loss costs.” It is the part of the premium used to pay claims and the cost of adjusting and settling claims, including adjuster and legal expenses.

⁸⁶ “Loss cost” is the term for the portion of each premium dollar taken in, that insurance companies use to pay for claims and for the adjustment of claims. Insurers use other parts of the premium dollar to pay for: their profit, commissions, other acquisition expenses, general expenses and taxes. Loss costs include both paid and outstanding claims (reserves are included through an actuarial process known as “loss development”) but also include trends into the future since rates based on ISO loss costs are for a future period. Thus, loss costs include ISO’s adjustments to make sure that everything is included in the price, even such factors as future inflation.

⁸⁷ The ISO has the largest database of audited, unit transaction insurance data of any entity in the United States.

and dropping steadily since then with 2008 seeing an astonishing 11% decrease.⁸⁸ Moreover, this decrease might have been even greater had 17 states not limited the decrease to 20%, likely because ISO wanted to control this drop. Most likely, this result was due to the recognition that, with profits as high as they were, medical malpractice insurance for doctors was greatly overpriced in prior years.⁸⁹

In its 2010 White Paper, *Business Insurance* reported additional confirmation of the current soft market industry-wide, specifically:

Rates are down: “One such factor is premium levels, which are approaching – and in some cases falling below – those reached in the late 2000, just before the last hard market... The average general liability and workers compensation premiums were 3.6% and 0.9% *below* year-end 2000 levels, respectively, as of June 30, 2010.”⁹⁰

Reserves that were excessive during previous hard market are being released and are still dropping: “Last year, U.S. property/casualty insurers also drew down on \$18.6 billion in reserves for losses in 2008 and prior years, according to Conning & Co.”⁹¹

In other words, there is no question that the country has been in a soft market since 2006.

What’s more, premiums have dropped in states irrespective of whether “tort reforms” were enacted, such as Texas.⁹² Once again, states with little or no restrictions on patients’ legal rights experienced the same level of liability insurance rate changes as those states that enacted severe restrictions on patients’ rights.⁹³ Compare, for example, Missouri and Iowa, two neighboring Midwest states. Missouri had enacted a cap during the second hard market the mid-1980s, as well as other “tort reform” in medical malpractice cases. Iowa has never had a cap. Between 2004 and 2008, Missouri’s pure premium increased 1%. Iowa’s dropped 6%.

And rates continued to drop through 2010. According to a December 2010 ISO publication, which examined reserves at year-end 2009, reserves were still redundant (i.e., excessive) for medical malpractice policies: 15% to 35% for occurrence policies and by 41% to 61% for claims made policies. This meant that rates had even further to fall.

It should be noted that insurance executives generally dislike soft market periods, very simply because the intense free market competition keeps them from raising everyone’s insurance premiums. As Marsh & McLennan Cos. CEO Brian Duperrault put it in an August 2011 New York speech before Lloyd’s of London clients, “Some of you may know that Lloyd’s was

⁸⁸ See, Americans for Insurance Reform, *True Risk: Medical Liability, Malpractice Insurance And Health Care*, July 2009. <http://insurance-reform.org/pr/090722.html>.

⁸⁹ Americans for Insurance Reform, *True Risk: Medical Liability, Malpractice Insurance And Health Care*, July 2009. <http://insurance-reform.org/pr/090722.html>.

⁹⁰ “Hard Market Game Plan; Steps Risk Managers Need to Take Before Rates Rise,” *Business Insurance*, Crain Communications, 2011, p. 8.

⁹¹ *Ibid.*

⁹² Americans for Insurance Reform, *True Risk: Medical Liability, Malpractice Insurance And Health Care*, July 2009. <http://insurance-reform.org/pr/090722.html>.

⁹³ *Ibid.*

created in a London coffeehouse in 1688. I think it was in 1689 that industry observers first started asking, ‘So when do you think we’ll see an end to this soft market?’”⁹⁴

The following industry quotes from 2010 are also instructive:

Thomas Phelan, president and CEO of the Injured Workers Insurance Fund (IWIF) [said] “2010 will be as bad as 2009.”⁹⁵

(That’s “bad” as in “low insurance rates for businesses.”) He continued,

Phelan, who said much of IWIF’s business is tied to construction, doesn’t expect things to improve much until next year. “By the second or third quarter of 2011, things should start to go in the right direction,” he said.⁹⁶

(That’s “right direction,” as in “the direction that will help us start raising rates again.”)

The head of W.R. Berkley Corp. said he sees an end in sight to the current soft market that’s affecting most of the industry. “I’ve always said to people my expectation is that prices will start to go up in the fourth quarter,” Chairman and Chief Executive Officer William R. Berkley said in an earnings conference call in which the company announced a slight drop in third-quarter net income to \$94 million from \$98 million. ... “There will be modest price increases beginning in the fourth quarter. We’re starting to see positive signs.”⁹⁷

(In other words, even though they are making plenty of money, they still want to raise rates on their customers.)

Nick Cortezi, chief executive officer at All Risks, a national specialty insurer based in Hunt Valley, Md., said he was “pessimistic” about the end of the soft market. “We are all competing more aggressively with more capital for a pie that keeps shrinking,” he said, explaining why the market is not hardening. “It’s going to take outside forces. ... I think a natural disaster, a natural property disaster, could be a causative event that could turn the market.”⁹⁸

⁹⁴ Mark E. Ruquet, Survey: Rates Flattening; Marsh CEO Says Don’t Rely On Hard Mkt. For Profit, *National Underwriter*, August 8, 2011.

⁹⁵ Bob Graham, “Property-casualty ‘soft market’ to continue for year or two, execs say.” This story originally appeared in the June 2010 print edition of Insurance & Financial Advisor but was found at <http://ifawebnews.com/2010/07/09/property-casualty-soft-market-to-continue-for-year-or-two-execs-say/>

⁹⁶ Bob Graham, “Property-casualty ‘soft market’ to continue for year or two, execs say.” This story originally appeared in the June 2010 print edition of Insurance & Financial Advisor but was found at <http://ifawebnews.com/2010/07/09/property-casualty-soft-market-to-continue-for-year-or-two-execs-say/>

⁹⁷ <http://www3.ambest.com/Frames/FrameServer.asp?AltSrc=23&Tab=1&Site=news&refnum=142164>

⁹⁸ Bob Graham, “Property-casualty ‘soft market’ to continue for year or two, execs say.” This story originally appeared in the June 2010 print edition of Insurance & Financial Advisor but was found at <http://ifawebnews.com/2010/07/09/property-casualty-soft-market-to-continue-for-year-or-two-execs-say/>

(In other words, there is way too much competition in the insurance market and we need a huge disastrous hurricane to turn this all around so we can start raising rates again.)

Soon, they got their wish.

2011

“The long-awaited turn in the property/casualty market has arrived ... There’s no question that the market turn is definitive. It is here.”
**William R. Berkley, Chairman & CEO, W.R. Berkley Corp.,
Best’s News Service, October 27, 2011.**

Just as the property/casualty industry was hoping, 2011 has turned out to be a year of weather catastrophes,⁹⁹ although many were not even in this country.¹⁰⁰ Even so, their own data still show that even in the midst of this, the industry has done extremely well. In fact, because the industry has been storing away excess profits for decades, it is now in an all-time safe financial position.

More specifically, the key measure of whether the industry’s financials are “safe” is the ratio of its “net premiums written” to “surplus” - the extra cushion insurers hold in addition to the amount they have set aside to pay estimated future claims. For many decades, a safe surplus was considered to be \$2 of net written premium for every \$1 of surplus¹⁰¹. Regulators became concerned if that ratio rose to 3:1. However, in the last decade or so, due to weather catastrophes, the target number dropped to between 1.5 to 1 and 2 to 1.¹⁰²

Today, the property/casualty industry is far safer than required. One might even say it is overcapitalized. Consider the following chart of the leverage ratio over time¹⁰³:

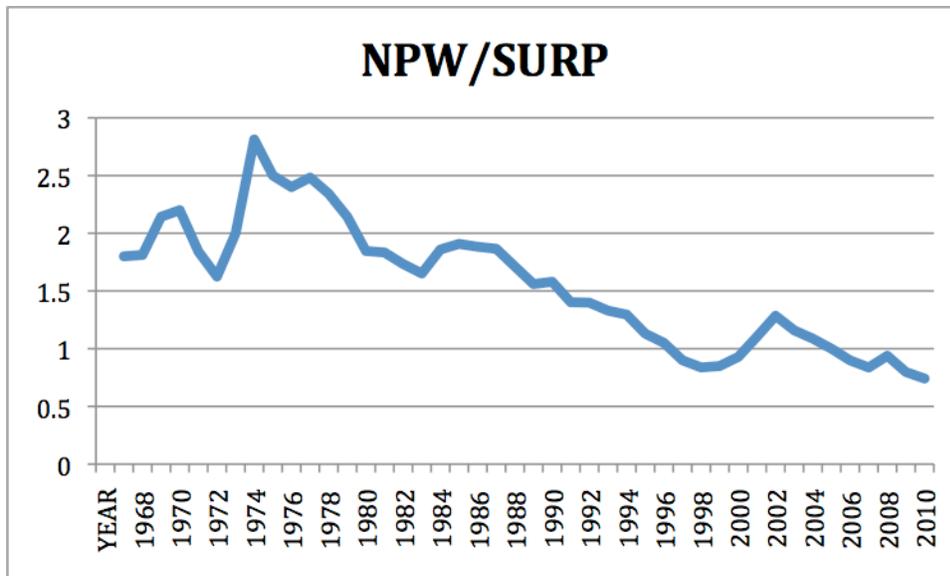
⁹⁹ According to the Natural Resources Defense Council, “so far in 2011, America has experienced 14 disastrous weather events that created over a billion dollars in damages each—and all-time record.” Billions of Dollars in Damages from Extreme Weather Shows the Cost of Climate Inaction, NRDC, http://switchboard.nrdc.org/blogs/plehner/billions_of_dollars_in_damages.html

¹⁰⁰ In the first half of 2011, this included natural disasters like the Joplin, MO tornado that struck in May as well as “the earthquake and tsunami that struck northeastern Japan on March 11 and the earthquake that struck Christchurch, New Zealand, on February 22.” “Property/Casualty Insurers’ Profits and Profitability Tumbled in First-half 2011 as Catastrophes Ravaged Underwriting Results,” Insurance Services Office, October 7, 2011.

¹⁰¹ This is the so-called “Kenney Rule,” named after financial columnist Roger Kenney, who wrote extensively on this topic.

¹⁰² See, e.g., Transcript of W.R. Berkley Corporation Goldman Sachs US Financial Services Conference 2011 December 6, 2011. (“William Berkley: ‘Well, when I got in the business in 1974 you could write three times your capital. Last time the cycle they allowed you to go to two. I would say it also depends as they say how much exposure you take, not only your premium... So in the short run you could probably write at one and a half, maybe even one and three quarters to one plus your capital base growing.’”)

¹⁰³ Source: A. M. Best, “Aggregates and Averages.” 2011 and earlier editions.



At the end of 2010, the leverage ratio was 0.74 to 1, meaning that surplus was about twice that required. Given these circumstances, the creation of a hard market now would be purely for the purpose of price-gouging buyers of insurance, particularly commercial lines insureds. But that hasn't stopped the industry from using these natural disaster to provoke a major turn in the insurance cycle. That is exactly what is happening now, and here is how they are doing it.

First, they are hyping the notion that they are in bad shape financially even though they are quite safe financially. For example, ISO issued an October 7, 2011 news release and analysis of the first half of 2011, called "Property/Casualty Insurers' Profits and Profitability Tumbled in First-half 2011 as Catastrophes Ravaged Underwriting Results," in which they emphasize that due to natural disasters, "The combined ratio — a key measure of losses and other underwriting expenses per dollar of premium — deteriorated to 110.5 percent for first-half 2011 from 101.7 percent for first-half 2010, according to ISO and the Property Casualty Insurers Association of America (PCI)."¹⁰⁴ (Notably absent is any discussion of or blame on the U.S. civil justice system.)

However, just as noted earlier in the discussion of "underwriting profits," developing any sort of public policy based on "combined ratio" numbers is an extremely unsound thing to do. First, combined ratios are calculated from "incurred" losses, which are not really "losses" at all. As noted earlier, they include billions of dollars of estimates - not actual costs - that insurers make in rate filings and we know are wildly overstated.¹⁰⁵ This figure is not a reflection of what the industry has paid out. In addition, combined ratios do not include investment gains, which are

¹⁰⁴ One insurance website defines "combined ratio" as: "The sum of two ratios, one calculated by dividing incurred losses plus loss adjustment expense (LAE) by earned premiums (the calendar year loss ratio), and the other calculated by dividing all other expenses by either written or earned premiums (i.e., trade basis or statutory basis expense ratio). When applied to a company's overall results, the combined ratio is also referred to as the composite, or statutory ratio. Used in both insurance and reinsurance, a combined ratio below 100 percent is indicative of an underwriting profit." <http://www.irmi.com/online/insurance-glossary/terms/c/combined-ratio.aspx>

¹⁰⁵ See, e.g., Jay Angoff, *Falling Claims and Rising Premiums in the Medical Malpractice Insurance Industry*, July 2005, found at <http://www.centerjd.org/ANGOFFReport.pdf>

significant.¹⁰⁶ Nor do they reflect the fact that the industry is still overcapitalized, or that the industry still made a \$4.8 billion profit in the first half of 2011, even with these catastrophes. (In fact, net profit for the first 9 months of 2011 turned out even better at \$9.7 billion.¹⁰⁷) Indeed, as noted earlier, the industry's financials suggest they are doing quite well. Even ISO notes:

Despite record-setting catastrophe losses from events like the deadly EF 5 tornado that struck Joplin, Missouri, last May, insurers emerged from first-half 2011 financially sound and well able to continue providing essential financial protection to consumers and businesses alike — a quiet but important testament to insurers' enterprise risk management and the effectiveness of state solvency regulation," said David Sampson, PCI's president and CEO. "As of June 30, 2011, insurers had \$559.1 billion in policyholders' surplus to cover new claims and meet other contingencies — more than 150 times all direct insured losses to U.S. property from **Hurricane Irene**. The industry is strong, well-capitalized, and capable of paying claims."

Which brings us to Hurricane Irene. This August 2011 storm, which was greatly hyped by the Weather Channel but wasn't nearly the catastrophe that was expected,¹⁰⁸ was also greatly hyped by the insurance industry, setting the stage for rate hikes and a new hard market. This is despite the fact that, as noted above, the industry is perfectly able to handle those claims, has stored away excess profits for decades so now is in an all-time safe position, and that creation of a hard market now would be purely to gouge buyers of insurance, particularly commercial lines insureds.

While the industry was clearly inching toward creation of a new hard market at the beginning of 2011, Hurricane Irene provided a catalyst for the industry to start pushing the idea — particularly with mainstream news media — that the industry needed a market turn. In the media, insurance executives began hyping the notion (1) the industry was in financial trouble (untrue), and (2) hurricanes and other catastrophes were going to force them to raise rates (also untrue, as the events were well within the industry's model projections and thus already priced in.)¹⁰⁹ In other

¹⁰⁶ According to ISO, "Combining net investment income and net realized capital gains, overall net investment gains rose \$2.4 billion, or 9.2 percent, to \$28.4 billion for first-half 2011 from \$26 billion for first-half 2010."

"Property/Casualty Insurers' Profits and Profitability Tumbled in First-half 2011 as Catastrophes Ravaged Underwriting Results," Insurance Services Office, October 7, 2011.

¹⁰⁷ Phil Gusman, "Specialty Insurers Lead Way in 2011, but Industry Underwriting Results Down," *National Underwriter*, November 22, 2011).

¹⁰⁸ See, e.g., Matthew Sturdevant, "Insurance Industry Spared Major Costs From Hurricane Irene," *Harford Courant*, August 30, 2011.

¹⁰⁹ Following Hurricane Andrew, the property/casualty industry, as a whole, completely changed the way it set rates for hurricanes. The purpose was to institute some stability in pricing and prevent huge price hikes after one storm. Models project, by segment of the coastline called "reaches," the anticipated storm damage for different category hurricane storms. The projections are for at least 10,000 years of virtual "experience" based on the best hydrological, meteorological, actuarial and other inputs available. One of the advantages of this approach is that the 10,000 years of projected experience includes periods of many and very large hurricanes (like multiple hurricanes hitting the state in one year and a category 5 storm making a direct hit on Miami and causing \$200 billion in insured loss) and also periods where no hurricanes make land fall on our nation's coasts. This means that the absence of storms for a decade should not lower rates as this is anticipated in the results projected by the models. Also, the happenstance of multiple storms in a state in a year or one large hit should not raise rates as this is likewise anticipated in the modeled projections. See, e.g., Americans for Insurance Reform, *At The Tipping Point: The Homeowner Insurance Mess In Florida And How To Fix It* (2006).

words, to insurers, Hurricane Irene represented the excuse they needed to start pushing each other in the direction of a new hard market, even though there was no need for rate hikes. Over the last few months in particular, industry executives – including unregulated foreign reinsurers – have been boldly declaring to the entire industry that it is time to end the soft market (including pressuring their own competitors to start raising rates). Some of these “signals” have been quite blatant, raising questions about why such anti-competitive behavior should be allowed.

For example, in October 2011, David Eslick, chairman and chief executive officer of Marsh & McLennan Agency, told an insurance audience, “insurers will not begin to ‘get rate’ unless they exhibit ‘stiffer backbone.’” Said Eslick “They need to take the initiative if they want more rate,” a clear signal for those with “weak backs” to get with the program and stop competing with lower rates.¹¹⁰ William R. Berkely, chairman and chief executive officer of W.R. Berkley Corp., and ACE Ltd. Chief Executive Officer Evan Greenberg both clearly signaled to those not yet on the same page to begin both rate increases and reserve hikes. They even suggested that companies not joining in this must be “relying on bad data”¹¹¹ or, as Greenberg put it:

Some companies continue to write irresponsibly. “They don’t know any better,” he says. “I’m convinced many of them don’t know the difference between what’s an adequate or inadequate price.” Meanwhile, the best companies “are endeavoring to do what we do and show discipline. And they are trying to press the market to recognize a price that reflects the risk. ... “I see a number of companies that are trying—a few that are brand names—that are trying to do what we’re doing.”¹¹²

Coordination seems obvious. The following brief chronology of trade publication and industry quotes for the second half of 2011 tells the more detailed story of how companies eventually pushed each other into creating a new hard market, stepping up this activity following Hurricane Irene, and have now set the stage for a new liability insurance crisis in this country:

PRE- HURRICANE IRENE, JULY, 2011

[T]he marketplace is pointing to a swing to a harder market....¹¹³

¹¹⁰ Mark E. Ruquet, “Carriers Not Getting What They Want Most: Rate Increases,” *National Underwriter Online*, October 5, 2011.

¹¹¹ “W.R. Berkley CEO: The Market Turn Has Finally Arrived,” *Best’s News Service*, October 27, 2011.

¹¹² Chad Hemenway, “ACE’s Greenberg, Fitch Ratings See Rates Improving,” *National Underwriter Online*, October 27, 2011.

¹¹³ “[P]ersonal-auto and homeowners’ premium rates are continuing to increase on a year-over-year basis while the commercial-insurance market remains mired in a soft market. Commercial insurers may see a change in the market cycle ... ‘It looks like workers’ compensation will be the coverage leading us out of the soft market,’ says Richard Kerr, MarketScout’s CEO. ‘Rates for workers’ compensation are up 1 percent. Workers’ comp is the only coverage with an actual rate increase in June.’” Mark E. Ruquet, *Industry Facing Profitability Headwinds, But Market Turn Starting*, *National Underwriter Online*, July 18, 2011.

PRE- HURRICANE IRENE, AUGUST, 2011

[It] increasingly looks like rates are beginning to stabilize in many lines, according to observations by an industry report and some chief executives.... There is not a lack of capacity, but what we are seeing is pricing transition,....”¹¹⁴

“When you look at the trend line over the past year, pricing has steadily inched upward,” says Ken A. Crerar, president of The Council of Insurance Agents & Brokers. “It isn’t increasing by leaps and bounds, but there appears to be some momentum.” ... With the losses the markets have experienced so far this year, and predictions of an above-average hurricane season, Duperrault says there is “a decent chance” of a turn occurring....¹¹⁵

Hurricane Irene hit in late August, 2011. Immediately, the industry starting pushing out to the mainstream news media the story that that the industry was in financial trouble and the soft market would have to end, even though the industry’s actual financial situation failed to support either of these notions. This can be plainly illustrated by an August 28, 2011, *New York Times* article entitled, “Irene Adds to a Bad Year for Insurance Industry,” where the reporter wrote the following:

Even before the current Atlantic hurricane season started in June, American property insurers had run through a typical year’s worth of catastrophe payouts because of an unusual string of severe natural disasters. Their losses could grow even more, because forecasters have been predicting an above-average hurricane season this year. ...

A.M. Best said the year’s series of major disasters would hurt insurers’ earnings, but was unlikely to threaten their capital. It noted, though, that the industry would “be tested through the remainder of 2011, as budgets for catastrophe-related losses already have been exhausted.” ...

Moody’s Investors Service said many property and casualty insurers were still profitable in the storm-ridden second quarter of this year, but their profits often shrank compared with the second quarter of 2010, and their reserves to pay claims had diminished and would have to be rebuilt at some point. A few, with large operations in the Midwest and Southeast, swung from profits to losses, Moody’s said, including Allstate, Hartford Financial Services, Travelers and Cincinnati Financial. ... Property and casualty insurers are also having a difficult year because of low investment income, a result of the Federal Reserve’s efforts to use low interest rates to stimulate the economy. In addition, insurers

¹¹⁴ He also notes that on the casualty side of the market, prices have become ‘more stable’ with reductions either slowing or stabilizing. In some cases there are increases.” Mark E. Ruquet, Industry Seeing Rate Increases, But Market Swing Not Expected Yet, *National Underwriter Online*, August 1, 2011.

¹¹⁵ Lines of business where rate increases occurred, according to respondents, include commercial auto, commercial property, directors and officers, and workers’ compensation. ... Adding to the evidence of a market swing, Flagstone Reinsurance Holdings CEO David Brown said during a conference call on the company’s second-quarter results that he is seeing signs of premium increases sticking. He says that the losses in the United States along with the revised Risk Management Services V.11 model change ‘aided in pushing rates up.’ North America catastrophe pricing rose 8-15 percent, he notes. Mark E. Ruquet, Survey: Rates Flattening; Marsh CEO Says Don’t Rely On Hard Mkt. For Profit, *National Underwriter Online*, August 8, 2011.

have been struggling with what is known as a “soft” market, in which competition for new business is intense and companies have a hard time raising premiums enough to cover all the risks they bear. Some analysts have been wondering whether the year’s storms will be the catalyst that changes those market conditions.¹¹⁶

The *New York Times* was not alone, of course, as the following articles show:

Hurricane Irene, threatening to become the first hurricane to hit the United States in three years, could be the catalyst the insurance industry has been seeking in its quest for across-the-board premium increases after years of weakness.... Insurers have not been able to raise rates for three years amid strong competition and readily available supply, but industry veterans say even a small storm now would be enough to trigger premium hikes.¹¹⁷

“A survey on four commercial lines suggests the soft market may be bottoming out, according to the Risk and Insurance Management Society Inc. (RIMS).... The survey indicates significant tightening in the price declines that have defined the soft market.”¹¹⁸

Robert Hartwig, president of the Insurance Information Institute, says this storm has a good possibility of being a multi-billion dollar event for the insurance industry. Industry experts have begun to discuss whether this hurricane—coupled with the many catastrophic events in the first half of 2011—will prompt rate increases.¹¹⁹

Homeowners on tight budgets should prepare for another financial strain: higher insurance bills.... A series of damaging storms in 2008 and 2009 resulted in most companies paying out an unusually large number of claims, Manders said. Those losses have pushed most of the companies to request higher premiums. The latest rate hikes do not even factor in this year’s deadly tornadoes that resulted in millions of dollars in damage statewide.¹²⁰

Al Tobin of Aon Corp.’s national property practice said the storm, coming after earthquakes in Japan and New Zealand and record tornadoes in the U.S., could provide a reason for insurers to raise their rates.¹²¹

The \$7 billion in estimated losses from Hurricane Irene will compound the vast damage caused by weather in the United States this year. Yet despite billions they've paid out for

¹¹⁶ Mary Williams Walsh, “Irene Adds to a Bad Year for Insurance Industry,” *New York Times*, August 28, 2011.

¹¹⁷ “It wouldn’t take much of a material event to cause significant firming,” said Gary Prestia, chief executive of the U.S. business at global reinsurer Flagstone Re. ... ‘It wouldn’t take the typical \$40 billion Katrina to push this into a firmer market than it is currently.’” “Hurricane could boost insurance pricing,” *Reuters*, Aug 23, 2011.

¹¹⁸ “Soft Market Reaching Bottom, RIMS Says,” *National Underwriter P&C*, August 22-29, 2011.

¹¹⁹ Chad Hemenway, “Hurricane Irene Sets Sights on States with Highest Values of Insured Coastal Property,” *National Underwriter Online*, August 26, 2011.

¹²⁰ State awaits new round of rate hikes; Storm losses cited as major providers push for higher premiums, *Atlanta Journal Constitution*, August 29, 2011.

¹²¹ “Insurers: Storm Might Have Been Worse Damage Could Be Less Than Feared,” *Wall Street Journal*, August 29, 2011.

floods, tornadoes and earthquakes, big insurance companies can expect another profitable year. And their customers can expect higher premiums....Another reason insurers are expected to raise premiums is that reinsurance companies are set to boost their rates Jan 1.”¹²²

SEPTEMBER 2011

For the second consecutive month, overall property and casualty rates came in at minus - 2 percent, indicating rates are continuing to firm, says MarketScout.¹²³

Although Lloyd's posted a 697 million pound (US\$1.22 billion) first-half loss on “unprecedented” catastrophe claims, Chief Executive Richard Ward worries the market is still not seeing sufficient boosts in pricing outside the business lines directly hit by disaster.¹²⁴

Cat losses are estimated to be as high as \$60 billion for the first half of 2011, so “companies are hoping for, but not betting on, a more dramatic improvement in property cat pricing at the January 2012 renewal,” A.M. Best Co. said in a Sept. 5 special report.... “Some of the companies that specialize in casualty lines have not had a capital erosion ... It takes a certain amount of fear to change the market psychologically, and I don't see a whole lot of fear out there. I don't see the market as a whole, or a majority of product lines, really pushing for an improvement.”¹²⁵

By October, 2011, it seems the industry finally started getting onboard with creation of a new hard market:

OCTOBER 2011

Insurance brokers say carriers are sending a clear message to them—they want to get rate where they can, but a weak economy and competitive pricing has them feeling glum about the prospects. ... David Eslick, chairman and chief executive officer of Marsh & McLennan Agency (MMA), says ... as insurers compete for business, they will not begin to get rate unless they exhibit “stiffer backbone,” Eslick says. “They need to take the initiative if they want more rate.”¹²⁶

¹²² Christopher S. Rugaber, Daniel Wagner, Higher Insurance Premiums Likely After Irene, *Associated Press*, August 31, 2011.

¹²³ Mark E. Ruquet, “MarketScout: Rates Continue to Show Signs of Firming,” *National Underwriter Online*, September 6, 2011.

¹²⁴ “Lloyd's CEO: Even After Record First-Half Losses, Industrywide Pricing Is Inadequate,” *Best's News Service*, September 21, 2011.

¹²⁵ How this year's record-breaking catastrophe losses will impact reinsurance rates is likely to be a hot topic at the annual Les Rendez-Vous de Septembre conference in Monte-Carlo, experts said. Robert DeRose, vice president at A.M. Best Co., said even though the cat losses from the first half of the year have consumed some reinsurance capital, reinsurance companies' balance sheets remain strong. ... “Reinsurers Ponder If Cat Losses Are Enough to Harden Market,” *BestDay Coverage of Rendez-Vous de Septembre*, Sept. 11, 2011

¹²⁶ “‘There are patches of rate firming,’ he says, pointing to some areas such as catastrophe property and workers’ compensation. Yet for other lines, such as directors and officers, some risks can see double digit decreases....For carriers, he says the current market has them ‘very depressed’ and fearful that the same factors that are keeping

[T]he current situation is “corrosive” for the industry as it deals with a significant catastrophe year that is eating away at reserves. ... “We must not lose sight of our primary mission—to take care of our customers, but we must also take care of ourselves.”¹²⁷

“There is a tightening, but we are not quite at an inflection point,” Mr. Case said.... “A cocktail of ingredients make up a cycle change,” noted Lex Baugh, London-based CEO of Chartis Inc.'s European operations. Currently, areas that are seeing “minihardening” include the airline business and catastrophe-exposed property, he said. These changes relieve some of the pressure for a more general hardening of insurance rates and lead to a “dampening of the overall cycle,” he said. The cycle is not dead, Mr. Baugh said, “but maybe it looks different than it did in the past.”¹²⁸

“There is some better news here,” Harris said. “All of these things can lead to insurers becoming more conservative. More insurers are starting to talk about areas where they see premium rate firming. This is a condition that normally comes ahead of a true turnaround of underwriting cycles.”¹²⁹

Property and casualty insurance brokers say prices edged up slightly during the third quarter of this year, with small accounts experiencing the largest increase, says the Council of Insurance Agents & Brokers.¹³⁰

“The long-awaited turn in the property/casualty market has arrived,” said William R. Berkley, chairman and chief executive officer of W.R. Berkley Corp.... “There’s no question that the market turn is definitive. It is here,” Berkley said. ... What drives the market turn is “always the same: fear of total loss of profitability,” Berkley said. “Sometimes it’s individual events that bring about that fear, and sometimes it’s an examination of trends,” he said. “Today, some companies are relying on data that isn’t as accurate as they think it is,” Berkley said. “What it is right now is the loss of redundancies in peoples’ reserves... one of the things that happens and is always a keystone of change in the cycle is [when] the data you relied on didn't prove to be accurate,” Berkley said.¹³¹

prices depressed will continue for the next 12 to 18 months.” Mark E. Ruquent, “Carriers Not Getting What They Want Most: Rate Increases,” *National Underwriter Online*, October 5, 2011.

¹²⁷ Quoting Paul Krump, president of commercial and specialty lines for Chubb Group of Insurance Companies, in an address during The Council of Insurance Agents & Brokers’ 98th annual Insurance Leadership Forum. Mark E. Ruquent, “Carriers Understand Market Challenges; Discuss Strategies Beyond Pricing,” *National Underwriter Online*, October 6, 2011.

¹²⁸ Rates for most insurance coverage will remain stable in the coming months, a panel of insurer, reinsurer and broker CEOs told the Federation of European Risk Management Assns. forum last week.... It is unlikely that there will be a single driver that will lead to rate increases, said August Pröbstl, Munich-based head of the corporate insurance partner division of Munich Reinsurance Co. But current conditions mean that underwriters have to increase their discipline in choosing which risks to underwrite, he noted. *National Underwriter*, October 11, 2011.

¹²⁹ Christina Brmalet, “Worsening Economy and Investment Income Strain P&C Industry; Conning Report Underscores Longer-Term Concerns,” *National Underwriter Online*, October 13, 2011.

¹³⁰ Mark E. Ruquent, “The Council Survey Finds Commercial Rates Edged Up,” *National Underwriter Online*, October 19, 2011.

¹³¹ “W.R. Berkley CEO: The Market Turn Has Finally Arrived,” *Best's News Service*, October 27, 2011.

The chief executive of insurance broker Arthur J. Gallagher is upbeat about the firm's third-quarter performance and told analysts that rate increases are necessary for the industry's health. "I'm very pleased with our third-quarter results," J. Patrick Gallagher Jr., chairman, president and chief operating officer of the Itasca, Ill.-based firm, said during a conference call with financial analysts. "This is the third quarter that we have been in positive organic territory, and I'm pleased with that."...¹³²

ACE Ltd. Chief Executive Officer Evan Greenberg says September was the best month for pricing this year, and a statement by Fitch says it is seeing "positive" rate increases, but as Greenberg says, whether the trend continues "remains to be seen." During a conference call to discuss third-quarter earnings, Greenberg says "pricing overall continues to firm" as "more classes achieve positive rate while rate decreases were smaller." Some companies continue to write irresponsibly, says Greenberg. "They don't know any better," he says. "I'm convinced many of them don't know the difference between what's an adequate or inadequate price." Meanwhile, the best companies "are endeavoring to do what we do and show discipline. And they are trying to press the market to recognize a price that reflects the risk." Greenberg continues, "I see a number of companies that are trying—a few that are brand names—that are trying to do what we're doing."¹³³

NOVEMBER 2011

More data on the insurance industry, this time compiled by the RIMS Benchmark Survey, points to an end to the soft market.¹³⁴

The soft-market cycle is over, according to MarketScout. Richard Kerr, chief executive officer of the insurance distribution and underwriting company, says that "the soft-market cycle has finally broken" after nearly seven years.¹³⁵

¹³² "In response to a question about the rate environment, Gallagher said 'it feels like' certain lines of business are hardening in parts of the country, and he equated the current situation to the rate environment after Hurricane Andrew in 1992 and other property catastrophes where property hardened, but other lines did not. 'Property is very tough in Oklahoma, for instance,' he said. 'Workers' comp is getting tough in Illinois and California. And workers' comp as a line, across the country, I think is going to get tight. [Directors and officers] is still soft.' He went on to say, 'The CEOs of the insurance companies that I talk to today are different in their outlook and discussion than they were in 2000. They all know that they have to pay attention to underwriting,' he added. 'They know their accident years aren't good. They know they are not getting any investment income and they recognize that they are going to have to get some rate or they will be in trouble.'" Mark E. Ruquet, "AJG Reports Growth; Says Rate Increases Necessary for Industry's Health," *National Underwriter Online*, October 27, 2011.

¹³³ Chad Hemenway, "ACE's Greenberg, Fitch Ratings See Rates Improving," *National Underwriter Online*, October 27, 2011.

¹³⁴ Chad Hemenway, "RIMS Benchmark Survey: Average Renewal Premiums are Up," *National Underwriter Online*, November 15, 2011.

¹³⁵ Chad Hemenway, "Commercial Soft Market Has Ended, Says MarketScout," *National Underwriter Online*, December 6, 2011.

DECEMBER 2011

The insurance industry is now “definitively in a hardening market,” according to W.R. Berkley CEO William R. Berkley.... “We’re just at the beginning of price increases.”¹³⁶

Finally, on December 13, 2011, two days before publication of this study, an article appeared in the *National Underwriter Online News Service* called “Towers Watson CLIPS Survey: Commercial Prices Up but Not Up Enough,” which encapsulates nearly every major point in this study. It reports on a Towers Watson Commercial Lines Pricing Survey (CLIPS), which Towers Watson uses as an opportunity to do essentially the following:

Pressure the industry to do more, explaining that a “real hard market” requires more and greater rate increases. Simple increases are not enough. Rates must spike.

Justify this by presenting “lost cost” figures, which, as explained earlier, do not represent actual payouts but rather “incurred” losses which are exaggerated during hard markets.

Encourage insurers to use “predictive modeling” to get their rates up, an anti-competitive practice that is legal because the industry is exempt from anti-trust laws.¹³⁷

A fourth liability insurance crisis seems headed our way.

¹³⁶ “The beginning of this year I told people that I expected 5% to 8% price increases by the end of the year, I would still expect that to be the case. But we are really just at the beginning of that happening and along with price hardening, terms and conditions are changing which lets the business you write become more profitable.” Phil Gusman, “Berkley: Market Is Hardening; Good Companies Can Seize Opportunities, *National Underwriter Online*, December 7, 2011

¹³⁷ Chad Hemenway, “Towers Watson CLIPS Survey: Commercial Prices Up but Not Up Enough,” *NU Online News Service*, December 13, 2011.

How To Fix The System

For the property/casualty insurance industry, creation of hard markets and phony liability crises have paid off and will pay off again unless lawmakers take responsible, remedial steps immediately to reign in the power and control the abuses of the property/casualty insurance industry. Otherwise, this country will never be able to deal systematically with the tactics of this industry, which consistently looks for scapegoats to cover up its own instability and mismanagement.

1. HEARINGS, INVESTIGATION AND DISCLOSURE.

Before Congress or state legislatures try to deal with the problems created by hard markets and industry-created insurance “crises”, the solutions must be premised on data. It must not be based on alarmist, prejudicial and sometimes flat out wrong information presented by the insurance industry or its trade association allies.

With rare exceptions, federal and state laws today do not force even licensed property/casualty insurance companies to disclose meaningful information to state authorities that could substantiate or refute their allegations about the financial health of the industry or the impact of the U.S. civil justice system. The Dodd-Frank Wall Street Reform and Consumer Protection Act grants authority to the Federal Insurance Office to collect some insurance data (although even this law is now under attack by the industry and its allies in Congress¹³⁸), but the need for data disclosure is far more urgent and broader than what this law contemplates.¹³⁹

Moreover, state reporting laws typically allow insurance companies to conceal such figures as:

- Reserves and the amount of losses “incurred but not reported” (IBNR) – the insurer’s guess at the amount for claims that have occurred prior to the end of an accounting period but are not reported until after the end of the reporting period – for each line of insurance;
- How much insurers pay out for different types of damages, *i.e.*, economic damages, non-economic damages and punitive damages;
- How victims actually fare – how long it takes for victims to be compensated, how much insurers actually pay in settlements or verdicts that are reduced post-trial compared to victims’ injuries and losses; and
- How much insurers pay in cases involving multiple defendants (where joint and several liability may be an issue).

¹³⁸ Elizabeth Festa and Arthur D. Postal, “New Legislation Poses Serious Threat to Federal Insurance Powers,” LifeHealthPro, December 9, 2011, found at <http://www.lifehealthpro.com/2011/12/09/new-legislation-poses-serious-threat-to-federal-in>

¹³⁹ See, e.g., Statement of J. Robert Hunter, Director of Insurance, Before the Federal Insurance Office Regarding Consumer Protection Needs in Insurance Regulation, December 9, 2011.

In short, neither federal nor state authorities currently have figures to justify the property/casualty industry's huge premium increases, policy restrictions or refusals to cover that characterize hard markets.

States need to enact laws or adapt policies so that public officials have information on payouts, losses, income, claims, cause of loss and reserve components to determine the true condition of the insurance industry in their state and how victims are faring under the present system.

2. STATES SHOULD REPEAL ANTI-COMPETITIVE LAWS AND ENACT STRONGER REGULATION AND OVERSIGHT.

- **Increase State Authority Over Rates.** State insurance departments must take a far more active role in controlling insurance rates. At a minimum, departments should be given more authority to approve or reject rate requests, or to advocate the rollback of insurance rates. For example, in 1988 California voters mandated a 20% rate rollback in insurance premiums, saving consumers billions of dollars and implementing the best system of rate control in the nation. In addition, underfunded and understaffed insurance departments must receive increased support for investigators, auditors, actuaries and other professionals to recommend appropriate insurance rates.
- **Specifically target for close examination price hikes during the early phases of hard markets.** State regulators should carefully review any requests for price increases in this emerging hard market. There are many things that need careful consideration. Here are some of them:
 - Because reserves get jacked-up in the hard market, regulators must carefully review incurred losses to make sure that padded reserves are not built into the prices consumers pay.
 - The profit provision in rates is based on a required rate of return on surplus less investment income. The starting surplus for this calculation should be *only* that part of the surplus which is “used and useful” to the consumer. If surplus is twice what is needed, profit calculations ought *only* be applied to the one-half actually supporting the underwriting. In other words, if the insurer needs a 8% return on surplus and surplus is \$1 million but only \$500 thousand is used and useful for underwriting, the profit required should be \$40,000, not \$80,000.
 - Regulators should look at California's concepts of an efficiency standard for expenses, disallowing lobbying, fines and other expenses that are not “used and useful” for pricing.
- **Repeal Anti-Rebate and Anti-Group Laws.** Many states have anti-rebate laws that prohibit insurance agents from offering discounts to policyholders. As a result, the most efficient agent cannot compete for market share by offering a discount. Also, groups cannot form in some states to buy insurance to benefit from economies of scale.

3. CONGRESS SHOULD REPEAL THE FEDERAL ANTI-TRUST EXEMPTION; AT A MINIMUM, THE NEW FEDERAL INSURANCE OFFICE MUST REVIEW ITS IMPACT.

As noted throughout this study, the McCarran-Ferguson Act allows insurance companies to fix prices. A law repealing the federal anti-trust exemption would ensure that all domestic and foreign insurers and reinsurers that do business in the United States are subject to federal anti-trust prohibitions applicable to other industries. Such legislation would prohibit the insurance industry from acting in concert to raise prices and would prohibit tying arrangements, market allocation among competitors and monopolization. Increased competition would bring lower prices and would increase the availability of insurance for consumers.

If the McCarran-Ferguson Act were repealed, the ISO and other rating bureaus could still jointly collect, compile and disseminate past data relating to premiums and claims. However, price-fixing agreements and manipulation of data to, for example, project data into the future would be illegal. Moreover, ISO would be forced to disclose to insurance buyers the documents it prepares for insurance sellers, listing both current prices major insurers charge for auto and homeowner insurance and the ISO advisory rates.

At a minimum, the newly created Federal Insurance Office (FIO), established by Title V of the Dodd- Frank Wall Street Reform and Consumer Protection Act, should include a review of the harm done to consumers by the antitrust exemption of the McCarran-Ferguson Act in the report it is preparing for Congress next year, as well as collect data on the impact of the Act on policyholders, particularly commercial policyholders.

Conclusion

In 2002, at the start of this country's last hard market and as conditions were beginning to worsen for certain policyholders, including doctors, Americans for Insurance Reform wrote to all 50 state insurance commissioners. AIR called on each commissioner to take specific steps to prevent large rate increases and tight underwriting that accompanies the start of every cyclical hard market. We documented the cycle and the events occurring in 2001 and early 2002 as the market turned from soft to hard in a classic insurance cyclical turn. We asked that the commissioners analyze the events then unfolding, particularly looking at the degree to which the pattern being observed was the result of low interest rates and stock market problems. We asked that they study what seemed to be the beginning of over-reserving of claims in some lines, perhaps to hide profits and to support excessive rate increases. We asked that price hikes being sought be carefully analyzed to determine if prices were going up too much. We suggested a brief rate freeze while these studies were made. We asked that they inform their state legislators that these increases were often cycle- related and not reflective of any unexpected jump in claims requiring limits on recoveries of injury victims.

As far as we could tell, little of any of this was done. As a result, rates skyrocketed, particularly for doctors, with insufficient oversight in most states. Few states analyzed the situation to see if rates were too high, although a few did stop some rate increases and rolled back a few as well. But few even looked at the reserving practices of the insurers. Few stopped insurers from

limiting coverage. Few advised their legislatures that the jump in rates did not require legal system limits but was simply a cyclical phenomenon of the industry. And now we may be facing the same cyclical phenomenon, once again.

This cannot happen. It is urgent that states consider effective insurance oversight, disclosure of data and other reforms to end these practices. And Congress must repeal the industry's anti-trust exemption – to stop the industry from abusing its enormous economic influence, which it uses to promote a legislative agenda that bilks the taxpayer and severely hurts the American public.

About Americans For Insurance Reform and the Authors

AMERICANS FOR INSURANCE REFORM is a project of the Center for Justice & Democracy at New York Law School. AIR is a coalition of nearly 100 consumer groups from around the country working to strengthen oversight of property/casualty insurance industry practice

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As a consultant on public policy and actuarial issues for various government agencies, his clients have included the U.S. Department of Housing and Urban Development, the General Accounting Office, and the Environmental Protection Agency, as well as state governments including California, Florida, Georgia, Massachusetts, Maine, North Carolina, New Jersey, New York, Oklahoma, South Carolina and Texas. Other experience includes work in the private sector, including as Associate Actuary for the Mutual Insurance Advisory Association and Mutual Insurance Rating Bureau (now AIPSO), Actuarial Supervisor for the National Bureau of Casualty Underwriters (now ISO), and Underwriter, Atlantic Mutual and Centennial Insurance Companies.

His awards include the Award for Excellent Service for the Secretary of the Department of Housing and Urban Development (HUD), for work performed from 1971 to 1977, the Esther Peterson Award for lifetime service to consumers in 2002, and twice, the Schraeder-Nelson Publications Award for article of the year: in 2002 for “Enron’s Impact on State Insurance Regulation” and in 2007, for “How Regulators Can Return P/C Profits to Reasonable Levels,” *Regulator Magazine*, Insurance Regulatory Examiner’s Society. He is the author of numerous publications on insurance and related topics and has served as an Executive Committee member and advisor to the National Association of Insurance Commissioners (NAIC). Over the past decades, Mr. Hunter has testified in every state in the union on the insurance cycle and related premium spikes.

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Joanne is a nationally recognized expert on civil justice and insurance issues. She has appeared on *CBS, ABC, NBC, CNN, CNBC, MSNBC, PBS*, and *Fox News*, as well as numerous radio programs around the country, and has been quoted in numerous

newspapers articles. Joanne has testified many times before Congress and state legislatures around the country. She was a member of the New York State Governor's task force on medical malpractice in 2007 and 2008. In 1991, Joanne was a member of the Steering Committee of the Brookings Institute/American Bar Association's Advisory Committee on the Future of the Civil Jury, and was an invited participant in the American Judicature Society's Conference on the Future of the American Jury System in 1999. She was also selected by the Stern Family Fund as the Public Interest Pioneer for 1999, an honor that was accompanied by two \$100,000 grants.