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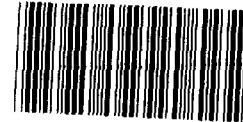
Testimony

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**Considerations in Measuring
the Relationship Between Tort
Reform and Insurance
Premiums**

Statement of
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Considerations in Measuring the Relationship Between Tort Reform and Insurance Premiums

Summary

You asked us to consider the feasibility of evaluating whether tort reforms reduce liability insurance premiums or mitigate their increase. After carefully considering possible strategies, and the various factors that complicate the assessment of the relationship, GAO feels that a well designed and executed study could discern the nature of the relationship.

Such a study, however, must be sensitive to the differences in the pattern of adoption and implementation of tort reforms across states, the variation in their potential effects, and the time it will take between initiation of reforms and likely effects on premiums.

Other state and national factors that could also affect insurance premiums must also be considered. These include changes in state regulatory requirements and law, insurance market competition, types of insurance sold, and interest rates and other national economic trends. State socio-economic factors such as urbanization may also be significant.

Tort reforms affect premiums by reducing insurer's losses or claim payouts, or mitigating their increase. Before the effect of tort reforms on premiums can be considered, it is essential to determine if losses were affected.

Data on all of the types of factors that could affect premiums would have to be systematically collected over a period of years to provide the information needed for the analysis.

Mr. Chairman and members of the committee, thank you for inviting GAO to testify concerning how to possibly measure the impact of tort reforms on insurance premiums. Since the mid-1970's states have passed a variety of tort reforms intended to promote the timeliness and equity of tort awards, limit the size of attorney's fees, increase the predictability of claim settlement amounts, and generally enhance the availability and affordability of insurance coverage. You have asked us to discuss the feasibility of evaluating whether tort reforms reduce liability insurance premiums, or mitigate their increase, and if it is feasible, what data would be needed.

To do the evaluation would require comparing experiences in different jurisdictions. The fact that some states have passed tort reforms and others have not, or have passed them during different time periods, provides a basis for comparison that allows an assessment of the impact of reforms.

In general, tort reforms are thought to reduce insurance claim payouts and enhance the predictability of future losses. Given a reduction in losses and greater predictability, insurers should lower premiums. A necessary condition, then, for tort reforms to lower rates is that they lower insurance claim payouts. If that is shown to be the case, then states with tort reforms should have lower premiums, or smaller increases in premiums, than states without reforms.

This seemingly straightforward comparison, however, belies some very difficult measurement considerations that I will discuss shortly. Any approach to making this comparison should be designed to isolate the effects of tort reform on changes in claim payouts and insurance premiums by accounting for the other factors that also could contribute to changes. It should also be capable of dealing with the potential time lag between passage of tort reforms and subsequent effects on losses and premiums. A brief discussion of the factors involved in employing this approach is included as an appendix to this testimony.

The remainder of the testimony focuses on measurement issues that we have encountered in our medical malpractice, commercial general, and products liability insurance work and their implications for data collection to address the issue of the relationship between tort reform and insurance premiums.

TORT REFORMS

One set of measurement considerations involves the tort reforms themselves. Each state passes its own configuration of reforms. Thus, each reform must be considered separately. Further, not all reforms are likely to affect total claims payouts and, hence, insurance premiums in the same way (see appendix B). Most reforms are designed to reduce claim settlement amounts and consequently reduce premiums. A few may

increase accessibility to the claims system, increasing the frequency of claims, which could result in increasing premiums.

Many reforms are related to specific types of claims, such as medical malpractice or product liability, and therefore affect specific types of insurance. Only those reforms that are likely to affect the specific type of insurance claims and premiums of interest are appropriate for inclusion in the analysis. If several types of tort reform/claim/premium relationships require testing, separate analyses are needed for each type.

The timing of the reforms must also be considered. Reforms were not passed by states at a single point in time, but were passed at various times. Within a single state some reforms were adopted one year and others in a later year. Therefore, the timing of the implementation of reforms varies greatly among and within states.

Along the same lines, the implementation of reforms varies. In most states, as tort reforms are passed into law, they apply only to new cases entering the legal system. Old cases are "grandfathered in" under the old laws. Since cases vary in their length, and many are likely to remain in the system for several years, the effects of the implementation of tort reforms on frequency of awards and their amounts will be spread across as many years. Since the effect of the reforms on insurance

premiums may depend on a record of fewer and smaller awards, their impacts may not be reasonably expected to be visible for several years.

Just as other state laws, tort reforms are subject to state constitutional challenges and legislative amendment. Some reforms have built in "sunset" provisions that will abolish them at a given future date. The recent judicial reversal of the Virginia cap on pain and suffering awards attests to the possibility of reforms being rendered ineffective by subsequent court actions. As a consequence, this too may contribute to delays in the insurance industry's reaction to reforms as they wait to determine whether the reforms will withstand challenges.

OTHER STATE AND NATIONAL FACTORS

A second set of considerations relates to the states themselves. All of the other factors that can affect insurance claims and premiums that are unique to each state must be considered and their effects separated from those of the tort reforms. These other factors could include changes in state regulatory requirements or laws, entrance into the market of major new competitors, or changes in the type of insurance sold. In terms of regulatory changes, for instance, a move to a prior approval system for rate increases could affect premiums. The

entrance of a large new risk retention group to the market could alter the competitive atmosphere. A shift to predominance of a claims made policy form from an occurrence-based policy market is an example of a change in type of coverage sold that could have a profound effect on both claim payouts and premiums.

Past research has found that there are other state environmental factors that are related to frequency and severity of insurance claims, and thus may also be related to premiums. Factors that could be considered, based on past research results, include urbanization and number of lawyers per capita. Variables such as these could be tested in the analysis to determine if they are needed to better explain the relationship between tort reforms and changes in premiums.

In addition to factors that are unique to each state, there are other factors that affect premiums. Interest rates and general economic trends are good examples. However, these variables tend to affect changes in premiums nationwide without regard for state boundaries. Their effects on rates are likely to be felt about equally by both states with tort reforms and states without the reforms and thus tend to cancel themselves out. These national factors can be included in the analysis.

LOSSES

Claim payouts, or losses, can be measured in terms of the average dollar amount per paid claim, and the number of claims on a state-by-state basis per year. These data are not currently compiled in this fashion across states. Of specific interest for the comparison is the change in the paid claim amounts from year to year in tort reform and non-tort reform states. The first stage of the analysis of the effects of tort reforms on insurance premiums would involve first determining if they have an effect on losses. If losses are not reduced, or increases mitigated, by the reforms, premiums will not be reduced or increases mitigated either.

INSURANCE PREMIUMS

The measure of insurance premiums, themselves, requires careful attention. The wide range of types and amounts of coverage, and the diversity of the businesses purchasing insurance, make it difficult to obtain an "average" premium amount that is comparable state to state and year to year. Fortunately, the combination of the insurance loss ratio (a ratio of premiums received in a year to losses paid and reserves for losses for the same year) and information concerning the reduction in losses (or mitigation of their increase) obtained in the first stage of the analysis provides an indicator of whether

premiums are following the pattern of losses. For the loss ratio to remain stable, given declining losses, the premiums must follow the same pattern of decline.

OTHER MEASUREMENT CONSIDERATIONS

As indicated in the beginning of the testimony, our basic approach to assessing the effects of tort reforms on insurance premiums is first to compare changes in claim payouts in states with tort reforms to corresponding changes in payouts in states without reforms. If reforms seem to reduce claim payouts, an examination of loss ratios should show whether premiums are showing a similar pattern of change. Because it seems likely that there will be a time lag between the adoption of tort reforms by a state and any effect on claims and premiums, the analysis will have to be sensitive to this potential lag. To isolate the effects of the reforms from those of other factors that could affect changes in claims and premiums, these other factors must be included in the analysis as well. (A list of potential variables for this analysis and potential sources for these data is in appendix C.)

Finally, regardless of the level of care in considering other potential reasons for change, there will still be some factors that affect claims and premiums that cannot be accounted for in the analysis. Because of this, the effect of the reforms,

if very minor, may not be detectable. This inability to detect small changes may not be a problem because these changes may not be of the magnitude that would be considered significant in mitigating an insurance affordability crisis, or preventing a potential one. Hence, these minor changes that might be "lost" in the analysis would not have a policy impact in terms of enhancing affordability of liability insurance.

During recent years there have been two waves of tort reforms. The first started in the mid-1970's and dealt with medical malpractice liability. The second started in the mid-1980's and is still ongoing. This latter set of reforms dealt primarily with product and general liability. The ability to reconstruct data concerning actual claim payouts on a state-by-state basis and other non-tort variables that may have affected premiums since the mid 1970s makes measurement of the effects of medical malpractice reforms extremely difficult at this time. In terms of the more recent round of reforms, data that could be collected currently and into the future would allow for an assessment of their effects using the type of strategy once a sufficient number of years of data were collected. However, the type of systematic data collection across insurers, states, and time periods that would be needed would require considerable effort and an extended period of time.

One final note of caution. Some tort reforms cover

liability for business activity that is generally intrastate in nature. Medical malpractice is an example. The insurer knows the jurisdiction in which any liability-related injury occurs and may adjust rates to accord with that jurisdiction's tort environment. However, when an insured's products or services cross state lines, tort reforms for any of the states the insured does business in could apply to a claim. For product liability for large manufacturers, for example, the insurer does not know in which jurisdiction an injury is likely to occur. The insurer, then, may take a conservative approach and assess premiums in relation to the less favorable tort environments. The most detectable effects of reforms on insurance premiums may be in lines of insurance or for sizes of businesses that are primarily intrastate.

In conclusion, I would like to stress that it is possible to develop a workable approach for measuring the effects of tort reforms on insurance premiums. We must also point out that the effects of tort reforms on premiums cannot be measured in a single year. Rather, it requires a well-planned data collection effort over many years. This data collection could be a substantial undertaking. As with the development of any methodology, this one would require refinements in the process of carrying it out. I would be pleased to answer any questions.

APPENDIX A

Factors Involved in Specifying a Regression Model for Measuring the Relationship between State Tort Reforms and Changes in Insurance Premiums

The basic premise of this analysis is that if tort reforms result in a subsequent lowering of premiums or mitigation of their increases, they will do so by reducing or mitigating increases in losses (claim payouts). If tort reforms do not affect losses, they will not affect premiums. The first step in the process, then, is to determine the relationship between state tort reform and losses.

Changes in the amount of insurance losses, or claim payouts, in a state are a function of a set of variables that are unique to each state--a set of background or control variables, and a set of tort reforms or the absence of tort reforms--and year-to-year changes that affect all states.

The first part of the analysis involves constructing a regression equation with changes in losses in each state in each year as the dependent variable. The independent variables include a set of variables at the state level that are likely to influence changes in losses. These could include changes in socio-economic and demographic conditions, such as urbanization, and changes in the type of coverage offered, such as a shift to the claims-made policy form from the occurrence-based form. A second set of state level variables represent the configuration of tort reforms present (or absent) in a state. Additionally, a variable representing year to year changes in those factors that change at the national level is included in the equation.

If this first analysis does not show that tort reforms reduce losses, or mitigate their increase, then they cannot be a factor in reducing premiums or mitigating their increase. If the initial analysis shows that they do reduce losses or mitigate increases, then a further test must be run to examine the relationship between this change in losses and subsequent premiums.

The key to measuring the effect of this tort-induced change in losses on premiums is the loss ratio. This ratio will not change if losses and premiums move in tandem. If, however, losses fall and premiums remain the same or increase, the loss ratio will change. A stable loss ratio, then, given a reduction in losses (or mitigated increases), is the indicator that shows whether tort reforms affect premiums.

Just as with assessing the effects of tort reforms on losses, other factors that could affect premiums must also be considered. These factors could include state regulations such as prior approval of rate increases.

The unit of analysis is a given state in a given year. Dichotomous variables, such as the presence or absence of tort reform, are entered as dummy variables. Because the aspect of the loss ratio of interest is its stability, changes in the loss ratios from year to year would have to be transformed into a measure of stability - how much they diverge from the previous value.

A time lag could be assessed by analysing the relationship between independent variables measured at one time period with the dependent variable measured at a later time period. It seems reasonable to expect that several lag time periods would be tested.

APPENDIX B

This appendix summarizes tort reforms that states have either enacted or proposed and the possible effects of each reform on insurers' payouts and the predictability of risk. The tort reform debate has focused on the indirect effects tort reforms may have on premium rates through their effects on insurers' payouts for damage awards and procedural costs and on the predictability of liability. The general contention is that, by lowering payouts or increasing the ability to accurately predict risk, tort reforms may lower premium rates or mitigate their increase.

Table 2 lists the reforms and indicates their possible impact on payouts and predictability. Definitions of each reform and a rationale for the effects coded in the table are included below.

Tort Reforms and Their Effects on Payouts and Risk Predictability

1. Ad Damnum Clause reform legislation prohibits plaintiffs from stating the amount of damages they are attempting to recover in their claims. Such prohibition may decrease payouts by removing any influence large demands may have on jurors making awards greater than that indicated by the evidence presented at the trial.

2. Alternative Dispute Resolution Procedures include expedited procedures such as pre-filing negotiations or arbitration in place of a jury trial. These procedures may be optional or required and are designed to decrease litigation costs. However, they could also increase access to the system and thus increase claim frequency.

3. Restrictions on Attorneys' Contingency Fees would limit fees that could be collected by plaintiff attorneys either to a percentage of the award less than the current typical fee of one-third; a sliding percentage scale where percentages would decrease with additional increments in awards; or, for large awards, fees that appear reasonable as determined by judicial review. Attorney fee restrictions may lower awards and procedural costs by mitigating juries "padding" of awards to help cover fees and by discouraging plaintiff attorneys from either filing suit or taking to trial high-risk award pain and suffering cases that could otherwise be settled.

4. Caps on Awards include provisions limiting entire awards or just non-economic damages to a fixed value or an amount based on life expectancy, injury severity, or actual economic damages. Caps are designed to lower awards by eliminating "excessive" awards and to increase risk predictability by limiting the range of awards.

5. Collateral Source reforms would eliminate the collateral source rule, which prohibits the introduction of evidence regarding payments for the same injury from another source, and/or would require that verdict awards be reduced by amounts paid by collateral sources. Collateral source reforms are often accompanied by provisions restricting collateral source reimbursement through subrogation liens. These reforms would decrease award amounts and, thus, payouts by virtue of deductions for payments by other sources. To the extent incentives for safety are mitigated by guilty parties not paying for all damages, decreases on awards may be offset by increased safety risks and increases in the number of claims. Collateral source reforms coupled with subrogation restrictions may simply transfer payments to other sources and require them to raise their premiums or costs as a consequence.

6. Modifications of the Comparative Negligence Rule would eliminate pure comparative negligence, in which awards are reduced in proportion to the injured parties fault, in favor of a modified rule. Modified rules would still reduce awards by the proportion of plaintiff's fault but would also bar collection of any award if plaintiff's proportion of fault were to exceed a certain level. Comparative negligence reforms are designed to enhance predictability by increasing the extent to which damages paid are based upon defendants proportion of fault. By eliminating any award in certain circumstances, these reforms may also reduce total payouts relative to pure comparative negligence.

7. Establishing Compensation Funds provides alternative mechanisms for compensating victims other than litigation and payment by liable parties. Such funds could compensate victims when defendants do not have the financial resources to cover damages, decrease the financial burden on insurers, and bypass costly litigation. To the extent liable parties do not have to pay for damages, establishing compensation funds may remove some deterrence for disregarding safety and may increase the number of claims,

8. Expert Witnesses reforms pertain to the qualifications and use of expert witnesses, such as requiring their testimony in order for a plaintiff to prevail in suits based on negligence.

9. Fault-Based Liability Standards reforms would require courts to use fault-based standards of negligence or foreseeability in determining liability. Fault-based standards' primary effect would be to increase risk predictability, since liability would be based on specified misconduct and safety criteria.

10. Frivolous Suit reforms attempt to eliminate the filing and/or processing of suits that lack either any redeeming legal merit or a serious basis for believing the defendant is liable. These reforms may implement sanctions such as awarding litigation costs and/or procedures designed to insure the merits of a case

at filing. Eliminating frivolous suits and/or their processing would decrease payouts for defense costs and court processing and increase the predictability of lawsuits alleging liability.

11. Grants of Immunity from Prosecution would limit the circumstances in which lawsuits could be filed against specific groups such as product sellers and municipalities. These reforms are designed to decrease payouts by reducing the number of claims filed against parties who are often only minimally liable.

12. Itemized Jury Verdicts would require juries to breakdown awards into amounts for specific damages, such as economic damages, pain and suffering, etc. These reforms have no obvious effects on payouts and liability risks, but coupled with judicial review, may eliminate any excesses in awards for specific damages.

13. Limits on Joint and Several Liability would restrict circumstances in which each of two or more defendants would be liable for paying all plaintiff's damages to economic damages or to cases in which there was concerted action. Joint and several liability reforms would reduce overall payouts of awards and increase risk predictability by (1) tying payments more closely to defendants' share of fault and (2) decreasing incentives for suing defendants with financial resources when they are only minimally responsible.

14. Limitations on Prejudgment Interest either eliminates juries' option of requiring defendants to pay interest on all or part of the award or put limits on the damages and/or time periods after filing for which interest can be paid. These reforms are designed to remove any incentives prejudgment interest may have on plaintiffs not settling before jury trial and may ultimately decrease payouts for awards.

15. Reforms Concerning Punitive Damages, which are damages intended to punish defendants, include a variety of reforms, such as provisions limiting their amount, raising the standards of misconduct and evidence required for their award, and prohibiting their request until after an initial finding of liability. These reforms may lower punitive damage awards and their amounts, which tend to be large. These provisions are primarily designed to increase predictability by limiting punitives to the deliberate and malicious disregard for the interest of others.

16. Statutes of Limitations and Repose include provisions requiring suits to be filed within a time period either following the injury, when a reasonable person would have known about the harm and its cause, or sale/delivery of the product/service. Statutes of repose may place a higher burden of proof on the plaintiff to show the product/service was unreasonably dangerous, for which gathering evidence may become more difficult with the passage of time. These statutes are designed to increase

insurance companies and manufacturers' abilities to accurately predict risk by eliminating long tail claims distributions.

17. Structured Settlements allow or require courts to convert awards from a lump-sum payment for large awards (e.g., over \$100,000) or future economic losses to periodic payments. The defendant may pay interest, which is estimated for the period of the plaintiff's disability or life. Periodic payments are designed to decrease the burden of large, lump-sum payments on defendants, make payouts more predictable, help assure funds are available for the intended purpose, and eliminate any windfalls to beneficiaries in the event the injured party dies.

Table 1: Hypothesized Effects of Tort Reforms. A "plus" denotes a reduction or a mitigation of increase in payouts, or an increase in predictability.

<u>Reform</u>	<u>Payouts</u>	<u>Risk Predictability</u>
1. Ad Damnum Clause	-	
2. Alternative Procedures	-	
3. Attorneys' Fees	-	
4. Caps on Awards	-	+
5. Collateral Source	+/-	
6. Comparative Negligence	-	+
7. Compensation Funds	+/-	
8. Expert Witnesses		
9. Fault-Based Liability		+
10. Frivolous Suits	-	+
11. Immunity from Prosecution	-	
12. Itemized Jury Verdicts		
13. Joint and Several Liability	-	+
14. Prejudgment Interest	-	
15. Punitive Damages	-	+
16. Statutes of Limitations/Repose	-	+
17. Structured Settlements	-	

Appendix C

Variables and Sources of Data

Dependent Variables:

- A measure of stability of loss ratio from year to year, by state.
- Change in claim payouts from year to year by state.

Data needed:

Loss ratios by line by state for each year for a series of years.

Claim payouts by line by state for each year in a series of years.

Source:

Insurance companies and other insurers such as risk retention groups.

Explanatory Variables:

- Tort reforms by type (the number of tort reforms may make grouping them together for the purpose of classification a reasonable strategy. For example, all reforms instituting caps on non-economic awards may be considered as one reform regardless of differing levels of caps. Or, alternatively, they could be classified into two groups-high cap and low cap-based on size of the cap).

Data needed:

Presence or absence of each type of tort reform in each state in each year in a series of years.

Source:

State attorneys general offices

- Changes in state insurance regulations, by type (i.e. prior approval of rate changes).

Data Needed:

Presence or absence of a set of state regulatory provisions in each state for each year in a series of years.

Source:

State insurance commissions

- Changes in market competition

(i.e. the entrance of a state-sponsored insurance fund)

Data needed:

Presence or absence of major new sources of insurance in each state for each year in a series of years.

Source:

State insurance commissions

- Change in market share of the form of insurance coverage (i.e. shift from occurrence based coverage to claims-made coverage).

Data needed:

Presence or absence of a major change in form of insurance predominant in the market.

Source:

State insurance commissions

- State socio-economic characteristics (i.e. urbanization, attorneys per capita).

Data needed:

Percent possessing the characteristic for each state for each year in a series of years.

Source:

Published sources such as the Current Population Survey

- Year (i.e. 1984, 1985, 1986, etc.)

Data needed:

Each year in the series covered by the analysis.

Source:

Enumeration of the years over which data were collected.