Center for Economic Justice Response to
Commissioner Montemayor's Discussion of Investment Income

4/8/2004

Following today's conference call, Commissioner Montemayor sent an e-mail with his thoughts on investment income in medical malpractice insurance. This note responds point-by-point to Commissioner Montemayor, with his points in italic and the response in normal font. With due respect to Commissioner Montemayor, his analysis is wrong and, if included in the med mal report, would reflect badly on insurance regulators.

Following the review of the Montemayor analysis, we conclude with a quantitative evaluation of the impact of reduced investment income on med mal insurer net income and show the impact of reduced investment income was far greater than suggested by Commissioner Montemayor – a fact which should affect proposals to address med mal market problems. At a minimum, our discussion and analysis should prompt a revision to the discussion of investment income in the NAIC med mal paper.

1.   *TDI was unable to re-create Mr. Birnbaum's investment income per unit of $1 earned premium.*

I have attached the complete spreadsheet so TDI should be able to replicate my numbers now. I should say that replicating my numbers is quite easy – they come right out of the NAIC Profitability Report – and am surprised that TDI was unable to do so.

2.   *Ratios of investment income to earned premiums will change with changes in investment income and changes in earned premiums.*

This is true, of course, but meaningless in the context of the question of the impact of investment income changes on revenue needs for insurers and med mal rates.

3.   *Significant increases in earned premium will result in significant declines in the ratio even given a constant investment income.*

This does not necessarily follow because significant increases in premiums should be associated with significant increases in investible assets as premium and loss reserves increase significantly. **But, if there is a lag between the premium increase and the associated increase in investment income, then this suggests the med mal problems will, to some extent, self correct as investment income catches up with premium increases. This argument indicates an even greater impact of investment income in explaining med mal insurer problems than ever.**

4.   *A more appropriate base to measure changes in investment income is the total dollars of invested assets.*

This is flat-out wrong and should be embarrassing to folks who should be experts in insurance ratemaking. The purpose is to explain what drove massive rate increases in med mal rates. Higher losses were one cause and lower investment income was another cause. The appropriate comparison of losses and investment is to insurer revenue – premium – and not to invested assets. Why, for example, would you compare dollars of losses to invested assets to explain how increased losses drove up rates? Of course, you wouldn't. Similarly, comparing investment gains to invested assets is interesting to evaluate the return on investment of such assets, but tells you nothing about how the reduced yields translated into increased rate needs for insurers.

5.   *Comparing investment income to earned premium for years where there have been substantial premium increases overstates declines in investment income.*

As stated in response to item 3, this does not necessarily follow. For this statement to be true, there must be a lag between the reporting of increased premiums and the associated increase in premium and loss reserves as invested assets. If this lag does occur, then the crisis in med mal has been driven, in part, by this lag and there will be some degree of automatic recovery as the lag disappears.

6.   *Example, Best's 2002 Aggregates and averages for med mal predominating companies shows $23B in invested assets and $5B in earned premium (4.6:1). Investment income is approx $1B, or 4.3% yield, or $.200 per earned premium. Assume a 20% increase in premium, 100% which immediately flows into invested assets with no change in interest rates. Invested assets are now $24B, earned premium is now $6B and investment income is now $1.04B. The new ratio is $0.173, or a decrease of 13.5%.*

As stated in response to item 4, this is a stunningly incorrect approach. If you did the same analysis, but used losses instead of investment gains, you would get a similarly modest impact of losses – and that is clearly wrong, too!

7.   *Best's Aggregate's and averages shows a 16% decline in net investment income as a ratio to total invested assets in 2002 vs. 2001 compared to Mr. Birnbaum's 40% decrease shown on his table in page 2 (see attached).*

See responses to items 4 and 6. My tables measure the actual impact of reduced investment gains on insurer revenue – the Best data on invested assets do not and can not be related to required changes in insurer revenue requirements.

8.   *Exhibit 2 has similar problems.*

What problems? Exhibit 2 compares investment gains to losses and combined ratios – all on the same basis – percentage of earned premium – percentage of revenue! The Montemayor analysis using invested assets compares apples to oranges – evaluates losses compared to one base and invested income on another base.

9. *Conclusion: Investment income declines are a factor, but NOT the leading factor, or even an EQUAL factor to losses.*

Faulty analysis leads to faulty conclusions. We never argued that investment income was the leading factor, but argued that it was a significant factor. In 2002, reduced investment gain was an equal factor to increased losses in driving med mal rates. The point is that investment income, as a percentage of premium, declined precipitously and caused a market problem to become a market crisis. Since investment income as a percentage of premium will recover from 2002 levels as a percentage of premium, a solid argument can be made that radical changes to the civil justice system are not necessary for medical malpractice markets to recover.

Additional Discussion:

The attached spreadsheet contains the data from the NAIC Profitability Report on med mal losses, loss adjustment expense, investment gains and return on net worth. These are the data we used to develop the tables in our earlier comment letter.

These data show that reduced investment income in 2001 and 2002 had a more significant impact on insurer revenue and rates than the 16% figure mentioned by Commissioner Montemayor. For 1991-1998, the average loss ratio was about 57%, the average LLAE ratio was about 89% and the average investment income was about 48% -- all measured as a percentage earned premium.

Loss ratios increased starting in 1999 -- with a peak in 2001 -- driving higher LLAE ratios -- which also peaked in 2001. If we compare 2001 and 2002 with the 1991-1998 average (the use of 91-98 as opposed to 91-2000 gives more influence to losses in this analysis), then we see that for 2001 losses increased to 98% -- an increase of 40 points and investment income decreased to 34% -- a decrease of 14 points. Thus, for 2001, reduced investment income accounted for 14/(14+40) or 26% of the decrease in income. For 2002, the increased losses were 86% -- an increase of 28 points and investment income was 20% -- a reduction of 28 points. So for 2002, investment income accounted for 50% of the decrease in income from historical averages. Measured as a change from 1999 or 2000, as opposed to a change from the 1991-1998 average, the impact of reduced investment income is even greater.

These data support our contention that reduced investment income was <u>a</u> significant contributor to increased med mal rates.