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PHC4 Research Briefs

Hospital Malpractice Expenses

The cost of medical malpractice insurance has been widely attributed as one of the principal factors contributing to rising hospital costs. To this end, the Pennsylvania Health Care Cost Containment Council (PHC4), with the cooperation of the Hospital and Healthsystem Association of Pennsylvania, began to collect information on the hospitals' expenses of meeting their malpractice exposure during fiscal year 2004 (FY04). This Research Brief reports the hospital revenue consumed by malpractice insurance expenses and establishes a baseline to track changes in the amount of hospital malpractice expenses in the future.

During FY04, Pennsylvania's 182 General Acute Care (GAC) hospitals reported their total malpractice insurance expenses of $636 million. These malpractice insurance expenses represent an average of 2.67% of the total statewide net patient revenue (NPR). Consequently, $2.67 of every $100 paid for patient care at GAC hospitals was used to satisfy malpractice insurance costs.

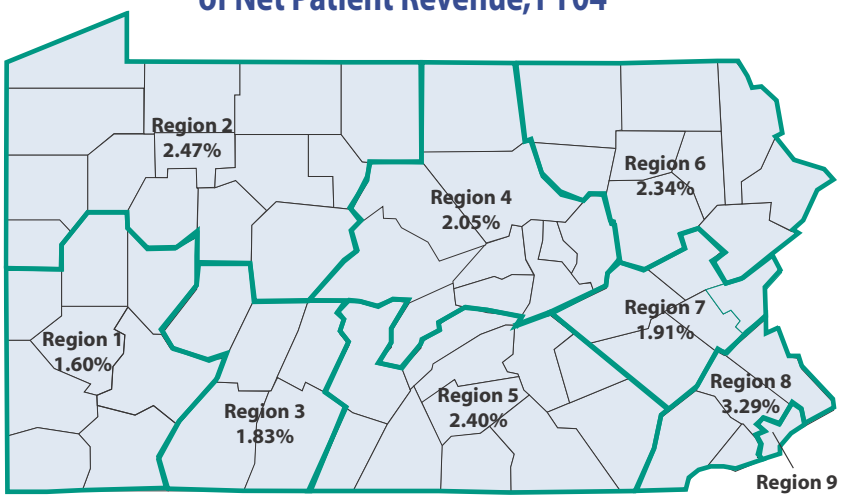
Hospital malpractice expenses are not the only malpractice costs incurred by the health care industry. In fact, while the $636 million in hospital malpractice expenses reflect the costs for all 182 GAC hospitals, the physician malpractice insurance expenses funded by hospitals represent only a limited portion of the total malpractice and Medical Care Availability and Reduction of Error (MCARE) costs incurred by Pennsylvania physicians.

In general, the malpractice expenses in this report include all hospital costs to obtain malpractice coverage, including self-insurance arrangements. These expenses also include the cost of malpractice claims paid out by the hospital, but not covered under malpractice insurance arrangements. Expenditures related to risk management and patient safety as well as funds used to capitalize insurance reserves are not included. More specific information on the components of malpractice expense is outlined below.

Regional Variations

A preliminary look at the various regions of the Commonwealth reveals that malpractice costs are the lowest in Southwestern Pennsylvania and are the highest in the Southeast. In the eight-county Southwest region (Allegheny County, the five adjacent counties, Fayette and Greene Counties), malpractice costs averaged 1.60% of NPR; more than a full point below the statewide average of 2.67%. The malpractice costs in Philadelphia County aver-

Malpractice Expenses as a Percent of Net Patient Revenue, FY04



Statewide Average: 2.67%

aged 3.94% of NPR, which was more than double the average rate in the Southwest. The other four Southeastern counties also had a rate that was higher than the statewide average. The hospitals in Bucks, Chester, Delaware and Montgomery counties reported malpractice expenses that averaged 3.25% of NPR.

Pennsylvania's MCARE Act requires hospitals to carry a primary layer of malpractice coverage at $500,000 per occurrence, and $2.5 million aggregate for policies issued or renewed in calendar years 2003, 2004 and 2005. This coverage can be obtained through an insurer licensed or approved by the Pennsylvania Department of Insurance or by utilizing a self-insurance arrangement approved by the Department.

MCARE Fund

The MCARE Act also established the MCARE Fund as the successor to the Medical Professional Liability Catastrophic Loss (CAT) Fund. The MCARE Fund is a mandatory state-administered malpractice insurance program for hospitals, physicians and other specific health care providers. For 2003, 2004 and 2005, the MCARE Fund provides the second layer of coverage for claims against hospitals above the $500,000 primary level up to $1 million per claim. The MCARE Fund also provides $1.5 million in aggregate annual coverage above the required $2.5 million primary layer to a total of $4 million per hospital.

The Department of Insurance develops annual assessments for the MCARE Fund designed to reimburse the Fund for claims in the preceding claims period (September to August), as well as cover administrative and interest expenses and maintain a 10% reserve. Each hospital's specific assessment is based on the methodology utilized to establish rates for Pennsylvania's Professional Liability Joint Underwriting Association (JUA). Annual hospital assessments are established by the Department as a percentage of the prevailing JUA rate for each hospital.

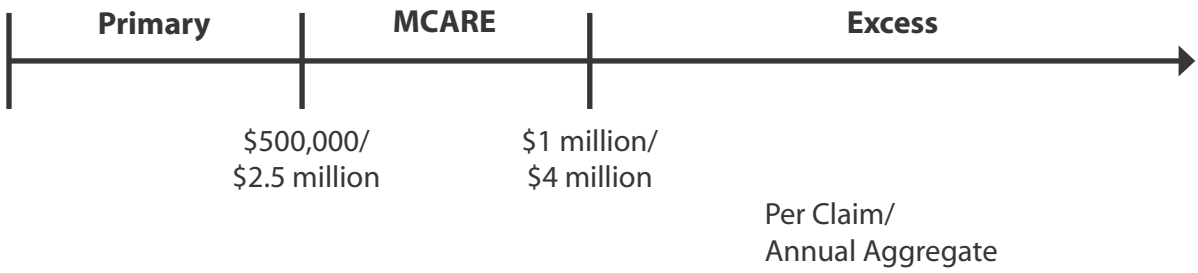
The 182 GAC hospitals reported their FY04 MCARE Fund assessments totaling $77 million which is about 12.1% of their malpractice costs. These figures do not include physician MCARE assessments that may be paid by a hospital. Hospital payment of physician MCARE assessments is discussed later.

Since the MCARE fund provides the second layer of malpractice coverage, hospitals must obtain their own primary coverage below the MCARE range and most hospitals carry one or more layers of excess coverage above the MCARE range. Hospitals can obtain these coverages from either a commercial insurer or some form of self-insurance approved by the Department of Insurance.

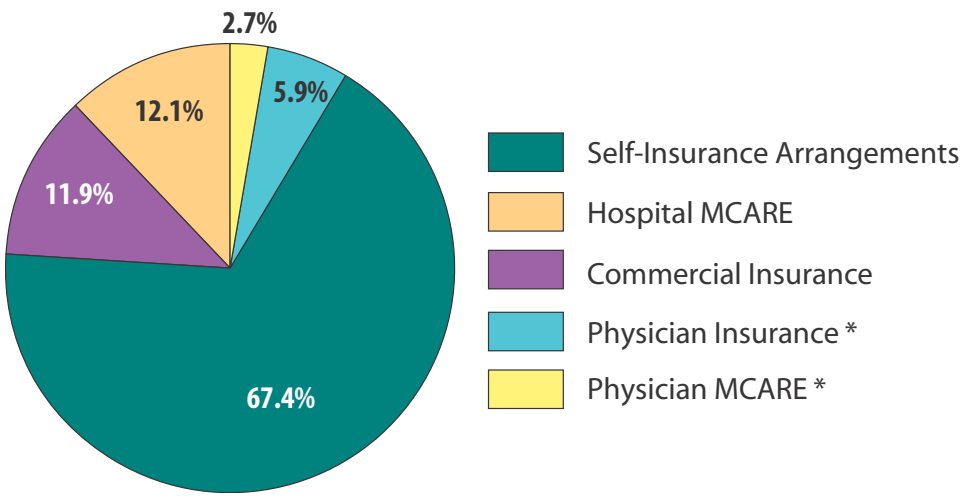
Commercial Insurance

Over the past few years, malpractice insurance from commercial carriers has become increasingly expensive and difficult, if not impossible, for hospitals to obtain. Some insurers have gone insolvent and others have determined it was not profitable to offer this line of insurance. As a result, on a statewide basis, Pennsylvania hospitals only utilize commercial insurance to meet a small part of their malpractice exposure. During FY04, 11.9% of total malpractice costs, or about $76 million,

Hospital Malpractice Insurance Layers 2003 - 2005



Statewide Hospital Malpractice Expenses, FY04



* Physician malpractice insurance costs and MCARE expenses funded by hospitals.

were for premiums to commercial insurance companies.

These expenses include insurance written directly with a commercial carrier and various forms of self-insurance that is reinsured with an insurance organization completely independent of a hospital.

Self-Insurance Arrangements

Hospitals and health systems have developed a broad spectrum of self-insurance arrangements and organizations to meet their malpractice exposure. These include risk retention groups (RRG) and wholly-owned domestic and offshore captive insurance companies. A few hospitals utilize an insurance company that is statutorily independent of the hospital, but all or part of the risk is ultimately reinsured by the hospital or health system. A few other hospitals have set aside reserves and self-insure for all or part of their malpractice exposure.

An RRG is a group of hospitals that pool their resources to develop the reserves necessary to form their own captive insurance company. The member-owner hospitals typically pay premiums that reflect the risk and malpractice experience of the individual members.

Eighty-nine percent (89%) or 162 of the 182 hospitals reporting malpractice expenses utilize some form of self-insurance, and the total annual expenses associated with these arrangements was $428.9 million or 67.4% of total malpractice expense. These self-insurance expenses include FY04 expenses associated with incurred but not reported (IBNR) accruals, claims paid directly by a hospital and administrative expenses of self-insurance companies or programs. Expenditures that were not posted to the hospital's statement of operations, such as the funding of a reserve, are not included.

One hundred twelve (112) hospitals were able to break out the administrative portion of their self-insurance expenses, such as the portion of a premium to an RRG, that was allocated to administer the RRG. For these 112 hospitals, about 4.8% of their self-insurance expenses was used to run these programs.

Physician Insurance

Fifty-nine percent (59%) or 107 of the 182 GAC hospitals underwrite all or a portion of the malpractice insurance for their physicians and other medical professionals. These hospitals subsidized the malpractice expenses for 5,289 physicians and medical staff at a total cost of $37.4 million for an average of $7,077 per physician. Physician malpractice insurance comprised 10.2% of their total malpractice costs for the 107 hospitals or 5.9% of statewide hospital malpractice costs. This hospital-funded physician insurance includes

both commercial insurance and physician components of hospital self-insurance programs.

For some hospitals, the malpractice insurance for physicians and other medical staff is embedded in the hospital coverage, and it was not possible for hospitals to isolate the portion of malpractice costs for physicians and other staff. Consequently, the statewide commercial and self-insurance hospital costs presented above include coverage for some professional staff.

Physician MCARE

The MCARE Act also requires physicians and nurse midwives to participate in the MCARE Fund for their second layer of malpractice insurance. Sixty-five percent (65%) of the hospitals reported underwriting all or a portion of the FY04 MCARE assessment for 6,441 individuals at a total cost of $17.0 million or 4.1% of the 119 hospitals' total malpractice costs. These physician MCARE expenditures represent about 2.7% of statewide GAC malpractice expenses.

Act 44 of 2003 established the Health Care Provider Retention Program which provided for abatements of the 2003 and 2004 MCARE assessments for participating physicians and nurse midwives. The 2003 abatements were credited retroactively during 2004. The portion of the abatements that were intended to reduce physician assessments paid by hospitals prior to FY04 (e.g. FY03) were not reflected in these expenses. Only those abatements related to physician MCARE assessments paid in FY04 are reflected in these expenses.

Effect on Hospital Income

While the $636 million in malpractice expenses reported by GAC hospitals was only about 2.67% of all operating expenses incurred by hospitals in FY04, it was greater than the $528 million in statewide operating income and 74% of the $858 million in statewide total net income (includes all sources of income such as investment gains and contributions).

Like all hospital expenses, changes in malpractice costs have a direct effect on hospital income. For example, if malpractice costs would have been 10% higher during FY04, statewide operating income would have been 12% lower and total net income 7.4% lower. Since income is essential for hospitals to finance the replacement and improvement of their equipment and facilities, changes in malpractice costs can have an effect on the hospitals' ability to keep pace in medical technology and meet the changing healthcare needs of the communities they serve.

During FY04, more than one-third (34%) of GAC hospitals posted losses (negative total margins) and 37% had a negative three-year average total margins (FY02 – FY04). Changes in malpractice expenses could also have an effect on the ability of these hospitals to achieve positive income levels in the future.

There was, however, no correlation between the level of individual hospital malpractice expenses and individual hospital income. For example, hospitals with low or negative operating margins in FY04 did not exhibit a pattern of spending a higher portion of their revenue on malpractice expenses.

Changing Dynamics

In the notes to their annual financial statements, most hospitals have reported significant changes in the manner in which they meet their malpractice exposure since 2002. Ongoing monitoring by PHC4 will map the dynamics of malpractice expenditures and how these expenses affect the financial health of Pennsylvania's hospitals.

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The Pennsylvania Health Care Cost Containment Council (PHC4) periodically releases *Research Briefs* on health care topics relevant to public policy interest.

PHC4 is an independent state agency created to collect, analyze, and disseminate information designed to improve the quality and restrain the cost of health care.