“Crises” in medical malpractice insurance: Evidence of excessive price-cutting in the preceding soft market

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Abstract

Prior work suggests that heterogeneous information or weak incentives for solvency could have caused some general liability insurers to charge low ex ante prices during the early 1980s and mid-to-late 1990s, putting downward pressure on other firms’ prices and plausibly aggravating subsequent periods of rapid premium growth. We analyse whether the 1994–1999 “soft” market in medical malpractice insurance led some firms to underprice, grow rapidly, and subsequently experience upward revisions in loss forecasts (“loss development”), which could have aggravated subsequent market “crises”. Consistent with the underpricing hypothesis, the results indicate a positive relation between loss development and premium growth among growing firms. Underpricing was likely more prevalent among non-specialist malpractice insurers.

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1. Introduction

Markets for many types of property/casualty insurance exhibit soft market periods, where premium rates are stable or falling and coverage is readily available, and subsequent hard market periods, where premium rates and insurers’ reported profits significantly increase and less coverage is available. Conventional wisdom among practitioners and many other observers is that soft and hard markets occur in a regular “underwriting cycle”, with potentially excessive price-cutting in soft markets amplifying premium rate increases and reduced coverage available during subsequent hard markets. A substantial body of work has considered the causes of volatility in insurance prices, with an emphasis on price dynamics during hard markets. Prior analyses of pricing during soft markets of the early 1980s and mid-to-late 1990s in general liability (GL) insurance provide evidence of excessive price-cutting by some firms, which could reflect heterogeneity in information and associated winner’s curse effects, or excessive risk-taking by some firms with weak incentives for solvency (Harrington and Danzon, 1994; Harrington, 2004).

We extend this work on excessive price-cutting in GL by using similar methods to analyse the mid-to-late 1990s soft market in medical malpractice insurance, a highly specialized market with significant policy relevance. The conclusions are broadly similar to those from GL insurance. Our empirical findings are consistent with the hypothesis that some firms underpriced and grew relatively rapidly during that period. These results suggest that market crises