Short Cuts
Issues & Answers

The Council for Affordable Health Insurance — Solutions for Today's Health Policy Challenges

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How High Loss Ratios Undermine Affordable Health Insurance

States across the country are unveiling various health reform proposals, and chief among those is the regulation of health insurance rates. California, Michigan, New Mexico and Pennsylvania have all introduced a health insurance price-control scheme that limits the insurers "loss ratio" (i.e., the percentage spent on direct health expenditures) to 70 percent of premium. While some believe the states have found a solution to the rising cost of health insurance, states that have actually implemented similar proposals have not been successful at lowering health insurance premiums.

What Is a Loss Ratio? A loss ratio is the percentage of premiums spent on direct patient care. A 70 percent loss ratio means that health insurers would be required to spend at least $70 on patient care for every $100 in premiums. Conversely, health insurers may spend only $30 of every $100 on administrative expenses. Loss ratios are, in effect, price controls, seeking to limit the cost of insurance by controlling administrative expenses.

What Is Included in Administrative Expenses? Administrative expenses include all the costs required to conduct the business of health insurance and provide customer services to members. These expenses include, among many others:

- The cost to collect premiums and credit those premiums to the correct account;
- The cost to process a medical claim accurately, including issuing and sending a check for services and providing an explanation of the payment;
- Monitoring efforts to ensure patients are getting appropriate care, especially those with chronic medical conditions;
- Customer service staff – often more than half of an insurer's employees – to answer questions from members and medical providers 24 hours a day, 7 days a week;
- Agent commissions;
- Costs imposed by state and federal laws, including premium taxes, external review fees (i.e., costs an insurer must pay to an independent provider to review a claim), assessments for high risk pools, timely claims payment requirements, and others; and,
- Profit, or excess revenue (non-profits), and general overhead costs.

In other words, insurers and health plans incur numerous costs in their efforts to process and monitor claims and care, set premiums, and comply with state and federal requirements. Unfortunately, while those efforts surely reduce claims costs and therefore reduce upward pressure on premiums, critics see only the costs, not the benefits. They are ignorant of the fact that some of those costs may actually save money.

Do Administrative Costs Add Value? Customer service and the business of insurance are not the only components of administrative expenses. Some health insurers have even spent millions of dollars on information systems to help consumers understand their medical choices, while others have provided direct phone access to nurses to help patients understand their medical conditions. These efforts reduce health care expenditures and result in lower health insurance premiums. Thus, loss ratios set too high may actually result in a lower quality of care and higher health insurance premiums.

Solution. A few states have experimented with increasing loss ratios to artificially lower premiums and cut administrative expenses. Both Kentucky and North Dakota passed higher loss ratios as part of a series of reforms in the 1990s. Kentucky's loss ratio bill was part of larger health reform legislation that decimated the market. Not until the loss ratio was lowered to a more reasonable 65 percent (which also allowed some administrative expenses to be included in claims costs, thereby lowering the actual loss ratio) did the individual market finally begin to recover. North Dakota has faced a similar crisis with carriers abandoning the market, few choices and higher premiums. With the passage of Senate Bill 2154, which lowers the group loss ratio from 75 to 70 percent and individual market loss ratio from 65 to 55 percent, policymakers in North Dakota expect a similar resurgence in the market.

In rate regulation, it appears that less is more. States that rely on a competitive market have tended to have lower overall health insurance rates.

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