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THE HEALTHCARE IMPERATIVE

Lowering Costs and Improving Outcomes

Workshop Summary

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The serpent has been a symbol of long life, healing, and knowledge among almost all cultures and religions since the beginning of recorded history. The serpent adopted as a logotype by the Institute of Medicine is a relief carving from ancient Greece, now held by the Staatliche Museen in Berlin.

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EXCESS HEALTH INSURANCE ADMINISTRATIVE EXPENSES

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Within the context of the 2009 U.S. healthcare reform discussion, significant attention has been paid to identifying opportunities to reduce administrative expenses. Every stakeholder in the health insurance system incurs some administrative expense—payers, providers, purchasers, and even patients. Efforts to reduce these costs, especially those of payers and providers, have the potential to produce substantial financial savings, which could be used to fund additional care or be redirected for other purposes.

Our experience working with both payers and providers convinces us that there is widespread agreement that administrative expense reduction is both worthwhile and possible. In many cases, we believe that there is also agreement regarding viable high-level tactics for reducing administrative expenses. The points of contention and disagreement, which have precluded

significant administrative expense reduction in recent years, tend to involve funding of cost-reduction initiatives (who will pay for them?), avoidance of risk associated with changes to the status quo, and the potential for loss of payer competitiveness through product commoditization.

This paper quantifies the industry-wide administrative expense-reduction opportunity that the commercial payer community could achieve by transitioning from today's average administrative expense level to a best-practice administrative expense level. In addition, the paper identifies some tactics that could be employed by the industry to achieve these potential cost reductions.

For the purposes of this analysis, we have defined administrative expense as all expenses incurred by payers for common administrative functions such as claim processing, customer service, underwriting, medical management, and sales and marketing, as well corporate overhead and external broker commissions. We have excluded premium taxes from the analysis.

It is important to note that this paper only focuses on the commercial market (e.g., not Medicare, Medicaid, or TRICARE) and excludes supplemental products (e.g., vision, dental, and hospital indemnity plans). It also ignores potential savings that could be realized by other stakeholders (specifically, providers and purchasers) through implementation of cost-reduction strategies by payers.

Quantifying the Expense Reduction Opportunity

We used the following methodological approach to quantify the magnitude of the administrative expense-reduction opportunity:

- Estimated the total dollar value of commercial premiums for the entire U.S. health insurance marketplace;
- Estimated the distribution of commercial premiums between self-insured and fully insured products;
- Estimated total administrative expense associated with fully insured commercial products;
- Estimated total administrative expense for fully insured commercial products assuming a shift from current expense levels to a best-practice level;
- Calculated the savings opportunity for fully insured commercial products as the difference between the current administrative expense level and the estimated best-practice expense level;
- Estimated the marginal expense reduction opportunity for self-insured business as a percentage of the marginal expense-reduction opportunity for fully insured business; and

- Calculated the range of total possible savings as the sum of the value for fully insured commercial business and the range of possible savings for self-insured commercial business.

The methodology and data sources we used to develop these estimates are described below.

Value of Current Total Commercial Health Insurance Premiums

Our estimate of the total value of health insurance premiums for the commercial health insurance market is based on the Milliman Healthcare Reform Database. The Milliman database contains cost details for U.S. subpopulations (market segments), with the total reconciling National Health Expenditures data for 2008. According to this data source, 2008 U.S. health insurance commercial premiums, including premium equivalents for self-funded products, totaled approximately $700 billion.

Distribution of Commercial Health Insurance Premiums

There are two primary types of risk arrangements in the health insurance market: fully insured and self-insured (also known as "self-funded"). For fully insured products, the insurance company (the payer) takes the financial risk on the claims cost. For self-insured products, the purchaser (typically the employer) takes that financial risk. The self-insured market has grown substantially since implementation of the Employee Retirement Income Security Act of 1974 (ERISA), which recognized self-funded plans as a viable option and exempted them from most state-mandated benefits.

Self-funded products are most prevalent for group sizes greater than 500 covered lives, but are a viable option for much smaller groups. This approach is typically unadvisable for groups of less than 100 covered lives because of the risk exposure. Self-funding offers several characteristics that are desirable to purchasers, including benefit design flexibility, and lower cost owing to exemption from state premium taxes (which can add 2 percent to the cost of a fully insured product) and the insurer's risk margin on the claims cost.

In our experience, fully insured products tend to generate a greater amount of administrative expense than self-insured products. This situation exists because of a variety of factors such as unbundling of administrative services, shifting of administrative responsibilities from the payer to the employer's human resources department, and price pressure. For that reason, it was necessary to estimate the distribution of total commercial premiums between these two risk arrangements. The data sources we used to make this distribution were the Medical Expenditure Panel Survey from

the Agency for Healthcare Research and Quality (AHRQ), and proprietary Milliman data. Through the combination of these two data sources, we estimated that approximately $375 billion of premiums are associated with fully insured products and $325 billion of premium-equivalents with self-insured products.

Administrative Expense for Fully Insured Commercial Products

We estimated 2008 total administrative expense for fully insured commercial products using benchmarks developed from administrative expense data collected from more than 100 payers. According to these proprietary benchmarks, median payer administrative expense for fully insured commercial products, expressed as a percentage of fully insured commercial premiums, was 11.3 percent. Note that this definition of administrative expense is inclusive of external broker commissions, but excludes premium taxes.

Using the combination of the total fully insured premiums in the commercial market and the median administrative expense level (using the median to approximate the mean) we calculated an estimate of $42.4 billion ($375 billion × 11.3 percent) to represent total payer administrative expense for fully insured commercial products.

Administrative Expense for Fully Insured Commercial Products at Best Practice

Next, we developed an estimate of what total payer administrative expense for fully insured commercial products would have been in 2008 if administrative expense as a percentage of premiums was shifted from 11.3 percent to a level equivalent to that exhibited by best-practice organizations. Best-practice payers tend to exhibit certain characteristics that allow them to offer high-quality service in a very efficient manner. For example, they maximize use of electronic transactions, leverage information systems to achieve high levels of automation, minimize low-value administrative activities, and generally avoid unnecessary complexity.

In terms of administrative expense, we defined the best-practice level, based on our experience, to be approximately 7.6 percent of fully insured commercial premiums. Although it is possible for organizations to operate effectively at lower administrative expense ratios, we find it is more common for organizations with administrative costs below this level to exhibit characteristics of poor performance (e.g., high claims turnaround times, long customer service call hold times, inadequate or ineffective medical management programs) that are due to insufficient staffing.

Furthermore, it is important to consider that certain administrative

costs can have an offsetting impact on benefit cost. For example, some medical management programs can help to avoid unnecessary use. Administrative spending on these programs can be considered an investment, which can result in lower expenditures for healthcare services and therefore a lower total cost. Elimination of such "good" administrative expenses must be carefully considered to ensure that any administrative expense savings are not offset by increases in benefit costs.

Using the best-practice administrative expense level defined above and our estimate of total fully insured commercial premiums, we estimated that total payer administrative expense would be approximately \$28.5 billion (\$375 billion × 7.6 percent).

Administrative Expense Reduction Opportunity

Fully insured commercial business Using the administrative estimates developed in the two prior sections, we calculated the total administrative expense reduction opportunity for fully insured commercial products as the difference between the 2008 median and the best practice: \$13.9 billion (\$42.4 billion-\$28.5 billion). This amount represents an estimate of the savings that could be achieved by shifting the industry median administrative cost level to a level representing current best practice.

Self-insured commercial business As previously stated, in our experience, self-insured products incur lower levels of administrative expense than do fully insured products. Therefore, we estimated the administrative expense reduction opportunity for these products by assuming the effect would be in the range between 50 and 75 percent of the marginal reduction for fully insured products.

Given that, we estimate that additional administrative expense savings for self-insured businesses could be in the range between \$6.2 billion and \$9.1 billion. We calculated these estimates as shown in Table 4-8.

Commercial Administrative Expense Reduction Opportunity

In summary, we estimate the total administrative expense-reduction opportunity for the commercial market as the sum of the estimate for the fully insured market (\$13.9 billion) and the range of estimates for the self-insured market (\$6.2 billion to \$9.1 billion). The resulting range is \$20.1 billion to \$23.0 billion, or approximately 3 percent of total commercial premiums.

Within the context of healthcare reform, this may be a relatively conservative estimate. It assumes that the entire payer community achieves an administrative expense level consistent with current best practices. If the

TABLE 4-8 Estimates of Payer Administrative Expense-Reduction Opportunity for Self-Insured Business

	Scenario 1	Scenario 2
Percentage of marginal FI savings that can be applied to SI business	50%	75%
2008 administrative expense ratio for FI business	11.3%	11.3%
2008 best-practice administrative expense ratio for FI business	7.6%	7.6%
Marginal improvement opportunity for FI business	3.7%	3.7%
Marginal improvement opportunity for SI business based on percentage of marginal FI business reduction	1.9%	2.8%
Estimate of total SI commercial premium equivalents	$325 billion	$325 billion
Estimate of administrative expense-reduction opportunity	$6.2 billion	$9.1 billion

NOTE: FI = fully insured; SI = self-insured.

definition of *best practices* changes due to significant changes to the administrative paradigm, then even greater administrative expense reductions may be possible. Furthermore, we caution users of this report to consider the caveats and assumptions described in the next section.

Caveats and Assumptions

Reviewers of this document should consider the following caveats and assumptions when evaluating the results:

- The savings estimates provided herein are only for payers. Secondary savings would likely accrue to providers, purchasers, and potentially patients. Those savings are not estimated in this paper.
- The savings estimates provided herein are only for commercial products. Additional savings may be achieved in noncommercial products (e.g., Medicare, Medicaid, TRICARE). Those savings are not estimated in this paper.
- The calculation methodology applies data in a general manner across the entire marketplace. These estimates are not intended to represent what is possible for a specific plan or group of plans. It may not be possible for all payers, especially small payers, to achieve the best-practice benchmark because of a variety of circumstances, most notably the effects of economies of scale.
- We do not guarantee an organization's or the industry's ability to achieve the savings estimates described herein, and Milliman disclaims any and all liability that may result from a third party's use of this white paper.

- The opinions expressed in this white paper represent those of the author and not the opinions of Milliman, Inc.

Next Steps

While the opportunity to reduce payer administrative expenses in the U.S. health insurance system is great, the realization of those savings presents many challenges. If the historical context is an indicator of the future, then the achievement of material administrative cost reductions will require concerted, collaborative expense-reduction efforts coordinated among all stakeholders.

We believe there are opportunities to reduce the complexity that drives inefficiency in the system. To that end, we have identified a few tactics targeting those functions that drive the majority of administrative expense, and therefore represent, in our opinion, high-priority areas of focus for administrative expense reduction efforts.

Eliminate Manual Transactions Between Payers and Providers

According to the U.S. Healthcare Efficiency Index (www.ushealthcareindex.com), the majority of common transactions between payers and providers are performed using labor-intensive, manual means. This is despite the fact that, in accordance with HIPAA, nearly every payer in the nation has the capability to accept electronic transactions, and significant financial benefits accrue to payers through their use. Eliminating manual transactions for claim submission, claim status inquiries, eligibility verification, claim payment, and remittance advices will substantially reduce both payer and provider administrative expenses.

Simplify the Sales Process

Today approximately 30 percent of payer administrative cost is driven by sales and marketing activities. Approximately one-half of that amount is driven by external broker fees. The process of purchasing group health insurance, and soliciting and evaluating proposals from multiple payers, is complicated and time consuming. Furthermore, most group insurance purchasers are not health insurance experts. These realities drive many purchasers to employ the services of a broker. Although the broker provides some valuable administrative services for less sophisticated purchasers, substantial reductions in sales and marketing expense could be achieved if purchasers could more easily compare products and prices, thus minimizing the broker's role, and associated costs, in the sales process.

Maximize Self-Service Capabilities and Adoption

Although health insurers have made significant investments in self-service capabilities (online and telephonic), adoption rates for these services could improve significantly. The administrative expense associated with a self-service transaction is negligible when compared to the cost of handling a telephone call or processing written correspondence.

Standardize Payer–Provider Interaction Processes and Rules

A typical provider may have contracts with 10 or more insurers and interact with others as a nonnetwork provider. Every payer has different processes, policies, and rules. Standardization of processes for common types of interactions could reduce both provider and payer administrative expense.

Scrutinize Medical Management Programs for Effectiveness

Since the advent of managed care, payers have implemented many programs intended to manage use of healthcare services. The clinical personnel (e.g., physicians, nurses, and other clinicians) responsible for these programs are often among the most expensive administrative staff. Although some of these programs are effective in managing use and cost, others have dubious value, especially when compared to the administrative burden they impose on payers, providers, and patients. The elimination of medical management programs that do not demonstrate value could significantly reduce administrative cost.

Of course, this is not a complete list, and successful implementation of all of these tactics does not guarantee realization of the full savings opportunity. However, we believe it is possible to substantially reduce payer administrative expense to the benefit of the U.S. healthcare system. We also believe that material administrative expense reduction can be achieved without harming competition among insurers, and without reducing provider reimbursement levels or diminishing quality and service to purchasers and patients. Such initiatives will, however, require coordination among all stakeholders, and implementation of carefully considered strategies adopted by all payers, to reduce complexity and eliminate administrative variation.