

## INSURANCE BASICS

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In the debate about health care reform I have noticed that there is one perspective that is missing - that is a view of the basics of insurance. Reform of the health care financing system has been my main political focus since 1992. In that year I read an article by Susan Schact who was an analyst with the Federal Reserve Bank of Boston where her main focus was the insurance industry. In the article she laid out how insurance works and how it related to health insurance. She was not advocating for any particular system, but she wanted people to know the functions of insurance so that they could properly evaluate health insurance options. I am a former corporate planner who used to design distribution systems for major corporations. When designing a system, I always found it helpful to go back to the basics of distribution, which is why I found her article so helpful. I will try to summarize her article.

One of the first points that she made was that the larger your **risk pool** the lower your costs. **Fragmented risk** leads to greater costs because each segment has to spend money on administration and marketing. In addition, each segment has to charge enough to cover possible catastrophic events, although some of this can be handled through the **reinsurance** market. Other major factors in a fragmented market are **cost shifting** and **minimizing risk**. Each segment of the pool has large numbers of actuaries who are analyzing the market and determining the demographics that will incur the least risk to their company. They also spend considerable resources determining how they can shift costs to other segments of the market. As Ms. Schact pointed out in her article, this is not a value judgment on insurance providers, this is what they are supposed to do.

In a fragmented market there is less of an incentive to improve health care outcomes because an individual insurer is not likely to receive the financial benefit of strategies to improve health care outcomes. Remember, the average stay in a health care plan is about one and a half years. Almost all strategies to improve health care outcomes do not show return in that short a term.

In a fragmented market it is less likely that innovative consolidation and simplification of paperwork and medical records will take place because the return on the capital investment required to consolidate/simplify the system will not be enough for any individual provider. Andy Grove, co-founder of Intel and activist on consolidation of medical information, has identified the fragmentation of the insurance providers as the major reason why this consolidation has not taken place.

Despite the popular belief, the more providers that enter the market the more our costs go up. The system was far more efficient when Blue Cross/Blue Shield had such a large share of the market that they were able to set the standards for the whole industry. Now, the United States spends at least 30% of its health care dollar on administration, marketing and profit, while the most any other industrialized country spends is 10%. On a national level, that is 20% of over 2 trillion dollars that is wasted – you can do the math.

When considering reform of the health care system I think we start with the basics of insurance and build from there.

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