CRITICAL ISSUES IN HEALTH REFORM

Merging the Small Group and Individual Markets

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As part of the ongoing health care reform dialogue, one question is whether legislation should include the merger of the individual and small group health insurance markets. This paper discusses the potential effects of merging these markets and necessary considerations to ensure adverse implications are minimized.

Massachusetts' health care reform initiative included a provision that resulted in the merging of the small group and individual health insurance markets in addition to the elimination of medical underwriting. One question is whether this approach should be part of proposals to develop comprehensive health care reform on a national level. There are essentially two approaches that could be taken to merge the existing markets: the first maintains an employer-based market structure and merges in individuals by treating them as "groups of one;" the second removes small groups below a specified size from the employer-based market and merges them into a reformed individual health insurance market.

There are many considerations that should go into merging the individual and small group markets. First and foremost is existing market differences that may cause significant disruption (e.g., unexpectedly large rate increases and/or mandated benefit changes) for current participants. Additional considerations include issues associated with the purchase decision, plan portability, and the taxation of benefits.

In order to make informed decisions on merging the two markets, policymakers should examine the major differences between the two markets as they exist today. Individual products are marketed, underwritten and rated very differently than small group market products in most states and such differences vary by state. As a result, the implications of merging the individual and small group markets depend upon the rating and underwriting rules in each of the states. This paper presents market effects of merging the markets as well as the issues needing attention to ensure adverse implications are minimized.

A merged market could significantly alter issue and rating rules unevenly across the country.

If all individuals seeking coverage within a new, merged market are guaranteed issued, then access to health insurance coverage will not be contingent on medical underwriting. In other words, insurers would be required to offer coverage to all applicants, regardless of health status. Guaranteed issue is currently mandatory in the small group market;[1] while underwriting is more common in the individual market. Merging the two markets into a single market, without adjustment, would likely result in higher premiums than currently exist for those in the individual market. This is because the guaranteed issue requirements that currently exist in the small group market would be applied to the individual market as a whole. Since the individual market is not subsidized by employer contributions, any increase in cost will likely cause individuals to drop their coverage. For a few states, such a change may have little impact (e.g., Massachusetts), but for other states the disruption would likely be significant.

Health insurance rate regulation varies

[1] The *Health Insurance Portability and Accountability Act of 1996* requires guaranteed issue in the current small group market.

ADDITIONAL RESOURCES

Market Reform Principles
http://www.actuary.org/pdf/health/market_reform_may09.pdf

Individual Mandates
http://www.actuary.org/pdf/health/individual_mandate_may09.pdf

Transitioning to New Markets
http://www.actuary.org/pdf/health/transition_aug09.pdf

Health Reform Now
http://www.actuary.org/issues/health_reform.asp

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significantly between the small group and individual insurance markets, and such variances are not uniform by state. If health care reform creates a unified approach to health insurance rate setting for the merged market, it will likely create transitional pricing issues that will need to be addressed by insurers and regulators. The pricing under such a merged market may well result in significant premium changes—increases or decreases—for some insurance policyholders depending on the rating and underwriting rules present in the current individual market compared to those in the small group market for each state. Individuals who paid low initial premiums because of medical underwriting at issue could experience significant premium increases. In fact, if HIPAA[2] regulations for the small group are applied to the merged market, then existing individual policyholders (effectively being rated as a "group of one") could enter the merged market at a rate for a lower-risk individual and then experience premium increases after claims are paid for that individual. In the current individual market, premiums generally do not increase with individual claims.

If, on the other hand, small group rate regulations are modified to look more like those in the current individual market, the large variation in individual rate regulations across the country will present challenges in developing uniform regulations. If insurers lose the ability to adjust premium rates based upon the emerging claims experience of the group, (current small group rate provisions often allow an additional rate adjustment for experience, frequently limited to a certain percentage) they may exercise greater diligence in risk selection (e.g., through marketing strategies, non-medical underwriting practices, etc.).

Current combinations of issue and rating rules vary across the country and could well impact each state very differently. For instance, in the few states that already have guaranteed issue and modified community rating rules in both the individual and small group markets (as was true in pre-reform Massachusetts), moving to a merged market with guaranteed issue and modified community rating could actually reduce premiums for those with individual coverage and increase premiums for those with small group coverage. In contrast, in most states that allow underwriting and premium variation by health status in the individual market, but guaranteed issue in the small group market, moving to guaranteed issue and modified community rating in a merged market could increase premiums for those with individual coverage. The introduction of an effective individual mandate could moderate overall premium increases in a particular market segment to some extent. However, some individuals could still face higher or lower premiums because of the implementation of guaranteed issue and no premium variation by health status. This is true regardless of whether the markets are merged.

A merged market would likely produce changes in the roles of the decision makers to purchase insurance.

Within the individual market, individuals make the decision to purchase coverage for themselves and, typically, the rest of their family. For the smallest groups (e.g., fewer than five to nine employees), the decision-making and purchase process parallels that of the individual market. A business owner makes the purchase decision largely based upon his or her personal needs, often purchasing insurance through the small group market to en-

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[2] Ibid.

The primary drafters of this policy statement include: Timothy J. Luedtke, chairperson, MAAA, FSA, FCA; Michael S. Abroe, MAAA, FSA; David J. Bahn, MAAA, FSA; Karen Bender, MAAA, FCA, ASA; Joyce E. Bohl, MAAA, ASA; David A. Shea., Jr, MAAA, FSA; Martha M. Spenny, MAAA, ASA; Thomas J. Stoiber, MAAA, FSA; Rod Turner, MAAA, FSA; and Thomas F. Wildsmith, MAAA, FSA.

sure policies are guaranteed issue and contain other features (e.g., maternity coverage) that may be unavailable in the individual market. One of the major reasons for larger small groups (e.g., 30 to 50 employees) to purchase insurance is to compete for employees rather than meet the personal needs of the employers and their families. The employer chooses the carrier, the benefit plan, and type of coverage, and the employees make their purchase selection from the employer's offering or may choose not to participate. Occasionally, an employee may be able to purchase less expensive coverage, even after considering the employer contribution, through the individual market or through government programs (e.g., young, lower-risk individuals).

Should health care reform result in fewer employer-sponsored health insurance plans, the purchase decision would be increasingly made by individuals. As such, individuals who are new to the individual market may have a greater variety of coverage options for insuring their medical needs. This could affect the underlying health status of any given risk pool—whether small-group or individual—as individuals make decisions based on their specific medical needs. As a result, similar to the introduction of Medicare Part D, individuals would benefit from significant educational programs and qualified/affordable expert assistance to support them as they make their health insurance decision.

A merged market with equivalent tax incentives for individual or group health insurance purchases may result in lower-risk individuals dropping employer-sponsored coverage for individual coverage.

In the individual market, premiums are generally paid with after-tax dollars. In the group market, employee contributions may be paid with before-tax income and benefits are received tax free. This reduces the employee's cost by 15 to 40 percent versus the cost in the individual market. Further, small employers often contribute at least 25 percent, and more often 30 to 60 percent, of the employee cost (if not a portion of the dependent cost) to small group plans.[3] These contributions are often necessary in order to meet insurer requirements. When combined with the tax benefits, the net cost of the insurance available to employees can be half of the cost of individual coverage. Thus, there is currently an economic incentive for individuals to acquire their health insurance through their employer. Any changes in these incentives between the group and non-group markets could create significant and dramatic changes in how individuals obtain health insurance. Depending upon the final rating rules, if consistent taxation is mandated for employer-sponsored and individual health insurance, employer-sponsored health programs with low employer contributions could experience significant changes in their insured populations with more of the younger, lower-risk individuals opting to purchase individual insurance.

A merged market will impact existing insurance policies.

Some reform proposals would "grandfather" insurance contracts in force prior to the implementation of any reform requirements, including both small group and individual policies. To produce a successful merged market with minimal disruption, careful consideration will have to be given to the merger of those policies into newly created markets. Although, with transitioning, the major concern is moving individuals and small groups to policies that may have significantly higher or lower premiums than those in pre-reform markets, other issues are equally as important although perhaps not universal. Key issues include: management of existing small groups through careful pricing and transition rules to avoid the immediate movement of groups eligible for lower premiums, leaving those remaining to pay higher premiums and create

[3] From Mercer as referenced in *Options Available to Reform the Comprehensive Standard Health Benefit Plan,* Maryland Health Care Commission, December 20, 2007.

rate spirals; and maintenance of equity for individual policyholders, especially those previously underwritten at issue if new entrants to the pool are not underwritten. Alternatively, existing small group pools may actually see improved pricing as those otherwise uninsurable join the new pool, leaving the lower-risk individuals to receive prospectively lower rates and putting increased upward rate pressure on the new pool.

A case study of possible effects of merging the individual and small group: the State of Florida.

It is instructive to consider the claims costs in several existing segments in order to gauge the effects of merging markets.[4] However, this type of data is not readily available in the public domain, specifically data that is broken down by medically underwritten policies and guaranteed issue policies. Because the State of Florida routinely collects and publishes the type of statistics required for a comparison of medically underwritten and guaranteed issue policies, it can help illustrate the possible effects these issues may have on merging the individual and small group markets.

The availability of Florida's published data allows us to study the different claim levels among individual and small group policies, as well as among medically underwritten and guaranteed issue policies in an environment that allows all of these. Published guaranteed issue data is available for small groups (six to 50 lives), micro groups (two to five lives), self-employed/sole proprietors (one life), conversion policies (individuals leaving fully insured groups), and guarantee issue (individuals leaving self-funded groups). Additionally, the individual market offers data for individuals purchasing insurance on a medically-underwritten basis. The table below includes the segments that would be combined in a merged market.

These statistics show that the claim costs for guaranteed issue self-employed and conversion contracts are significantly higher than the claim costs for individuals purchasing insurance through the individual medically-underwritten market. While differences in the distribution of insureds by age and gender, as well as differences in cost sharing provisions, may vary between these populations, these would not be expected to account for the entire difference in claim costs. Furthermore, in the absence of medical underwriting, the table indicates that in a guaranteed issue environment the smaller the group size, the higher

Florida Small Group and Individual Market Data

Market Segment	Insureds	Average Claim per Insured	Ratio to Individual Underwritten
Small Group (6–50 lives)	1,042,020	$2,314	104%
Micro Group (2–5 lives)	186,359	$3,187	144%
Self-employed/Sole Proprietors (1 life)	33,250	$4,901	221%
Conversion Policies (individuals leaving fully insured group plans receive guarantee issue)	45,568	$4,932	222%
Guarantee Issue (individuals leaving self-funded plans)	40,882	$2,405	108%
Individual – Medically Underwritten	733,482	$2,218	100%

Source: *CY2007 Gross Annual Premium and Enrollment Accident and Health Markets,* Florida Office of Insurance Regulation, July 2008. http://www.floir.com/pdf/AHGAPCY2007.pdf

[4] *CY2007 Gross Annual Premium and Enrollment Accident and Health Markets*, Florida Office of Insurance Regulation, July 2008. http://www.floir.com/pdf/AHGAPCY2007.pdf

the claims cost per insured.

There are currently a few states that require guaranteed issue in the voluntary individual market. A study completed by Milliman, Inc (an independent actuarial consulting firm) in 2007,[5] showed that rates in the individual market increased materially and that carriers exited the market after the implementation of these reforms in a voluntary market. In such states, we would expect the premiums for the previous individual market to be lower in a newly merged market, which actually occurred in Massachusetts.[6]

Absent an enforceable and effective mandate, Milliman's findings can be expected to be generally replicated since guaranteed issue requirements in the individual market, without any financial penalties, encourages individuals to delay the purchase of insurance until they know they have a need for services, resulting in unaffordable premiums for everyone. If such a guaranteed issue individual market is merged with the existing small group market, we would expect to see rates in the combined market to eventually increase overall. The magnitude of the increase would be dependent upon several factors, including the rating factors allowed in the expanded small group market. In fact, rates may increase very rapidly if employers and individuals realize that they can defer the purchase of insurance until there is a need for care.

Conclusion

The impact of merging small group and individual markets will vary depending upon the rating and underwriting rules in the respective markets for the various states, as well as the effectiveness of any mandates on coverage and the tax treatment of coverage. Rating rules vary materially across the country which will result in different impacts by state when merging markets.

[5] Wachenheim, Leigh and Hans Leida. *The Impact of Guaranteed Issue and Community Rating Reforms on Individual Insurance Markets,* Milliman, August 2007.
[6] Gorman Actuarial, et al. *Impact of Merging the Massachusetts Non-Group and Small Group Health Insurance Markets,* December 2006. http://www.mass.gov/Eoca/docs/doi/Legal_Hearings/NonGrp_SmallGrp/FinalReport_12_26.pdf