# Risk Pooling

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**Risk pooling and the implementation of new risk pooling mechanisms are a major focus of the health reform proposals currently being considered. To understand the impact of these various types of proposals, it is important to understand the fundamentals of risk pooling.**

Policymakers are exploring alternative risk pooling mechanisms as part of their efforts to expand the availability and affordability of health insurance coverage. From proposals that would create health insurance exchanges to those that would include an individual mandate, these alternatives have the potential to significantly affect the composition of health insurance risk pools and subsequently affect premiums.

**For a risk pool to remain viable, it must be of sufficient size and comprised of a broad cross section of risks.**

Health insurance risk pools are large groups of individual entities (either individuals or employers) whose medical costs are combined in order to calculate premiums. The pooling of risk is fundamental to insurance. Large pools of similar risks exhibit stable and measurable characteristics that enable actuaries to estimate future costs with an acceptable degree of accuracy. This, in turn, enables actuaries to determine premium levels that will be stable over time, relative to overall trends.

Pooling risks together allows the costs of those at higher risk of high medical costs to be subsidized by those at lower risk. Creating a large risk pool, however, does not necessarily translate into lower premiums. Just as a pool with more low-risk individuals can result in lower premiums, a large pool with a disproportionate share of high-risk individuals will have higher premiums. When healthier individuals perceive no economic benefit to purchasing coverage, the insurance pool becomes increasingly skewed to those with higher expected claims. This is commonly known as adverse selection.

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Pools created as a by-product of membership in a group that is formed for other reasons, rather than a group that is formed for the specific purpose of obtaining health insurance, tend to be less subject to adverse selection. For instance, a large employer often creates its own pool to provide coverage to its workers, who automatically join the pool as an incidental benefit of employment. This limits an individual's ability to select against a plan. In contrast, people purchasing health insurance coverage in the individual market do so for the express purpose of obtaining coverage, not as an incidental by-product of being part of a group. Therefore, risk pools made up of those in the individual market are much more subject to adverse selection. In between these two extremes are small and medium-sized employers. They are not large enough to form their own pools, so insurers will combine many of these groups together

## ADDITIONAL RESOURCES

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

Wading Through Medical Insurance Pools: A Primer
http://actuary.org/pdf/health/pools_sep06.pdf

Frequently Asked Questions on Association Health Plans
http://actuary.org/pdf/health/ahp_mar05.pdf

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to form a larger pool. Although there is less potential for adverse selection than in the individual market, employers can still select against insurers by moving into and out of the insurance market and from carrier to carrier.

### Issue and rating rules can affect the extent of adverse selection.

Issue and rating rules, which vary by state, can have an impact on adverse selection, and therefore also on premium levels and the viability of a health insurance risk pool. For instance, guaranteed issue and community rating rules can increase the access to insurance among high-risk individuals and at the same premium charged to everyone else. However, these regulations tend to increase adverse selection, by providing people an incentive to delay purchasing coverage until they have health care needs. As a result, average premiums can be higher under these types of market rules. In contrast, allowing insurers to deny coverage and to charge higher premiums to those with higher than average expected health spending could reduce adverse selection by reducing premiums for lower risks. However, high-risk individuals could be denied coverage or face unaffordable premiums.

Risk pooling is essential for a viable insurance program, but it does not by itself guarantee a viable insurance program. It is important to understand the advantages of pooling, but also the dangers that can occur if pools are disrupted by market reforms. If all pools have to abide by the same rules, such as those that do not encourage adverse selection, then adverse selection could be minimized. Allowing different rules within the same market, however, will threaten a pool that has the more stringent requirements, and will result in market disruption. In other words, rules governing health insurance attempt to balance the tradeoffs between access to coverage and premium affordability. Proposals to implement alternative risk pooling arrangements need to maximize the enrollment of healthy risks, while not pricing the unhealthy risks out of that market.

### An individual mandate can reduce adverse selection by increasing participation.

Increasing overall participation in health insurance plans could be an effective way to minimize adverse selection. Requiring individuals to have insurance coverage is one way to increase participation rates, especially among low-risk individuals, and to create a pool with a broad cross section of risks, thereby reducing adverse selection risk. Other types of incentives to increase participation include: limiting open enrollment periods with penalties for delayed enrollment, subsidizing premiums, and instituting automatic enrollment. Medicare Parts B and D include some of these incentives. Nevertheless, an effective and enforceable individual mandate would likely achieve even higher participation rates than these types of voluntary incentives.



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