# Wading Through Risk Pools:
## Practical Implications for Health Insurance

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**Tuesday, May 20, 2008**
**430 Dirksen**

# Session Agenda - Background

- Risk pooling basics
- Issue and rating rules
- Benefit package considerations for policymakers

# Session Agenda – Practical Implications

- Risk pooling mechanics
- Rating variables
- Risk pooling/rating variable example
- Issues unique to the individual market
- Issues unique to the small group market

# Risk Pooling Basics

- Risk pools are large groups of individuals (or groups) whose medical costs are combined to calculate premiums.
- Pooling risks together allows the costs of the less healthy to be subsidized by the healthy.
- In general, the larger the risk pool, the more predictable and stable the premiums can be.

# Risk Pooling Basics (cont.)

- BUT, creating larger risk pools will not necessarily lower premiums.
- Must consider the size of the risk pool AND how it is comprised.
- If a pool attracts those with higher expected claims (i.e., adverse selection), premiums will be higher.
- Pools created as a by-product of membership in a group (i.e., group was created for purposes other than buying insurance) tend to be less subject to adverse selection.

# Risk Pooling Basics (cont.)

- Large employer groups
  - Workers automatically obtain coverage as a side benefit to employment.
- Small/medium size employers
  - Workers automatically obtain coverage as side benefit to employment, but employers can move into and out of the insurance market.
- Individual market
  - Individuals enter insurance market for the express purpose of obtaining health insurance.

# Risk Pooling Basics (cont.)

- Consider two pools, with the same number of members
  - Pool A: Fewer groups, more members per group
  - Pool B: More groups, fewer members per group
- Pool A will likely be more stable

* For this and other information on risk pooling basics, see the American Academy of Actuaries' issue brief, "Wading through Medical Insurance Pools: A Primer" (Sept 2006).

# Issue and Rating Regulations

- Regulations attempt to balance the goals of access to health insurance and premium affordability.
- Issue rule examples
  - Guaranteed issue
  - Allow underwriting
- Rating rule examples
  - Pure community rating
  - Modified community rating
  - Experience rating

# Issue and Rating Regulations (cont.)

- Creating alternative pooling arrangements (e.g., regional health markets, cross-state purchasing) by state or federal initiatives to operate alongside existing arrangements, could result in adverse selection if issue and rating rules are not the same in both markets.

# Benefit Package Considerations for Policymakers

- Adverse selection implications of different benefit packages need to be considered.
- When offered a choice of plans, those at risk of higher health spending will tend toward more generous benefit packages.

# Practical Implications

# Session Agenda – Practical Implications

- Risk pooling mechanics
- Rating variables
- Risk pooling/rating variable example
- Issues unique to the individual market
- Issues unique to the small group market

# Risk Pooling Mechanics

- Generally, insurance carriers pool the revenue and claims experience based on “market segment” (individual, small group, large group) to determine rate increases
- There are no hard and fast rules regarding risk pooling in the determination of premiums, outside of state regulatory constraints
- Carriers prefer larger pools to smaller pools, which increases the predictability of projected claims; increasing predictability should not be interpreted as “lower cost”

# Risk Pooling Mechanics

- Within a market segment (e.g., individual), carriers sometimes segment the experience based on:
  - State of the insured
  - Network differences (HMO versus PPO), since provider contracting differences drive unit cost
  - Benefit design (actively marketed versus not actively marketed)
- Again, there is a delicate balance in determining the appropriate level of risk pooling, to avoid disaggregating experience in such a way that sacrifices predictability

# Rating Variables

- Outside of the large employer market, there are a considerable number of ways in which premiums vary where allowed by law
- These exist to minimize adverse selection in a voluntary market
- A carrier must consider the variables in each state to also avoid adverse selection as much as possible

# Rating Variables

- Differences in benefit design, network and family status (to a degree) are generally acceptable rating variables everywhere
- Outside of these, all bets are off
- When allowed (or not specifically disallowed) by regulation, the following rating variables can be found in the individual and small group market:
  - Age (either individual ages or age bands)
  - Area/location (cities, counties, MSAs)
  - Gender
  - Risk classification/underwriting tier

# Rating Variables

- The aforementioned rating variables are usually not separate risk pools
- Factors are applied to arrive at premiums that vary by the rating variables, and experience is monitored over time, separately from the determination of overall rate levels
- The following example will illustrate how this works

# Risk Pooling/Rating Variable Example

- A carrier has a book of individual business in one state with no restrictions on rating variables
- There are two products, one HMO and one PPO, of equal size
- Within each product, rates were initially established to vary by gender, area, underwriting tier and age
- The carrier needs to update the rates for the coming year based on emerging experience

# Risk Pooling/Rating Variable Example

- The carrier analyzes two pools within individual: the HMO product and the PPO product
- From that analysis the overall rate increase is determined for each; if the carrier does no other analysis, all rates go up by the same percentage
- Must also consider if the rates make sense from a marketing perspective
- In this example, the HMO rates will go up 8% and the PPO rates will go up 10%
- The carrier then decides to examine the experience within each product by area/location

# Risk Pooling/Rating Variable Example

- Each product has two rating areas within a state, of equal size
- From the earlier analysis the carrier has determined the overall required rate increases; this additional analysis will determine how those overall rate increases are split between rating area
- For the HMO product, one rating area needs to go up 10% while the other needs to go up 6%, which still achieves the overall increase of 8%
- Since the PPO product is marketed side-by-side with the HMO product, consideration should be given to not only the experience within the PPO but the rate changes for the HMO
- It is decided to increase one rating area by 11% and the other by 9%, achieving the overall 10%

# Issues Unique to the Individual Market

- The insured pays 100% of the premium
- In most cases, premiums increase as the policyholder ages
- Medical underwriting plays a huge role in determining rates for a a policyholder
- Actual rates can vary by many parameters (age, gender, area, underwriting, tier, etc.)
- Probably the most price sensitive of all market segments

# Issues Unique to the Small Group Market

- The insured usually pays a larger portion of the premium than in large groups
- In some cases, premiums increase as the policyholder ages, but this could be obscured by the employer contribution
- Medical underwriting plays a large role in determining rates for a group
- The premium spread between low and high risk groups is almost always limited by state law
- Small groups are much more price sensitive than large groups

# Questions/Comments

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