How are Insurance Rates Regulated?

A Guide to Underwriting Laws in Utah & Policy Recommendations

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Background

The yearly increases in health insurance premiums are a growing concern for both employers and individuals. Yet there is little understanding around how or why insurance companies decide to increase premiums. In fact, most of these decisions are *not* arbitrary. Federal and state laws establish parameters around the premium rates that insurers can charge. Generally, federal laws are applied to large employers, while state laws govern the individual and small group market. As Utah embarks on health system reform, making changes to current rating practices will be essential.

Rate Regulations in Utah's Individual and Small Group Market

Utah law allows insurance companies to *underwrite* enrollees. This means an insurer is allowed to evaluate certain *case characteristics* (gender, age, etc.) and *health status* (prior health history) before making a decision regarding the cost of premiums, benefits covered or exempted, and, in the case of individuals, whether the person is insurable at all. The following *case characteristics* are allowable in Utah:

- Age – the older you are, the more expensive you become.
- Gender – females of child bearing years are typically more expensive than men of the same age.
- Industry – what a person does for work: high-risk jobs (like construction) generally have higher premiums.
- Geography – where a person lives can either lower or raise premiums.
- Family composition – a larger family is naturally more expensive.
- Group size – the smaller the group, the higher the premiums.

States have four options for limiting the variation in premium rates based on health status: *fully underwritten*, *rate bands*, *pure community rating* and *adjusted* or *modified community rating*. **Utah uses *rate bands*.** This means limits are set on how much more a person can be charged due to variations in health status. Each insurer calculates rates for the plans it offers by considering the benefit package, administrative costs, projected profits, and

State Options to Limit Variation in Rate Setting[i]

Fully underwritten means there are no limits on the amount an insurer can vary premiums. The insurers are allowed to rate up the policy without limits based on the insured's case characteristics and health status.

Rate bands set limits on the amount an insurer can vary premiums at different levels ('bands') of risk in reference to the *index rate*, or average premium rate. The boundaries of the rate band, the 'floor' and 'ceiling', represent the lower and upper limits on the amount an insurer can vary premiums for enrollees within the band.

Pure community rating requires insurers to rate everyone the same within a community, i.e. all community members pay the same premiums. It does not allow underwriting on health status or most case characteristics, but premiums may vary according to geographical location and/or family size.

Adjusted or modified community rating does not allow underwriting on health status, but some case characteristics can be used (within limits) to underwrite enrollees. For example, states may choose to underwrite by age: as you grow older your premiums increase.

commissions paid to brokers. Beyond that, insurers can vary the rates by specific percentages within a given band. State law places limits on the percent by which certain case characteristics can be raised. The National Association of Insurance Commissioners (NAIC) also sets *safe harbors* or standards set as additional guidelines for the case characteristics. *Safe harbors* protect insurers if they are setting rates within an appropriate spectrum and protect consumers by setting limits on what constitutes appropriate levels of increases.

How are premiums initially set?

To apply for insurance everyone must fill out an application that includes personal information: age, gender, occupation, family size and health history. This information is used to determine the price charged for insurance, i.e. your premium. Age, gender, industry, geography, family composition and group size (if group insurance is being purchased) help build the *street rate*. The *street rate* is the lowest rate you can be charged; it is the floor or lowest level of the *rate band* into which a group or individual can be placed. After the street rate is determined, health status is added to the equation. The insurer can charge the group or individual up to 186% higher than the lowest rate, the upper end of the *rate band*. In the individual market, if a person's health risk is too high the application will be declined and the person will be sent to Utah's high risk pool, Utah Comprehensive Health Insurance Pool (HIPUtah). Following is an example of how a rate is calculated for two different 45-year old Moab residents in the construction business: one who is very sick and the other healthy.[ii]

	Very Sick		Good Health	
		2007 Calculation		2007 Calculation
Base rate for HMO plan	$158.80		$158.80	
• **age 45**	x 1.75	$277.90	x 1.75	$277.90
• **family coverage**	x 2.91	$808.69	x 2.91	$808.69
• **small employer with 3 employees**	x 1.20	$970.43	x 1.20	$970.43
• **construction business**	x 1.15	$1,115.99	x 1.15	$1,115.99
• **resides and works in Moab**	x 1.09	$1,216.43	x 1.09	$1,216.43
• **underwriting results (limited to 1.86)**	x 1.86	$2,262.56	x 1.00	$1,216.43
Final Rate		**$2,262.56**		**$1,216.43**

Recreated from a Utah Insurance Department power point presentation, *Utah Health Insurance 101*, May 12, 2008.

Health underwriting in Utah can increase premiums for a sick person by 46%!

Why do premiums increase each year?

Premiums are reassessed by insurers on an annual basis. At renewal time insurers can raise a group's or individual's premium by a maximum of 15% on the basis of changes in health status. If a person was initially charged the highest allowable premium in their rate band, then according to state law, the rate cannot be increased on the basis of health status. In the example above, the very sick person cannot be rated higher according to their health status since they are at the top of their band, but the person in good health can have their rate increased by 15% until they hit the ceiling of their band.

At the same time, the overall rate can increase due to changes in case characteristics and inflation. For example, if a person jumps to a new age bracket, adds another family member, hires a new person, or changes their job, such changes can contribute to increased premiums. Two case characteristics have limits on the yearly increases allowed: industry (allows a 15% maximum increase) and group size (allows a 20% increase). Increases in inflation average around 10% annually. Each insurer determines the increase by assessing inflation and other trends in the market. Again using the example of the Moab construction worker, the table below shows a typical annual increase for the sick person and for the once healthy person who became sick in 2007. All of these factors can add up quickly!

	Very Sick				Good Health – Now Sick			
	2007 Calculation		2008 Calculation		2007 Calculation		2008 Calculation	
Base rate for HMO plan	$158.80		$158.80 x 1.10	$174.68	$158.80		$158.80 x1.10	$174.68
• **age 45**	x 1.75	$277.90	x1.75	$305.69	x 1.75	$277.90	x1.75	$305.69
• **family coverage**	x 2.91	$808.69	x2.91	$889.56	x 2.91	$808.69	x2.91	$889.56
• **small employer with 3 employees**	x 1.20	$970.43	x .20	$1,067.47	x 1.20	$970.43	x1.20	$1,067.47
• **construction business**	x 1.15	$1,115.99	x1.15	$1,227.59	x 1.15	$1,115.99	x1.15	$1,227.59
• **resides and works in Moab**	x 1.09	$1,216.43	x1.09	$1,338.07	x 1.09	$1,216.43	x1.09	$1,338.07
• **underwriting results (limited to 1.86)**	x 1.86	$2,262.56	x1.86	$2,488.82	x 1.00	$1,216.43	x1.15	$1,538.78
Final Rate		**$2,262.56**		**$2,488.82**		**$1,216.43**		**$1,538.78**
% Increase from last year				**10%**				**26.5%**

The table was developed with the assistance of the Health Insurance Director at the Utah Insurance Department.

The same rules apply to the small group and individual market; yet since risk is not shared in the individual market, a change in health status can cause even higher rate increases in the individual market. As noted above, having an illness one year can increase a person's premiums 16.5% more than if they had been healthy.

WHAT DO RATING LAWS MEAN FOR THE CONSUMER?

Utah's insurance laws have strayed too far from the original purpose of insurance: to share risk and make it possible for policy holders to retain access to affordable health care *despite* changes in health status.[iii] As time goes on premium increases due to changes in health status or accidents are forcing more and more people to drop their coverage. As shown above, in Utah's current system of rate bands, a small business or individual can be priced out of health insurance after an accident or illness. The impact is magnified in economic hard times. Additionally, a pre-existing condition like cancer, asthma, or diabetes can make enrollees uninsurable in the individual market, or can cause a small group premium to become cost prohibitive for the entire group. Here in Utah, as elsewhere, choices are dwindling or even disappearing for the typical consumer.

POLICY ALTERNATIVES FOR MANAGING RISK

Access to affordable health insurance and health care is becoming increasingly out of reach. Utah policymakers and business leaders want to see private market-based solutions, but if changes are not made to the way Utah manages risk, the private market will only be accessible to the healthy or wealthy. Moving to a community rated system should be one of our first priorities. The Task Force's **draft** *Insurance Market* bill includes modified community rating in the new *portal* market. Community rating must be expanded to all markets to ensure the new *portal* markets success.

Community or modified community rating spreads risk over a larger pool and prohibits the practice of medical underwriting. In doing so it brings us closer to the original purpose of insurance: to share risk. As seen above, an illness or accident can increase an individual's premium by 16%, not including inflation or changes in case characteristics.

As the system currently operates, insurers only have incentives to avoid risk. Community rating realigns incentives for all insurers at once, so that all are in the business of keeping people healthy. This will only work in one fell swoop, inside and outside any new marketplace that may be created through reforms. Even better, community rating supports the private market allowing it to serve as the platform for a reformed, fully re-aligned and transparent health care system.

Policy Recommendations

Community Rating – Should be expanded to all markets because it:

- Ensures people can access coverage and care;
- Facilitates comparative shopping on a free market;
- Takes unnecessary costs out of the system;
- Realigns incentives so all insurers focus on keeping people healthy

Risk Adjustment Mechanism – Such as reinsurance should also be expanded to all markets since it:

- Protects insurers
- Keeps premiums down

Individual Mandate – Utah should set a benchmark for reducing the number of uninsured. If it is not met by a specified date, explore the mandate to ensure:

- Everyone in the system
- Promote efficiencies in quality and cost

As Utah tries to move to a consumer-driven market, community rating will allow people to shop more effectively for insurance. Currently, an accurate cost quote is not accessible until after a person has been fully underwritten. A true free market would make it possible for consumers to shop for value at the right price on a *portal* and instantaneously attain a live quote. Furthermore, the process of underwriting adds *cost* to everyone's premiums. All of the questions on an insurance application regarding health history must be processed, with follow up on any questionable illnesses or accidents.

However, community or modified community rating should not be implemented in isolation from other changes needed in the market. If imposed in a given marketplace community rating will naturally attract the sickest and oldest to that market, thus driving up premiums in that market. In actuarial terms this is called *adverse selection*, and according to a Milliman study, it has been the kiss of death for many reforms.[iv] To prevent adverse selection community rating must be imposed inside and outside any new marketplace and be coupled with a risk adjustment mechanism, such as reinsurance. Reinsurance is basically insurance for insurance companies. Insurers purchase reinsurance to cover their high cost claimants, which spreads the risk and keeps costs down. This type of risk adjuster has been proven to protect insurer's solvency and keep premium rates down.[v] The *Insurance Market* bill includes both modified community rating and reinsurance. To avoid the pitfalls of previous reforms, both mechanisms must be applied to all markets simultaneously.

Another study on community rating confirms that while it does not increase the number of uninsured, it also does not increase the number of insured.[vi] To increase the number of insured while keeping premium rates down, provisions must be in place to draw the young and healthy into the market. This generally happens through a combination of premium subsidies and a requirement to participate, an *individual mandate*. Yet Utah should not impose an individual mandate until and unless the following provisions are in place: 1) assessing what is truly affordable for families and providing the necessary subsidies; and 2) determining a basic benefit package, the minimum acceptable benefit package that, according to evidence-based medicine, will preempt cost shifting.[vii] As a first step, Utah should set a benchmark for reducing the number of uninsured. If the goal is not met then an individual mandate should be considered.

Community rating, in conjunction with a risk adjuster and an individual mandate, is a necessary policy step to creating a more efficient health care system. A community rated system will ensure greater efficiencies, reduced costs, increased quality and expanded access while continuing to support the private market. The **draft** *Insurance Market* bill includes both modified community rating and reinsurance for the new *portal* market. These should not only be supported, but should be expanded to all markets to have the greatest impact. Also, a benchmark for reducing the number of uninsured should be included so an individual mandate can be implemented if necessary to further the goals of reform.

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[i] Fisch-Parcham, Cheryl. *Understanding How Health Insurance Premiums are Regulated*, Families USA, September 2006.
[ii] Utah Insurance Department power point, *Utah Health Insurance 101*, May 12, 2008.
[iii] Kofman, Mila J.D. and Pollitz, Karen M.P.P. *Health insurance Regulation by States and the Federal Government: A Review of Current Approaches and Proposals for Change*. Health Policy Institute, Georgetown University. April 2006.
[iv] Wachenheim, Leigh and Leida, Hans. *The impact of Guaranteed Issue and Community Rating Reforms on Individual Insurance Markets*. Milliman, July 10, 2007.
[v] Wikler, Beth and Fish-Parcham, Cheryl, *Reinsurance: A Primer*. Families USA, April 2008.
[vi] Buchmueller, Thomas and DiNardo, John. *Did Community Rating Induce an Adverse Selection Death Spiral? Evidence From New York, Pennsylvania, and Connecticut.* National Bureau of Economic Research, January 1999.
[vii] *A Consumer Guide to State Health Reform: Individual Mandates*. A joint project of Families USA and Community Catalyst.

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