Policy Brief #4: Ensuring Exchange Stability and Protecting Against Adverse Selection

About this Series:

The creation of a new health insurance exchange offers states an opportunity to improve health care and lower costs by pooling consumers' bargaining power, creating economies of scale, and pushing insurers to delivering lower costs and higher quality. PIRGIM's *Building a Better Health Care Marketplace* project provides recommendations to advocates and policymakers for how to create a strong, pro-consumer exchange. Support for the project is generously provided by the Robert Wood Johnson Foundation. For further information on this project, and other policy briefs in this series, please visit http://www.pirgim.org.

The idea of creating health insurance purchasing pools, like those called for in the Affordable Care Act, is not a new one. In the past, many states have experimented with creating such pools, and their experience has shown that mechanisms like the exchange can succeed at improving choice and holding down costs. But experience has also shown that success is not automatic. In some states, the pools have been failures, forced to close their doors by upwardly-spiraling premiums and downwardly-spiraling enrollment. In designing their exchange, states must take care to avoid past mistakes and create a stable marketplace for individuals and small businesses.

Past failures in pooling can often be traced to a single dynamic. Sicker enrollees congregated within the purchasing pools, with healthier enrollees remaining outside. Because sicker enrollees cost more to insure, this drives up premiums, leading more healthy people to drop coverage and secure less expensive coverage on their own, which in turn sends premiums within the pool up again. This phenomenon, called adverse selection, can lead to a vicious cycle that only ends with the destruction of the purchasing pool.

If a state decides to allow insurers to sell their products to individuals and small groups without going through the exchange (as most appear to be planning), the fundamental challenge is to ensure that the exchange does not become a dumping-ground for less-healthy patients, with healthier enrollees purchasing coverage outside of it.

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Fortunately, the ACA guards against the worst risks of adverse selection by preventing insurers both on and off the exchange from directly discriminating against the sick, and it also contains specific provisions aimed at balancing risk on and off the exchange. But to complement these ACA policies, states should adopt additional measures to ensure that adverse selection does not undermine the viability of their insurance market.

Baseline Protections in the ACA

The Affordable Care Act contains important provisions to avoid adverse selection on state exchanges. Per the federal law, enrollees who purchase a product that is sold both inside and outside the exchange must be in the same risk pool, and insurers must charge the same premium in both cases. The same minimum benefit standards will apply across the entire insurance market as well, limiting insurers' ability to scoop up the healthy by offering low-cost, low-benefit plans. Tax credits will be available to some consumers who purchase coverage on the exchange, making it an attractive option for both sick and healthy. Most importantly, whether an insurer is doing business on the exchange or off, they may not deny coverage renewal, to people based on pre-existing conditions, and the ACA's rating rules (how it allows premiums to vary based on age, geography and tobacco use) must apply identically inside and outside the exchange.

Further, all insurers will participate in a series of programs aimed at reducing the impact of differences in enrollee health. These programs (variously labeled reinsurance, risk adjustment, and risk corridors) mean that insurers who cover more sick people face less of a financial disadvantage than they otherwise would. The programs will apply both on and off the exchange, but by increasing the overall stability of insurers' risk pools, they will help reduce the incentive for insurers to segregate healthy enrollees off the exchange.

However, these protections, as important as they are, will not by themselves fully prevent the risk of adverse selection. For example, while healthy and sick enrollees must be charged identical premiums, the same is not true for young and old enrollees – the ACA imposes some limits, but insurers can still set lower premiums for the young, who tend to be more profitable. As a result, insurers will still have the ability to structure and market their plans to attract younger, less expensive enrollees to their non-exchange offerings.

Further, risk adjustment programs will likely be most effective in equalizing risk across insurers within the exchange –

reducing the impact of health differentials across the state's entire health care market will be more challenging. As a result, many insurers may push to keep their non-exchange risk pool as healthy as possible.

States should compensate by incorporating the ACA's protections into their own law. For example, states can create their own supplemental reinsurance programs if the federal one proves insufficient. Further, to the greatest possible extent, states should make sure that identical rating rules should apply to their entire insurance market, both on and off the exchange – not only will this help protect against adverse selection, it will also minimize disruption for consumers who move in and out of the exchange. The remainder of this policy brief outlines additional steps states should take to guard against adverse selection.

Eliminating Steering

One way that less-healthy people can wind up in the exchange is if insurers or brokers put them there. While the Affordable Care Act limits the ability of insurers to make greater profits from the healthy than the sick, as discussed above many insurers might still wish to keep their non-exchange risk-pool as healthy as possible.

To guard against this possibility, states should protect the exchange by prohibiting insurers or brokers from steering people either onto or off of the exchange, through setting different broker commissions, adopting targeted marketing strategies, or by any other method. This prohibition should be policed via the state insurance regulator, as well as the licensing authority for brokers.

Products Available On and Off the Exchange

If certain kinds of products are primarily available on the exchange, or primarily available outside the exchange, consumers who want those kinds of products will be drawn to that marketplace. If products that appeal most to healthy consumers are primarily available outside the exchange, or if products that sicker consumers will want to buy are primarily available on the exchange, this could create a risk of adverse selection.

A state can reduce the risk of adverse selection by requiring insurers to offer "mirror" versions of all their products, such that they sell identical exchange and non-exchange versions. That way, consumers will have access to a broad array of benefit choices in both marketplaces, preventing the restriction of options that can lead to adverse selection. Additionally, since, as discussed above, the federal law requires that identical products use the same risk pool and charge the same premium both inside and outside the exchange, this would greatly reduce the risk of undermining the exchange.

If that approach is not possible, states could ensure that at least some products are available both inside and outside the exchange. The federal law already requires that exchange-participating insurers offer both at least one silver and one gold product inside of the exchange, so one place to start would be requiring insurers to offer those products outside the exchange as well.

States could go further and require insurers to offer more than one product at those silver and gold levels, or they may insist that plans also offer a product at the highest-benefit platinum tier. Further, states could require insurers who offer catastrophic coverage plans outside the exchange to offer identical plans on the exchange as well – since enrollees of these plans are most likely to be young and healthy, they pose the greatest adverse selection risks.

In developing the precise requirements, the state should closely examine the products currently being offered on its health insurance market, with a goal of ensuring that consumers both on and off the exchange have a robust set of choices between products with varying degrees of comprehensiveness.

Increasing Exchange Eligibility and Enrollment

The risk of adverse selection is closely tied to the overall number of the exchange's enrollees – if the exchange is large, it will take a much greater imbalance in enrollees' health status to create an adverse selection problem. Put simply, a larger exchange has a greater "buffer" to protect against adverse selection. This means that outreach and enrollment efforts will themselves help the exchange's stability. Further, increased outreach may be needed to reach healthier consumers, since in many cases those with health problems are most alert and receptive to new information about coverage options.

There are, of course, many other benefits to having a large exchange – it increases the negotiating power of the exchange, as discussed in the second policy brief in this series, and also helps more of a state's residents enjoy the benefits of the exchange. The fact that this approach also helps to better guard the exchange against adverse selection means that the state has a further reason to widen the eligibility rules for the exchange (for example, by including larger businesses, so long as the state is careful to open eligibility in a way that does not itself pose an adverse selection risk), and put a strong effort into outreach and enrollment programs.

Feedback and Monitoring

In addition to adopting the above policies, the state should closely monitor changes in the insurance market once the exchange is up and running, for imbalances in risk, premium spikes, or changes in the types of products available on and off the exchange. This task could be taken on by the exchange itself, the state insurance department, or some other entity. Regardless, whoever studies the market's stability should regularly make recommendations to the state on any action that is needed to maintain the viability of the exchange, and the appropriate body – whether the legislature, an agency, or the exchange itself – should take swift action to protect consumers by mitigating the problem.