

Consider having Two Insured Groups

Anthem's recent announcement of rate hikes of up to 39% highlights a serious problem with the health insurance industry. Despite public consternation, Anthem can justify the increase using legitimate risk analysis. The problem is not entirely Anthem. The problem is a marketplace in this country that defies logic, and has done so for decades. All private health insurers including Anthem are benefiting from this absurdly inefficient market.

The U.S. is not one single homogeneous insurance market. Rather, it is multi-tiered divided between *government* and *private*. Government pays almost 50% of all medical costs for the 30% of population on Medicare and Medicaid. The private market is further divided into *self-insured* and *risk* segments, roughly split 50:50 by population.

The self-insured consist of large enterprises that have so many members that it costs more to buy insurance than to pay medical expenses themselves and have insurers only administer claims. Insurers make a profit on administrative expenses, but nothing on medical costs. Medicare operates the same way as self-insured, contracting membership and claims to insurers. Insurers make nothing on any self-insured claims because the insurers carry no medical risk.

Service fees on self-insured groups of the top 10 insurers average 6% of insured premiums. Medicare overhead runs even less. Adding government and self-insured costs, some 75% of all insured U.S. health care is administered with expense ratios of about 5%. By extension, just **25% of all insured costs occur in the risk segment where insurers produce billions in profits.** How can one segment be so efficient while the other has such high costs and profits? The only difference is the number of members and how they are grouped. Self-insured are in huge pools of people. Risk insured are in thousands of smaller pools.

The cost difference involves statistics as simple as flipping a coin and spinning TV's "Wheel of Fortune." Flipping a coin 10 times rarely yields 5 heads. But flip a coin 10,000 times. It is almost certain that heads would come up very close to 50%. Mathematics calls this *likelihood* risk; the larger the number or population, the lower the likelihood of an unexpected outcome occurring. The second risk is the *consequence* if that outcome occurs. If spinning the wheel of fortune on the TV show stops on "bankrupt", you lose it all. In the real world, an unfortunate few percent are hit with medical costs so high that they ARE bankrupted or nearly so. However, those few percent amount to nearly a million people each year.

In the risk market the population is divided into thousands of small pools, each with a greater likelihood of extremely costly consequences. Insurers call it "*adverse selection*". **Collectively, those adverse risk factors pile billions of extra dollars onto expected costs of healthcare.** Reduce the number of pools and increase their size and you drive down adverse selection risks toward levels approaching the self-insured market. Now pools in the risk market are categorized on how insurers compute expected claims – *experience rated* and *community rated*.

Larger entities that buy insurance are experience rated. Each entity becomes its own pool and their historical claims are used to predict future costs. Insurers then add an adverse selection risk cushion as protection in the event member(s) become ill and cause claims to spike. The smaller the group, the greater is both the likelihood and consequence of adverse selection. At some point, adverse selection risk becomes so costly nobody would buy the insurance.

Insurers then utilize community ratings where insurers charge the same premium for everyone in the community or local market area. *Modified* community ratings allow differences for characteristics like age and lifestyle. In community pools, adverse selection risk should be less unless the pool is too small. Then adverse selection risk can again become a major factor. That is what drove Anthem's premium increases. The healthy in their community pools dropped insurance while higher cost members stayed.

Community ratings are desirable but not as structured today. Increasing community size and decreasing their number would drive down costs of adverse selection. **The optimal solution would be to have only self-insured and community rated markets for everyone.** Eliminate experience rated, small group and individual plans and combine all into large community rated pools. Add high-risk reinsurance to the mix, and community pools would approach self-insured plans in terms of medical risk.

Of course, there are other expenses. Sales costs need to come down. Were there at least one basic benefits plan sold by all insurers, sales efforts would consist of service and price. Price sells itself, and selling only service is far easier than pushing the complex and confusing policies of today. However, this should result in sharply lower profits for insurers who now benefit handsomely from a complex and highly fractured risk market that they themselves created.