

RISK SELECTION AND RISK ADJUSTMENT:
IMPROVING INSURANCE IN THE INDIVIDUAL AND SMALL-GROUP MARKETS

Current proposals to expand health insurance coverage all include an important role for individual and small-group health insurance. Typically, these markets have been plagued by the problem of **adverse selection**: sicker individuals are more likely to want to buy insurance, driving up premiums and potentially pricing healthier individuals out of the market.

Economists Katherine Baicker of Harvard University and William Dow of the University of California at Berkeley discuss policies to mitigate the problem of adverse selection in the individual and small-group health insurance market. Historically, states have relied on premium regulation and state high-risk pools in response to adverse selection. Baicker and Dow discuss the lessons learned about the limitations of these approaches. They also discuss alternative approaches to mitigating adverse selection that are, increasingly, the focus of interest among policymakers: individual and employer mandates, government-sponsored purchasing pools, risk adjustment, and reinsurance.

Key points from their discussion include:

- Premium regulation by states – for example, mandatory community rating or “rate bands” – may aggravate the adverse selection problem by driving healthier individuals out of the market. In the extreme case, insurance plans may exit the market altogether.
- State high-risk pools have a number of limitations. They are typically financed by raising premiums on the privately insured, including those who are sickest; they face no incentive to ensure that care is delivered in a cost-effective manner; and they often offer very little choice to enrollees.
- Individual and employer mandates solve the adverse selection problem in the aggregate by forcing everyone into the risk pool. However, some of the insurance plans may still suffer from adverse selection, and insurers’ incentives to cream-skin persist. As a result, mandates need to be combined with other risk-adjustment mechanisms in order to be effective.
- Health insurance purchasing pools, like the “Connector” in Massachusetts, establish a managed competition framework within which individuals or small groups can buy insurance more easily than in an unregulated market. However, these arrangements by themselves do little or nothing to reduce the adverse selection problem and so – like mandates – require additional risk-adjustment mechanisms in order to function well.
- Reinsurance arrangements pick up the cost of very high-spending beneficiaries so that insurers have no financial incentive to avoid these individuals. Reinsurance at the aggregate level is widespread in the insurance industry, but has not been much used in the individual or small-group insurance markets. Although reinsurance is

theoretically a powerful tool to improve the functioning of these markets, Baicker and Dow note that the actual effect may be quite small, suggesting that reinsurance is not a substitute for more sophisticated individual risk-adjustment.

- Risk adjustment refers to an arrangement in which payments to insurance plans reflect the expected spending of the plans' actual enrollees. That is, if an insurance plan for some reason has more sick enrollees – based on their *ex ante* characteristics – that plan receives additional payments. Basing this risk adjustment on *ex ante* characteristics removes the incentive for cream-skimming while preserving the incentive to deliver cost-effective medical care. In practice, individual risk adjustment may be used in conjunction with other policies; for example, Medicare uses a combination of individual risk adjustment and limited reinsurance to reimburse Medicare Advantage plans.

Baicker and Dow conclude by noting that risk adjustment has, so far, seen very little practical application, perhaps because until recently risk adjustment was widely viewed as too immature for widespread use. Their review suggests that well-designed flexible risk adjustment schemes could form a key component of reform proposals intended to increase insurance coverage.