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## How can individual health plans use adverse selection to their advantage?

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Without underwriting, individual coverage applicants on average cost 40% more than applicants for small group coverage.<sup>1</sup> While the individual market provides insurers more opportunities to take rating actions and to improve their competitive positions, it also presents more risks than group insurance since individual health insurance applicants are collectively less healthy and have greater variance in their claim costs than applicants in other markets. For these reasons, the individual market is especially susceptible to adverse selection.

While this represents a clear risk for individual insurers, it also presents a competitive opportunity. Making market-sensitive adjustments to the underwriting process, structure of family contracts, and rescission rules can provide a significant competitive advantage.

### **Adverse selection**

In this context, we loosely define adverse selection as the risk an insurer faces because only those who benefit from insurance at the offered price will buy it. People with poorer health are more willing to purchase health insurance coverage because they know they will need it.

### **Ask and you shall receive**

In the health insurance underwriting process, applicants often know much more about themselves than we do. Despite the best efforts of insurers to collect the information needed to make accurate underwriting predictions, applicants will provide—and withhold—information based on what they believe is in their best interest.

How can this dynamic be put to use? Consider this example of two different insurers. Insurer A uses very refined underwriting guidelines and detailed questions to make underwriting decisions. Insurer B uses less sophisticated underwriting guidelines and asks fewer questions. A sicker applicant will be more attracted to Insurer B, because it might seem more likely their ailments will escape full evaluation. A healthier applicant will be more attracted to Insurer A, because they have nothing to hide, and will likely receive a lower rate after the detailed underwriting process confirms their healthy status. Therefore, the more rigorous Insurer A will attract healthy applicants, and the less rigorous Insurer B will attract sicker applicants. Over time, Insurer A can charge lower rates, while the opposite will be true

for Insurer B. As rates for the less rigorous Insurer B are forced to rise over time, only the sickest members remain on the block of business, which then requires greater rate increases.

This cycle, or "death spiral," of adverse selection is a significant concept in underwriting and an important reason to understand how rigorous the other insurers in your market are compared to your current methods. Clearly Insurer A has the more advantageous competitive position.

### **Family contracts**

The structure of the rates used—tier factors versus member-level rating—provides another opportunity. A tier-factor approach might charge one rate for an employee, another for an employee plus spouse, and still another for a family. A member-level rate instead accumulates the individual rates for each person on the contract. In a tier-factor approach, a family with ten children may pay the same rates as a family with two children. In a member-level rating structure, the rates will be higher for a family with ten children to account for the additional members, whereas the rates will be lower for a family with only two children. Therefore, families with ten children will be attracted to plans using a tier-factor approach. It is important to review the structure of other plans offered in the same market, to ensure there are not unintended consequences of your company's particular choice of structure.

### **Rescission**

A critical yet sometimes overlooked area of initial underwriting process is the balance between up-front underwriting versus back-end actions. While it might be tempting to push to speed up the initial underwriting process by requesting less information and performing less rigorous underwriting, doing so may result in a larger portion of applications leading to rescission. Rescissions are terrible for public relations, and can lead to costly litigation, so it is important to consider the full picture of costs associated with making a decision to move to less up-front review. Many insurers opt not to pursue rescissions, or do so only for very serious cases, because of the fear of litigation and bad public relations. However, if the market knows that a particular insurer never pursues failure-to-disclose misrepresentation actions, then it is likely that the insurer will attract greater misrepresentation. It is amazing how tuned in brokers are to specific insurer behaviors like likelihood and methods for rescission, and how brokers are able to educate and direct their clients.

Furthermore, rescissions are sometimes overturned by the courts, even in cases where it may at first seem clear that there has been falsification on the part of the insured. For example, if an applicant fails to disclose a condition, but there is sufficient information in other areas of reporting for the insurer to determine that the applicant has the condition (such as a reported prescription drug), the courts may rule that the insurer had adequate information. In other cases, regional courts may simply be more likely to rule against insurers for reasons beyond our control, such as prevailing political sentiments. In any case, it is clear that a system that minimizes the need to pursue rescissions is preferable for an insurer.

The solution? Avoid rescissions in the first place by taking the time to properly underwrite applicants at the outset. Doing this will not only prevent adverse selection, but it will help avoid the kind of publicity problems that can ensue from rescissions.

## **Conclusion**

These tools can work together to compound their returns. An insurer with better underwriting will attract a healthier pool of applicants and will have more adequate risk protection built into the premiums of its higher-risk members. Understanding how the structure of the contract affects member behavior can again lead to creating contracts that attract a healthier, lower-cost applicant pool. More attention to the details of underwriting may help an insurer spot the signs of an unreported condition, allowing the insurer to make the correct adjustments from the beginning and avoid the need to pursue a rescission later. And with stronger underwriting and better-planned contract designs, an insurer can be more likely to attract better risks. It is a synergistic relationship among the different aspects of the contract creation process. The end result is a competitive advantage over companies that ignore the potential benefits of strategizing to account for adverse selection.

1 Milliman's Health Cost Guidelines™