



# *Backgrounder*

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### Medical Insurance Pools

Some health care reform proposals have been exploring the use of alternative pooling mechanisms as a means to expand the availability and affordability of health insurance coverage. For instance, some proposals would create regional health markets and others would allow for the purchase of insurance across state lines. To better understand the impact of these various types of proposals, it is important to first understand some risk-pooling fundamentals.

Medical insurance pools are large groups of individual entities (either individuals or employers) whose medical costs are combined in order to calculate premiums. The pooling of risk is fundamental to insurance. Large pools of similar risks exhibit stable and measurable characteristics that enable actuaries to estimate future costs with an acceptable degree of accuracy. This, in turn, enables actuaries to determine premium levels that will be stable over time, relative to overall trends.

Pooling risks together allows the costs of those at higher risk of high medical costs to be subsidized by those at lower risk. For a pool to remain viable, it must be of sufficient size to reflect a balanced cross-section of risks. Creating a large risk pool, however, does not necessarily translate into lower premiums. Just as a pool with more low-risk individuals can result in lower premiums, a large pool with a disproportionate share of high-risk individuals will have higher premiums. When healthier individuals perceive no economic benefit to purchasing coverage, the insurance pool becomes increasingly skewed to those with higher expected claims. This is commonly known as adverse selection.

Pools created as a by-product of membership in a group that is formed for other reasons, rather than a group that is formed for the purpose of obtaining health insurance, tend to be less subject to adverse selection. For instance, a large employer often creates its own pool to provide coverage to its workers who automatically join the pool as an incidental benefit of employment. This limits an individual's ability to select against a plan. In contrast, people purchasing health insurance coverage in the individual market do so for the express purpose of obtaining coverage, not as an incidental by-product. Therefore, risk pools made up of those in the individual market are much more subject to adverse selection. In between these two extremes are small and medium-sized employers. They are not large enough to form their own pools, so insurers will combine many of these groups together to form a larger pool. Although there is less potential for adverse selection than in the individual market, employers can still select against insurers by moving into and out of the insurance market and from carrier to carrier.

Issue and rating rules, which vary by state, can also have an impact on adverse selection, and therefore also on premium levels and the viability of a medical insurance pool. For instance, guaranteed issue and community rating rules can increase the access to insurance among high-risk individuals and at the same premium charged to everyone else. However, these regulations could increase adverse selection, potentially raising premiums for all purchasers. In contrast, allowing underwriting and experience rating, which tie premiums more closely to an individual's risk, could reduce adverse selection by reducing premiums for lower risks. However, high-risk individuals could be denied coverage or face unaffordable premiums.

Pooling is essential for a viable insurance program, but it does not by itself, guarantee a viable insurance program. It is important to understand the advantages of pooling, but also the dangers that can occur if pools are disrupted by market reforms. If all pools have to abide by the same rules that do not encourage adverse selection, then ad-

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verse selection could be minimized. Allowing different rules within the same market, however, will doom a pool that has the more stringent requirements, and will result in market disruption. Medical insurance is a balance of encouraging enough healthy risks to enroll to subsidize the unhealthy risks that have the economic incentive to purchase insurance. Any proposals to implement alternative risk pooling arrangements need to strike the balance between maximizing the enrollment of these healthy risks and not pricing the unhealthy risks out of the market.

### **Additional Resources from the American Academy of Actuaries**

- [\*Wading Through Medical Insurance Pools: A Primer\*](#) (September 2006)  
This issue brief describes the types of medical insurance pools, highlights issues that are fundamental to pooling and illustrates how changes within a multiple small-employer pool would affect medical costs.
- [\*Frequently Asked Questions on Association Health Plans\*](#) (March 2005)  
This issue brief examines some common questions about AHPs and addresses some possible unintended consequences and related concerns that could arise if the creation of AHPs is not approached carefully.
- [\*Analysis of Small-Business Health Plan Legislation—S.1955\*](#) (May 2006)  
This letter provides comments on S.1955, the Health Insurance Marketplace Modernization and Affordability Act of 2006, which was designed to create small-business health plans. This letter discusses the potential effects of the legislation on the small group market as well as the individual market.