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THE BOTTOM LINE

ON

Risk Classification in Voluntary Individual Disability Income and Long-Term Care Insurance

Risk selection and risk classification, commonly known as "underwriting," play an important role in most private insurance systems, but are often inadequately understood outside the insurance industry. Underwriting helps maintain financial soundness in the voluntary individual disability income (DI) and long-term care (LTC) insurance markets and is considered by actuaries to be vitally important for both insurers and consumers to keep premiums low as well as protect the insurers' ability to deliver payment, when needed.

As advances in technology and research into the human genetic structure continue to reveal links between specific genes and serious medical conditions, insurers face a dilemma regarding the use of genetic testing results in the underwriting process. A voluntary, individual insurance market can only work when insurers and applicants have equal knowledge of all significant underwriting factors. Currently, the complexity and expense of genetic tests preclude the widespread use of genetic testing in underwriting. However, as genetic technologies advance there is a growing concern among consumers that they may be denied insurance if they become seriously ill or if tests reveal an increased likelihood of future illness. This information can pose a challenge if not reported to insurers, because the cost of providing insurance depends at least in part on the health of their policyholders. As more people gain information about their health status through genetic tests, insurers could find adverse selection an increasingly costly problem.

The American Academy of Actuaries' Task Force on Genetic Testing Issues developed this issue brief to help policymakers and the public better understand risk classification in voluntary individual DI and LTC insurance in relation to the impact that genetic testing is likely to have on the underwriting process. This issue brief is part of a series of papers published by the Academy addressing the impact of genetic testing issues on various insurance markets. For more information visit the Academy's website at www.actuary.org.

The following key points are examined in this paper:

- Insurers must charge adequate premiums to pay policyholder claims, in order to avoid insolvency.
- Risk classification groups together individuals with similar levels of risk and expected costs, and permits insurers to charge an adequate premium and remain financially healthy.
- Adverse selection occurs if individuals purchase insurance on the basis of health information that is unknown to the insurer. Adverse selection means that healthier people subsidize the less healthy, which tends to drive healthier people from the insurance system. Ultimately, if enough healthy individuals leave the system, it may lead to insurer insolvency.
- Advances in technology and research continue to reveal new information that helps insurers better classify risks. Banning the use of such information could lead to higher costs and reduced access to individual insurance than might otherwise be expected.

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