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What People Don't Know About Health Insurance Exchanges

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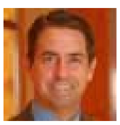 

by Peter Lee and **John Grgurina**

Editor's Note: *For more on health insurance exchanges and health reform, see* Building A Health Marketplace That Works *by Alain Enthoven.*

Much of the heat so far in the debate over how health care reform will expand coverage to uninsured Americans has been about whether or not there should be a public plan option. That has overshadowed one of the most important issues – how to design effective health insurance exchanges to meet the needs of small employers and individuals.

Both houses of Congress have now proposed frameworks for expanding coverage that rely on exchanges. A health insurance exchange is simply a structured marketplace where people can choose among health plan options. The exchange offers information to help people make informed choices, and it provides administrative services such as simplified processing of enrollment, subsidies, and premium payment. This can be of great value to small employers and individuals who don't have access to employer-sponsored group plans.

Plenty of academic experts have written about the ideal design of an exchange, but we bring a unique, real-world perspective. We know why exchanges have and haven't worked based on our experience running one of the largest voluntary health insurance exchanges in the country, PacAdvantage, which served over 10,000 small employers in California from 1993 to 2006, at its peak providing insurance for 150,000 enrollees.

Health insurance exchanges can provide huge value, but they are bound to fail if not structured correctly. PacAdvantage, even though it grew to a large size, failed because of what economists call “adverse risk selection” – the same reason similar programs have failed across the country in the past fifteen years. People with higher medical costs enrolled in PacAdvantage, while lower-risk people obtained coverage outside the exchange where they could find less expensive insurance. This drove up premiums inside the exchange, causing healthier people to drop out. This is known in the insurance business as a classic “death spiral.”

We must learn from these lessons in order to avoid the problems that have doomed exchanges in the past. We must design exchanges to be sustainable and prevent them from being relegated to the dustbin of well-intentioned but flawed health reform proposals not anchored in the real world.

What has caused the adverse selection “death spiral” in past health insurance exchanges? In the health insurance market for small employers, insurers usually insist on being the “sole source” for an employer group; insurers feel threatened if employees are free to choose among competing health plans. As a result, insurers often steer lower-risk people to their products outside of the exchange. The exchange is left with higher-cost enrollees, which drives up the premiums and creates a death spiral.

Designing Sustainable Exchanges: Adequate Size And A Level Playing Field

We can create exchanges that are not destined to fail. First, size does matter – but NOT because of negotiating clout. (Just as for large employers, the price small employers will pay for covering their employees in an exchange will be driven by the underlying health care costs.) Size matters because of economies of scale and the potential to dramatically reduce administration and marketing costs. In the current market, insurers sell to and administer benefits for each individual and small employer separately; as a result, insurers have very high marketing and administrative expenses. An exchange would consolidate the market and enable insurers to lower their administrative costs and premiums.

To achieve sufficient size – a “critical mass” – for the exchange, policymakers need to consider requiring individuals and very small groups (10 or fewer employees) to use the exchange. While this runs the risk of dampening innovation in insurance products and benefit designs, the trade-off is that it would offer huge potential savings to the participants and lessen the danger of the adverse selection death spiral. For larger small employers – up to, say, 100 employees – it may make sense to allow them to be in exchange or not (a “dual market”).

Second, where there is a dual market, we need to make sure there is a “level playing field” between the exchange and the market outside of the exchange. For example, the rules regarding pricing and benefit design must be the same inside and outside the exchange, and insurers that participate in the private market must be in the exchange. This is needed to minimize the danger of adverse risk selection.

The Importance Of Responsiveness And Accountability

Third, we need to look closely at how exchanges are run. There are big advantages to having exchanges be responsive to the local situation of the states they operate in, rather than a one-size-fits-all national exchange. While exchanges need to be locally responsive, they should all be accountable for assuring that the plans they offer meet national quality standards and that those who enroll have access to high-quality care through their networks. In addition, it is the exchange — not the public plan – that is the real “cooperative.” The exchange needs to be run by and responsive to its individual and small-business members. Exchanges need to be accountable to those they serve by offering them the best choices, useful tools, and creative plan options and by being adaptive to changing conditions.

Finally, while well-structured exchanges can be part of the solution to the health care mess, we need to remember that the core problem is the increase in the costs of health care generally. Exchanges need to be part of the effort to drive for better quality and more efficient use of resources from doctors, hospitals, and insurers.

Congressional Health Reform Proposals: How Can The Provisions On Insurance Exchanges Be Strengthened?

The health reform proposals being considered in Congress would create insurance exchanges or “gateways” that build on some of the lessons learned over the past fifteen years. However, their design should be strengthened in order to create exchanges that are not destined to fail.

First, the exchanges should be opened up to more small businesses in order to achieve “critical mass” – which will lower insurers’ administrative costs and reduce premiums. The most recent versions of the House Tri-Committee and Senate HELP Committee bills were amended to allow “larger” small employers to join the exchange, but this still might not be enough for exchanges to reach critical mass.

Second, to assure their long-term viability, the exchanges need to have stronger protections against adverse selection. The current House and Senate bills envision purely voluntary exchanges – where individuals and even the smallest employers can choose to buy coverage inside or outside the exchange. While this is attractive politically, it creates a serious danger of adverse selection. Congress should strongly consider making the exchange the exclusive market for individuals and very small employers – say, 2-10 employees.

Even with these changes, however, very strong measures are needed to prevent exchanges from falling into a death spiral. The current bills have some elements to prevent this, but more are needed. Specific provisions that would protect against adverse selection include:

- The same insurance regulations (especially benefit design and rating practices) should apply inside and outside the exchanges.
- Where insurers can offer products for the same groups inside and outside an exchange, they should be required to set premiums based on the entire pool.
- Insurers should be prohibited from advantaging their comparable non-exchange products, such as through marketing practices that discourage enrollment by high-risk people outside of the exchange.
- If an insurer participates in the individual and small-group markets outside of the exchanges, it must also participate inside the exchanges.

If these elements are added to the bills in Congress, it is far more likely that exchanges can be part of expanding coverage in the long run.

We shouldn't expect health insurance exchanges to be the answer to everything that is wrong in our current health system, but they are an essential part of comprehensive health reform. The motto of the program we ran in California – "Choice, Simplicity, and Affordability" – serves as a good guidepost for getting it right this time around. Robust exchanges for small employers and individuals – if designed correctly – have the potential to reduce premiums, expand choice, encourage healthy competition, and help drive improvements in our health care system.

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