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## Beware Adverse Selection

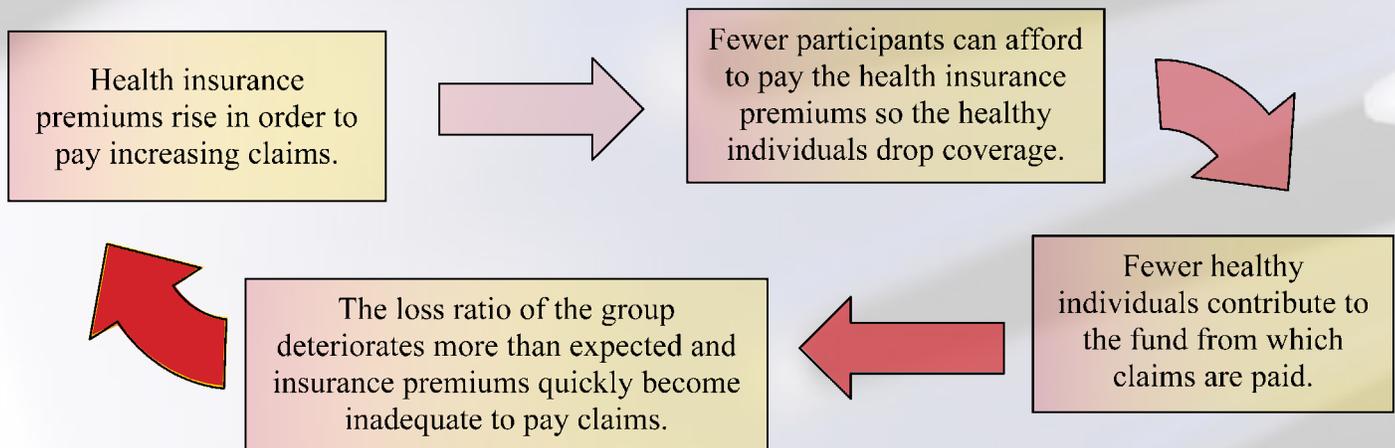
During the most recent WPMA national convention in Las Vegas, I had the opportunity to visit with many employers about their businesses and the problems they face. While it seems the worst of the economic crisis has come and gone for most companies, a number of pesky challenges remain.

As I visited with one employer, he shared with me his frustration at the amount his company's health insurance premiums rise year after year. It didn't take me long to figure out that part of the problem is that his company's insurance program has been established in such a way that it fosters adverse selection.

Adverse selection is the tendency for people to buy insurance after they have developed a need for the coverage. In other words, these people have done the math and determined they will be better off financially if they pay monthly insur-

ance premiums rather than the cost of their personal medical care. In the case of this particular employer's plan, adverse selection exists because his company doesn't contribute toward the premium of the lower-level employees. Instead, it allows those employees to participate in the plan on a voluntary basis provided they are willing to pay the entire premium amount out of their own pocket. While this may sound like a good idea because it protects those employees from the risk of financial ruin, this type of arrangement will invariably result in adverse selection since it ensures those who are sick will participate in the plan, while those who are healthy generally will not.

Ultimately, adverse selection will create the following cycle where only the sickest individuals are willing (or can afford) to pay ever-increasing health insurance premiums. In the end, this "death spiral" will cause the insurance arrangement to collapse.



# and the *DEATH SPIRAL!*

Adverse selection is like throwing a potluck dinner party where all of the guests eat more food than they bring. Unless you have some guests who bring more food than they eat, it won't take long for the food to run out, leaving some guests hungry and unhappy. Likewise, in order for insurance to work properly, it is imperative that people participate in the insurance pool even when they are healthy and don't immediately need the coverage. Losses must be spread amongst all participants and must be random, or the system will become nothing more than the transfer of known risk where those with the risk will pay for coverage, and those without the risk will opt out. Once that happens, premiums will increase at abnormally high rates and the death spiral will begin.

In order to avoid a death spiral, it is necessary to avoid adverse selection. While adverse selection can occur in many ways, one of the most common is when an employer allows employees (and dependents) to participate in the health insurance program primarily (or entirely) at their own expense. Because these employees are usually the lower-level employees who don't earn as much as the higher-level employees, they are faced with the difficult choice of going without health insurance or directing a large portion of their take-home pay to health insurance premiums. In those cases, the employees generally put a pencil to it and calculate their personal premium costs versus their expected claims. If they estimate they are going to receive more insurance benefit than they will pay in premium, they will generally opt in. If not, they will forgo coverage and "go bare."

While this makes financial sense for an individual employee, it defeats the broader purpose of insurance and circumvents the inherent actuarial assumptions of the insurance model. In the end, the plan will experience higher claim costs, collect less money in the claim pool, suffer deteriorating loss experience, and dole out higher premiums (see *diagram*). This is why meaningful employer contribution is critical to the success of an

employer-sponsored health insurance program. Incidentally, it is also why the individual mandate that requires Americans to carry insurance coverage is so critical to the federal Affordable Care Act (aka ObamaCare).

So what can an employer do in order to avoid adverse selection and the resultant death spiral?

**Here are a few suggestions:**

- **Contribute as much as possible** toward all employees' health insurance premium (even if this means sponsoring a cheaper health plan). If the company is unable to contribute at least 75% of the premium rate for a particular class of employees, the plan should specifically exclude those employees from participating (as permitted under applicable law) so they don't jeopardize the stability of the entire plan.
- **Contribute a meaningful amount** toward the premium rate for dependents. In reality, few employers can afford to contribute the same percentage for employees and dependents, but any contribution will help reduce adverse selection at the dependent level.
- **Avoid multiple plan options.** If employees are allowed to choose between different plans with different deductibles and benefits, sicker participants will generally migrate to the richer benefit plan, and healthier participants will migrate to the cheaper plans. This will result in a rate inadequacy and the death spiral.
- **Utilize age-banded rates** that more accurately reflect insurance risk and expected costs, rather than composite rates that charge everyone the same amount regardless of age. Composite rates require younger employees and their dependents to subsidize the premiums of the older employees and their dependents. This leads to lower participation by the younger (and generally more healthy) employees and their dependents, and higher participation by the older (and generally higher cost) employees and their dependents.

## *If you have questions ...*

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