In certain situations, Americans who become chronically ill have to pay higher rates to continue their health insurance coverage. Indeed, although the majority of Americans are insured, hardly anyone is fully protected against the risk that their next insurance policy will cost considerably more than their current one.

Although illness can last for any period of time, a typical health insurance contract lasts for one year. This means that insurance contracts often have to be renewed while people are sick; and policyholders may be exposed to reclassification risk—the risk that their premiums will be increased because they are ill. In this article, I examine how and to what extent the current health insurance system in the U.S. protects individuals against such reclassification risk, and discuss some potential solutions.

The textbook solution to insuring persistent medical expenses is a lifetime health insurance contract. This would insure individuals against not only the current costs of their medical treatment, but also future changes in their premiums due to, say, a chronic health condition. However, in a voluntary health insurance system, healthy people may opt out of such contracts, leaving the insurer with only relatively sick customers. This would make the system unsustainable. In some developed countries (e.g., the UK and Italy), this problem is solved by universal mandatory participation of individuals in a nationalized health insurance system. In such a system, everyone can obtain health insurance at a risk-independent rate, i.e., a rate that does not depend on an individual's health. This type of insurance scheme relies on risk pooling. In other words, the sick are subsidized by the healthy. And the universal mandate ensures that there are always enough healthy participants in the pool.

In the U.S., the primary source of coverage for non-elderly individuals is private health insurance obtained through employers or purchased directly. Both sources of coverage have their own mechanisms to protect individuals against reclassification risk.

**Employer-based insurance**

About 63% of non-elderly adults in the U.S. get their insurance through either their employer or spouse’s employer. Employer-sponsored health insurance partially protects participants against reclassification risk because it allows all employees in a plan to buy insurance at the same basic rate regardless of their health status. This is possible because employer-based pools are usually large and have enough healthy participants to make average premiums insensitive to health fluctuations of some individuals.

The participation of healthy individuals in employer-based pools is supported by two factors. First, the major part of the health insurance premium is contributed by the employer. In 2009, employers that provided health benefits to their workers contributed, on average, 83% of the premium for single coverage and 73% for family coverage. Second, employer-based health insurance premiums are
Individual private insurance

In the marketplace, profit-maximizing insurance firms charge individuals a premium that reflects their expected medical costs conditional on their current health status and their history of claims. Currently, most states allow insurance firms to medically underwrite applications for health insurance, i.e., to check the medical history and health status of applicants. To reduce individuals’ exposure to reclassification risk, federal regulations require insurers to write insurance contracts with guaranteed renewability. This means that a person cannot be denied a renewal of health insurance based on a claims history. This provision was introduced at the federal level by the Health Insurance Portability and Accountability Act (HIPAA) of 1996. This federal law does not put any restrictions on premiums charged at a renewal. However, Patel and Pauly found that 47 states require premiums at a renewal to be the same for all individuals within a risk class.

Guaranteed renewability with limitations on premium increases on renewal assures some protection against reclassification risk. However, this does not represent full protection, because insurance firms can legally rescind a policy at a later date. At some point after a policy has been issued and claims submitted, an insurance company may choose to conduct post-claims underwriting. This is a detailed and costly investigation, so it is usually undertaken on policies that have become very expensive for the insurer, e.g., because the insured individuals have become seriously ill. Post-claims underwriting may result in a policy being retroactively canceled, which means that not only is the coverage terminated but the insurance company is no longer responsible for the claims previously submitted. Insurers can only do this if they discover new information that would have mattered when the application for the policy was first considered. In many states, there is no requirement that the information be related to the claim that triggered the insurance company’s investigation. For example, a person who is diagnosed with cancer can have his policy rescinded if the post-claims investigation discovers that he did not report some health problem that has no connection with the cancer. The total number of policies rescinded is not large relative to the number of existing policies. For instance, in Texas in 2007, fewer than 1% of the total number of policies in force were rescinded. However, because rescissions are usually concentrated in policies with the most expensive claims, policy termination occurrence is higher among people who experience a health status deterioration.

Transition from employer-based to individual coverage

Those most exposed to reclassification risk are people who have lost their employer-based insurance. In order for a firm to buy into a group insurance plan that will cover all participants at the same basic rates without adjusting for health status, it has to have enough workers to obtain a sufficiently diversified risk pool. In addition, it has to pay them enough so that a wage adjustment for the employer’s health insurance expenses does not leave the worker with an income below the minimum wage. As a result, large firms are more likely to offer employer-sponsored coverage and high-wage workers are more likely to be covered. In 2009, 98% of firms with 200 or more workers offered health insurance; among firms with fewer than 200 workers, the rate was only 59%. In addition, in 2008 only about 19% of individuals with an annual income of less than $25,000 were covered by employer-based insurance; among those with an annual income higher than $75,000, approximately 82% had coverage.


Those most exposed to reclassification risk are people who have lost their employer-based health insurance.
Any interruption of health insurance coverage may lead to a situation where a new health insurance contract can be obtained only at a significantly higher rate, if at all.

in many states is to buy coverage through high-risk pools. High-risk pools were originally designed to provide subsidized coverage for those who are denied coverage or face too high of a rate in the individual market. Many states also use high-risk pools to help those who lose employer-based insurance to obtain coverage. Out of 33 states that have high-risk pools, 29 of them cover HIPAA-eligible individuals. The premiums in high-risk pools are higher than average standard rates in the individual market—they are typically capped at a level of 150% to 200% of the standard rates. A second disadvantage of these pools is that people with pre-existing conditions often face a waiting period after they enroll. During the waiting period, any treatment related to their pre-existing condition is not covered. Enrollment in high-risk pools is small, constituting, on average, less than 2% of individual market participants.

Increasing protection against reclassification risk

Approaches to increasing protection against reclassification risk fall into two main categories. The first approach imposes more restrictions on the ability of insurance firms to risk-adjust premiums and deny coverage—I call this the regulatory approach. The second approach eases existing regulations and relies more on market mechanisms—I call this the free market approach.

The problem of reclassification risk arises because insurers charge people different premiums based on their health status. The key to the regulatory approach is forbidding insurers from charging prices based on health status. This type of restriction is known as community rating. The downside of community rating is that it creates an incentive for insurers to deny coverage altogether to high-risk individuals. Because of this, another regulatory restriction often proposed together with community rating is guaranteed issue, which forbids insurers from denying coverage based on the individual applicant’s health status. However, community rating combined with guaranteed issue may have unintended consequences that would make the coverage more expensive for everyone. Specifically, healthy people may wait to buy insurance until their health status deteriorates, leading to increases in premiums that encourage additional

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or provide partial coverage, e.g., excluding treatments related to pre-existing conditions. Health status insurance protects people against fluctuations in premiums, but it cannot do much in an environment where premiums are restricted from varying by a wide margin, with insurance companies denying coverage to those who are very sick.

Conclusion

The current health insurance system provides only limited protection against reclassification risk. Most people obtain their insurance at a risk-independent rate through their employer. People with continuous coverage in individual markets are mostly protected by the guaranteed renewability provision. However, any interruption of coverage may lead to a situation where a new health insurance contract can be obtained only at a significantly higher rate, if one can be obtained at all. Given that 86.7 million non-elderly Americans experienced some interruption in coverage during 2007–08, reclassification risk is an important issue to address.

4 Kaiser Family Foundation and Health Research and Educational Trust (2009).
5 Ibid.
11 These states are Maine, Massachusetts, New Jersey, New York, Vermont, and Washington.
14 While explicit health status insurance contracts are not available, Cochrane (2009) states that an insurance product with similar features has recently become available from UnitedHealth Group.