

Adverse Selection and the CLASS Act



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Funding long-term care (LTC) for the elderly and disabled in the United States is a vexing problem. LTC costs are expensive and can quickly exhaust an individual's lifetime savings. Not nearly enough individuals purchase and maintain LTC coverage from the private insurance market to cover the costs population-wide. Medicaid and to a certain extent Medicare already fund a majority of LTC in this country, but both programs are predicted by many to face serious financial challenges not too far in the future, particularly given the growing proportion of seniors in the population.

While the eventual effects of complex financial programs are difficult to forecast, the CLASS Act as currently structured is conspicuous because it introduces guaranteed-issue LTC benefits without installing the kinds of protections necessary to minimize adverse selection risk.

In light of these challenges, public and private strategies and approaches to increase LTC insurance have been proposed. One of the most recent such proposals, the Community Living Assistance Services and Support Act (CLASS Act), is included in the current House and Senate healthcare reform bills.¹ The CLASS Act has important implications in the overall healthcare reform debate with respect to the budget impact, but also poses risk to the American taxpayer and future generations if the program fails. While the eventual effects of complex financial programs are difficult to forecast, the CLASS Act as currently structured is conspicuous because it introduces guaranteed-issue LTC benefits without installing the kinds of protections necessary to minimize adverse selection risk.

HIGH-LEVEL OVERVIEW OF CLASS ACT STRUCTURE

The CLASS Act is a voluntary federal program financed from participant premiums without any federal subsidy.

Eligibility

- Any American age 18 or over who meets an actively-at-work requirement can participate in a voluntary federal LTC insurance program.

Premiums

- Monthly premiums are charged based on age at enrollment and year of enrollment. Premiums are intended to be level over an individual's lifetime; however, premiums can be increased by the Secretary of Health and Human Services if it is determined necessary for the financial health of the program.
- An individual must pay premiums for a 60-month vesting period before being able to access benefits.

Benefits

- The program provides a cash benefit of at least \$50 per day indexed to the consumer price index (CPI), for an impaired individual living in the community.
- To qualify for benefits, an individual must be unable to perform at least two or three activities of daily living or be cognitively impaired.

Looking beyond this base structure, the CLASS Act also contains provisions that increase the risk of adverse selection and may threaten the ultimate success and viability of the program.

LTC INSURANCE SUSCEPTIBLE TO ADVERSE SELECTION

One of the challenges of LTC insurance—and health insurance in general—is adverse selection. Briefly, adverse selection occurs when insurance benefits or premium levels attract a larger-than-expected number of high-risk participants, which can lead to higher costs and premiums.

Health insurance programs all have the potential for adverse selection. Those who are likely to need benefits are inherently more likely to seek them out. However, unlike medical insurance, which pays for ongoing healthcare costs that are a clear and present reality for most, denial of the risk of a potentially far-off event causes many healthy individuals to see little value in purchasing and paying

¹ U.S. House Affordable Health Care for America Act, retrieved Dec. 15, 2009, from http://energycommerce.house.gov/index.php?option=com_content&view=article&id=1687&catid=156&Itemid; U.S. Senate Patient Protection and Affordable Care Act of 2009, retrieved Dec. 15, 2009, from <http://democrats.senate.gov/reform/patient-protection-affordable-care-act.pdf>.

premiums on LTC coverage. Nationally, only a very small percentage of people carry private LTC insurance.

As they do with most kinds of insurance, private insurers offering LTC coverage use well-known techniques to manage adverse selection, to keep premiums in line with benefits, and to offer coverage profitably. Underwriting enables these insurers to determine eligibility for coverage and charge premiums that are in line with the risk. Employer group coverage for employees often includes more simplified underwriting but typically requires a significant minimum actively-at-work requirement of 20 to 30 hours per week.

The highest-risk cohorts may find premiums unaffordable or be denied coverage altogether. The unfortunate consequence is that, by the time it becomes clear to individuals that they might need some way to pay for LTC, their options for doing so can be significantly curtailed. Combined with the fact that many people forgo LTC insurance altogether regardless of cost or need, we end up with a system in which the government pays for the majority of LTC.

PROVISIONS LEADING TO POTENTIAL ADVERSE SELECTION

The base structure of the CLASS Act is a voluntary program with guaranteed issue for individuals who meet an actively-at-work requirement. *Voluntary* means that citizens can opt out of the program; there is no mandate that they participate. *Guaranteed issue* means that no one can be denied coverage. Individuals must meet a modest actively-at-work requirement, but everyone who does is guaranteed issue.

Combining the above provisions with voluntary enrollment could lead to unintended consequences—most importantly, substantial adverse selection. The model of a voluntary program that is managed for risk—that is, one in which underwriting is used to set premium levels and eligibility—is already used for profitable LTC insurance plans in the private sector. On the other hand, it is conceivable that a guaranteed-issue program could work in theory if it was mandatory, because all risk levels from the very low to the very high would be gathered in one risk pool. We say *in theory* because most any mandate may have exceptions (people willing to take on tax or other penalties; people gaming the system).

A similar dynamic is currently playing out on the healthcare reform main stage, as policymakers debate restricting underwriting and rating as they look to impose an individual mandate for healthcare. This dynamic is discussed in the recent briefing paper, *Adverse Selection and the Individual Mandate*.²

Together, guaranteed issue and voluntary participation add up to a risky combination. The voluntary aspect of the program allows low-risk individuals to never sign up for the program while the guaranteed issue enables some of the highest-risk individuals to join the program. This is a formula that is virtually certain to create financial

instability in any insurance program unless there are other important provisions to control risk.

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Important provisions of the CLASS Act that are intended to control adverse selection may not go far enough in this regard, and other provisions of the CLASS Act may actually exacerbate potential selection issues. Some of those issues include:

Guaranteed issue for those actively at work

The CLASS Act contains a relatively liberal definition of actively at work. The requirements include a low-annual-income requirement (\$1,120 in 2010³) versus a minimum-number-of-hours-per-week requirement in the private group LTC insurance market. This provision may lead to adverse selection as satisfaction of the requirement may not provide any significant underwriting benefit to the program. And, significantly, the House version of the program includes guaranteed issue for spouses of qualified participants without any actively-at-work underwriting requirement. Spouses with chronic conditions would have an incentive to sign up for the program and begin collecting benefits as early as possible, creating an extraordinary level of adverse selection.

Opt-out (and opt-in) provisions

There are specific rules with respect to the premium payment period and actively-at-work requirements in the current versions of the CLASS Act. For example, the Senate version of the bill requires that an individual must be actively at work for the first three years of the 60-month vesting period, and 24 months of coverage must be consecutive if a lapse in coverage occurs for more than three months. While these provisions attempt to help control adverse selection, the specific rules provide *holes* that could be *gamed* by savvy program participants.

One potential mitigating factor in all of this is the negative opt-out nature of the CLASS Act program, meaning that employers can enroll individuals on an automatic basis similar to a 401(k) program. This tactic has been widely praised in the world of retirement savings for increasing 401(k) enrollment rates, and it may result in somewhat higher enrollment for the CLASS Act. However, 401(k) accounts may be perceived quite differently from LTC insurance. In retirement savings, the money belongs to the enrollees and is available to

² Snook, Thomas D. & Harris, Ronald G. (October 2009). Adverse selection and the individual mandate. Milliman health reform briefing paper. Retrieved Dec. 15, 2009, from <http://www.milliman.com/perspective/healthreform/pdfs/adverse-selection-individual-mandate.pdf>.

³ Social Security automatic increases. Social Security Online. Retrieved Dec. 15, 2009, from <http://www.socialsecurity.gov/OACT/COLA/QC.html>.

them to use. By comparison, LTC insurance may or may not provide benefits. Also, most people can imagine themselves retiring at some point; they may even relish the prospect. On the other hand, most people prefer not to think about needing to enter a nursing home or requiring other long-term care.

Premium subsidies

Students and individuals making less than 100% of the federal poverty level (FPL) will pay only a nominal premium of \$5 per month under the Senate version of the CLASS Act, resulting in the need for other participants to subsidize their low premiums. Premium subsidies that are financed solely from the premiums of non-subsidized participants may influence participation levels (and ultimately adverse selection levels) of those participants.

Marketing

The bill provides for only 3% of premium to be used for administration and marketing. The resulting lack of marketing of the program may lead to significantly lower participation levels. The private group LTC insurance market experience indicates that that marketing, and the number of *touches* of potential program participants, significantly impacts participation and aids in obtaining a reasonable spread of risk.

Benefit design

The current program design pays *cash* benefits and provides these benefits for an individual's lifetime. While this structure is easy to understand and provides the participant with benefit flexibility, it also is a structure susceptible to adverse selection and higher claim levels.

Presumptive benefit eligibility

The CLASS Act contains a presumptive eligibility trigger that is not found in the private LTC insurance market. It provides LTC benefits for someone discharged from a hospital, from a nursing facility, or from an institution for mental diseases.

CLASS ACT STRUCTURE AND PRICING RISK

The CLASS Act requires that the Secretary of Health and Human Services set the final plan design and premiums based on an actuarial analysis of the 75-year costs of the program to ensure solvency throughout that 75-year period. However, potential adverse selection may make it difficult to adequately price the program to achieve solvency throughout this period. In addition, the CLASS Act precludes premium increases until it may be too late to establish solvency and limits the increases such that a funding shortfall may well fall to future generations. The rate increase limitations include not allowing increases for individuals over age 65 that have paid premiums for 20 years or more.

The drivers of adverse selection are rational consumer choices on the part of individuals, but the result is that the program is forced to increase premiums to make up for the costs sustained by a riskier pool of insureds. This further upsets the cost/reward ratio for relatively healthy individuals, causing more of them to select out of the program, causing further increases in premiums, and so on. In the worst case, this creates a *selection spiral* that can lead to collapse of the program. How might this develop? A premium amount will have to be put forward at the outset, and if that premium is not attuned to certain price sensitivity, there may not be sufficient *good risks* opting in. But since no one can make a claim for five years, it will be difficult to know for some time if this new risk pool is financially balanced or not.

Premium estimates for the program to date assume a participation level and spread of risk. For example, the American Academy of Actuaries predicts that for the CLASS Act to maintain solvency over the long term, premium levels would need to be set at \$160 per month assuming a 6% participation rate.⁴ The Chief Actuary of the Centers for Medicare and Medicaid Services (CMS) predicts lower participation. After taking into account the same factors we have discussed, as well as the fact that LTC is a *new and unfamiliar benefit*, the Office of the Chief Actuary estimates that only 2% of those eligible would participate—and that the premium could be as high as \$240.⁵

The actuarial pricing challenge with respect to the CLASS Act is trying to find a premium level that will yield the assumed participation level used to develop that premium. In order to determine a premium that will solve this *circular* problem, adverse selection must be controlled. Otherwise any premium level will eventually result in financial ruin of the program. In other words, there is fundamental risk that the program cannot be priced adequately.

The participation level of the program is expected to be highly contingent on pricing. A recent survey of about 1,000 people conducted by Matthew Greenwald and Associates in October illustrates the sensitivity of premium on participation. It indicated that only 3% of people would participate in the program at a \$160 monthly premium, but that 43% of people would participate at a \$35 monthly premium.⁶ The survey confirms that participation is highly contingent on pricing, which magnifies the risk of adverse selection.

Another potentially significant influence on participation levels for the CLASS Act is the private LTC market. Lower-risk individuals who see value in having LTC coverage may gravitate to the private market where they can find benefits tailored to their needs and premiums that are likely more competitive than the federal option. In addition, given the great uncertainty about participation and obtaining a reasonable spread of the risk, there is potential that the CLASS Act program will need rate increases in the future. The private market has

⁴ Foster, Richard S., Chief Actuary (December 10, 2009). Estimated financial effects of the Patient Protection and Affordable Care Act of 2009, as proposed by the Senate Majority Leader on November 18, 2009. Department of Health and Human Services, Centers for Medicare and Medicaid Services. Retrieved Dec. 15, 2009, from http://enzi.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=85899a92-a646-4bca-87b6-81ae629e7533.

⁵ Foster, *ibid.* Not incidentally, this premium level is significantly higher than the premiums initially required by the CLASS Act. For more detail on potential imbalances between premiums and benefits in the CLASS Act, see the American Academy of Actuaries report at http://www.actuary.org/pdf/health/class_nov09.pdf.

⁶ Matthew Greenwald & Associates, Inc. ACLI CLASS Act survey: Report of findings. American Council of Life Insurers. Retrieved Dec. 15, 2009, from <http://www.acli.com/ACLI/Issues/GR09-316.htm>.

had its own problems with rate increases, but insurers have learned a great deal about the risks associated with given benefit designs and given underwriting levels. In short, there is probably greater risk that the CLASS Act will need rate increases than the private market.

Perhaps one of its most important merits is the mere fact of its existence as a way of illuminating the need for financing solutions for the LTC risk.

SILVER LINING?

The CLASS Act has the noble intention of remedying difficult problems with LTC funding. Perhaps one of its most important merits is the mere fact of its existence as a way of illuminating the need for financing solutions for the LTC risk. The auto-enrollment features may not operate in the same way as those used to encourage 401(k) adoption, but they do have the effect of putting people in a position where they have to consider their long-term care needs. If the end result of the CLASS Act is to increase planning and financing of the LTC risk, it will have served a great purpose. However, the potential

adverse selection associated with the current program structure and the long-term impact on public and private financing of LTC is potentially devastating.

It may be possible to make changes to the structure of the program that would increase its stability, and the American Academy of Actuaries recommends several in its report such as stricter eligibility rules, benefit design changes, premiums that are indexed to the CPI, and an increased marketing/education allowance. It is important to keep in mind the risk inherent in any insurance program that combines guaranteed issue with voluntary enrollment. By attempting to fix problems caused by adverse selection, such a program may unintentionally exacerbate them.

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