California HealthCare Foundation

Insurance Markets

Rules Governing California's Small Group Health Insurance Market

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Issue Brief

Introduction

California's small group health insurance market is regulated by a special set of rules designed to strike a balance between the broad social goal of allowing small employers fair access to health coverage and the need of insurance carriers to avoid unpredictable costs.[1] This issue brief describes the rationale for having such laws, summarizes the rules that apply to California's small group market, and places small group rules in the context of other market forces. A companion document, "Rules Governing California's Individual Health Insurance Market," is also available at **www.chcf.org**.

The Basics of Risk Selection

Consumers who expect to use health services extensively have the strongest motive for obtaining health insurance. People in good health, on the other hand, may expect to use few services and be less interested in buying coverage. If only those who know they will need care participate in a group plan, premiums rise and coverage becomes unaffordable. When a health insurance carrier attracts mostly sick individuals, it is said to experience "adverse selection."

Insurance carriers don't worry much about adverse selection when coverage is provided through large employer groups. Virtually all employees of large companies accept coverage, in large part because their employers pay most of the cost. This high participation rate means that a large group's risk pool is likely to be similar to that of the general population.

When a small firm seeks coverage, carriers have more reason to be apprehensive about adverse selection. They may be concerned that:

- Employer decisions to buy coverage are based on known health needs of a particular employee or employees.
- If small firms require employees to pay a sizeable share of the cost of coverage, only employees who anticipate high health care use will enroll.

In order to avoid adverse selection, carriers have an incentive to be choosy about the small groups they cover and the circumstances under which they write coverage.

Most small group market rules seek to reconcile competing interests. Allowing carriers to pick and choose among small groups could exclude many small businesses from the health insurance market. On the other hand, requiring carriers to cover any subset of a small group's employees as soon as they identify a need for care could undermine carriers' legitimate business objectives. Market rules acknowledge that neither of these extremes is desirable. Both state and federal laws impose rules

that aim to balance the marketplace needs of insurance buyers and sellers. Table 1 provides an overview of these market protections.

Key Protections under California Law

A 1992 California law (AB 1672) provides health insurance purchasing protections for small businesses that were once enjoyed only by much larger firms. The specific protections that apply to small groups under this law are described below. (Information about market protections in other states is available elsewhere.[2]) Because the federal Employee Retirement Income Security Act of 1974 (ERISA) prohibits states from enforcing laws relating to private-sector employee health benefit plans, California law applies to the carriers from whom small employers purchase coverage, not the employers themselves.[3]

Guaranteed issue. Every small employer has the right to buy any health insurance product sold by a carrier to small employers. A product is a package containing a list of benefits (what the plan covers) and a type of service delivery (e.g., HMO or PPO).

Guaranteed renewal. A carrier may not cancel a small group's coverage just because one or more enrollees gets very sick and generates high health care costs. A carrier may only cancel coverage for fraud or failure to pay premiums.

Rating protections. No law sets health insurance rates, nor requires that they be approved by state regulators. California law does limit a carrier's ability to charge low rates to groups whose members are in good health and high rates to those that include individuals in poor health. These protections operate by basing premium calculations on a "standard" rate that every carrier develops by taking certain allowable factors into account. Plans must set actual premiums no more than 10 percent above or below the standard rate. This creates a "rate band" within which the carrier may adjust employer rates for risk factors such as previous use of health services or industry type. An explanation of rating terms and their relevance is shown in Table 2.

The law does not restrict carriers' *average* annual premium increases, but does limit their ability to raise a

Table 1. Market Protections Defined

TERM	What Is It?	Why Is It Important?
Guaranteed Issue	The right to buy coverage (regardless of industry, health status or age of employees, or any other risk factors).	Without such a protection, health insurance carriers could reject any small group that includes an employee with a costly, chronic medical condition or exclude the employee with the chronic condition.
Guaranteed Renewal	The right to renew coverage (regardless of changes in employee health status or use of services, or any other risk factors).	Without such a protection, carriers could drop a group when one or more employees experience a high-cost medical condition.
Rating Protections	Limits on how much carriers may vary rates based on the health status of employees or any other risk factors.	Without such protections, carriers could impose unaffordable rates on higher-risk groups, pricing them out of the market and circumventing the intention of guaranteed issue and renewal.
Portability	Limits on the ways in which carriers can exclude coverage for existing health conditions among new members.	Without such protections, workers might avoid changing jobs simply because they want to maintain coverage for existing health conditions. Job mobility would be greater for people in good health than those with (even relatively minor) health conditions.

small employer's premium due to changes in employee health status or other risk factors. Carriers may not increase the Risk Adjustment Factor (RAF) more than 0.10 in a single year. So, for example, a group that was assigned a RAF of 0.9 in Year 1 could receive a RAF no higher than 1.0 in Year 2. An illustration of how new and renewal premiums are computed under California's rating rules can be found in the Appendix.

Allowable rating factors. Carriers may establish standard rates based on only three specific categories: age, geographic location, and family size. For example, a plan could develop one rate for a single employee aged 40 to 49 living in the Los Angeles area, and a different rate for an employee in the same age bracket who lives in Modesto and needs coverage for two children.

Portability — Limitations on the use of pre-existing condition exclusions. Prior to the passage of AB 1672, changing carriers could mean losing coverage for a specific health condition under a pre-existing condition exclusion clause. Now, pre-existing condition exclusions are limited to a one-time, six-month period. If the enrollee had previous coverage, the new carrier must count that coverage toward the six-month period, provided the employee becomes eligible within 62 days of losing the old coverage.

Marketing provisions. Carriers must "fairly and affirmatively offer, market and sell" *all* of their small group products. This means that brokers and agents must provide small employers with a summary brochure that describes the full range of benefit plans available from the insurers they represent. Specific disclosure requirements are intended to make it difficult for carriers, brokers and agents to steer business toward one product or another, such as guiding groups with sicker individuals to a particular benefit plan that costs more.

Enforcement. Carriers must file detailed information with state regulators regarding the products they sell in the small group market. Those that break the law are subject to penalties ranging from $2,500 to $100,000 per violation. Brokers and agents that do not comply with marketing and disclosure provisions may be subject to penalties ranging from $250 to $2,500.

Table 2. Rating Terminology Used in California Law

TERM	What Is It?	Why Is It Important?
Standard Employee Risk Rate (SERR)	The starting point in computing the premium for a small group. Carriers may use only three factors to develop the SERR: employee age, family size, and geographic location. To ensure a transparent rating methodology, carriers must file SERRs with regulatory agencies.	Carriers may not take health status into account in calculating the SERR. Through the SERR, small groups with higher costs are partially subsidized by small groups with lower costs.
Rate Bands/Risk Adjustment Factor (RAF)	The second (and final) step in computing small group premiums. By applying a RAF to the SERR, carriers may adjust the group's rate based on factors such as employee health histories. Actual premiums must fall within a specified range (between 90% and 110% of the SERR) referred to as a rate band. The RAF is usually expressed as a multiplier between 0.9 to 1.1. When the SERR is multiplied by the RAF, the result is a premium that falls within the required rate band.	The RAF is the only way a carrier may vary rates among different groups to reflect risk factors other than those used to determine the SERR. Examples of such risk factors are health history, claims experience, and industry. By limiting the RAF to a rate band (between 90% and 110% of the SERR), the law requires plans to charge each small group premiums that are comparable to those for similar groups.

Whom Do the Rules Protect?

California law protects small employers who buy health care coverage for their employees. Among its key points:

- "Small employer" means a business with 2 to 50 full-time employees.
- Providing coverage is voluntary. There is no mandate requiring small businesses to offer or provide group health insurance to employees.
- If an employer offers coverage, it must extend that offer to all full-time employees. The employer may also include part-time employees (defined as 20 to 29 hours per week) as part of the group as long as all part-time employees are offered the coverage.
- Protections apply when the employer pays any part of the premium. But the law allows carriers to impose minimum contribution requirements (described below), so small employers generally must pay a substantial share of premium in order to offer health insurance.

How Can Carriers Address Selection Concerns?

California law allows health insurance carriers some leeway in managing risk and addressing adverse selection concerns. Carriers can:

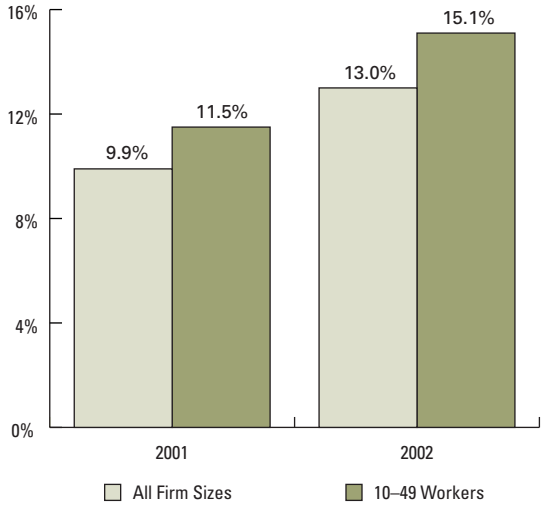
- Require that a minimum percentage (such as 70 percent) of employees be covered. By setting minimum participation requirements, carriers aim to spread premium dollars and health care costs across both low- and high-risk employees.
- Impose contribution requirements, such as obligating the employer to pay at least 50 percent of the premium. The more an employer pays, the greater the likelihood that healthy, low-risk individuals will enroll.

Conclusion: The Broader Market Context

Market rules offer important protections that make coverage more accessible for small groups, especially those with employees who are older or in less-than-perfect health. Rules are a force for stability in the market, ensuring an opportunity to offer coverage for many small employers who otherwise might be excluded. However, they do not address the key issue of affordability.

As shown in Figure 1, premiums have risen rapidly for California businesses in recent years. Future increases are likely. It is increasingly challenging for businesses large and small to obtain coverage. Market protections do not eliminate these challenges.

Figure 1. California Premium Increases, by Year



Source: Kaiser/HRET 2001 and 2002 California Employer Health Benefits Survey.

APPENDIX
Small Group Rating Calculations

Examples are illustrative only and do not reflect the actual rates of any particular group or carrier.

Step 1. Computing Year 1 Standard Employee Risk Rates

EMPLOYEE	Monthly Standard Employee Risk Rate (SERR)
Age 45 Plus one child Area 1	$520
Age 25 Single Area 1	210
Age 32 Plus spouse and child Area 2	550
Total Group SERR	**$1,280**

Note: Monthly per employee premiums, based on each employee's age, family size, and geographic location are added together to produce a base rate for the group.

Step 2. Applying a Risk Adjustment Factor

RISK LEVEL	Rate Calculation
Lower Risk For example, most employees are younger and healthier than the carrier's overall membership.	$1,280 × .90[1] = $1,152 [1]Can be as low as 90% of SERR (RAF = .90).
Average Risk	$1,280 (100% of SERR)
Higher Risk For example, most employees are older and sicker than the carrier's overall membership.	$1,280 × 1.10[2] = $1,408 [2]Can be as high as 110% of SERR (RAF = 1.10).

Note: Final Year 1 rates for each similarly situated group (same employee age, family type, and geographic distribution) must fall within a "rate band" of 90% to 110% of the SERR.

Step 3. Computing Year 2 (Renewal) Standard Employee Risk Rates

EMPLOYEE	SERR Year 1	"Trend" Rate Increase	SERR Year 2
Age 45 Plus one child Area 1	$520	× 11%	$577.20
Age 25 Single Area 1	210	× 11%	233.10
Age 32 Plus spouse and child Area 2	550	× 11%	610.50
Total Group SERR	**$1,280**	**× 11%**	**$1,420.80**

Note: Rules do not limit carriers' overall rate increases (or "trend"). Each year, rates must fall within the SERR rate band. In this illustration, Year 2 rates would be between 90% and 110% of $1420.80, or $1,278.72 and $1,562.88.

Step 4. Applying a Risk Adjustment Factor (RAF) to Compute Renewal Premiums

YEAR	RAF × SERR	Final Rate
Year One	0.9 × $1,280 =	$1,152
Year Two	1.0 × $1,420.80 =	$1,420.80
Total Premium Increase (year 2 over year 1)		**23%**

Note: Renewal RAFs may increase no more than 0.10. A group that had been assigned an RAF of 0.90 in Year 1 could be assigned a Year 2 RAF no higher than 1.0 — even if risk factors in Year 2 indicate that the group has become a higher-than-average risk. Because the overall rate increase ("trend") and Year 2 RAF combine to produce the total premium increase, this increase can be much greater than 10%.

Acknowledgment

Analysis was conducted by Debra L. Roth, who at the time of writing was an attorney and health care policy consultant with Ruderman & Roth in Sacramento.

Related Reading

"Trends and Analysis in Insurance Markets: Small Businesses and Individuals Face Greater Cost-Sharing and Increasing Complexity," California HealthCare Foundation, April 2002.

"Why Don't More Small Businesses Offer Health Insurance?: Summary Report on the 2000 California Health Care Foundation/ Mercer Survey," California HealthCare Foundation, March 2002.

"Small Businesses, Information, and the Decision to Offer Health Insurance," *Health Affairs* 20: 278–82, September/ October 2001.

"Small Businesses, Information, and Health Insurance: Summary of Focus Group Results," California HealthCare Foundation, December 2000.

Future editions will identify trends in California's insurance markets, analyze regulatory and policy issues, and provide industry updates. Analyses will be posted as they become available at the California HealthCare Foundation's Web site at **www.chcf.org**.

The California HealthCare Foundation's program area on Health Insurance Markets and the Uninsured seeks to improve the functioning of California's health insurance markets, particularly the small group and individual markets, and to expand coverage to the uninsured. For information on the work of Health Insurance Markets and the Uninsured, contact us at **insurance@chcf.org**.

ENDNOTES

1. In this document, "insurance carrier" or "carrier" is used to refer generically to both health plans regulated by the Department of Managed Health Care (DMHC) and insurers regulated under the California Department of Insurance (CDI).

2. More information about health insurance market protections in all fifty states is available at **http://www.healthinsuranceinfo.net/**, a site sponsored by the Institute for Health Care Research and Policy at Georgetown University, and at the Blue Cross and Blue Shield Association Web site, **http://bcbshealthissues.com/state/appendix/C_StateSmallGroup.pdf** and **http://bcbshealthissues.com/state/appendix/EG_SSGRIRLadd.pdf**.

3. For more information on ERISA and California law, see "Regulatory Oversight of Health Insurance in California," and "Regulation of ERISA Plans: The Interplay of ERISA and California Law," available at **www.chcf.org**.