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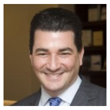

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Obamacare Faces A 'Death Spiral' -- But It Turns On The Declining Participation Of Health Plans, Not Just Rising Premiums

Given the failed launch of Obamacare, there's a real chance that the entire scheme falls into an "insurance death spiral" — but not as visibly (or rapidly) as the way these sorts of unsuccessful insurance pools usually unravel.

A death spiral happens when only the sickest beneficiaries get into an insurance pool, causing the cost of medical claims to rise, and in turn raising future premiums.

These higher premiums, in turn, dissuade healthier beneficiaries from buying coverage. This exacerbates the strains and makes sure the pool continues to attract only the sickest consumers who are most in need of the medical coverage, and willing to pay the rising premiums. This is how the downward spiral ensues.

Commentators have rightly noted here and here that Obamacare contains some provisions to guard against this sort of outcome. Chief among them are "risk corridors" that limit the losses insurers would face from higher-than-expected medical claims, as well as a pool of money (collected off a tax that is imposed on all non-exchange insurance products) to offset some of the rising costs and provisions that fix premiums as a percentage of peoples' income (at least until 2018, when some of the ACA's reinsurance programs sunset, although the risk adjustment provisions continue).

But these provisions don't eliminate the possibility of adverse selection against the Obamacare exchanges, and a downward spiral for these health plans, if younger and healthier consumers don't enroll this year.

For one thing, the exchange health plans would have to skinny down their networks, and benefits, to control rising costs. Meanwhile, plans sold entirely outside the exchanges will be subject to a different risk pool, and as a result, lower pricing.

Over time, conforming and non-conforming insurance policies sold entirely outside the exchanges could look increasingly attractive to consumers; even accounting for the subsidies many people would get for staying inside the exchanges.

Health plans would be encouraged to drop out of the exchanges, or in the case of national insurers like Aetna [NYSE:AET] and United Healthcare [NYSE:UNH] and Cigna [NYSE:CI] (who have largely stayed out of these schemes) decide not to get in. For these insurers, their decision to stay out of the exchanges is looking smart.

The risk adjustment only reduces, but doesn't eliminate the loss that insurers would take if the exchanges attract older, sicker consumers this year.

The potential woes stem from an oversight made by the architects of Obamacare.

Under the law, insurers who offer policies inside the Obamacare exchanges are required to treat their enrollees inside and outside the exchange as a single risk pool. Among other things, this provision was meant to reduce the chance that insurers would steer healthier patients into plans sold outside the exchanges.

But the law doesn't prevent insurers from offering plans exclusively outside the exchange. If they are entirely outside the exchange, they get to create their own risk pool, and aren't subject to the same pricing that burdens plans inside the exchange. (See this Commonwealth Fund Brief for a fuller explanation)

As the pool inside the exchange becomes older, sicker, and costlier, more plans will have an economic incentive to get out of the Obamacare market altogether.

Once outside, they are free to price their products to match a better risk pool.

Other provisions will further encourage plans to drop out.

While an insurer inside the exchange is required to offer (at least) one silver plan and one gold plan, outside the exchange there's no such requirement.

So an insurer could offer only the lowest cost "bronze" options outside the exchange, to attract healthier members. Since they are outside the exchange risk pool, they could price these low cost plans to their healthier pool, rather than being required to price the plans to match the less healthy risk pool inside the exchanges.

Moreover, inside the exchanges, cost-sharing subsidies that reduce co-payments for lower-income beneficiaries, only attach to "silver" plans. This is another way in which the "bronze" plans sold entirely outside these exchanges could look attractive (even for low income individuals) to comparable plans sold in the exchanges.

While consumers wouldn't have the benefit of subsidies outside the exchange, it's possible that for younger individuals, the plans sold entirely outside the costlier exchange-based risk pools could be more attractive than plans sold inside these markets. Even for those who make less than 400% of the federal poverty level (about $40,000 for a single person) and benefit from the subsidies, the risk pools completely outside the exchange could offer comparable, if not cheaper options.

The death spiral won't result from a big premium spike in 2015 as a consequence of the failed launch in 2014. The reinsurance programs and risk adjustment will help guard against such an outcome. But as the pool inside the exchanges becomes more akin to a high-risk pool, which seems possible (if not likely) then there will be a stronger incentive for insurers to stay out of these markets, and select against them.

The bigger story of the Obamacare launch isn't its failed website, but how many big insurers sat out of this program, even after brow beating from the White House.

After what's likely to unfold this year, and the unfavorable pool that's taking shape, these insurers will have even more economic incentive to stay out of Obamacare.

Trouble is, the architects of Obamacare never envisioned that the big insurers wouldn't play. That's why they forced insurers to conform to a single risk pool that assumed these carriers would be offering some of their plans inside the exchange.

Now that provision will add incentive for insurers to stay out of the exchanges altogether, and develop an exclusive risk pool in the individual market that remains behind, and price those products according to the lower risk of their members.

All this doesn't mean that the premiums won't see the effect of a declining risk pool. The risk adjustment sunsets, and over time, these premium subsidies are tied to the cost of living, not the cost of healthcare, which will rise faster. (By contrast, the cost sharing subsidies are tied to the cost of medical care in the risk pool). Moreover, the total value of the premium subsidies is eventually capped as a percentage of GDP.

But conservatives opposed to Obamacare shouldn't predict its imminent demise. Its architects were clever, and guarded against an immediately bad outcome.

But the failed launch this year (and the lack of participation by the big insurers) will make it far less likely that the second year is any kind of a rebound.

Instead, these exchanges could become a niche market for higher medical risk Americans and low-income families who will benefit the most from the subsidies.

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