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HEALTH INSURANCE REGULATION

Variation in Recent State Small Employer Health Insurance Reforms

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The Honorable Harris W. Fawell
Chairman, Subcommittee on Employer-Employee
Relations
Committee on Economic and Educational
Opportunities
House of Representatives

Dear Mr. Chairman:

Most state governments have recently passed legislation designed to improve portability, access, and rating practices for the small employer health insurance market and, to some extent, for the individual health insurance market. Currently, your Subcommittee is considering legislation that includes provisions to reach the same goals within a consistent and uniform national framework.

To assist your Subcommittee in its deliberations, you asked for an overview of what states have adopted thus far and a description of variations in ways states treated key components of their recently passed legislation. Specifically, you asked us to identify variations in how states define the types of small employers covered by their health insurance laws, focusing in particular on how these changes affect self-employed individuals and small employer insurance provided through group purchasing memberships or associations. You further asked us to provide detailed information on variations in state approaches to guaranteed issue and renewal provisions, premium rate restrictions, limitations on preexisting conditions, and renewability requirements as well as other key differences in state approaches.

To develop this information, we identified states that passed small employer health insurance reforms between 1990 and 1994. We reviewed the legislation or other available state materials describing key elements of these reforms. When necessary to clarify issues, we supplemented our review through discussions with state officials involved in the implementation of the reforms.

We used the National Association of Insurance Commissioners (NAIC) Small Employer Health Insurance Availability Model Act (#118) that was in effect in April 1993 as a benchmark for comparison of state plans. NAIC made significant amendments to this model in March 1995, but we used

the earlier version because it more closely characterized the NAIC position at the time most states passed their legislation. The NAIC model itself provides for substantial state flexibility in many of its specific provisions.[1] We conducted our work from April to May 1995 in accordance with generally accepted government auditing standards.

Background

Earlier studies consistently point to the high and rising cost of insurance as the key factor preventing small employers from offering coverage to their workers.[2] Some insurance practices exacerbate the problem by substantially increasing costs or denying coverage for some firms and workers. Consequently, most states have recently adopted some type of insurance market reforms designed to improve access and affordability of insurance for this segment of the population. Reforms include measures to help ensure that (1) employees who want health insurance coverage will be accepted and renewed by insurers; (2) waiting periods for preexisting conditions will be short, occur only once, and be based only on recent medical history; (3) coverage will be continuous and portable, even when an individual changes jobs or the employer changes insurers; and (4) extremes in premium costs will be narrowed to fall within ranges specified by the states.

States recognize the tough trade-offs involved in crafting reforms that may improve availability of health insurance for some but that could also raise average premiums. The reforms are intended to address a growing sense of unfairness in an insurance market in which individuals who change jobs or experience costly medical conditions can be excluded from coverage or effectively priced out of the market. On the other hand, these restrictive practices enable insurers to charge lower premiums to employers with young and healthy workers. Consequently, reforms may cause insurers to pass on the resulting costs to all consumers, thereby raising the average level of premiums.

In extending greater protections to consumers through tighter regulation of the insurance market, states also recognize the responsibility of consumers and employers in the insurance market. State requirements for

[1]To measure variation in state approaches, we used specific limitations in the NAIC model as benchmarks for comparison. For example, the NAIC model provides that carriers generally use no more than nine business classes for rate-setting purposes. We considered states that permitted fewer than five business classes or that did not allow carriers to establish any classes as major variations from the maximum of nine classes specified in the model.

[2]See Access to Health Insurance: State Efforts to Assist Small Businesses (GAO/HRD-92-90, May 14, 1992).

insurance carriers to guarantee coverage to individuals, for example, need to be balanced against the potential for some individuals to avoid obtaining coverage until they become sick. In requiring guarantees that insurance coverage would be renewed at reasonable rates for all current policyholders, states had to consider responsibilities of the employer to file honest and accurate claims and to continue paying premiums promptly. Defining and balancing the responsibilities of carriers, small employers, and consumers in the health insurance market became the source of much of the debate and variations among states in their reform efforts.

Overview: Comparison With the NAIC Model

We identified 45 states that passed legislation regulating the small employer health insurance market between 1990 and 1994. While most laws address commonly perceived small employer health insurance problems, including guaranteed issue and renewal, portability, limitations on preexisting conditions, rating practices, and minimum participation requirements, approaches adopted by the states vary, often substantially, with no states following the NAIC model on all of the key provisions. (See sec. 1.)

Defining Who Is Covered by State Laws

There is substantial variation among states in both the way they define small employers and how they define which employees are eligible for coverage. Differences in how a full-time worker is defined and whether part-time or temporary workers are covered are among the sources of state variation.

Whether to extend provisions of the state reforms to self-employed individuals was among the most contentious issues the states faced. Only 20 states include the self-employed; moreover, all provisions of the state reforms, most notably those requiring carriers to guarantee coverage, are not always extended to the self-employed. We also identified 15 states that passed separate legislation regulating health insurance plans that cover individuals. Reflecting this state variation, NAIC recently amended its model legislation by changing the definition of small employer to include self-employed individuals and deleting any reference to a maximum number of employees. Treatment of more complex insurance arrangements through multiple employer welfare arrangements (MEWA) and insured plans offered through fraternal organizations or trade associations are often not clearly delineated in the state reforms. (See sec. 2.)

Substantial Variation in Specific Provisions of State Laws

Provisions affecting guaranteed issue, guaranteed renewal, limitations on preexisting conditions, portability, and premium rate restrictions are included in most state reforms, but most states deviate, often substantially, from at least one of these key provisions as defined in the NAIC model. The provision least likely to be adopted by states is guaranteed issue of insurance products. Even those including guaranteed issue typically deviate from the NAIC model in at least one of the following dimensions: definition of small employers, the number of plans that carriers must guarantee issue, or the characteristics of guaranteed plans. All but one state include guaranteed renewal of policies in their reforms. Guaranteed renewal provisions tend to have only minor variations from the NAIC model.

State reforms typically include limitations on preexisting condition exclusions and portability requirements that waive any preexisting conditions or waiting periods for individuals who change plans and can demonstrate previous coverage under another plan. States, however, differ in the waiting periods required for coverage to take effect.

Most of the state laws also place some restrictions on insurer rating practices—that is, the way insurers determine prices of the health insurance products at initial issuance and/or at time of renewal. State restrictions on rating practices used by insurers are probably the most variable and controversial element of state reforms. While 28 states employ the rate-banding approach in the NAIC model, most of them made significant changes in how they use the relatively complex rate-banding methodology.[3] Sixteen states took a different course, generally using an adjusted community rating approach that allows no adjustments based on the claims or health experience of the group covered.

State variations in approach are evident in many of the elements of rate determination, including the premium rate adjustment factors allowed in setting rates, premium variation permitted, number of business classes for which carriers can define separate rates, and permitted increase in rates at renewal. For example, some states added adjustment factors such as nicotine use, participation in wellness programs, or unhealthy lifestyles to the age, family size, geographic area, gender, industry, and group size case factors specified by NAIC. (See sec. 3.) More detailed information comparing each state's reforms with the NAIC model is in appendix I.

[3]The NAIC rate-banding approach limits the insurer to nine separate business classes for which it can charge separate rates. The model also restricts the variation in premiums the insurer can charge to firms that fall into one of these classes and further restricts the variation allowed among business classes.

This report provides some initial information on small employer health insurance reform issues. You also expressed interest in more information on the impact of these reforms. Since many of them were passed recently, little evaluative information rooted in solid data is currently available. We are continuing to investigate the effectiveness of these reforms.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request. Please contact me at (202) 512-7119 if you have any questions. Major contributors to this report are listed in appendix II.

Sincerely yours,

Sarah F. Jaggar
Director, Health Financing
and Policy Issues

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Abbreviations

ERISA	Employee Retirement Income Security Act of 1974
MEWA	multiple employer welfare arrangement
NAIC	National Association of Insurance Commissioners

Recent State Reforms: Comparison With the NAIC Model

Growing concerns about the availability and affordability of health insurance coverage for the workers of small employers led to a flurry of state legislative activity in the early 1990s. Between 1990 and 1994, at least 45 states passed legislation that modified the terms and conditions under which health insurance is offered to small employers. During the same period, at least 15 states also passed legislation affecting the offerings of insurance to individuals.

There are substantial variations in the way states approached small employer health insurance reforms. This report identifies the most common types of reforms introduced and delineates some of the differences among states on key elements of those reforms.

The NAIC Small Employer Health Insurance Availability Model Act

State insurance regulators established the National Association of Insurance Commissioners (NAIC) to promote effective insurance regulation and encourage uniformity in state approaches to regulation. NAIC has developed legislative models for states to use in formulating licensing and regulation requirements for all lines of insurance under the purview of state insurance departments. Many states adopt NAIC models in whole or in part, but NAIC has no authority to require states to adopt them.

NAIC has developed and refined its Small Employer Health Insurance Availability Model Act, which serves as the basis of substantial portions of many state reform laws. We used the NAIC model as a benchmark or reference point for assessing the extent to which states vary in their treatment of key components.[4] This section discusses key components of the small employer health insurance reforms in the NAIC model. Later sections take a more detailed look at how states deviate from the model.

Small Employer Definition

The NAIC model addresses insurance policies for small employers with no more than 25 eligible workers. (However, all of the model's provisions do not apply to all such employers.)

Applicability

The NAIC model applies to any carrier-provided health benefit plan that covers the eligible workers of a small employer in the state. Eligible

[4]As a specific benchmark, we used NAIC model #118, which reflects NAIC recommendations as of April 1993. This model most closely reflects the NAIC position at the time most states introduced their reforms. In March 1995, NAIC amended the model to introduce adjusted community rating provisions, to expand the definition of small employer, to require guaranteed issue of all products, and for other purposes.

employees are defined as full-time (30 hours or more) workers and include sole proprietors, a partner in a partnership, and independent contractors. The model permits carriers to require a minimum number of eligible employees to participate in a small employer's health plan as long as the carrier imposes the minimum consistently across all employers of the same size.

A carrier is defined as any entity that provides health insurance that is subject to state regulation, including insurance companies, prepaid hospital or medical care plans (such as some Blue Cross and Blue Shield plans), and health maintenance organizations. The model also applies to multiple employer welfare arrangements (MEWA). It is more difficult to assess the extent to which the model applies to other organizations that may provide or serve as intermediaries for health plans (including collectively bargained Taft-Hartley plans and fully insured plans offered by fraternal benefit societies and trade associations). The model indicates that it applies to any similar entity subject to state regulation.

Guaranteed Issue

The NAIC model requires all carriers to actively offer at least two health plans (a basic and a standard plan) to small employers within the state. The model reserves to states substantial flexibility in defining the coverage requirements for these plans, suggesting only that a state appoint a commission composed of representatives of carriers, small employers and employees, health care providers and producers to define the two types of benefit packages. NAIC characterized the basic plan as a "bare bones" package providing coverage at lower cost by excluding state-mandated benefits or by requiring high deductibles, coinsurance, or low lifetime maximums. NAIC characterized the standard benefit package as representing average or typical plans in the state.

Guaranteed Renewal

The NAIC model requires that all policies be renewed regardless of health status or claims experience of plan participants with limited exceptions, such as cases of fraud or failure to pay premiums.

Preexisting Condition Limitations

The NAIC model permits carriers to deny coverage for preexisting conditions for no more than 12 months after coverage is effective. A preexisting condition is one that was diagnosed or treated during the 6 months immediately preceding the effective date of coverage.

Portability

The NAIC model requires carriers to waive a preexisting condition period for covered services if comparable services were previously covered under another policy that was continuous to a date not more than 90 days prior to the effective date of the new coverage.

Restrictions Related to Premium Rates

Under the NAIC model, carriers are subject to a number of restrictions on (1) the factors they can use in setting rates, (2) the number of business classes for which they can charge different rates, (3) the variation allowed in rates within a business class, (4) the variation allowed in rates among business classes, and (5) the amount of increase in rates permitted at the time of renewal. The restrictions are as follows:

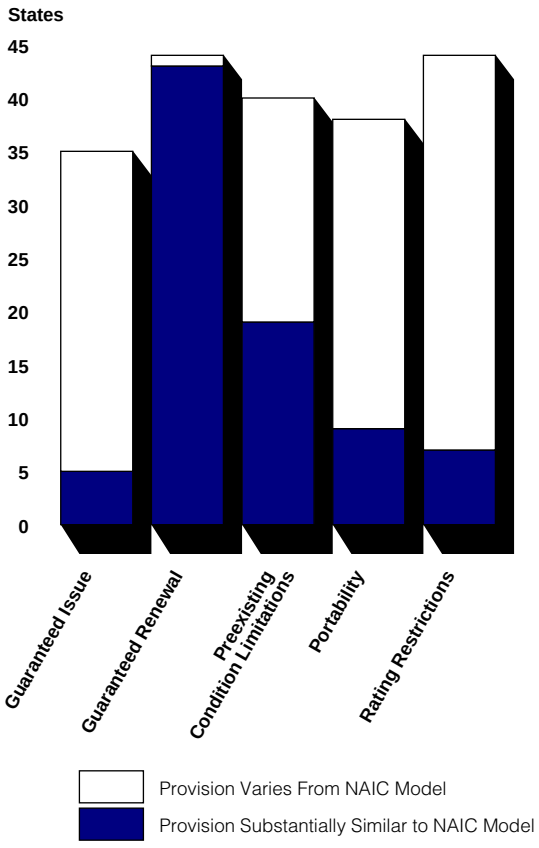
- Premium rate adjustment factors—The NAIC model stipulates that carriers "shall not use case characteristics other than age, gender, industry, geographic area, family composition, and group [employer] size" in determining rates. Other consistently applied case characteristics can be employed only with approval of the state insurance commissioner. But the model specifically lists claim experience, health status, and duration of coverage as factors that cannot be used as case characteristics in rate determination.
- Business classes—Small employer carriers may establish rates for up to nine separate business classes for rating purposes to reflect substantial differences in expected claims experience or administrative costs. Additional business classes may be used only with approval of the state insurance commissioner.
- Rate differences between classes—The difference between the "index" or average premium rate for any business class should not exceed the index for any other business class by more than 20 percent.
- Premium rate differences within a single business class—The lowest or base rate charged should be no lower than 25 percent below the index rate. The highest rate allowed within that same business class would be no more than 25 percent above the index rate.
- Restrictions on premium rate increases at renewal—Increases in premium rates for a new rating period cannot exceed more than 15 percent annually because of the claims experience of the group. Additional increases are permitted for any changes in coverage or case characteristics of the covered population and for changes in premium levels charged to all insured health plans.

State Variation From NAIC Model

Important differences surface among states as to how a small employer is defined and how a state determines applicability of the law to different types of employers. There are even more substantial differences in the way states treat individuals who wish to purchase health insurance.

Figure 1.1 shows the extent to which states adopted key reform strategies and the extent to which they essentially followed or modified the NAIC approach for five specific provisions we investigated. We found that all 45 states that passed reforms in the 1990s changed at least one of the key provisions of the NAIC model.

Figure 1.1: States Adopting NAIC Model Provisions



Thirty-five of 45 states passed guaranteed issue provisions, but in our judgment only about half of them closely followed the NAIC model. They typically varied from the model in the types or numbers of plans for which guaranteed issue applied or in the characteristics of small employers to which guaranteed issue applied. States were more likely to pass guaranteed renewal legislation and more closely follow NAIC guidelines in that area.

Both preexisting conditions and portability clauses were included in most state laws. States tended to deviate from the NAIC model particularly with respect to the length of time associated with these clauses.

Some type of rating restrictions were included in all 45 state laws, but the states' approaches to rating varied substantially.

Defining Who Is Covered by State Small Employer Health Insurance Reforms

Before examining variations in specific provisions of the small employer health insurance reforms, it is essential to note that states adopted different approaches toward defining a small employer, an eligible worker of a small employer, a carrier, and associations that offer insurance to small employers. States struggled with applicability of the law particularly in regard to the self-employed or groups of one to three eligible employees and in defining an approach to multiple employer plans. Indeed, several states passed separate legislation governing provision of insurance to individuals. NAIC is working on model legislation to cover state reforms in the individual market.

Defining Employers Covered by Reforms

The NAIC model defines a small employer as any person, firm, corporation, partnership, or association that is actively engaged in business that, on at least 50 percent of the working days during the preceding calendar quarter, employed no more than 25 eligible employees, the majority of whom were employed within the state. The guaranteed issue provisions would apply only to firms with 3 to 25 workers.[5] This provision on minimum employer size was included to protect small employer carriers from adverse selection.

States vary from the NAIC model on both ends of the spectrum regarding firm size. Most commonly, states extend the maximum to employers with about 50 eligible workers (2 states set the limit at 100 eligible workers). Differences at the lower end are more controversial. Some states exempt employers with fewer than three workers not only from guaranteed issue provisions, but also from all other provisions of the state reforms. Others also extend guaranteed issue to employers with 1 (11 states) or 2 (14 states) eligible workers. Arizona's guaranteed issue requirements currently apply to employers with 25 to 40 eligible workers, while other provisions apply to employers with 3 to 40 workers.

Several states phase in the requirements over time for different size employers. California, for example, initially applied guaranteed issue requirements to employers with 5 to 50 workers, but will apply the requirements to employers with as few as 3 workers effective July 1, 1995.

States tend to follow the NAIC model in applying the law to the broadest range of employer types. Some states include language to ensure that particular types of employers would be included or excluded. For

[5]The 1995 amendments to the NAIC model changed the size to include as few as 1 self-employed individual and removed the upper limit of 25, leaving the maximum to the state's discretion.

example, Wisconsin specifically includes a farm business and certain village or town governments as employers covered by its legislation. California does not require that small government units be protected under its small employer health insurance legislation because they already have the option of obtaining insurance through a state-sponsored health purchasing alliance.[6]

Defining Eligible Employees

The NAIC model defines an eligible employee as one who works on a full-time basis with a normal work week of 30 hours or more. The term includes a sole proprietor, a partner of a partnership, and an independent contractor if this person is included as an employee under a small employer's health benefit plan. "Eligible employee" does not include an employee who works on a part-time, temporary, or substitute basis. The model permits carriers to impose a minimum employee participation requirement on small employer plans as long as they do so consistently across all employers of the same size.

Several states modified requirements pertaining to eligible employees. At least six states reduced the required normal work week to 17.5 through 25 hours. For example, Minnesota legislation includes employees with a normal work week of 20 hours. States generally do not extend the provision to part-time, temporary, or substitute employees. However, at least eight states do not define "eligible employee" and two states explicitly give employers the option of including part-time employees. For example, carriers in New Hampshire would have to guarantee issue and follow other provisions of the act for any small employer who chooses to offer insurance benefits to part-time workers. Finally, at least eight states also impose restrictions on carriers' use of minimum participation requirements. Four states permit carriers to impose a requirement of no more than 75 percent, four states impose a 75- through 90-percent minimum participation requirement on carriers or employers, and one state does not permit carriers to use any minimum participation requirement for groups of four or more.

Self-Employed and Individual Coverage

States that extend guaranteed issue and other provisions of their small employer health insurance reforms to firms with one eligible employee (that is, self-employed individual with no employees) typically require that the person covered have sufficient documentation to verify his or her

[6]See Health Insurance: California Public Employees' Alliance Has Reduced Recent Premium Growth (GAO/HEHS-94-40, Nov. 22, 1993).

status as self-employed. Individuals who are not self-employed are generally not protected by the small employer reforms. States that attempt to extend rating protections or guarantees of coverage to individuals who are not self-employed generally do so through separate individual market reform legislation.

We have identified at least 15 states that have passed some type of individual market reform. At least 10 of the states closely follow most of the provisions in their small employer reforms. In four of the states, the individual reforms only include insurance rating restrictions.

NAIC is currently drafting model legislation for states regarding health insurance for individuals. Initially, NAIC attempted to develop model legislation that included both individual and small employer coverage but recognized the different insurance market characteristics of employed individuals and those who are not attached to the workforce.

Defining the Carrier

Most states follow the NAIC model definition of an insurance carrier as any entity that provides health insurance in the state. Carriers are defined to include insurance companies, prepaid hospital or medical care plans such as some Blue Cross and Blue Shield, health maintenance organizations, and any other entity providing a plan of health insurance or health benefits subject to state regulation.

States have the most trouble in dealing with entities that provide coverage to a number of small employers or individuals through some type of group purchasing process. These organizations argue that they are not carriers, that small employer insurance reforms do not apply to them because they cover large groups, or that they are exempt from state regulation under the federal Employee Retirement Income Security Act of 1974 (ERISA, P.L. 93-406). Some of the differences in how these types of group purchasing associations are treated are discussed next.

Multiple Employer Welfare Arrangements

ERISA defines MEWAs as employee welfare benefit plans or similar arrangements, including health plans, established or maintained for the purpose of offering or providing benefits typically provided by an employee welfare benefit plan to employees of two or more employers. The term does not, however, include such arrangements when they are established under a collective bargaining agreement or by a rural electric cooperative. Generally, ERISA broadly preempts states from regulating

employee welfare benefit plans but allows them to retain greater authority to regulate MEWAs whether or not they are employee welfare benefit plans. Under ERISA, any MEWA that is an employee welfare benefit plan and fully insured is subject to certain state insurance laws and regulations that a state may impose. In addition, self-insured MEWAs are subject to any state insurance laws that are not inconsistent with ERISA.

Furthermore, the 1982 amendments to ERISA that created the MEWA provisions leave MEWAs that are not employee welfare benefit plans fully subject to state regulation.

A drafting note to the NAIC model suggests that states include MEWAs within the list of carriers covered by state provisions if a state licenses MEWAs. NAIC further suggests that states that do not have separate licensing for self-funded MEWAs should treat them as unauthorized insurers. Some states chose to specifically include MEWAs in their legislation. Others did not, but it is not always clear whether MEWAs were intended to be excluded or whether the states expected them to be covered under the clause covering "any other entity providing a plan of health insurance or health benefits subject to state insurance regulation."

Murkiness in State Definition and Treatment of Association Plans

Fraternal organizations, trade associations, and unions are entities that may offer health plans to small employers and individuals. Whether the state's small employer health insurance laws apply to such entities is often unclear, differs among states, and reflects sharp differences in how states define and regulate these types of entities.

- Fraternal organization plans—A drafting note to the NAIC model suggests that states enact language that would include plans offered by fraternal benefit societies. Several states have done so, but many have not expressly included fraternal benefit organizations within their legislation. In our discussions with state officials, those from at least two states indicated that separate legislation covered fraternal benefit plans operating in their states. Since these plans are not explicitly included in the states' small employer reform legislation, the officials were uncertain whether any of the reform provisions are applicable to the fraternal benefit plans.
- Association plans—A number of small businesses and individuals obtain health insurance coverage through trade or other association plans. The NAIC model is silent on association plans that potentially insure a

substantial share of the small employer market,[7] but states have taken a variety of approaches to deal with them. Montana, for example, exempts association plans if they guarantee issue to their members. Vermont and New Hampshire allow association plans to use their own community rate. California took the approach of defining guaranteed associations by expanding the definition of small employer to include any "guaranteed association" acting on behalf of individuals or employers meeting the association's membership criteria to purchase health insurance. Any association that meets the definitional requirements in California law would be afforded the protections of the state's small employer health insurance reforms, including but not limited to guaranteed renewal of the plan for all of its individual and employer members.[8]

- Taft-Hartley plans—Taft-Hartley plans are essentially union-organized plans that provide, for example, health coverage under collectively bargained agreements. The NAIC model provides that a state require such plans to seek written approval from the insurance commissioner for waiver of the insurance rating provisions of the state's reform law. Some states included this requirement. However, an official in one state said it was unnecessary to include it because Taft-Hartley plans are exempt from state regulation under ERISA, which preempts all state laws related to employee benefit plans. Recognizing that ERISA preempts state regulation of Taft-Hartley plans, NAIC deleted the language at issue from the most recent version of the model.

State officials we contacted had differing interpretations concerning the role of states in regulation of both fraternal organization and association plans. One interpretation is that association plans are intermediaries offering insured products; thus, any state regulation should be directed toward the insuring entity. Another state official contended that associations domiciled in other states assert that any other state's laws do not apply. Some plans may be inappropriately claiming they are not subject to the state laws because they are exempt under ERISA. States maintain that they often cannot identify such plans until an already serious problem is brought to the attention of the insurance commissioner's office.

[7]Information on the extensiveness of association plan coverage is limited. One state official estimated that about one-fourth of the small employer market in that state was probably covered by association plans. A recent article estimated that about 17 percent of small firms nationally obtain insurance through association plans. Definitions and structure of association plans vary widely. We are conducting further work for your Subcommittee on the role of association plans in the small employer insurance market.

[8]The California law requires that the guaranteed association plan cover at least 1,000 people with each carrier with which it contracts.

Variations in State Approaches: Guaranteed Issue and Renewal, Preexisting Conditions, Portability, and Rating Reforms

Most states included guaranteed issue, guaranteed renewal, preexisting condition limitations, and portability provisions in their small employer health insurance reform legislation.[9] Except for guaranteed renewal, most states deviated, often in substantial ways, from the NAIC model. Guaranteed issue was frequently modified and, in several instances, omitted from state reforms altogether. While premium rate restrictions are more commonly included in state reforms, there is less adherence to the more complex provisions of the NAIC model. Most states also included preexisting conditions and portability in their small employer statutes. Nearly half of them essentially followed the NAIC model with respect to preexisting condition limitations, and about one-fifth did so with respect to portability. (See fig. 1.1.)

Guaranteed Issue

At least nine states did not include guaranteed issue provisions in their reforms: Arkansas, Georgia, Illinois, Indiana, Louisiana, New Mexico, South Dakota, Utah, and West Virginia.

Among the 35 states where guaranteed issue was included, there were often significant variations in the number or types of plans an individual carrier was required to offer to all small employers. In 10 states, insurers were required to guarantee issue all plans that they offered in the small employer market. Guaranteed issue of only one plan was required in six states. One state required carriers to offer five guaranteed issue products. Only 18 states followed the NAIC model in offering 2 plans. These states typically offered something akin to the NAIC standard and basic plans (the latter was sometimes labeled “bare bones” or “minimum” plan in state legislation).

Even the states that offered the two plans suggested by NAIC often deviated from the NAIC model in other important ways. The most notable variation was in the size of the employer subject to guaranteed issue provisions. As noted previously, several states extended guaranteed issue to self-employed individuals and employers with only two eligible workers, while others extended guaranteed issue to larger employers.

The actual benefit structure of the basic and standard plans is a potential source of even more variation in state reform legislation. While most states followed NAIC suggestions to have a state board or commission define these benefit packages, composition of the boards coupled with

[9]Washington passed the comprehensive Health Services Act in 1993 that included all of these provisions. However, since the reform was not specifically designed for the small employer market, Washington is not included in the following discussion.

differences in health industry and structure in the states further contributed to differences in the product subject to guaranteed issue. Among the issues debated within states are size of deductibles or copayments and whether specific services like mental health are covered. We did not try to assess the full range of differences in benefit structure.

Guaranteed Renewal

Every state we examined except Georgia included guaranteed renewal within recent reform legislation. Most states followed NAIC provisions by limiting cases where an insurer can refuse to renew coverage to incidents of fraud or failure to make required payments. It is interesting to note that 8 of the 43 states that included guaranteed renewal did not have guaranteed issue provisions.

Preexisting Condition Limitations

Only 4 of the 44 states had no provision limiting the use of preexisting conditions to deny coverage for specific illnesses. The NAIC model stipulates that an insurer may deny, exclude, or limit benefits for a covered individual's losses incurred no more than 12 months following the effective date of coverage because of a preexisting condition. Preexisting conditions should not be more restrictively defined than

- a condition that would have caused an ordinarily prudent person to seek medical advice, diagnosis, care, or treatment during the 6 months immediately preceding the effective date of coverage;
- a condition for which medical advice, diagnosis, care, or treatment was recommended or received during the 6 months immediately preceding the effective date of coverage; or
- a pregnancy existing on the effective date of coverage.

About half of the states follow the NAIC provisions with respect to both the 6-month period before coverage as the appropriate length of time for defining preexisting conditions and the maximum 12-month waiting period after the coverage is effective.

The two most common changes to NAIC's guidelines were (1) to extend the definition of "preexisting condition" from a condition diagnosed or treated 6 months before the effective date of coverage to one diagnosed or treated 12 months before (11 states) and (2) to shorten the waiting period before a preexisting condition is covered to 6 months (6 states). Four states deviated further from the time periods suggested in the NAIC model. At one extreme, Maryland eliminated preexisting conditions entirely as a basis for

limiting coverage for any illness or condition. In sharp contrast, Montana's reform legislation built on previous legislation that permits insurers to limit coverage for preexisting conditions that arose up to 5 years before coverage became effective.

We identified at least three states that did not include a specific statement regarding pregnancy on the effective date of coverage and had a 6-month period for defining preexisting conditions, leaving uncertainty as to whether some preexisting pregnancies would be covered.

Portability

Thirty-eight states included a portability provision in their small employer health insurance legislation. Portability provisions require carriers to waive any preexisting condition or waiting period before an individual is covered. Portability applies to individuals who had previous health insurance coverage that was continuous to a date not more than 90 days prior to the effective date of the new coverage. Nine states used the 90-day waiting period, while 29 states changed that period, generally reducing it to either 30 or 60 days.

Portability becomes a more complicated issue when an employer switches to a policy that has different limitations on services or conditions covered. For example, if a person switches from a plan that does not include coverage for mental health services to one that does, a question arises as to whether the carrier would be required to waive preexisting condition limitations for this service. Most states follow the NAIC model, which does not require carriers to do so. However, we identified 15 of the states with portability provisions that do not have any specific linkage requirement between coverages in current and prior policies. In these cases, preexisting conditions for all services covered under the new policy would presumably be waived.

Premium Rate Restrictions

At least 44 states included premium rate restrictions as part of reforms passed between 1990 and 1994. Most followed a variation of NAIC's rate-banding approach or used other approaches, such as adjusted community rating. (See table 3.1.) Premium rate restrictions include many complex and technical provisions. Some of the key sources of differences among state approaches are highlighted here with the understanding that interaction among specific state provisions and additional detailed provisions also contribute to state variation.

Table 3.1: State Approaches to Premium Rate Restrictions

Approach	States
NAIC rate banding	7
Modified NAIC	21
Adjusted community rating or other	16

The approach to premium rating NAIC used in its model prior to the 1995 amendments permitted insurers to define up to nine business classes and to allow claims experience as an adjustment factor for determining rates at the group level but not for determining any individual employee's rate. Earlier this year, NAIC amended the rating methodology by abandoning the separate rate classes and eliminating any adjustments for claims experience. This simpler rating methodology comes closer to an adjusted community rating methodology.

Indeed, NAIC's recent model amendments reflect recognition that many states did not use the banding approach because it was too complex. Some states also considered the earlier NAIC approach too lax in the restrictions placed on carriers' rating flexibility. Thus, a number of states opted for narrower rating bands or chose an adjusted community rating methodology.

NAIC officials characterized the organization's recent decision to build adjusted community rating into its model as a highly contentious one. As a compromise, adjusted community rating was included in the amended model but was followed by a drafting note stating that NAIC does not endorse this or any particular approach to premium rate restrictions. Changes in the model reflect the constantly changing and dynamic nature of health insurance markets.

At least 21 states modified the NAIC rate-banding approach. States most commonly modified provisions relating to the number of allowable rating factors and business classes carriers may use in setting rates, the degree of permitted variation in index rates among business classes, and the degree of permitted premium rate variation within a class. (See table 3.2.)

Table 3.2: States That Modified Key NAIC Rating Provisions

NAIC rating provision modified	States
Allowable premium rate adjustment factors	17
Allowable business classes	13
Index rate variation among classes	7
Premium rate variation within classes	10

The modifications made by 11 states are limited to the number of premium rate adjustment factors or business classes carriers may use. For example, Iowa places no explicit limit on the number of allowable business classes and removes industry and gender as allowable rate adjustment factors. Montana does not enumerate the allowable rate adjustment factors but otherwise follows the NAIC approach fully. More significantly, 10 states modified the permitted rate variations within or among business classes. For example, North Dakota permits index rates among classes to vary by no more than 15 percent (NAIC permits 20 percent) and premium rates within a class to vary from the index rate by no more than 20 percent (NAIC permits 25 percent). In Ohio, premium rates within a class may vary from the index rate by as much as 35 percent with exceptions that permit even further variation, and no limits are placed on index rate variation among business classes.

While at least 28 states use NAIC's rate-banding approach or a variant, 16 states use some other approach to rate restrictions—generally a form of adjusted community rating. States using adjusted community rating permit adjustments in the community rate for various factors and impose various limits on the extent to which rates, after adjustments, may vary. For example, in New Hampshire, premium rates may be adjusted only for age in a range of 50 percent above or below the community rate for policyholders with similar family compositions. Maine permits several additional adjustment factors to be used but limits rate variation to a range of 33 percent above or below the community rate.

Table 3.3 shows the allowable premium rate adjustment factors in states using a rate-banding approach and an adjusted community rating approach.

Table 3.3: States Using Specific Premium Rate Adjustment Factors

Adjustment factor	NAIC rate-banding approach or variation	Adjusted community rating and other
Age	15	13
Family size	14	12
Geography	15	12
Gender	13	6
Industry	12	4
Group (employer) size	12	3
Smoking practices	2	2
Not specified	12	1
Other	2	5

The NAIC model does not specify allowable ranges or limitations on specific premium rate adjustment factors beyond a limitation that adjustments for industry not vary by more than 15 percent. Some states specify how individual factors are to be used. Treatment of age, for example, differs widely. Many states permit carriers to use any age ranges they wish to determine premium rates, while other states permit carriers to use only certain age categories. For example, California permits the use of only seven age categories—younger than 30, 30 to 49, 40 to 49, 50 to 54, 55 to 59, 60 to 64, and 65 and older. Finally, in addition to rate banding or adjusted community rating restrictions, at least four states also impose a minimum loss ratio[10] requirement on carriers of between 70 and 75 percent.

[10]Loss ratio is usually defined as the ratio of paid claims plus changes in funds set aside for future health claims to earned premiums.

Structure of State Small Employer Health Insurance Reforms

Table I.1: Variation in State Adoption of NAIC Model

State	Employer size (no. of employees)	Guaranteed issue (no. of plans/applicable employer size)	Guaranteed renewal	Portability	Preexisting condition exclusions	Restrictions related to premium rates
Alabama	—	—	—	—	—	—
Alaska	2-25	2 plans/2-25	X	X	X	Variation
Arizona	3-40	1 plan/25-40[a]	X	31[b]	12/12	Variation
Arkansas	X	—	X	—	—	Variation
California	4-50[c]	All plans/4-50[d]	X	30[b,e]	6/6	Other
Colorado	2-50[f]	2 plans[g]/2-50	X	X	6/6	Adjusted community rating
Connecticut	Less than 50	All plans/less than 50	X	30	X	Other
Delaware	1-50	2 plans/2-50	X	60	X	Variation
Florida	50 or less	All plans/1-50	X	30[b]	X	Adjusted community rating
Georgia	1-50	—	—	—	—	Other
Hawaii[h]	—	—	—	—	—	—
Idaho	1-49	2 plans/2-49	X	30	X	Variation
Illinois	3-25	—	X	30	12/12	Variation
Indiana	3-25	—	X[i]	—	—	Variation
Iowa	2-50	2 plans/2-50	X	X	X	Variation
Kansas	1-50	2 plans/1-50	X	31	6/90 days	X
Kentucky[j]	100 or less	1 plan/ 100 or less	X	60[b]	6/6	Adjusted community rating
Louisiana	3-35	—	X	60[b]	12/12	Variation
Maine	Less than 25	All plans/less than 25	X	X[k]	12/12	Adjusted community rating
Maryland	2-50	1 plan/2-50	X	N/A[l]	None	Adjusted community rating
Massachusetts	X	All plans/1-25[m]	X	30	6/6	Adjusted community rating
Michigan	—	—	—	—	—	—
Minnesota	2-29[n]	All plans/2-29	X	30[b]	X	Other
Mississippi	1-35	1 plan/1-25	X	30	12/12	Variation
Missouri	3-25	X	X	30	X	X
Montana	3-25	X	X	30	5 years/ 12 months	Variation
Nebraska	3-25	X	X	X	X	X
Nevada	—	—	—	—	—	—

(continued)

State	Employer size (no. of employees)	Guaranteed issue (no. of plans/applicable employer size)	Guaranteed renewal	Portability	Preexisting condition exclusions	Restrictions related to premium rates
New Hampshire	1-100	All plans/1-100	X	Not NAIC[o]	3/3/9[p]	Adjusted community rating
New Jersey	2-49	5 plans/2-49	X	X	6/6[q]	Adjusted community rating
New Mexico	2-50	—[r]	X	31	6/6	Variation
New York	3-50	All plans/3-50	X	60	X	Adjusted community rating
North Carolina	1-49	2 plans/1-49	X	60[b]	12/12	Adjusted community rating
North Dakota	X	2 plans/1-25	X	X	X	Variation
Ohio	2-50	2 plans/2-50	X	30[b]	X	Variation
Oklahoma	50 or less	2 plans/2-50	X	0[s]	X	X
Oregon	3-25	1 plan/3-25	X	30[b]	X	Other
Pennsylvania	—	—	—	—	—	—
Rhode Island	50 or less	2 plans/3-50	X	30	X	X
South Carolina	50 or less	2 plans/2-50	X	30	12/12	Variation
South Dakota	X	—	X	—	—	Variation
Tennessee	3-25	X	X	30[b]	12/12	Variation
Texas	3-50	All plans/3-50	X	60[b]	X	X
Utah	1-50	—	X	X	X	X
Vermont	1-49	All plans/1-49	N/A[t]	0[u]	12/12	Adjusted community rating
Virginia	2-49	2 plans/2-25	X	30[b]	12/12	Variation
Washington[v]	—	—	—	—	—	—
West Virginia	2-60	—	X	30[b]	12/12	Variation
Wisconsin	2-25	1 plan/2-25	X	30	X	Variation
Wyoming	2-25	2 plans/ 2 or more	X	X	X	Variation

Legend

— = No provision exists.
X = Provision is substantially similar to the NAIC provision.
N/A = Not applicable.

[a]This provision will be applicable to groups of 3-40 beginning on 7/1/96.

[b]The act does not specify that services covered previously must have been comparable to current coverage.

[c]On 7/1/95, the definition of small employer will be changed to 3-50.

[d]After 7/1/95, this provision applies to groups with 3 or more.

[e]This may be extended to 180 days in cases where an individual changes employers but still maintains employer-related coverage.

[f]As of 1/1/96, the small group definition will include a business group of 1.

[g]As of 1/1/96, this provision will also apply to a business group of 1.

[h]Hawaii was the first state to attempt universal coverage with its passage of the Prepaid Health Care Act in 1974. With the act's employer mandate and public programs to ensure coverage, the state comes closer to having universal coverage in place than any other state. Because this act was passed before the federal ERISA law, Hawaii is the only state granted an exemption under ERISA.

[i]Expressly refers to and limits cancellations.

[j]These reforms will be effective 7/15/95.

[k]The services covered under the portability provision differ based on whether an employee changes jobs or an employer changes coverage.

[l]Preexisting condition limitations are generally prohibited.

[m]A carrier has the option to deny issue to a group of 5 or fewer eligible persons if the group does not enroll through an intermediary.

[n]As of 7/1/95, the definition of small employer will be changed to 2-49.

[o]Time an individual was covered under a prior health plan must be credited toward any preexisting condition exclusion period of the new plan if there was no lapse in coverage. However, if a lapse in coverage resulted because of unemployment, carriers must treat the unemployment period as continuous coverage.

[p]A waiting period for preexisting conditions may be no more than 3 months if individuals incur no medical treatment expense in connection with the preexisting condition during those 3 months. Otherwise, the waiting period may be no longer than 9 months for a preexisting condition diagnosed or treated up to 3 months prior to the effective date of coverage.

[q]Preexisting condition limitations apply only to groups of five or fewer eligible employees and may not be imposed on larger groups.

[r]Related provision exists under state Health Alliance Act.

[s]Time an individual was covered under a prior health plan must be credited toward any preexisting condition exclusion period of the new plan if there was no lapse in coverage. The act does not specify that previously covered services must have been comparable to current coverage.

[t]State has continuous open enrollment.

[u]Preexisting condition period must be waived if substantially similar coverage under a prior policy was in effect for the previous 9 months. Does not provide for a lapse in coverage.

[v]Washington passed the Health Services Act in 1993 to create a universal coverage program for all residents through an employer mandate. This act included provisions to ensure the availability and affordability of health coverage to all residents of the state. Although the state did not pass separate small employer health insurance reform, the comprehensive act contains provisions that would ensure guaranteed issue (all plans), guaranteed renewal, limitations on preexisting condition waiting periods (3/3), portability of coverage (90 days), and adjusted community rating.

Table I.2: State Restrictions Related to Premium Rates

State	Restrictions
Alabama	No provision exists.
Alaska	Variation—Premium rates may vary within a range of 35% (2:1) of applicable index rate. No limit on the variation of index rates among business classes. No limit on the number of allowable classes.
Arizona	Variation—Accountable Health Plans cannot vary premium rates by more than 60% (4:1) from the applicable index rate. No limit on the variation of index rates among business classes. The act does not specify allowable demographic characteristics but excludes some factors. No limit on the number of classes, and the only allowable rating factors are family composition, geographic area, and demographic characteristics.
Arkansas	Variation—The act does not explicitly limit the number of business classes. Case characteristics are not specified but may not include claims experience, health status, or duration of coverage.
California	Other—Eligible employees are placed in a risk category based on age, geographic region, and family composition. Carriers assign a standard risk rate to each category with no limits imposed on the allowable variation in standard risk rates between categories. Within a category, premium rates may vary from the standard risk rate for individual employees by no more than 20% (1.5:1) for actual or anticipated claims experience. After 7/96, premium rate variation within a category is limited to 10% (1.2:1).
Colorado	Adjusted community rating—Adjustments limited to age, family size, and geographic area. For new business premium rates, the act allows an additional variation of 20% (1.5:1) for industry and class of business but not for health status. Beginning in 1998, no adjustments will be allowed.
Connecticut	Other—Premium rate variation limited to 120% of the base rate by year-end 1994 and will be phased out by 7/95 for groups of 1 to 25. After that, community rating with adjustments for age, gender, geographic area, industry, group size, and family composition for groups of 1 to 50.
Delaware	Variation—Within a class, a premium rate variation of 35% (2:1) of the applicable index rate is allowed with an additional combination variation of no more than 10% for age, family composition, and geography. Unhealthy lifestyles and industry are also allowable case characteristics. Unhealthy lifestyles include smoking or maintaining excessive weight, blood pressure, or cholesterol other than because of organic causes.
Florida	Adjusted community rating—Adjustments for gender, age, family composition, tobacco use, or geographic area.
Georgia	Other—Pool rating with adjustments allowable for age, sex, size, area, industry, occupational, and avocational factors. Based on these adjustments, the total premium may vary by not more than 25% (1.67:1) of the pool rate.
Hawaii	Reform is comprehensive, not specific to small employer insurance.
Idaho	Variation—Age and gender are the only allowable case characteristics.
Illinois	Variation—Case characteristics are not specified but may not include claims experience, health status, or duration of coverage.
Indiana	Variation—Premium rates cannot vary from the applicable index rate by more than 35% (2:1). Case characteristics are not specified but may not include claims experience, health status, or duration of coverage.
Iowa	Variation—No limit on the number of allowable classes, and industry and gender are not allowable case characteristics. Basic benefit coverage policies must return a cumulative loss ratio of at least 70%.
Kansas	Substantially similar to NAIC provision.

(continued)

State	Restrictions
Kentucky	Adjusted community rating—Adjustments for age, geography, family status, plan design, cost containment, participation in the alliance, and some discounts for healthy lifestyles. Healthy lifestyles have not yet been defined.
Louisiana	Variation—Premium rates within a class may not vary by more than 20% (1.5:1) of the applicable index rate until 1/1/96, then reduced to 10% (1.2:1). The allowable number of classes is essentially limited to 6. Case characteristics are not specified but may not include health status, claims experience, or duration of coverage.
Maine	Adjusted community rating—Adjustments for age, smoking, industry, geographic area, wellness programs, group size, and family status with an allowable variation of 33% (2:1). Allowable premium rate variation is annually decreased and will be phased out by 7/15/97.
Maryland	Adjusted community rating—Adjustments for age, geographic area, and family composition, with an allowable variation of 50% (3:1) until 6/30/95. This variation will gradually be decreased to 16% (1.38:1) after 7/1/97.
Massachusetts	Adjusted community rating—Premium rates must be set within a range of 2:1 with variation allowed for age, sex, industry, group size, and participation rate.
Michigan	No provision exists.
Minnesota	Other—Pure community rating after 7/1/97. Currently, adjustments for age 50% (3:1), geographic area 20% (1.5:1), and a general premium variation of 25% (1.67:1) that is based on health status, claims experience, and occupation. The general premium variation is to be decreased to 12.5% on 7/1/95.
Mississippi	Variation—Case characteristics are not specified but may not include claims experience, health status, or duration of coverage.
Missouri	Substantially similar to NAIC provision.
Montana	Variation—Allowable case characteristics are not specified but may not include claims experience, health status, or duration of coverage.
Nebraska	Substantially similar to NAIC provision.
Nevada	No provision exists.
New Hampshire	Adjusted community rating—Adjustments are permitted only for age within a range of 4:1 for the first year (1994) and 3:1 thereafter and for family size. Annual increases are limited to 25% plus increases related to industry trends and the age composition of the group generally.
New Jersey	Adjusted community rating—Adjustments are allowed only for age, gender, and geography, and rates can vary by no more than 300%. Also, the act imposes a minimum loss ratio of 75%.
New Mexico	Variation—The number of allowable business classes is limited to 2, and allowable case characteristics are limited to age, gender, geographic area, and smoking practices. Premium increases at renewal are generally limited to 10% for claims experience, health status, or duration of coverage, in addition to any increases related to overall industry trends such as medical cost inflation. Effective 7/1/98, community rating with an adjustment allowed only for 2 age categories—under 19 or over 19 years of age.
New York	Adjusted community rating—Adjustments permitted only for family composition and geographic area. Premium rate increases must be approved by the Commissioner unless carrier meets an anticipated minimum loss ratio requirement of 75%.
North Carolina	Adjusted community rating—Adjustments permitted only for age, gender, family composition, and geographic area.
North Dakota	Variation—Index rates may not vary among classes by more than 15% (1.35:1). Premium rates within a class may not vary by more than 20% (1.5:1) of the applicable index rate.
Ohio	Variation—There is no limit on index rate variation among classes of business. Premium rates within a class that vary by more than 35% (2:1) of the applicable index rate are subject to additional rate increase limitations. There is no explicit limit on the allowable number of classes. Allowable case characteristics are not specified but may not include health status, claims experience, and duration of coverage.
Oklahoma	Substantially similar to NAIC provision.

(continued)

State	Restrictions
Oregon	Other—Premium rates may not vary from the average rate in a geographic area by more than 33% (2:1), with adjustments allowed for family composition. Period-to-period increases may not exceed 15% plus any overall increases related to industry trends such as medical cost inflation.
Pennsylvania	No provision exists.
Rhode Island	Substantially similar to NAIC provision.
South Carolina	Variation—The act does not explicitly limit the allowable number of business classes.
South Dakota	Variation—The act does not specify the allowable case characteristics, but they may not include claims experience, health status, and duration of coverage. The act does not place an explicit limit on the allowable number of business classes.
Tennessee	Variation—Index rates may not vary among classes by more than 25% (1.67:1). Premium rates within a class may not vary by more than 35% (2:1) of the applicable index rate. The allowable numbers of business classes and case characteristics are not specified, but case characteristics may not include claims experience, health status, or duration of coverage.
Texas	Substantially similar to NAIC provision.
Utah	Substantially similar to NAIC provision.
Vermont	Adjusted community rating—Limited adjustments that may produce rates that vary by no more than 20% (1.5:1) from the community rate.
Virginia	Variation—There is no limit on index rate variation among classes. Premium rates within a class may vary by no more than 20% (1.5:1) of the applicable index rate. There is no explicit limit on the number of allowable business classes, and case characteristics are not specified but may not include claims experience, health status, and duration of coverage.
Washington	Reform is comprehensive, not specific to small employer insurance.
West Virginia	Variation—Case characteristics are not specified but may not include claims experience, health status, or duration of coverage. The allowable number of business classes is limited to 4. In order to increase rates at renewal, carriers must meet an anticipated minimum loss ratio requirement of 73%.
Wisconsin	Variation—No limit on variation of index rates among business classes. Premium rates cannot vary from the applicable index rate by more than 30% (1.86:1). Case characteristics are not explicitly specified but may not include claims experience, health status, or duration of coverage.
Wyoming	Variation—The act does not specifically limit the allowable number of business classes.

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