"Preexisting Conditions" The Faux Bogeyman

Ray Wu

Justification for Obama's "healthcare reform" is based on the dreaded "preexisting conditions". After all, insurance companies are using these as a way to "gouge" their customers, right? This argument can sound appealing on its face, but deeper analysis shows that "preexisting conditions" are the basis of all types of insurance.

Let's back up and first detail how the foundation of how the whole insurance industry works. The idea behind insurance is that there are certain catastrophic events that are prohibitively expensive for individuals to try and pay for. While it is virtually guaranteed that some people will suffer through these events, the vast majority of people will not. If everyone pays in a small amount (their premium), the money can be pooled together to pay for the extraordinary expenses of the unlucky few.

Insurance companies make a profit based on how close their calculated odds are to the actual real life occurrences of these events. A numerical example will make this clearer. Say that a family takes out fire insurance in case their home accidentally burns down. The insurance company that provides the policy offers a premium of $100/month for 1,000 different families. The company estimates, based on statistics/probabilities, that roughly 1 out of every 1,000 houses will burn down in a month. The cost of rebuilding the burned down house will be roughly $95,000. Therefore, the insurance company will make a profit of $5,000 if their calculation turns out to be correct. They collected $100,000 in premiums for the month and paid out $95,000 in claims. (These numbers are probably not realistic, but they keep the math simple and still illustrate the point).

Why should insurance companies be allowed to make a profit on this? Calculating these probabilities requires a lot of number crunching by insurance actuaries. The actuaries also have to take into account a ton of different variables. So, the "reward" for having the closest prediction to real life events is turning a profit and staying in business.

What keeps insurance companies from charging excessive premiums is the fact that there are other insurance companies who are making similar calculations. The companies have to compete with each other on price while still turning a profit. Banning insurance companies, or at least insurance company profits, will not make these catastrophic events stop happening. Indeed, making it illegal to turn a profit on providing insurance will only guarantee that there will be no insurance industry at all and that anyone who goes through a catastrophic event will be financially ruined.

I do want to clarify that insurance companies competing with each other on price is what would happen in "perfect capitalism". That is, companies would have to be constantly innovating and keeping track of what their competition is doing so that they could offer a quality product at a competitive price. In reality, this is not what is really happening because the government has put a lot of arbitrary barriers on the industry that prevent competition. The inability to buy certain types of insurance across state lines for example.

Also, depending on the type of insurance, some businesses are working under the assumption that if their calculations are not realistic, the government will bail them out. AIG was the most visible example of this. It offered insurance on a lot of financial products, and then when the claims came in for certain catastrophic events, they could not pay them. Based on the previous example, it should be clear why this corrupts the whole concept of the industry.

If it does not matter if the company can actually pay the claims or not, then the company can basically charge whatever premium it wants. This is not to say that AIG is the only insurance company that has not been able to pay claims. We can argue about whether AIG made a good faith attempt to provide insurance, or whether they never had any intention of paying the claims and just wanted the premiums.

In cases besides AIG, there are companies who ARE trying to run a legitimate business, it is just that their actuaries were wrong on their probabilities. In this case, some of the insurance holders will be left with claims that cannot be paid. This is where business reputation comes into play. If a potential customer realizes that there is a possibility that their claims will not be repaid, they will have more incentive to do some research on the existing companies.

They could examine how long a company has been in business and whether their prior clients were satisfied with the service. This is not a foolproof system, but I would challenge anyone to come up with ANY system that is foolproof when predicting human behavior. This natural skepticism by potential customers is short-circuited if they feel that the government is researching all these companies for them. As the government still cannot find a way to make a monopoly on mail delivery a profitable endeavor, it is hard to understand why people think they can monitor all forms of insurance policies and know that they are all sound.

I think that is enough about the structure/principles of the insurance industry, so let's get back to the subtopic of "preexisting conditions". This explicit term may not be used, but these conditions are taken into account in all forms of insurance. Going back to the fire insurance example: the "preexisting condition" is that your house has not already burned down!

That is the extreme case, but another "preexisting condition" may be that you engage in particular business activities that make it more likely your house will burn down. Correspondingly, you will pay a higher premium because by definition your odds of having your house burn down have gone up.

I believe one reason that it is easy (or at least easier) to vilify "preexisting conditions" when it comes to health insurance is that a lot of these conditions are a result of genetics. This can seem intrinsically unfair because, after all, a person cannot choose their genetic predispositions.

Of course, if you want to go down the fair/not fair road, you will find that it is an endless path. You could just as easily argue that it is unfair that some people get cancer and some don't. The insurance industry is NOT about making life "fair", but about pooling people together so they can share risk.

I do want to state that insurance companies are do share some of the blame for how the system works today, but not in the way it is portrayed in the media. Again "perfect capitalism" requires

total transparency where both parties to an agreement know exactly what they are getting into when they enter a business relationship. So, while there is nothing wrong with the concept of preexisting conditions if the reasoning is explained/disclosed, it CAN be a problem when it becomes an "escape hatch". Let me elaborate a little on this.

If a person with an insurance policy discloses all their medical conditions/preexisting conditions, then they will most likely have higher premiums. In and of itself, this is fine because of the preceding arguments. However, there have been reports of insurance companies who both charge the higher premiums, and then deny to pay claims when these policy holders actually need them! The "escape hatch" is that they may claim that somewhere in the fine print of the mountains of paperwork involved with an insurance policy, their particular claim is excluded.

This could lead into a whole other discussion about our litigious society and how everything we do has to be clarified by pages and pages of disclaimers. I would just say that the system worked better when people did not think of a lawsuit when something goes wrong. Now that we have gotten to this point, instead of trying to be transparent and live up to our agreements, we now count on the government and the courts to sort out everything for us.

I would say that the best solution is to try to get to a system where people know what is involved with the contracts they are signing and what their corresponding responsibilities are. While there still needs to be a court/objective third party to rule on cases where one party does not deliver, we should not use that as a crutch. If that is too "pie in the sky" then I suppose the only other solution is to have the government totally control healthcare. Of course, if government control is the only way to run a "fair" healthcare system, that begs the question, why not put the government in charge of everything? For those who are thinking, "right on!", to each their own. I would just say that this has been tried before, and it was called communism.

For a further discussion on the broken health insurance system along with some reforms to start righting the ship, check out Anti Social: Rebooting Capitalism and the American Dream, available at www.rebootingamericandream.com!