

Consumers Take Charge: Defined-Contribution Health Plans

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Consumers Take Charge: Defined-Contribution Health Plans

After twenty rocky years, employers, physicians, patients, and politicians are growing more and more frustrated with managed care, and are supporting a new consumer-driven system. The goal is to temper rising costs and improve service quality by giving consumers better information and greater control over how they spend their health-care dollars. Defined-contribution plans won't replace managed care plans, but they will be the next dominant form.

Complaints about America's health-care system are legion and familiar to employees and employers alike. After twenty rocky years, more and more people — employers, physicians, patients, and politicians — are showing their frustration with the managed care system. Medical costs and insurance premiums keep rising. The doctor-patient relationship seems to have become as impersonal as an ATM transaction. And no one seems to have solutions.

Despite its slow pace, change in the healthcare and insurance services system has been building for several years. The shift is especially evident in a new kind of health plan, which seeks to address rising costs and service quality shortcomings by giving consumers better information to make decisions and giving them greater control over how they spend their health-care dollars.

The new plan has different

names, known variously as defined-contribution, consumer-directed, self-directed, or consumer-driven but it's a singular idea — power to the consumer — whose time has arrived. Indeed, 2003 may be the year that defined-contribution plans begin to make their mark as the most influential new form of health insurance coverage since managed care, according to health-care researchers at the University of Pennsylvania's Wharton School and consultants at Booz Allen Hamilton.

“By the end of 2003, we believe consumer-directed plans will come to be seen as an inevitable paradigm shift in health care. Defined-contribution plans won't be the final form of American health care, but they will be the next dominant form,” says Gary Ahlquist, a Booz Allen senior vice president, based in Chicago.

These experts say that consumer-directed plans will never completely replace managed-care

institutions, such as health maintenance organizations (HMOs) and preferred provider organizations (PPOs). But they are another option that could have as significant an impact on the operating principles and direction of the health-care sector as HMOs and PPOs did when employers began to embrace them in the 1980s and 1990s. Under defined-contribution plans, HMOs and PPOs are products a consumer may choose, not a single answer for everyone.

Ahlquist says that the future of health-care insurance seems to be evolving into “a pluralistic system, a continuum, in which health benefits are tailored to the needs of employees.” The defined-contribution plan, he notes, is one part of the spectrum. But Ahlquist believes that over time consumers will be able to choose from a broad array of products, all of which are flexible and can, to varying degrees, be cus-

tomized for the individual. “Some customers will be attracted to the defined-contribution plan and some won’t,” says Ahlquist. “But employers increasingly see the need to offer alternatives to their employees.”

How the Plan Works

A typical consumer-driven plan works this way: An employer places a certain amount of money each year (a defined contribution of, say,

ee’s physician for that problem participates in a managed-care network. Any of the \$2,000 that remains in the account at the end of the year can be carried over to the following year and added to the new employer contribution of \$2,000.

Issues, such as the amount of the company’s annual contribution, the deductible, the catastrophic insurance premium, and whether accumulated savings can be rolled

an employee would receive each month upon retirement.

Precise figures on the adoption of consumer-directed plans are hard to come by, but various estimates suggest defined-contribution plans now account for about 2% of all health care coverage in the United States. That’s only about 300,000 to 400,000 people, or less than 1% of all company-insured employees. Booz Allen, Wharton, and other healthcare industry experts looking at the future see the trend accelerating among companies large and small, and believe, within five years, these sorts of plans will be much more common. According to a 2002 survey by Mercer Human Resource Consulting, 7% of employers with 20,000 or more employees offer defined-contribution plans, and another 14% will likely make them available by the end of 2004.

Among large corporations, early adopters include Novartis, Aon, Budget Group Inc., Scientific Atlanta, Inc. Textron, and Medtronic, Inc. In 2002, every employer member of the Pacific Business Group On Health, including CalPERS, the giant California state pension fund, offered a defined-contribution plan to at least some of their employees. Launched in January 2002, Budget’s first consumer-directed plan enrolled about 13 percent of eligible employees, according to *HR Magazine*. Mark V. Pauly, professor of health care systems, at Wharton says his research has turned up “a few cases where a third of a company’s workers have signed up” for defined-contribution benefits.

On the supply side, Web-savvy companies provide the technology tools and administrative support to help companies manage their plans.

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\$2000) into an employee account that can be used to pay medical expenses. So-called Health Reimbursement Accounts (HRAs) are often the foundation of defined-contribution plans. The contribution is funded directly by the employer on a pretax basis rather than through salary reductions; employees are reimbursed up to the limit when expenses are incurred. These plans also include a catastrophic insurance policy with a high annual deductible, perhaps \$3,500 for a family and \$1,500 for individuals.

If the employee uses all of the \$2,000 for medical expenses, he or she would then be responsible for the additional \$1,500 in expenses to meet a \$3,500 deductible. Afterwards, the catastrophic insurance takes effect. The percentage of expenses the insurance covers is often 80%, with employees paying 20%. But that could vary, depending on whether or not the employ-

over to another company if an employee leaves, vary from employer to employer. Employers also differ on the maximum amount they will allow an employee to accumulate in a medical account. Most companies place limits on the total amount of money that is allowed to accumulate in an employee’s account as funds are rolled over from year to year.

Not coincidentally, the health-insurance industry has borrowed the term “defined contribution” from the choice-driven 401(k) retirement-planning nomenclature. Defined-contribution retirement plans are those in which employers make contributions to the accounts of employees, who then have the power to invest the money themselves as they see fit. These retirement plans have revolutionized corporate pension schemes and largely replaced old-fashioned defined-benefit plans, under which employers used a formula to determine the monthly sum

Definity Health and Lumenos were among the firms that pioneered HRAs. CareGain recently created a variation on the HRA it calls the “Healthcare IRA”. As reported in Employee Benefits News in April 2003, the Healthcare IRA “skims” a percentage of each member’s HRA funds, say 25%, and at the end of the year puts the money into a “portable lifetime medical expense account,” which is regulated by Section 213 (d) of the IRS code. Providers offering similar technology and services, include Destiny Health, FlexScape, MyHealthBank, PlanScape, and WellPoint.

Sean Nicholson, a professor of health care at Wharton, says rising healthcare costs are making companies pay closer attention to defined-contribution plans. According to the Towers Perrin 2003 health care costs survey (conducted in August/September 2002), the average HMO rate of increase for active employees is 15%. While this is not dramatically higher than historical increases, it is still irksome to companies. “At some point employers become infuriated with another 12% to 15% increase in annual premiums. They say, ‘We’ve got to try some new way to get costs down. No single type of plan will be able to keep medical costs growing at less than the rate of inflation. If any plan can keep costs from growing faster than inflation, it’s done its job.’” According to Nicholson, good plans will be those that allow premiums to increase at 6% to 8% a year rather than 12% to 15% a year.

Trade publications reporting on

early pilot programs at companies suggest the new plans are attracting strong interest among employees, and are positively viewed by management. The health benefits company Humana signed up 6 percent of 4,800 employees in a 2001 pilot. The next year, it opened the plan to

Filling a Void

Booz Allen’s consultants argue consumer-directed healthcare plans exist because they address an “incomplete agenda” left by 20 years of experimentation and failure with managed care. Another reason is corporations remain paternalistic towards their

“Defined contribution plans will never grab 100% of the market, but they will eventually be used by about 10% to 15% of U.S. employees.”

all employees, and 18 percent of its 14,000 employees signed up. A spokesperson for the company also noted that premium increases have fallen from 19% to 10% per year since the plans were introduced. Not all companies, however, say that saving money is their primary motivation. At Medtronic, for example, a senior benefits executive said the company was not facing onerous increases in medical costs when it introduced its plan; leaders simply believe the consumer-driven approach is a better model.

Although it is becoming apparent that the employer community is showing robust interest in adopting a consumer model, insurers are not moving as fast. “There is a high degree of inertia among a broker community that has taken a more conservative view of the movement, says Ahlquist.

employees. Even as the choice paradigm spreads, most employers today still pick the health plans themselves; then employees choose from a very limited menu. “Businesses have gotten away from that paternalistic approach in the retirement area and now they’re moving away from it in the health-insurance area,” observes Ahlquist. Companies are doing this because their employees want it that way. “In the health-care surveys we’ve done, employees tell us more and more that they want choices,” Ahlquist notes.

But with more choice comes more responsibility, and the need for employee education. These plans are not less complicated than existing options, and the financial implications for employees are not clear cut. “Managed care puts doctors and insurers at financial risk; defined-contribution plans put the employees themselves at financial

risk,” says Pauly. “This is a lot of risk for people to take on. Still, people feel more capable of handling their own health-care rationing today than they did before.”

Clearly managed care, in addition to falling out of favor with consumers, has not reduced health care costs as much as was predicted two decades ago. Consumers view health benefits purchased each year as an evaporating asset they had better spend. Without provisions for carry-over or portability, rational consumers will consume such bene-

why consumer-driven plans can fill a major void:

- Many consumers fail to recognize that the majority of their health-care benefit dollars comprise a subsidy for current, routine, predictable consumption, not catastrophic insurance against unforeseen events.
- Consumers have no incentive to choose economically rational care and treatment options. Why stop smoking, go on a diet and exercise

those without work-based plans are out of luck. Without tax deductibility for those lacking an employer-sponsored health plan, even good risks with means opt out of the system — a bare-bones policy (\$5,000 deductible) for hundreds of dollars a month leads many to depend on luck and good genes rather than insurance. Younger consumers, especially, choose this path because they see no reason to pay into a system that builds no equity for future needs.

Overall, the goal is to create incentives for people to pay closer attention to preserving their health and being better-educated consumers.

Policy Friends and Foes

In 2003, economic pressures and public policy trends continue to make defined-contribution plans seem sensible. The weak U.S. economy has cut into corporate earnings, and forced companies to look for ways to trim expenses any way they can.

Another factor driving up corporate interest in defined-contribution plans was an important Internal Revenue Service ruling on June 26, 2002, which allowed for the tax-free rollover of employer-contributed health-care benefit dollars, similar to the rollover permitted in 401(k) plans. Although the same feature needs to be extended to employee contributions, this IRS ruling and other proposals show the Bush administration has clearly signalled its intent to encourage consumer-directed plans.

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fits or lose them. Throw into the mix that it is someone else’s money (the employer’s and the insurer’s) and the result is unfettered spending. Indeed, a powerful argument for adopting consumer-driven plans is that they will make employees more cost conscious, which could substantially reduce employers’ health-care costs. “When people spend their own money, they are more frugal,” says Pauly.

Booz Allen’s Alquist and colleague David G. Knott, vice president and managing partner in Booz Allen’s New York office, suggest other factors that explain the flaws of the current system and reasons

when one’s health plan pays for a lifelong prescription to an anti-cholesterol drug? The consumer never sees any benefit from the money that is saved.

- Two-income households get little advantage from having two employers’ health-care options at their disposal. They are forced to choose the better of the two plans, without being able to pool two contributions to purchase superior benefits.
- Currently tax deductibility is confined to employer-sponsored plans. Self-employed persons and

Going forward, several ingredients are needed to accelerate the momentum of consumer-directed health plans. One, already mentioned, is the tax-free rollover for employee contributions and the portability of all unused balances. With Republican majorities in both Houses of Congress, Booz Allen consultants expect the issue of employee-contribution rollovers and portability to be addressed in 2003 or 2004. Many states are already looking at their insurance regulations to find new ways of pooling risk, especially for the self-employed and employees of small businesses.

Other crucial ingredients include a more competitive provider marketplace, and the success of new entrants. “Yes, we need people to be responsible and educated consumers of health care, which should bring down costs, but we also need real competition among providers. Defined-contribution plans may have an impact on reducing the overall cost of health care in America, but the existence of these plans alone is not enough to do that,” says Knott.

To be sure, not everyone supports widespread adoption of defined-contribution health plans. There’s the argument that these plans are only a good deal for the young and healthy. “Some employers are afraid if they offer one of these accounts alongside very strict managed care plans, the healthy people will go right after the self-directed plan and the chronically ill will be stuck with managed care and premiums will rise,” says Wharton’s Nicholson.

Organized labor has also spo-

ken out strongly against them. “Unions say consumer-directed plans are a scam,” Nicholson explains. Labor advocates argue that deductibles are certain to rise over time, and unless employers are willing to make ever-increasing annual contributions to employee medical accounts, the gap between the employer contribution and the deductible will also widen and leave a major burden on employees. “Unions feel that there may be

of these plans, they’re also concerned education is costly, and may not always be effective. “Employees like seeing the upfront money, but if they get a big medical bill and have to spend all the money and start paying out of their own pocket, they blame it on their employer for not explaining it well enough,” he says.

What Comes Next

Although consumer-directed plans will never grab 100% of the market,

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nothing inherently risky now about these plans that will scare anybody, but if that gap becomes \$4,000 or \$5,000, that can be a real hardship,” adds Nicholson.

Another hurdle: Some employers feel obliged to continue the paternalistic approach in the sincere belief that there are many employees who are unable or unwilling to take charge of their own health spending. As Wharton’s Pauly puts it: “Consumer-directed plans give employees the power to make choices, but they also give people the power to screw up.” That worries the employers Wharton surveyed, says Pauly. Although they believe education and communications strategies are critical to the success

experts from Booz Allen and Wharton agree that these plans will eventually be used by perhaps 10% to 15% of workers. That’s a powerful number. They note managed-care plans have never captured more than one-third of the market. Nonetheless they changed the face of health care in America.

And so it will be with the new defined-contribution approach. “Consumer-directed plans will grab an across-the-board slice of the market,” Pauly predicts. “And I don’t think they will be attractive only to the young and healthy. They will attract the attention of people willing to try new things and people who want health-care costs to be low. They also might well appeal to

employers of low-wage and secondary workers who otherwise couldn't afford to offer health benefits."

Nicholson says defined-contribution plans may have the ironic effect of convincing some people that much-maligned managed-care plans are not so terrible after all. He argues the establishment of these plans might segment the market so that the strictest HMOs will probably come back into style. Why? "Once people get into these self-directed plans, they're going to recognize that the managed-care product doesn't look so bad. In the end, the upside of the defined-contribution market will be capped by how many

involves a single physician, or several doctors, taking on a relatively small group of patients and charging them a flat fee of, say, \$2,000 a year. In exchange, each patient gets 365-day access to the doctor, and perhaps even house calls — a sort of Marcus Welby, M.D., redux. "The beauty of concierge medicine is that patients can once again get to know their doctors on a personal basis, spend time with them, and play a major role in directing their own medical care," Ahlquist says. "That's what people say they miss when they enroll in an HMO."

With the growth in popularity of consumer-driven plans, Ahlquist

at the national level, they say. A decade from now, this could be the unwitting forerunner of a kind of national health insurance.

What is more, as the industry's insurers and payers continue to experiment with consumer-directed plans, the new requirements of an increasingly retail-driven marketplace will need to be addressed by new capabilities and business systems for providers and suppliers. In many cases, say Knott and Ahlquist, these needs will be met through alliances with newer entrants offering consumer-friendly Internet-based portals for enrollment and claims, medical advisory services, and health-related products. In others, they will be met by direct-to-consumer advertising by pharmaceutical companies emphasizing not just the merits of one drug versus another, but the merits of drug therapy versus other treatment alternatives.

At the same time, the potential commoditization of catastrophic risk coverage, combined with the need for consumer-friendly functions and services, will create a squeeze play on the traditional space of insurers and health plans. Sorting out a sustainable position or a symbiotic alliance will be major challenges for some of the largest insurers and health plans.

It may take five years or more for the full weight of defined-contribution health plans to be felt. "At that point, says Wharton's Sean Nicholson, we'll know how popular they are. People will vote with their feet."

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sophisticated consumers there are who are comfortable shopping for the best medical prices and taking control of their dollars," he says.

Meanwhile, Ahlquist says the current health plan business is headed for even tougher times. Booz Allen expects to see more of the largest health-care plan pioneers exploring ways of diversifying beyond the core business — seeking opportunities for new products and lines of business, including so-called "concierge medicine."

Concierge medicine typically

and Knott foresee other developments in the months and years to come. First, they expect to see the first inklings of the commoditization of catastrophic risk coverage in 2003. This sort of coverage will be the cornerstone of all consumer-directed health plans, and is likely to continue to be purchased by employers on behalf of their employees. Since the benefits of pooling are so substantial, and the opportunities for differentiation so limited, this is a business that wants to be commoditized, perhaps even

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