

Unhealthy Times for U.S. Managed Care

The recession could wreak havoc on coverage, but there are several ways forward for managed care plans.

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For decades, many analysts believed that the U.S. health care sector was insulated from the most severe economic effects plaguing other industries, and perhaps even recession-proof. Our analysis suggests that this belief is no longer valid. Moreover, the combined effects of a deep recession, an unsustainable cost situation, and a new president's health care agenda could lead to sweeping changes in the structure and dynamics of the U.S. health care market.

While the health sector has weathered previous recessions relatively well, it has now become quite unhealthy, and the current economic decline has pushed the sector to a tipping point that may reshape the health benefits that Americans are offered, the way benefits are financed, and the balance between private companies and government. Oliver Wyman analysis suggests that economic pressures could put health insurance out of reach for a broader cross-section of employers, creating coverage risk for up to 24.4 million additional people.

This article aims to illuminate the issues, stimulate debate, and motivate positive changes among the various constituents in order to improve the U.S. health care system.

Employers Push Back

The U.S. health care market, at \$2.4 trillion, represents 16% of GDP, and at a projected five-year annual growth rate of almost 10% will remain a core growth engine for the foreseeable future. The domestic sector has been a magnet for global talent and a net exporter of technology

and services. Meanwhile, it has created more jobs located in-country than any other industry and now represents one in every nine jobs in America.

Within the sector, managed care has been a star industry among investors. Rising medical costs allowed managed care companies to price for increased medical risk while creating business model operating leverage through administrative efficiencies, self-service models, and process automation. The combination of these factors has led to high-single-digit revenue growth and strong double-digit earnings-per-share growth, a recipe for dramatic increases in market capitalization.

It's unlikely that managed care health plans can maintain this performance during the recession and beyond. So far since early 2008, all indicators paint a bleak picture: Unlike past recessions, the managed care sector fared relatively poorly (see Exhibit 1) as financially strained U.S. employers pushed back on unrelenting cost increases that render health benefits increasingly unaffordable.

For years, employers and policy-makers have been questioning the sustainability of the system in light of unrelenting increases in the

cost of health care and continuing erosion in the cost-to-value equation. The notion that volume is rewarded almost regardless of quality simply cannot endure (Exhibit 2).

With the cost of health benefits approaching one-quarter of total compensation costs, many U.S. employers have been reducing their contribution levels or even cutting benefits altogether. Over the past five years, U.S. employers removed 13 million American workers and dependents from their benefits eligibility list, and they shifted another \$90 billion of health benefit costs to their workers; eligible employees and dependents now pay about 35% of the total cost of health benefits.

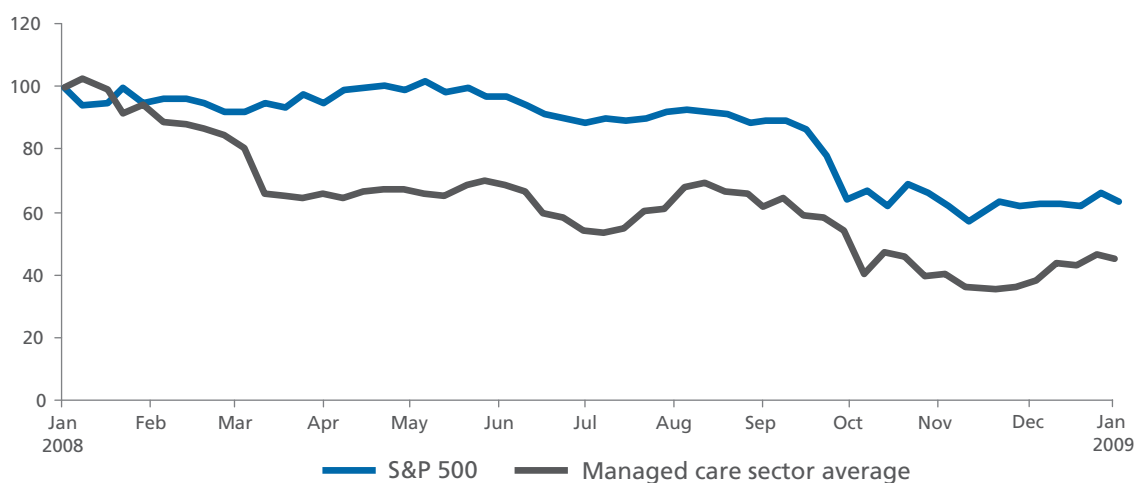
Employers and health plans have tried to soften the cost impact through cost-shifting programs and a move to higher-deductible benefit plan designs. Yet even with these product shifts, health-benefit costs are still rising 6-8% a year, more than double most other business cost components. So while the employer benefits market has been growing in dollar terms, the market has been contracting in terms of membership, as fewer employers choose to offer health benefits.

Ripples Through Other Funding Sources

Employer health benefits don't operate in a

Exhibit 1 Managed care has cooled down

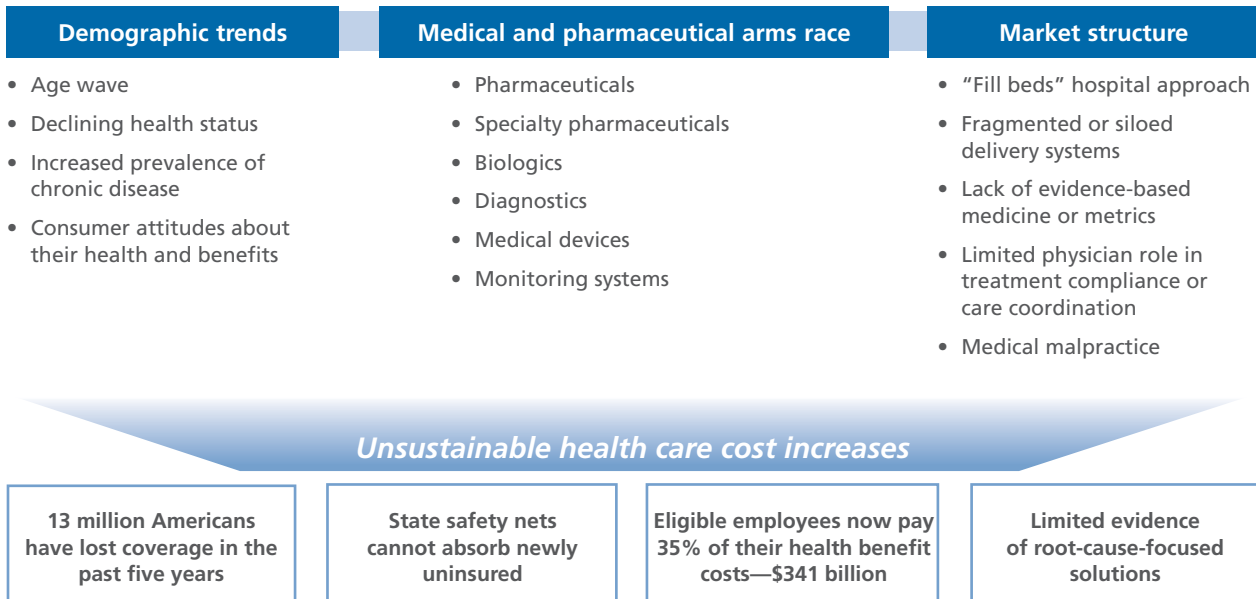
Normalized stock price performance



Note: Managed care sector average includes United, Cigna, Humana, Aetna, and Wellpoint.
Source: Google Finance

Exhibit 2 **The coverage and affordability problem at a glance**

U.S. health care is built on a flawed foundation that rewards volume with limited consequence for quality variation.



Source: Oliver Wyman analysis.

vacuum, of course; they interact with other major funding sources. For example, expected Medicare cost cuts impact employer health benefits, as providers shift Medicare reimbursement deficits to commercially sponsored plans and fuel as much as a 2% annual increase in medical costs. Conversely, small changes in the employer-sponsored market make waves across the other funding platforms, because the former provides primary coverage to 156 million Americans, more than half the population. Given this ripple effect dynamic, the employer-sponsored marketplace becomes a primary lever for market reform (Exhibit 3).

A 5% contraction in the employer-sponsored marketplace shifts 7.8 million Americans to an alternative funding platform, but most available funding options are under pressure in this recession, removing or tightening the traditional safety valves. So if all of those people were to become uninsured, the uninsured

roster would expand to 53.4 million, representing a 17% increase from today (even before factoring the lagged effect of the 2.6 million job losses in 2008).

The Consequences of Unemployment

Continued job cuts will aggravate the situation. Many economists project that the U.S. unemployment rate will reach 10% by the end of 2009. This could create an additional loss of 2.6 million jobs and further reduce the employer-sponsored health benefits marketplace by over 3.0 million beneficiaries (including dependents). A soft economy and increasing unemployment lead to changes in the implicit employer-to-employee contract. For instance, employers that are hiring may not have to offer benefits to attract top talent or may only have to offer benefits to the employee. Unions may reduce efforts to improve health benefits for members and instead concentrate on job retention and retraining programs.

Exhibit 3 How health benefits are distributed

Population figures in millions Cost figures (total and consumer paid) in \$ billions	Distribution by funding source ¹					
	Employer ² sponsored	Individually insured	Medicare	Medicaid/state and local programs	Uninsured	Total
Participation by funding source						
Primary coverage	\$155.7	\$17.1	\$44.0	\$45.7	\$41.0 ³	\$303.5
Secondary coverage	\$15.8	\$9.6	\$0.0	\$7.5	\$4.6	\$37.6
Total coverage	\$170.8	\$26.8	\$44.0	\$53.2	\$45.6 ⁴	\$341.1
Payer or MCO management						
Total membership	170.8	26.8	10.0	35.6	0.0	243.2
Share of membership	100%	100%	23%	67%	0%	71%
Average membership growth (3-Year CAGR)	0-(1%)	0-1%	2-3%	2-3%	1-2%	0-1%
Program cost and consumer share						
Total cost	\$974.3	\$117.3	\$598.3	\$375.8	\$176.4	\$2,242.1
Consumer paid	\$341.0	\$117.3	\$137.6	\$37.6	\$58.2	\$691.7
Consumer share	35%	100%	23%	10%	33%	31%
Total cost per beneficiary	\$5,704	\$4,380	\$13,596	\$8,232	\$3,869	\$7,405
Program cost growth rates (three years)						
Total cost	7%	8%	11%	5%	9%	8%
Sponsor cost	6%	—	11%	5%	10%	8%
Consumer cost	10%	8%	9%	4%	8%	9%
	Driver of market reform	Safety valve market	Social contract with America	State reform trigger	National reform trigger	Composite picture

1 Each funding source includes the aggregate spending associated with the program, including sponsor and individual contributions.

2 Private and public employers, including union trusts.

3 Stated in full-year-equivalent person years.

4 Reported from the current population survey as of March 2008.

Sources: Census Bureau, "Current Population Survey", CMS, Kaiser Family Foundation, EBRI, U.S. GAO, CBO., Oliver Wyman analysis.

Here's how specific employer and consumer actions could erode the employer-sponsored marketplace:

- **Employers cut jobs.** This shrinks the market through the loss of jobs and the loss of coverage for dependents. In 2008, there was an unprecedented 1.9% net job loss, or 2.6 million aggregate lost jobs. In a moderate recession scenario, we expect an additional net loss of 2.6 million jobs over the next two years. Our research indicates that this incremental job loss will contract the employer-sponsored health benefits market by an additional 3 million Americans (including dependents) through 2010.
- **Employers exit the health benefits market.** This has already started as benefits become more expensive. Our research indicates that employers will opt out of the benefits market at an accelerated pace over the next two years, further contracting the market by 2 million Americans through 2010.
- **Employees and dependents become ineligible for benefits.** Employers are reducing employee and dependent eligibility, first by rotating full-time jobs to ineligible part-time jobs; second, through the migration of employment from large employers to small employers; and third by cutting dependent coverage. Our analysis indicates that increased eligibility constraints will further contract the health benefits market by another 5.1 million Americans through 2010 (combining with the 2 million noted earlier to a loss of 7.1 million in a moderate recession scenario).
- **Employers reduce coverage and financial sponsorship.** Faced with difficult tradeoffs, employers will likely reduce coverage and shift a greater share of benefit costs to employees. While benefit design changes will not contract the marketplace in numbers, these changes will slow premium or price increases by as much as two to three percentage points.
- **Consumers opt out of the employer benefits offering.** As employers shift benefit costs to

Exhibit 4 Impact on membership and premiums of various recession scenarios

Employer-sponsored marketplace, 2-year aggregate change through 2010 (job numbers are incremental to the 2.6 million jobs lost in 2008)

Current market baseline ¹	
Covered lives	156 million
2007-2008 membership growth	-1%
Total cost	\$806 billion
Cost per member	\$431/Month

	<i>Modest recession</i> 8.5% unemployment by 2010	<i>Moderate recession</i> 10% unemployment by 2010	<i>Deep recession</i> 11% unemployment by 2010
Net member reduction (in millions except where noted)			
Forecast net job losses through 2010 ²	-406	-2.6	-4.1
Loss from net job change (includes dependents)	-466	-3.0	-4.7
Loss from employer opt-out ³	-4.4	-7.1	-14.4
Loss from consumer opt-out ⁴	-1.9	-3.6	-5.3
Total membership loss	-6.7	-13.7	-24.4
% membership loss	-4.3%	-8.8%	-15.7%
Total premium expenditures lost (\$ billions)	-\$24.0	-\$64.3	-\$117.5

- 1 Current market baseline includes only those members with primary employer-sponsored coverage with corresponding cost figures.
- 2 Isolates the impact of job changes for the full years of 2009-2010; excludes 2.6 million jobs already lost in 2008.
- 3 Employer opt-out includes those employees and dependents not offered coverage and also those who are no longer eligible for coverage due to full-time to part-time and inter-segment job rotations.
- 4 Includes consumer premium contribution, consumer OOP spending and buy-downs.

Source: Robert Reich, former U.S. Labor Secretary, in Congressional testimony on stimulus bill, Oliver Wyman analysis.

employees, benefits will become so expensive that more employees will opt out altogether. Our research suggests that employees can expect to spend 11-12% more each year on premiums and out-of pocket medical expenses, and the resulting opt-out will further contract the market by 3.6 million Americans by 2010.

The sum of these actions has the potential to contract the health benefits market by 13.7 million Americans, or about 9% of the total market, by the end of 2010 in a moderate recession scenario, including the 3 million covered lives displaced as a result of job cuts expected in 2009 and 2010 (Exhibit 4), with some alleviation offered through the short-term impact of the stimulus package. Depending on the severity of the recession, the market contraction could range from 6.7 million to 24.4 million Americans.

Health plans will benefit to some extent from medical cost inflation, which will allow the impact of membership contraction to be partially offset by price-driven growth. But the

employer-sponsored benefits market will be hyper-sensitive to a deep recession if employers are faced with core choices about offering benefits or sustaining the organization.

Market contraction on a large scale could substantially diminish the attractiveness of the employer marketplace or accelerate government-led market redefinition. For example, in the moderate recession scenario, we assume employer actions will drive a sharp increase in the uninsured at a time when state Medicaid programs may also be restricting eligibility. The individual insurance market probably will not absorb the newly uninsured, so without federal intervention, the uninsured roster would exceed 55 million people.

Implications for Health Plans

Health plan executives face a twofold challenge. They must determine how to remain profitable (even viable) during this recession, and they may have to reposition their plan for the long term to offer the advanced affordability and quality of health care required of a post-reform marketplace.

To be sure, health plans and employers have worked together to try to curb medical cost increases and to extend employer sponsorship, largely through plan design changes. Such short-term strategies have mitigated premium increases by as much as 2 to 4 percentage points of premium increase per year. But they have not addressed the root causes of cost or fundamentally altered the trend. So the first big wave of solutions—new plan designs, cost shifting, first-generation consumer-engagement models, and unit-cost/access-focused provider network changes—have now run their course. And if managed care companies run primarily defensive plays during the recession (such as cost-cutting) at the expense of the long-term investments required to address affordability and quality, then the industry risks further market contraction. Furthermore, health plans face the possibility of ceding major portions of the marketplace to the government.

The path that health plans take will materially impact their long-term success and market

positioning. Exhibit 5 provides a perspective on the attractiveness and economic outlook for each of the major addressable markets over the next two years. Commercial and government-sponsored segments will face market contraction as well as price and cost pressures, leading to much slower growth and reduced contribution margins. While the drop-out of 14 million people could represent new potential individual insurance buyers, it's very possible only a small portion of new buyers will re-enter the market, as consumers will not be able to justify the price to perceived value of individual coverage.

Despite this gloomy economic outlook and the potential for regulatory change, there are short- and long-term strategies that can help improve health plans' competitive position over the next three years, as shown in Exhibit 6. Specifically:

- Health plans must actively manage their products as a portfolio and retool to support a new long-term value equation.

Exhibit 5 Three-year outlook for the major markets

	Employer-sponsored 156 million people		Medicare 44 million people			Individual 17 million	Medicaid 46 million people		Uninsured/new government platform 41 million ¹
	Fully insured	Self-insured	Medicare advantage	Medigap	Traditional government		Managed	Fee-for-service	
Membership	-4.5% ↓ • Equates to a 14 million employer-sponsored coverage drop-out over the next two years		+2.5% ↑ • Demographic-driven growth • Modest rotation away from MA—leaner benefits offset by age-in boomer preference for MA • 3.5% annual Medicare membership increase	+4% ↑	+4% ↑	0% — • Household budget crunch • Slimmer plan designs hold price-sensitive buyers	+6% ↑ • Rolls bulge as economy sours • State red ink keeps eligibility tight • Rotation to managed care as new populations require cost control	+11% ↑ • Increases the uninsured population by 9.5 million over the next two years (excluding the approximately 3 million uninsured yet to hit from 2008 job losses)	
Premium equivalent (after buy down)	+6% ↑		-3% ↓ • Gap to FFS costs closed	+5% ↑ • Basic medical trend offset by reform to standard product designs in out-years	+2% ↑ • Modest provider reimbursement adjustments	-5% ↓ • Due to product shift to catastrophic and more limited plan designs	+2% ↑ • State offers limit rates -2% reflects pre-stimulus plan impact		
Composite trajectory²	+2% • Burning membership platform is offset by premium inflation		-1%	+9%	+5%	-5%	+8%		
Capture of the employer fallout	14 million drop-out of group coverage		Normal age-ins			Marginal capture	20% or 3 million Modest capture	80% or 11 million Major fall-through	
Whether the lion's share of employer-sponsored drop-out flows into Medicaid or uninsured, significant government reform will likely be triggered.									

1 Uninsured numbers expressed in full-year equivalents – CPS number is 45 million as of March 2008.

2 Composite trajectory based on total premium revenue growth assuming a moderate recession

Note: All percentage figures expressed per annum. Analysis conducted on primary coverage membership for each funding source.

Source: Oliver Wyman analysis.

Exhibit 6 Strategies for health plans

	Portfolio and product design	Market and consumer segmentation	Consumer experience	Provider partnered health management
Key performance lever	Actively manage products as a portfolio and retool design to support long-term value equation	Take full advantage of segment-specific opportunities to drive growth and profitability	Continue to drive down administrative costs while enhancing the consumer experience	Dramatically increase focus on managing costs of care delivery
Short term	<ul style="list-style-type: none"> Evaluate profit and growth profile of the product portfolio Eliminate or streamline low-contribution products Shift product mix through incentives to higher-contributing products Take advantage of current trends: <ul style="list-style-type: none"> Flexible, low-cost individual products Pre-retirees for bridge to Medicare 	<ul style="list-style-type: none"> Prioritize market segment focus (Fully Insured, Self-Funded, Medicare, Medicaid, and Individual) Focus growth on profitable lines Shift segment mix to rising-tide markets 	<ul style="list-style-type: none"> Focus on performance optimization through: <ul style="list-style-type: none"> Cost cutting and elimination of low-value activities Streamlining processes using technology Deploying web and self-service models 	<ul style="list-style-type: none"> Identify and deploy short-term health management programs with proven returns Initiate provider network strategies to lower the cost of care Strengthen member identification and engagement programs to lower costs
Long term	<ul style="list-style-type: none"> Evaluate the alignment of product portfolio with long-term market view Identify gaps and attractive long-term opportunities Build value-based benefit design capabilities and other post-recession investment products 	<ul style="list-style-type: none"> Build advanced predictive modeling to support segmentation and consumer engagement Evaluate the market segments from a long-term perspective 	<ul style="list-style-type: none"> Build and deliver integrated and personalized service Design seamless multi-channel service Build and deploy point-of-care services Build and deploy smart ID cards 	<ul style="list-style-type: none"> Develop a longer-term integrated health management strategy to compete on health care management (cost and quality) Build and deploy new provider partnering model to lower costs and improve quality Revamp consumer engagement models to significantly improve consumer health engagement
	<ul style="list-style-type: none"> Shift human and financial capital to align with long-term view Leverage unprecedented opportunities to fill gaps in capabilities or enable long-term strategies through acquisitions of under-valued assets 			

Source: Oliver Wyman analysis.

- Segment-specific opportunities must also be considered to drive growth and profitability.
- Consumer experience investments should be augmented to enable companies to generate the customer loyalty necessary to sustain gains made among target groups.
- Provider-partnered health management requires a dramatic increase in focus on the management of cost and quality of care—a paradigm shift for many organizations.

Heal Thyself

The managed care industry now stands between sickness and health. Falling returns from investments, rising health care costs, declining membership, and increasing competition have com-

bined to potentially upend the entire sector. How to turn the tide? Designing low-cost plans for the unemployed and transitional plans for young adults and pre-retirees will help to fill in the holes in membership lost during the recession. Using stores of cash and capital to make targeted acquisitions will round out the product offerings of the top companies. Trimming the cost base in lean times will ensure a more nimble and profitable enterprise. Only those firms that take advantage of current weaknesses to reposition themselves for the future will emerge from this crisis with a clean bill of health. ❖

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