

# The Recession: U.S. Managed Care's Mandate for Change

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For decades, many analysts believed that the U.S. healthcare sector was insulated from the most severe economic effects plaguing other industries, and perhaps was even recession-proof. Our analysis suggests that this premise is no longer valid. Moreover, the effects of a deep economic recession combined with the unsustainable cost situation, as well as the presidential healthcare reform agenda, could lead to sweeping changes in the structure and dynamics of the U.S. healthcare market.

While the managed care industry 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 over 13 million additional people and further justifying the need for government intervention.

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



## Employers Push Back

The U.S. healthcare 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 larger healthcare market, 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 technology-enabled 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 health plans can maintain this performance during the recession and beyond. So far during 2009, 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.

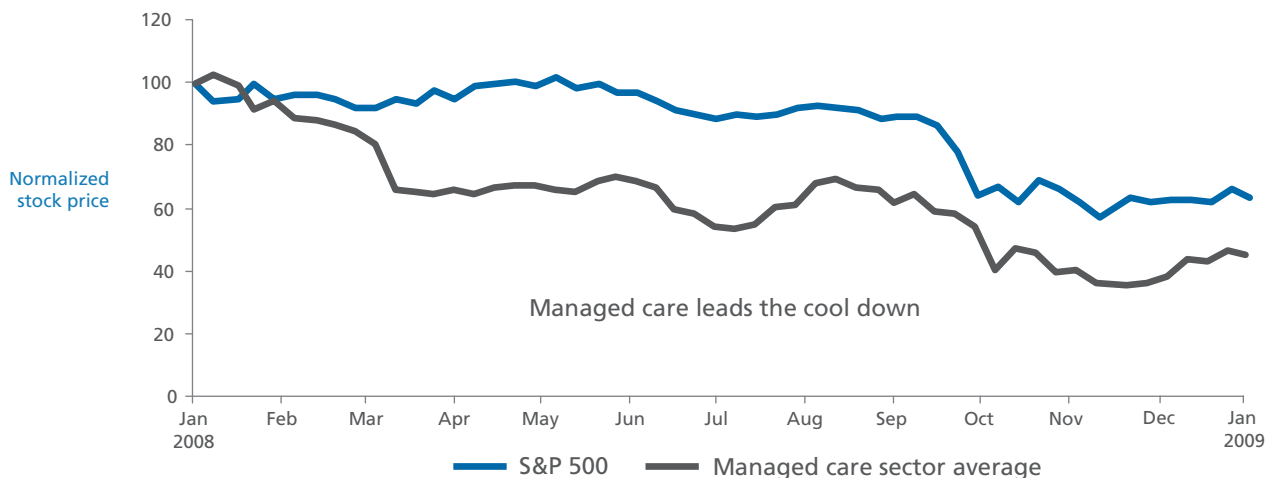
For years, employers and policy-makers have been questioning the sustainability of the system in light of unrelenting increases in the cost of healthcare and continuing erosion in the cost-to-value equation. The notion that volume is rewarded almost regardless of quality simply cannot endure (Exhibit 2).

With health benefits representing nearly 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. They also 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.

### Exhibit 1 Sick on the street

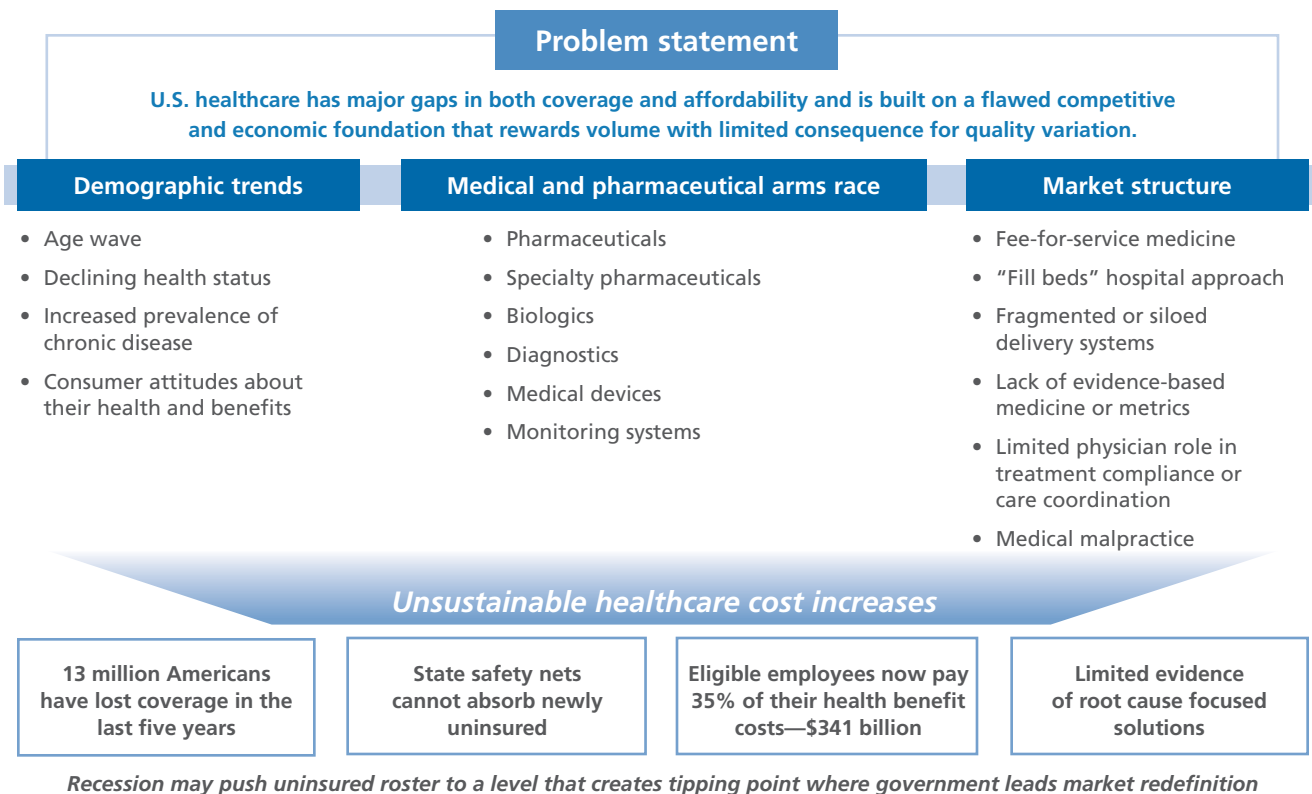
#### Normalized stock price performance



Source: Google Finance

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

Exhibit 2 Coverage and affordability crisis is likely to continue without market reform



Source: Oliver Wyman analysis.

**Ripples Through Other Funding Sources**

Employer health benefits don't operate in a vacuum, of course; they interact with other major funding sources. For example, proposed Medicare cost cuts impact employer health benefits as providers shift Medicare reimbursement deficits to commercially sponsored plans, fueling as much as a 2% increase in medical cost trend. 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 (see 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 2008 job losses).

**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.

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

### Exhibit 3 Distribution of cost and population across funding sources for health benefits

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

- 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.

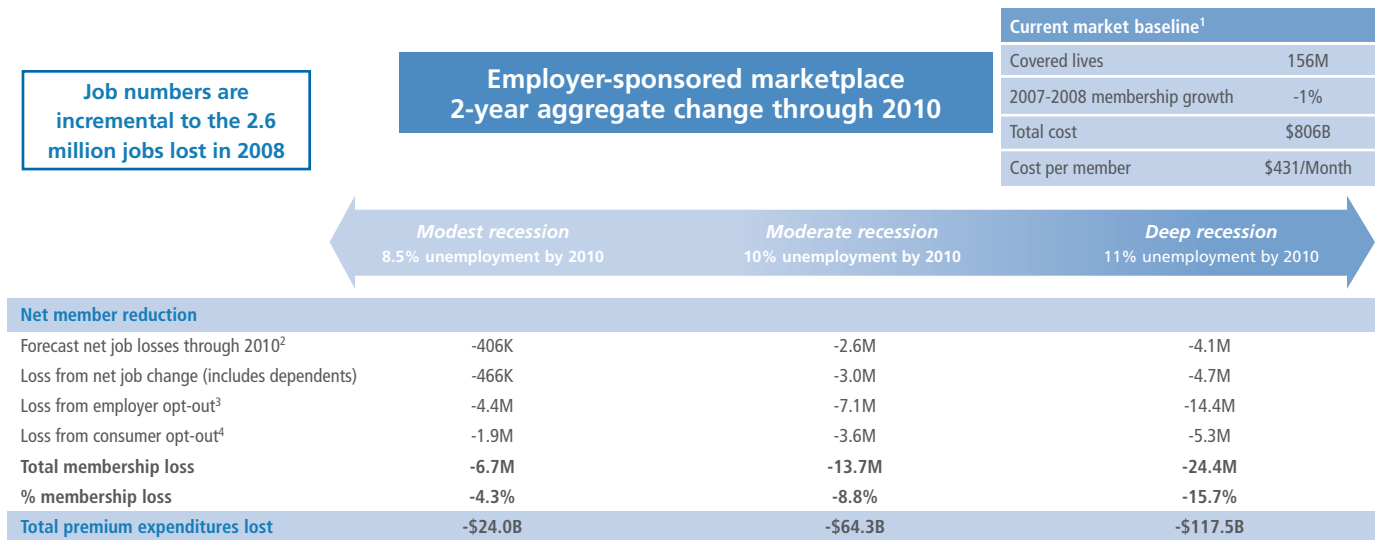
Sources: Census Bureau, "Current Population Survey", CMS, Kaiser Family Foundation, EBRI, U.S. GAO, CBO., Oliver Wyman analysis.

- **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 would normally contract the employer-sponsored health benefits market by an additional 3 million Americans (including dependents) through 2010. The American Recovery and Reinvestment Act could mitigate some of the resulting uninsured increases in the short term through expanded eligibility and subsidies for COBRA benefits, but does not materially alter the unemployment projections.
- **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 (combines to 7.1 million referenced in Exhibit 4 under employer opt-out).

- **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, they 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 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.

## Exhibit 4 Impact on membership and premiums for various recession scenarios



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 US Labor Secretary, in Congressional testimony on stimulus bill, Oliver Wyman analysis.

The sum of these actions has the potential to contract the health benefits market by 13.7 million Americans by the end of 2010, 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; in a moderate recession scenario, we expect a market contraction of 13.7 million Americans, or about 9% of the total market, equal to nearly \$65 billion in premiums.

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 and 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 healthcare 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 two to four percentage points of premium increase per year. But they have not addressed the root causes of costs that fundamentally alter 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

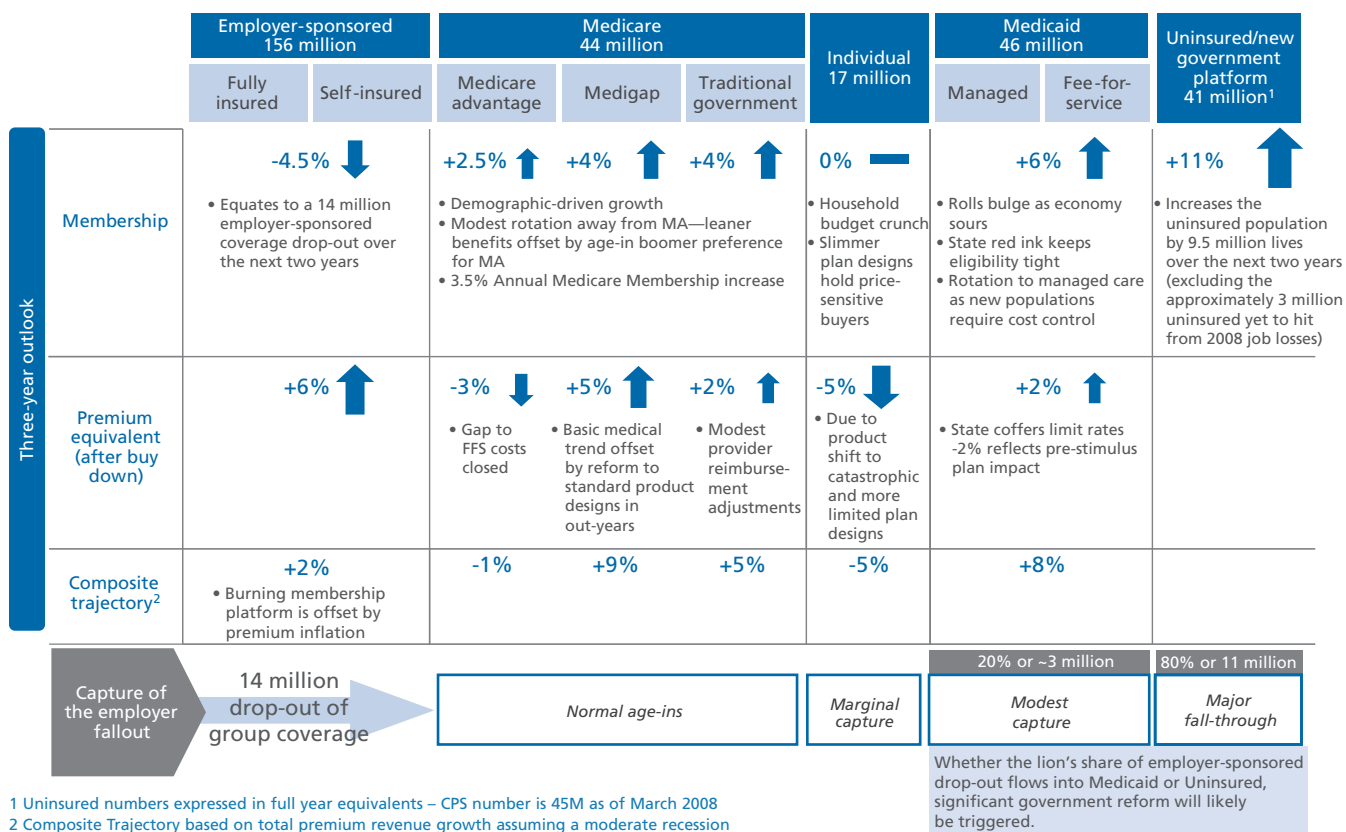
changes—have now run their course. And if managed care companies execute primarily defensive plays during the recession (such as cost-cutting) at the expense of the long-term investments required to address affordability and quality, then they face further market contraction and the possibility of ceding 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. The American Recovery and Reinvestment Act does soften the immediate market impact of the recession through COBRA extensions and subsidies as well as additional Medicaid funding. However, without significant advancements in the underlying industry dynamics, the market shifts outlined in Exhibit 5 belie the likelihood of more extensive reform efforts.

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. Segment-specific opportunities must also be considered to drive growth and profitability, while consumer experience investments enable the loyalty necessary to sustain the

**Exhibit 5 Market contraction and price/cost pressure facing the commercial and government-sponsored segments**



1 Uninsured numbers expressed in full year equivalents – CPS number is 45M 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 Key levers across the value chain to shape short- and long-term 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"> <li>Evaluate profit and growth profile of the product portfolio</li> <li>Eliminate or streamline low contribution products</li> <li>Shift product mix through incentives to higher contributing products</li> <li>Take advantage of current trends:                             <ul style="list-style-type: none"> <li>Flexible, low-cost individual products</li> <li>Pre-retirees for bridge to Medicare</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Prioritize market segment focus (Fully Insured, Self-Funded, Medicare, Medicaid, and Individual)</li> <li>Focus growth on profitable lines</li> <li>Shift segment mix to rising tide markets</li> </ul>	<ul style="list-style-type: none"> <li>Focus on performance optimization through:                             <ul style="list-style-type: none"> <li>Cost cutting and elimination of low-value activities</li> <li>Streamlining processes using technology</li> <li>Deploying web and self-service models</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Identify and deploy short-term health management programs with proven returns</li> <li>Initiate provider network strategies to lower the cost of care</li> <li>Strengthen member identification and engagement programs to lower costs</li> </ul>
Long term	<ul style="list-style-type: none"> <li>Evaluate the alignment of product portfolio with long-term market view</li> <li>Identify gaps and attractive long-term opportunities</li> <li>Build value-based benefit design capabilities and other post-recession investment products</li> </ul>	<ul style="list-style-type: none"> <li>Build advanced predictive modeling to support segmentation and consumer engagement</li> <li>Evaluate the market segments from a long-term perspective</li> </ul>	<ul style="list-style-type: none"> <li>Build and deliver integrated and personalized service</li> <li>Design seamless multi-channel service</li> <li>Build and deploy point-of-care services</li> <li>Build and deploy smart ID cards</li> </ul>	<ul style="list-style-type: none"> <li>Develop a longer term integrated health management strategy to compete on healthcare management (cost and quality)</li> <li>Build and deploy new provider partnering model to lower costs and improve quality</li> <li>Revamp consumer engagement models to significantly improve consumer health engagement</li> </ul>
<ul style="list-style-type: none"> <li>Shift human and financial capital to align with long-term view</li> <li>Leverage unprecedented opportunities to fill gaps in capabilities or enable long-term strategies through acquisitions of under-valued assets</li> </ul>				

Source: Oliver Wyman analysis.

gains made among target groups. Finally, 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 and Heal the Industry

The health insurance industry now stands between sickness and health. Falling returns from investments, rising healthcare costs, declining membership, and increasing competition have combined to potentially upend the entire sector. How can man-

aged care organizations turn these risks into opportunities? 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. ❖

## About Oliver Wyman

With more than 2,900 professionals in over 40 cities around the globe, Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm helps clients optimize their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is part of Marsh & McLennan Companies [NYSE: MMC].

Oliver Wyman's Health and Life Science's practice serves clients in the pharmaceutical, biotechnology, medical devices, and payer sectors with strategic, operational, and organizational advice. Deep healthcare knowledge and capabilities allow the practice to deliver fact-based solutions.

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