The Defined Contribution Approach To Health Insurance

William Gallagher Associates
Phone: 888.261.8884
www.WGAins.com

Sara S. LaVallee, CEBS

Sara LaVallee is an Assistant Vice President in William Gallagher Associates' Employee Benefits Practice. William Gallagher Associates is a leading provider of insurance brokerage, risk management, executive and employee benefits services to firms in selected fast-growth industries including high technology, life sciences, financial services, healthcare services, energy, and environmental services. WGA has offices in Boston, MA; Atlanta, GA; Columbia, MD; Princeton, NJ; and Paris, France.

I. The Evolution of the Defined Contribution Health Plan

"Harness the power of the individual consumer, and you shall control health care costs" ***- Business and Health***

The initial premise of defined contribution health plans is that they give a certain amount of money to each employee for healthcare needs. In turn, each employee purchases individual health insurance. This type of plan is sometimes referred to as a "voucher program" where the employer's contribution acts as a "voucher" for health insurance. In this scenario, there is no sponsorship by an employer of any given insurer or product.

For obvious reasons, this approach is not right for every employer. Though it would distinctly define an employer's medical insurance expense budget from year to year (based on the number of employees and the level of contribution), it would invite a host of employee-relations issues. Because HIPAA does not prohibit the use of health questions when it comes to individual coverage, obtaining insurance on an individual basis could be problematic for older and sicker populations. As such, those at a disadvantage may be faced with higher premiums and stripped-down plan designs, while the young and healthy populations will get quite the opposite. This creates a thorny question of equity.

The defined contribution health plan model has evolved quite a bit. But when discussing its evolution, it is important to remember where the concept started. Though drastic, the so-called "voucher" approach is the most predictable for employer cost and gives the employees ultimate flexibility to purchase a plan that is right for them. Variations made upon this original model have scaled down the cost savings and the flexibility but have provided a more palatable forum for employers to capitalize on the positive effects of the defined contribution approach. It is useful to consider why defined contribution approaches are gaining such popularit)y of late. Though they were originally introduced in the early 90s, they are only now being discussed in almost every employee benefits' circle. Here's why:

The Need for Reform

"There is evidence that health care cost growth never really declined, but instead it was temporarily masked by managed care" ***- Employee Benefits Research Institute***

Though managed care is not going anywhere, and is in fact incorporated into many defined contribution products, it has failed to consistently battle skyrocketing healthcare trend. While utilization management and provider discounts represent real cost-savings, managed care may have been more of a one-time shot than a fundamental solution to containing costs over a long period of time. When first introduced, provider discounts, tightly managed hospitalizations, and primary care physicians sparked real dollar savings for purchasers of healthcare. As time wore on and these methods of operating became tiresome and inconvenient, patients began filing lawsuits and registering complaints against managed care companies,

forcing them to relax their standards. In addition, economic growth in the mid-1990s required employers wanting to compete for the best employees to offer richer fee-for-service plans with fewer restrictions. This dilution process has caused managed care to become less effective. Today, premium increases are as high as they have ever been. Very few incentives remain to modify behaviors and force the public to be savvy consumers of healthcare.

The defined contribution approach is a logical step to promote consumerism, a missing element in the standard benefit plans offered most commonly today. Furthermore, there is evidence that the defined contribution approach to healthcare could curb the growth rate of healthcare costs. This notion is explored later.

For most people, the defined contribution approach made its debut among the proposals on how to reform the healthcare delivery system in America, more specifically the public programs of Medicare and Medicaid. This is a good place to start since the biggest purchasers of healthcare fall under our public systems (employer-sponsored health insurance makes up only 27% of all healthcare costs in the United States).

Proponents of the defined contribution approach argue that implementing such a plan for Medicare and Medicaid users would create horizontal equity since contributions to Health Reimbursement Arrangements (HRAs) are tax deductible. In addition, the pre-tax feature of this plan reduces the cost of medical care making it affordable for more people. As the balances in the HRA accounts accrue year to year, individuals can fund their own health care ending the need for public programs entirely.

Another clue that defined contribution health plans are on the legislature's agenda is that the Health Insurance Portability and Accountability Act of 1996 included a provision creating a four-year test pilot program for plans using the Medical Saving Account feature combined with a high deductible insurance plan. This is clearly a sign of the times.

How Defined Contribution Plans are Marketed Today

Inspired by the defined contribution approach, leading insurers have developed products that are being marketed as "Consumer-Driven Health Plans" (CDH Plans). So-called CDH Plans incorporate a Health Reimbursement Arrangement (HRA) with a high deductible or catastrophic insurance plan (or selection of plans) for the employee to select as one option. The HRAs are funded by the employer and are meant to cover the deductible and other small claims (some products cover preventive care at 100% without using HRA funds). Overall, CDH Plans are a product that combines the positive aspects of the defined contribution approach (i.e., consumerism and employee ownership) with the safety and assurance that is associated with an actual insurance arrangement.

Some insurance companies, such as Great West Life are keeping it simple by offering a Flexible Spending Account (which they help to administer) that is funded by the employee, employer or a combination of both, coupled with a PPO, HMO or high-deductible indemnity plan. This is not the optimal arrangement since Section 125 plans are subject to discrimination testing and the 'use it or lose it rule'. The insurance aspect has more cost-sharing than the typical PPO program and the Flexible Spending Account is designed to defray the out-of-pocket costs.

More sophisticated programs offer a Health Reimbursement Arrangement that is attached to an array of insurance products. The Health Reimbursement Arrangement is meant to house employer funds which can be used to pay for deductible, coinsurance or other small claim costs. Online services assist the employee in figuring out account balances versus healthcare expenditures and can model an employee's future healthcare dollar. The Lumenos Healthcare Spending Account and Aetna's HealthFund are two examples of this.

See your WGA Account Executive for more details on what is available in the each regional insurance marketplace as the current products are dynamic and changing. The IRS has announced in mid-2002 some exciting and surprising rulings for the Health Reimbursement Arrangement balances. Among them:

- Health Reimbursement Arrangement balances can be used to pay for health insurance premiums (such as COBRA or Retiree premium) in addition to other qualified medical expenses
- Former employees and retirees can have continued access to unused funds in a Health Reimbursement Arrangement
- Where both plans exist, a Section 125 Flexible Spending Account funded by employee contributions could be the primary source of reimbursement with a Health Reimbursement Arrangement as secondary funding (this gives employees more assurance that unused balances will not be lost under the use it or lose it rule).
- Health Reimbursement Arrangement are subject to COBRA continuation provisions
- Health Reimbursement Arrangements have no regulatory cap

These decisions, cited as remarkably and uncharacteristically flexible and innovative of the IRS, will no doubt inspire many more creative products in the marketplace. Employees, in turn, may be more likely to select a defined contribution plan since the balances in the accounts are now more portable than previously thought. In addition, these rulings have been said to open the door for small employers to participate in the defined contribution approach.

II. Practicality of the Defined Contribution Approach

"We believe the new era in health care is upon us. While we know that consumer-driven style plans may not be a silver bullet, they re a good first step in positioning us to deal with dramatic changes in the marketplace." ***- HR Manager for Levi Strauss***

Though the recent IRS rulings may change this, the typical employer offering a defined contribution approach has no less than 3,000 employees. In addition, the defined contribution plan offering exists as an option, not a total replacement. Employers with large employee-bases are able to slowly introduce the concept of a defined contribution plan because they have a sufficient number of people among which to spread the risk.

Though most employers understand that the defined contribution approach is the most effective from a cost perspective when offered alone, they are uncomfortable as having that as the sole option for medical insurance. Generally employers who introduce the defined contribution approach have a set corporate philosophy and are committed to containing healthcare costs in the long term, not as a short-term solution.

Case Studies:

- Levi Strauss & Co. has 8,000 employees in the United States of which 2,600 are eligible for their new defined contribution health care option offered through Aetna's Healthfund product. This option went into effect as of June 1, 2002 and final enrollment numbers are not now available. The company was projecting to get as many as 10% of all eligible employees to enroll.
- Pharmacia Corp has 17,000 United States employees and had 3% enroll under their new defined contribution style offering through the Lumenos Healthcare Spending Account product introduced this year.

Both of these large employers state that the success of a defined contribution program hinges on the level of education assistance that is provided to employees well in advance of the implementation. The defined contribution philosophy is new to employees who are accustomed to minimal participation in their health care plans. Particularly with the more developed products, the Internet provides a great deal of information about providers and the costs associated with their procedures as well as other links to healthcare information. Under the new defined contribution approaches, consumers are best served to do the research and comparison-shopping generally reserved for the purchase of large items, such as cars or computers.

Shortcomings of the Defined Contribution Approach

"With defined contribution, insurance costs for the few, very sick employees who need comprehensive coverage can skyrocket as healthy employees move to lower-cost bare bones options or forgo coverage altogether…the premise of insurance, that the healthy help subsidize the sick will be undermined and overall costs will continue to rise." ***- Charlie Baker, CEO, Harvard Pilgrim Healthcare***

The claims are the claims:
Though rooted in sound philosophy, proponents of defined contribution plans often ignore many facts about healthcare in America. For example, offering a defined contribution health plan to your employees may cut down on small claims but it does not mitigate the fact that, on average, 11% of a given population incurs over 75% of all claims. What this means is employees with high-dollar illnesses are not going away no matter what approach to healthcare is being employed. Given this perspective, defined contribution programs seem to be nothing more than an overly complicated system for containing very small claims, not a tool to cut down on overall healthcare expenditures.

Adverse selection:
Further, if coupled with an insurance program, catastrophic or otherwise, defined contribution approaches will not be able to control the adverse selection that will take place. By and large, older and sicker populations will elect the most generous insurance program available simply because they anticipate the need for them. Younger, healthier populations would be more likely to choose the flexibility and lower-cost defined contribution choices. This combination sets the stage for some ugly claims experience and even uglier renewals in subsequent years.

Asymmetry of information:
Though consumerism is a key behavior employers are hoping to elicit from their employees, it is important to remember that there is an asymmetry of information that takes place in the doctor-patient relationship that may account for some unwise healthcare spending. Patients trust the recommendations of their doctors and tend to act on them. It is not common (or even possible at some hospitals) to get an estimate for a procedure *before* it is performed. Indeed most hospital billing practices are retrospective, making it difficult for consumers to actually "price shop".

Who Pays for the Mistakes?
When given a variety of choices, someone who is young and healthy may choose the plan that will cost them the least. If an unforeseeable illness occurs, it may fall onto the hospitals and governments to pick up the tab for the employees who have made poor choices under their employer's medical plan offerings. That is why a well-designed selection of offerings and corresponding contributions must be developed and tailored to each employer's demographic in order for the program to succeed.

How Is It Supposed to Save Money?

"Defined contribution health benefits can be part of a solution that enables workers to choose between healthcare cost and quality and thereby enforce a discipline on health plans and providers that has not been present before." ***- Employee Benefit News***

Any health plan product derivative of the defined contribution approach has one basic theme: a shift in responsibility from employer to employee. Under a defined contribution plan, the purchaser bears much more responsibility for how the HRA funds are spent. Since any unused funds roll over into subsequent years, participants in a defined contribution arrangement have much more incentive to spend wisely and shop around for the best prices. This type of ownership, it is argued, should cut down on waste and foster a healthy competition among healthcare providers.

In addition, the defined contribution programs on the market today are funneling populations into lower cost catastrophic insurance plans with high deductibles. When paired with a managed care network, these types of insurance arrangements tend be lower in premium costs (though such savings may not be long term).

From a macroeconomic perspective, it can also be argued that certain types of catastrophic insurance arrangements can serve to curb the overall growth rate of medical costs. Early on in the defined contribution program development, actuaries estimated about a 10% savings in claim dollars. Now economists see defined contribution health plans as a way to help set the demand for healthcare services in such a way as to discourage intense medical technology.

If the increasing cost of healthcare can be attributed to technological advances (new surgical techniques and drug therapies, etc.) the best way to reduce this cost is to curb the demand for such services. This can be achieved by specially crafted insurance programs that will only pay for lower-tech (yet equally effective) procedures that will also steer patients toward less invasive and innovative courses of treatment. This supply and demand scheme will only work if the lower-tech options available are equally as effective as the higher tech procedures and if the patients are willing to use them.

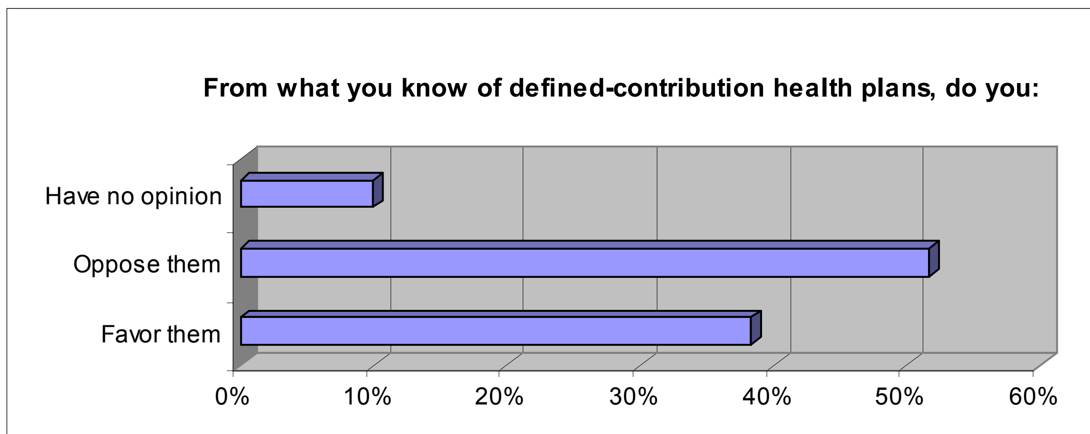
III. Are We Ready For It?

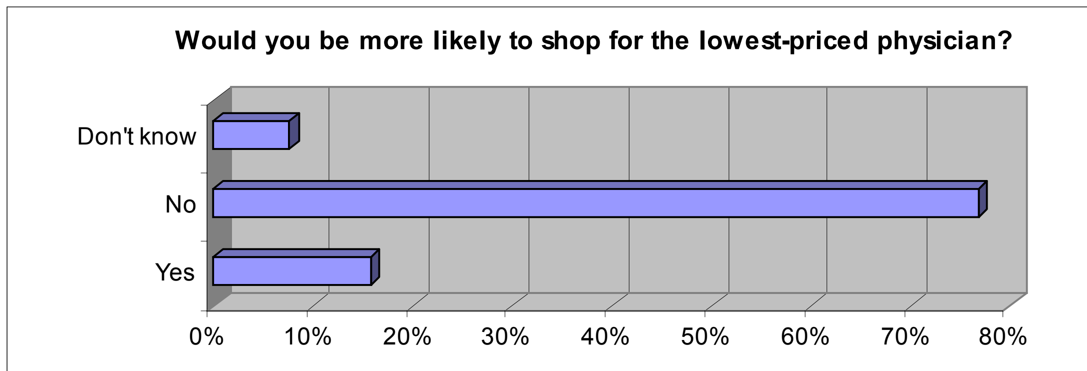
"Americans like to talk about being rugged, independent individualists, however, it is well-proven that we actually want womb-to-tomb protection from someone else." ***- Society of Professional Benefit Administrators***

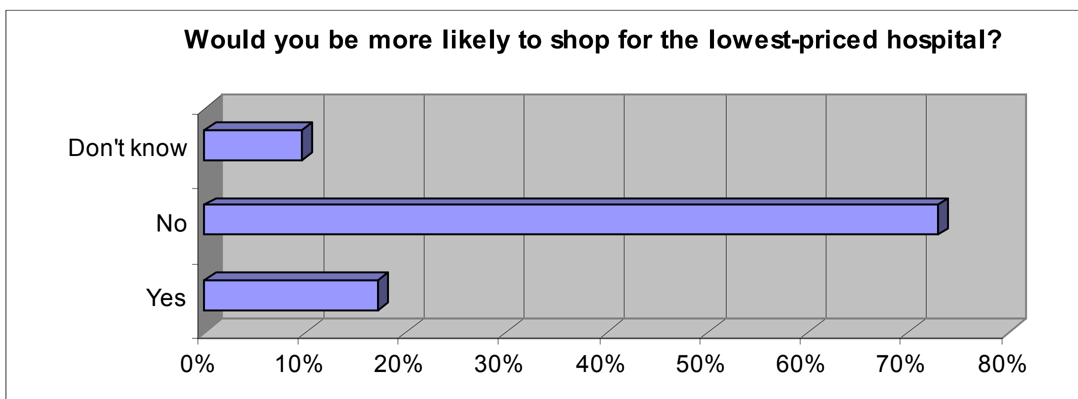
The logical viewpoint would be that defined contribution plans are a step in the right direction, not just toward employer-sponsored health insurance but for overall healthcare reform as well. Until consumers start involving themselves in healthcare decisions, providers will have the freedom to charge any fees they like and increase these fees year after year. Managed care is of some assistance but the defined contribution approach might be that radical next step to rate relief. It is clear that governmental interests are on board with these theories, however, it is unclear if the same can be said about the average consumer.

Though large employers seem to be offering such plans in small numbers, the jury is still out as far as the actual effects it will have on health insurance premiums and behaviors over the long term (See Appendix for consumer opinion polls and pros and cons). The larger employer, however, can weather potential adverse selection and other undesirable side effects. Much more research needs to be done before such an approach could be recommended to employers of moderate size. The road to acceptance could be long and painful, but in the end, a consumer-driven health plan is a likely catalyst for change.

IV. APPENDIX

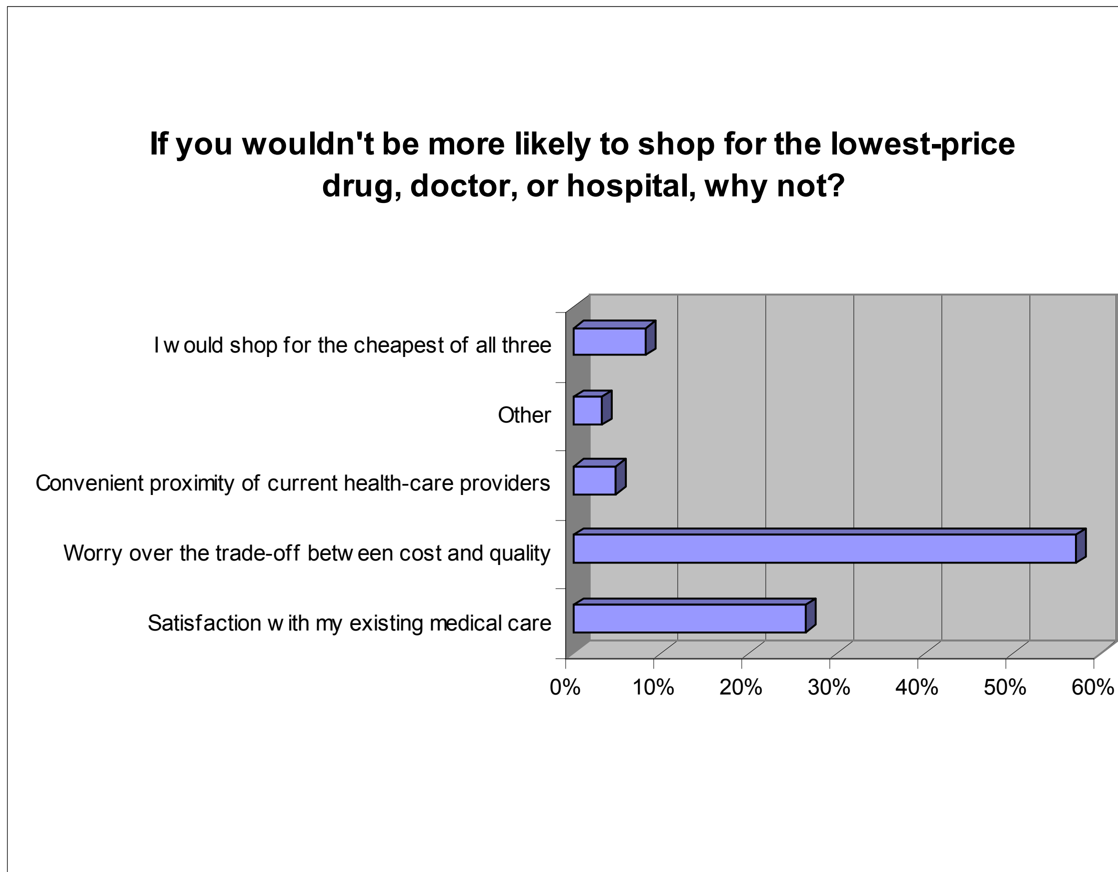


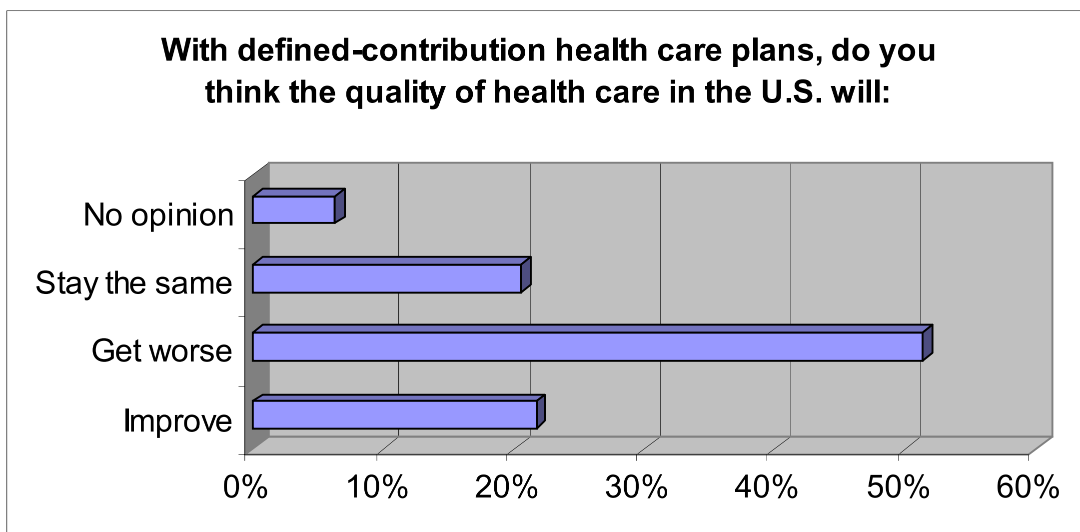




Source: Business Week On-Line

APPENDIX





Source: Business Week On-Line

APPENDIX: Pros and Cons of the Defined Contribution Approach

Proponents Say:	*Opponents Say:*
It will empower consumers of healthcare by putting the spending decisions in their hands.	Under this arrangement, it may be tempting to forgo preventive or necessary care in the interest of maintaining a Health Reimbursement Arrangement balance. Also, employees and other purchasers of healthcare may not want to invest the time and energy that it would take to price shop for quality care.
It will instill consumerism among the purchasers of healthcare, causing the market to become more competitive and higher quality.	It may be difficult for consumers to compare prices of healthcare since prices are not readily available. It does not address the fact that serious and chronic illnesses make up most claim dollars, not smaller claims.
It will result in lower, more predictable employer costs.	It may result in a demand for higher salaries as perceived out-of-pocket expenses are higher.
It may serve to curb healthcare inflation over a long period of time.	Actual data to support this does not exist.
It can be offered as a plan option, not necessarily as a total replacement.	It is practical for very large groups, even so, it could result in adverse selection. Best results only appear if this product is offered alone.
Recent IRS rulings have made HRA funds portable. They are subject to COBRA provisions.	Therefore, sponsoring a defined contribution plan cannot be seen as an employee retention tool.

APPENDIX: Defining Terms

Defined Contribution vs. Defined Benefit:
These terms are more commonly used to describe retirement plans. Defined benefit plans are those that promise to pay a participant's benefits that are determinable based on such factors as age, years of service, and compensation. For example, employees with 30 years of service may be eligible for a benefit of $10 a month for each year of service, amounting to a pension of $300 a month upon retirement.

Defined contribution plans, conversely, specify the dollar or percentage amount that will be contributed by the employer on behalf of employees. This amount is quantifiable and determinable, generally, by the employer. In a 401(k) plan, for example, an employer may commit to contribute 5% of compensation per year, per employee.

Taking from this model, a defined contribution plan is one where employers dedicate a certain contribution amount for each employee.

Acronyms:
When discussing the defined contribution approach to medical insurance, references to the healthcare spending account which is funded by employers and designed to fund a high-deductible wrap around plan are captured in print by several acronyms. Among them are:

- Health Reimbursement Arrangement (HRA) – Most commonly used by the IRS
- Personal Care Account (PCA)
- Medical Savings Account (MSA) – Used to reference smaller employer's plans

Managed Competition:
This term refers to the effect that defined contribution health plans are supposed to have on the healthcare industry. If defined contribution plans provide incentives for employees to shop around for the most cost-effective healthcare, this will spawn competition among providers to offer more competitive pricing and higher quality.

Consumer-Driven Health Plans:
This term has become the more politically correct phrase to describe the defined contribution approach to healthcare. Where the crude version of a defined contribution health plan may be seen as a set amount of money given to each employee to purchase their own insurance, "CDH" Plans are more of an amalgam of a Healthcare Reimbursement Account coupled with a high-deductible wrap around plan both of which are sponsored by the employer.