# The Consumer Revolution in Health Benefits

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Supported by major changes in Federal tax policy, health benefits are undergoing the most significant change in 30 years. This change, intended to give consumers both more control and more accountability in managing their health care, promises to revolutionize the way in which health benefits are structured in this country. Incidentally, it is also likely to change the way consumers think about health and wealth, the way they plan for their financial needs – particularly in retirement – and ultimately the products and services they demand from their life insurance agents and financial advisors.

**Background:**

Although insurance is one of the few U.S. industries regulated primarily by the states, health insurance has been dramatically influenced by Federal policy. Wage and price controls following World War II are broadly credited (and criticized!) for the expansion of employer-based health benefits in the later half of the 20th century. These employer plans are by far the dominant source of health coverage for working Americans. They are also extremely popular; employees routinely cite health coverage among the top two or three reasons they choose to work for or stay with an employer.

In light of the popularity, it is not surprising that the trend in health benefits has been toward ever-increasing coverage. Employer plans in the 1950's typically paid for less than 50% of an employee's total health care expenditures. By the end of the century this number had reached 75% and in some cases 80% or more. This result is all the more remarkable in light of the dramatic increase in underlying health care costs: out-of-pocket health care costs as a percentage of household income among working Americans has remained relatively flat for half a century, while health benefit costs have risen dramatically as a percentage of both total employee costs and total costs of goods sold for most employers.

In response to what were seen as "unsustainable" health care cost increases in the 1970's, the Federal government influenced adoption of a new approach to health coverage: managed care. The Federal HMO Act of 1974 allowed

Federally-qualified HMOs to mandate that their plans be offered to employees as an alternative to more traditional health insurance. The value proposition was an intriguing one: HMOs offered richer coverage – often requiring only nominal, fixed-dollar co-payments – at a lower price. This was accomplished by encouraging or requiring that members receive non-emergency care from participating providers and that care be monitored and reviewed for effectiveness and efficiency.

**The Emergence of a New Model – Consumer-Directed:**

Consumers reaped an extraordinary benefit from managed care. Premiums were reduced along with out-of-pocket costs. Drugs, diagnostic tests, doctor's visits and, in some cases, even hospitalizations could be obtained for $10 dollars. The actual cost of the underlying care was of even less concern than under traditional health insurance with its percentage cost-sharing requirements. That was the HMO's problem.

At the same time, many resisted the very elements that allowed these enhanced benefits, demanding more flexibility in choosing services and providers with less supervision of the care they received. Not surprisingly, costs also continued to increase, driven by demographics, advances in science and technology, increased marketing of health services and even an expansion in the definition of care. By the late 1990's employers were once again facing "unsustainable" levels of health care cost increases, this time coupled with demands from their employees for greater levels of control over the use of their benefit dollars.

The response has been a new approach to health benefits, centered on consumer choice and responsibility. These plans, which began to emerge around 2000, re-introduce certain elements of traditional insurance, notably deductibles and percentage cost-sharing, while adding a benefits "fund" that employees can use to help pay for any qualifying health service they choose. This fund structure was given a major boost by the U.S. Treasury in 2002 with its guidance permitting Health Reimbursement Accounts ("HRA" – an employer-paid health spending account), and even greater support with the passage of Health Savings Account ("HSA") legislation as part of the Medicare Modernization Act of 2003.

Early adoption rates of these consumer-directed models have been strong, and the predicted growth rates are dramatic. A Hewitt study conducted in 2004 found that 60% of employers were considering adoption of a consumer-directed health plan. A Forrester study done a year earlier – predating the passage of HSAs – suggested that by the end of this decade 25% of employer health benefit plans would be consumer-directed models. Others have suggested that even this estimate is conservative.

**Retiree Health Benefits:**

For separate but not entirely unrelated reasons, many employers have also begun to scale back or discontinue their retiree health benefits programs. In part this trend relates simply to the nature of work these days; increasingly employees today work for multiple employers during their careers. Employers are also facing increasing competition, both from foreign corporations which typically have much lower employee costs and from domestic start-ups that do not have a significant number of retirees and in any event do not offer retiree benefits. More recently changes in accounting rules have required employers to recognize their retiree costs and, in the case of employers with defined benefit retiree health programs, to recalculate their liabilities based on changes in health care inflation. These recalculations can create significant, unanticipated swings in an employer's balance sheet, an unacceptable risk in a time of increasing competition and financial scrutiny.

Again the HRA and HSA rules provide some potential relief for employees losing retiree coverage, since accumulated balances in both of these accounts can be carried forward into retirement. In fact, the HSA legislation specifically allows consumers over the age of 50 to deposit additional amounts into their accounts in anticipation of retirement needs. Predictions on the future of retiree health benefits differ, but the continued reduction in employer-provided defined benefit coverage for this population seems very likely, as does the additional accumulation of funds within defined contribution vehicles such as HRAs and HSAs.

**So What?**

In the realm of health benefits these are major, transformational changes. Health insurers, health providers, benefits managers and even insurance regulators are watching these developments closely, and there is broad consensus that the future will be quite different from the recent past. But at least thus far less attention has been paid to what is likely to be the much more far-reaching impact these changes in health coverage will have on the life insurance and financial planning industries.

The simplest change is that many consumers will now have access to an additional tax favored savings vehicle: the Health Savings Account. Moreover, with one stroke of the legislative pen Congress has now created the single best tax savings vehicle available to most individuals. Unlike 401(k) dollars, which are tax-deferred until retirement, HSA dollars are completely tax free, including all inside build-up, if used for health care. Even if a Medicare-eligible chooses to take their HSA money out in cash it still has the same tax benefits of a 401(k), making HSAs, at worst, the equivalent of the popular pension savings plans.

Like 401(k) contributions, employers can also choose to match their employee's contributions to an HSA. It is still too soon to tell if this will become common-place, but it is not unreasonable to think that employers who match pension savings may do the same for health savings, particularly since HSA dollars can also be used by their employees to pay for more immediate health care needs. Thus financial planners – not to mention radio talk show hosts dispensing financial advice – will soon be obliged to start their conversations with a new line of inquiry: "Does your employer provide access to an HSA? Are you eligible for a match of these funds? If so, this is now your single best savings vehicle for retirement, even better (assuming a comparable match) than your 401(k)."

More fundamentally, consumer-directed health benefit plans will begin to reconnect consumers with the costs of health care. By extension, consumers' perceptions of their health plans are likely to evolve from "a source of care" to "a source of care financing", and ultimately to "a source of care financing and financial protection". This, some would suggest, brings the health insurance industry full circle, focusing on the fundamental aspect of any insurance program, financial protection against unanticipated risks. In fact, health care plans will almost certainly continue to do more than that, helping to finance routine care, providing reliable health information and assisting consumers in making informed choices about care quality, efficiency and effectiveness, but the aspect of financial protection undoubtedly will become more visible.

Employers are likely to increase this visibility through changes in their compensation, bonus and even severance plans. Consider, for example, an employer that intends to make an average 3.5% cost-of-living adjustment in employee salaries next year. If this employer offers an HSA-compatible plan to all their employees, they may consider instead a 3% salary adjustment, allocating the other .5% to HSA contributions on behalf of their employees. The cost is the same to the employer, but the benefit arguably is greater to the employee, since the HSA dollars are tax-favored. Similarly, employers might choose to allocate a certain portion of annual bonuses to these tax-favored accounts, something many have begun to do with their 401(k) plans. It is even conceivable that employers will change their severance plans to provide that a portion of those dollars would be set aside in a health account, again leveraging the tax advantage to the benefit of (former) employees.

The decline in defined benefit retiree health coverage, coupled with what many see as the inevitable failure of Medicare to keep pace with the health care demands of an aging population, is already focusing consumers on the potential impact of health expenditures on their retirement planning. Fidelity recently published an attention-grabbing (and sobering!) estimate of the *out-of-pocket* health care costs an average person can expect to incur

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in retirement notwithstanding Medicare: $167,000. This exceeds the total retirement savings of a significant percentage of the American population.

The appreciation of numbers like this will lead more and more individuals in this country to think about their future protection needs in terms of financial exposure to health care costs. Health benefit accumulation vehicles such as HRAs and HSAs can help. So would further tax incentives being sought from Congress. Additional attention will also be focused on aspects of care not covered by Medicare or other traditional retirement plans, notably assisted living support. Long term care insurance may be the single most under-appreciated personal financial protection coverage available to consumers. Growth in demand for protection against these costs can be expected to grow significantly. Note that dollars accumulated in both HSAs and HRAs can be used to pay for qualified long term care premiums, which should provide further impetus for this demand.

Numbers like that published by Fidelity also crystallize a growing perceptual change with broad implications for the life insurance industry. Historically, individuals purchased life insurance – at least term and whole life plans – to protect their families from the adverse financial consequences of their death. There is an increasing perception that the greater risk may be in their dying, or more precisely in the cost of maintaining their health and life in old age. This may prove to be the corollary to perception among an increasing number of younger Americans that they will not be able to rely on either Social Security or Medicare to protect them financially; that ultimately we will each be obliged to provide for ourselves.

Viatical features and cash-balance life insurance do allow consumers to take some money out of the life insurance plans today. However, the stronger re-connection of health and wealth is likely to drive demand for new approaches to coverage with greater flexibility and improved tax efficiency. There is a view, for example, that long term care is simply "one coverage too many"; although the protection is perceived as valuable, the plans simply must compete for a limited share-of-wallet with health and life insurance, not to mention auto, homeowners and other property/casualty protections, college savings, etc. The answer may well lie in reconfigured coverage that combines life and health protections, for example a life insurance plan the cash value of which can be used to purchase long term care assistance at negotiated prices. Other combinations might also be attractive, such as life and dread disease protection or health savings with a life benefit. Individual plan customization, increasingly available in health benefits, could also be extended to health-related financial protection: "peril packaging" based on an individual's age, savings, availability of other coverage, health status and (although it would raise some challenging public policy concerns) perhaps even genetic risks.

Finally, consumers are likely to demand solutions defined in terms that are both meaningful and concrete to them. Health and pension savings, and even health and life insurance, are a level or two of abstraction from actual consumer needs. It will be interesting to see how the market will begin to address this gap. Assisted living communities are a step in this direction. Packaged retirement living is a further step. Future health care costs are sufficiently unpredictable to make creation of these sorts of packages challenging. However, empowered consumers have revolutionized virtually every other industry. The future for all of us will be interesting!