Defined Contribution

A familiar model, redefined for health care

Executive Summary

Amid all the turbulence clouding today's health care landscape, a new era is taking shape—one in which consumers have more control over their medical decisions. Health care consumerism is about transforming an employer's health benefit plan into one that puts economic purchasing power, and decision-making, into the hands of participants.[1]

Several factors are coalescing to create this shift: rising health care costs, government reform and increasing consumer demand for cost transparency and control. As a result, countless employers are being forced to reevaluate their health benefits strategies. Many are finding the answer in a familiar model: defined contribution.

[1] The Institute for HealthCare Consumerism, theihcc.com

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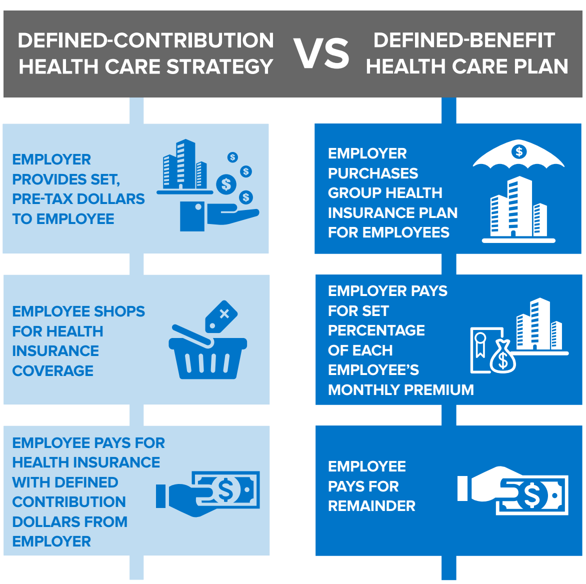
Defined Contribution, Defined

While the concept of defined contribution is new to health care, it has been used with corporate retirement plans since the 1980s. In its simplest terms, it refers to a model whereby the employee, employer or both contribute a fixed amount or percentage to a plan, typically a 401(k). The employee controls how the funds are invested and the payout depends on the plan's performance.

This is in contrast to a defined-benefit plan, which the employer contributes to and which promises a set benefit at retirement.

In health care, the model isn't too different. Employers contribute a fixed amount of money (the "defined contribution") to an account that employees can use to shop and pay for their own insurance coverage and other eligible medical expenses. This differs from the traditional, defined-benefit model, in which the company provides health benefits and harbors the health care costs—and risk.

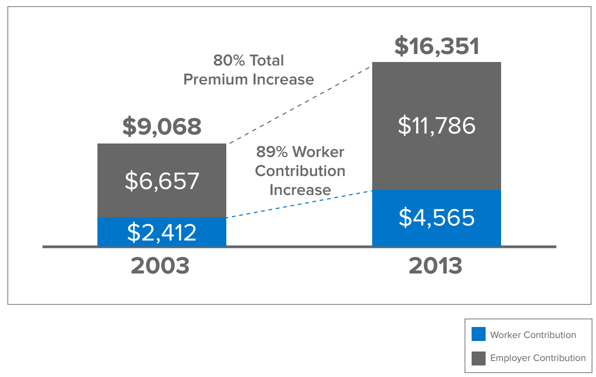
It is important to note that a defined-contribution plan is technically not a health insurance plan. Rather, it is a strategy for offering health benefits.[2]



Why Now

Industry experts and economists predict that 2014 will be the tipping year for defined-contribution health care. Forecasting the transition, economist Peter Orszag, former Director of the Office of Management and Budget, wrote in 2011 that the shift to defined-contribution health plans would gradually take over the health insurance market over the next decade.[3] There are three key reasons for this trend: rising costs, health care reform and consumer demand.

Average Annual Health Insurance Premiums and Worker Contributions for Family Coverage, 2003-2013



SOURCE: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2003-2013.

1. Rising costs

For most companies, the cost of providing health care benefits has become unsustainable. Nearly ten years ago, U.S. automakers were raising red flags about its impact to their balance sheets. General Motors claimed employee health care added $1,525 to the price of every car that left their lots, estimating they spent $5.2 billion on such benefits in 2004—more than the company paid for steel.[4] Fast forward to today. Employer-sponsored insurance covers about 149 million nonelderly people.[5] On average, that insurance costs employers $5,884 for single coverage and $16,351 for family coverage—the latter representing an 80 percent increase over the last ten years.[6]

As costs continue to climb, health care reform is adding more salt to the wound.

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[2] Christina Merhar, "Top Five Questions on Defined Contribution Plans," Zane Benefits, July 2013.

[3] Christina Merhar, "The Tipping Year for Pure Defined Contribution Health Care," Zane Benefits, November 2013.

[4] Center for American Progress, "Healthcare by the Numbers, Ensure Affordable Coverage for All," May 2007.

[5] The Henry J. Kaiser Family Foundation, Kaiser Commission on Medicaid and the Uninsured, "The Uninsured: A Primer: Key Facts About Americans Without Health Insurance," October 2012.

[6] The Henry J. Kaiser Family Foundation, "2013 Employer Health Benefits Survey," August 2013.

2. Health care reform

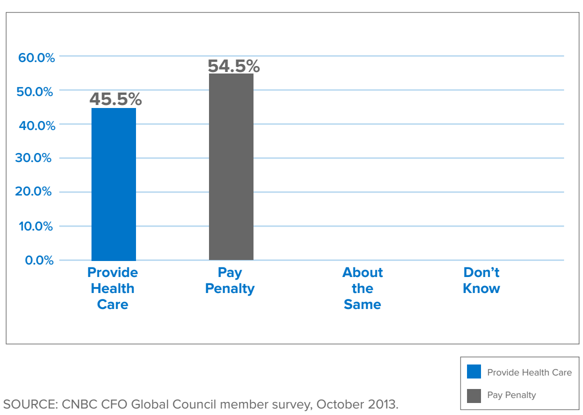
Signed on March 23, 2010, the Patient Protection and Affordable Care Act (ACA) aims to extend health care coverage to more than 45 million uninsured Americans by changing the delivery system.[7] This includes a mandate that companies that employ 50 or more full-time employees provide insurance coverage and pay at least 60 percent of the covered health expenses. If the business does not cover 60 percent of the covered expenses, the employer must pay $3,000 per full-time employee.

The employer-provided health care costs cannot exceed 9.5 percent of a family's income. If the plan cost exceeds that, then the employer must pay $3,000 per full-time employee for not offering affordable coverage.[8]

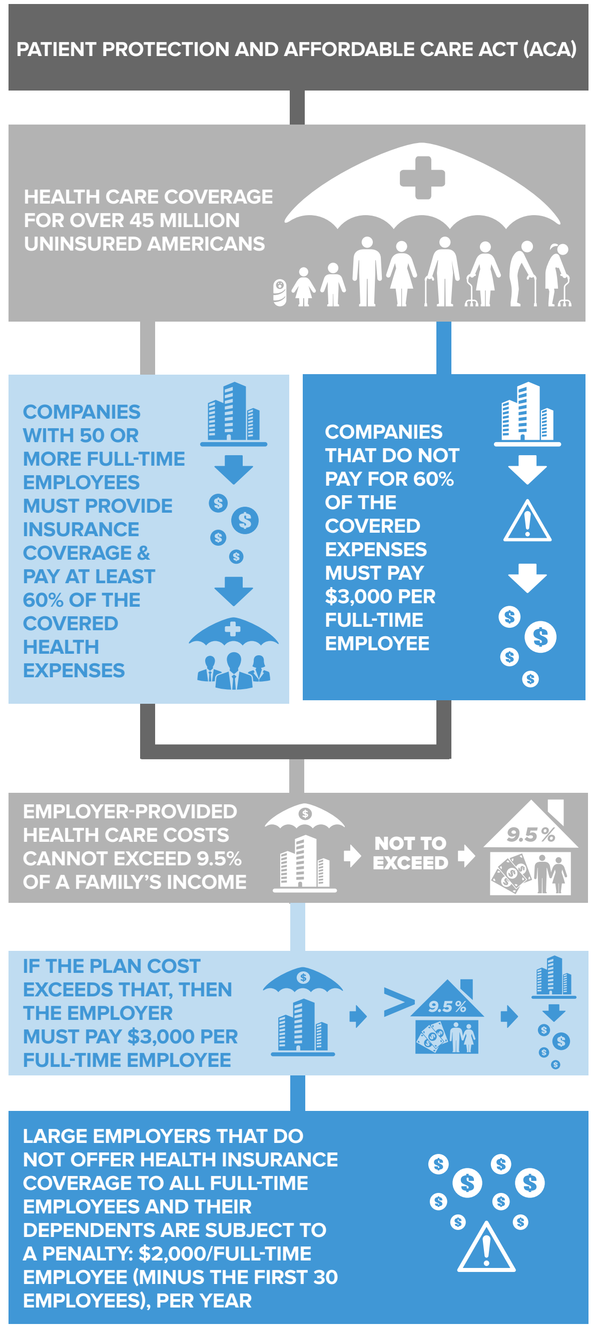
And there's more. If a large employer does not offer health insurance coverage to all full-time employees and their dependents, it is subject to a penalty of $2,000 per full-time employee, minus the first 30 employees, per year.[9]

As employers crunch the numbers, some are finding it may be more cost effective to drop coverage, pay the penalties and let their employees find insurance through the public exchanges. Alternatively, some may consider reducing employees' hours to less than 30 per week. According to a survey of CNBC CFO Global Council members, over 54 percent of the employers who responded feel it will be more cost-effective to pay the penalties.[10]

Is it more cost effective for your company to provide an employee with health insurance or pay the employer penalty for not providing coverage?



SOURCE: CNBC CFO Global Council member survey, October 2013.



[7] Young, Jeffrey, "Uninsured Americans 2012: More Than 45 Million Lacked Health Insurance Last Year, CDC Reports," Huffington Post, March 21, 2013.
[8] Sharon Myers, "Employers hear update on Affordable Care Act requirements," The-Dispatch.com, October 2013.
[9] Ibid
[10] Anthony Volastro, "CFO Survey: Penalties are cheaper than health care," CNBC, October 2013.

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Yet, other surveys show that employers agree that providing benefits is vital to recruiting and retaining top talent, and that they will do what's necessary to continue to help their employees with health insurance.[11]

Defined-contribution health care may help alleviate these concerns.

3. Consumer demand

Increasingly, employees are shouldering more of their own health care costs through high-deductible insurance plans and health savings accounts (HSAs). In fact, more than a third of Americans who get health insurance through their employers now have high-deductible plans—a sizable increase compared to the 10 percent who had them in 2006.[12] In 2012, out-of-pocket expenses, not including premiums, increased to an average $768 for each privately insured consumer. They are projected to skyrocket by as much as 50 percent in 2015 under ACA mandates.[13] Additionally, the rollout of state-based health insurance exchanges (HIEs) has increased consumer awareness around cost and quality transparency.

As more employees take an active role in managing their health care decisions, the defined-contribution model becomes an increasingly attractive option.

[11] Employer survey conducted by Cambia Health Solutions, November 2011.

[12] Matthew Rae and others, "Snapshots: The Prevalence and Cost of Deductibles in Employer Sponsored Insurance," The Henry J. Kaiser Family Foundation, November 2, 2012.

[13] "2012 Healthcare Cost and Utilization Report," Health Care Cost Institute, September 2013.

Cost Control and More

With so many moving parts in health care today, it is nearly impossible to get a handle on—let alone plan for—current and future costs. A defined-contribution strategy can help both employers and employees manage costs and make more informed decisions.

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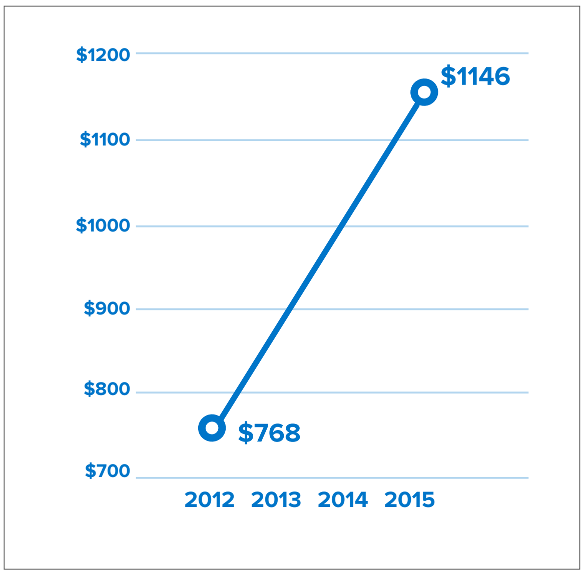
Out-of-Pocket Expenses



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Employer benefits

Faced with having to shift more responsibility for health care costs to their employees, companies are finding a viable compromise with defined contribution. Employers can fix their health care costs on a monthly basis and still provide employees with health care coverage options that meet their unique needs. The result is more control over these unpredictable expenses and a new option for recruiting and retaining talent.

There are a handful of ways employers can take advantage of defined contribution. Brad Davis, a benefits attorney at Wraith, Scarlett & Randolph Insurance Services, explains, "With the defined contribution approach, the menu can be as simple as the multiple options under a Section 125 cafeteria plan, or can involve a dedicated online platform or, increasingly, use of a private health care exchange." [14]

Private exchanges are essentially online marketplaces where consumers can shop for health coverage and compare plans. Employers who go this route can still maintain the tax advantages that come with providing group coverage. The bonus is that they can define contribution amounts, thereby controlling their costs. Additionally, they can keep their annual contribution amount the same year after year or adjust it with inflation. Either way, employers can predict their costs more easily over having to budget for a percentage of premium costs, which can change annually.

Zane Benefits cites the following employer benefits for defined contribution[15]:

Fixed Liability	With a defined-contribution health care plan, the employer's maximum financial exposure is capped at the monthly defined contribution and distributions are only made for approved medical expenses. Additionally, most defined-contribution plans have a utilization rate of less than 100 percent, meaning only a fraction of the total liability will result in an actual expense.
Plan Design	An employer may wish to provide different benefits for a manager, full-time employee and part-time employee. With a defined-contribution health care plan, the employer can customize benefits for an unlimited number of employee classes, and designate which medical expenses the contribution can and cannot be used for. Additionally, the employer can choose to provide the benefit based on many factors: date of hire, full-time status, geography, etc.
Easy Administration	Defined-contribution health care plans are extremely flexible, and they allow an employer to provide a quality health benefits program in less than five minutes per month. Each employer designs its plan with the help of a broker and an administration provider, and can set terms and conditions that meet the company's exact needs. Once the defined-contribution plan is set up, employee reimbursement requests (or "claims") are reviewed and approved by a third party, and tax-free reimbursement is paperless via direct deposit or a payroll system, requiring minimal involvement from the employer.

[14] Joanne Sammer and Stephen Miller, CEBS, "Time for Defined Contribution Health Benefits?," Society for Human Resource Management, October 2013.
[15] Emily Ritter, "Defined Contribution: A Win for Employers and Employees," Zane Benefits, October 2012.

Gaining Momentum

Many of the nation's big-name employers are recognizing the value of moving to a defined-contribution model.

In fall 2013, **Walgreen Co.** announced that it would be moving more than 160,000 of its employees over to this type of plan starting in 2014. They join **Sears Holding Corp.** and **Darden Restaurants, Inc.,** which operates the **Red Lobster** and **Olive Garden** chains, as well as **IBM** and **Time Warner,** who have already moved retirees into private exchanges.

These examples do not mean that defined contribution is best suited for big business. In fact, it might make even more sense for small and mid-size companies that have really felt the squeeze with rising health care costs or have not been able to afford group health coverage at all.

Planning Ahead

Today, defined-contribution health care accounts for a relatively small proportion of the health insurance in the U.S. That balance is shifting though, as awareness of private health exchanges grows. The consulting firm Accenture estimates that by 2018 there will be 40 million people enrolled in coverage through a private exchange. That's compared to the 31 million predicted to be enrolled through public exchanges at this same time period.[16]

With so much uncertainty muddying the health care scene, there is good reason for employers to explore their benefits options. Defined contribution may be the ideal solution for companies wanting to control costs but still give their employees access to affordable, quality health care. ✚

Engaging Employees

Awareness and education are key to helping employees embrace a defined-contribution strategy. Employers should consider the following when making the shift:

Over-communicate. Make everyone aware of the new plan, through email, printed materials, online communications and in-person meetings—the sooner the better.

Plan on helping employees with decision-making, especially those who have never had the opportunity to select health insurance on their own. This also means translating the new health care lexicon for them, including its acronyms, mandates and inconsistent terminology.

Be sensitive to different demographic groups. Younger employees may get on board more quickly than older ones. Married employees may have concerns that they'll be spending more for spouses and children.

[16] Tom Murphy, "The Big Story, Walgreen moves health coverage to private exchange," AP, September 2013.

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