McKinsey&Company

JUNE 2011

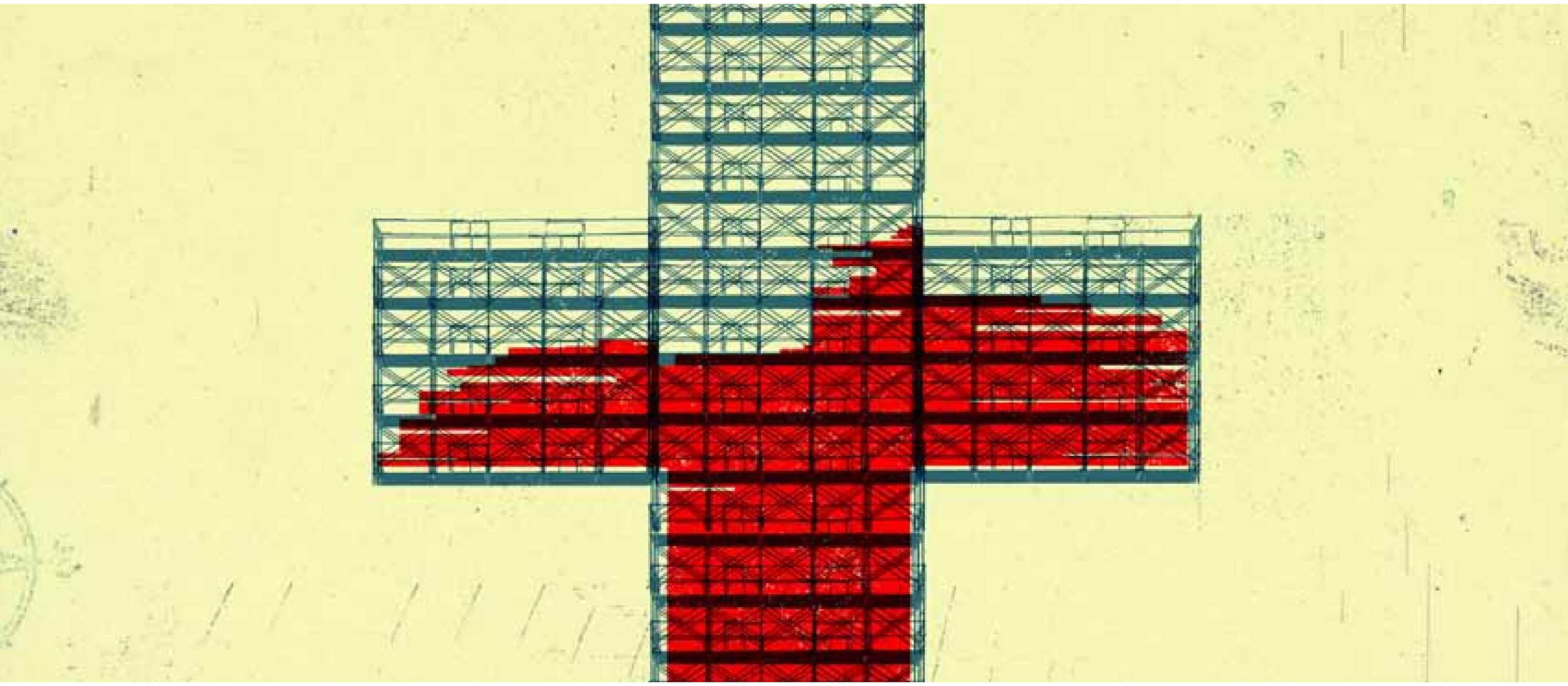
McKinsey Quarterly

HEALTHCARE PAYOR AND PROVIDER PRACTICE

How US health care reform will affect employee benefits

The shift away from employer-provided health insurance will be vastly greater than expected and will make sense for many companies and lower-income workers alike.

Shubham Singhal, Jeris Stueland, and Drew Ungerman



US health care reform sets in motion the largest change in employer-provided health benefits in the post–World War II era. While the pace and timing are difficult to predict, McKinsey research points to a radical restructuring of employer-sponsored health benefits following the 2010 passage of the Affordable Care Act.

Many of the law's relevant provisions take effect in 2014. Our research suggests that when employers become more aware of the new economic and social incentives embedded in the law and of the option to restructure benefits beyond dropping or keeping them, many will make dramatic changes. The Congressional Budget Office has estimated that only about 7 percent of employees currently covered by employer-sponsored insurance (ESI) will have to switch to subsidized-exchange policies in 2014. However, our early-2011 survey of more than 1,300 employers across industries, geographies, and employer sizes, as well as other proprietary research, found that reform will provoke a much greater response.

- Overall, 30 percent of employers will definitely or probably stop offering ESI in the years after 2014.

- Among employers with a high awareness of reform, this proportion increases to more than 50 percent, and upward of 60 percent will pursue some alternative to traditional ESI.

- At least 30 percent of employers would gain economically from dropping coverage even if they completely compensated employees for the change through other benefit offerings or higher salaries.

- Contrary to what many employers assume, more than 85 percent of employees would remain at their jobs even if their employer stopped offering ESI, although about 60 percent would expect increased compensation.

In this new world, employers must quickly examine the implications of health care reform on their benefit and workforce strategies, as well as the opportunities and risks that reform generates. Of course, the type and extent of the changes employers make will vary by industry, collective-bargaining agreements, and other constraints. Most employers, however, will find value-creating options between the extremes of completely dropping employee health coverage and making no changes to the current offering. Even employers that intend to provide benefits similar to those they currently offer can take no-regrets moves, like tailoring plans to maximize what their employees will value most about ESI after 2014. Employers pursuing more radical changes will have to rethink benefit packages for higher-income employees.

And all employers must continue to keep in mind their employees' health and wellness needs, even as insurance coverage levels evolve. To serve employers, insurers must retool their business models to provide more consultative support during the transition and develop innovative approaches to support employers' new benefit strategies (see sidebar "Implications for health insurers"). For employers and insurers, success after 2014 will require a better understanding of employee and employer segments, and the development of the right capabilities and partnerships to manage the transition.

A transformed employer market

Health care reform fundamentally alters the social contract inherent in employer-sponsored medical benefits and how employees value health insurance as a form of compensation. The new law guarantees the right to health insurance regardless of an individual's medical status. In doing so, it minimizes the moral obligation employers may feel to cover the sickest employees, who would otherwise be denied coverage in today's individual health insurance market. Reform preserves the corporate tax advantages associated with offering health benefits—except for high-premium "Cadillac" insurance plans.

Starting in 2014, people who are not offered affordable health insurance coverage by their employers will receive income-indexed premium and out-of-pocket cost-sharing subsidies. The highest subsidies will be offered to the lowest-income workers. That reduces the social-equity advantage of employer-sponsored insurance, by enabling these workers to obtain coverage they could not afford on today's individual market. It also significantly increases the availability of substitutes for employer coverage. As a result, whether to offer ESI after 2014 becomes mostly a business decision. Employers will have to balance the need to remain attractive to talented workers with the net economics of providing benefits—taking into consideration all the penalties and tax advantages of offering or not offering any given level of coverage.

What the law says

Health care reform imposes several new requirements on employer health benefits. Some changes will be incremental; for example, annual and lifetime limits on care must be eliminated, and coverage must be offered to dependents through age 26. Plans with premiums above certain levels will be subject to a so-called Cadillac tax.[1]

Other requirements are game changing and could prompt employers to completely reconsider what benefits they offer to employees. Reform requires all employers with more than 50 employees to offer health benefits to every full-timer or to pay a penalty of $2,000 per worker (less the first 30). The benefits must provide a reasonable level of health coverage, and (except for grandfathered plans) employers will no longer be able to offer better benefits to their highly compensated executives than to their hourly employees. These requirements will increase medical costs for many companies. It's important to note that the penalty for not offering coverage is set significantly below these costs.

[1]Current Affordable Care Act thresholds are $10,200 for an individual plan and $27,500 for a family plan. Above these levels, plans are subject to a 40 percent excise tax.

Implications for health insurers

Group insurance, sold mostly to companies and institutions, is the mainstay of commercial payers. This industry will change significantly in the wake of the Affordable Care Act. Competitors will emerge to serve new needs, such as providing a seamless transition for workers moving from employer-sponsored insurance (ESI) to public- or private-insurance exchanges or other coverage options. In response, payers must develop a better understanding of their customers and new capabilities to serve them. Three themes will underpin the moves of winning payers.

Segmenting and managing a changing group market

The ranks of the insured in the group market are in play. Payers must sharpen their account-planning and execution skills to identify the optimal benefit strategy for each employer. They must also develop approaches to capture employees likely to shift from ESI to the individual market—for instance, by offering desirable product and price combinations and having staff on site to help people who lose coverage from their employers. Our research shows that more than 70 percent of employees would stay with their insurer if it offers a seamless transition and appropriate products. Each payer also must understand how changing employer benefit strategies will shift the risk profile of its membership and set prices appropriately.

Catering to the new mix of ESI-covered employees

For companies continuing to offer ESI, the ability of a payer to differentiate itself through products and services will be more important than costs: the insured population will shift toward higher-income employees who will be less price sensitive, so more comprehensive or value-added plan designs will be essential. In addition, payers should consider offering a broader suite of supplemental products (such as life, disability, dental, and vision insurance) and membership in concierge or preferred-access physician groups. Better-off customers will have higher expectations, so payers could differentiate themselves by offering service levels beyond a basic call center to answer inquiries. They could, for example, offer services to help consumers find the right providers, schedule appointments, and deal with billing issues.

Shifting to a consumer-centric coverage model

For employers that move away from traditional ESI health benefits, coverage models will proliferate—for subsidized and unsubsidized employees, increasingly part-time workforces, defined-contribution models, and private exchanges. Employees will inevitably become more involved with their insurance choices, while the employer's role will change from insurance plan sponsor to facilitator of employees' choices. This development opens the way for consumer-focused attackers to emerge as distribution intermediaries.

To stay ahead, payers must not only sell products and services that help employers make this shift but also reach employees more directly. Payers must, for example, offer employees advice about their plan choices—advice based on a detailed understanding of each employee's health care options and economics—and a seamless platform to help employees choose the right coverage. Products must include tools to help consumers better understand and use their benefits, to provide advice and support for healthy living, and to enable frictionless claims processing. The further a company shifts from ESI, the more consumer focused a payer's response must be.

Payers must also reevaluate their marketing approaches and the effectiveness of their sales force. Employees and end-consumers should be targeted with tailored messages—for example, to persuade lower-income employees to remain with the payer's brand (whether through ESI plans or an individual exchange) and to convince higher-income employees that the payer's customer service levels are distinctive. As employers explore options beyond ESI, they will rely on a payer's sales force to help them design the benefit package best suited to their own workers. To do so, the sales force will need a comprehensive understanding of reform's economic implications for a variety of employee segments and develop more sophisticated consultative-selling skills.

Reform also offers options for workers to obtain affordable insurance outside the workplace. Individuals who are unemployed or whose employers do not offer affordable health coverage, and whose household incomes are less than 400 percent of the federal poverty level,[2] are eligible for subsidies toward policies they will be able to purchase on newly created state insurance exchanges. These will offer individual and family policies of set benefit levels (bronze, silver, gold, and platinum) from a variety of payers.

The subsidies will cap the amount lower- and middle-income individuals and families will have to spend on health coverage, to 9.5 percent of household income for those at 400 percent of the federal poverty level and less for those at lower income levels. The subsidies will keep the cost of insurance coverage from the exchanges below what many employees now pay toward employer-sponsored coverage, especially for those whose earnings are less than 200 percent of the federal poverty level.

[2]Today, 400 percent of the federal poverty level comes to a bit more than $89,000 for a family of four.

A bigger effect than expected

As we have seen, a Congressional Budget Office report estimated that only 9 million to 10 million people, or about 7 percent of employees, currently covered by ESI would have to switch to subsidized exchange policies in 2014. Most surveys of employers likewise show relatively low interest in shifting employees from traditional ESI.

Our survey found, however, that 45 to 50 percent of employers say they will definitely or probably pursue alternatives to ESI in the years after 2014. Those alternatives include dropping coverage, offering it through a defined-contribution model, or in effect offering it only to certain employees. More than 30 percent of employers overall, and 28 percent of large ones, say they will definitely or probably drop coverage after 2014.

Our survey shows significantly more interest in alternatives to ESI than other sources do, for several reasons. Interest in these alternatives rises with increasing awareness of reform, and our survey educated respondents about its implications for their companies and employees before they were asked about post-2014 strategies. The propensity of employers to make big changes to ESI increases with awareness largely because shifting away will be economically rational not only for many of them but also for their lower-income employees, given the law's incentives.

We also asked respondents questions about their philosophy and decision-making process for benefits: the current rationale for providing them, which employee group is considered most when decisions are made about them, their importance in the respondent's industry, and geography. These questions prompted the respondents to consider all the factors that will influence their post-2014 decisions. Finally, we tested options beyond dropping coverage outright. These alternatives will probably be the most effective ones for delivering a reasonable return on a company's investment in benefit programs after 2014. We would therefore expect to see a level of interest higher than that generated by surveys asking only about plans to keep or drop ESI.

Estimating the employer impact

As employers consider their post-2014 options, they should take a dynamic view by considering how competitors for talent—other employers—and their own employees will react. Many employers will be shifting from ESI; it is unlikely that only one company in an industry or geography will move away from it.

ESI might also be less valuable than most employers assume. Among employers not likely to drop ESI, three of the top five reasons given (and two of the top three) were concerns about talent attraction, employee satisfaction, and productivity. Among employees, however, McKinsey consumer research found that more than 85 percent—and almost 90 percent of higher-income ones—say they would remain with an employer that dropped ESI. Overall, employees value cash compensation several times more than health coverage.

Further, many younger employees also value career-development opportunities and work–life balance more than health benefits.

Making employees whole

To make up for lost medical insurance, most employers that drop ESI will increase employee compensation in other ways, such as salary and other benefits like vacation time, retirement, or health-management programs. Employees think this will happen: 60 percent say they would expect employers to increase compensation if health benefits were dropped, our consumer research shows. Employers will do so to remain competitive for talent. In addition, ensuring some level of employee health, through higher investment in wellness programs or another mechanism, helps to maintain the productivity of workers.

Our research found that even with conservatively low assumptions about eligibility for employee subsidies, at least 30 percent of employers would benefit economically by dropping health coverage even if they make employees 100 percent whole. Employers could do so by paying sufficient additional compensation to help employees purchase coverage with no other out-of-pocket expense (less subsidies for employees with household incomes below 400 percent of the federal poverty level), the additional individual income and payroll taxes levied on the increased compensation, and the $2,000 government penalty.

But we believe that employers will not have to provide 100 percent of the value of the lost insurance. If so, even more employers will benefit economically. In the course of our research, we interviewed executives at Liazon, a defined-contribution-benefit company. They have found that when employees are shifted from coverage selected by their employer to a defined-contribution plan (under which the employer provides a fixed dollar amount and the employee can choose how to allocate it among a variety of benefit options), about 70 percent of employees choose a less expensive health plan.

Higher-income employees, who won't receive subsidies and would have to pay the entire cost of individual coverage out of pocket, will have a greater need to be made whole. These higher-income employees, however, are also more likely to be satisfied with partial compensation or with tax-advantaged forms of compensation, such as retirement benefits.

The need to make employees whole will decrease over time. Subsidies will be awarded to keep premiums below a fixed percentage of an individual's household income. As long as income continues to rise at a rate lower than that of medical inflation, even employees who initially have to pay more out of pocket toward an exchange policy than they would toward ESI will have less of a difference to make up each year, and the employer will have to provide less to make employees whole.[3]

[3] Employer medical costs have nearly doubled since 2000, increasing at more than 5 percent each year—well above the general inflation rate.

This development should not suggest, however, that employers considering the elimination of ESI are focused exclusively on the bottom line, at the expense of their employees. In fact, because of the subsidies, many low-income employees will be able to obtain better health coverage, for less out of pocket, on an exchange than from their employer.

In fact, employers indicating that they will definitely or probably drop (or otherwise shift from) ESI post-2014 are more likely to consider the impact on low-income workers (as opposed to other groups of employees) when making benefit decisions and two to three times more likely to view benefits as important to attracting talent in their industry and geography. These employers are considering shifting from ESI not because they don't care about their employees but because they recognize that, after 2014, ESI may not be the most efficient way to provide health coverage (see sidebar "The range of coverage options for employers").

Getting ready for the new world

To prepare for 2014, employers should explore the economics of benefits after reform, maximize the return on investment (ROI) of benefit packages, design them for higher-income employees, and satisfy the health and wellness needs of the whole workforce.

Explore the economics of postreform benefits

Employers must understand, at the microsegment level, the eligibility of employees for subsidies under different scenarios—for example, when the employer provides no coverage at all, coverage defined as "unaffordable" (at a premium above 9.5 percent of the household income) for some employees, or coverage above the Cadillac-plan threshold. Companies must determine the cost of making employees whole, using market research tools to find out how much they value ESI, cash compensation for it, and a variety of other benefits. The importance for workers of a given benefit may not correlate directly with its tax-adjusted cost to the employer.

Maximize the ROI of the benefit package

The discussion to date has largely focused on dropping versus keeping coverage, but for most employers the most value-creating options lie in between. Employers should evaluate the economic impact not only of expanding ESI to every employee (compared with dropping it completely) but also of shifting toward part-time labor, allowing lower-wage employees to qualify for exchange subsidies through setting premiums above 9.5 percent of their household income, or adopting defined-contribution models. These intermediate options will probably be the most effective way to secure a reasonable ROI for benefits after 2014, because they enable employers to provide the best possible result for each segment of employees—ESI for higher-income ones not eligible for subsidies, as well as affordable coverage from a subsidized exchange for lower-income workers.

The range of coverage options for employers

Instead of completely dropping employer-sponsored insurance (ESI), employers could also choose, in effect, to cover only part of their workforce, without violating the provisions of reform that prohibit employers from discriminating against lower-income employees in a health benefits offering. One way of doing so would be to increase the proportion of part-time workers, for whom employers are not required to provide coverage. In industries with a high proportion of low-wage employees not covered by ESI today, such as retailing and food service, this approach allows the employer to avoid significant additional medical costs while still providing coverage to higher-income management and corporate employees.

Another option is restructuring into two separate companies: one comprising management and corporate employees who would receive ESI, the other lower-wage employees who would not. Given the income-indexed exchange subsidies, both populations of employees could be better off in this scenario.

One option likely to help most employers economically is setting the employee premium above 9.5 percent of the household income of lower-wage workers, so these employees can opt out of ESI and receive the same exchange subsidies they would if their employer did not offer ESI. All employees who opt out and receive these subsidies will pay less out of pocket than they would with ESI, as the maximum any subsidized individual spends toward an exchange policy will be 9.5 percent of his or her household income. If employees opt out and receive an exchange subsidy, the employer pays a penalty: $3,000 for each employee who does so or $2,000 for every employee, minus the first 30—whichever is less. That will be lower than what the employer would have paid toward ESI for that employee. For all employees who remain with ESI, the employer has still shifted more of the premium's cost to them.

If employers could adjust premium costs perfectly, so that every person with a household income below 400 percent of the federal poverty level had an ESI premium above 9.5 percent of household income, our economic projections show that about 60 percent of employees could be made eligible for subsidies. This level of premium adjustment would be difficult in practice. If employers set premiums so that the bottom quartile (by income) of their employees becomes eligible for subsidies, however, our economic modeling shows that over 90 percent of employers will benefit economically. That remains true if some employees eligible for subsidies prefer to remain on ESI because of the time and effort required to switch.

Even if premium sharing isn't increased intentionally to shift lower-income employees to an exchange, so long as employers' medical costs continue to increase faster than wages, more employees will become eligible for subsidies every year. Assuming that employee ESI premiums continue to increase at the current rate of 9 percent for employers' medical costs, about 15 percent of employees' families will be eligible for subsidies in 2014, growing to 20 percent in 2016 and to 28 percent in 2018. This will happen without a single employer discontinuing coverage or increasing premiums above its level of medical-cost inflation.

Even employers that continue to offer ESI—and many will, especially in heavily unionized industries where flexibility may be limited—could make no-regrets moves to maximize the ROI of benefits after 2014. Market research tools could be used to determine the preferences of employees, so that the benefit plan emphasizes what they value most while minimizing other features. Other strategies would involve designing plans and enrollment features to reduce costs, pricing plans to promote responsible use, and ensuring that wellness spending produces a positive return. Retiree medical benefits could be shifted from traditional ESI toward Medicare (the federal government's health care program for those 65 and older) and Medicare Advantage (the private-sector version of the government plan).

Design benefit packages for higher-income employees

Because lower-income employees will be eligible for exchange subsidies if their employers don't offer them affordable health coverage, we expect that ESI will shift toward higher-income employees. This group will have more demanding expectations for service levels and convenience, as well as different attitudes toward benefits covered.

Employers should tailor their ESI offering to include navigation tools that make it easier to identify and get appointments with high-quality health care providers and fast access to well-informed people for assistance with billing or coverage issues. These services could be provided through partnerships with enterprises that specialize in explaining medical bills and pricing. Higher-income employees may also value preferred-access or other enhanced-care physician services more than a traditional Cadillac ESI plan. These alternative benefits may be more cost effective for employers once the Cadillac tax comes into effect, in 2018.

Satisfy employee health and wellness needs

Even for an employer that drops ESI for all or some employees, maintaining their health, productivity, and satisfaction will continue to be important. Employers could not only

Related thinking

"Designing better employee benefits"

"Linking employee benefits to talent management"

"Conversations on health care reform: John Hammergren of McKesson"

"Conversations on health care reform: Harvey Fineberg of the Institute of Medicine"

"Conversations on health care reform: Rick Anderson of PTV Sciences"

expand or refine wellness programs to focus on elements that have a substantive, positive, and documentable impact on employee health and satisfaction but also provide the right incentives to encourage participation. In addition, employers could establish clinics at work sites, or partnerships with local providers or pharmacies so that employees can easily and affordably receive preventative care, such as flu shots or annual physicals. Another way to keep employees satisfied and avoid disrupting their lives would be to partner with a broker or another enterprise that helps them understand their benefit options and enroll for coverage on insurance exchanges.

Employers should recognize that as the ESI market changes after 2014, the system will react dynamically. If many companies drop health insurance coverage, the government could increase the employer penalty or raise taxes. Employers will need to be aware of actions by participants at any point along the health care value chain and prepare to adapt quickly.

Whether your company is poised to shift from employer-sponsored insurance or will continue to offer the same benefit package it does now, health care reform will change the economics of your workforce and benefits, as well as how your employees value coverage. Understanding these changes at a granular level will enable your company to gain or defend a competitive advantage in the increasingly dynamic market for talent.

The authors wish to thank Erica Hutchins Coe and Gene Kuo for their contributions to the development of this article.

Shubham Singhal is a director in McKinsey's Detroit office, **Jeris Stueland** is a consultant in the New Jersey office, and **Drew Ungerman** is a principal in the Dallas office.