Goldman Sachs

United States: Managed Care

2H2009 update on industry pricing and product trends

A national perspective on the middle market

We hosted our seventh annual conference call with Ken Ambos, national employee benefit practice leader for Equity Risk Partners, a full-service insurance brokerage and employee benefit consulting firm with a focus on the mid-sized employer segment of the industry. We continue to see this market segment as a bellwether for health insurance industry trends.

A transcript of the conference call is provided in the body of this report.

Conservative pricing is widespread in the industry

In our last call in August 2008, Ken Ambos and his firm were early in spotting a trend of strengthening pricing discipline that followed in the wake of severe margin erosion for the public companies in 1H2008. This trend has led to a stable margin environment for the public companies (though not for the major not-for-profit plans; we refer readers to our 9/16/2009 report, "The industry down-cycle hitting the not-for-profits hard for 2009").

This year, Ken and his firm have seen pricing continue to become more conservative, even as purchasers remain more price sensitive than ever. Ken and his firm see carriers being more selective in pursuing new business, with fewer pricing outliers, which is partly attributed to concerns over potential risk pool deterioration given the economic backdrop.

Pricing trends are seen in the 9-13% range, slightly higher at the top end of the range as compared to a year ago. Cost-sharing increases (higher co-pays, deductibles) continue but have decelerated somewhat from last year.

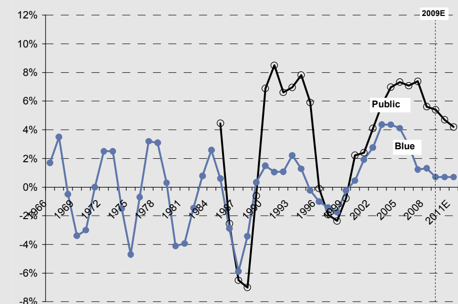
However, margins remain biased downward, in our view

The observations from Ken and his firm are consistent with our own channel checks with other employer consultants and non-public carriers—i.e., the pricing discipline is real. However, acceleration in medical cost trend appears to be negating the impact of conservative underwriting, such that margins are flat rather than expanding for the public companies, while margins have contracted for many of the non-public companies.

Looking ahead, we continue to see margins biased to the downside before we reach a final trough to the industry down-cycle in 2010- 2011. Partly for this reason, we continue to favor CIGNA (CL-Buy), which has significantly less exposure to cyclical trends in the commercial fully-insured (risk) business, as well as less exposure to health reform risk.

40 YEARS OF THE HEALTH UNDERWRITING CYCLE

Industry average underwriting profit margins
Blue Cross plans versus the public companies, 1966-2011E



Source: State insurance reports, BCBSA, Company data, Goldman Sachs Research estimates.

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Transcript of conference call (September 15, 2009)

MATTHEW BORSCH, GOLDMAN SACHS: Good morning. Thank you for joining us today for the Goldman Sachs Managed Care Industry Expert Conference Call. What we will do here is a very brief introduction and then I will walk our guest expert, Ken Ambos, through a list of key topics. We should probably wrap it up in 30 minutes or so.

Let me give you three quick points of introduction as context.

1. First, let me welcome back Ken Ambos as our guest expert. Ken is the national employee benefits practice leader for Equity Risk Partners, which is a full-service insurance brokerage and employee benefits consulting firm focused exclusively on the needs of private equity firms and their portfolio companies. As background, since 2001, Equity Risk Partners has provided due diligence advice and analysis, employee benefits consulting, risk management strategies, and insurance brokerage services on hundreds of transactions for thousands of portfolio companies.
2. The second point to highlight here is the importance of the perspective on the middle market (or mid-sized employer) segment that Ken brings, which we have found to be the bellwether for commercial health insurance industry trends.
3. And then third and last, I want to highlight from our own experience with Ken Ambos that goes back to 2002 that he has on multiple occasions brought to our attention key marketplace trends in advance of their becoming generally known to the investor marketplace.

   On at least three occasions Ken has flagged situations where carriers have been headed toward major service disruptions that have caused both fundamental and stock disruptions well in advance of it becoming known generally.

   I'd also point to our call from a year ago where Ken focused on, early and correctly in August of 2008, the firming up of pricing in the market which we have seen as a trend coming in to 2009; that was at an early point last year relative to that trend and Ken's call was spot on.

So with that, let me begin with the first topic and again, I'm going to walk through a series of these.

We don't want to get bogged down in a healthcare reform discussion here, but I do want to ask Ken as an opening question, whether he has seen indications of the reform debate directly impacting the behavior of buyers and/or sellers in the mid-sized employer healthcare plan segment.

KEN AMBOS, NATIONAL EMPLOYEE BENEFITS PRACTICE LEADER, EQUITY RISK PARTNERS: Thanks for having me back again this year Matt, and good morning everyone.

To address your healthcare reform question, the short answer is "no" or "not really" from the seller/carrier side of the equation. **There has been no clear evidence that we've been able to discern where, for instance, pricing has gotten more aggressive to possibly take heat off the industry in terms of the court of public opinion about the healthcare debate.**

I imagine we will discuss this at length in the subsequent questions but there is really no indication of that happening or being likely to happen in the near term.

From the buyer/employer side, mid-market employers need to make the best, most timely decisions they can with the information currently available; they just can't afford the luxury of waiting for the reform process and its related outcomes to materialize. Consequently, they're really not able to allow the on-going debate to affect how they make plan decisions today. That's not to say it won't alter the decision process landscape going forward, but as

they make renewal and plan change decisions for the remainder of this year, the reform debate should not be a significant direct factor.

As a sidebar, I thought it would be germane to address a healthcare reform-involved aspect of the federal stimulus package from several months ago—the COBRA subsidy baked in to the stimulus package—and whether or not it has had any material impact on industry dynamics.

From the standpoint of our client base, the subsidy hasn't been meaningfully significant. **There has been only a nominal COBRA enrollment increase since the advent of that subsidy being available.** So, rather sarcastically, I could say that the apparent government funding surplus in that bucket could help pay for some of the other reform elements that may be coming down the pike.

On a more tangible level, there has undoubtedly been some element of conservatism in carrier underwriting going forward from that subsidy date, for fear that there would be a deterioration of the risk pool associated with a higher influx of COBRA participants; that appears, at least from our corner of the world, not to have happened to any material degree.

Before we move on to the more crux issues of the market, a comment on the government/"public" option element of the healthcare reform debate. From the middle market employer perspective, I think it is fair to say there's prevalent exhaustion and exasperation in attempting to find ways to manage their way through the healthcare maze. If a public option were to be made available, and it was one where such employers could get out from under the direct obligation to provide health plans, a good majority of them would very seriously consider that.

So, I may be stating the obvious here but it seems clear from our perspective that if a viable government option were made available, many employers in this sector would look for ways to take advantage of that and get out of the healthcare plan provision business, to focus more on what they actually do for a living.

BORSCH: That makes sense, Ken. So let's take that as a segue into the next topic, which is key here—the broad subject of health plan market competition. Could you start by characterizing the overall level of competition in the current market that you're seeing, and to an extent contrast that with what you were seeing on our call a year ago?

AMBOS: Sure. It's essentially the same in the sense that no new players have been introduced to the mix, and the majority of the players that remain have continued to pursue a "maintenance of market share" mindset.

However, our observations note **a significant lessening of competitive market behaviors** amongst those players. This is evidenced most clearly by a **more selective pursuit of new business opportunities and a related higher level of declinations to quote on new business** opportunities. This is markedly up relative to the prior year.

BORSCH: Okay, that's interesting and gets a little bit to a question that I had.

Could you elaborate any more on what has come up from a number of investors? If the industry was pricing, for the sake of argument, let's say seven percent in the first half of 2008, and that was a period of time when competition was more intense and now this year, it's eight percent.

We can't necessarily conclude from a producer's standpoint that just because the pricing trend is up a hundred basis points that the pricing is firmer relative to margin because it all of course depends on where the underlying trend is. But you're pointing here to specific carrier behavior as it relates to willingness to quote on cases. Is there anything else you can point to that would indicate to you a sort of lessening of the intensity of price competition?

AMBOS: I think this is the most obvious reflection of that mindset, Matt.

BORSCH: Okay. I was alluding to what you saw as an issue in 2008, when you referred to more outliers with respect to carrier quotes that were pretty widely different. I think you've said previously you're seeing more clustering.

AMBOS: Yes, we are **seeing less evidence of outlier pricing and tighter ranges of quoting** outcomes. We'll get into that in a little bit more detail in the next couple of points.

BORSCH: Alright, so let me ask the next question then. Are you seeing differences in new business versus renewal underwriting?

AMBOS: Not appreciably. There's still an element of inherent new business discounting, as there is in virtually any sales function but otherwise, not much variation. **Underwriting discipline has been very consistent and persistent throughout the industry**. We had isolated examples where a particular carrier might have gone to the hoop strong on a case they felt comfortable with, but conservatism is much more the rule. On a somewhat related note, Matt, is the underwriting question you asked me a couple of days ago about whether we'd seen any evidence of risk pool deterioration...

BORSCH: Yes.

AMBOS: ...and how that might be playing out in the underwriting process. The most overt form of that would be evidence of increased levels of coverage waivers by a demographically desirable section of the population. Viewing this from the vantage point of our book of business, we have not seen a statistically significant level of that occurring, but it certainly bears continued watching. And, while you will never find it listed as a separate line item in an underwriting calculation, it's fairly likely that thinking along those lines is a factor in to the conservative underwriting cycle we are currently experiencing.

BORSCH: Got it. Related to that, and sort of coming back what would maybe what I was driving at earlier, what are you seeing in terms of the range of price points between carriers and to the extent the gaps have narrowed or widened.

AMBOS: Overall, **we believe it's tightened up, to about a 10 percent spread. We were looking at a broader range of market pricing outcomes, 10 to 15 percent, in last year's discussion.** So, I would say a narrowing has occurred, which reflects the absence of the outliers that you mentioned earlier. It also reflects a relative sameness of underwriting approach as we've talked about before: with the consolidation in the industry, it's become a case of everyone migrating to the mean, if you will.

Incumbent carrier renewals as a measure stick relative to that range, unsurprisingly, typically will fall toward the high end of that range of outcomes and not infrequently north of the high end.

BORSCH: Great, and any regional or geographic variances that spike out?

AMBOS: Not really, Matt. In past years, we have had anecdotal evidence or even more measurable sector variations where you'd see material differentiating patterns, but nothing is really jumping out this year. What we're finding in more (or less) competitive situations is they reflect single case pursuits where geography was largely incidental to the ultimate outcome.

BORSCH: Okay. Well that itself is interesting. Let me segue into the next topic here, which is on the level of price increases themselves and start with what averages or ranges you've seen so far for 2009 and how these compare with last year or recent years.

AMBOS: Matt, **we're seeing price adjustments, generally, in the 9 to13 percent range.** That would be after negotiations and application of market leverage (if there is any to bring to bear); it also reflects "as-is" plan renewals, meaning without factoring any adjustments for plan design change.

BORSCH: Okay.

AMBOS: So this about the same as what we were seeing last year, though a touch higher on the top end of the range**. I think we had talked about 9 to 12 percent as the range in the discussion year.** So we're seeing a little bit of a widening and it's widening toward the higher end. This harkens back to our first question on whether the market's responding in any way to pressures to perform more aggressively due to healthcare reform concerns. This range of outcomes would seem to suggest a lack of concern about that.

BORSCH: Got it. And on this front, any regional variances that you can identify?

AMBOS: Not measurably, Matt. We've had a couple of what I would consider aberrational indications of volatility on a handful of Texas-based businesses but that was more, I think, a function of single case review than any kind of a regional trend.

BORSCH: Got it. What is the impact here of negotiation and market leverage, relative to past years?

AMBOS: **The ability to negotiate with insurers has gotten much more difficult; this speaks directly to the premise of underwriters being more conservative, disciplined, whichever term you want to use.** So other than in larger, fully experienced rated matters where interpretation of credible data can be more readily debated, negotiation latitude has proven more difficult to secure. Market leverage is effective in achieving better renewal outcomes, if you can create any. So to sum up, there's not too much movement on pricing without competitive pressure, and competitive pressure has not been there consistently.

BORSCH: Got it. On a slightly different topic, when we talked about the 9 to 13 percent range, the impact of plan design buy-downs was not included. What buy-downs are you seeing as most prevalent?

AMBOS: And, what buy-downs are left at this point!

BORSCH: Yes.

AMBOS: The 9 to 13 percent range is for what we called "as-is" renewals earlier. The usual suspects in terms of plan design alteration continue to be applied in 2009, to the extent they're still available—increased deductibles, copays, out-of-pocket maximums, etc. The difference recently is that the downward price impact those type of changes are creating is to chip away possibly 2 to 3 percent off the 9% to 13% as-is range. This is less than we've seen in recent prior years, where we'd said 3% to 5%, even 5% to 8% decremental value.

Two things come to mind in explaining this. One we just alluded to—there're fewer options available of this type, given most mid-sized employers have already tapped this source of plan savings heavily in recent past years. The other is that it's another reflection of more conservative underwriting practices.

BORSCH: Got it.

AMBOS: As a last note on this category, Matt, and I hesitate to mention consumer directed health plan alterations in the context of buy-downs (despite the fact that, at least in the middle market, pricing reductions are driving the majority of market share growth for these products), but they warrant inclusion in the plan restructuring conversation. We'll touch on this as a separate topic a little bit later in our discussion.

BORSCH: Okay. Then, let me ask, have you seen any notable change in the nature of buy-downs, say between plan design changes that increase employee expense when using the plan versus employee contribution increases that impact all participants?

AMBOS: Yes, though this may be somewhat of an anomaly we've experienced in our client base. I heard repeatedly from our consultant teams in gathering my notes for this conversation that **many employers in our purview are trying hard not to increase per paycheck contributions**, thus plan design changes by default have been the more prevalent path.

In past years, there's been more of a balancing act between buy-downs and contribution increases, but the main rationale being cited this year, not too surprising in light of economy-driven negative events for employees such layoffs, salary freezes, and even pay cuts, is many employers don't think they can also dent compensation by jacking up contributions for the remaining employees. So, we're seeing a bit less aggressive overall movement toward cost shifting on the per-paycheck side of things.

BORSCH: That makes sense. And lastly on this topic, have consumer-driven health plan designs taken noticeably more market share this year and, as I have asked in prior years, do you think we're close to a tipping point in adoption of these programs?

AMBOS: Well, Matt, **I'm finally ready to say that we believe (at least by some measures) the CDHP tipping point has been broached**. Broad market surveys suggested that as of year-end 2008, roughly 14 percent of employers had some form of a CDHP in place. Bringing that forward, at least from Equity Risk Partners' book of business standpoint, we're seeing in excess of 25 percent of our clients now having some form of a consumer-directed plan amongst those programs they offer to their employees. We anticipate that's going to rise to closer to 30 or even 40 percent by 2010. So in that sense, CDH has arrived.

BORSCH: Yes.

AMBOS: However, since CDHPs are still mainly being used and framed by smaller employers as a lower cost option to the more traditional PPO and Point of Service-type programs, **membership has not yet reached 10 percent of the enrolled population, a more tangible way to measure whether critical mass has been achieved. We believe it is likely that level will be reached either next year or 2011 at the latest**, so by that secondary measure, critical mass will also be achieved in the near-term, barring any significant paradigm shifts that healthcare reform may create in this space.

As I alluded to earlier, **most employers in the middle market continue to use CDHP options primarily as a down-pricing driver versus embracing it as a platform/approach change.** However, some have gone for it in a big way with the mindset that they've effectively tried everything else so why not see where it takes them.

As a last note on the emergence of CDHPs as a force in health plan design, I would say the next frontier (if we stipulate that they have become a fixture in the process of evaluating health plan offerings) is whether/when CDHPs will displace PPO or POS type programs as the prevailing health plan construct. I think we're still a few years away from that happening, but it's not an inconceivable thing any longer, given the footing that has finally been established.

BORSCH: That's great, Ken. Let me wrap this up with a couple of more questions.

Besides price, which we've explored here from a number of angles and particularly given the tight clustering of price point, what other criteria do you see employers using to choose between carriers, whether it be service, provider network, CDH capabilities, wellness, brand image, or anything else you can point to?

AMBOS: Beating the same dead horse I killed last year, it's first and foremost price, price, and price again. Firmly rooted in the second tier would be network access and service. If price is close and you've got a service problem or a network deficiency, it could tip the thing in a new direction.

One change in ranking these other evaluation criteria since last year seems to be that access to wellness programs/member health engagement initiatives has moved up the scale. It's become more of a prevalent discussion in the process of planning for renewals and so forth, especially if the access to viable wellness arrangements are baked in to a plan for "free" or even better added with some form of carrier rate discount. It's certainly an increasingly palatable concept that employers can embrace to help address cost growth, even if perhaps out of that sense that they've tried everything else. And there's certainly the prospect that the healthcare reform movement, with a focus on improving the health and well-being of the population, will accelerate this aspect of health plans taking on a more prominent role.

The wellness parameter may have also moved to up to some extent by default. CDHP administrative capability is now considered more or less a given, expected element (a carrier wouldn't be in consideration if they couldn't provide this type of service), so it's less of a differentiating criterion.

The category you identified as "brand image" has been important in past years when insurers were receiving negative, front page press for a variety of reasons. Somewhat surprisingly, they haven't been there at all in recent vintage on a specific level due to a negative event such as stock option scandals, network battles with prominent providers, etc. There's been a relative absence of that type of issue, and a relative absence of significant/systemic service platform problems.

The entire industry has an image problem of course, and will continue to be flogged from all sides in the reform debate but that's not specific to one player. Therefore, brand image, this year, has been a much less significant differentiating element in the carrier selection process.

BORSCH: That's great Ken, and obviously in some ways that's, I guess I could say almost remarkable given that if we look back, **in almost every year this decade one of the major carriers has been on the ropes. So in some ways that makes this year more exceptional, in that you don't have one that has a major service or operational problem going on.** It'll be interesting to see how that plays out as we move forward.

Let me ask one last question here, which is if you look at your employer clients have you seen a greater or lesser willingness to move from carrier to carrier, given the backdrop of the difficult economic environment and relative to our discussion last year?

AMBOS: I think it's fair to say generally, **yes there is a greater willingness to move**. The unfortunate addendum to that is that competitive alternatives, as we've discussed at length, have been fairly difficult to come by. **So there's a desire and a willingness to make change to curtail cost and drive a more positive outcome, while the availability of alternatives to do that has lessened considerably.** We touched last year on this question, and I think it bears repeating that we came out of a cycle in the prior several years where movements from carrier to carrier had not been that common. Despite continued healthcare hyper-inflation, the renewal outcomes weren't as bad as many clients had expected; therefore, there wasn't enough urgency to transfer to a new insurer.

Last year, we thought there would be an uptick in carrier transitions; looking back, this did not materialize to a measurably higher degree. Therefore, we're back in that same position as we look at this year's outcomes—a reason not to make a move would be the concern of the disruptive effects of a carrier change on the workforce; but if you haven't gone through a transition in several years, you're less worried about enduring that disruption if the economics warrant it now.

So for all of those reasons, we say yes, there's clear indication that employers would more willingly move, to the extent that there are more favorable things out there to move toward.

BORSCH: Got it. It makes perfect sense. Okay, we're at 35 minutes here—it's a good time to wrap it up and thank everyone for dialing in. Special thanks to Ken Ambos and Equity Risk Partners for again doing this call; these insights are very valuable to us and our clients.

AMBOS: Thank you, Matt.

Reg AC

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