

Americas: Managed Care

A front-line perspective on 2010 commercial price & product trends

Transcript from our sixth annual call with Steve Lewis

We hosted our seventh-annual industry expert conference call with Steve Lewis, regional leader for the employee benefits practice of Willis, the third largest insurance broker in the world. The call provided a front-line perspective on 2010 industry pricing and product trends, with a focus on the key middle-market segment of the industry.

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

Industry price discipline has strengthened further

Two years ago, Lewis and his team were one of the few industry sources pointing (correctly) to aggressive pricing by the carriers in a lead up to severe margin deterioration experienced in 1H2008. Then, a year ago, Lewis and his team pointed to stronger pricing discipline by most of the public companies (though with some outliers). Now, Lewis and his team find price discipline has strengthened noticeably further.

Our view is that the industry downcycle is bottoming

We note that the improvement in commercial industry pricing discipline has emerged from multiple industry sources over the past 18 months. Our view is that it reflects a recovery from the severity of under-pricing during the recent industry down-cycle that we think is now bottoming.

With the group, our favorite names are UNH and CI, both CL-Buy rated. That said, ours is a sector call as we see a 'rising tide lifting all boats' as: (1) the cycle turn shows in reserve building this year, with margin expansion next year, (2) health reform uncertainty recedes, and (3) the headwind to earnings from negative operating leverage eases as we anniversary the severe member drop of 2009.

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Transcript of conference call with Willis

Matt Borsch, Goldman Sachs:

Good morning, everyone. Thanks for joining us today for the Goldman Sachs Managed Care Industry Expert Conference Call with Steve Lewis of employer benefit consulting firm Willis. This will represent our 7th annual conference call with Steve Lewis.

Steve and his team have agreed to give us frontline perspective on 2010 managed care pricing and product trends. As background, Willis is the third largest insurance broker in the world with approximately 350 million in employee benefits revenues in North America with a focus on the middle market employer segment.

That focus is particularly valuable given the lack of visibility on the segment from the other health benefit consulting firms. And let me just elaborate on that. The context is that national employer benefit consultants such as Hewitt, Mercer, Towers Perrin, and others really focus their attention on the jumbo employer segment, which is overwhelmingly a fee-based non-risk model.

However, the biggest earnings driver for the managed care companies are the fully insured risk lives, and those are mostly through the small and mid-size employers that buy through health insurance brokers. And we found that the brokers typically lack the scale and sophistication to have a good perspective on macro industry trends.

However, as healthcare coverage has become more and more of a significant outlay for employers, they've needed greater expertise but are often under served by the national benefit consultants that focused on jumbo employers, so that's where Willis has built its focus, serving as a high service benefit consultant for the middle-sized employers.

With that as an intro, let me reintroduce our guest speaker Steve Lewis, executive vice president at Willis and regional practice leader. As background, Steve has 20 years of experience in the employer benefits industry and previously served as a national account executive with Oxford Health Plans, and also worked previously as a consultant with Hewitt Associates.

With that, I'll turn it over to Steve to kick it off. Following that, I will serve as moderator for a series of topical questions, and then, we will open it up to investor Q&A.

Steve Lewis, Willis HRH:

Good morning, Matt. Thank you again, for hosting us on this call. As always, I enjoy the opportunity to do this with you each year. I also want to publicly acknowledge and thank our team here for their support. The insight that I'll provide today and have previously provided is largely the amalgamation of information that's developed from our team working day in and day out with clients throughout the country.

I would add that my comments on this call will be directly based on my team's experiences and do not necessarily reflect the experience of my Willis colleagues from around the country.

BORSCH: Thank you for that, Steve. Let me jump right in here with, perhaps, the most important question from the standpoint of institutional investors looking at the sector, and that is, what are you seeing in terms of competition between the carriers, specifically relative to last year or two years ago or whatever you want to use as the baseline, has price competition increased or decreased?

Price competition is down from year ago even on the renewal business.

LEWIS: As a specific answer to that, we would say, price competition is down from year ago. An overall theme that we would characterize this year, meaning, when I say this year, the just completed January 1 renewals, and continuing up and through today. We feel this is the most challenging environment for us and our clients in my 20 years in the business.

Not only is price competition down from year ago (when we had characterized last year's price competition as being down from the prior year), but trend or (healthcare) inflation is also up and appears to be rising. The incumbent carriers seem more willing than ever to walk away from existing business resulting in some carrier changes.

And that's a significant adjustment from last year where we saw aggressive pricing on the renewal front but not so much on the new business front. And then I'd say the other real theme is we've seen some service levels that have gapped among few of the major players which has further increased switching of carriers.

BORSCH: Let me move on to the next question here. If you look at the landscape, what role do you see Third Party Administrators or TPAs playing in the competitive landscape? And I guess this gets down to a related question if you could address between the employer decision to self-fund or go with the fully insured purchase, are employers shifting one way or the other.

LEWIS: Yes, I think taking the Third Party Administrator piece first, as in prior years, we've seen little to no new penetration in our client base from the TPAs. There's still an occasional place for them in the marketplace, but fewer and farther between in our opinion.

The networks have expanded to the extent across the country that there is now very significant overlap, and the TPA discounts no longer really compete with what the major managed care carriers have been able to do from a network standpoint.

With respect to the second part of your question (related to the self-funding versus fully insured question), our clients primarily seem to want certainty in this economic environment with respect to their healthcare spend.

So, unless they have either a reasonable track record of consistent and relatively predictable claim patterns, clients that we expect to be fully insured are still largely biased in that direction, and those that are on the fence as to whether they should be fully insured or self-funded seem to, again, be biased more towards the fully insured product.

I would add that where we have had increased conversations is with our smaller client segment that are increasingly frustrated with what we call blind renewals, meaning, no claims data, and experiencing large increases on top of no claims data.

As a result, there's absolutely increased interest at the smaller client segment in evaluating potential self-funding with stop loss protection.

BORSCH: Getting back into the topic of the competitive dynamics, can you touch on how criteria other than price play a role in carrier competition, whether that's in fully insured or self-insured or to the extent you draw a distinction, and to the extent that maybe that's changed or not changed a little bit versus a year or two ago?

LEWIS: Yes, I think, as we've talked about in prior calls, price remains king in the middle market, and is probably queen as well. Factors that can be a tie breaker other than price would include network disruption to the specific population; market perception of the competitive carrier's reputation; product flexibility, meaning willingness to allow prescription drug carve-outs; ability to provide detailed reporting in a certain employee population level, and funding arrangements offered. Not just the self-funded versus fully insured argument but some of the hybrids or the more creative solutions within the fully insured marketplace such as minimum premium or participating contracts in the fully insured environment.

There's increased interest at the smaller client segment in evaluating self-funding with stop loss protection.

Those things taken together can all factor in as tie breakers with respect to how employers are evaluating carriers. But even still, price certainly remained the most significant driver.

I would add one thing; you asked how it's changed from prior years. I think last year on this call, we talked specifically about the playing field that was fairly level on the service end of the equation and as I mentioned at my opening comment, we have seen a bit of gapping with respect to the services at some carriers. And that is driving employers to certainly take a look at what's available on the marketplace. Then again, finding that there's not a lot of aggressive price competition, the service disruption would have to be fairly significant for somebody to move knowing that they're not going to be able to trade down pricing very significantly.

BORSCH: Is it the case that the service disruptions that you've seen in some instances are severe enough to reach the threshold where they switch?

LEWIS: The short answer is yes. We have seen some of that, and I think we've seen it at a lower price threshold than what we would've seen in the past.

BORSCH: Let me move to a slightly different topic here, and obviously, the background here is the severe recession that was certainly having an impact when we talked a year ago. But, now we've been through a lot more pain even though the economy is showing signs of recovery. A lot of the impacts of these types of things are lagged.

So, I guess, it's sort of a general question how significant a role has the recession played in the clients' product managed care strategies. And, what have you seen in terms of the overall group enrollment changes related to that? It's sort of a high level question there, but trying to understand what the impact of the severe recession has been on the way employers look at things, buy things, and on enrollment?

LEWIS: Yes, I'd say, it's a great question and an interesting one particularly as we look at this market. You mentioned the lag factor and the timing of the stock market drop of mid-September 2008 was fairly late in the game to impact many employers' January 2009 strategies. So, most were not making any significant benefit changes, and/or made the specific decision to hold the line when it came to health benefits at the end of the day due to the freezes or cutbacks in other areas such as pay, 401K matches, and staffing levels.

So this year, I think, we saw a lot of employers saying, they were not going to make that mistake again or very early on in 2009 looking back and saying, if I had to do it over again, I probably would've made more drastic changes and not held the line with health benefits.

So, it is a bit ironic that they didn't – a lot of employers chose not to make the change last year when we were in the deepest part of the recession. But this past year the renewal process started much, much earlier for employers even knowing that the sooner they started, the more impact trend uncertainty would have on their renewal.

Strategic planning just started much earlier, and employers wanted to see just about every option under the sun both in terms of pricing, plan design, extreme options, really hedging themselves trying to get some clarity as to what their options were with respect to health benefits, because they didn't have clarity on either the direction of the market, the economy, or even their own specific prospects.

So, as I mentioned at the outset, it was without a doubt the most challenging renewal cycle in my 20 years of this business with employers really struggling with how and what was going to drive their decision combined with the lack of aggressive and competitive pricing in the marketplace.

I think, to your last point about how that may have impacted group enrollment, I'm not sure I have anything significant statistically to share with you today. However, anecdotally, I would say that enrollment is down across our book of business. We looked at 2009 going

In some cases, service disruptions are leading to carrier switching at a lower price threshold than in the past.

It was without a doubt the most challenging renewal cycle in my 20 years of this business

into the year and planned for the enrollment on our client base to be down 10 percent, and I would say that was fairly accurate.

BORSCH: You alluded to something I just wanted to clarify – it may be that this isn't measurable, but on the question of adverse selection (and, here, we're talking about the employer market, not the individual market), you alluded to the potential that some employees might be more likely not to take up coverage or, in fact, to discontinue employer subsidized coverage, because even though it is subsidized it can be a very sizable chunk out of their pay for a benefit package that may look less attractive after some of the changes the employers have made.

So, to the extent you can infer if you're seeing any of that (and, related to that, the COBRA uptake), has that been something that you measure? Has it come up in how the carriers have presented their pricing? Finally, do you have any sort of visibility on whether that trend is increasing or abating?

LEWIS: Let me take the first part on something I've alluded to about the potential for adverse selection due to younger, healthier folks dropping and/or not selecting coverage to begin with. You know, I think it depends a bit on the demographics of the population, the type of industry; our clients really span just about every industry out there.

Adverse selection appears to be on the rise in the group market.

So is adverse selection on the rise in the group market? I would say it is, but I don't have any data to back that up, but just based on the fact that the population is down 10 percent across our book. And we look how the census in those client populations has shifted. I would suggest that there is: I don't want to overstate it because I'm not sure it's significant at this point, but I certainly would see some creep, if you will on adverse selection.

I think that ties to your second point about COBRA uptake. We did not keep specific statistics on the extent of COBRA uptake. But we certainly saw it across the board, in our client base, and we certainly believe that it is impacting the pricing that our clients are experiencing.

BORSCH: Given what you're facing from a more conservative underwriting environment amongst the carriers, how are you leveraging or seeking to leverage current market conditions to your clients' advantage in renewal negotiations?

LEWIS: Well, as stated the outset, and probably ad nauseum at this point and it's been a tough year.

Carriers were very selective in going after new business, and incumbents were willing to walk away from existing clients. So we had to be incredibly creative in our negotiation tactics as well as in our strategic advice with clients. And again, it was something that fortunately for us, in the process, we did start early and while it consumed a lot of energy from all of the stakeholders it was probably the year of creativity.

With respect to negotiation tactics, one of the interesting things is that we seemed to have seen a bit of a bifurcation in the marketplace at the plus or minus 300-employee size.

In the groups under 300 employees, many of them don't have or are unable to get control of their claims data either as a result of the products they've purchased or just underwriting guidelines at the carrier level where they don't have complete control of their claims data. In that under 300-market place, there was very little competition and very high renewals right out of the gates.

However, in the over 300-employee market, if the claims data was available and in a detailed way and you could make a story about that claim's pattern and possibly make adjustments for a spike – a one-time spike. Then, you would see competition pick up. But again, it was very selective and certainly not anything we would characterize as overly aggressive.

Benefit plan changes are more substantial than a year ago.

BORSCH: This lead in to the next question: Can you generalize about what is the average rate increase that you're observing: both the initial carrier request and the final end point, post negotiation and plan changes? And can you tell us about the extent of plan benefit reductions in achieving final results for your clients?

LEWIS: Averages are tough, you're right, and probably don't tell a very good story and some clients look at that and say, wow, how did you get that average? I must've been the high person. But the range was all over the place and fairly extreme. I'd say we settled in a range, on our book of business, from a 5% reduction to a 50% increase.

But generally speaking, we were in low to mid-teens out of the gates, and this is where the real challenges begin. Because negotiations generated no more than one to one and a half points with no plan changes. And so it's almost like you were getting a first and final and you had to dig through the renewals to find a mistake.

That's less movement than we've had in each of the prior years and certainly, not turned in the right direction from our clients' perspective.

BORSCH: But on the benefit plan changes that your clients have implemented, would you say those are more substantial today than what you saw a year ago?

LEWIS: I would say that incrementally the changes are more substantial, but visually to employees, they're fairly significant. You know, just about everybody did something this year. And it did vary as you would imagine by the extent of the renewal and the existing plan structure, but things like 100% co-insurance are virtually gone.

BORSCH: Yes.

LEWIS: What we saw was a lot of tweaking, where we'd see the employers bifurcating the primary and specialist co-payments, adding prescription drug deductibles on top of co-payments, and really focusing on plan changes first and foremost before looking at impacting employee contributions.

INVESTOR QUESTION: You talked about client renewal process starting earlier as the planning process started earlier. Does that mean the contracts are actually being signed earlier and therefore the carriers will have more visibility into the premium yield this year compared to previous years?

LEWIS: Great question. The answer is no. The contracts are not renewing any earlier, just the negotiation process. So, in our world, generally speaking, we would look to get a renewal (depending on the size of the group) from 90 to 120 days before the expiration of a renewal.

This year, clients were looking to us (and to a certain extent from the carriers) to extend that to 6 months out: where we start predicting where the renewal is going to end up. And to the extent that the carriers were willing to provide a preliminary renewal, they have to load in a lot of trend because they have to make guesses on the claims going forward.

And then as you move closer to the expiration date, they offset trend with the wrong claims experience. So nobody was renewing or signing contracts earlier, they were just dragging the process out much, much longer from both the carrier side and the employer side.

BORSCH: Let me ask a question, and hopefully, this is isn't repetitive, but in the market studies that you've reviewed, how wide have the gaps been between the different carriers? Have you noted one carrier or groups of carriers relative to the others that have been especially aggressive or perhaps overly conservative that stand out?

Generally not seeing one carrier being more aggressive than the others.

LEWIS: The short answer is no. I think in particular situations, we've seen a couple of carriers be more aggressive than others. But I'm putting quotes around more aggressive because we're generally in the three to five percent range between pricing from where an incumbent renewal might be and what might be considered aggressive.

Now, there were few exceptions on some of our larger middle market clients, as I've mentioned earlier, with very clean data, stable business, perhaps a one-year blip with the incumbent that cause the incumbent to get skittish and want to shut the business and a competitor to come in and price it more aggressively. But as a general rule, Matt, we were in a pretty tight range during the market study process.

BORSCH: We've talked in prior years about tracking the gradually growing interest in the consumer-directed health plan products. Where you would say we stand now? Have you seen the uptake increase meaningfully as a result of all the pressure of the last year? And, you know, if you can offer a little bit of a forecast, do you think that may change going into 2011?

Surprisingly, not a significant shift towards the consumer directed plans.

LEWIS: Yes. Surprisingly, we have not seen a significant shift towards the consumer directive plan. Across the board, it's now an option for most employer groups. And the clients that have offered it for the longest period of time (call it three-plus years) are now exceeding double-digits, but that's the low double-digits for enrollment as an option.

New offerings continue to generate very low enrollments out of the gates with still almost no full replacements at this point. I think the one shift we have seen is a swing towards health reimbursement accounts and away from health savings accounts that more employer-friendly. And employers are doing more to tie their wellness rewards and strategies to their health reimbursements accounts.

So I'd say if you ask about a crystal ball, really the tying of wellness and to focus on improving the health of a population, then consumer health plans tied to an HRA account is where we see this market moving and really the potential for the biggest surge.

BORSCH: Let me just conclude with one last one I want to throw at you here, Steve. This has been tremendous insight that you've brought for us so I want to thank you. On health reform, obviously, this is a huge thing in the background but it's a practical matter, but it doesn't necessarily have that much day-to-day impact on things.

But to what extent is health reform something that the employers are looking at? Are they talking to you about it? Have you got 'two cents' on where opinions fall amongst employers about what they would like to see happen relative to what's been presented in Washington.

LEWIS: Yes, we are talking to our clients a lot about it. There is a lot of what I would call academic interest at this stage of the game. They're very mixed in their reaction, quite candidly consistent with what we're seeing in the polling numbers by party lines.

I think most people would acknowledge that there's a need for healthcare reform, employers continue to be very frustrated. So when they look at what the Obama administration and the Democratic Majority state as their goals to increase access and lower cost and rail at what maybe termed oligopolistic behavior of carriers in certain markets, I think employers really buy in to that message and have much of that frustration and anger at our lack of solutions.

But I would also say that many of them still view the legislation and the partisanship coming out of Washington as possibly the medicine worse than the disease. So, many employer groups that we're talking to feel like it would be a shame to lose an opportunity to do something with respect to healthcare reform. But many are starting to feel like maybe nothing is better than something in this current environment.

BORSCH: This is probably a good place to end our call. Steve, thank you very much. This is really a great frontline perspective on industry trends and I want to thank you and your firm Willis, and also thank our investor clients who dialed in.

LEWIS: Thank you, Matt. I appreciate it.

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