Perspective

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The Emergence of Private Health Insurance Exchanges *Fueling the "Consumerization" of Employer-Sponsored Health Insurance*

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EXECUTIVE SUMMARY

Health insurance in the U.S. is at the cusp of a major transition from an employer-driven payor model to a model directly involving many more employees and consumers. Private health insurance exchanges with a defined contribution approach represent a significant step toward catalyzing this change. In this paper—part of an ongoing series of Booz & Company Perspectives on the shift to consumerism in health insurance[1]*—we consider the impact of this change on the payor industry and the strategic approach that leading companies need to take.*

Note: A followup to this Perspective titled "Private Health Exchanges: Where Are We Headed? Developing an Exchange Strategy by Employer Segment" is available at *http://www.booz.com/media/file/BoozCo_Private-Health-Exchanges.pdf*

[1] "Health Insurance Gets Personal," by Ashish Kaura, David S. Levy, and Minoo Javanmardian (*strategy+business*, Autumn 2010); "The Health Insurance Exchange Dilemma: To Play or Not to Play?," by Ashish Kaura, Patricia Andriolo-Bull, Robert Pottharst, and Gary Ahlquist (Booz & Company, 2011).

THE SHIFT TO DEFINED CONTRIBUTION

For decades, U.S. companies that offer healthcare benefits to employees have stuck to a defined benefits model, in which the company offers a standard set of health benefits and shoulders most of the financial burden and risk of healthcare cost.

Over the past decade, this model has come under increasing strain as healthcare costs have more than doubled, creating an affordability crisis for employers. Now the problem has reached a tipping point. Some employers are considering a paradigm shift to their health benefits strategy that's akin to the transition from pension plans to 401(k) accounts: switching from defined benefits toward a defined contribution model. Instead of designing and offering defined health benefits, companies make cash contributions to savings accounts that employees use to purchase insurance products of their choice. This model allows the company to cap its healthcare cost at a desired threshold, improving control of current expenses and future liabilities.

In addition to the affordability problem, the employer-sponsored insurance landscape is also being altered by healthcare reform, particularly the establishment of the individual mandate and public health insurance exchanges. Healthcare reform specifically aims to make health insurance more affordable for individuals and small businesses; however, midsized and large employers might decide to use these public exchanges to control their own costs, terminating their insurance and routing employees to the public exchanges. This would compress payor margins and force payors to respond defensively with alternative solutions such as defined contribution plans and private exchanges. Meanwhile, intermediaries, such as benefits consultants, see an opportunity to strengthen their role in the value chain by offering solutions that help employers of all sizes control costs.

WHAT IS A PRIVATE EXCHANGE?

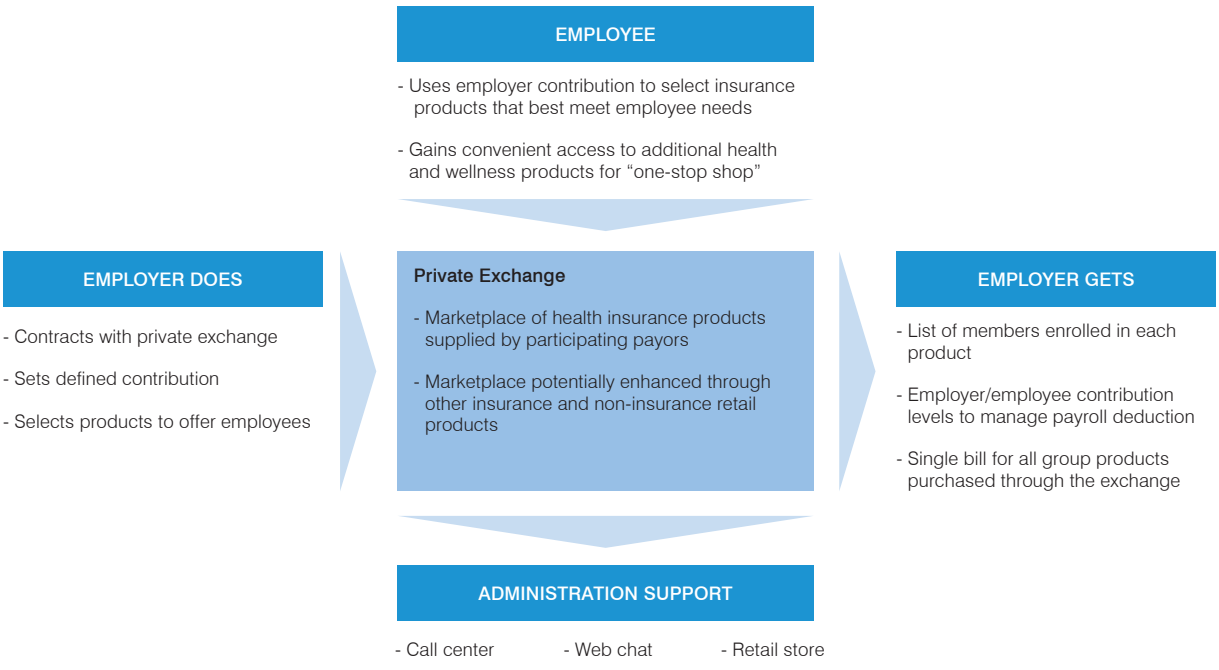
Private exchanges are marketplaces of health insurance and other related products. Employers purchase health insurance through the private exchange, and then their employees can choose a health plan from those supplied by participating payors. One big attraction of private exchanges is that they facilitate the migration to a defined contribution model while allowing employers to retain some involvement in their employees' healthcare. Private exchanges can operate with or without defined contributions, but this paper will focus on private exchanges using a defined contribution model (*see Exhibit 1*).

The value proposition of private exchanges differs from public exchanges in some important ways. First, private exchanges are flexible and can be customized to address the needs of any employer group, unlike public exchanges, which are targeted to individuals and small groups. For instance, private exchanges can design benefits tiers specific to employer segments with robust multichannel employee decision support. Another

Exhibit 1
A Conceptual Overview of Private Exchanges

Private exchanges are emerging as marketplaces of health insurance and other related products promoted by private industry stakeholders (e.g., payors, benefits consultants), generally with options for employers to administer defined contribution arrangements

ILLUSTRATION OF PRIVATE EXCHANGES TARGETED TOWARD EMPLOYERS



Source: Booz & Company

advantage is that private exchanges can offer a broader range of retail products, such as dental and life insurance and even non-insurance products, than public exchanges can. Two private exchange models are emerging:

Single-carrier exchanges: These exchanges are promoted by a single payor and target employers that wish to maintain some role in choosing both the insurance carrier and plan design. Depending on how involved employers want to be in benefits design and negotiation, products may be customized and priced for the employee group or individuals.

Multi-carrier exchanges: These exchanges, predominantly promoted by third-party intermediaries such as brokers or benefits consultants, will provide a broad range of payor and plan design options and encourage employers to take a more hands-off role. For payors, multi-carrier exchanges that list individual products on a menu of offerings pose commoditization risk that could squeeze payor margins (*see Exhibit 2*).

Exhibit 2
Emerging Exchange Types

		Defined Contribution Insurance	
		Single-Carrier Exchange	**Multi-Carrier Exchange**
Overview	**Description**	Exchanges promoted by payors to give members and employers access to their products (group products)	Exchanges designed to link consumers and employers to a variety of benefits plans across several payors (individual products)
Overview	**Emerging Players**	- Bloom/WellPoint/HCSC/BCBS Michigan - BlueCross BlueShield of Minnesota - Highmark - Towers Watson	- ADP - AON Hewitt - CaliforniaChoice - eHealthinsurance - Extend Health - Health Connector - Walgreens
Employee Value Proposition	**Group or Individual Products**	Group (likely) Individual (possible)	Individual (likely) Group (possible)
Employee Value Proposition	**Level of Decision Support**	High	Varied
Employee Value Proposition	**Number of Plan Options**	~3–5 (one carrier)	~10+ (across carriers)
Employer Value Proposition	**Employer Involvement**	Passive to active	Passive
Employer Value Proposition	**Administrative Burden**	Medium to high	Medium
Employer Value Proposition	**Relationship with Carrier**	High	Low to medium

Source: Booz & Company

GROWTH AND UNCERTAINTY

Several powerful demand- and supply-side forces are driving the creation of private exchanges. First, continued increases in healthcare costs are reaching a tipping point, forcing employers to consider shifting from defined health benefits to a defined contribution model as a way to cap current expenses and future liabilities. Second, the advent of public health insurance exchanges creates the possibility that some employers will terminate insurance and route employees to these public exchanges where they can choose individual insurance from a menu of offerings. To avoid the product commoditization that could occur on these public exchanges, payors are devising strategies—such as private exchanges—to preserve the value proposition of their group-based insurance business. Third, intermediaries (such as benefits consultants) are racing to remain relevant and perhaps emerge stronger by establishing multi-carrier private exchanges so they can play their traditional role of gathering demand and supply. Finally, employees increasingly want more healthcare choices. They still need guidance and support during the process, but they are more open to the independent transactions made possible by private exchanges and the defined contribution model.

Given these dynamics, the potential for private exchanges to grow in the medium to long term is strong. However, the velocity of growth will depend on the near-term ability of private exchange proponents to address key employer concerns, such as the inexperience of private exchange administrators and maintaining competitive benefits, as well as payor concerns, such as margin compression and disintermediation. Growth of these exchanges also hinges on payors' ability to assess their private exchange strategy and develop the capabilities required to execute this strategy. The capabilities necessary to compete in the new private exchange marketplace include employer education and consultative sales, flexible and consumer-oriented product offerings, employee advocacy centers, and administrative simplicity. Some key questions payors should consider include the following:

- Should you launch your own private exchange or join a third-party exchange?
- How does your competitive position by employer segment influence your choice?
- How robust are your retail-centric and defined contribution capabilities?

CAN PRIVATE EXCHANGES BECOME VIABLE?

The healthcare affordability crisis is so intense for employers that private exchanges have a strong potential to grow in the medium to long term. For some insight into how these exchanges might perform, it's instructive to study how such exchanges currently serve some retirees.

In the 1990s, the Financial Accounting Standards Board (FASB) enacted an accounting rule requiring employers to recognize future retiree health benefits liabilities. This rule forced many employers to find ways to cap their liabilities. Some simply dropped coverage for retirees. Others set a cap on how much they would contribute to retiree benefits each year. (By 2011, according to a Towers Watson survey, 40 percent of employers had capped their current retiree contributions.) Over time, new third-party private exchanges emerged with support centers where retirees could shop for Medicare insurance products using defined contribution employer funds, while the administration of benefits was simpler and more cost-effective for employers.

THE PROSPECTS FOR EMPLOYER DEMAND

There may be a significant opportunity to extend the success of private exchanges for retirees to current employees. A recent Booz & Company research study of more than 500 employers and 300 consumers found strong interest in private exchanges. Of the employers surveyed, 70 to 80 percent indicated that they would prefer a private exchange to a public one. Still, there are some key hurdles to widespread private exchange adoption:

- *Lack of education:* Many employers do not fully understand the distinction between the defined contribution and defined benefits models and the value proposition of private exchanges. Employers are also understandably concerned about the tax implications of moving to defined contribution and whether these plans will adhere to post-reform requirements for qualified benefits packages.
- *Concerns about maintaining competitive benefits:* In 2011, 94 percent of companies with 50 or more employees still provided health insurance, according to the Kaiser Family Foundation Employer Health Benefits Survey. Clearly, the vast majority of companies still consider health insurance an important part of the employee benefits package. They worry that moving to a private exchange with a pure defined contribution solution could hurt their ability to attract and retain talent.
- *Unfamiliarity and novelty:* Employers have limited experience with private exchanges, and some worry that new exchanges are untested, with inexperienced staffs, and may not deliver a high enough quality of service and customer support.
- *Uncertainty of health reform:* With so much uncertainty around health reform, many employers are hesitant to make any big moves until after major provisions, such as public exchanges, have been implemented.

To address these issues, exchange administrators will need to take the initiative to educate employers and offer them a compelling value proposition.

They will need to clearly explain the cost and benefits of moving to a defined contribution model, the purchase process, and the support available on a private exchange.

Payors should keep in mind that preferences for the type of private exchange model are likely to vary. For instance, Booz & Company research shows that most employers favor multi-carrier exchanges to provide broader choice to their employees, limit the burden of administering a more complex offering, and yet stay somewhat involved in the options employees can select (*see "Survey Shows Robust Interest in Private Exchanges"*). Private exchanges represent an opportunity for employers to shift from selecting a few plans that their employees *can* have to selecting a few options they *cannot* have. Meanwhile, roughly 30 percent of employers would prefer single-carrier exchanges. This preference may be due to their legacy relationships with single carriers, along with their interest in choosing carriers and designing plan benefits (including keeping their group rating) to better recruit and retain talent. Indeed, some payors are already piloting private exchange solutions with small employers and, in some cases, are launching solutions for larger groups.

Survey Shows Robust Interest in Private Exchanges

A recent Booz & Company research study of more than 500 employers and 300 consumers found strong interest in private exchanges, particularly for unsubsidized consumers. Indeed, the findings of the survey have significant implications for payors:

- Seventy to 80 percent of employers surveyed would prefer to purchase insurance from a private exchange than from a public exchange due to greater product choices (including ancillary products), design flexibility, customer service, and a general wariness of government-run entities.
- More than 50 percent of employers surveyed would gravitate to multiple-carrier exchanges, while less than 30 percent prefer a single-carrier exchange.
- Employers favor a defined contribution model that gives employees the power to choose from a wider array of selected payor and plan options. However, less than 20 percent plan to move to a pure defined contribution arrangement in which they would have little to no involvement in benefits selection and management.
- Lower-income individuals are likely to gravitate to the public exchanges in order to receive government-sponsored premium subsidies.
- Consumers want a "guided" purchasing experience with plan and product recommendations based on consumer needs. The quality of this experience should be clearly superior to that offered by public exchanges.
- Consumers expressed a strong desire for real-time administrative support (via either online chat or phone) to answer questions while making their selection.
- For many consumers, the payor brand was of little importance as long as the payor's name was "recognizable."

PAYOR CONCERNS ABOUT PRIVATE EXCHANGES

Payors, too, have concerns about private exchanges. Private exchanges require a radical change to the payor's business model—going from a purely business-to-business company to a business-to-consumer company—and there is understandable trepidation.

Three concerns are most prevalent:

- *Margin compression:* Greater choice of health plans on a private exchange may reduce cross-segment subsidization by healthier members and reduce overall payor margins. Multi-carrier exchanges could commoditize products and potentially lead to higher transaction fees—payors may have to pay an individual brokerage commission on what was formerly a group sale through a B2B channel. Finally, some payors worry that introducing some employers to a private exchange could encourage a broader transition to a lower-margin exchange market.

- *Administrative burden:* Employees will need more decision support to select their plans. This burden may fall on the payor, which could, for example, require it to provide increased customer support to help employees select among product options,. Also, payors and exchanges will need to integrate their product, member, and billing data, which could increase administrative costs and complexity.

- *Disintermediation:* Today, payors largely own the employer relationship and can strongly influence retention, up-sell, and cross-sell. In the future, the exchange administrator may control the sales and marketing process, diluting a payor's contact with the customer and thus its ability to manage the relationship.

Private exchanges require a radical change to the payor's business model, and there is understandable trepidation.

PAYOR PARTICIPATION WILL VARY

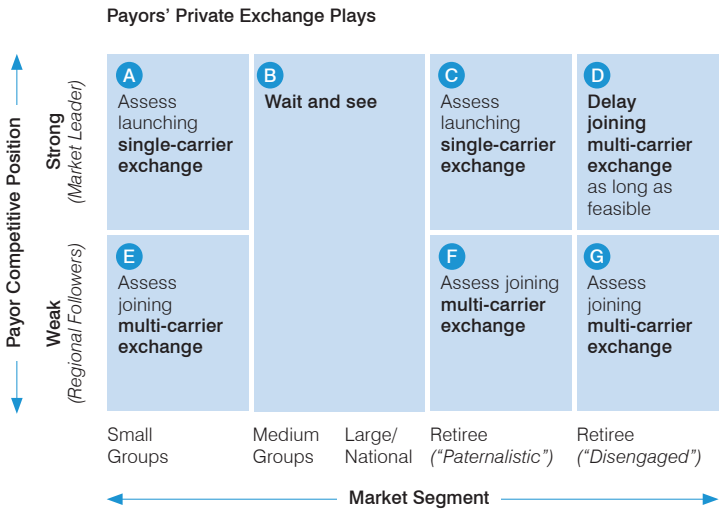
Despite these challenges, payors will increase adoption of private exchanges as the demand side gathers momentum. However, since private exchanges are predominantly a defensive strategy for payors, the stronger a payor's current competitive position, the longer it's likely to delay. A payor's decision about exactly when to adopt private exchanges will vary considerably depending on its competitive position across segments within a market (*see Exhibit 3*).

Payors with relatively weak market positions in small employer groups and in some retiree groups could benefit by joining multi-carrier exchanges in the near term. The payors in categories E, F, and G could disrupt the market by aggressively responding to employer affordability demands and offering defined contribution plans. This could "level the playing field" and put stronger payors and other competitors on the defensive.

Payors with a strong market position may generally adopt a more cautious approach. Given the potential for margin compression on private exchanges, market leaders in the small groups market (category A) should be careful not to promote the defined contribution model ahead of demand. But they should maintain a high level of preparedness to launch a single-carrier exchange once demand matures.

Market leaders working with "paternalistic" employers (category C—those

Exhibit 3
High-Level Framework for Payors in Private Exchange Plays



Source: Booz & Company

that want to stay involved with retiree benefits) might benefit by proactively promoting their private exchanges to retain retirees on group-based products. On the other hand, market leaders working with "disengaged" employers (category D—those that take a more hands-off approach to retiree benefits) should assess the risk of losing interested customers to multi-carrier exchanges versus the benefit of avoiding product commoditization.

A few payors in the medium and large group markets (category B) are close to launching private exchanges, but most are taking a wait-and-see approach. This latter group needs to stay especially vigilant—monitoring interest in exchanges closely and being ready to launch an exchange when demand matures—to avoid being caught flat-footed. Early adopters may ultimately enjoy a first-mover advantage, since a greater number of members and payors participating on an exchange increases its potential for success. For large national payors spanning many markets—small, medium, large, and retiree—a market-by-market strategy may be necessary (*see "Market Questions to Consider Before Launching a Private Exchange"*).

Market Questions to Consider Before Launching a Private Exchange

- What is the adoption potential for the defined contribution model in your market and across what type of employers?
- How well does your market segment understand defined contribution?
- What types of private exchange models do you think will emerge in your market?
- What is your competitive position by segment? How does your position influence your choice among private exchange models? What is the best private exchange strategy by segment?
- What are the costs, benefits, and risks of the private exchange strategy under consideration? (That is, what is the actuarial impact of offering a greater choice of products on an exchange compared to traditional benefits plans?)
- Should your private exchange strategy be proactive or reactive?

THE CAPABILITIES NEEDED

Regardless of a payor's rationale and timing for building or joining a private exchange, success will require that the payor develop a range of new capabilities. More specifically, building a private exchange will require capabilities across four key dimensions:

- *Education and consultative sales:* Payors need to educate employers about defined contribution plans, the value they bring, and how they differ from defined benefits plans. This is part and parcel of creating a compelling business case for employers to switch to defined contribution plans. Payors also need to articulate the tax and reform implications of switching to a defined contribution plan.
- *Flexible and consumer-oriented product offerings:* Exchanges need a flexible technology and business process architecture. This will allow them to contract with many different insurance carriers and offer a wide range of products. These products need to be simple and clear for employees to navigate.
- *Employee advocacy center:* Payors need to educate employees about the benefits of defined contribution plans, create a robust online enrollment portal, and deliver unbiased decision support through a variety of channels: call center, Web, and live enrollment sessions.
- *Administrative simplicity:* Private exchanges must be managed adeptly. The required administrative capabilities include dynamic reporting and account management functionality, seamless interaction and exchange of information between health plans, consolidated billing of all products purchased through the exchanges, and facilitation of employee payroll deductions.

Joining a multi-carrier private exchange will require fewer new capabilities, since exchange administrators will handle most of the administrative burden. But payors in a multi-carrier exchange will undoubtedly need to differentiate themselves by developing their own low-cost product offerings to compete side by side on a menu of comparable plans.

Whether a payor expects to build a private exchange or to join one, it must also prepare for the public exchanges by coordinating capability-building efforts (*see "Capabilities Questions to Consider Before Launching a Private Exchange," page 12*). All exchanges will require interfaces with existing systems to ensure seamless transfer of product, member, and group information. To mitigate the looming complexity and implementation and operational expense, payors need to design for flexibility.

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PRIVATE EXCHANGE DIFFERENTIATION

Looking ahead, private exchanges are likely to proliferate. It's also likely that many will be undifferentiated "me too" offerings that are launched quickly with just a basic menu of products and functionality. But to win in this marketplace, a private exchange will need to differentiate itself by creating and honing a distinctive value proposition. Possible strategies might include the following:

- Become the Amazon.com of all health and wellness needs, providing not just insurance but a wide array of products and services. To create a differentiated user experience, the exchange might include social networking features such as "Like" and "Comment."
- Integrate health, payroll, and employee time and labor data (workforce productivity solutions) and then encourage healthy behavior through various incentives such as tiered employer contribution amount.
- Drive convergence of "health and wealth" by integrating the management of tax-advantaged vehicles (HRAs, HSAs, IRAs). This way employees can better manage their entire financial and retirement portfolio, including healthcare savings.
- Partner with providers to develop add-on insurance products/packages that employees can elect to purchase in addition to their traditional health insurance plan.

Capabilities Questions to Consider Before Launching a Private Exchange

- How robust are individual-/retail-centric capabilities? (Examples include billing individuals directly and providing decision support to assist individuals in product selection via a call center, the Web, or a retail store.)
- What capabilities specific to a defined contribution model are needed? (These might include the ability to administer defined contribution funding vehicles, such as HRAs; the ability to administer defined contribution for employers and employees; interfaces with employer payrolls; list billing; and payment aggregation and disaggregation across carriers.)
- Where are the capability gaps and how significant are they?
- Should the payor acquire or build the missing capabilities? What is the cost benefit, including speed-to-market?
- How do these capability needs align with other initiatives across the enterprise, particularly preparation for public exchanges?

CONCLUSION

Private exchanges are not a panacea for rocketing healthcare costs. But the healthcare landscape is changing, and employers will seek approaches such as private exchanges to transition health benefits from an employer-driven model to a more consumer-driven one. Payors need a robust competitive response. If executed thoughtfully and deliberately, launching or joining a private exchange could be a critical strategy for payors to adapt and thrive.

This article is the second in a series of Perspectives from Booz & Company on the evolution of healthcare exchanges, consumer purchasing dynamics, and the implications for key industry stakeholders.

Also see "The Health Insurance Exchange Dilemma: To Play or Not to Play?," by Ashish Kaura, Patricia Andriolo-Bull, Robert Pottharst, and Gary Ahlquist (Booz & Company, 2011), available at http://www.booz.com/global/home/what_we_think/reports_and_white_papers/ic-display/49085975.

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