

## The Rise of the Defined Contribution Market

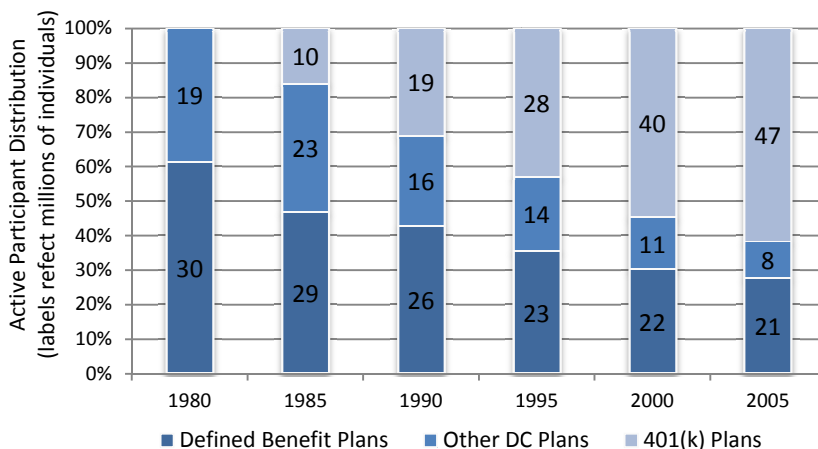
Over the last year, new distribution channels such as private exchanges have gained traction prior to the launch of public exchanges in 2014. Private exchanges have created a viable alternative for employers to cap their financial exposure and continue to facilitate the growing shift to a defined contribution model. Notable acquisitions by major benefit consultants and national insurance companies have lent credibility to the notion that private exchanges can co-exist alongside state exchanges.

### Past Lessons Learned

These new sales distribution channels are essentially vehicles for employers to shift their health insurance offerings from a defined benefit to a defined contribution model, requiring health plans to add one more channel to their future sales strategy. This shift is reminiscent of the '80s and '90s as pension fund management shifted from the “wholesale” trust fund model (employers as decision makers) to the “retail” 401(k) defined contribution model (consumers as decision makers), allowing new competitors, such as Fidelity, to reshape the retirement market.

Over a 20-year timeframe, individually-directed 401(k)s surpassed company-directed pensions as the new norm for market competitive retirement benefits. In the years shortly after the IRS formally described the 401(k) rules, several large U.S. employers began adopting 401(k) plans. These initial adopters preferred the more predictable funding requirements over defined benefit plans. New firms, especially small companies or those in growing industries, also were more likely to offer 401(k) plans because they provided benefits that vested quickly and were portable for workers, and thus, were valued more highly than defined benefit plans.

**Transformation of the Private-Sector Retirement Market**



Source: Investment Company Institute, Research Perspective, November 2006.

The similarities between the healthcare and retirement market may provide guidance on how the healthcare market may evolve. **Within both industries, regulatory changes spurred employer interest in new product designs, and cost containment concerns continue to drive employers to switch from defined benefit to defined contribution products.** The same shift to defined contribution products is likely to increase in the healthcare market in the near future.

## Expanding Capabilities

Defined contribution products have gained traction with the development of private exchanges. Over the past 10 years, companies such as Extend Health, Inc. and Senior Educators (now Aon Hewitt Navigators Insurance Services Inc.) have introduced a defined contribution concept to employers for a market segment that already has guaranteed issue – the Medicare-eligible market. These companies act like brokers “connecting” retirees with product offerings from multiple health insurers. They reduce the administrative burden for employers by managing the enrollment, product offering and financial components of the solution, allowing HR departments to focus on human capital concerns closer to the core of their business.

Other private exchange companies are focused on making inroads into the active employee segment, with the most recent being the acquisition of Bloom Health by three Blue Cross and Blue Shield companies - Wellpoint, Health Care Services Corporation, and Blue Cross and Blue Shield of Michigan. Other partnerships have formed in the marketplace, such as Towers Watson allying with Extend Health and United acquiring Connexions for its customer experience technology.

| Private Exchange Players and Recent Activity         |                                                             |                                                              |
|------------------------------------------------------|-------------------------------------------------------------|--------------------------------------------------------------|
| Extend Health                                        | Aon Hewitt Navigators                                       | Bloom Health                                                 |
| Largest Medicare-focused Private Exchange            | Purchased Senior Educators, primarily focusing on Medicare  | Majority share sold to Blue Plans (BCBSIL, BCBSM, Wellpoint) |
| Towers Watson Partnership allows continued expansion | Large employer focus, expanding to include active employees | Current solution focuses on active employees                 |

The products offered through private exchanges continue to evolve. The predominant model for the Medicare-eligible population is to offer individual health products from multiple carriers. However, as private exchanges gain traction with active employees, several health plans have developed “single-carrier” private exchanges that only offer a choice of products from that one health plan. This satisfies an employer’s desire to cap financial expense while eliminating competition and providing the health plan the flexibility to continue to underwrite the employer as a group.

It is likely that until 2014, the majority of active employees will be underwritten as groups to avoid some employees being denied coverage. However, there has been some traction for private exchanges selling individual products for active employees in states with high risk pools. It is still unclear whether health plans can create enough differentiation in their single-carrier option to make it a sustainable long-term strategy or if multi-carrier exchanges will be the dominant model.

## Growing Employer Interest

There seems to be consensus that a significant number of employers will continue to offer health insurance as an important benefit to attract and retain talent. **Furthermore, penalties for dropping coverage and the need to address large pools of employees not eligible for subsidies will ensure a strong off-state exchange market.** The following four key factors contribute to the creation of private exchanges as an alternative distribution channel, which will shift membership to individual products, even though they are offered through employers. This shift will continue to put downward pressure on the market share of traditional defined benefit products historically offered in the “wholesale” employer group market.

1. **Emergence of Guaranteed Issue Community Rating:** By far the most dramatic accelerant to defined contribution products, the requirement for guaranteed issue community rating on and off-exchange starting in 2014 will essentially lower the value of group products. Employers no longer need to worry if employees would be denied coverage if they purchased individual insurance. Private exchanges allow employers to transition employees smoothly to individual products and essentially exit the health benefits administration business.
2. **Continued Popularity of Cost-Containment Product Designs:** Employers are more eager than ever for cost containment strategies. According to the 2011 Mercer National Survey of Employer-Sponsored Health Plans, approximately 17% of all employers in 2010 offered their employees a consumer-directed health plan, and that percent increases to 51% for very large employers. The popularity of these products, along with health savings accounts, demonstrates a willingness to try new product designs to cap costs. Furthermore, private exchanges have already been successfully used by many employers for Medicare-eligible retirees. Employers will likely want to evaluate how such cost containment measures can be replicated within the larger active employee segment.
3. **Wholesale Assessments of Benefit Programs:** The development of state exchanges has acted as a catalyst for employers to re-evaluate their health insurance offering and available alternatives to traditional defined benefit design. Several large group employers are attracted to private exchanges as a long-term solution to exit the administration of health benefits while still contributing to their employees' health. Many small group employers will leverage private exchanges as part of their transition strategy to state exchanges. This approach gives employers more control of employee communication and education and mitigates the risk of negative employee feedback as the employer transitions out of the role of healthcare administrator. Whether private exchanges will be just a transition strategy or a long-term option is still an open question that will depend on the final structure and competitiveness of current state exchanges in development. If state exchanges are not able to deliver on the consumer experience needed to gain significant adoption, many employers will end their migration and continue to use private exchanges.
4. **Greater Product Comparison and Standardization:** The ability to effectively compare products across insurers has been a challenge in the individual market. Advancements in decision support capabilities, greater transparency and common product designs (i.e., "precious metals" on and off-exchange) will increase competitive transparency. As employers become more comfortable with their employees' ability to make informed decisions, their likelihood of offering more than one insurance carrier increases. They will use private exchanges to coordinate multiple carrier product options, creating an environment where insurers compete for individual employees within each employer in the large group market. While all products on private exchanges will need to meet the minimum essential health benefits developed for state exchanges, there is more flexibility on the actuarial value than directed through state exchanges.

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## Health Plan Opportunities

Overall, the shift to defined contribution plans and the individual controlling the decision-making process presents an opportunity for health plans. Smaller, regional plans in particular could realize significant gains for many national accounts now controlled by national insurers. Four key advantages of participating in this channel include:

1. **Early Exchange Experience** – Much has been written about potential consumer purchasing behaviors on state exchanges starting in 2014. Many health plans are not currently in the individual market and have not developed the level of sophistication needed to ensure state exchange competitiveness. Plans that use private exchanges as a mechanism to gain insight on buying patterns and preferences will be better positioned to compete on state exchanges.
2. **Capture New Local Business** – As employers shift from group to individual products, the insurance-purchasing decision moves down to the consumer, and the ability to offer access to broad provider networks will no longer be seen as significant of a competitive advantage. Smaller integrated care networks should present an opportunity for regional health plans and potentially integrated health systems that are able to offer low priced products.
3. **Platform for Product Diversification** – Some health plans view single-carrier private exchanges essentially as the next step in the member online sales experience, whether the customer arrives through the individual or group market. These health plans are using this platform to offer the full suite of options that consumers may want to purchase and compete with multi-carrier private exchanges based on a differentiated experience. For example, health plans are exploring partnerships with companies inside and outside healthcare as distribution channels to new potential clients. This broader platform creates expanded profit opportunities for health plans that will not be subject to the same level of regulatory control or actuarial value requirements.
4. **Increase Member Stickiness** – Brand loyalty will become increasingly important, and challenging, on the exchange market, particularly as members migrate over time back and forth between state and private exchanges. Even if private exchanges are only a transition strategy for some employers, the experience individuals will have with health plans on private exchanges may transfer over to state exchanges. Health plans that ensure robust offerings on private exchanges can create greater member stickiness and will likely retain more members on the state exchanges.

With national employers taking the lead in adopting private exchanges, health plans will need to respond to private exchange market growth based on local market dynamics. In order to proactively enter this distribution channel, plans must have a solid understanding of the potential membership and financial implications to current business.

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*HealthScape Advisors has significant experience assisting health plans address the changing health care landscape. We welcome you to contact us to discuss Private Exchanges and how they will impact your organization. For more information, please visit our website [www.healthscapeadvisors.com](http://www.healthscapeadvisors.com) or contact:*

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