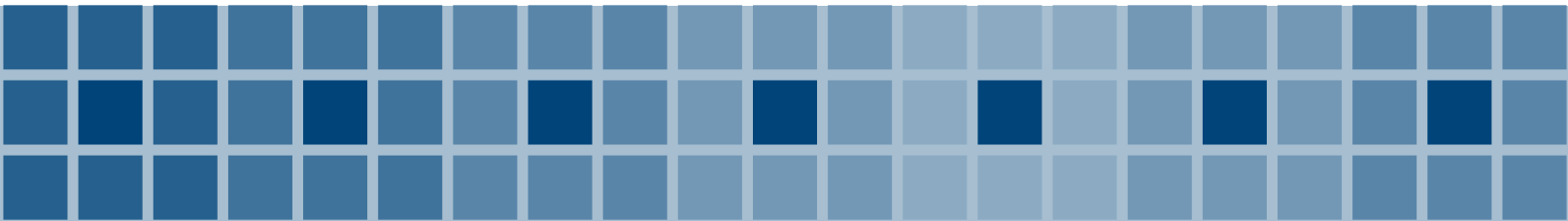


FINANCIAL SERVICES



Healthcare and financial services

The case for partnership

A bank CEO and a health insurer CEO were out one day having lunch. The bank CEO was distraught. Listen to this, he said. My businesses are flat; the old reliable credit card business has suddenly started slowing down. The only thing that's moving is the supplementary health products we're selling to our card customers – they're up twenty-five percent this year.

The healthcare CEO sympathized. All my customers already have all the insurance they can afford, she said, but I can't reach the people who don't. I've even been thinking about opening a bank. Maybe if we can do something with claims and payments we can crack the financing side of things. And then the two CEOs looked at each other.



This scenario is imaginary, of course. But the meeting of minds is quite real. Healthcare and financial services are on converging paths – and financial services and healthcare companies that can forge workable and profitable partnerships have an enormous opportunity to grow revenue and earnings.

The cost of obtaining and providing healthcare is a major and growing challenge for everyone involved in healthcare delivery including; policy makers, insurance companies, healthcare providers, employers and consumers. Each of these groups has taken steps to make healthcare more affordable.

Policymakers are struggling to decrease the cost of care, both for today's seniors and for generations to come: for example, with the introduction of Medicare Advantage programs and Health Savings Accounts (HSAs). Employers are trying to gracefully detach themselves from healthcare costs through Consumer Driven Health Plans (CDHP); and consumers are paying directly for increasingly large proportions of their medical expenses.

Consumers, providers and policymakers share a keen interest in finding new ways to finance the rising costs of healthcare

Healthcare is thus one of the few opportunities in which consumers, policymakers and financial services companies have truly aligned objectives; and all this activity creates demand for financial services and insurance in the healthcare sector. The resulting market opportunities can be summarized in three broad categories:

- **Distribution and marketing:** Payors (that is, insurers) need to extend their capabilities to reach small businesses, seniors, the middle market and those who are currently uninsured. Financial institutions can leverage their distribution networks and targeted marketing capabilities to make this happen. Immediate opportunities exist in areas such as Medicare Advantage and Part D products, or for temporary and low-income workers. We see 'aggregator' business models emerging to fill this need, with financial services firms sourcing many niche products and using their deep customer knowledge to sell the right products to the right customers
- **Asset management and payment services:** CDHPs, particularly those involving savings accounts dedicated to healthcare, have resulted in complex asset management, administrative and payment needs. These have attracted the bulk of attention to date – but the economic appeal of asset-under-management strategies is potentially limited. However, the opportunity to streamline the claims process and shorten the revenue cycle for providers creates opportunities for value-added payment services. We see 'payment-focused partner models' emerging that help payors streamline the end-to-end claims processes

Market opportunities are being created in distribution and marketing; asset management and payment services; and lending and credit services

- **Lending and credit services:** The growth of out-of-pocket spending and elective procedures creates a greater need for financing (on the part of consumers) and for credit risk management (on the part of providers). Consumer finance companies can partner with health insurers, employers and providers to offer consumers credit, bill payment services, financial record-keeping and so on. We are seeing the role of ‘finance partners’, which has long existed in retailing (e.g. Sears and Citigroup or GE Consumer Finance and Wal-Mart), being fine-tuned for the healthcare industry.

Most of these opportunities require a combination of health insurance and financial services capabilities. Some of the opportunity is being created by the shift to CDHP, while some lies in finding a preferred position in the payment or financing sales process. There is also ample scope to create more tailored and affordable products to distribute to specific consumer segments. And there may be sizeable additional gains to be made by sharing in the benefits that arise from streamlining archaic and costly distribution, coverage verification, claim adjudications and claim paying processes, and improving revenue cycle management for providers.

Financial institutions possess customers and distribution channels whose application as ‘business assets’ in health markets is readily apparent. Leading financial services companies hold detailed information about the lives of tens of millions of customers, including indicators of the lifestyle changes that trigger healthcare purchases. These customers are drawn from many segments with diverse needs and make frequent contact with their finance providers through a variety of channels – which financial institutions have become adept at tapping through data-driven niche, affinity and lifestyle marketing.

Health plans understand which products and sales processes will find favor with different customer segments (large and small employers, healthcare providers, individuals), and how customers can be migrated from simple introductory products to fuller-featured solutions. They also understand that healthcare involves managing customers whose needs cannot always be easily reduced to purely financial transactions; managing concerns about privacy and efficiency is central to the provision of healthcare.

There is considerable anecdotal and market-based evidence that health- and wealth-based solutions are converging from financial planning to credit cards. For example, Exante Financial Services, launched by United Healthcare in 2003, announced in December 2005 that it would launch HSA-linked credit cards in partnership with Discover. That announcement came hot on the heels of The Blue Cross and Blue Shield Association’s statement that it would launch an HSA-focused bank in 2006. A number of other firms are also moving on this market, including Kaiser Permanente, GE Consumer Finance, American Express and JP Morgan Chase. Many such initiatives involve partnership between providers, insurers, banks and consumer finance companies, which make sense for all sides.

Distribution and marketing

The most basic argument for partnership between health plan and consumer finance companies is the ability to access new customers – customers that both sectors need, but would struggle to reach independently.

Finance companies can reach underserved customers, while health insurers can develop products for them

Health insurers are increasingly finding themselves operating in saturated markets; their customers are typically large employers whose strong negotiating positions allow little scope for price or margin variation. Growth is consequently very slow. Niches and narrower markets, such as smaller companies and individual consumers, are promising; but many insurers lack the marketing and distribution capabilities needed to reach these customers in a profitable manner: they have woefully inadequate expertise in ‘retail’ marketing.

Consumer finance providers are likewise finding that their ‘core’ markets are becoming increasingly competitive. They have attempted to expand into new categories to increase their share of wallet. However, they have had a tough time persuading their customers to buy anything except credit products. Attempts to push life insurance, for example, have mostly proven disappointing. For many, healthcare products seem like a step too far.

One of the largest growth opportunities arises from small groups and individual consumers, who are currently underserved by the healthcare market and are increasingly looking for affordable insurance products. These are attractive niches: for example, there are 24 MM Americans working for companies with fewer than 25 employees, which have the highest uninsured rates of any segment but which can be much more profitable than mid-market and large accounts. Insurance carriers certainly have designs on this market, but the key challenge to overcome is making it work in distribution.

Today’s broker-driven models of health insurance, which account for 90% or more of the market, simply cannot reach these customers cost-effectively. Our research, however, indicates that the dominance of brokerage channels will continue to be erode. Technology will make it easier for consumers to compare, design, administer and buy into plans without intermediaries – whose costs will therefore seem less justifiable, particularly as healthcare costs continue to rise. And both regulatory and consumer demands for greater choice will also foster migration to new channels.

Given these trends, we expect that channel options will multiply, and that over the next five years new channels will account for 15-25% of the market for small groups and 30-40% for individuals and ‘micro-groups’. Such channels might include affinity groups, associations, human resources outsourcers, retail, financial advisors and direct-to-consumer (DTC) and direct-to-sponsor (DTS) approaches. Of these, we expect retail and DTC to experience the fastest growth.

Large national carriers have made a number of recent acquisitions of specialists in this area – for example, United/Golden Rule, PacifiCare/

Co-operative distribution agreements facilitate more tailored customer propositions and targeted products

AMS and Aetna/SRC. Financial institutions are also moving towards this market: for example, Capital One's acquisition of the InsLogic Distribution Platform has created a 'switchboard' model that aggregates a wide range of insurance products (which could in the future include healthcare) for sale to its 50 MM customers. The 'managing general agent' structure reduces costs enough to encourage customers to switch, and captures the highest commissions without assuming underwriting risk.

However, many firms will choose to strike up distribution agreements rather than opting for the long haul of organic expansion or the uncertainties of cross-sector acquisition. Some of these partnerships will be evolutionary: co-marketing arrangements with trade associations and affinity groups, for example. Others, such as retail or business partnerships, outbound telesales and Internet sales, and forward integration into distribution, are more radical. In general, we believe these approaches will prove more successful, albeit perhaps in relatively limited contexts.

Financial institutions' customer bases and marketing strengths make them natural participants in this activity. Their skills have immediate application in the highly segmented healthcare market. Healthcare needs vary significantly by income, life-stage and other characteristics, each of which is best served by tailored value propositions and products.

For example, students and recent graduates tend to need affordable access and gap coverage; pointing to dental care, mini-med, new affordable lifestyle products (such as Blue Cross of California's Tonik health plan) and discount cards. Those consumers approaching retirement but not yet eligible for government-sponsored programs, by contrast, need solutions that anticipate future health problems and ensure financial stability; they are therefore looking for consumer discounts and risk mitigation. They understand that the greatest risk to their future wealth is the amount of risk they take on relative to their future health costs. Other segments, such as recent immigrants, need low-cost benefits and financing. Each segment offers a unique set of opportunities for financial institutions to develop creative new solutions.

There is also demand for products and services that will cover gaps left by employers' retreat from comprehensive plans – and of course, some 40 MM Americans have no insurance at all. We believe the key to serving these markets is accurate segmentation, a skill in which financial institutions have proved themselves adept.

As financial services providers evaluate product expansion in both existing and new channels, it is important to evaluate each product and channel against customer needs, potential size, relative economics, and the optimal business model. Figure 1 shows a view of potential product categories and available channels.

Figure 1: Traditional insurance product and channel opportunities

Product category	Existing channels				New channel
	Direct (call center, mail, web)	Bank Platform	Retail lending	Price bank	Independent agents
Term	<ul style="list-style-type: none"> Aggregators capture bulk of volume Simple issue is an emerging opportunity 	<ul style="list-style-type: none"> Solid opportunity with correct sales training Choice is less of an issue, but affordability is key 	<ul style="list-style-type: none"> Difficult to sell non-credit products at point-of-sale Licensing and compliance could be an issue 	<ul style="list-style-type: none"> Not the key life product for these customers Will bankers take health info? 	<ul style="list-style-type: none"> Are the economics good enough? Willing to invest in wholesaling and marketing?
Small Business Health	<ul style="list-style-type: none"> Possible for simple products Leverages the card portfolio and is emerging channel for these product categories 	<ul style="list-style-type: none"> Very large potential opportunity Need to match products, customer segments, and sales expertise 	<ul style="list-style-type: none"> Similar to bank platform 	<ul style="list-style-type: none"> Could be an option depending on nature of products 	<ul style="list-style-type: none"> Potential option – key channel for these products today
A&H	<ul style="list-style-type: none"> Highly profitable product category Key is low cost distribution, given low average premium 	<ul style="list-style-type: none"> Need to match to customer base and desired branding and value proposition Needs further study 	<ul style="list-style-type: none"> Already successful channel with credit products If individual products can expand sales or improve economics, this could be attractive 	<ul style="list-style-type: none"> Not an affluent market product 	<ul style="list-style-type: none"> Bulk of market is direct marketing or captive salesforce May not be worth the investment
Long-term Care	<ul style="list-style-type: none"> Cost of product and complexity make this unlikely 	<ul style="list-style-type: none"> Could be an option with the right product Finding something simple enough to sell in branch is key 	<ul style="list-style-type: none"> Cost of product and complexity make this unlikely 	<ul style="list-style-type: none"> Clientele needs product and can afford it The right offering may be difficult to find 	<ul style="list-style-type: none"> Product sales have slowed and innovation is limited Significant infrastructure needed
Individual/Student Health	<ul style="list-style-type: none"> Possible for simple products Has been successful for AARP and others 	<ul style="list-style-type: none"> Complex sale but limited attempts through bank channel 	<ul style="list-style-type: none"> Similar to bank platform, but is an even more delicate sales environment 	<ul style="list-style-type: none"> Could be an option especially for early retirees or individuals between jobs 	<ul style="list-style-type: none"> Traditional sales channel for this product but would require infrastructure build out
Senior Health Products (medigap, Part D, medicare advantage, discount cards, continuity health related products)	<ul style="list-style-type: none"> Possible for a variety of products Successful models most notably AARP, PacifiCare 	<ul style="list-style-type: none"> Rarely – if ever attempted 	<ul style="list-style-type: none"> Rarely – if ever attempted but if greatest risk to wealth is health . . . 	<ul style="list-style-type: none"> Could be an option depending on nature of products and as an offset to wealth risks 	<ul style="list-style-type: none"> Key channel for these product categories

Manufacturing opportunities

Distribution opportunities

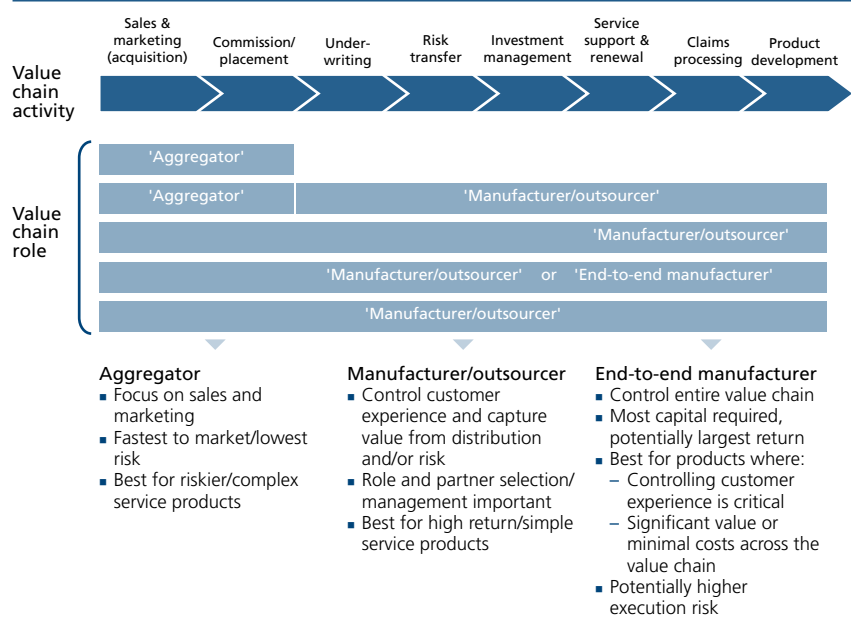
Risk sharing/reinsurance opportunities

Business model may vary

In thinking about a large existing customer base, it is important to understand other potential value chain roles, not just distribution (as shown in Figure 2). The role chosen will affect the profit, risk, returns and capabilities required. For some products with high returns and simple service requirements, such as supplemental AD&D, a

manufacturing role could allow a distributor to extract even higher returns and profit. For other products, such as healthcare insurance, the aggregator role might be appropriate. For still other products, the aggregator role might be a good starting point, but experience might in time make selective manufacturing activities appealing.

Figure 2: Overview of alternative insurance services' value chain roles



Asset management and payment services

Market growth aside, the biggest trend in healthcare is the move away from managed care to more consumer driven models. Individuals are increasingly saving for their own healthcare through CDHPs, rather than relying on employer-funded programs, or spending directly from their own pockets, particularly on 'elective' healthcare products and services

The key product in this respect is HSAs, which are forecast to grow rapidly over the next decade. Estimates suggest that there will be 6 MM accounts holding almost \$5 BN by 2008, increasing to 18.6 MM accounts holding \$34.7 BN in assets by 2012. More than a quarter of employers expect to offer a consumer-directed health plan by 2006¹, the majority including an HSA component. Growth in Flexible Savings Accounts (FSAs), by contrast, appears to have leveled off.

While most of the banking needs associated with HSAs are relatively straightforward – being like traditional activities such as account servicing and deposit-taking – there is one major exception: payment processing. The US model is to 'act first and pay later' – which makes for complex settlement issues, since a payment may be sliced into numerous tranches, payable by different entities.

¹ Forrester Research

The rapid growth of consumer-driven healthcare spending is fostering demand for asset management and payment services

For example, HSAs are not the only consumer savings vehicles in the healthcare space: FSAs and Health Reimbursement Arrangements (HRAs), as well as consumers' own out-of-pocket deductibles, also play roles in meeting healthcare costs. The objective for many firms in this market is to collapse this complexity into a single payment system facilitated by a 'smart card' that automatically draws on the (multiple) plans and accounts that apply to the treatment in question. This kind of smart card operation needs to support a number of novel processes, including:

- **Stacking:** The payment should draw from various accounts sequentially according to predefined rules. For example, a card might draw up to some limit on the FSA first, then on the HRA and finally the HSA. To make matters still more complicated, a wide variety of expenditures must be included – everything from buying aspirin to heart surgery – with dramatically different payment implications
- **Audits:** The card should 'understand' which purchases and vendors are acceptable under various payment plans
- **Membership administration:** Cards are emerging that additionally support member administration; these are able, for example, to verify eligibility for health benefits and co-payment information at the doctor's office or other point of sale

The current level of activity in the payment segment may not be justified by its economics

This is obviously a complex and challenging brief. Therefore it's worth considering the segment's economics carefully before rushing to join this 'land-grab'. On the estimates above, the direct rewards for companies managing these assets – in the form of asset management fees, interchange revenues, and savings spreads – appear rather small, even for a player that achieves market dominance: and we believe that the market is actually moving towards greater openness and competitiveness. We estimate total revenue accessible to financial institutions at less than \$1.7 BN by 2012 – hardly justifying the current level of market effort. However, when these opportunities are viewed through a "total solution" for healthcare producers or as new product distribution opportunity the potential revenues are enormous.

Putting the opportunity aside, the payment services opportunity could be larger when viewed from the end-to-end claim submission and payment process. For example, some larger medical practices have estimated that they spend 30% or more of their administrative costs on billing, collection and forms preparation. The average time to payment for a provider is about 60 days. Bad debt is another unwanted cost. In addition, the payor suffers significant costs in processing paperwork to pay claims. When thinking about the total value available from streamlining the end-to-end process, it becomes apparent that there may be ways to charge for payment facilitation other than a standard merchant discount or transaction fee.

Ultimately, the opportunity may not be in serving the HSA itself but in creating an advantaged position in facilitating payments and other benefits from ownership of customer relationships, and the consequent revenue opportunities (from credit card purchases to the capturing of additional retirement assets) that may be of most value.

Lending and credit services

An increasing proportion of the healthcare market is made up of consumers spending out-of-pocket, amounting to some \$250 BN today and estimated to almost double in seven years. Consumers paid directly for just over half of all retail medicine expenses in 2004 (excluding services), nearly three-quarters of complementary and alternative medicine charges, and the entirety of the 'wellness' costs of health clubs, health foods and day spas².

Increasing uninsured expenditure is creating demand for financing and credit solutions from both consumers and providers

This spending creates demand for financial services. In the retail space, there is a largely unmet need for products and services catering to the needs of the chronically ill. Conditions like diabetes, depression and obesity require long-term care, which is currently provided and paid for on a somewhat ad hoc basis. There is scope to formulate this into a combined healthcare and financial program.

For example, diabetes sufferers need to purchase drugs and equipment on a regular basis. Emerging businesses already exist under which their requirements are filled and paid for automatically. Another possibility in this space is care management – where early diagnosis and preventative treatments could forestall the need for (expensive) emergency care. Obesity, a major public health issue, could also prove amenable to these kinds of solutions.

A second category of out-of-pocket expenses arises from treatments that aren't considered medically necessary or clinically effective – complementary and alternative medicines. Elective procedures such as cosmetic surgery, orthodontistry and fertility treatment might also be counted in this category. The number of elective surgical procedures, for example, has been growing by 28% per year, with costs reaching \$12.5 BN in 2004³. Given that very few, if any, of these procedures will be covered by insurance, they create a demand for financing that a variety of small players are already attempting to service.

Not all plays in this space are targeted at the end consumer. Around three-quarters of healthcare providers have out-of-pocket financial needs that are currently under-served because they are too small to be reached by existing means. A \$50,000 X-ray machine may be a sizeable investment for a small dental practice, for example. Not only will the providers require finance, but they may also offer their customers financing, much as auto dealers do – using finance first to buy their inventory and equipment, and then offering finance to the customers who use their services.

This facilitates treatments and procedures that might otherwise be hard to finance; and by the same token, creates a relatively low-cost distribution channel that is already trusted by the consumer. Improving the payment system and providing applicable credit solutions can also help to smooth over difficult or awkward parts of the healthcare transaction cycle such as: debt collection, which is a major challenge for hospitals working on an 'act first, pay later' basis.

² Centers for Medicare/Medicaid. BenefitNews.com

³ American Society of Plastic Surgeons

Conclusion

The healthcare market provides a valuable growth and profit opportunity for two groups of companies – health insurers and financial institutions. While we are still in the early stages of this opportunity, it has certainly not gone unnoticed. The increasing amount of activity suggests that both groups have placed a high priority on this space.

Yet our review of the space reveals that at least some of this activity is directionless. Much of today's activity seems to us to be very much in the nature of 'land-grabs' intended to secure first-mover advantage, but sometimes in the absence of business models with well-defined revenue and profit motives.

We suggest that the best approach, in many cases, will be for finance companies and healthcare services to join forces. The two groups have complementary skills, and may find co-operation to be a more productive approach than head-on competition in each others' natural territory. As the two CEOs in our opening anecdote realized, two heads are sometimes better than one.

Some key questions for executives

For health insurers

- Where might I leverage new distribution channels?
- How can these new channels improve the economics of delivering my products?
- Can I create benefits for providers by using better payment vehicles to shorten their revenue cycles or reduce their bad debt? How much of the benefit can I capture?
- What is the right way to participate in the financial services value chain?
- Can I actually make a profit or is this a defensive move?
- Which companies represent the best partners? What are the underlying economics of the relationship?

For financial institutions

- Where do I see opportunities for creating an advantaged position to tap into healthcare: distribution, payments, financing, processing?
- Which health sectors show the greatest promise (e.g. payers vs. consumers; new service areas such as chronic disease mgt.; financing elective procedures)?
- Are there acquisition opportunities that will accelerate capability development and market entry?
- Are we making a co-ordinated effort or are our healthcare initiatives spread out and disconnected across the company?

OLIVER WYMAN

Originally published in April 2006 by Mercer Oliver Wyman

For more information please visit our website at
www.oliverwyman.com, or contact:

In North America

marketingna@oliverwyman.com

1 212 541 8100

In Europe

marketingeu@oliverwyman.com

44 20 7333 8333

In Asia Pacific

marketingasia@oliverwyman.com

65 6510 9700

Copyright © 2006-2007 Oliver Wyman Limited. All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman. This report is not a substitute for tailored professional advice on how a specific financial institution should execute its strategy. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisers. Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages.

This report may not be sold without the written consent of Oliver Wyman.

