

Escaping Rapunzel's tower:  
How single-state Blue Cross Blue  
Shield health plans can build scale  
and meet new capability demands



# Executive summary

Single-state Blue Cross Blue Shield plans likely should consider strategies that allow them to gain greater access to capital to effectively compete in the new health insurance marketplace. In a recent analysis of publicly available data, Deloitte found that the “Big Five” insurance companies spend on average nearly six times more on capital expenditures (CAPEX) than single-state Blues plans.

Deloitte also conducted interviews with former state insurance commissioners about alternative strategies for expanding access to capital and found there are surprising insights into how attractive some of the options might be. Selecting the right pathway is a matter of finding the option that aligns with the plans’ overall strategy, mission, and goals for future growth.

## Introduction

As the fairytale goes, there once was a beautiful young girl named Rapunzel who was locked in a tower by a guardian who wanted to hide and protect her from the world beyond. Rapunzel longed to escape from the tower to explore the stunning landscape she could see through her one tiny window. She dreamed of one day gaining freedom to set off in new directions.

Many of the single-state Blue Cross Blue Shield plans are living this same story today. These independent, non-profit health plans are finding themselves trapped in a tower of expectations and regulations that have built up around them over the last 60 to 70 years and the new business context resulting from the Affordable Care Act (ACA). The legacy of the single-state Blues plans is strong on almost every dimension – competitive market share, responsive customer service, insurance provider to those unable to obtain it elsewhere, government programs participant, large employer, and active community foundation. Interviews with former state insurance commissioners and various media reports suggest there is a common perception that these single-state Blues are well-prepared to grow and thrive in a market characterized by intensifying competition, demand for new operating models and capabilities, potentially lower margins, and increasing consolidation.

Our Deloitte analysis reveals a slightly different story. The single-state Blues' legacy of success, the expectations of state regulators, and the constraints of their enabling birthrights may be limiting Blues' ability to take advantage of business opportunities that are sitting just outside their reach – opportunities that may be critical for their survival. Short of a prince riding in to save the day, what options do the single-state Blues have to move beyond their current predicament to build a sustainable business model and compete in today's health insurance market?

## The landscape of opportunities and challenges has never been more complex and uncertain

The ACA is creating significant new growth opportunities for health plans that are interested in expanding their business to individuals seeking coverage through health insurance exchanges. More than eight million people have obtained insurance through the exchanges, and this figure is expected to rise during future open enrollment periods as early implementation kinks are worked out and more people gain exposure to and experience with the exchanges. The individual market is also likely to grow as more employers decide to scale back or opt out of providing health care benefits for their employees in response to continued cost increases. More than half of the

insured population is expected to obtain health insurance through non-employer choice-based channels by 2020.<sup>1</sup>

Opportunities for growth are also coming from the increasing numbers of individuals who are gaining coverage through expanded state Medicaid programs or aging into Medicare eligibility. Between 2012 and 2022, the Medicare and Medicaid market is projected to grow nationally by 34 percent and 39 percent, respectively.<sup>2</sup>

At the same time, the ACA is pushing health plans and providers to become more "accountable" by shifting towards value-oriented care delivery and payment systems that hold promise for reducing costs, improving care quality, and achieving better health outcomes. The push for value is also coming from employers and consumers: Many employers are shifting their employees to defined contribution plans, and consumers are becoming more attentive to value (or lack thereof) as they become better informed and more directly engaged in decisions that affect their health, health insurance, and health care. In addition to demanding greater value, consumers also want their purchase and service experiences to look and feel more like the retail experiences offered by other industries. Also, as individuals increase their use of technology in other spheres, their desire for well-designed websites and mobile apps in the health care space is increasing. Consumers want access to better information and the ability to interact with their health plan quickly and directly, whether they are comparing plans or providers, monitoring and managing their health, or trying to resolve a payment issue.

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The single-state Blues are facing the unique challenge of maintaining a mission that is no longer as distinctive as it once was.

Optimizing core business strategies has become harder for health plans given the complexities and uncertainties these opportunities and challenges present. This may be especially true for single-state Blues plans, as they try to maintain the mission they have been very successfully carrying out since 1929. That mission has evolved from providing hospital coverage to a group of teachers in Dallas, Texas, to offering full-scope hospital and medical care coverage to groups and individuals in all 50 states.<sup>3</sup> As the health plan market has evolved, Blue Cross Blue Shield plans who were once the insurer of last resort and held other distinctive attributes now need to refine their value proposition in the context of the ACA, which is leveling the playing field for everyone.

However, it will be harder for the single-state Blues to differentiate themselves and compete purely on their not-for-profit status and charitable investments in the community through health and wellness. The ACA has leveled the playing field by requiring all health plans to accept individuals with pre-existing conditions and provide coverage at community-rated prices. This is not to suggest that the single-state Blues should give up their mission. Their non-profit status and investment in their communities continues to be valued by many consumers, employers, and regulators. The ACA provisions, though, have narrowed the differences among health plans and the single-state Blues may now need additional ways to distinguish themselves in the market.



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**The investments that are needed to secure these capabilities require scale and regulatory flexibility. And therein lies the potential problem for the single-state Blues.**

**New capabilities will likely require significant capital expense and possible acquisitions, which may be beyond reach for single-state Blues**

Emerging growth opportunities and business challenges are driving fundamental shifts in what it takes to compete in the health plan market. Now, more than ever, gaining a competitive edge requires achieving new levels of operating efficiency, demonstrating value, and offering improved affordability, product flexibility, and service responsiveness. Traditional business models are no longer sufficient, and many health plans are taking steps to diversify their product and service offerings, modify care and payment arrangements with providers, and improve their interfaces with consumers in ways they hope will differentiate them from competitors.

To make these moves, health plans are finding they may need to invest in new capabilities in several areas,<sup>4</sup> including:

- **Delivery system transformation:** Value-based care solutions and payment models; provider collaboration or integration; telemedicine; clinical advice and management systems
- **Information systems and analytics:** Business intelligence and information management; secure health information exchange; analytics to measure and target issues and opportunities related to cost, quality, and outcome patterns for enrolled populations
- **Retail and consumer engagement:** Health care system navigation; self-service tools; digital/mobile/social media applications; gamification; retail storefronts; decision support
- **Product development, diversification, and pricing:** Government programs; global insurance products, specialty business (e.g., voluntary benefits, long-term care, home care, specialty pharmacy); consumer segmentation; custom pricing models.

Large for-profit health plans and multi-state Blues plans can build or buy these capabilities more readily than a single-state Blues plan. The single-state Blues are facing the same market conditions but, just as Rapunzel was restricted by her confinement in the tower, the single-state Blues lack the scale and regulatory freedom they may need to invest in the capabilities that likely will be required to compete in the changing health insurance market. Even if a single-state Blues plan is well-capitalized, it cannot, as a not-for-profit

### Financial analysis

Using publicly available company financial statements and select NAIC reports, we compared recent capital expenditures, amounts of capital available for investment, and acquisition activity among the five largest national health plans and 19 single-state Blues plans operating today. Stark differences in scale suggest that the nationals are in a far more advantageous position to invest in capabilities and take advantage of growth opportunities.

entity, access equity markets or use stock as currency for acquisitions. Just how competitively disadvantaged are the single-state Blues? Consider the following:

#### Single-state Blues don't have the scale to spend as much on fixed-cost investments:

The five largest publicly owned national plans (the "Big Five") invested an average of \$554 million, or about one percent of their revenue, on capital investments in property, equipment, and other capabilities in 2012 (Table 1). Total capital expenditure by 18 single-state Blues was considerably lower, averaging \$92 million (about four percent of revenue). Actual per-member capital expenditure by the same Blues was higher per member than the Big Five average in 2012 (\$80 versus \$24), but their cumulative spend didn't come close to matching the scale of investment made by the Big Five because of their smaller membership bases. The Big Five spent four times less per member, but six times more in total than the single-state Blues. For smaller plans, the higher per member spend for investments puts more pressure on premium pricing and the ability to get the most for their dollar in capabilities.

Table 1. Comparison of capital expenditure (CAPEX)

	National plans (five largest plans)	Single-state Blues plans (sample of 18*)	Magnitude of difference
Average revenue in 2012 (millions)	\$57,450	\$2,326	Big Five = nearly 25x larger in total revenue
(range in millions)	(\$29,199 – \$110,618)	(\$269 – \$6,558)	
Average capital spend in 2012 (millions)	\$554	\$92	Big Five = nearly 6x more available capital spend
(range in millions)	(\$338 – \$1,070)	(\$1.67 – \$271)	
Average percentage of 2012 revenue spent on capital investments	1.0%	4.51%	Big Five = nearly 4.5x less revenue spent on capital investments
(range)	(0.8% – 1.2%)	(0.15% – 25.67%)	
Average per member spend on capital investments in 2012 (millions)	\$24	\$80	Big Five = nearly 3x less per member spend on capital investments
(range in millions)	(\$15 – \$34)	(\$4 – \$417)	

Source: Deloitte analysis of 2012 data obtained from publicly available company financial statements and NAIC reports.

\*Sample excludes one of the 19 plans due to losses in 2012.

Variation in factors such as membership size and composition, geographic range, product portfolios, and operating infrastructure, would affect the level of investment that a health plan might need to make in new capabilities. However, the magnitude of the discrepancy in the scale of investment is so large that it is difficult not to acknowledge that the single-state Blues may be in a disadvantaged position.

**Single-state Blues have less available capital to invest:**

State regulators require insurance companies to maintain a minimum amount of capital to support their business operations, and that level is determined by their size and risk profile.<sup>5</sup> Historically, most single-state Blues plans have exceeded their required capital by a significant margin. In spite of this, single-state Blues plans typically have significantly less capital than the Big Five to use for investments in capabilities. In our comparison, the Big Five had on average over 14 times more capital available to them in 2012 than the single-state Blues plans — an average of nearly \$8.9 billion among the five nationals versus an average of \$630 million among the full set of 19 single-state Blues plans (Table 2).

**Single-state Blues’ engagement in M&A is limited by their financial position and regulation:**

The national plans have been aggressive with acquisitions in their quest to acquire capabilities and gain market share. In 2012, the Big Five spent an average of \$4.6 billion, or 10 percent of revenue, on acquisitions. If a dollar of investment is equivalent to a dollar’s worth of new capability, then the single-state Blues do not have the scale to compete for the same assets. Bound by their non-profit status, the single-state Blues do not have access to public equity capital markets and are limited to using cash to execute a transaction (debt financing is allowed but is not commonly used). In contrast, for-profit health plans, as publicly traded

companies, can raise funds by selling stock and offer an equity stake in the entities that are formed through mergers and acquisitions (M&A).

**View of the tower from the vantage point of state insurance commissioners**

State insurance commissioners have a unique birds-eye view of the dynamics of the health plan market in their states. To enhance our analysis, we interviewed 10 former commissioners representing a diverse set of health plan markets across the country.

**Competitive disadvantage:** The former commissioners generally shared a perception that the single-state Blues operating in their state have a good reputation, benefit from strong brand recognition, and are well-positioned financially to maintain or increase their market share. They also expressed a sense that the single-state Blues’ future financial strength may be diminishing, especially after seeing the results of our financial analysis that show sizeable scale differences in investing potential. Some noted that single-state Blues which currently are market leaders may continue to do well for some time in their state or region, but acknowledged that others may be at a serious competitive disadvantage moving forward.

**Mission and brand awareness:** Some former commissioners said they believe that the single-state Blues are holding strong to their mission and offering something unique to consumers. Others sensed that certain Blue Cross Blue Shield plans are being pulled away from their original mission and look like their publically owned competitors. All seemed to agree that walking this line will become increasingly difficult as the single-state Blues plans try to figure out ways to maintain awareness of their unique brand and strengthen their capabilities to operate in the post-ACA world.

**Table 2. Comparison of available capital**

	National plans (five largest plans)	Blues plans (19 single-state plans)	Magnitude of difference
Average available capital above 400 percent RBC in 2012 (millions)	\$8,867	\$630	Big Five = 14x more on average than single-state Blues
(range in millions)	(\$3,117 – \$21,652)	(\$40 – \$1,870)	

Note: Available capital above 400 percent RBC was calculated for each health plan as the difference between the health plan’s surplus/retained earnings and 400 percent of the health plan’s authorized control level for RBC. The average, range, and sum of those figures are reported above for each set of plans. Source: Deloitte analysis of 2012 data obtained from publicly available company financial statements and NAIC reports.

**Regulatory framework:** The regulatory requirements the single-state Blues must meet as non-profit health plans vary somewhat by state, but almost all states place greater restrictions on the non-profit, single-state Blues than for-profit plans with respect to the use and transfer of capital, affiliations, and joint ventures. In addition, most states require community representation on the Blues' boards and the foundations established for charitable purposes. Some of the former commissioners indicated that these requirements might need to be evaluated in light of market developments that are leading to less distinction between the missions and strategies of non-profit and for-profit health plans as they try to take advantage of growth opportunities and respond to new business challenges.

**Strategies for unlocking capital:** When asked about the appeal of different business strategies for investing in new capabilities, the former state commissioners' views varied widely due to differences in the circumstances they experienced during their tenure and to differences in the regulatory contexts and business conditions in their states. They were asked to rate the attractiveness from a regulatory standpoint of four options — conversion to for-profit ownership, merger with another not-for-profit Blue Cross Blue Shield plan, joint venture, and new holding company (Table 3). One further option, affiliation, is discussed but was not rated by the former commissioners because of the uniqueness and complexities associated with the different types of affiliations.

### Escaping the tower: What options do the single-state Blues have for unlocking investment potential?

Rapunzel was fortunate to escape her tower with the help of a prince. Short of that particular fairytale ending, what options do the single-state Blues have to build scale, acquire new capabilities to remain competitive, and diversify earnings? Conversions, mergers/acquisitions, affiliations, joint ventures, and new holding company structures are all possibilities, but each involves different risk/reward tradeoffs.

**Conversion:** Conversion to a for-profit enterprise can lead to greater capital investment flexibility. In exchange, conversion requires that the non-profit give up its tax advantages and create an independent philanthropic foundation with the fair market value of their assets to benefit the community. A non-profit, single-state Blues plan might convert directly to a regular for-profit corporation or alternatively to a mutual-benefit corporation owned by the subscribers, either as an end in and of itself or as a step towards regular for-profit status. Conversion may be the most difficult model from a regulatory standpoint.

### Former state commissioner interviews

To gain additional insights on key issues facing Blue Cross Blue Shield plans, we interviewed 10 former insurance commissioners from across the country. We opted to interview former rather than current commissioners to benefit from the reflections and opinions they could share having experienced a full tenure in the role.

Each former commissioner was asked:

- What are the priority focus areas for health insurance companies in the upcoming years?
- Are single-state Blues competitively disadvantaged compared to national plans in the future post-ACA environment?
- Are the single-state Blues plans meeting their mission?
- Is the not-for-profit versus for-profit competition an important element to the lower cost of care in your state?
- Regarding regulatory barriers, what makes Blue Cross Blue Shield plans different in relation to other insurers?
- How attractive are certain business strategies from a regulatory standpoint?

The former state commissioners we interviewed rated conversion unfavorably (average rating was 3.9 on a scale from 1 = most attractive option to 5 = least attractive option from a regulatory standpoint). They noted that this option can be a tough road for single-state Blues plans because of the perception of straying from the Blue Cross Blue Shield mission, executive compensation issues, providers' concerns about consolidation, and the regulatory friction that seems likely to arise throughout the process. Conversion is not easy and may not even be an option for many of the smaller, independent, single-state Blues.

**Merger/acquisition:** A merger is a more attractive option from a regulatory standpoint, according to the former state commissioners (average rating of 2.0 on the scale from 1 = most attractive to 5 = least attractive). A merger can be more straightforward than other options in terms of achieving strategic alignment and implementing changes in governance, operations, and financial relationships. Integrating two entities can be very challenging and expensive.<sup>6</sup> From a regulatory standpoint, a merger requires significant due diligence, clear delineation of the new governance structure for the merged entity, and an understanding of how the original mission will be met. If the two entities do not have the same legal structure, a conversion may be required to transact the merger. For example, a not-for-profit combining with a mutual would need to convert to a mutual as a precursor to close.

**Affiliation:** There are two types of affiliation models: (1) a controlled affiliation in which one company assumes a level of control over the other; and (2) a contractual affiliation in which they commit to a long-term permanent relationship which may include an escape clause even if a divorce would be impairing to the organizations. In both cases, the affiliation allows existing legal entities to remain intact, with separate balance sheets and financial statements, yet it creates opportunities for synergies and innovative solutions by combining operations and enables savings to be reinvested in additional capabilities. Through affiliations, health plans can pursue diversification opportunities and other strategic partnerships that might not otherwise be available, and they may not be required to establish a community foundation, as can be the case with mergers and acquisitions. However, in the case of a controlled affiliation, local board powers are dictated by the holding company’s bylaws and there is potential for perceived conflicts in board members’ fiduciary responsibilities between the holding company and the affiliate. Poor affiliate performance, or regulatory action by one or more of the states in which the affiliated companies operate, are potential conflicts. Should the two parties seek dissolution of the affiliation after operations are merged, separating can be expensive and disruptive. The former state commissioners did not rate this particular option because of the uniqueness and complexities associated with the different types of affiliations.

**Joint venture:** This option involves creating a separate legal entity whereby the respective parties each have an ownership stake, contribute resources to the partnership, and share in the gains and/or benefits from the synergistic cost savings. A joint venture can open avenues to complementary capabilities and create a test environment for new products, services, or acquisition possibilities. Joint ventures can also be attractive to investors, and typically present fewer regulatory hurdles than mergers and affiliations. However, the state commissioners rated a joint venture as somewhat less attractive than a merger from a regulatory standpoint (average rating of 2.6 on the scale from 1 = most attractive to 5 = least attractive). These arrangements typically involve rigid reporting requirements and reaching agreement on governance, dispute resolution, and conditions of exit. Joint ventures work best when there is alignment of vision enabling management and governance to work as if it were one organization; but, that is easier said than done. A joint venture also may not provide sufficient scale required to make meaningful change in each party’s competitive position.

### Former state commissioners’ ratings of options

When asked about the attractiveness of certain business strategies from a regulatory standpoint, the former state insurance commissioners rated each of the following options using a scale of 1 = most attractive to 5 = least attractive.

Their views varied widely due to differences in the regulatory contexts and business conditions in their states. Each option received ratings spanning the 5-point scale, with one or more minimum ratings (1) up through one or more maximum ratings (5). The average ratings provide a measure of the relative attractiveness of the options across the 10 states.

**Table 3. Former state insurance commissioners’ ratings of the attractiveness of options from a regulatory standpoint**

Average rating	
2.0	Merger/acquisition 
2.6	Joint venture 
3.1	New holding company 
3.9	Conversion 
1 = Most attractive → 5 = Least attractive	

**New holding company:** This approach involves one company dividing into two legally separate entities or acquiring another that remains separate. One of the entities is designated as a regulated insurance holding company that owns the licenses to operate as a health insurer, and the other is designated as a non-insurer holding company that owns the non-insurance related products and services companies. Separating the reserves into two distinct pools allows for different investment options and returns on capital strategies that potentially create greater value for the entire enterprise without non-insurance businesses being constrained by insurance regulations. This works

well when the non-insurance holding company invests in diverse but complementary businesses such as clinical care delivery assets, technology enablement, wellness initiatives, employer work site services, and pharmacy services. This strategy requires fewer structural changes than other options and enables the health plan to engage in investment actions like mergers and acquisitions (including with entities outside the insurance industry) while keeping certain tax breaks and other advantages of a non-profit enterprise intact. This option benefits from being carried out by one management team with a single investment roadmap and strategic plan. According to the state commissioners, a holding company is in the middle – less attractive than a merger or a joint venture from a regulatory standpoint (average rating of 3.1 on the scale from 1 = most attractive to 5 = least attractive) but more attractive than a full restructure with conversion to for-profit.

### Unlocking the single-state Blues' investment potential: Configuring to compete

Just as Rapunzel benefited from her alliance with an “outside party,” the prince, single-state Blues plans may be able to gain the scale they need through alliances with other organizations. Scale is achieved in different ways with varying costs and risks, but each of these options provides increased access to new capabilities and the ability to spread the costs and risks over a larger base.

None of the options offers a clear best choice for escaping from the tower and unlocking the single-state Blues' potential to invest in needed capabilities. Single-state Blues plans have had mixed success with each approach, and the choice will depend on a plan's financial position, market characteristics, and the particular set of regulations they must follow within the states they operate. While each option has its strategic advantages and disadvantages, poor execution could lessen the full value delivered from any arrangement.

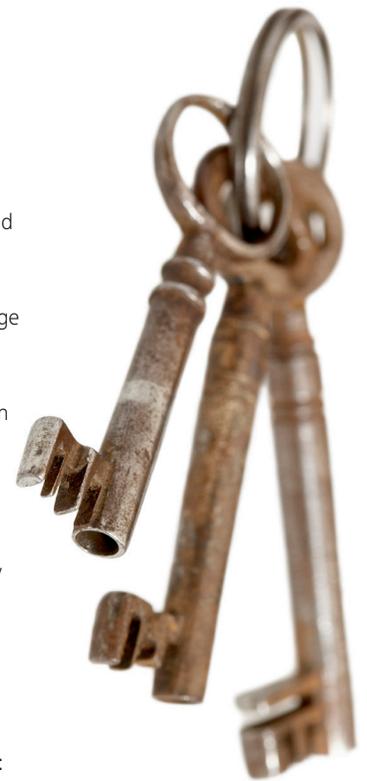
Single-state Blues plans should consider the following:

- **Convey urgency:** Spend time developing and conveying an understanding about your current situation and future viability to all of your constituents (e.g., insurance commissioners, providers, consumers, etc.) — engage in a broader dialogue.
- **Confirm discretionary capital:** As you undertake Own Risk and Solvency Assessments (ORSA) and RBC evaluations, recalculate and confirm your actual and required discretionary capital for your overall strategy and future initiatives.

- **Think beyond traditional solutions:** Don't use today's performance measures to evaluate your future needs. Rather, think about the problems your customers are looking for you to solve. What new solutions and options might create the value your customers are looking for?
- **Target specific capabilities:** Identify the specific new or expanded capabilities your particular plan needs to differentiate and compete in your market.
- **Stake out a path:** Assess the potential risk/reward profile of the full range of opportunities currently available to your plan for building or buying the capabilities you need. Align your management team and your board on these key priorities.
- **Change of control protection for executive management:** The board of the directors can encourage management to take a long-term enterprise view without being compromised by personal financial considerations by having change of control provisions in the employment agreements for executive leadership.
- **Garner support early in the regulatory process:** Collaborating with state insurance commissioners is a key factor to success when making decisions that have regulatory implications. Developing a proactive strategy to get regulators on board early in the process can be critical for fostering understanding about objectives, anticipating and addressing potential roadblocks, and increasing the efficiency of what can be a long and complicated process.
- **Push for regulatory changes that might be needed:** Some of the former state insurance commissioners indicated that regulatory changes may be needed going forward to help single-state Blues get out of their tower.

The health plan market seems headed towards even greater consolidation, with intensifying competition among fewer and fewer players.<sup>7,8</sup>

Single-state Blues plans should consider taking action now to build or buy the capabilities they may need to hold or improve their market position. There are options to build scale and develop required capabilities without giving up the Blue Cross Blue Shield non-profit mission. Choosing the right avenue is a matter of identifying the option that ties in best with the health plan's overall business strategy and plan for growth.





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## Endnotes

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