Article Title: ARCHIVE | Criteria | Insurance | Health: Evaluating Health Plans' And Health Insurers' Competitive Positions Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by an article titled "Evaluating Insurers' Competitive Positions," which was published on April 22, 2009.) In assessing future financial strength, it is critical to identify an insurer's fundamental characteristics and its source of competitive advantage or disadvantage. Competitive position can prove to be one of the decisive factors underlying a final rating decision, as the analyst defines the key characteristics of organizational structure and activity that constitute competitive strengths and weaknesses. These strengths and weaknesses are intricately tied to the insurer's strategy and operational effectiveness and will strongly influence its financial profile. It is through Standard & Poor's Ratings Services review of a company's competitive position in each major line and region of activity that it determines whether there is solid potential for satisfactory performance. At the same time, such a review will also likely highlight whether any significant diversification that might have occurred into new activities or new regions has added to or diminished the level of risk within the company relative to likely returns. Evaluating a company's competitive position involves substantial subjective interpretation of the basic facts and data associated with lines of business, premium volumes, market shares, and technical performance. Large size suggests economies of scale but does not guarantee conspicuous success. Small scale suggests a lack of diversification but might be offset by compelling competitive strengths that render niche status both profitable and defensible into the foreseeable future. In other words, an insurer's strengths and weaknesses in the marketplace are often vital to the company's future performance. The relative strength of the competitive review can frequently offset other positive or negative factors used in Standard & Poor's analysis. Standard & Poor's analyzes the company's business profile to evaluate the revenue-generating capacity and its competitive strengths and weaknesses. The analysis looks not only at the company's past and present positions but at how Standard & Poor's believes the company will fare going forward given its particular characteristics and strategy and the competitive climate. Standard & Poor's reviews the competitive position of the entity relative to its peers as well as relative to the industry as a whole. In addition, if the health plan is part of a larger group (such as a family of HMOs under a holding company), Standard & Poor's also will analyze all of the HMOs as a group, as well as other insurance companies or noninsurance operations, irrespective of whether they are rated. This allows Standard & Poor's to gain a complete understanding of how the rated health plan fits in with the rest of the group, the nature of these related activities, and whether these activities strengthen or detract from the company being rated. Standard & Poor's assesses the success of a company's portfolio of business units and product lines, distribution systems, degree of business diversification, and appropriateness of niche strategies. The analysis includes the aspects of the business that affect the absolute level, growth rate, and quality of the revenue base. Ultimately, to demonstrate competitive advantage, an insurer must be expected to show either superior operating performance in the industry, stronger growth characteristics, or both. The rating also incorporates an evaluation of the financial strength and business strategies of important subsidiaries and affiliates. Standard & Poor's often is asked, "How does a company's rate of revenue growth affect the ratings on that company?" Clearly, a strategy of growth for growth's sake can be a road to ruin and is inappropriate in soft markets where excess growth can only be obtained by underpricing business. Nor is size alone equated with credit strength. Over an intermediate- or longer-term horizon, Standard & Poor's would expect stronger companies to have good growth prospects. This view is always balanced against a belief that there are times when no growth or slow growth is better and that preservation of earnings and capital is paramount. In making Standard & Poor's evaluation, there is a clear link between the strength of an insurer's business position and its corporate strategy. On the other hand, a health plan or insurer's business position must be evaluated in the context of the financial performance that is expected of the company. Standard & Poor's expects strong companies to maintain sound levels of capital and earnings. Companies with sustainable competitive advantages in niche markets can still be highly rated if they can demonstrate a strong record of earnings performance that is expected to continue. To illustrate the degree to which a company enjoys strong, defensible franchises or to which it is prudently diversified across a variety of profitable or potentially profitable sectors, an appropriately detailed analysis of business units will be undertaken. Standard & Poor's will examine the company's ownership structure, market stature, and product distribution, even of specific product lines, where these are felt to be of particular significance. In taking a prospective view, Standard & Poor's will also analyze features and trends in the general market environment, particularly where these constitute a possible opportunity or threat to the rated entity. Market Position and Competitive Advantage When assessing market position, analysts will, in effect, look at what an insurer is actually doing and then define each activity and describe the company's business position in each major line relative to peers. An assessment of the overall, consolidated position will then be made. However, to reinforce the prospective nature of the analysis, the subject of competitive advantage must also be addressed. The presence of distinct competitive advantages across major lines of business and principal markets will likely suggest that current market franchises will improve or, at the very least, remain relatively stable in the face of competition. Meanwhile, the analysis of operating performance under a separate section of the analysis will also help substantiate whether management is successfully translating any perceived business strengths into incremental earnings. However, for a variety of reasons from mutuality to catastrophe and from periodic price wars to fluctuating investment markets, Standard & Poor's recognizes that the degree of correlation between competitive position and operating performance could vary somewhat over time. But what is competitive advantage? In practice, it is anything that will help differentiate an insurance provider in its marketplace in a positive sense and thereby allow it to compete more effectively against peers and improve its ability to write more business, earn higher margins, or both. In this sense, competitive advantage could include a brand name that inspires greater customer confidence and loyalty, a cost base that allows competitive pricing at sustainable and satisfactory margins, or a means of distribution that accesses a preferred type of client in a cost-effective manner. Similarly, the advantage could be in product design, with an individual contract efficiently meeting a market need through coverage or flexibility or, alternatively, a range of complementary products that together attract and retain a class of policyholder that might not otherwise have been drawn to the company. Quality of service could also be a competitive advantage, but it is one that is claimed by nearly all the insurers that Standard & Poor's speaks to and might consequently be more a prerequisite for market success than a facilitator of it. Whatever the case, the analyst will try to identify such competitive strengths that may exist or be lacking and to opine what the effects of such strengths and weaknesses are likely to be on the local and overall market position of the company or group under review. Diversification Through Product and Geographic Spread of Risk Diversification is the very essence of insurance, with a pooling of risks so that the losses incurred by a minority may be settled using the premiums paid by the majority. At a very fundamental level, a sufficient degree of size and diversification at an insurer is essential to cover fixed costs, avoid adverse selection, and increasingly enjoy the benefits of the actuarial law of large numbers, whereby the frequency and severity of seemingly random events becomes accurately quantifiable. However, some way beyond this minimum level, there comes a point in the evolution of any reasonably successful company when it has a realistic choice between aiming to maintain a stable, status quo business strategy or taking the more radical option of conscious diversification by developing or acquiring new activities or by expanding or buying into new regions. Neither strategy is without risk. When consciously forgoing diversification while seeking to maintain financial strength, management at a focused, niche insurer must be supremely confident that its company can sustain its viability in traditional activities and regions into the long term. Similarly, before introducing new products, new lines of business, or new, remote operations to justify additional flags on the map, companies must consider whether they have the skills, the means, and the infrastructure to achieve a similar level of ultimate success in the new activity that they currently enjoy in their existing principal operations. If the new undertaking risks seriously underperforming relative to the traditionally core range of activities, then arguably management is gambling with the company's financial strength by assuming higher levels of exposure in lines or areas where the increased risk is unlikely to be compensated by sufficiently increased earnings. In this context, therefore, far from being seen as either positive or even neutral, further diversification and growth risk become significant and negative risk factors. Experience suggests that diversification into new activities is always a challenge, and even if the initiative is ultimately successful, it could at the very least consume disproportionate levels of management time and energy until operational equilibrium and a reasonably stable track record have been established. For its part, therefore, Standard & Poor's has learned to react with an instinctive prudence in its analysis of start-up and newly acquired operations, most particularly if these new ventures appear to be a departure from management's proven sector or regional strengths. However, to the degree that the passage of time proves diversification to have been successful and sustainable, then it will likely be regarded as a distinct strength relative to an otherwise similar but nondiversified peer. Meanwhile, specific to the product spread of risk, the rating analyst will study the lead product offerings in a company's main markets and ask questions such as: Does the company manufacture or outsource its products? Is it low or high value added? Is it high or low risk? Is the company largely dependent on one or a few products, or does it have a whole range of diversified product offerings? Although there are no invariably right or wrong answers to such questions, it is clear that both the analyst and the rating committee will tend to feel greater comfort when a company is found to be selling value-added rather than commodity products—as long as the added value is also apparent in the pricing. Similarly, products providing stable, long-term revenues or asset accumulation are likely to be preferred over those that are short-term and volatile or that consume capital or place a potential strain on liquidity. Naturally, the greatest level of comfort will be achieved when a company is exploiting its competitive strengths to sell capital-self-sufficient products at margins that are supportive of sustainable, long-term earnings. Distribution Increasingly, distribution could itself be the key competitive factor in many markets. A good name, a good product, and a good quoted premium all help, of course. However, the conclusion of an actual sale might ultimately rely on ease of access by the would-be policyholder. Again, the rating analyst will pose a number of questions: How is the company managing its distribution today as opposed to in the past? What changes in distribution could occur? Is distribution a high or low cost relative to competitors? Finally, and most important of all: Is the means of distribution effective? Ultimately, distribution costs are one of the few variables over which management can exercise some real control. In practice, though, in the field of distribution as elsewhere, there is no panacea. Consequently, most larger insurers appear to be going down the route of multi-distribution, allowing policyholders to choose their own channel of approach, whether electronic, across the bank counter, or face to face with an agent. Whatever the case, the important factor is effectiveness in bringing an appropriate product to the attention of the customer in a cost-efficient manner and then converting that moment of attention into a physical sale at an economic premium level. Legal Organization The discussion of an insurer's legal organization will succinctly address factual considerations of who owns the company under review, what the legal structure of the organization is, and what the significant sister companies and subsidiaries within the group are? More significantly, analysts will seek to ascertain whether the legal structure is effective for meeting the company's objectives and, of equal importance, whether there are any other associated operations outside the current analysis that could consume capital. If so, do these operations risk having an indirect but negative impact on the financial strength of the company or companies specifically under review? The following items are examples of the types of information used in evaluating a firm's competitive position: The degree of competitive advantage enjoyed by the organization because of distribution capabilities, product structure, investment capabilities, quality of service, cost structure, and market-segment dominance. It is vital for a company's long-term success to differentiate itself from its competitors. Companies without a sustainable competitive advantage are viewed least favorably. Diversification of revenue by business unit, geography, product, and distribution channel. The most favorable scenario for a company is to have developed a national presence and to offer multiple products over a broad range of business lines, with each product line maintaining competitive advantages in its market and thus offering long-term profitability. Besides being broadly diversified across a company's country of domicile, a significant international presence is also viewed favorably. Type of health delivery contracting primarily used (fee-for-service reimbursement, contracted arrangements with discounted charge reimbursements in propriety or rented networks, pre-paid (capitated) arrangements, or staff or group model HMOs) and relative advantages within the health plan's service area. Range of product offerings (i.e., HMO versus PPO, size of network, options for co-payments and deductibles, Health Savings Account), and relative penetration in the respective market. Growth rates of enrollment in total and by line of business on both net and gross bases, generally over a five-year period. Provider contracting strategies with hospitals, physician groups, and others such as pharmacy benefit managers. Duration of provider contracts and provider quality evaluation. Regulatory restrictions/oversight on lines of business, the ability of the health plan to obtain rate increases, and the restrictions, if any, on the accumulation of capital. Related noninsurance activities of the group. Market share of the total firm and by major product lines. A high market share in significant and growing markets is most desirable. However, a high market share that is sustainable over the long term in product or geographic niches is also consistent with strong ratings. Equally important is how a company obtains and maintains its market share. Clearly, the more favorable and sustainable situation is when market share has been obtained through a company's competitive advantage rather than simply through price cutting. Efficiency of the distribution system. The types of distribution channels used by a company are examined to determine their cost effectiveness. Clearly, to maximize sales efficiency, it is important for the most appropriate distribution channel to be used for each product line. For example, although it is likely that a direct-marketing effort will entail less cost than maintaining a career agency system, for relatively complicated products that require a higher degree of explanation, the additional cost of a career agent is likely justified. Failure by a company to fully harness and use its chosen distribution channels can be a negative rating factor. The market chosen by a company in which to do business. If a health plan or insurer caters to a particular niche market, the growth trend of that particular market and the underlying factors driving the growth are examined to help determine their likely future course. While maintaining or expanding market share in growing markets is viewed favorably, participation in markets that afford strong financial performance is also a key consideration. Growth of revenue in the last five years and projected growth over the next several years. A health plan or insurer's growth will be evaluated in the context of the markets in which it operates. Although growth over the longer term is consistent with higher ratings, growth must be balanced against market fundamentals when constraining growth leads to sound profitability. Analytic Guidelines for Evaluating a Competitive Position In evaluating a health plan or insurer's business position, Standard & Poor's has established a list of guidelines for the analyst to use. The guidelines should not be construed as a benchmark exercise, given that any particular company that scores well in some categories could be maintaining its competitive position by constraining itself in other categories. As a result, Standard & Poor's is not constructing a grid in which it is dictating the business profiles of highly rated companies by requiring companies to fit a range of specific characteristics. Instead, Standard & Poor's expects companies with very strong competitive positions to have some characteristics that will give them a sustainable competitive advantage and help them maintain a strong financial profile. Health Plan and Health Insurer Scoring Guidelines: Competitive Position MOST FAVORABLE FAVORABLE LEAST FAVORABLE MARKET ADVANTAGES/MARKET SHARE High market share in significant markets. High market share in smaller markets or middle-of-the-road competitor in larger markets. Low market share. Maintains cost advantages or sustainable product advantages over competition. Alternatively, maintains extremely strong competitive advantages in niche markets. Competitive product structure. No sustainable competitive advantages. Operates in markets that afford strong financial performance. Operates in competitive markets, but can still produce good financial performance. Operates in highly competitive or irrational markets. Low threat of potential competitors disrupting the insurer’s financial performance. Moderate threat of potential competitors disrupting the insurer’s financial performance. High threat of potential competitors disrupting the insurer's financial performance. Favorable regulatory environment exists. Moderately favorable to neutral regulatory environment exists. Unfavorable regulatory environment exists. Good track record of raising premium rates when required. Moderate success in raising premium rates when required. Limited ability to raise premium rates when required. PRODUCT DIVERSIFICATION Offers multiple products (at-risk, administrative services only, and specialty) to a wide range of business segments. Offers a small range of products (at-risk, administrative services only, and specialty) over one or two lines. Narrow product offerd over one or two business segments. Most product lines maintain competitive advantages in their markets and offer long-term profitability. Only a couple of product lines offer good prospects of long-term viability. The long-term viability of most products and lines of business is in question. Strong track record in medical management and product development. One product line accounts for more than 50% of long-term company profitability. One product line accounts for more than 80% of long-term company profitability. Fair track record in medical management and product development. Limited success in medical management and product development. DISTRIBUTION Has loyal distribution system providing high-quality business. Company has clear control over product distribution. Maintains average control over distribution, which provides good-quality business. Persistency is average, and the company is usually the preferred provider of products to this distribution system. Distribution system has low level of loyalty to company, often sells competitors' products, and produces poor-quality business, leading to poor persistency. Uses multidistribution systems and/or has strong control over a distribution system that has good access to a variety of markets. Distribution system has good access to a couple of markets. No apparent distribution strengths in any market. Distribution system is highly cost-efficient. Distribution system does not place company at a competitive disadvantage due to high cost structure, nor does it give the insurer a competitive advantage. High cost of distribution places company at a competitive disadvantage. GEOGRAPHIC DIVERSIFICATION Maintains national presence over a broad range of product lines (i.e., competes in several states). Maintains strong regional presence (competes in a few states). Local presence only (competes in only one state). Top five states constitute less than 35% of premiums. Top five states constitute less than 50% of premiums. Top five states constitute in excess of 50% of premiums. Top 10 states constitute less than 60% of premiums. Top 10 states constitute less than 85% of premiums. Top 10 states constitute in excess of 85% of premiums. No unusual concentrations. Only minor concentrations. Clear concentration risks exist.