Executive Summary

In the midst of China's massive healthcare reforms, including focus on expanding health insurance coverage, one area has not received much attention from policy makers and market participants until recently - the private health insurance market.

Despite the Chinese government's first proposal of developing private insurance to supplement China's public health insurance in 1996 as part of the Ninth Five-Year Plan, and high-level attention given to the concept by President Hu Jintao and Premier Wen Jiabao in their speeches over the years, the industry today remains small and immature. This is not withstanding intense interest from the private sector - Cigna Corp., CEO David Cordina has called China "a huge opportunity" and China Life's CEO Wilf Blackburn has espoused the company's "increasing focus on China's commercial health insurance market, which shows great growth potential".

In his opening speech March 5 during the Fifth Session of the 11th National People's Congress, Premier Wen said that China was "building the basics of a national health insurance network, with a pilot program under way that includes coverage for lung cancer and 11 other major diseases." Vice-Premier Li Keqiang also announced in the official Party newspaper and during a State Council meeting on healthcare reform that the Chinese government intends to "actively develop commercial health insurance" and "facilitate the [combination] of basic medical insurance and commercial medical insurance."

Skepticism arose as to whether such comments indicated a serious intent to develop the industry, or were simply more high-level policy guidance without concrete action.
Business As Usual?

With the Chinese government's investment of RMB 850 billion ($134 billion) in 2009 to reform the healthcare sector, China's health insurance system, which is primarily public, has seen basic medical insurance coverage increase drastically from roughly 24% to 95% of the population from 2005 to 2010. As of 2010, the three largest government social insurance programs, Urban Employee (UEBMI), Urban Resident (URBMI) and Rural Co-operative (NRCMI), covered 94% of China's total population (“2012 China Outlook: China's Year Of The Dragon Will See Continued Growth Grounded By Healthcare Reform Stabilization” - PharmAsia News, Jan. 20, 2012 5:34 PM GMT).

At the same time, private health insurance coverage in China has expanded. Insurance premiums collected grew at 27% per annum over the past decade to reach RMB 70 billion in 2010, with an estimated 6-9% of the urban population enrolled in private health insurance plans. Private health insurance penetration (total insurance premium divided by GDP) doubled and density (per capita spending on insurance) grew ten times over the past decade.

### Private Health Insurance Premium Collected In China (2000-10)

<table>
<thead>
<tr>
<th>Year</th>
<th>Billions of RMB</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>6.5</td>
</tr>
<tr>
<td>2001</td>
<td>6.2</td>
</tr>
<tr>
<td>2002</td>
<td>12.2</td>
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<tr>
<td>2003</td>
<td>24.2</td>
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<tr>
<td>2004</td>
<td>26.0</td>
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<tr>
<td>2005</td>
<td>31.2</td>
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<tr>
<td>2006</td>
<td>37.7</td>
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<td>2007</td>
<td>38.4</td>
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<tr>
<td>2008</td>
<td>58.5</td>
</tr>
<tr>
<td>2009</td>
<td>57.4</td>
</tr>
<tr>
<td>2010</td>
<td>67.7</td>
</tr>
</tbody>
</table>

Source: China Insurance Regulatory Commission (CIRC)

Fueling this increase is the growth in the number of personal insurance companies (the China Insurance Regulatory Commission considers health insurance as a subset of life insurance) and the number of health insurance plans offered in the market. The number of companies more than doubled from 2004 to 2010 with roughly 60 approved personal insurance companies in 2010, and the number of health insurance plans increased from an estimated 300 in 2008 to more than 1,000 currently available in the market.

Despite the large number of plans, the variety of products offered in the market is limited. Plans currently offered can be divided into two types:

- Hospitalization supplemental insurance - a partial payment for hospitalization expenses in addition to reimbursement allowed by government insurance schemes, thereby reducing effective out-of-pocket payment by patient; and
- Severe disease insurance - a lump sum payment to patient upon
contracting a major disease.

With limited innovation observed in the market, insurance companies are competing on prices, sacrificing margins for volume and the opportunity to cross-sell life insurance products. Although operationally, insurers appear able to manage their payouts at about a 35% level, or RMB 35 for every RMB 100, thus controlling their risk exposure.

Despite the impressive growth numbers and the increasingly important role private health insurance has been playing in healthcare funding, private healthcare insurance still currently accounts for less than 2% of China's overall healthcare expenditure. Given the scale of growth China has seen in other industries and by international metrics used to measure the development of the insurance industry, few would say that the private health insurance market in China is on a path of explosive growth.

Three major trends, however, point to a positive future for the industry: improving demand and affordability; governmental policies and regulations; and insurance companies' efforts

**Improving Demand And Affordability**

First, the combined trends of an aging population, increasing life expectancy, continued urbanization, and increasing personal income is expected to drive China's healthcare expenditure. This, together with increasing awareness of the concept of insurance, will likely drive the growth of the private health insurance market.

With higher levels of education, the younger Chinese generation has higher awareness of risk than their parents. Given widespread media attention on the rising costs of healthcare, they are increasingly aware of the need to supplement basic social security protection currently provided by the government. In a survey conducted by Swiss Re in 2011, the younger Chinese generation was less willing to take risks compared with the previous survey conducted in 2009. Moreover, 72% of Chinese respondents reported to be planning to buy life or health insurance products within the next 12 months while 54% were concerned about the amount they have to pay out-of-pocket for medical expenses relating to major illness.

Even with the 2009 healthcare reform, that risk is justified since the incidence of many serious diseases is rapidly increasing in China, driving up demand for healthcare.

For example, the incidence rate of various types of cancer is expected to increase by 1.2%-5% per annum from 2010 to 2030, representing about 600,000 to 1 million new patients diagnosed with colorectum and lung cancer, respectively, each year.

Despite pockets of wealth, with the large population, funding is scarce and inadequate. While reimbursement for social insurance for major diseases is available in many cities, it is neither uniformly available nor sufficient. In the case of chronic kidney disease, pre-dialysis treatment is not reimbursable while dialysis treatment is largely paid out-of-pocket in tier 2 and tier 3 cities with treatment costs varying between 1x to 5x the average annual per capita income in the city.

In addition, targeted therapies for cancer are currently not available for reimbursement across most cities in China and are only recently being
considered for partial reimbursement by provincial and city governments such as Guangzhou and Qingdao in conjunction with risk-sharing agreements with pharmaceutical companies. This might be one area that offers opportunities for private health insurance to fill gaps for basic as well as specialty insurance.

There Are No Orphans Here

Rare diseases are currently not reimbursed by the Chinese social insurance scheme other than in pilot programs such as Beijing Municipality's pilot reimbursement for children with congenital heart diseases and leukemia, which commenced in May 2011, and the Ministry of Health's similar reimbursement for children in rural areas that began in June 2010. Manufacturers such as Genzyme (now Sanofi) and Actelion Pharmaceuticals Ltd. have proactively collaborated with charity organizations such as the China Charity Federation with disease and product-specific programs.

While awareness is rising with initiatives like Shanghai Medical Association's opening of a rare disease department in February 2011, based on our analysis of other healthcare systems, rare disease are unlikely to obtain reimbursement status even by 2020.

Healthcare Expenditure Per Capita In Year Of Rare Disease Reimbursement Decision*

Note: * Per capita healthcare data is from 2008, for counties where government does not reimburse for rare disease ** In U.S., patients need to pay US$1,000 extra insurance fee to access free orphan drugs

SOURCE: WHO, IMF, L.E.K. interviews and analysis

Governmental Policies And Regulations

Acting on central directives to develop private health insurance to supplement public health insurance, local governments have been engaging in various private insurance pilot programs over the years. These initiatives appear to be gathering momentum.

Since the Ninth Five-Year-Plan in 1996, private health insurance has consistently been mentioned by the Chinese government as a much-needed supplement to the social insurance scheme. For example, President Hu
discussed that need in 2007 during the 17th National Congress, and in the Healthcare Reform in 2009, and that message was reinforced by Premier Wen in 2010. Over the years, the Chinese government's message has evolved from encouraging private health insurance to be a supplemental scheme to encouraging employees with the financial means to voluntarily obtain coverage to direct intention to actively develop the market.

Responding to the central government's directives, local governments have launched several pilot initiatives collaborating with private insurance companies. These initiatives include:

- **Management of public insurance**: Since the early 2000s, local governments such as Fujian and Chongqing have partnered with private health insurance companies in managing public insurance schemes, in particular, the New Rural Cooperative Medical Scheme. These win-win partnerships allow local governments to leverage private company funding and expertise in benefit design, enrollment and provider management, while allowing private insurance companies to establish their brand in the insurance marketplace and cross-sell life insurance products to local consumers;
- **Instant claim initiatives**: Local governments initiated collaborations between hospitals and private health insurers, building alliances and laying the groundwork for the local development of the private health insurance market. The most common initiative is direct settlement of patient bills between hospitals and insurers. This initiative was introduced in early 2000 and is being piloted in many locales such as the cities of Wuxi and Tianjin, and the provinces of Henan, Shaanxi and Hunan. The latest development is in Shanxi province where 27 hospitals concluded a cooperative agreement with the 38-member Insurance Association of Shanxi Province in December 2011 to introduce the direct settlement scheme;
- **Private health insurance pilot schemes**: Local governments have also piloted schemes to provide supplemental health insurance over and above the mandated basic coverage. As an example, since 1997, Xiamen has developed a system of supplementary commercial insurance coverage for urban employees, covering expenses above the social insurance cap (RMB 53,000) up to RMB 150,000 per patient per year, with a 10% co-insurance rate. The annual premium for such insurance was roughly RMB 53 in 2007, with about RMB 17 paid by Xiamen's social insurance bureau.

Beyond insurance programs, wider public hospital reforms being carried out support the development of the market in a variety of other ways. The Ministry of Health's 2009 pilot of 112 China-specific clinical treatment guidelines (i.e. clinical pathways), which has been expanded to all administrative regions in China, standardizes treatments and allows the formation of a rich pool of data about patient characteristics and epidemiology.

In addition, reform of provider payment systems like the pilot trial of the diagnosis related groups (DRGs) in Beijing in October 2011 indicates the existence of a comprehensive set of patient data. That data will become even more robust from pilot programs and could improve actuarial efforts of insurance companies if information-sharing efforts between hospitals and payors improves (“China’s Pilot DRG Reimbursement Systems Indicate Substantial Changes To Hospital Prescription Habits” - *PharmAsia News, Jul. 28, 2011 12:00 PM GMT*).
Insurance Companies' Efforts

Insurance companies have been keen to tap into this growing market. All of the top 10 life insurers and seven out of 10 of the top property insurers in China currently offer private health insurance, with **China Life** and **Ping An Insurance** leading the market ("China Signals Need For Private Investment To Support Its Healthcare Reforms; Private Insurance Options Likely To Widen" -  *PharmAsia News*, Dec. 16, 2010 2:00 PM GMT).

Many companies are making significant efforts to enhance their private health insurance services across the nation. For example, since 2004, China Life has expanded its instant claim initiative from one pilot in Deyang, Sichuan Province to more than 400 hospitals in 2009, with the eventual target of full coverage in its entire network. Other insurance companies like Ping An Insurance, **Aviva-Cofco**, **People's Insurance Company of China** and **Taikang Life Insurance** have also launched similar programs.

Importantly, more foreign companies are entering China, bringing much-needed expertise and knowledge. Currently, 28 foreign companies operate in the domestic life insurance market with more looking to tap into this market opportunity. In addition, **Prudential Financial Inc.** and **Fosun Group Ltd.** formed a 50-50 life insurance joint venture in 2011, marking the first deal in China for a non-state owned life insurance company.

Also, **Insurance Australia Group** and **Allianz SE** bought stake in **Bohai Property Insurance** and **China Pacific Insurance**. Other companies like **WellPoint Inc.** and are actively looking for joint-venture partners to expand beyond their current consultancies and third-party administrative services and international customer base. Speaking on WellPoint's future, China CEO John Domeika said that private health insurance in China is "without question, a significant market opportunity" and that WellPoint is "looking at opportunities to become an industry leader in China over a long time horizon."

Potential Opportunities And Challenges

L.E.K. anticipates the private health insurance market may grow 10-26% per annum over the next 10 years and could reach close to RMB 700 billion by 2020, with developments likely to present themselves in the following ways:

- Considering the importance of private health insurance as a supplement to social health insurance, the Chinese government may roll out favorable policies such as tax incentives for companies or individuals purchasing health insurance, which will provide more concrete support to this sector;
- Consumers are expected to gain better awareness of health insurance and realize the benefit of using it to decrease medical expense payments, hence driving the growth of commercial health insurance;
- The rise of per capita income will increase affordability for purchasing additional insurance to supplement existing basic medical insurance;
More business models can be expected in the future, and will likely create new business opportunities for private health insurance.

Nevertheless, foreign insurance companies, healthcare industry market participants and private investors need to be aware of several possible and real challenges:

- The limited amount of patient data makes it difficult for insurers to use more robust statistical techniques and create new products, both increasing risk and resulting in price competition around similar products; and
- Given the current incentive structure within the healthcare system, which encourages over-prescription, there is little control on the cost of treatment, rendering it costly for private insurers to provide insurance.

**Murky Road Ahead For Private Health Insurance Companies**

With the multitude of uncertain factors, the road ahead for companies in China's private health insurance market is neither apparent nor clear. Will the authorities introduce new initiatives to spur market development? If so, what are likely initiatives and how should industry market participants and financial investors position themselves to leverage such initiatives? If not, would healthcare system reform pave the way for development of the industry without further intervention by the Chinese government?

To best position themselves to benefit from the potential rise of this market, companies will need to understand the dynamics underpinning each of these questions to exploit this market opportunity amidst uncertain and gloomy global economic conditions. In our view, distinct market participants ought to have different strategies:

- Insurance companies can target distinct segments of the market with varied product mix and features, such as offerings to the broad population with basic supplementary coverage and to the affluent population with specialized offerings and extensive coverage. In addition, insurance companies should design programs that are preventative in nature that do not automatically attract only those who need it, such as people with serious health conditions.
- Foreign insurance companies can partner with local insurance companies to leverage their local expertise and experience in product development and risk management to accelerate market efforts in China;
- Domestic and foreign insurance companies can collaborate with local provincial or city governments to provide skill and data in insurance program management such as actuarial work and claims administration;
- Pharmaceutical and medical device companies can partner with insurance companies to educate consumers and increase awareness as well as provide cost-effective treatment options; and
- Healthcare services companies can provide health information systems-related expertise to hospitals or insurers facilitating data and payment transfers.

There is no doubt that a private insurance market has its place in China's insurance system. Whether the market will rapidly take off or plod along its current development trajectory remains to be seen. But companies that will
benefit most from the evolution of the market landscape will be those who take steps to position themselves to influence and act upon opportunities from government actions and the constantly changing China market.

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