October, 2005

Ms Mary Harney TD
Tánaiste and Minister for Health and Children
Department of Health and Children
Hawkins House
Hawkins Street
Dublin 2

Dear Tánaiste,

Introduction

I refer to my letter of 12 September, 2005 (copy enclosed) setting forth the proposed recommendation of The Health Insurance Authority ("the Authority") in relation to risk equalisation, in accordance with the provisions of the Health Insurance Acts 1994 – 2003 ("the Act") and the Risk Equalisation Scheme, 2003 as amended ("the Scheme"). I am writing to you to convey the decision of the Members of the Authority and the Members have expressly adopted the terms of this letter.

This letter, together with the letter dated 12 September, 2005 from the Authority to relevant registered undertakings setting forth the proposed recommendation and the enclosed Staff Report of October 2005, subject only to the deletion referred to in this paragraph, which includes the representations by registered undertakings, constitute the Report of the Authority to the Minister. The only part of the Staff Report that has been withheld, is a short part that details the identities and proposed strategies of potential new entrants. This is in accordance with the Authority's policy in relation to potential new entrants.

Proposed Recommendation and Representations

You will recall that the Scheme stipulates that the Authority shall evaluate returns made to it under the Scheme and determine the Market Equalisation Percentage ("the MEP") for the particular period under consideration. Further, it is provided for in the legislation that where, as a result of its evaluation and analysis, the Authority determines the nature and distribution of risks among registered undertakings, as expressed in the Scheme by the MEP, to be not less than 2% and not more than 10%, the Authority is required by the Scheme to make a recommendation to you. Using a Health Status Weight ("HSW") equal to 0, the MEP was determined to be equal to 4.2%. By letter of 12 September, 2005 to registered undertakings, the Authority advised the undertakings, that it had analysed carefully the most recent statutory returns made to it under the Scheme and that, on foot of those returns and the analysis thereof, the Authority proposed to recommend, for the reasons stated therein, to the Minister the commencement of risk equalisation payments.

Pursuant to the statutory consultation process set forth in the Act, a number of registered undertakings duly submitted representations to the Authority in relation to the proposed recommendation. These were analysed in considerable detail, as is evidenced in the enclosed Staff Report, which was compiled for the benefit of the Members of the Authority. Elements of that material are strictly confidential and commercially sensitive to one or more particular registered undertakings and others. The Staff Report includes the full text of the representations of the registered undertakings, but interlineated within those, in blue font, are comments by the Staff of the Authority upon those representations. This material was considered carefully by the Members of the Authority in making their recommendation. The Members of the Authority endorsed the analysis and evaluation contained in the Staff Report as to the representations made by registered undertakings. The comments made in the Staff Report (including any provisionally attributed to the Authority) on these representations, accurately reflect the views of the Members of the Authority.

<u>Recommendation</u>

Article 10 of the Scheme, made pursuant to Section 12 of the Health Insurance Act, 1994, provides that:

"…the Authority shall inform the Minister whether he/she ought or ought not, as it considers appropriate having had regard to the best overall interests of health insurance consumers, to exercise his/her powers under Article 13 [*to commence risk equalisation payments*]. The Authority's report shall contain the reasons for the recommendation provided."

The issue of whether the Authority ought to recommend the commencement of risk equalisation payments is a complex one and has required very careful consideration and analysis by the Authority. It is not a uniquely mathematical exercise but rather requires the bringing to bear of the judgment of the Members of the Authority.

The Members of the Authority have carefully weighed up the arguments for and against commencement of risk equalisation payments including those discussed and analysed in the Staff Report and have been driven by what they consider to be in the best overall interests of health insurance consumers. The underlying analysis set out in the Staff Report commended itself to the Members of the Authority in the application of their judgement. Having regard to those matters and for the reasons set out in this letter, following careful consideration, the Authority has decided to recommend the commencement of risk equalisation payments.

The Authority has decided to recommend to you the commencement of risk equalisation payments for the following reasons:

- The Authority is in agreement with many other independent experts, that risk equalisation payments are normally appropriate in a community rated market with open enrolment and lifetime cover. These independent experts include the following:

- The former members of the Advisory Group on the Risk Equalisation Scheme[1]
- The Competition Authority[2]
- Mercer Human Resource Consulting[3]
- The Society of Actuaries in Ireland[4]
- York Health Economics Consortium[5]

The absence of risk equalisation payments in a community rated market gives a regulatory advantage to insurers with lower risk profiles, such as BUPA Ireland. For the purposes of the Scheme and with a HSW of zero, the lower risk profile of BUPA Ireland arises from the different age and gender profiles of the insured populations of each of the insurers and the higher claims costs of older people, as reflected in the calculated values of the MEP and the Market Phased Equalisation Adjustments ("MPEA")[6]. Risk equalisation aims to reduce this regulatory advantage considerably. It does not appear to the Authority that risk equalisation payments would constitute unfair payments to any one player.

It may be argued that in the particular circumstances of the Irish private health insurance market it may be in the best overall interests of health insurance consumers to afford some form of advantage to new entrants in order to assist them in competing with Vhi Healthcare and to encourage the development of a multi-player market (and it was in this context that previous reports of the Authority referred to the possibility that the commencement of risk equalisation payments could reduce competitive pressures in the market). However, the Authority must have regard to whether this regulatory advantage, currently held by BUPA Ireland, is harmful to the best overall interests of health insurance consumers by, for example, reducing the competitive pressure on BUPA Ireland or impacting negatively on the maintenance of community rating across the market. It is important to note that any super-normal profits or inefficiencies that are facilitated by the absence of risk equalisation payments are ultimately funded by health insurance consumers. Furthermore, the Authority considers that the only way in which a truly level playing field could be achieved, the benefits of competition maximised and the threat to community rating minimised in a market with open enrolment, lifetime cover and community rating, where significant risk profile differences exist between insurers, involves the commencement of risk equalisation payments.

The extent to which differences in risk profiles in the Irish market restrain Vhi Healthcare in competing with BUPA Ireland, for example, is clear when it is considered that, in the returns for the period January to June 2005, cell equalised benefits per person for those over the age of 70 for the market as a whole are more

[1] Source: Submission to The Health Insurance Authority, 2 May 2002

[2] Source: Submission to The Health Insurance Authority, 8 April 2002

[3] Source: Advice to the Tánaiste and Minister for Health and Children, 27 June 2005

[4] Source: Report of the Risk Equalisation Working Party, May 2002

[5] Source: Assessment of Risk Equalisation and Competition in the Irish Health Insurance Market, November 2003

[6] The MPEA represents the amount of the transfer that would have been paid in respect of the 6 month period if risk equalisation were in force and no phasing applied to the payments.

than 5 times the cell equalised benefits for those under the age of 70 and that, in the same returns, Vhi Healthcare have 12.5 times the proportion of policyholders in this age group that BUPA Ireland have, i.e. while Vhi Healthcare have almost 4 times the number of policyholders that BUPA Ireland have in the returns, they have almost 50 times the number of policyholders aged over 70. It is the view of the Authority that this significant competitive advantage afforded to BUPA Ireland and arising from the lack of risk equalisation payments has facilitated it in making an operating surplus of circa 17.3% of earned premium in 2004. This compares to BUPA Insurance Limited's profits of circa 5% of earned premium in the UK in 2002 and 2003. These profits are ultimately being funded by health insurance consumers.

The regulatory advantage afforded to insurers with significantly lower risk profiles could also facilitate inefficient insurers in competing with insurers with higher risk profiles. Such inefficiency being facilitated by the regulatory structure through reduced competitive pressures would be of as much concern to the Authority as super-normal profits being facilitated in this way, because either would ultimately be funded by health insurance consumers.

As noted earlier, the regulatory advantage currently being afforded to insurers with a lower risk profile (such as BUPA Ireland) may benefit the best overall interests of health insurance consumers by, for example, increasing the competitive pressure on Vhi Healthcare. The Authority has considered carefully the impact (including both costs and benefits) of this regulatory advantage on the best overall interests of health insurance consumers.

- The MPEA changed little since the previous report (it has reduced from €16.7m to €16.5m). These figures are in respect of the transfers that would have arisen in respect of the two six-month periods July to December, 2004 and January to June, 2005 respectively, if risk equalisation payments had been commenced and there was no phasing of transfers. The MEP has reduced from 4.7% to 4.2% with the HSW = 0. In its April, 2005 report to the Tánaiste the Authority stated that it considered that 0.7 percentage points of the MEP (which was 4.7% for the period July to December, 2004) could be attributed to the increase in costs for BUPA Ireland's policyholders aged 80 or over and that this increase may have been significantly affected by random variation. Therefore, the MEP for the period January to June 2005 is in line with the Authority's view of an underlying trend of increase in the MEP. Indeed, if the effect of variation in the claims per member within age and gender cells is smoothed[7] in order to remove any random effects in this variation then "the smoothed MEP" for the four periods to date would have been 3.7%, 4.0%, 4.2% and 4.4% with the HSW=0. The Authority is also of the view that the factors in the April 2005 Report, already circulated, on which it based its view of the trend of increase in the MEP, still apply.

  While there may be some seasonality and random variation in the data being included in returns received under the Scheme, the Authority is satisfied that the underlying trend in the MEP and in the MPEA is upward and is likely to so continue.

[7] The effect of variation in claims per member was smoothed by replacing the claims per member within each age and gender cell in each return for each undertaking with the average claim per member for each age and gender cell for each undertaking over the four periods.

Furthermore, the Authority considers that the basis for this view would not be materially affected by any seasonality or random variation in the data.

In the context of any possible seasonal variation affecting returns, it is appropriate to consider the change in the MPEA over the two 12-month periods ending June 2004 and June 2005. Between these two periods the total MPEA increased from €23.4m to €33.2m. It should be noted that, as well as the factors affecting the MEP, the MPEA is also affected by overall inflation in claims costs and the total amount of claims subject to risk equalisation, which is affected by overall growth in the market.

The Authority noted the alteration in the MEP as well as the small change in MPEA, which are both fully consistent with the Authority's expectations at the time of its previous report.

The Authority, including in response to representations, gave detailed consideration to the extent to which changes in the Open Enrolment Regulations, effected in July of this year, may affect the MEP and the MPEA. An analysis of this matter is included in the Staff Report. The Authority is of the view that any effect of the change in Regulations is likely to be small and that the trend in the MEP and MPEA is likely to continue to be upward in the absence of risk equalisation payments. The Authority further notes BUPA Ireland's recent marketing campaign and promotion directed at older people and considers that this may also affect the number of older people insured by BUPA Ireland. However, the Authority also notes that in the absence of risk equalisation payments or the prospect of such payments the greater financial incentive is for insurers to market to younger people. It is also relevant to note that if risk profiles converge then any risk equalisation transfers would reflect this.

- As detailed in its Policy Paper (see, in particular, Section 3), the Authority is cognisant of the risk of instability arising in a community rated market, which would threaten the maintenance of community rating across the market, and that in certain circumstances the commencement of risk equalisation payments might be appropriate including in order to address this risk.

  In light of the Authority's view that the risk of instability arising in a community rated market is greater in the absence of risk equalisation payments, as part of its deliberations the Authority considered analyses of certain trends in the market, including trends in the values of the MEP and MPEA, the levels of lapses and sales for different insurers, the growth in the numbers of policyholders of different insurers, the total growth of the market, the risk profiles of insurers as well as other matters detailed in its Policy Paper (see, in particular, Section 3). In doing so it aimed, among other things, to consider afresh whether the risk of market instability arising, is such that it should be addressed at this stage by the immediate commencement of risk equalisation payments.

  Whether the risk of market instability arising in the Irish community rated market would warrant the immediate commencement of risk equalisation payments was also considered in the context of the financial positions of the insurers. In particular, in assessing whether such a threat to individual insurers exists, which could lead to instability in the private health insurance market as a whole, levels of profitability were considered relevant. In this context the Authority considered both publicly available information (Annual Reports for Vhi Healthcare, returns to the UK Financial Services Authority by BUPA Insurance Limited) and other financial information provided to the Authority on a confidential basis by Scheme undertakings.

In light of the Authority's view of the underlying trend in the MEP and MPEA and matters referred to above, the Authority is of the opinion, based on the data available to it, that the risk of market instability arising in the community rated market in the absence of risk equalisation payments is undiminished since the Authority made its recommendation to the Tánaiste in April, 2005. The Authority further considers that a risk of market instability, in itself, is counter to the best overall interests of health insurance consumers and that the stability of the community rated market and the best overall interests of health insurance consumers would be best protected by acting to address it.

- The Authority notes that premium increases in the market since 1997 have averaged circa 9% p.a. In this context and in the context of the ratios between claims incurred and premiums earned, the Authority is concerned about the level of competitive pressure on insurers with policyholders with favourable risk profiles.

  The Authority sees merit in arguments that the commencement of risk equalisation payments could potentially benefit competition in the market in some ways, for example, by increasing competition for older policyholders and increasing the competitive pressure on insurers with favourable risk profiles amongst their policyholders.

  It would appear from the growth in the number of people with private health insurance in Ireland and from other data provided by insurers that, while Vhi Healthcare's sales appear to have increased, combined sales for BUPA Ireland and VIVAS Health appear to continue to comprise a significant proportion of the total sales in the market. The Authority also notes your comments in relation to plans to commence work on addressing certain perceived advantages accruing to Vhi Healthcare by virtue of its commercial status although the Authority, in deciding on its recommendation, has confined itself exclusively to the factors with which it is charged under the applicable legislation.

- In the points above, the Authority has discussed the direct benefits that could flow from the commencement of risk equalisation payments, and the impact of risk equalisation payments on the maintenance of a community rated market and on the facilitation of competition. The Authority recognises that these matters are interlinked. The Authority sees merit in the argument that circumstances in which a threat to the stability of a community rated market without risk equalisation might be avoided for a time are circumstances where price following exists. However, price following could lead to excessive inflation of health insurance premiums to the benefit of one or more insurers and to the detriment of consumers. In this context, the Authority notes the similar premium increases for Vhi Healthcare and BUPA Ireland since BUPA Ireland entered the market. Of course, the higher premium inflation that would result from an uncompetitive market, in which price following exists (and which would be facilitated by the regulatory regime in the absence of risk equalisation) might also increase the possibility of a threat to the stability of the market. This threat might arise from any increasing difficulties that consumers might have in being able to afford higher health insurance premiums in future. For example, a threat may arise if younger people either choose not to purchase health insurance or allow their policies to lapse to a greater extent than older persons.

Having regard to the best overall interests of consumers (as that term is defined in applicable legislation), the Authority remains of the view that the benefits to health insurance consumers, which would accrue from the commencement of risk equalisation payments, would outweigh any countervailing factors including any possible reduction in competitive pressure on Vhi Healthcare.

It may also be noted that the commencement of risk equalisation payments would have the consequential effect of removing any uncertainty concerning when and if risk equalisation payments may commence, which might currently affect the market.

The Authority's recommendation is made in the context of the evidence available to it.

Accordingly, I hereby convey that it is the recommendation of the Authority that you exercise your powers to commence risk equalisation payments in accordance with the statutory time frame appended to the Staff Report.

Circulation of Report

In accordance with the provisions of the Scheme, the Report of the Authority must be filed with the Minister for 14 days before it may be made available to relevant registered undertakings. The Authority proposes to make the Report available to these undertakings following the expiry of the 14 day deadline, but having deleted from such communications to these undertakings, confidential or commercially sensitive information, as appropriate. In other words, it would be a redacted version of this Report but made available otherwise on as full a basis as possible.

The Authority repeats its offer of consultations in relation to its report should you or your officials consider it helpful.

Yours sincerely,

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Dermot Ryan
Chief Executive/Registrar

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