

September, 2005

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Dear #####

I am writing to you regarding the Authority's proposed recommendation to the Tánaiste and Minister for Health and Children following its evaluation and analysis of returns received for the period January to June, 2005.

The Role of the Authority

As you are aware, the role of The Health Insurance Authority ("the Authority") in relation to risk equalisation is set out in the Health Insurance Act, 1994, as amended ("the Act") and in the Risk Equalisation Scheme, 2003, as amended ("the Scheme"). The Scheme stipulates that the Authority evaluate returns made to it under the Scheme and determine the Market Equalisation Percentage ("the MEP") for the particular period under consideration.

Where, as a result of its evaluation and analysis, the Authority determines the nature and distribution of risks among scheme 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 the Minister. Article 10(4) of the Scheme provides that in any such recommendation: -

"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 [to commence risk equalisation payments]. The Authority's report shall contain the reasons for the recommendation provided".

The Act goes on to provide some guidance as to the best overall interests of health insurance consumers. It states that *"the best overall interests of health insurance consumers includes a reference to the need to maintain the application of community rating across the market for health insurance and to facilitate competition between undertakings"*.

The Evaluation and Analysis of Returns

In accordance with the terms of the Scheme, the Authority received returns at the end of January, 2004, at the end of July, 2004 and at the end of January, 2005 in relation to the three six-month periods 1 July – 31 December, 2003, 1 January – 30 June, 2004 and 1 July – 31 December, 2004 respectively. The Authority also sought and received

additional information (including, for example, financial information) in relation to scheme undertakings.

At the end of July, 2005 the Authority received further returns from BUPA Insurance Limited, The Voluntary Health Insurance Board and ESB Staff Medical Provident Fund. These returns relate to the period 1 January, 2005 to 30 June, 2005. VIVAS Health is not required to make a return until January, 2006. The Authority again sought and received additional information in relation to the scheme undertakings.

On 10 August, 2005 a data adjustment was received from one insurer. This data adjustment is allowed for in the Authority's evaluation and analysis and in the information provided in this notice.

The Authority evaluated and analysed each of the returns received for the period January to June, 2005, allowing for the data adjustment received on 10 August and all of these collectively, for the purpose of ascertaining the differences, if any, in the nature and distribution of insured risks among scheme undertakings. A Health Status Weight ("HSW") equal to zero was adopted for the purposes of the evaluation and analysis. From the evaluation and analysis the Authority has, for the period 1 January, 2005 to 30 June, 2005, determined the following (allowing for the data adjustment received in August):

The Total Market Insured Persons ("MIP(Total)")¹ is equal to 1,925,234
The Total Market Equalised Benefits ("MEB(Total)")² is equal to €387,901,259
The Market Positive Equalisation Adjustments ("MPEA")³ is equal to €16,453,775
The Market Equalisation Percentage ("MEP")⁴ is equal to 4.2%

For your information, if a HSW equal to 0.5 were used in the calculations, the MEP would be 5.3%.

Proposed recommendation of the Authority

In light of the foregoing evaluation and analysis, and having regard to the best overall interests of health insurance consumers, including the need to maintain community rating across the market for health insurance and to facilitate competition between undertakings, the Authority proposes to include in its Report, which it will shortly furnish to the Tánaiste and Minister for Health and Children, a recommendation that the Tánaiste and Minister for Health and Children ought to exercise her powers under Article 13 of the Scheme (which relate to the commencement of risk equalisation payments).

¹ The MIP(Total) represents the average of the number of persons insured with products that are subject to risk equalisation (excluding those serving initial waiting periods) at 1 January, 2005 and the corresponding number taken at 1 April, 2005.

² The MEB(Total) represents the amount of benefit that is subject to risk equalisation that was paid by undertakings in the 6 month period.

³ 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.

⁴ The MEP is equal to the MPEA divided by the MEB(Total).

Before deciding on its proposed recommendation, the Authority carefully considered the arguments for and against the commencement of risk equalisation payments. These arguments are set out, discussed and analysed in detail in the Authority's report to the Tánaiste and Minister for Health and Children of 29 April, 2005, which was circulated to all scheme undertakings. The Authority has, of course, considered all of these matters afresh. Any material changes in matters that the Authority considered relevant to its proposed recommendation are set out in this notice. Having carefully considered the matter in detail the Authority considers the advantages of commencing risk equalisation payments outweigh the disadvantages.

The Authority proposes to recommend that the Tánaiste and Minister for Health and Children ought to exercise her powers to commence 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 Scheme⁵
 - The Competition Authority⁶
 - Mercer Human Resource Consulting⁷
 - The Society of Actuaries in Ireland⁸
 - York Health Economics Consortium⁹

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 MPEA. 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

⁵ Source: Submission to The Health Insurance Authority, 2 May 2002

⁶ Source: Submission to The Health Insurance Authority, 8 April 2002

⁷ Source: Advice to the Tánaiste and Minister for Health and Children, 27 June 2005

⁸ Source: Report of the Risk Equalisation Working Party, May 2002

⁹ Source: Assessment of Risk Equalisation and Competition in the Irish Health Insurance Market, November, 2003

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 cell equalised benefits per person for those over the age of 70 for the market as a whole are more than 5 times the cell equalised benefits for those under the age of 70 and that Vhi Healthcare have 12.5 times the proportion of members in this age group that BUPA Ireland have. 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 c. 17.3% of earned premium in 2004. This compares to BUPA Insurance Limited's profits of c. 5% of earned premium in the UK. 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 a 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. 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 (of 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 smoothed¹⁰ 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. 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 €23.4 to €33.2m.

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.

- 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 memberships 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

¹⁰ 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.

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 view, 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 c. 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 memberships 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.

It would appear from the growth in membership of the insurers and from other data provided by them that, while Vhi Healthcare's sales appear to have increased, 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 the comments of the Tánaiste and Minister for Health and Children that she intends to commence work on addressing certain perceived advantages accruing to Vhi Healthcare by virtue of its commercial status although the Authority, in rendering a view as to a proposed 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 introduction 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 and in the context of the above, 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 pressures on Vhi Healthcare.

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

It may also be noted that the proposed 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.

Representations

By means of this notice, the Authority invites ##### to make, within 21 days from this date (i.e. on or before 3 October, 2005), representations to the Authority in relation to the nature of the recommendation (or any other matter arising from this letter) that in the opinion of ##### the Authority ought to include in its report to the Tánaiste and Minister for Health and Children.

In accordance with Section 12(5)(c) of the 1994 Act (as amended), the Authority will take account of any such representations made to it within the period specified above before finally deciding what the nature of its recommendation to the Tánaiste and Minister for Health and Children ought to be.

Yours sincerely

Dermot Ryan
Chief Executive/Registrar