An tÚdarás Árachas Sláinte
The Health Insurance Authority

HIA Recommendation for an Appropriate Benchmark for the Overcompensation Assessment

July 2021

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1. Introduction

Given the nature of the RES (not a grant of state money but a symmetrical state scheme that is capable of benefiting any scheme participant in a variable manner), the required overcompensation test in European Union state aid law is relatively complicated.

In the circumstances of a SEGI like the RES, the EU Commission Framework states that a beneficiary should not make a profit greater than a reasonable profit from the benefit that it derives from the RES. The recommended methodology to assess reasonable profit is return on capital. However, financial capital in many businesses (and insurance is a significant case in point) is subject to considerable variation for reasons not directly related to the operational and/or profitability aspects of the business. This problem is greatly amplified when the subject entities are not independent companies. Therefore, in practice return on capital may not be an optimal measure of profitability for the purposes of determining overcompensation and arguably, this is true for the RES. Return on sales is identified in the Framework as one of the acceptable alternatives to return on capital. While there are obvious theoretical weaknesses with using return on sales, the principal advantage is substantially greater predictability of the quantity of sales compared to the quantity of financial capital.

It is the intention of the Department of Health to maintain the metric Return on Sales for the upcoming RES 2022-26, as the appropriate definition of reasonable profit.

In 2016, the RES included a return on sales benchmark of 4.4% for the overcompensation assessment for the duration of the RES (2016-2020, extended to 2021). This was set out in section 7F(4A) of the Health Insurance Acts and was based on a report by Oxera Consulting. The Oxera analysis examined European non-life insurer financial data for the period 2010 to 2014, to estimate a forward looking benchmark.

The Department of Health asked the Health Insurance Authority to update the benchmark for the 2022 RES using more recent data than 2010 to 2014. Oxera has assisted the Authority in updating the revised benchmark and their report accompanies this note. The brief included using the same methodology as had been used in the Oxera 2015 report for the 2016 benchmark.

This report is provided as a recommendation to the Minister for Health, in the fulfilment of the Health Insurance Authority of its statutory functions.

2. Current Benchmark

The current benchmark is based on financial data from European non-life insurance companies for the years 2010 to 2014. Oxera obtained the data from Datastream and analysed it. It is a return on sales benchmark figure that is gross of reinsurance and excluding investment activities (these last two criteria were agreed between Ireland (Dept of Health) and the EU Commission). During the research process, the HIA asked Oxera to provide the ROS estimates for two subsamples of European health insurers based on the impact of excluding investment activities on estimates of the ROS:

- ‘high impact’ subsample, which consists of insurers for which the exclusion of investment activities has a larger impact on the ROS than the median impact for the whole sample;
- ‘low impact’ subsample, which consists of insurers for which the exclusion of investment activities has a smaller impact on ROS than the median impact for the whole sample.

The ROS benchmark was based on data from the low impact subsample. The financial results showed a low level of profitability (return on sales) for the period and indeed negative returns in some years, probably partly due to the global recession and ongoing global financial crisis, which was especially protracted in Europe due to the Euro currency crisis. The Department decided to use the financial data for the low impact subsample for the year 2014 as the benchmark and it was this figure (4.4%) that was enacted in the legislation.

3. Insurer Consultation on Return on Sales Benchmark

The registered insurers were provided with the opportunity to input into the assessment of the approach to the return on sales benchmark for the upcoming RES 2022. All three insurers provided feedback on their views of the benchmark for the 2016-2021 period, and issues for the upcoming RES.

[redacted]

[redacted]

[redacted]

[redacted] considered that a number of factors should be taken into account when setting the return on sales benchmark. These included:

- Typical ROS achieved by other companies operating in Ireland.
- [redacted]
- Appropriate benchmark payments for ROS set in other EU cases to determine reasonable profit thresholds.
- EU legal precedents that supported the argument that account should be taken of various risks (outlined in their submission) of operating in the relatively small Irish health insurance market.

[redacted]"…believes that a much higher ROS level is justified. The ROS overcompensation test should increase and to a minimum of between [redacted] (based on comparable companies operating in Ireland). This range also includes the average ROS profit earned in the Irish PMI market."

[redacted] said that "In addition to the three-year rolling test, there should be a comparison of the return on sales percentage in the most recent year to the average over the previous three years. If the return on sales percentage in the most recent year is significantly greater than the three-year average, immediate action should be taken to address the overcompensation in the most recent year, even if the rolling three year average is below the reasonable profit threshold."

[redacted] argued for transparency for the overcompensation assessment. It also argued for greater flexibility in the assessment, viz; "The overcompensation test (and the Risk Equalisation Scheme more generally) needs to be flexible to respond to significant market events."

[redacted] stated as follows; "…strongly of the view that reasonable profit calculation should be standardised where possible, …believes there is significant merit in determining profitability based on submissions produced as part of solvency II disclosures rather than statutory accounts. It is our view that the both the benchmarking exercise and the overcompensation testing should be calculated using Solvency II submission as the bases."

The Authority has addressed these issues as appropriate in the following sections. In addition, several of the insurers raised comments regarding the treatment of different items in the financial statements made by the net beneficiary. The Authority considers that these are addressed in a fair and balanced manner in the draft Regulations provided for in section 7F(2)(b) and that it would not be feasible to address these points in this recommendation report.

4. Options for Benchmark

In determining the approach to setting the benchmark, the Authority considered three different options:

- Benchmark based on comparators in the Irish health insurance market;
- Benchmark based on comparators in other European markets;
- Hybrid benchmark including both European and Irish comparator companies.

The strengths and weaknesses of these approaches is discussed below.

Benchmark based on the Irish Market Comparators

The Department of Health informed the HIA that during the discussions in 2015 with the EU Commission, the Commission said that the preference in state aid law would be for a benchmark based on comparators from the Irish market. However in 2015, it was considered that the necessary data for the Irish market was not available.

The HIA considers that it is not advisable to use a benchmark based solely on the Irish market for the following reasons;

- There is relatively limited competition in the small (compared to Europe) Irish health insurance market with only three competitors (not considering the small "cash plan" provider, HSF).
- None of the three insurers are independently owned companies.
- VHI Insurance DAC is a wholly owned subsidiary of a state-owned statutory body that has never received a share capital injection and does not pay a dividend.
- VHI Insurance DAC has approximately 50% of the market and is the net beneficiary of the RES and therefore there is a "circularity" problem if they were included in the benchmark. However, if they were not included, the benchmark would only represent 50% of the market. There is also the possibility that at some point in the future that registered undertaking(s) other than VHI Insurance DAC would be net beneficiaries of the RES.
- The profitability of wholly owned insurance subsidiaries of multinationals is subject to considerable variation for reasons that have nothing to do with the underlying profitability of the market they operate in. In particular, the amount of financial capital provided by the parent company can vary considerably and the level of reinsurance and the nature of the reinsurance contract can also substantially impact profitability, especially if the parent company uses another subsidiary or an associated company as the source of the reinsurance.
- The accounts that we receive for Elips Insurance are only branch accounts for the Irish health insurance business and are not the accounts of a legal entity. Elips Insurance also has business outside of Ireland. It is a relatively small wholly owned subsidiary of a very large Insurance/Reinsurance multinational, Swiss Re.
- The great majority of the cost of operating the Laya/Elips health insurance business is incurred by Laya Healthcare Ltd (a wholly owned subsidiary of the large insurance group AIG), a registered insurance broker but not a registered undertaking with the HIA. The HIA is not privy to the detailed contractual arrangements between Elips/Swiss Re and Laya, which could be quite pertinent to assessing the usefulness or otherwise of the calculated return on sales of the Irish health insurance business of Elips.
- Irish Life Health is a relatively small wholly owned subsidiary of a large financial services multinational, the Power Corporation of Canada.

Benchmark including Irish health Insurers

The HIA asked Oxera to compile possible benchmarks that included financial data for the three Irish health insurers. In response to a request from the HIA, Oxera calculated two benchmarks - one where the European non-life insurance sample also included data for all three Irish health insurers and another that only included Elips and Irish Life Health (that is, that excluded the net beneficiary, VHI Insurance). The latter benchmark is the one quoted in the conclusions to the Oxera note.

Oxera are concerned about the "circularity" problem which occurs by including the current beneficiary in the comparator group for the benchmark.

A benchmark including Irish and non-Irish European insurers has the advantage of a larger sample size compared to an Irish only benchmark. There is a likelihood, however, that the benchmark could be skewed by the inclusion of the Irish comparator companies, for the reasons outlined above.

Benchmark Including non-Irish European Insurers

Oxera also considered the options to construct a benchmark using non-Irish European insurers. This required them to identify the appropriate comparators to include in the sample.

5. Benchmark Analysis

Time Period

The Department asked the HIA to recommend an update of the benchmark for the return on sales assessment applicable for the 2022-26 period.

As noted by Oxera, the forward looking estimate of reasonable profit would be estimated from business plans or forecasts of the future profitability of comparators. However, in the absence of forward looking data for the comparators, the analysis needs to be based on historical data, on the basis that recent past trends in profitability provide an appropriate indication of the forward looking benchmark.

As in 2016, the forward looking benchmark for the 2022-26 period is based on historic data. In assessing the appropriate time period for the evaluation of historic return on sales, the Authority weighed two factors. First it considered important that the data used to set the benchmark should be as recent as possible. Second it should be as robust as possible, i.e., the historic data used for the benchmark should reflect market conditions likely to be experienced during the period of the next RES – 2022-26. In balancing these two objectives, the Authority had to determine whether or not to include data from 2020 to set the benchmark. While the most recent data potentially available, there were two down sides. First, the Authority were concerned that 2020 financial data would not be available for comparator companies. In addition, even if there was sufficient data available for 2020, it would be obviously inappropriate to use 2020 data because of the covid-19 pandemic and its unprecedented impacts on the healthcare sector and the general economy. For this reason, the Authority determined that the appropriate time period for examining the comparator data to set the benchmark was 2017-2019. The three year period of 2017 to 2019 was a relatively "normal" period of reasonable economic growth in Europe and is probably at least as suitable as any other immediate period to use for the purposes of identifying an updated benchmark.

As in the original benchmark research in 2015, there are many technical issues with identifying suitable insurance companies for the subject sample where there is sufficient available data. One problem in particular was that Oxera could not use the exact same sample of companies for each of the three years 2017 to 2019; that is, the return on sales figure in each year is derived from a slightly different sample of companies in each year. Oxera's methodology is designed to ensure that despite having a slightly different sample of companies in each year, that the results for each year are a fair reflection of the European insurance sector for each year. (There is a more detailed discussion available in the Oxera report.)

Choice of Comparator Companies for Benchmark

A feature of insurance, including non-life insurance, is the important business role of investment income. Insurance is a cash positive business and typically insurers rely on investment income from the "cash-rich" balance sheet to contribute a substantial proportion of pre-tax profits. The Oxera note illustrates this point. However, below zero interest rates and near zero bond yields have changed this feature significantly for as long the current monetary conditions last, which is likely to be at least two years in Europe and possibly longer. Therefore currently, insurance companies (especially in the Eurozone) are greatly constrained in the investment return they can earn from cash-rich balance sheets.

Another feature of non-life insurance is the substantial variation in the proportion of profits accounted by investment income as between different companies. All three Irish health insurers show a very low proportion of investment income.

The Irish health insurance market is characterised by substantial underwriting profitability, especially gross of reinsurance and this is evident in all three main insurers. This is at variance from much non-life insurance in Europe where it is frequently the case that underwriting profitability is relatively low or loss-making and many insurers are reliant on investment income for much or all of their profits.

Effectively, this is an argument for taking the profitability characteristics of the Irish health insurance market into account in any selection of comparators for the benchmark for assessing return on sales.

Non-life insurance also has a substantial variation in the duration of claims liability, depending on the class of insurance, or length of the "tail" in the industry jargon. Health insurance is almost at the extreme of short tail (claims are paid soon after they are incurred), which is likely to lead to a lower proportion of profits from investment income for two reasons. Firstly, the insurer has a lower average holding of cash in its balance sheet than for longer tail (e.g. many categories of liability insurance where it can take years before the insurer must pay out on an incurred claim). In accounting terms, much of this balance sheet cash would be represented by the item "provision for incurred claims". Secondly, the shorter duration requires the insurer to maintain a large proportion of its "cash" in highly liquid investments, like short dated highly rated bonds. However, in the current monetary circumstances, such investments earn a zero or negative return. This is in stark contrast to the entire period from 1950 to 2011, when such investments earned useful single digit annual percentage returns.

In contrast, to most non-life insurance companies, all the Irish health insurers derive the great majority of their pre tax profits from underwriting profits and not investment income. Given the particular characteristics of the Irish health insurance market, including the substantial level of underwriting profitability, it is recommended that the financial features of the Irish market are taken into account in identifying a suitable benchmark for assessing reasonable profit. However, for the reasons outlined in section 4, it is not recommended that a benchmark should be derived that is based entirely on financial data from the Irish market.

6. Results of Benchmark Analysis

Oxera was able to obtain reliable and appropriate financial data for a reasonable selection of non-life insurance companies that would offer a fair reflection of profitability in European insurance and that would be appropriate for an updated benchmark for the overcompensation assessment.

It should be noted that Oxera's methodology and in particular the "low impact" subsample that comprises the comparator insurer group for estimating the benchmark ROS takes account of key financial features of the Irish market including the low level of investment income.

The Oxera analysis showed a benchmark based on European only comparators ranging from 5.5% to 8.6%, depending on the treatment of book value of equity, for the "low impact" subsample, as most closely reflecting the conditions in the Irish health insurance market.

The similar range for the benchmark including Laya and Irish Life Health among the comparators increases the range of the benchmark to [redacted].

As discussed above, the HIA has concerns about including the Irish insurance companies in the benchmark calculation due to the small size of the market, and the fact that the reporting structures reduce the transparency of the financial results. We consider that too great a regard for the financial features of the Irish health insurance market (including a substantial level of profitability) might result in excessive leeway for all insurers, including the net beneficiary, to charge higher prices for health insurance than would be optimal from either an economic policy or healthcare policy perspective. An important consideration is the relatively limited degree of competition in the market and the fact that in the recent past, the number of competitors has fallen from four to three (ignoring the restricted membership undertakings). The HIA therefore considered a benchmark within the range reported by Oxera for the European only comparators.

Relative to many other non-life insurance markets in Europe, there appears to be a high level of underwriting profitability in the Irish health insurance market in recent years. Given the high level of market concentration, there is a possibility that that profitability could be above economically normal levels. Taking account of the fact that the largest health insurer, VHI, might be a price leader in the market, the return on sales benchmark ought not facilitate excessively high premiums in the market leading to unnecessarily high levels of profitability.

In basing its recommendation for the benchmark, the HIA also took into account consideration of the anticipated effect on insurer behaviour of the introduction of Regulations under section 7F(2)(b). These Regulations might well have a significant effect on the reported profits and the calculated return on sales of the registered undertakings, including VHI Insurance DAC, as regard the financial statements furnished to the HIA pursuant to Section 7F.

For these reasons, the HIA is recommending a benchmark for the Return on Sales of 6% for the 2022-26 period. The uplift over the minimum based on the Oxera report is warranted given the changes in the financial reporting requirements as a result of the over-compensation regulations. It is also warranted because of the significantly higher return on sales when Irish health insurers are included in the European comparator group. The HIA considers that this reflects a commercially acceptable return on sales that would be earned in a competitive market, absent the public service obligation arising out of community rating and risk equalisation.

[redacted]

This is a proposed return on sales benchmark. Depending on how health insurers arrange their finances, a return on sales that was close to 6% (or indeed over 6% in one of the three years of a period subject to an overcompensation assessment) could easily translate into quite a high return on capital and a high level of underlying profitability. And therefore, an even higher proposed return on sales benchmark might lead to an even greater risk that the overcompensation benchmark might lead to an unnecessary high level of profitability in a net beneficiary, which might well be earned at the expense of healthcare consumers. (There is no price control in Irish health insurance and no price or cost controls in Irish private healthcare, other than government fixed charges in public hospitals.)

Another reason for not proposing a higher benchmark than 6% is that the Irish health insurers (and potentially their shareholders) have the considerable benefit of a substantial positive cash flow from Irish health insurance consumers even though Irish health insurers earn a low proportion of their profits from investment activities.