IRELAND'S PRIVATE HEALTH INSURANCE MARKET: THE INTRODUCTION OF RISK EQUALISATION AND THE CONSEQUENCES FOR COMPETITION

CIAN Ó MÓRAIN

Senior Sophister

The controversial Risk Equalisation scheme has sparked much debate of late within the Irish Private Health Insurance Market. Certainly it has significant consequences for competition. In this essay, Cian Ó Mórain discusses the nature of the scheme, outlining its advantages and disadvantages. He concludes that its implementation will be beneficial, subject to the inclusion of a number of essential reforms.

Introduction

The ongoing and controversial introduction of risk equalisation in the Irish private health insurance (PHI) market has been widely publicised in the Irish media. Opinion from within the market and from the media on the matter has been far from harmonious. In addition to this, having initially been commissioned to publish a report together, both the Health Insurance Authority (HIA) and the Competition Authority have recently published separate reports on the PHI market dealing in detail with the issue of risk equalisation. Owing to the unprecedented popular and official attention this issue has received, I intend in this essay to investigate the effects of risk equalisation on competition in the Irish PHI market. Some of the reforms necessary to promote competition in the market in the future will be recommended accordingly.

This essay will first outline a framework to address the effects of risk equalisation on competition. A definition will be given of the concept of risk equalisation and an explanation of why it is used in PHI markets. It will include a summary of the risk equalisation system being used in Ireland, highlighting its strengths and weaknesses, and then address the anti and pro-competitive effects of risk equalisation. Subsequently we reach a verdict on whether or not the scheme will have a positive effect on competition in the market. To conclude, I assess the main issues for competition in the Irish PHI, be they surrounding risk equalisation or otherwise.

Framework

Before addressing risk equalisation it is important to outline a framework for analysing the problem. To properly analyse the issue of risk equalization, it is necessary to address two issues. First, the relevant market within which we will analyse risk equalisation must be defined. Then a set of criteria will be outlined in order to decide whether or not risk equalisation is competitive. A relevant market can be defined as:

> …a set of products and geographic area, such that if all the production capacity in the set were owned by a single firm (a 'hypothetical monopolist'), that firm profitably could raise price by at least some percentage (for example, 5 percent or 10 percent) above the current (not necessarily competitive) level for a 'significant non-transitory' time period. (Salop, 1987:7)

Thus, to define the relevant market for Irish PHI, its 'set of products' and 'geographic area' must first be clarified. In a report recently published by the Competition Authority the PHI market is described as follows:

> For the purpose of this Report, the relevant market is open enrolment PHI policies that offer indemnity for in-patient hospital services with varying levels of hospital accommodation in Ireland. (The Competition Authority, 2007:34)

It is important to note what this definition omits from the market. The most notable products not considered, are restricted entry PHI schemes [1] and related health insurance plans.[2] Perhaps most significantly, the public health system is also omitted from the relevant market.[3]

In order to effectively analyse the effects of risk equalisation on competition in the PHI market, some criteria are required for analysing the problem. In this essay the following shall be considered:

[1] The biggest of these schemes are those for ESB workers, Gardaí and Prison officers. These are omitted from the relevant market as the restrictive nature of their entry means they are not substitutes for PHI.

[2] These are health cash plans, serious illness insurance and income protection insurance plans. These are omitted from the relevant market as they are not comprehensive enough to act as substitutes for PHI (HIA, 2007).

[3] The public health system is not viewed as a substitute to PHI owing to the perceived superior quality of care available from PHI. Accordingly, they are viewed as complements (HIA, 2007).

1. The likely effect it will have on rivalry[4] within the market.

2. Will its introduction act as a barrier to entry for potential entrants?

3. The effect it will have on efficiencies in the market.

Finally, before proceeding, it is important to stress the high market concentration that exists in the Irish PHI market. There are only three players in the market: VHI, BUPA[5] and VIVAS. Their respective market shares are approximately 75%, 22% and 3% (HIA, 2007). Computing the HHI[6] gives us a very large result of 6118. In international terms the Irish PHI market is very highly concentrated (Barrett, 2005)

Risk Equalisation in Ireland

In the *White Paper on Health* (1999), risk equalisation is described as:

> …a process which aims to equitably neutralise differences in health insurers' costs that arise due to variations in risk profiles. This results in cash transfers from insurers with healthier than average risk profiles to those with less favourable risk profiles (White Paper, 1999:40)

In an unregulated PHI market, health insurance companies can charge customers different premiums according to their risk profiles and risk equalisation is not an issue. However Ireland, like many other countries, regulates the PHI market with social goals in mind. In pursuit of inter-generational solidarity, and also equality, the government have entrenched the following concepts into the Irish PHI market:

- Community Rating – "Under a health insurance contract for any specific level of benefit, a health insurer must charge the same premium in respect of all such contracts regardless of the age,

[4] Rivalry being the extent to which there is competition between competitors in the market.
[5] BUPA have recently been taken over by the Quinn Group. For the purpose of this essay I will assume that the trading name BUPA will be retained.
[6] The HHI, or Hirschman-Herfindahl Index, is the method most commonly used to gauge market concentration. It is calculated by summing the squared values of the market shares of each competitor in the market. Merger regulations state that a merger which results in a HHI greater than 1800 are likely to cause competitive concerns (The Competition Authority, 2002)

gender, sexual orientation or current or prospective health status of insured persons." (ibid:33)

- Open Enrolment – "Under a system of open enrolment, all applicants are guaranteed acceptance for cover regardless of their risk profile" (McLeod and Parkin, 2001:vii)
- Lifetime Cover – "Lifetime cover regulations ensure that a health insurer cannot refuse to renew an insured person's health insurance cover…This gives protection for every insured person – so that as they get older, or as their health may deteriorate, or in the event of sustaining serious injury – their health insurance may not be terminated by the health insurer" (White Paper, 1999:54)
- Minimum Benefits – Under minimum benefit regulations "each health insurer must not provide benefits below a prescribed level"[7] (ibid).

As a result, companies in the Irish PHI market may not charge customers different premiums based on their risk profile. This regulation favours those companies that have customers with a lower risk profile and a risk equalisation scheme attempts to correct for this.

Risk equalisation schemes are used in many countries and although the concept behind them is broadly similar, there is considerable variation in the type of scheme used in different countries (McLeod & Parkin, 2001). It is therefore important to outline the scheme being used in Ireland.

The risk equalisation scheme being implemented in Ireland attempts to deduce whether the claims costs experienced by an insurer would have been greater or lower had the risk profile of their customers been equal to an average market risk profile. This is achieved by taking account of the age and gender profile of individual companies and comparing them to that of the market. A third mechanism for deducing risk profiles, that of health status, is not currently used in calculations, although there is a provision in the legislation to introduce such a mechanism if the HIA deemed it necessary (The Competition Authority, 2007). The so-called 'Health Status Weight' (HSW) adjusts for it[8]. The scheme also incorporates a 'Zero Sum Adjustment', which ensures that the scheme is self-financing.[9] Risk equalisation payments in Ireland are calculated in a retrospective manner.

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[7] Usually this is equal to basic public hospital accommodation.

[8] The health status weight measures risk profiles through utilisation of healthcare services. Under Irish legislation, this weight can be between 0 and 0.5. Currently it is at 0. (The Competition Authority, 2007)

[9] Were the zero sum adjustment not used, the amount payable into the risk equalisation scheme would not necessarily equal the amount payable out of the scheme. This is owing to the fact

Could a better scheme be implemented in Ireland? The question of whether or not health status, through the HSW, should be included in calculations is an important one. Without it there is still an incentive to seek out lower risk customers but its introduction would also decrease incentives to achieve lower costs through efficiencies (The Competition Authority, 2007). The issue of retrospective calculation also provides difficulties; risk equalisation payments are only calculated ex-post, so it is difficult for companies to factor these cost/revenues in. There may be scope for the introduction of a prospective scheme that is more predictable for companies.[10]

Anti-Competitive Effects of Risk Equalisation

There is no doubt that risk equalisation represents a barrier to entry in the Irish PHI market. Seven potential new entrants, who have considered entering the Irish PHI market, have listed the introduction of risk equalisation payments as a factor against their entering the market (York Health Economics Consortium, 2003). Indeed Mr. Justice Liam McKechnie, while presiding over BUPA's challenge of risk equalisation, also acknowledged that the scheme did make entry into the market less attractive (The Competition Authority, 2007).

The introduction of risk equalisation is also likely to have a detrimental effect on rivalry in the PHI market. Currently, both BUPA and VIVAS are able to charge lower premiums than VHI for similar products[11] owing to the lower risk profile of their customers (ibid). This factor is forcing VHI, with its far greater market share, to compete on price.[12] However, the introduction of risk equalisation will have the effect of harmonising prices among providers (ibid). As a result the ability of VIVAS and BUPA to price significantly below VHI will be greatly restricted. It will

that the average claim of customers within age and gender profiles differs from one company to another. (The Competition Authority, 2007)

[10] Although the cost of such a system is far greater than that of a retrospective system (White Paper, 1999).

[11] As an example, VHI's most popular plan, plan B, costs €50.29 per month in comparison with BUPA's essential plus, which costs €43.74 (HIA, 2007).

[12] Surveys suggest that it is young (and therefore lower risk) customers who are most price sensitive in the PHI market (HIA, 2005a) and thus it is important for VHI to compete for these customers.

also have the effect of creating substantial market power for VHI[13], reducing the need for it to compete as regards price.

Finally, risk equalisation provides a certain disincentive for companies to seek to lower their claims costs through greater efficiency. The downside of 'Zero Sum Adjustment', which serves to make the scheme self-financing, is that it shares out a certain amount of savings made from such efficiencies. Notably, as mentioned above, this effect would increase health status, through the 'Health Status Weight', introduced.

Pro-Competitive Effects of Risk Equalisation

Although the introduction of risk equalisation will not have any positive effect on competition as regards barriers to entry or rivalry, the reasons for its introduction can be seen in the effect it will have on the efficiency of market operations. The community rated PHI market in operation in Ireland suffers from certain failures which cause the market to work inefficiently. One of these failures is the problem of risk selection, or 'cherry picking', which is the main driver behind the implementation of risk equalisation. The practice of risk selection occurs when insurers target lower risk groups specifically. If an insurer is able to attract customers with lower risk it can charge lower premiums while still earning high profits. In addition, as it is younger and consequently lower risk customers who are more likely to switch due to lower premiums (HIA, 2005a), the insurer can then attract more customers with low risk profiles. Thus, they further increase their profitability while maintaining a low risk profile.

Although community rating and open enrolment ensure that companies must accept customers of any risk profile into their schemes, it is possible to tailor and market them towards people with lower risk profiles (HIA, 2007). The result of this market failure in Ireland is that newer entrants, i.e. BUPA and VIVAS, have managed to attract a customer base with a lower risk profile than that of VHI. As both companies have been successful in doing so, two options have been left open to them. First, they can charge a substantially lower price than VHI and attract large amounts of customers away from it. Secondly, they can choose to follow the price of VHI, charging a price that is lower but that only attracts a small number of

[13] The price convergence of risk equalisation, coupled with factors such as (i) its market share (ii) its solvency requirements (which will be alluded to later in the essay) and (iii) the strength of its brand mean that VHI's hypothetical market power would be turned into substantial market power. (The Competition Authority, 2007)

younger customers away from VHI. It is the second option which both companies have apparently chosen to operate.

Since their entry into the market a decade ago, BUPA have followed the premium increases of VHI, always maintaining their premium circa 10% below that of VHI (The Competition Authority, 2007). This practice has had serious implications for the market. VHI's risk profile has been increasing, pushing up costs and causing it to increase premiums to compensate. At the same time, BUPA and VIVAS, who are not experiencing the same large cost increases, are also increasing premiums, thus earning supernormal profits.

Risk equalisation corrects for this market failure. As the system equalises the risk of all customers, it makes the community rated PHI market more efficient by encouraging companies to compete for customers of all risk category. It also allows companies to concentrate on cost saving through efficiencies, rather than attracting less risky members.

Risk Equalisation: Pro or Anti-Competitive?

It is evident, from the above analysis, why the issue of risk equalisation is such a contentious one. On the one hand there are those arguing against its implementation who point to its anti-competitive effects. Risk equalisation does act as a barrier to entry, creates substantial market power for VHI and will dampen price competition. On the other hand, those in favour of the system point to the risk selection being practiced by BUPA and VIVAS without the scheme.

One might, at first glance, be tempted to claim that risk equalisation is not applicable to the Irish PHI market. It has a number of anti-competitive effects and while community rating and open enrolment are giving BUPA and VIVAS a substantial regulatory advantage, is this not merely forcing VHI, with its large market share, to compete on price? However, when one examines the situation a little closer and discovers how VHI are financing their relative price competition, the extent of the regulatory advantage being afforded to the newcomers becomes apparent. While BUPA must meet the solvency requirement of the UK's Financial Services Authority (FSA) and VIVAS those of the financial regulator, VHI is in fact exempt from solvency requirements. Without this mechanism VHI's current premium prices, which are already above those of their competitors, would be unsustainable and (without running its solvency down to nothing) not profitable. It is, in fact, the anti-competitive effect of risk selection without a risk equalised market that outweighs the anti-competitive effects of its implementation. While

BUPA and VIVAS will be able to adjust to risk equalisation and retain profitability, PHI is not profitable for VHI without risk equalisation.

Pressing Issues for Competition in the Irish PHI Market

The implementation of risk equalisation will be important for competition in the Irish PHI market as long as the government wishes to retain the idea of community rating as the cornerstone of PHI provision. There is however much scope for increasing competitiveness in the market. It is highly concentrated and the VHI does possess some amount of market power (especially after the implementation of risk equalisation). Indeed, there are a number of further reforms without which the benefits of risk equalisation will be undermined. The most important and pressing of these are:

1. VHI's Solvency Requirements

As stated above, VHI are currently not required to meet any solvency requirements. This is a significant regulatory advantage. While risk equalisation would harmonise the premium prices of competitors, the retention of this regulatory advantage would mean that the VHI would be able to artificially hold its prices at low levels for prolonged periods. As a result VHI would be able to match any lower premiums achieved by its competitors through efficiencies and price competition would be completely undermined. It would also act as an immense barrier to entry. Entry into a market with such a dominant player would not be viewed as a healthy prospect.

2. Uncertainty

In a consultation process with potential new entrants, conducted on behalf of the HIA in 2003, one of the main factors against entry stated was the uncertainty surrounding the market (HIA, 2007). Uncertainty surrounding the market is currently one of the largest barriers to entry for the Irish PHI market. This uncertainty stems from a number of areas. First, there is the uncertainty surrounding risk equalisation[14]. Secondly, there has been uncertainty since December 2006 when BUPA announced its intention to depart from the Irish PHI market. Although the Quinn Group are in the process of purchasing it, there is a great deal of uncertainty surrounding how BUPA will compete in the future.

[14] Currently BUPA is appealing the High Court case they lost against risk equalisation. There is also still a great deal of uncertainty as regards the three year derogation from risk equalisation payments afforded to new entrants.

Thirdly, the more or less simultaneous publishing of reports on the market by both the Competition Authority and the HIA has stirred some uncertainty. Both bodies were initially instructed in December 2005 by the Minister for Health to compile a report together on the market (The Competition Authority, 2007) but rather than doing this they both published separate reports. The fact that both the bodies charged with overseeing competition in the market cannot find the consensus to publish a report together[15] will undoubtedly breed uncertainty about the future direction of the market. Which report will be followed when legislators attempt to reform the market? Given the amount of uncertainty it is unsurprising that potential entrants prefer to adopt a 'wait and see' policy rather than entering.

3. Reform of the Minimum Benefits

Under the minimum benefit regulations there is a certain minimum level of benefits that every PHI plan must provide. These regulations ensure that there is a minimum level of quality for every plan available. Minimum benefits unfortunately act as a constraint on competition between providers as regards quality of brand, as they restrict the amount one company can differentiate their product from those of a competitor. Although minimum benefits are not going to be removed from the PHI market, there is scope for reforming them. The minimum benefit regulations have not been reviewed for a long time and some of the benefits specified have become outdated and could be replaced by newer procedures (The Competition Authority, 2007). This would give insurance providers a little more room to differentiate their product further from those of their competitors.

4. Reducing Switching Costs

As a result of risk equalisation there will be more competition for customers with higher risk profiles. Currently in the market, there is a lot of inertia among customers as regards switching insurers (HIA, 2005a). Although open enrolment, community rating and lifetime cover ensure that switching is easy and almost costless, there is a perception that switching is difficult and costly (HIA, 2005a). If customers' risk profiles are equalised but older people are highly unlikely to switch insurer (even with substantial cost savings), VHI's market power would be greatly increased having a negative impact on competition. They

[15] Although the basics of the reports are, to a great extent, identical they do contain a couple of major differences. For example, while the Competition Authority are in favour of both bundling/tying arrangements and buyer power in the market, the HIA are not.

would have an effective monopoly over a sizeable segment of PHI consumers. Thus, it is of utmost importance that the HIA address this issue.

Conclusion

The risk equalisation scheme which is in the process of being implemented in the Irish PHI market has both anti-competitive and competitive aspects to it. As a result there are compelling arguments for and against its implementation. On balance however, the benefits of correcting the instability in the market owing to risk selection outweighs the negative effects that risk equalisation will have on the market. In accordance with the fact that the implementation of risk equalisation is vital for the market, there are a number of other reforms that are vital for promoting competition in the market. Without these further reforms the benefits of risk equalisation are likely to be undermined.

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