Competition in the Private Health Insurance Market

Response to Public Consultation

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Introduction

Goodbody Economic Consultants provides economic consultancy services to clients in the public and private sectors. Since its inception in 1993, the company has undertaken studies for most Government departments. It also has a strong presence in the semi-state sector and has undertaken work for major private sector corporations.

As a result of this work Goodbody Economic Consultants has significant knowledge of the operation of competition in Irish markets, in particular those markets subject to a degree of regulation, including the health insurance market. Based on this, Goodbody Economic Consultants would like to offer certain observations on competition in the private health insurance market.

Goodbody Economic Consultants operates as an independent unit within Goodbody Stockbrokers, and is a subsidiary of Goodbody Holdings Limited, a member of the AIB Group. The AIB Group is an investor in VIVAS, a private health insurance provider.

Health Insurance is a significant market worth examination

Health Insurance is a significant product in terms of share of total spending by consumers. According to the Department of Health and Children, total spending on health insurance in 2003 was €978m. Effective competition in the market for private health insurance has the potential to realise significant benefits for consumers.

Historically, the provision of private health insurance was the preserve of a State-sanctioned monopoly. The potential gains from opening private health insurance to competition are the same as those realised in, for example, the air travel, telecoms and taxi markets. It is important to remember that prior to liberalisation the incumbents in these industries did not necessarily show signs of excessive profitability. The harm to consumers took the form of "x-inefficiency" i.e. inefficient operation, insufficient supply and a lack of innovation and improvement in products and services. All of these reversed when competition was introduced. The market for private health insurance has shown some of these improvements since competition was introduced, but it is crucial that these benefits are maintained and maximised.

In order to achieve the benefits of competition it is not enough to simply remove the legal barriers to entry. Proper application of competition laws, and, where applicable, industry regulation that promotes and protects competition are necessary to ensure that new entrants can do their job of competing. There is no point in replacing a legal monopoly with a dominant producer abusing its position

Need for a Risk Equalisation scheme

For very good social policy reasons, Irish health insurers are obliged to "community rate" i.e. to charge the same premium to all customers regardless of their age or health status. For obvious reasons, there is a huge difference in the level of claims between young and old customers for private health insurance. In addition, younger customers both have a higher tendency to switch insurer and form most of those buying health insurance for the first time.

The combination of these factors makes it possible for a new entrant to act opportunistically on the Irish private health insurance market. An opportunistic new entrant could enter the market with the intention of cherry picking, setting unsustainably low premiums in the knowledge that their customer base would contain a disproportionate number of young people who would have a very low level of claims. Such a new entrant could operate profitably for a number of years undermining the ability of the incumbent to insure all of its customers as the incumbent's average customer age would rise as younger customers defected to the new entrant. This type of behaviour could destabilise the market and endanger community rating. This means that a Risk Equalisation scheme needs to be available to be triggered, if only to act as a deterrent to this type of behaviour.

However even a bona fide new entrant that intends to accept all types of member and apply community rating will have a disproportionate number of younger members during the early stages of its operation on the Irish market. This can help compensate for start up costs, and for the fact that there are high fixed costs in providing health insurance, with member numbers building up only over time.

It is clearly useful to have the possibility of introducing Risk Equalisation quickly in response to opportunistic behaviour by a new entrant. Such a scheme could serve its purpose by acting as a deterrent to opportunistic new entrants without actually having to be implemented. However, the decision to actually put the scheme into operation needs to be carefully considered given that requiring new entrants to subsidise a incumbent operator with a large market share will clearly harm competition by discouraging new entrants and by weakening the position of relatively small operators compared to a powerful incumbent operator.

State of competition on the market for private health insurance

In 2006, over fifteen years after the introduction of competition into private health insurance, there is only limited competition in the provision of this service.

- Only two firms have entered the market to compete with the incumbent: BUPA and VIVAS. The latter is a very recent entrant and still operates on a small scale. It is a feature of the private health insurance market that it takes a number of years for a bona fide new entrant to establish itself as a viable competitive force on the market. Launch costs and fixed operating costs are relatively high and it inevitably takes a number of years, and considerable expense, to grow a new firm's customer base to a sustainable level. This is recognised in the current Risk Equalisation scheme where, even if payments have been triggered, a new entrant is granted a transitional period before it has to make payments.

- The VHI still has an extremely large market share. This market share is of the size normally associated with dominance. In any other market, an established incumbent with such a large market share would be subject to greater restrictions on its behaviour under competition law than its competitors, and might even be the subject of sector specific regulation from a body like Comreg or the CER. It would be considered very unusual for smaller new entrants to actually pay a subsidy to such a well-established incumbent.

- Unlike all other insurance companies, including its competitors in the provision of private health insurance, VHI does not have to meet solvency requirements. As of February 2005, VHI's reserves are €65m below what they would have to be to meet the standard solvency requirements of IFSRA. This represents profit that the VHI did not have to earn and retain in the business. This creates the same advantage for the VHI relative to its competitors as a capital grant of €65m. Late in 2005, it was announced that this situation will be changed, however the VHI will continue to enjoy an advantage in its reserving requirements for a further six years.

- The VHI enjoys a further, state funded, advantage over its competitors. It does not yet pay dividends to the State. This gives the VHI the same advantage over its competitors as an annual subsidy equivalent to the return on capital that would be required by a commercial owner. This situation may represent an illegal State Aid under EC Treaty rules. The book value of VHI at February 2005 was €280m. This would represent a low estimate of the capital tied up in the VHI. A reasonable return on this would be comparable to the €33m Risk Equalisation payment that is sought from BUPA[1]. In other words, the fact that the government does not require a return on its investment in the VHI represents a subsidy similar in size to the cost disadvantage the VHI suffers as a result of its older customer base.

- Irish population and income per head have been growing at an exceptional rate for a number of years. In addition the proportion of the population holding private health insurance has been increasing. Despite this there has been only one new entrant to the private health insurance market in recent years. This suggests that barriers to entry are high, and that the risk of opportunistic short-term entry is low. Caution should be exercised before activating another barrier to entry such as Risk Equalisation payments.

[1] See announcement of Risk Equalisation implementation on www.dohc.ie

- It should also be noted that the loss of one of the three operators on the private health insurance market could effectively end competition. If there were only two operators consumers would be unlikely to enjoy the full benefits of competition. In a number of plausible scenarios, market price and output could be closer to the levels that would occur under a monopoly than to those under competition. For example, the smaller of the two operators could simply match the price set by the larger firm and share the resulting demand with the large firm. There are good theoretical and common sense reasons why at least three competitors are needed to realise the benefits of competition.

No need to implement Risk Equalisation now

There is a clear need to have a Risk Equalisation scheme "on the books" so that it could be implemented quickly in response to a threat to community rating. However, given the current state of competition on the market for private health insurance, Risk Equalisation should not be implemented. A decision to implement Risk Equalisation payments can only be justified where they will benefit consumers by preserving community rating, which will outweigh the harm they will do to competition.

Competition on the Irish health insurance market is already fragile due to the continued dominance of VHI. In addition, there are two Government mandated concessions to VHI in place that have the same effect on competition as significant subsidies (VHI's derogation from normal reserve requirements and the fact that it is not run on a commercial basis). The only threat identified to community rating is a difference in the age profile of the VHI and its competitors that would give rise to a Risk Equalisation payment of €33m to the VHI. Since the "subsidies" that VHI already receives are equal to or greater than this amount there is no need to implement Risk Equalisation payments.

In fact, Goodbody Economic Consultants believe that the implementation of Risk Equalisation should not be considered until the regulatory advantages already enjoyed by the VHI are removed. Only when the VHI has the same reserve requirements as its competitors and is required to earn a commercial return on its capital, will the higher average age of its customers place it at a disadvantage relative to its competitors. Only then will there be even a potential need to implement Risk Equalisation payments.

Unfortunately the detailed rules of the Risk Equalisation scheme in force[2] mean that the Minister's decision of December 2005 to implement Risk Equalisation payments cannot be reversed without an amendment to the Scheme. Such an amendment would require the approval of the Oireachtas. However, in view of the risk that the implementation of these payments, combined with the advantages already enjoyed by the VHI, may eliminate the benefits of competition from the market, it would be worth making such an amendment to the Risk Equalisation Scheme.

[2] As set out in S.I No. 261 of 2003 "Risk Equalisation Scheme, 2003"

Role of VHI on the market for health care

Although the market for health care is outside the scope of this examination, Goodbody Economic Consultants would like to draw attention to an insurance related issue on the market for health care. VHI will only reimburse its members for care in facilities "approved" by VHI. On at least some occasions this approval may have gone beyond an assessment of the nature and quality of care offered by the facility. There have been reports of the VHI refusing approval to a facility on the grounds that it represents surplus capacity. Although this type of assessment is doubtless made in good faith, the question of whether extra capacity is needed should, be left to the market, rather than to an insurer in a competitive insurance market. This type of assessment by the VHI risks creating an unnecessary barrier to entry in to the provision of private medical care.

Conclusion

Risk Equalisation is an essential reserve power to have on the books to prevent opportunistic behaviour by new entrants into the private health insurance market. However it should not have been implemented given that there is no evidence of opportunistic, destabilising, behaviour by VHI's competitors. In addition, any cost disadvantage suffered by the VHI relative to its competitors due to its older customer base is more than compensated for by the other advantages enjoyed by the VHI. These advantages enjoyed by the VHI – derogation from normal reserve requirements, and no obligation to earn a return on capital - also distort competition on the market in the same way as a direct subsidy to the VHI. Risk Equalisation should not even be considered until these subsidy equivalents are brought to an end. Therefore the Health Insurance Authority and the Competition Authority should recommend that the current Risk Equalisation scheme be amended to allow the implementation of payments to be delayed at least until these advantages for the VHI are brought to an end.

In addition, even where Risk Equalisation payments are necessary it is appropriate to allow new or recent entrants to the market long grace periods before they are required to make payments. The nature of the industry is such that new entrants take a long time to become viable and immediate application of Risk Equalisation payments could be an insuperable barrier to entry. In addition the value of payments foregone by the incumbent should be small given that recent entrants will not be of significant size.