

Private Health Insurance Premium Change Process: A Review

Dr David Charles, Director, Insight Economics

July 2011



Special Note: The objective of the Australian Centre For Health Research Limited (ACHR) is to undertake activities aimed at improving the provision of health and ageing services in Australia. To this end, the ACHR commissions independent research on topics of importance in health and ageing, in order to stimulate further exploration of areas of shared concern. The presentation of factual matters, and the ideas and conclusions expressed in the independent research reflect the views of the author of that research, and do not necessarily represent all of the views of ACHR or its individual officers.

Insight Economics Pty Ltd

ACN:141 097 565

ABN: 29 627 712 906

Level 1, 530 Lt Collins Street
Melbourne VIC 3000
Australia

Disclaimer:

While Insight Economics endeavours to provide reliable analysis and believes the material it presents is accurate, it will not be liable for any claim by any party acting on such information.

© Insight Economics 2011

CONTENTS

<i>Executive Summary</i>	3
Chapter 1 <i>The project</i>	5
Chapter 2 <i>The context</i>	6
Chapter 3 <i>The premiums increase process</i>	8
Chapter 4 <i>Characteristics of a good public administration process</i>	10
Chapter 5 <i>Criticisms of the current process</i>	12
Chapter 6 <i>The way ahead</i>	15
<i>Acknowledgements</i>	18

Executive Summary

The purpose of this report is to examine the current process for approving increases in private health insurance premiums. The high degree of government involvement in and control of the process has been a feature of the broader set of private health insurance policies for a number of years.

The most notable part of the private health insurance arrangements is the base 30 per cent rebate for people taking out such insurance. This involves a cost to the budget of well over \$3 billion per annum. Other elements include the Lifetime Health Costs arrangements and the risk equalization provisions. The presence of these policies has seen the penetration of private health insurance rise for hospital tables to about 45 per cent of the community. For ancillary (general purpose treatment), the coverage is approximately 50 per cent of the population.

A number of years ago provision was made for increases in private health insurance premiums to take place in a block once a year effective from on or after 1 April, the later date applying for premiums already paid beyond the effective date. In the latter part of the prior year and the early part of the year in question a process applies in which all private health insurance entities are required to submit their proposed increases to the Minister/Department of Health and Ageing. Since the introduction of the *Private Health Insurance Act 2007* the Minister has had the power to reject applications for premium increases – previously the Minister had the power to approve premium increases.

While proposals are submitted to the Minister/Department, the proposals are sent to the Private Health Insurance Administration Council (PHIAC) for advice on whether the premium increases are the minimum necessary for the continued operations of the private health insurers. In the case of the five biggest private health insurers and some smaller insurers, advice is also sought from the Government Actuary.

Once PHIAC's advice is received by the Minister/Department a further approach is made to some of the private health insurers asking them to either give further reasons why the proposed premium increases should go ahead or to provide revised premium increases. This process can go on for a number of rounds until agreement is reached.

When examining public administration processes it is common practice to see how they perform in terms of the key characteristics that should be present with well designed arrangements. Such characteristics include:

- Appropriateness
- Transparency
- Predictability
- Confidence

- Simplicity
- Low compliance costs

The discussions conducted as part of this project with key stakeholders shows that some progress has been made recently in improving the transparency of the process from the point of view of the private health insurance entities. The most notable change has been to make the advice provided by PHIAC on individual proposals available to the entities concerned. However, concerns remain about the transparency of the process.

Many stakeholders were of the view that the compliance costs of the process were out of proportion to any benefits that might be obtained. These concerns tended to focus on the process being too long, calling for excessive amounts of information and generally producing outcomes little different than would have occurred without them.

A relevant consideration to the process and its ongoing appropriateness is whether market failures exist in the private health insurance market that would justify the kind of heavy handed intervention that is now being applied. The salient facts are that there are 35 private health insurance entities competing in the market and that five of them hold significant market shares. One of these five is Medibank Private which is 100 per cent government owned. On the face of it, in the national market at least there is a reasonable degree of competition. This is also the view reached by PHIAC the prudential regulator of the industry. The ACCC in the case of the 2007 proposal by BUPA to merge with MBF decided that competition considerations at the national level and at the level of the South Australian market didn't stand in the way of allowing the merger to take place. In reaching these conclusions the ACCC noted that the industry was subject to real competition both internally and externally from Medibank.

Having regards to the balance of benefits and costs, a case can be made that there should be a shift to a lighter handed approach to the fixing of premium increases by the private health insurance entities.

Three options are identified for doing this. These are:

1. deregulating the process;
2. maintaining for a period a monitoring role for PHIAC; or
3. keeping the process but with a number of changes to significantly reduce compliance costs and to give the key role to PHIAC but with a reserve power to intervene being held by the Minister/Department.

Having regard to the reality that as long as the 30 per cent rebate for private health insurance remains in place there will be a corresponding desire for the government to retain a certain degree of involvement in premium setting, the choice is between Options 2 and 3.

On balance, Option 2 is preferred. It will substantially eliminate compliance costs but will for a defined period give the government a window into the setting of private health insurance premiums.

CHAPTER 1

The project

The ACHR commissioned Insight Economics to conduct a review of the process used by the Commonwealth Government to approve increases in premiums for private health insurance to determine whether a justification for the process remains and, if so, whether there is a case for making reforms to it. Private health insurers wanting to increase their premiums are required under the Private Health Insurance Act 2007 to seek regulatory approval. The Minister is empowered to reject premium increase proposals if they are not in the public interest.

The process which has operated for a number of years involves the proposals for increases in private health insurance premiums being considered on an annual basis for all insurers with any increases due to apply from 1 April. The process is led by the Minister for Health and Ageing and the Department of Health and Ageing. The 2011 premiums process has recently been completed and the increases were announced by the Minister on 26 February 2011.

In carrying out the review interviews were held with the organizations listed in the acknowledgements. The report has been written to avoid ascribing views to particular organizations, unless they already exist on the public record. The author wishes to thank the people concerned for making the time available to discuss the issues involved and to share their experiences.

The approach used in the review was to outline a set of characteristics of good public administration process design including the threshold matter of whether a case exists for the continuation of the process and to see how the current process matches up.

CHAPTER 2

The context

The context for the private health insurance premium review process is the reality that the Commonwealth Government provides a special framework for the operation of private health insurance in Australia. The most notable elements of the framework are as follows.

The 30 per cent rebate for people taking out private health insurance which has applied since 1999 and now is estimated to cost over \$3 billion per annum. Since 1 April 2005 the rebate is 35 per cent for people aged between 65 and 69 and 40 per cent for people aged over 70 years.

Lifetime Health Cover which since 1 July 2000 reinforces that private health insurance is not risk rated and insurers cannot refuse to insure any person and must charge the same premium for the same level of service (ie, premiums are community rated). There is a Lifetime Health Cover loading of 2 per cent for each year over 30 when first purchasing hospital cover up to a maximum of 20 per cent. People who are paying the Lifetime Health Cover loading are encouraged to retain their private health insurance by the provision that the loading is removed after 10 years.

A private health insurance risk equalisation pool for people over 55 and for high cost claims administered by the Private Health Insurance Administration Council (PHIAC) which is the prudential regulator for private health insurance entities.

Since the changes made in 1999/2000 to make private health insurance more attractive, the proportion of the population taking out private health insurance has risen strongly to be over 45 per cent. From the mid 1980s to the mid 1990s, the proportion of people with private health insurance had declined to a low of 30.2 per cent.

The private health insurance industry consists of about 35 entities of which the five to six leading entities control over 80 per cent of the market and 21 entities control 93 per cent of the market. The biggest single provider is Medibank Private which is 100 per cent owned by the Commonwealth Government and now operates on a for profit basis. A number of the private health insurance entities are not-for-profits. Generally speaking, profit margins in the industry are relatively modest with consistently low underwriting margins and overall profitability dependant on investment returns.

Total premiums paid in the industry are running at an annual rate of around \$14 billion which is increasing at a rate of about 5 per cent per annum. Benefits paid to members are around 86 per cent of total premiums paid. As elsewhere in the developed world, hospital and medical costs are increasing at a rate beyond that of the CPI. Other factors driving premiums are the ageing population and the introduction of new but higher cost medical, pharmaceutical and prosthetics technologies.

Mergers and acquisitions in the industry are subject to review by the Australian Competition and Consumer Commission. The biggest recent merger was the 2007 merger of BUPA and MBA which was approved by the ACCC on the basis that it did not have the effect of substantially lessening competition in any relevant market in contravention of S 50 of the Trade Practices Act.

CHAPTER 3

The premiums increase process

The *Private Health Insurance Act 2007* provides the right for the Minister to reject premium increases proposed by private health insurance entities. Prior to this the *National Health Act 1953* provided for the Minister to approve not disapprove premium increases.

If after the process is completed, the Minister is still not satisfied with any lower premium increase sought or further evidence provided by the insurer, the insurer's request for a premium increase may be refused. The insurer will be given a draft Statement of Reasons which includes reasons for the inclination not to approve the premium increase and copies of all documents considered by the Minister in making the decision. A refusal by the Minister must be tabled in Parliament along with the reasons for refusal.

The process by which premium increases are considered is run by the Minister for Health and Ageing and the Department of Health and Ageing. The role played by PHIAC is not specifically provided for in the *Private Health Insurance Act 2007*.

The Department lays down both the forms which the private health insurance entities must complete in making their submissions and sets the timetable for the annual rounds.

Submissions are made to the Department with copies being provided to PHIAC for advice to the Department. PHIAC as a matter of course also gets advice from the Commonwealth actuary on the premiums proposed by the biggest 5 providers. The Minister/Department has the capacity to ask the private health insurers that they consider to have proposed too high premiums to provide revised submissions or to give greater reasons why their original proposals should be accepted.

PHIAC approaches its task of examining proposed premium increases in terms of whether they are the minimum necessary to meet the prudential standards appropriate to entities in the industry and ensure their continued viability.

The Minister/Department can also give attention to other matters which are judged to be in the public interest. According to a recent document on the 2011 round, the Minister considers premium increases to not be in the public interest unless they are the minimum necessary to ensure insurer solvency, support benefits outlays, and meet prudential standards concerning capital adequacy, while also ensuring the affordability and value of private health insurance as a product. Each insurer's application is assessed on its own merits.

The timetable for the premium approval process in the 2011 premium round was as follows:

- Insurers provided with the approved form 11 Oct 2010
- Deadline for submission of applications 18 Nov 2010

- Assessment of applications 19 Nov– 22 Dec 2010
- Resubmissions prepared by insurers 15 Dec -10 Jan 2011
- Assessment of resubmissions 11 – 27 Jan 2011
- Further resubmissions by insurers 28 Jan – 8 Feb 2011
- Assessment of further resubmissions 9 – 23 Feb 2011
- Insurers notified of approvals 16 – 25 Feb 2011
- Public announcement of Minister’s decision 25 Feb 2011
- Insurers commence notification of members 25 Feb 2011
- Premium changes take effect on or after 1 April 2011

In the 2011 round, all 35 private health insurers submitted applications for premium increases. The Minister wrote to 17 insurers and requested they consider resubmitting with a lower premium increase or provide further evidence for the increase sought. New applications for lower premium increases were submitted by 8 insurers. The Minister wrote again to 7 insurers and requested that they consider resubmitting with a lower premium increase or to provide further evidence for the increase sought. New applications for lower premium increases were submitted by 5 insurers. Overall, there were 10 individual insurers that resubmitted their applications with lower increases.

The average increase in private health insurance premiums that occurred in the 2011 round was 5.56 per cent. No indication was provided in the Minister’s press release of the extent to which the final outcome was less than would have been the case if the increases proposed in the original submissions had been accepted. In the Minister’s media release for the 2008 round it was estimated that the savings were 0.22 per cent or around \$30 million.

Efforts have been made since the Federal Budget of 2009-10 to increase the transparency of the premium setting process by releasing the average premium increases for individual private health insurers and providing reasons for the premium increases at an industry level. Also of great significance for the insurers was the decision in the 2011 round to allow PHIAC to provide the advice it gave to the Minister/Department about the premium increases sought by individual insurers to the insurers concerned.

CHAPTER 4

Characteristics of a good public administration process

In designing public administration processes, regard is generally given to the presence of a number of characteristics which are held to be desirable for good outcomes and high levels of acceptance by affected parties. These characteristics are considered briefly below.

Appropriateness

The threshold characteristic is that a clear public policy rationale exists for any given public administration process. It may be that, over time, the original rationale that led to the establishment of a particular process no longer retains its strength due to other developments. It is appropriate that from time to time the existential question should be asked. Reflecting the reality of changing circumstances a number of public administration processes have a set life which is specified when they are introduced.

Transparency

An important characteristic of a good public administration process is that there is a high degree of transparency available to the parties affected by the process. This generally means that there are clear process operating guidelines and that decisions are soundly based on supporting documents and analysis. The presence of transparency assists in ensuring that processes are not arbitrary exercises that are unlikely to retain the confidence of the parties that are affected by them.

Predictability

Related to the concept of transparency is the concept of predictability. The presence of this characteristic ensures that the affected parties are able to participate in any given process with a degree of certainty about the:

- ground rules both in terms of process guidelines and timetables which give adequate response times to provide submissions; and
- entities running the public administration process.

Confidence

There must be confidence by affected parties in the professional capability of the entities running the public administration process that they have the necessary resources and understanding of the issues to carry out their functions in a professional manner. There

must also be confidence that due process is being followed and that arbitrary actions are not taken.

Simplicity

While some matters are by their nature complex, in general it is preferable that the design of public administration processes is kept as simple as possible. This assists both the transparency of processes and also keeps compliance costs down by avoiding unnecessary complexity.

Low Compliance Costs

The design of public administration processes needs to have regard to keeping compliance costs as low as possible and usually only a small fraction of the benefits being sought by the process. Only information that is relevant to the central matter at hand should be sought and in ways that can readily be provided by affected parties.

CHAPTER 5

Criticisms of the current process

Appropriateness

In purely economic terms, because of the level of competition in the private insurance market in Australia, including the presence of a major competitor owned by the Commonwealth Government and a number of not-for-profits, the insurers tend to the view that the overall outcomes that would occur in the absence of the present approvals process are likely to be little different from what tends to occur through the process of submission and resubmission.

Based on the estimate previously given by the Minister in the 2008 round of a reduction of 0.22 per cent, it looks like the outcome of the process is to produce a relatively small reduction in premiums from those proposed in the original submissions. A “saving” in the range of \$30-40 million is small compared to the overall level of premiums paid, the increase in premiums paid in any one year and the rebate itself.

As well, it seems plausible that much of the “savings” occurs as a result of time passing between the original submissions (based on experience with claims to the June quarter 2010 for the 2010-11 round) and the subsequent submissions (based on experience with claims in the September quarter) which means that the forecasts made by the insurers of future benefits likely to be paid become better specified. When forecasts have to be made further in advance there is a tendency to err on the side of conservatism with respect to the size of estimated future benefits, appreciating that health insurance is a short-tail sector and subject to sizeable fluctuations which will stabilize over a 12 to 18 month timeframe.

Having regard to economic factors, there is a considerable doubt whether it is appropriate to continue to regulate directly private health insurance premiums.

However, that said, the insurers recognise that there may be political factors at work in particular associated with the 30 per cent rebate for private health insurance that underlie the Commonwealth Government’s desire to be seen to be in control of increases in premiums. This does not rule out the search for more efficient and effective ways of exerting control.

Transparency

As mentioned earlier, the transparency of the process has taken a significant step forward this round by the decision to allow PHIAC to provide copies of its advice on individual insurers proposed premium increases to the insurers concerned.

This decision has had the effect of bringing into relief the comparative lack of transparency of the basis upon which decisions are reached and the reasoning applied by

the Minister/Department/Regulator in seeking resubmissions from the insurers. The precise interpretation given to the public interest in the case of private health insurance premium increases remains something of a black hole.

Confidence

The Minister's media release announcing the outcome of premium increase rounds conveys the impression that the need to be seen to be doing something requires that, irrespective of the submissions received, about half the insurers are asked to resubmit/give better reasons and about a third required to actually reduce their original premium increases somewhat (if only marginally in many instances).

There is no attempt to undertake economic analysis to support the contention that the outcomes produced by all the process involved actually produces a significant result. The size of the "savings" shown in the 2008 media release which is presumably representative of those produced in later years underlines their marginal nature. The risk, of course, is that if large reductions in originally proposed premiums were sought they would in all likelihood significantly distort the market and reduce innovation for the benefit of consumers.

Inefficiency

To the extent that the process of resubmission and the pressure for reduced premium increases is directed to insurers with above average margins there is likely to be a perverse effect in penalising the more efficient and innovative insurers in favour of a more homogenous result. Equally it creates a reluctance to implement innovative health management measures which will have a far more favourable medium to long term effect.

Compliance Costs

Compliance costs tend to reflect the length of the process and the number of times the insurers are required to justify their proposals or submit revised premium increases and the level of detail sought in the information that must be provided by the insurers.

The compliance costs associated with the process are considerable and the demands on resources onerous for both the insurers and the government agencies involved.

The original submissions from the 35 insurers require a great deal of information to be provided so that PHIAC (and the Commonwealth Actuary in the case of the five largest insurers), the Department, the Regulator and the Minister can reach informed judgements.

The resubmissions are required to go into the same level of detail sought in the original submissions. In some cases insurers have to make multiple submissions and/or supply more detailed reasons to justify their earlier submissions. Revised positions in premiums sought have to be agreed by the insurers' Boards.

Under the 2011 timetable the process runs for insurers from 11 October when they receive the approved form until 8 February and even beyond in some cases. An artefact of the timetable is that the insurers are required to provide resubmissions over the Christmas/New Year holiday period.

The length of the process and the relatively high proportion of insurers who are required to justify their original proposals and/or submit revised premium increases means that different data bases must be used in the original proposals and the subsequent responses/proposals. Typically, claims data for the June quarter provides the basis for the original proposals, while later responses/revised proposals are based on September quarter claims data.

CHAPTER 6

The way ahead

The experience with the process for approving increases in private health insurance premiums suggests that there is little to be gained by continuing with the current quite detailed and in many ways unduly onerous intervention arrangements in the setting of premiums. They seem to be delivering at best minor presentational benefits and little real economic impacts.

At the same time the nature of competition in the market for private health insurance seems to not be such as to justify special intervention over and above that available through the normal processes of the ACCC.

The nature of the market for private health insurance, which is characterised by a relative large number of insurers and with five or so large insurers, strongly suggests there is a reasonably high degree of competition in the market for private health insurance. For example, the ACCC found in its 2007 consideration of the BUPA-MBF merger that even though the merged entity would hold 27 per cent of the Australian market it was unlikely to have the effect of substantially lessening competition in the national market or even the South Australian market (where the combined entity would hold a significant market share) and was not in contravention of S 50 of the Trade Practices Act. The room for individual insurers to overcharge their customers is very limited as a result of the degree of competitive pressure they face even allowing for a degree of stickiness of members in the shorter term.

PHIAC's assessment is that competitive forces are strongly present in the industry and are demonstrated by:

- sophisticated marketing and advertising campaigns;
- a proliferation of products; and
- generally narrow price/coverage spreads combined with narrow margins.

As PHIAC (and the ACCC) points out, Medibank Private imposes major competitive discipline on the private health insurance industry.

There may be some barriers to entry to the industry but these do not seem to be such as to significantly limit competition

Having regard to the recent experience with the process for approving increases in private health insurance premiums and the nature and strength of competition in the market for private health insurance, a strong case can be made for moving away from the current highly interventionist approach to premium setting to a much lighter touch approach. Three options suggest themselves.

Option 1

There is a reasonable case that the current process of premium increase approvals has run its course and could be scrapped without leading to increases in private health insurance premiums which are not justified by underlying cost increases or the provision of improved benefits for consumers. To the extent that structural barriers to entry or other kinds of inhibitors are identified to competition in the private health insurance market these should be addressed directly by the ACCC.

Option 2

If the Commonwealth Government wanted to maintain a window into the premium setting activities of the private health insurance entities it could allocate to PHIAC a premium monitoring role which would sit alongside its prudential role. This could be treated as giving a degree of confidence to policy makers during, say, a three year period after the current system was replaced.

Option 3

If the Commonwealth Government wanted to maintain its current power to reject private health insurance premium increases but at the same time lower the process' compliance costs, improve its transparency and enhance predictability it could:

- Move to a situation where PHIAC became the recognised lead advisor on premium increases and leave the Minister with a reserve power to intervene in special cases where the public interest was involved. This would be similar in principle to the way proposals for foreign investments in Australia are handled by the Foreign Investment Review Board, but with the Treasurer able to intervene in special cases where the public interest was at stake.
- To enhance transparency PHIAC should provide greater clarity about the benchmarks it uses to judge the performance of the private health insurers in terms of achieving the minimum increases in premiums needed to maintain viability. In particular, the benchmarks in terms of reserves needed and margins justified should be made clear.
- The period set for the process of lodging and assessing proposed premium changes should be significantly shortened.
- The information required to be provided by the smaller insurers (ie, those who neither have market power nor do they significantly influence final outcomes) should be significantly reduced.

Such an option would put the process by which premium increases were considered at arm's length from the Minister. Transparency would be enhanced as PHIAC's advice would be available, as is now the case, to the individual insurers and greater clarity would be provided in terms of the benchmarks PHIAC uses to judge matters such as holdings of reserves and margins. Public interest based interventions by the Minister would be expected to be few in number.

The option should in principle lead to a reduction in compliance costs for the industry as the potential for arbitrary political interventions and the associated resubmission/better reasons process would be expected to be limited.

To further streamline the process, and hence lower compliance costs, a distinction could be drawn between the insurers which hold a significant share of the market, say, 10 per cent and above and the remainder of insurers. The reporting obligations placed upon the smaller insurers who have minimal impact on total outcomes could be substantially lightened.

Recommendation

The choice between the three options depends on the relative weight that is placed on the perceived presentational benefits of the current process versus reducing the associated compliance costs.

Given the presence of the 30 per cent rebate for private health insurance and the relatively high budgetary cost that is associated with it, there may be presentational advantages for the Government in maintaining a degree of oversight of the setting of private health insurance premiums. However, at the same time steps should be taken to reduce the compliance costs imposed on both the government and insurers by the current process by moving to a lighter touch regulatory approach.

The choice boils down to either Option 2 or Option 3.

On balance, the preferred approach is Option 2. This approach will allow the government to say that it is monitoring premium increases with the implied threat that if the monitoring shows that premiums are systematically increasing at a rate greater than might be expected by movements in the fundamental cost drivers of medical and hospital costs (including the costs of pharmaceuticals and medical devices) then a more interventionist approach will be re-introduced. At the same time Option 2 will minimize compliance costs for government and the insurers.

Appendix 1

Acknowledgements

Insight Economics would like to acknowledge the following organizations making their officers available to discuss the private health insurance premiums process.

- Australian Unity Health Ltd
- BUPA Australia Health
- Department of Health and Ageing
- HBF Health Funds Inc
- HCF
- Health Insurance Restricted Membership Association of Australia (HIRMAA)
- Medibank Private Limited
- Navy Health Ltd
- Peoplecare Health Insurance Ltd
- Private Health Insurance Administration Council (PHIAC)
- Teachers Federation Health Ltd.