

An economic study on the use of age and disability in insurance pricing

Proposal prepared for the CEA

December 6th 2011



1 Introduction

The current draft of the Equal Treatment Directive (SEC(2008) 2180) contains a provision which allows the use of age and disability in insurance pricing where this can be justified. The proposed Directive has parallels with the EU Gender Directive (Council Directive 2004/113/EC), which provides for equal treatment between men and women in the access and supply of goods and services, and contains an exemption for insurance products: under Article 5(2), Member States can opt out of banning the use of gender and can allow 'proportionate differences' in insurance premiums and benefits.

On March 1st 2011, however, the European Court of Justice ruled that this time-unlimited opt-out provision in relation to gender discrimination is inconsistent with the European Charter ('Test-Achats ruling'). The Court set a time limit on the gender exemption, which will expire on December 21st 2012. In light of the Test-Achats ruling, there is a risk that the proposed exemption on the use of age and disability in the provision and pricing of insurance and other financial services might be withdrawn or limited in time.

This creates an opportunity for the insurance industry to inform the European Commission about the use of age- and disability-based practices in insurance, and the consequences of a possible ban on the use of age and disability.

Oxera has been at the forefront of the policy debate on discrimination in insurance and financial services, and has published influential reports on this issue for the UK's Government Equalities Office, the Association of British Insurers, and Gesamtverband der Deutschen Versicherungswirtschaft (GDV).

This document outlines the proposed scope of an economic study to inform the policy debate, and sets out how we would deliver this study in terms of approach and methodology, the project team, outputs, timescales and budget.

2 Content and scope of research

The content scope of the project would be as described in this section.

We have developed an approach for the study which would be consistent with the budget estimate provided below. We also describe possible additional research that could be conducted that would be consistent with the higher budget estimates (see section 2.4). Our methodology is designed to be both flexible and manageable so that the scope and level of detail of the analysis of the study can best meet your requirements.

2.1 Research objectives

The main objective of the study would be to provide the CEA with robust, evidence-based economic analysis to:

- explain why and how age and disability are currently used as risk factors in insurance pricing, and why risk-based pricing is key to the functioning of private insurance markets. This would involve an analysis of the importance of the use of age and disability on the pricing and availability of insurance products;
- evaluate the potential impact of a ban on the use of age and disability on the industry, consumers and the wider market; and, consequently, to assess the cost of a ban for consumers and the wider society;
- inform the European Commission and others involved in this debate about the importance of the use of age and disability in determining insurance premiums.

The study would result in an independent and objective research report that is suitable for publication and contains the economic analysis and evidence needed to allow the CEA and its members to inform the ongoing policy debate. The assessment would be based on a mix of qualitative and quantitative analysis.

2.2 Oxera's approach

The study would build on previous research conducted by Oxera, in particular: (1) on the impact of the use of age-based practices in insurance in the UK;¹ and (2) on the impact of a ban on the use of gender in a number of EU Member States.² However, the study would be 'European' in nature and provide an analysis of EU markets, and consider products not covered by existing studies (see section 2.3).

Oxera's previous research suggests that a ban on the use of age could lead to significant consequences for the insurance industry and consumers. For life insurance products in particular, age is a vital component both of risk-based pricing and for the proper functioning of private insurance markets, and there are reasons to suspect that a ban on the use of age could result in a collapse of private insurance provision for some products.

As for a potential ban on the use of disability, there are preliminary indications that disability, too, is an important risk-rating factor in certain insurance segments in some countries—the

¹ Oxera (2009), 'The use of age-based practices in financial services', a report prepared for Government Equalities Office, May.

² Oxera (2011), 'The impact of a ban on the use of gender in insurance in the EU', a report prepared for Gesamtverband der Deutschen Versicherungswirtschaft, forthcoming.

impact may, however, depend on national definitions of types of disability and the type of insurance products involved.

Oxera's study would therefore focus on clearly explaining, and providing empirical evidence on, the following issues.

- A conceptual discussion around private insurance market functioning and risk-based pricing, and the economic impact of removing a relevant risk factor from pricing models.
- An analysis of the current use of age and disability in insurance, and how this is related to risk and claims, with a focus on a number of relevant insurance products (life and non-life) and evidence from several EU countries (see section 2.3). The aim of this would be to illustrate that age and disability are relevant risk-rating factors. This would include an analysis to understand how age- and disability-based practices currently affect consumers in terms of the pricing and availability of insurance products.
- A description of how the insurance industry would respond to a ban on the use of age and disability, and an assessment of the potential consumer detriments resulting from such a ban. This would include identifying private insurance products that could potentially cease to be provided as well as quantitative estimates of the potential impact on prices.
- A qualitative assessment of the wider consumer benefits that come from the use of age and disability in determining insurance premiums, as well as the potential consequences arising from a ban on the use of age and disabilities due to changes in demand (adverse selection) and the reduced availability of insurance products.

Oxera's study would be based on a positive and balanced approach that explains the benefits that arise from risk-based pricing of insurance products, as well as an analysis of the impacts that could arise from a ban.

Based on Oxera's experience in conducting these types of studies, the research would involve a number of different work activities, including the following.

- Structured interviews with major European private insurance companies and insurance associations, in order to collect data and to discuss a series of questions about the functioning of the relevant insurance markets and the importance of using age and disability in insurance pricing.
- The collection of data on insurance premiums and average claims cost per policy from insurance companies, insurance associations, price comparison websites and other public sources.
- Desk-based research into the data collected, including analysis of distribution effects to illustrate the importance of the use of age and disability.
- A literature study to identify relevant sources of information about, and assessments of, the role of age and disability in insurance pricing.
- Report-writing, bringing together all of the analysis into an independent Oxera report, which would be a publishable report.

Oxera's experience suggests that empirical evidence can have a significant impact, and hence the availability of relevant data will be critical for producing an influential study. Some of the data is likely to be available from public sources and price comparison websites, but some crucial pieces of evidence and analysis are likely to be available only via insurance companies or associations (such as modelling of the redistribution effects and the impact on

pricing). Industry involvement would therefore be crucial for successful research, and Oxera would interact closely with the insurance companies and associations.

2.3 Scope of research

Based on Oxera's experience, it is not necessary to conduct a 27-country study to inform policy debates at EU level. What matters more is a strong conceptual analysis combined with a number of good examples from a sample of EU markets. With regard to country coverage, this would, to some extent, depend on the data that can be made available, in particular by the insurance associations and the pan-European insurers that support this study. We would suggest including evidence from five or six countries.

At this stage, we would suggest that these countries include: Germany; France; the UK; a central European country such as Poland or the Czech Republic; Spain and/or Italy; and another smaller European country.

In terms of product coverage, Oxera proposes to focus the analysis on four products: life insurance, motor insurance, travel insurance and health insurance. This selection should provide a useful combination of life and non-life insurance products which are affected by age and disability.

While it would not be possible to obtain data for all products in all countries, the aim would be to provide examples and illustrations for several products in a cross-section of countries.

The exact coverage of the study in terms of countries and products would need to be agreed with the CEA, taking into account the relevance of age and disability as risk-rating factors and data availability, so as to convincingly illustrate the importance of the use of age and disability.

2.4 Additional research options

The scope of work described above is consistent with the main budget estimate provided below. There are additional research options that could be conducted, however, which would require additional budget. These additional options include the following.

- **Conducting market research** into consumer experience of and attitudes towards the use of age and disability in determining insurance premiums; this could explore consumer attitudes towards the use of risk-based pricing, the extent to which they have access to insurance products, and their understanding of why risk-based pricing is used; market research could also provide evidence on the potential extent of adverse selection given a ban on the use of age and disability. Oxera notes that conducting market research is optional and not necessary for us to produce a robust assessment. It is possible to produce the study without doing the market research. The costs of conducting a consumer survey could amount to around €10,000 per country.
- **Increasing the number of countries** included in the study; this may be helpful particularly if results are desired from various different countries in order to directly address country-specific issues regarding risk-based pricing in insurance markets; for instance, this may be appropriate if there is a wide variety of different approaches to insurance pricing or if only country-specific results are likely to be effective in national debate about the issue; data availability can be a constraint on analysis for some countries, however.
- **Widening the scope of products** included in the study; this may be required if there is an interest in other specific products, although it should be noted that data availability can be a constraint on the effectiveness of research into some insurance products.

Oxera is an independent economics consultancy—one of the longest-established in Europe—with an international reputation for integrity, intellectual rigour and work of the highest quality. We are driven to preserve our objectivity and integrity. Oxera is completely independent in both ownership and delivery of our analysis. As we are not tied to any one customer, investor or sector, we offer unbiased, credible results, and often act as an intermediary/facilitator to two or more points of view.

Since the Company's inception in 1982, we have been offering economics advice using a combination of extensive industry knowledge and unsurpassed expertise in industrial and quantitative economics and corporate finance, placing Oxera at the forefront of developments for company strategy, government policy, competition law, and regulation.

In financial services and other industry sectors, companies rely on our analysis when looking to influence policy debates, develop commercial strategy, and strengthen their position in competition or regulatory proceedings.

Regulators and competition authorities depend on us to provide rigorous support for their decision-making in regulatory and competition law proceedings. Oxera is at the forefront of applying economics to improve the tools used by both regulators and policy-makers.

Policy-makers prize our proven ability to analyse problems from a public-policy perspective in order to increase the quality of both policy decisions and the policy debate.

The following examples of Oxera studies help to demonstrate our experience of relevance to this proposed study.

- **The impact of a ban on the use of gender in insurance on consumers in Europe, Gesamtverband der Deutschen Versicherungswirtschaft (GDV), 2011**
GDV, the German insurance association, asked Oxera to conduct an economic and objective study of the potential impact on consumers of a ban on gender-based pricing for insurance products (life and non-life) in Europe. The study assessed the potential impact of the ban on consumers by providing quantitative estimates of the impact on insurance premiums and benefits as well as considering wider social consequences. The study demonstrated that it is possible to assess the potential impact on consumers of a ban on the use of gender and to provide quantitative estimates of the potential impact on premiums. The report will be published on December 7th 2011 and will be available from the Oxera website.
- **Impact of potential gender discrimination legislation on insurance markets, Association of British Insurers (ABI), 2010**
Focusing on motor, private medical and term-life insurance, and pension annuities, this study concluded that risk-based pricing is key to the efficient operation of private insurance markets, and that there are significant gender differences in accident, morbidity and mortality risks. A ban on a relevant rating factor such as gender in insurance pricing could not, in any case, be achieved without costs, which would ultimately be borne by consumers. The study also found that there would be redistribution effects; for example, motor insurance premiums for young females would increase by up to 25%. While the study found that unisex pricing was unlikely to trigger an 'adverse selection' downward spiral at the market level, with lower-risk individuals exiting the market some demand adjustments would be expected. Importantly, simply removing gender as a rating factor would not, in itself, necessarily achieve gender neutrality in insurance prices, which in practice would be very costly, if not impossible, to

achieve. The report, published in September 2010, is available from the Oxera and ABI websites.

– **The use of age-based practices in financial services, Government Equalities Office, 2009**

Economic assessment of the use of age-based practices in the provision of financial services and the impact of restricting financial services providers in the way they currently use age in their pricing and product offerings. The study was commissioned by the Government Equalities Office to inform its decisions around age discrimination legislation in financial services. The report presents significant empirical evidence to explain why age is a key factor to ensure risk-based and cost-reflective pricing in some types of financial services (eg, motor and travel insurance). Based on the assessment of the status quo in the market, the study evaluates the impact of different policy options that would limit the ability of financial services providers to use age in their supply decisions. Published alongside the government's own consultation document, the Oxera report provides an economic basis for the policy debate and consultation with industry, age-sector organisations and other stakeholders.

– **Contract to provide research into risk sharing options to support the private market for flood insurance, Association of British Insurers (ABI), 2011**

Since 2000, the provision of insurance to residential and small-business properties against flooding has been governed by the Statement of Principles, an agreement between the UK government and the insurance industry, but this is due to expire on June 30th 2013. The ABI is therefore seeking to identify measures that will support the continued widespread availability of flood insurance in the UK (including to properties at relatively high risk of flooding) after this date. This economic analysis of the current functioning of the market for flood insurance identified options for potential arrangements for risk-sharing between the UK insurance industry, government and property owners, and evaluated each option in terms of its potential to support the private market for flood insurance. We developed a framework for an alternative arrangement to the Statement of Principles, which will now be considered by the ABI.

– **Insurance guarantee schemes, European Commission DG MARKT, 2008**

Insurance guarantee schemes have been implemented in a number of EU Member States to provide last-resort protection for consumers in the event of failure of an insurance undertaking. However, there is no European requirement for Member States to establish an IGS and no harmonisation of protection standards. In a report for the DG Internal Market and Services, Oxera provided an inventory and cross-country comparison of IGS in the 27 Member States. The report examined the role of IGS and the cost of establishing one. Based on an assessment of the current situation and potential problems arising from the coexistence of different national approaches to IGS, the study also presented an evaluation of the options available to remedy any identified issues at the national and EU cross-border levels.