Fairness in the Life Insurance System – Concept Note

IDII

SEPTEMBER 2021

Disability Insurance Taskforce of the Actuaries Institute

Actuaries Institute

Published
September 2021

About the authors

This document has been prepared by the Disability Insurance Taskforce of the Actuaries Institute (the Taskforce).

Disclaimer

This paper is published by the Disability Insurance Taskforce for the purpose of providing information on its work on individual disability income insurance. The Disability Insurance Taskforce is comprised of a range of participants and stakeholders in the Individual Disability Income Insurance ecosystem. The work of the Disability Insurance Taskforce has been to establish guidelines for a sustainable ecosystem including the development of a Reference Product for Individual Disability Income Insurance. The work has been undertaken to promote better, more sustainable outcomes for both consumers and the industry. The Taskforce participants have shared knowledge on the basis that the outcome was of public benefit in advancing the debate of more sustainable product design.

Acknowledgement of country

The Actuaries Institute acknowledges the traditional custodians of the lands and waters where we live and work, travel and trade. We pay our respect to the members of those communities, Elders past and present, and recognise and celebrate their continuing custodianship and culture.

About the Actuaries Institute

The Actuaries Institute is the sole professional body for Actuaries in Australia. The Institute provides expert commentary on public policy issues where there is uncertainty of future financial outcomes.

Actuaries have a reputation for a high level of technical financial expertise and integrity. They apply their risk management expertise to allocate capital efficiently, identify and mitigate emerging risks and to help maintain system integrity across multiple segments of the financial and other sectors.

This expertise enables the profession to provide important insights on a wide range of issues including life insurance, health insurance, general insurance, climate change, retirement income policy, enterprise risk and prudential regulation, finance and investment and health financing.

Fairness in the Life Insurance System – Concept Note

All financial services customers expect and have the right to be treated fairly and with empathy.

At the same time, fairness to customers is fundamentally important to the sound operation of financial services and to consumer trust in the overall financial system.

This note considers one aspect of fairness in the life insurance system. It is intended to assist interested parties to understand the concepts at work.

Micro and Macro Fairness

Fairness in life insurance emerges at two levels.

First, there is the experience of the customer in their personal dealings with the insurance company. For example, this might be with respect to claims assessment and processing, or administrative issues or the fine print in their policy.

Secondly, there is fairness in the overall life insurance system.

This note is focused on the second of these two aspects – fairness in the overall system.

Pooling of Risk

Insurance is based on the idea of the pooling of risk. That is, an adverse event which might have an intolerable risk for an individual – for example, their house burning down – may be manageable within a community if the cost of that event is shared by members of the whole community.

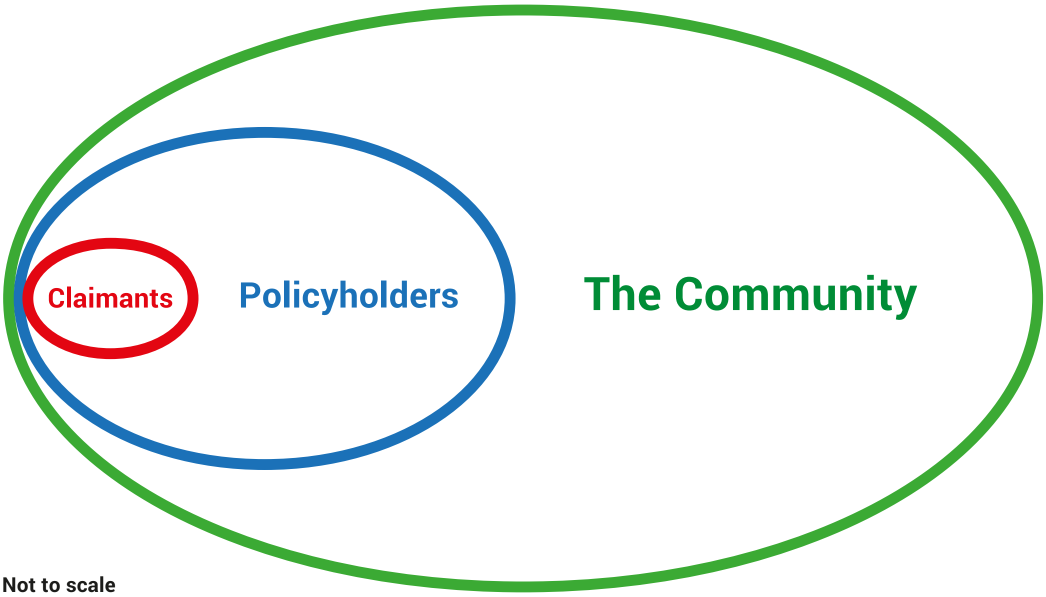
There are various ways that a community can share the costs of an adverse event. The most important of these in modern society is through insurance. With all members of an insured group making regular contributions (paying premiums on their insurance), adequate funds are made available (through a claim paid by the insurer) to compensate the individual when an adverse event occurs.

The premiums paid by the insured group overall must be sufficient to cover the cost of all claims as well as compensate the insurer for its services. The premium paid by each member of the group should reflect the particular risk of that individual – for example, an expensive house in a bush fire-prone area will cost more than a more basic house in suburbia.

While life insurance may appear to be more difficult to understand than house insurance, exactly the same principles are at work.

This concept of pooling of risk as an inherent feature of life insurance – in particular, the link between claims experience and ultimate premium rates charged – is not well understood.

The following diagram shows the concept of pooling, with an explanation set out below.



Not to scale

At the most fundamental level, premiums charged to all policyholders are used to pay benefits to claimants. Thus, an appropriate balance is needed between the benefits paid to claimants and the costs to all policyholders.

The wider community also has an interest in benefits paid to claimants. If insurance is too expensive, then fewer people will take out insurance and the cost to the community of adverse events such as death or disablement will be borne in other ways. Similarly, if insurance terms are unduly restrictive then the insurance system will not meet policyholders' expectations. The wider community will then carry a greater proportion of costs which flow from adverse events than would otherwise be the case.

On the other hand, if life insurance benefits are too liberal, in the sense that they:

a. go beyond indemnifying the insured person for financial losses; or

b. are of an unnecessarily high amount; or

c. cover minor complaints; or

d. do not require the life insured to minimise the loss,

then there are negative consequences for policyholders and the community. For example:

- **For the many customers who do not make a claim:** their premium rates will be higher than necessary, and potentially those premium rates may be subject to unexpected increases as the full consequences of liberal policy features are felt by insurers and passed on in premium rate increases over time;
- **For the wider community:** if fewer people who need the cover take out or continue insurance because of its costs, the community will bear the brunt of the financial consequences of this (e.g. through small businesses closing down, increased social security costs, other community support costs, and likely consequent higher taxes).

  Equally, if it is overly easy to qualify for a claim (for example, for an income benefit on disability), a drag on productivity will emerge as customers are disincentivised to work in their usual capacity; and
- **For those consumers who claim:** To the extent benefits are too liberal, there can be longer-term adverse consequences from delayed return to wellness and work by the customers

themselves - for example, decline in mental health, loss of confidence and self-worth. (There are many medical studies pointing to the benefits of work.)

The fact that a policyholder may pay premiums (potentially for many years) and not ever make a claim *should not be seen as an indication of poor value*. There is inherent value in the protection provided by insurance – and so, for example, people readily pay for house insurance every year and hope they never make a claim.

And So ...

It is in everyone's interests – customers, insurance companies and the wider community – that:

- Policies provide cover that is genuinely needed and benefits are not unduly restrictive or liberal;
- Benefits are not payable in unintended circumstances – perhaps because medical advances render a once-serious ailment financially inconsequential. Benefits paid in these circumstances are in effect a windfall, and add unnecessarily to the cost of insurance for others; and
- Premiums are set fairly for both the pool and for individuals within the pool, and are adjusted over time to reflect actual claims experience of the pool.

Institute of Actuaries of Australia
ABN 69 000 423 656
Level 2, 50 Carrington Street,
Sydney NSW Australia 2000
t +61 (0) 2 9239 6100
actuaries@actuaries.asn.au
www.actuaries.asn.au