Ms Helen Owens
Presiding Commissioner
Disability Discrimination Act Inquiry
Productivity Commission
Locked Bag 2
Collins Street East
Melbourne 8003

11 September 2003

Dear Commissioner

ICA makes this submission to the Productivity Commission Inquiry into the *Disability Discrimination Act 1992* (the DDA) on behalf of ICA members, all of whom are licensed insurers and subject to the *Insurance Act 1973*.

ICA and the general insurance industry

ICA is the representative body of the general insurance industry in Australia. ICA members account for over 90 per cent of total premium income written by private sector general insurers.

ICA members, both insurance and reinsurance companies, are a significant part of the financial services system. Recently published statistics from the Australian Prudential Regulation Authority (APRA) show that the private sector insurance industry generates over $20.5 billion per annum in gross premium revenue and has assets of $59.2 billion[1]. The industry also employs about 25,000 people.

ICA's interest in the Inquiry

ICA makes reference to section 46 of the DDA.[2] Among other things, section 46 "does not render it unlawful" for the refusal of "a policy of insurance against accident or any other policy of insurance"[3], if the discrimination:

- is based upon actuarial or statistical data on which it is reasonable for the first-mentioned person to rely and
- is reasonable having regard to the matter of the data and other relevant factors or
- in a case where no such actuarial or statistical data is available and cannot reasonably be obtained – the discrimination is reasonable having regard to any other relevant factors.[4]

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[1] APRA, 2002, Selected Statistics on the General Insurance Industry – Year Ending 30 June 2002", p. 5, see: www.apra.gov.au/Statistics/.
[2] S. 46 specifically relates to discrimination on the basis of disability in the provision of superannuation and insurance products and services.
[3] s. 46(1)(d)
[4] s. 46(1)(f)(i) – s. 46(1)(g)

Section 4 (1) of the DDA defines in physical, mental, inter-temporal and third-party perception terms what constitutes a disability for the purposes of the Act.

The role of insurers and the insurance process

Insurers have a vital role to play in the function of any market economy. Insurance provides protection against the unfortunate consequences of sudden and unforeseen events and the risk of financial losses that may arise, by transferring the possible risk of loss from a person or organisation (the insured) to the insurer. In exchange for this vital service, insurers charge and collect premiums based on factors relevant to the policy being underwritten.

The basic principle underlying insurance is that of sharing risks and the business of writing insurance is explicitly one of differentiating on the basis of risk.[5] Just as no two people are the same, so too the risks they represent to an insurer are different.

To ensure that there is enough money to meet possible claims, insurers assess the level of risk associated with each type of cover. Risk is determined by factors such as the likelihood of the event occurring, its timing and magnitude. In ascertaining and assessing the risk that they are willing to accept insurers rely upon information from a variety of sources, such as the applicant and their own claims records. For certain classes of insurance, it is inevitable that some of the factors that determine the level of risk of a particular applicant for insurance relate to that individual's personal characteristics. The effect of these factors will be based on past experience and predictions of future trends for groups or events with similar risk characteristics. The premiums reflect the insurer's assessment of the degree of risk for the policy. As ASIC puts it:

> *"Insurance policies involve the transfer of risk. The insurer agrees to compensate you for a loss rather than you having to pay for that loss yourself. Usually the insurer assesses whether to accept the risk (and if so, on what terms) through information they get from you."* [6]

However, while risks are assessed on an individual or per policy basis, as a part of their normal operations insurance companies pool the premiums paid by policyholders to meet any insurance claims. Not all policyholders will make a claim, yet they are all covered for certain risks and can lodge a claim if necessary. This process of risk assessment and risk spreading works best in situations where insurers are free to underwrite insurance without price intervention and in a privately underwritten and free market. Insurance companies also seek to increase the value of the pool through investing wisely in property, equities, government securities, cash and fixed-term deposits and managed funds.

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[5] The exception would be where price controls of any type exist, as is the case in statutory classes of insurance (workers compensation and CTP) in some Australian jurisdictions.

[6] http://www.fido.asic.gov.au/fido/fido.nsf/byheadline/How+insurance+works?openDocument , accessed on 21 August 2003.

An insurer who acts in accordance with s.46 is merely performing a normal and necessary part of the insurance process that includes the assessment of individual risks. In a market with risk-based pricing, the active participation of licensed insurers brings with it certain advantages including:

- the application of strong prudential standards – which include appropriate reserving, and a regular reporting regime to APRA and

- risk-based pricing – where insurers can adjust premiums based on risk which ensures that premiums reflect the actual performance and hence create the appropriate financial signals and incentives, and cost-shifting and cross-subsidisation are minimised.

The economic reasoning for the exemption

For many years, economists have been aware of the existence of transactions costs. Such costs affect all markets but are of special relevance for forward (particularly contingent) markets and can be substantial owing to the high degree of uncertainty about future contingencies. Transactions costs are also increased in the presence of asymmetric information.

Asymmetric information refers to the unequal and incomplete amount of information available to the parties to a transaction. Where asymmetric information exists it can give rise to:

- adverse selection, where one of the parties (the principal) is unable to unable to observe (or take account of, as it may be) important characteristics of the other (the agent) or of the good involved in the transaction[7] and

- moral hazard, where the principal is unable to monitor the actions of the agent following the decision to proceed with the transaction and where the agent has no incentive to act in the principal's interest. A pertinent example would be where a fully insured person might not then take appropriate risk reduction measures.

The exemption under s. 46 of the DDA recognises the existence of asymmetric information and the associated adverse selection and moral hazard problems. By allowing price and other differences on the basis of, statistical and / or actuarial data, s. 46 helps restore the natural balance of the market in charging actuarially or statistically fair premiums.

For these reasons, the exemption should be retained in its current form.

[7] The seminal discussion of this problem is: George A. Akerlof, 1970, "The Market for 'Lemons': Quality, Uncertainty and the Market Mechanism", *Quarterly Journal of Economics*, August 1970, pp. 488-500.

The effect of removing the exemption

Were the exemption to be removed, insurers would no longer be able take account of relevant characteristics as variables for assessing risk under relevant lines of insurance and hence as a factor when setting premiums. There would, therefore, be no differentiation between these risks.

This interference in the normal operation of the insurance pricing model would, in effect, be a form of price control and it's possible effects of this could include the emergence of cross subsidisation where the 'good' risks pay more owing to the 'bad' risks paying less than their fair share. This would create disincentives for 'good' risks to insure, following which better risks may choose to opt out of insurance, rather than pay more than their share of risk-based premiums. The end result could well be a pool of insureds dominated by higher risk individuals and over time it could reasonably be expected that premiums would rise.

Concluding comments

Risk-based premiums are fundamental to the insurance model. Removing the exemption under s. 46 of the DDA is likely to have far reaching and indeterminate effects for both insureds and insurers.

The current working of section 46[8] provides the appropriate legislative check through which insurers can take account of disabilities[9] whilst addressing the asymmetric information and adverse selection issues that are of particular relevance to insurance.

Yours sincerely

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[8] s. 46(1)(f)(i) – s. 46(1)(g).
[9] As defined in s. 4(1) of the DDA.