

FINANCIAL ROUNDTABLE REPORT SERIES

Disability Insurance: Issues of Importance

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This report is based on a roundtable discussion organised by ACFS and involving the following participants: Annabelle Butler (Executive Manager, Public Policy and Stakeholder Management, Suncorp), Bruce Harris (Executive Director, Financial Services, Ernst and Young), Vicki Mullen (Senior Policy Manager Financial Services Council), Greg Moran (Director, AM Actuaries), Eva Urban (Senior Public Policy Advisor, Suncorp), and Prof Kevin Davis (Research Director, ACFS) and David Michell (Business Manager, ACFS). The report summarizes issues arising from that discussion and, except where indicated, none of the views should be attributed to individual participants.

1. Introduction

Disability insurance is an important part of the financial sector and the social fabric and is an important component of society's approach to dealing justly with, the economic social costs which disability creates. Currently, the Productivity Commission is examining the potential role for a National Disability Scheme, including the role of insurance schemes within such a more general framework. That broader topic of a national scheme is beyond the scope of this report which focuses specifically upon existing and potential disability insurance schemes and issues identified as arising therefrom.

2. Current Disability Insurance (DI) Arrangements

There exists a diverse range of DI schemes operated by governments and the private sector, some of which involve compulsory participation. Most familiar amongst these arrangements are the various Workers Compensation (WC) and Compulsory Third Party (CTP) Motor Vehicle Insurance schemes. The designs of these schemes differ between the States in relation to

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criteria such as eligibility, benefits, and private sector involvement. A number of issues arise from the existence of such variety of schemes

- What can be learned about optimal scheme design from comparative analysis of existing schemes?
- Is the existence of multiple State-based schemes with different characteristics preferable to a unified National scheme?

A key lesson from failed schemes is that it is better to “fail fast and fail small”. There may be value in any national scheme being developed and refined in proto-type on a smaller scale e.g. in one state or region or product area.

Other DI arrangements can be found packaged within other insurance arrangements. For example, life insurance policies may provide prepayments upon discovery of a terminal disease, and thus provide funding for costs associated with that health induced disability prior to death. They also can provide coverage for total and permanent disability (TPD) or income protection (where earning capability is temporarily limited by sickness or disability). This type of coverage is also available through superannuation schemes.

- Do individuals take out an appropriate level of this type of coverage?
- Are there substantial levels of the population who do not have such coverage because of non-participation in institutionally based superannuation schemes?

Specific insurance products provide protection for producers and service providers, and compensation for victims, for disabilities arising from specific events. These include medical indemnity schemes, public and private liability schemes, sporting injury schemes, crime victims compensation schemes.

There is probably scope for privately provided insurance products for individuals, tailored for specific or multiple life events, to fill some of the current gap in product coverage for loss of income due to disability. Products such as friendly society investment or insurance bonds are tax efficient for low income investors are tailored to pay out against multiple life events. Arguably, Government should consider incentives to encourage potential innovations in the lifecycle risk management products such as provided by friendly societies.

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3. *Issues Identified from Existing Scheme Experience*

Disabilities arising from accidents range from minor to catastrophic, and assessment of appropriate amount and form of compensation is problematic.

(a) Fault v No-fault.

Eligibility may be based on fault or a no-fault basis, such as whether a car accident is caused by a third party or not, creating the situation that individuals suffering the same level of disability from an accident may or may not receive compensation depending upon the nature of the accident. While moral hazard concerns caution against a no-fault system, on the ground that individuals may take less care to avoid such accidents, the empirical significance of this argument is hard to assess.

(b) Equity issues – outcome versus causes

While the fault – no fault distinction can lead to discrepancies in the funds available to care for individuals suffering disability due to accidents, a potentially greater source of apparent inequity arises from the treatment of accident-acquired versus inherited/genetically based equivalent disabilities. Private insurance schemes to cover the latter situations are unlikely to exist, or be extremely expensive, due to problems of adverse selection, indicating that provision of such insurance is likely to involve a role for some national tax based scheme which provides overall coverage. But implementation of a national scheme for inherited/genetically based disabilities raises the question of whether such a scheme should also cover accident induced cases, thereby reducing the potential role for insurance schemes.

It should also be noted that the net costs of a national scheme may be less than the “headline” cost – to the extent that families who opt to take on the role of care-givers, often because of inability to afford external care arrangements, may themselves become dependent on social welfare because of reduced ability to participate in the labour market. In assessing the cost of a national scheme, it is important to take into account potential consequential reductions in other social security costs etc.

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(c) Ongoing care costs

In the case where the disability involves significant ongoing expenditures for care and medical treatment, significant issues arise in determination of the appropriate amount of compensation and in the nature of payment of compensation amounts. In principle, the amount of compensation could be determined either (a) at the time the claim is agreed based on an estimate of future costs or (b) as a contingent liability of the insurer to meet agreed specified costs as they arise in the future. In the former case a number of options arise. Payment could be made as a fixed lump sum, or it could involve an annuity style payment over the life of the beneficiary – and in which case payments could cease on death or could, in the event of early death, involve a residual payment to the beneficiary's estate.

Such alternatives involve different risk-sharing arrangements between the insurer and beneficiaries (and their families). But perhaps more important is the comparative ability of affected individuals and their families to manage the investment of funds provided for long term care relative to the insurer and associated entities. It would appear that lump sum payments increase the risk of eventual depletion of funds while there is still a need for care, forcing beneficiaries into reliance upon social welfare arrangements.

Also relevant in this regard is the arrangements for sourcing of care and medical services. Governments or insurers who can aggregate demand of many beneficiaries may be able to arrange for better or cheaper cost services (albeit with the possible downside of less tailoring of care to individual preferences).

(d) Compensation Amounts

Where an amount of compensation is determined at the time of the claim (regardless of whether payment is via lump sum or annuity style), the issue arises of the appropriate determination of amount. Standard practices involve forecasting future cost of care amounts and discounting to a present value. It is not clear that current approaches adequately allow for the relative inflation rate of medical and care costs (relative to general inflation) nor that the discount rate does not overstate an appropriate risk based rate of return, with both factors creating a downward bias to compensation amounts.

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A further complication arises because of the potential for developments in medical science which may generate treatments which enable certain disabilities to be reversed or offset. Given uncertainty about the possible emergence of such treatments and their costs, assessment of appropriate compensation for future care costs is highly problematic.

(e) Insurer Solvency

Disability insurance is a “long tailed” risk business, emphasizing the problem of ensuring solvency of the insurers.

4. Tax and Legal Issues

(a) Common Law Settlements v Insurer payouts

Recipients of payouts for disability claims may receive payments as a result of agreements with insurers, or through judgements through the courts. In the latter case, lump sum payments are typically awarded, which can give rise to the problems identified earlier of beneficiary management of such lump sums for future care.

(b) Structured Settlements

Over the past decade there have been attempts to enable common-law court determined settlements to be paid in the form of structured settlements, in which beneficiaries received payouts in an annuity form rather than as a lump sum. However, taxation arrangements appear to make this approach impractical.

(c) Special Disability Trusts

For families with the financial capacity, the option of establishing a trust structure to provide funds for future medical and care expenses of disabled family members is an important option. While tax laws permit such structures there may be some issues associated with eligibility arrangements.



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(d) Pension Age

The announced change in the pension eligibility age to 67 creates a number of complications for insurance schemes which are currently written with a pension age of 65 involved.

5. Insurance Gaps

With the ageing of the population, there will be increasing prevalence of age-related disabilities which require care and medical expenses. While public and private health insurance provides a level of insurance in meeting such costs, there do not appear to be separate products available for those wishing to obtain additional cover for a higher level of care. In part this may reflect both adverse selection issues and difficulties in specifying precise eligibility conditions (such as onset of Alzheimer's disease). Nevertheless, this would appear to be a gap in the market warranting attention.

Conclusion

Just as the true cost of disability is under-estimated, ACFS assesses that the current role of disability insurance is under-estimated by both the community at large, and also the financial sector.

Similarly, the opportunity for commercially-provided insurance products and schemes to shift some of the funding burden from the public purse may have been overlooked by government, and the scope for business growth has been under-estimated by the financial sector.

Issues of adverse selection and moral hazard are prevalent and unavoidable when insuring against the costs of disability. This is the argument for a central role for government and statutory bodies. Under private provision adverse selection and moral hazard may be mitigated but at cost of higher premiums and by trading off certain civil liberties (e.g. subjecting people to genetic testing).

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Scheme and product design in this area is particularly difficult given variable payout practices and difficulties in forecasting medical inflation. Lump sum payments are sub-optimal as they increase the risk of eventual depletion of funds while there is still a need for care, forcing beneficiaries into reliance upon social welfare arrangements. Annuity-type insurance products would appear to be better. For common-law court-determined settlements to be paid as structured settlements in the form of an annuity a modification of taxation arrangements is required.

Disability insurance is a “long tailed” risk business. The greater involvement of private insurers, friendly societies etc would support innovation over time, and would spread the risk, but there must be opportunity for profit. Any proposal for mandating the involvement of commercial providers in disability insurance schemes must consider the solvency of insurers.

A key philosophical issue must be addressed at the outset. How important is the cause of the disability? What’s important, the cause of disability or the outcome? Specifically, if there is to be a national scheme for inherited or genetically based disabilities, should such a scheme also cover accident induced cases? If so, this would likely leave the taxpayer carrying more of the burden while reducing the potential role for an under-utilised tool, insurance.

This report was included in the Australian Centre for Financial Studies’ submission to the Productivity Commission Inquiry into Disability Care and Support. The submission can be accessed via <http://www.australiancentre.com.au/long-term-disability-care-support-scheme-involve-private-providers/>

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