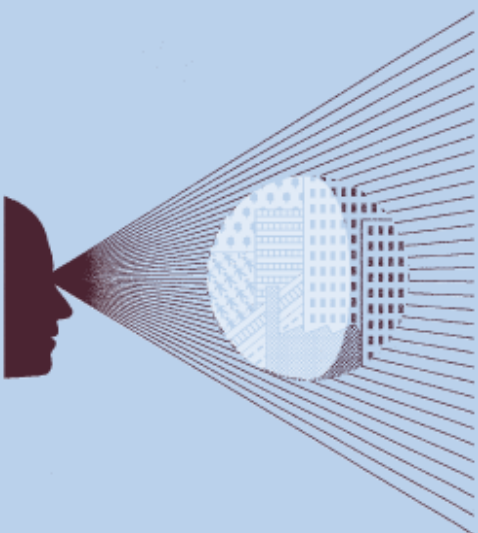


# The use of age-based practices in financial services

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## Executive summary

The Equality Bill, published in April 2009, will outlaw discrimination on the basis of age in the provision of goods, facilities and services in Great Britain. As a result, and depending on the secondary legislation to be introduced under a power in the Bill, the way in which age is used in the provision of financial services may need to change. Some current age-based practices may not be compatible with the new law.

The Government Equalities Office (GEO) commissioned Oxera to conduct economic analysis and provide evidence to inform its development of detailed legislation on age discrimination in financial services. The analysis comprises both an assessment of the current use of age-based practices in financial services and an evaluation of the economic impact of restricting certain practices in the market. The focus is on the markets for motor and travel insurance, with additional analysis presented for (unsecured) personal loans. The main findings are summarised below.

### **Current age-based practices in the provision of financial services (sections 3 and 4)**

Age-based practices in the provision of motor insurance, travel insurance and personal loans vary across products and providers. Notwithstanding this variation, there are general patterns that emerge, as follows.

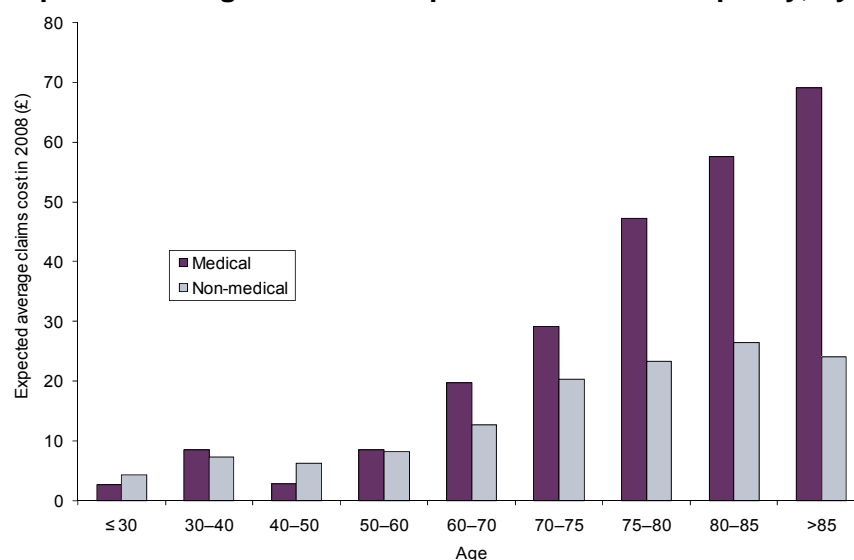
- Prices for motor and travel insurance differ depending on the age of the customer. Older people pay more than other age groups to obtain similar cover for motor and travel insurance; for motor insurance, it is the youngest drivers (under 25) who tend to pay most.
- Prices for travel insurance often stay flat within an age band, but then can jump in a step-wise manner (and often significantly) as the customer moves to the next age band.
- Providers of motor and travel insurance specialise. Targeting specific age groups (and refusing to supply specific groups) is common practice. There are therefore fewer providers of motor and travel insurance for some specific age groups—particularly the older age groups (for motor and travel insurance) and the young (for motor insurance).
- Age (over 18) has less of an impact on personal loan offerings and pricing, and there is no age-based specialisation of lenders similar to that found in the motor and travel insurance markets.
- Age is often used as a filter to determine how risk is assessed and a product sold, so prospective customers of different ages can be treated differently in the transaction process. For example, older customers can be asked to provide additional information (eg, medical screening) or to buy products in a different way (eg, by phone rather than the Internet).

These patterns show that age is used as a significant piece of information in determining how prospective customers are treated, including whether the provider will offer a service at all and at what price.

However, the current market also displays the following features.

- No age group is excluded from the market in the sense that there is *no* provider at all that is willing to supply them. For example:
  - more than 30 different motor insurance quotes are available for individuals aged 80 plus from one price comparison website alone (see Figure 3.4 in the report). An external market report lists 60 different policies for an 85-year old, and more than half of these insure ages up to 99 or are without age limit. Also, motor insurers generally do not apply maximum age limits for their existing customers, so renewal is possible irrespective of age;
  - about 20 different travel insurance policies (single-trip cover) are offered to an 80-year old from one price comparison website alone (see Figure 3.5 in the report). An external market report lists more than 60 single-trip policies for those aged 85 years, of which more than one-third are without maximum age limit.
- Only a small proportion of people have experienced being refused insurance cover because of their age (see Figures 3.6–3.8 in the report). For example, only 3% of respondents aged 80 or over have been refused travel insurance cover in the last year because of their age. For motor insurance, the percentage of refusals experienced by those aged 80 or over is even lower, at 1.5%, and is similar to the refusal rate experienced in the 18–24 age group (1.4%).<sup>1</sup> Most of those refused insurance because of their age subsequently find an insurer willing to provide cover.
- The number of suppliers varies with the size of the group of potential customers who have a similar profile—there are more suppliers in the larger markets, and fewer in those markets with fewer potential customers.
- Unlike many other products or services, in motor and travel insurance age is strongly correlated with the costs of provision. Figure 1 illustrates how the (expected) average claims cost per travel insurance policy increases with the age of the insured—in particular in relation to medical claims.

**Figure 1 Expected average claims cost per travel insurance policy, by age group**



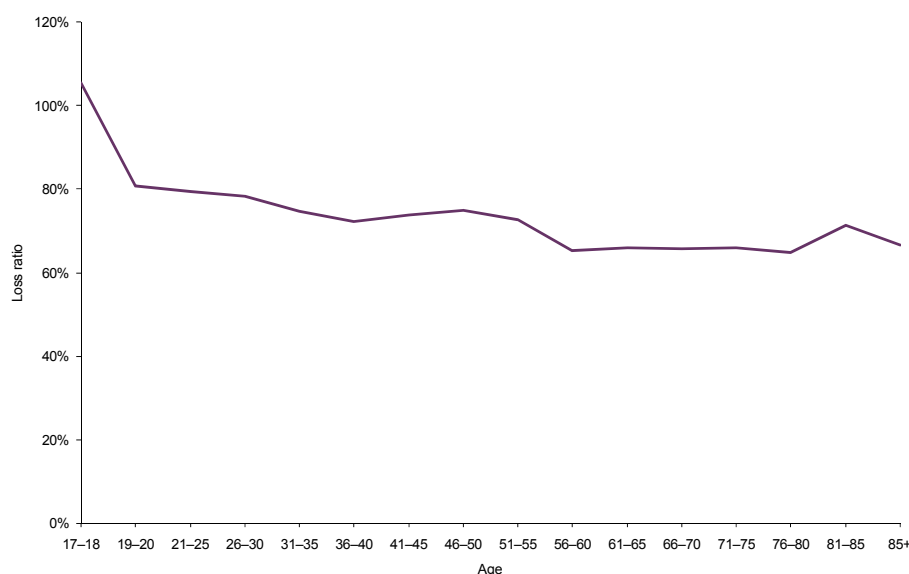
Notes: Expected average claims cost is calculated by multiplying the average cost of claims by the frequency of the claims occurring in each age group, distinguishing between medical and non-medical claims. The data refers to a large travel insurance scheme for underwriting year 2008.

Source: Oxera analysis based on data from a travel insurance provider.

<sup>1</sup> Based on a consumer survey conducted face to face by GfK NOP with more than 2,000 consumers, of whom nearly 700 are in the 60+ age group and just over 200 in the 80+ group.

- Given the considerable differences in the risks and costs of provision, risk-reflective and cost-based pricing will imply significant price differences between age groups.
- There is no obvious systematic bias in the pricing of motor or travel insurance such that certain age groups are being overcharged and more profitable for the insurer than others, notwithstanding the higher premiums paid by these age groups.
- Loss ratios in insurance (which measure claims costs relative to insurance premiums) are reasonably similar across the age groups.<sup>2</sup> Figure 2 shows an example of the loss ratios for motor insurance, calculated from aggregate market data on claims costs and premiums.

**Figure 2 Loss ratios in motor insurance, by age group**



Notes: Loss ratios calculated by dividing total claims costs by total gross written premiums for each age group. Data captures more than 90% of the market for private motor vehicle insurance (cars) and refers to underwriting year 2005.

Source: Oxera analysis based on Association of British Insurers data.

- The aggregate loss ratio for the 17–18 age group exceeds 100%—ie, claims costs exceed the premiums earned on the policies sold to this group. With this exception, and taking account of the random element in claims costs, loss ratios are reasonably similar, at between 65% and 75% irrespective of whether the age groups of 31–40-year olds are considered (4.8m policies are included in the data) or the 51–60-year olds (4.3m policies), or indeed the 81+ year olds (0.4m policies).
- Separate data made available by a sample of motor insurers confirms that there is no systematic overcharging of older drivers. In fact, any bias in pricing works in favour of the oldest group of drivers: the available data shows that policies sold to drivers above the age of 90 do not, on average, cover the costs of claims (see Figure 4.14 in the report).
- In travel insurance, the loss ratios examined (see Figures 4.15 and 4.16 in the report) also show that premium levels do not always increase sufficiently with age to cover the higher claims costs (and the greater uncertainty around these claims costs).

<sup>2</sup> Loss ratios cannot be directly translated into profitability as they do not include all expenses incurred by insurance companies, nor any returns on the investment of premiums.

- For both motor and travel insurance, there is no evidence of a systematic overcharging of certain age groups. If there is a bias in pricing relative to the risk and cost of provision, it tends to work in favour of older people (as well as the young in the case of motor insurance).
- Some age-based practices, such as the use of broad age bands combined with significant price increases between age bands, may appear arbitrary. However, they can be explained by the interplay of risk considerations and transaction costs, where simple age rules are being used to keep down transaction costs while preserving a pricing structure that broadly reflects risks.

This suggests that, from an economic perspective, the risks that are correlated with age are being correctly priced and that, in terms of absolute availability, there are no significant age-related segments of the market that are currently unserved (for the products examined).

Overall, there is undeniably a clear differentiation of consumers in the market on the basis of their age. However, the differences are driven by the real differences between age groups in the costs of provision (and the level of demand). The specialisation of providers, combined with differences in the economics of supply, can explain much, if not all, of the differentiation experienced by consumers of different ages in the market. Whether this outcome in the market is *acceptable* or *fair* (from an equity perspective) is not an economic question.

## **The impact of limiting the use of age in financial services provision (section 5)**

There is significant evidence, in the academic literature and elsewhere, to show that any restriction on risk-based and cost-reflective pricing leads to distortions in the operation of insurance and loan markets, resulting in higher prices (or lower quality) for consumers. There is also significant evidence on the importance of age as a proxy for many risks.

The Government has made clear that the new law would not mean the complete removal of age-based practices in financial services provision. The policy objective is to ban the use of those practices that are unreasonable and cannot be justified on the basis of objective evidence.

Nonetheless, when evaluating the impact of different policy proposals, a number of general economic considerations apply:

- any policy measure that restricts the use of age in risk underwriting and product supply decisions will impose costs. The costs that can more easily be quantified are the pure administrative or system costs of complying with the new requirements. These costs are often small. The more significant sources of cost are likely to relate to adverse impacts on the efficiency of pricing and the wider functioning of the market;
- if the risks correlated with age are correctly priced, a restriction in the use of age can in general not make the supply of the products more efficient. In other words, the outcome will *not* be ‘more or better products for consumers at a lower price’. Any increase in the risks or other costs of provision as a result of a policy change will ultimately be borne by customers;
- while some age groups may benefit from a restriction on age-based practices, this will almost certainly be at the cost of other age groups. If a policy measure does not correct a market failure and deliver overall efficiency benefits, any improvement in the outcome for one consumer group (eg, older people) will be to the detriment of other groups (eg, younger people).

The following summarises the main impacts of the specific policy measures that have been the focus of the recent policy debate.

### **Ban on age limits**

Under this option, providers would no longer be able to refuse to supply consumers according to their age, but would instead be required to offer products to consumers of all ages.

The main sources of benefit therefore relate to those consumers obtaining access where the product was previously not supplied or difficult to find, and the reduced time searching for providers supplying the relevant age group.

While the benefits of product access may be important for individual consumers, the aggregate benefits of the policy intervention are limited because of the small proportion of consumers currently excluded from the market on the grounds of their age. Importantly, exclusion as a result of price would not be improved—ie, a requirement to supply all age groups does not imply a reduction in price, so consumers who consider the products to be too expensive for them would not benefit. Instead, the potential beneficiaries are confined to those who have been unable to *locate* a suitable product where that product currently exists in the market.

In addition to the direct administrative or systems costs incurred by providers to comply with a removal of age limits (in motor and travel insurance), there would be costs to insurers associated with the mispricing of risks due to the lack of data and actuarial expertise when supplying age groups previously not supplied. Where such mispricing occurs, the financial losses can be significant.

Not all insurers have the necessary expertise or capability to price the spectrum of risks in the market. This applies to age-related risk as much as to other kinds of risk, and it explains why there is a degree of specialisation in the market. Thus, extending supply to cover all ages would not only require changes to the existing systems, but would also result in the costs of building up the required actuarial expertise. The consequence may be a reduction in the underwriting quality, as providers would be underwriting risks for which they do not currently have this expertise.

To respond to the requirement to supply all ages, providers have three main options:

- offer prices that reflect expected costs (inflated to account for the uncertainty). Such costs may be extrapolated from existing proprietary data, or from monitoring prices currently available in the market from providers already supplying the age group(s) in question; and/or
- limit the volume of additional business by offering very high prices (in excess of the prices already available in the market) or imposing restrictions on other risk characteristics; and/or
- remove certain products entirely from the market to avoid supplying to customers with higher risk.

Under the second and third options, product access is unlikely to be increased. Even under the first option, the gain to consumers is also not clear—prices are unlikely to fall even for those age groups where currently fewer providers are active in the market. Prices are instead more likely to rise.

Any response by firms would involve additional costs, such as quoting for products across age groups that are subsequently not sold, or establishing what other risk characteristics

could be used instead of age to segment the market. Unless absorbed by providers, these costs would be passed on to existing customers through higher prices.

The costs would also increase if the ban on age limits were implemented such that age could no longer be used as a trigger to invoke a different application or underwriting procedure (because the potentially more costly procedure would then need to be applied across customers of all ages), or if age (date of birth) can no longer be used for identification or verification purposes more generally.

### **Requirement to narrow age bands**

The effects of a requirement to narrow age bands can be expected to be less significant than a ban on age limits (and apply to travel insurance only). Currently, individual consumers may experience steep increases in the level of premiums from one year to the next as they move from one age band to the next. Such price jumps may appear unfair, particularly if unexpected.

With narrower age bands, these jumps would be avoided and replaced by a ‘smoother’ price structure (eg, where prices change every year). However, the change would mainly result in a redistribution of prices—prices are likely to increase for customers currently at the older ends of the current age bands (who at present tend to receive a cross-subsidy from the younger ages within the same age band) and fall for the younger ages in each band.

### **Objective justification requirement**

There are different ways of implementing a requirement for providers to justify objectively the use of age-based practices, and the impact depends on the chosen approach.

At the general level, since there is little evidence of ‘unfair’ age-based practices in the market, the overall economic benefits from objective justification cannot be expected to be large. There may, of course, be ‘unfair’ practices in individual cases. Granting individuals the right to legal redress and requiring firms to justify their practices in the individual case can be expected to reduce the incidence of such practices.

However, the benefits of protection from unfair practices in these individual cases may require very detailed justification at the individual firm level, rather than aggregate industry-level data. Put differently, a justification based on shared data and industry-wide information may deliver little benefit in the sense that such data would not necessarily provide the evidence needed to justify the different practices in individual cases.

At the same time, the more detailed or disaggregated the evidence required at individual firm level, the higher the administrative and other costs are likely to be. For example, the costs of ‘proving’ that a particular price increase is justified for 74-year olds turning 75 is likely to be significantly more costly than presenting statistics on the actuarial correlation between age and risk at the insured class level. If the justification were required at the level of a *specific* 74-year old turning 75, the process would be even more costly—or indeed not possible—thus requiring the use of some other factor(s) to set prices (eg, introducing detailed medical or other tests in an attempt to measure the true functional age of an individual).

Statistical results will always be volatile and prone to error. Thus, even if prices are set in an actuarially fair manner when the risk is underwritten, a provider may not be able to provide evidence for this using the data available at the time the proof is needed. The legal risk for individual providers of not being able to provide justification if they are taken to court may trigger more cautious underwriting or force providers to hold more capital for the same level of risk, resulting in costs that are passed on to customers.

A justification requirement can have an asymmetric effect on different firms in terms of the costs of generating the information required, with small (or new) firms in the market having a comparative disadvantage because they may have less (or a shorter history of) statistical

data. Shortage of data (and the greater variability that comes with it) makes it difficult for firms to develop a commercial strategy that is both economic and can be justified on the basis of their own data.

In addition to creating barriers to entry for new firms in the market, the justification requirement may hinder new products or policy terms being developed because firms cannot provide the evidence (and cannot restrict their risk by limiting availability to a specific risk class) when piloting an innovative scheme.

The adverse consequences can be reduced or eliminated by relaxing the level of proof required for individual firms, allowing approximations, exempting new firms or new products, having industry-wide justification only or, indeed, exempting certain practices from the justification requirement completely.

However, as noted, a justification requirement delivers few aggregate benefits given that there is little evidence of widespread ‘unfair’ practices in the market—eg, the data available does not show any systematic overcharging of certain age groups in the market. Therefore, objective justification mainly delivers benefits if it prevents ‘unfair’ practices in individual cases, which do not follow the pattern of pricing or product availability generally observed in the current market.

### **Signposting and referrals**

From a market-wide economic perspective, there is no evidence of significant unmet demand by certain age groups. If there are failures in the market, they are more likely to be in the way it currently matches demand and supply—ie, there is evidence of some consumers having greater difficulties in finding the relevant products or providers because of their age.

Signposting and referrals seek to address access problems and improve market outcomes by changing the distribution process—ie, consumers refused at the point of sale because of their age would be given the relevant information about, or be directly referred to, a provider catering for their particular age group.

Setting up the signpost or providing referral services in the motor and travel insurance market would impose costs and, as with all policy measures in this area, the age groups who would benefit from the change are not necessarily those who would pay for the cost. However, the services would be targeted at those (few) consumers currently refused supply by a provider on the basis of age, and hence avoid the potential costs and distortive effects on market functioning that arise with restrictions on the underwriting process, product offerings and pricing structures.

Signposting and referrals would still imply a differential treatment in the transaction process of consumers on the basis of age (eg, an 85-year old would continue to be refused travel insurance by some providers and instead be passed on to a specialist).

Nonetheless, compared with the alternative of removing age limits and requiring all providers to supply all age groups (potentially through all distribution channels), the options are less costly and, at least in principle, can deliver equivalence in the desired market outcome; namely, those (few) consumers who are currently refused or find it difficult to obtain insurance cover because of their age are more likely to obtain cover.

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