

Superannuation: Assessing Competitiveness and Efficiency



Submission to Productivity Commission – Insurance Aspects

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1. Executive summary

1.1 About Rice Warner

Rice Warner was established in 1987 to support superannuation funds and businesses operating in the financial services industry. It is an Australian business, owned and controlled by its key executives. Rice Warner is an independent firm of consultants, using actuarial skills and a strong research base to back its opinion.

Over the last three decades, Rice Warner has built a strong reputation for insightful commentary. Its independence means clients can be sure the firm always acts in their best interest and provides unbiased advice. Clients include most large superannuation funds as well as many other participants in the industry (service suppliers to funds, regulators and industry bodies).

Through its research and public policy activities, Rice Warner has built an unrivalled reputation for delivering a unique perspective across the superannuation, wealth management and life insurance industries.

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1.2 About this report

As part of its inquiry into the competitiveness and efficiency of the superannuation system, The Productivity Commission ('Commission') released an Issues Paper in July 2017. This Paper called for submissions from interested parties. This report forms Rice Warner's submission covering the insurance aspects of the Issues Paper.

In summary, Rice Warner's view is that insurance in superannuation provides a valuable benefit for working age Australians and their families. If life insurance were not built into the design of a MySuper product, most members would not be covered. The growth of insurance within superannuation over the last 30 years has closed the gap significantly between the insurance needs for a member (and their family) and the amount of cover provided.

Further, life insurance is provided in a way that is efficient, competitive and offers benefits to the Government and economy by way of reduced social security payments and increased spending capacity for members and their families.

This submission sets out to show:

- The levels of default cover have provided valuable insurance for most working Australians.
- Default levels of insurance cover do not inappropriately erode the retirement savings of most members.
- The extent to which life insurance cover offsets costs to Government in the form of reduced social security payments.

We acknowledge that there are aspects of the current system that could be improved to provide better outcomes for members. There has been criticism that:

- Young people are provided with insurance they don't need – Rice Warner has previously made a submission to the Commission on improving the value of superannuation for young people.
- Default insurance can be excessive for some groups of members.
- People with multiple accounts may have duplicate insurance.
- Insurance premiums can be excessive and erode retirement savings.
- Disability income benefits are not good value.
- Claims handling is inefficient.

We have made various suggestions within this report to address these concerns.

1.3 Impact of life insurance premiums on retirement incomes

Trustees have a legislative requirement to provide default levels of life and Total and Permanent Disability insurance under MySuper. They can also provide members with the facility of purchasing voluntary additional insurance cover. However, they are also bound (under the covenant set out in Section 52(7) of the Superannuation Industry Supervision (SIS) Act) to only offer to, or acquire insurance for, members if the cost does not inappropriately erode the retirement income of beneficiaries.

To assist Trustees, Rice Warner carried out its *Affordability Study of Group Insurance in Superannuation*, producing a report in December 2016. This report considers the affordability of default death, total and permanent disability (TPD) and income protection (IP) insurance cover provided to members through their Australian superannuation funds, based on an investigation of 21 funds which are predominately industry funds.

This report highlighted that for most members, insurance is affordable. However, for certain groups of members the cost of insurance may detrimentally impact retirement outcomes.

We recommend that focus is given to the key risk areas where member accounts are most likely to be eroded, namely:

- Members with no contributions, or low contributions.
- Members with low salaries or with intermittent contributions.
- Funds with higher than average premiums and members with high premiums due to age or occupational classification.
- Funds that provide default IP cover.
- Members with low account balances.

This can be achieved by assisting Trustees to review the affordability of the fund's default insured benefit design for various groups of their members.

Our *Affordability Study of Group Insurance in Superannuation* did not extend to non-default cover. Opt-in or voluntary cover makes up a small portion of cover in many funds and we would expect that most members with this cover would be aware that this cover is in place and of the level of premiums they are paying. Where premiums are high relative to Superannuation Guarantee (SG) contributions, (say, above 10% of SG contributions), Trustees should communicate this to members and recommend that they make voluntary additional contributions.

1.4 Impact on Government and economy

When an Australian of working age dies, or becomes disabled, there are costs to the Government and the economy arising from:

- Lost taxation revenue from the person dying or becoming disabled and from their spouse where they need to cease work or reduce their working hours to care for family members.
- The provision of social security payments.
- Lost stamp duty on premiums for default life insurance premiums.
- Lost economic productivity and spending ability of the individual and their spouse.

All the above costs are lessened where life insurance exists. Rice Warner's estimate of the financial impacts of removing/reducing default life insurance from superannuation funds is shown in Table 1.

This estimate has been produced on two bases:

- **Basis 1 (Removal of all default cover in superannuation):** All voluntary cover in superannuation is retained and all default cover removed (no changes to cover outside the wholesale superannuation environment).
- **Basis 2 (Default cover in superannuation partially removed):** Total cover in the wholesale superannuation environment is reduced by 50%.

Table 1. Additional annual cost to Government and the economy

| | Basis 1 (Removal of all default cover in superannuation) | Basis 2 (Default cover in superannuation partially removed) |
|--|--|---|
| | (\$ million p.a.) | |
| Lost Tax and Spending Capacity/Economic production due to reduced insurance claim payments | 4,040 | 2,240 |
| Social Security | 1,661 | 922 |
| Stamp Duty | 270 | 154 |
| Total | 5,971 | 3,316 |

Note: The stamp duty costs have been estimated as approximately five percent of the premium lost each year.

The impact of lost tax and spending capacity due to the spouse reducing their work hours is insignificant relative to the above components, so has been excluded.

We have not attempted to place a value on the economic benefit of the *peace of mind* provided by the insurance *safety net*. This refers to an insurance premium being traded (paid) in exchange for certainty (i.e. removing a risk from the consumer/insured person). When no insurance is in place, some individuals will curb their spending (and others will feel they should be curbing their spending) to increase family savings for future unforeseen events.

1.5 Improvements to insurance structure

We consider that the superannuation industry provides valuable benefits for most members in an efficient manner. The market is competitive, offering good value for members. It is self-correcting and many improvements have been made over recent years.

The most important improvements that need to be implemented are:

- Consistency and clarity of communications.
- Consistency and completeness of data.
- Focus on affordability of premiums for all members.

Other changes that could be considered to provide better outcomes for members are:

- Removal of default cover for young members (under 25), with cover provided on an opt-in basis only.¹
- Removal of default IP cover from superannuation.
- Amending rules relating to release of death benefits for funeral benefits.
- Consider paying all death benefits into a deceased member's estate to simplify the process for paying death benefits.

We acknowledge that further investigation is required to determine whether the existence of life insurance is a barrier to account consolidation is a concern. We understand that the Insurance in Superannuation Working Group (ISWG) will consider this issue.

¹ See our previous submission covering this issue: http://www.ricewarner.com/wp-content/uploads/2016/11/Final_Rpt_Submission-to-the-Productivity-Commission-re.-Alternative-Default-Models.pdf

1.6 Conclusions and suggestions

Insurance continues to be an important feature of superannuation funds and removal of default insurance cover will have substantial impacts both at Government level and for the individuals (and their families) who die or become disabled.

Rice Warner supports changes that will improve outcomes for members and is keen to provide further assistance by way of data, research and advice.

We would be pleased to discuss any aspects of our submission and to provide data and other information to assist in the assessment of the *Competitiveness and Efficiency of Superannuation*.

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2. Value of insurance within superannuation

2.1 Genesis of insurance in superannuation

Defined benefit funds tended to provide death benefits based on a formula, often linked to the prospective retirement benefit. TPD was originally designed as an advance of the death benefit for those who were terminally ill or disabled to the extent that they would never be able to work again.

When industry funds were created from 1984 onwards, the award contribution was 3% of salary. The funds provided universal life insurance but the premium was constrained by the small size of contributions. The typical premium was \$1 a week.

Industry funds could use the scale of their membership to provide life cover to all members without any underwriting requirements. Even members who were not able to obtain retail cover due to their health or occupation were covered. Further, the cost was cheaper than was available in the retail marketplace. Funds could deliver these benefits by having cross-subsidisation, particularly from younger members.

Over time, superannuation funds have improved their benefit design. Premiums now average about \$4 a week but the scope of benefits is much broader. Funds have tried to set the level of cover close to the needs of an average member. However, they don't have sufficient information about family circumstances to set this as anything other than a crude approximation to a member's needs. Nonetheless, the lump sum death and TPD benefits are usually set at acceptable levels. IP is more difficult as the funds don't know the member's salary; usually the benefit is inadequate and for relatively short periods, two years being common.

There is still a cost advantage for group life insurance and the levels of cross-subsidisation have been significantly reduced.

It is apparent that insurance cover has long been a feature of superannuation funds and goes some way towards alleviating the underinsurance gap in Australia. The provision of death benefits is one of the core purposes of superannuation as set out in the Superannuation Industry Supervision (SIS) legislation. The provision of benefits on temporary or permanent cessation of work due to ill-health is an ancillary purpose.

Trustees are well-placed to obtain cover for fund members on good terms and at relatively low cost, without the need for members to complete forms or undergo medical assessment. MySuper funds are required to provide default death and TPD cover subject to certain conditions and may provide default IP cover.

2.2 Trustee responsibilities relating to insurance

Current legislation is detailed in setting out Trustee responsibilities in relation to insurance, with the key requirements set out in the Superannuation Industry (Supervision) Act (SIS). For example, Trustees need to meet the covenants set out in SIS Section 52(7), which requires that Trustees must only offer to, or acquire insurance for, members if the cost does not inappropriately erode the retirement income of beneficiaries.

Superannuation Prudential Standard (SPS) 250 sets out further requirements in relation to making insurance benefits available to members and beneficiaries covering the specifics of the Fund's Insurance Management Framework. This standard requires Trustees to have an appropriate process for selecting insurers and covers due diligence and monitoring of the insurers on an ongoing basis.

The focus by trustees on the requirements of SPS250 mean that competition is generally strong in the group insurance market and Trustees are generally able to obtain insurance cover that provides benefits for a reasonable cost. The ratio of benefit payouts to premiums is around 80%, higher than the retail market.

2.3 Current levels of life insurance cover

Based on Rice Warner's risk insurance database and broader consulting work, the estimated total amount of death, TPD and IP across Australia for working age people aged below 65 is set out in Table 2.

It should be noted that direct life products have been excluded from these figures as much of this business is currently covering older Australians, for example, under funeral plans. Direct business constitutes 10% of the market in terms of the amount of cover provided.

Also, note that business insurances constitute about 5% of all retail products and therefore we have adjusted the sums insured of all retail products downwards by 5%.

Table 2. Total Death, TPD and IP Cover across Australia – working age below 65

| Market segment | Total Death | TPD | IP |
|--------------------------|-------------|-----------|--------|
| | (\$million) | | |
| Wholesale | | | |
| Corporate Risk Insurance | 175,995 | 132,606 | 4,629 |
| Industry Funds | 1,622,318 | 1,416,526 | 7,745 |
| Public Sector Funds | 355,090 | 330,274 | 1,944 |
| Employer Master Trusts | 321,414 | 297,269 | 2,138 |
| Retail | | | |
| Superannuation | 893,229 | 388,181 | 952 |
| Non-Superannuation | 912,068 | 280,635 | 4,514 |
| Direct | 557,968 | 51,417 | 244 |
| Total market | 4,838,082 | 2,896,908 | 22,166 |

This demonstrates that much of the cover for death, TPD and IP is insured via wholesale insurance via superannuation funds. It is estimated that 50% of all death cover and IP cover in Australia is default cover provided by superannuation funds and 70% of TPD cover is default superannuation cover.

Consequently, any removal of default insurance cover would make a significant dent in the level of life insurance cover of Australians. If default insurance were removed, but voluntary cover was still permitted, we would expect many (perhaps most) new members not to hold any cover. We would expect that most existing members would choose to retain their cover (or a portion of their cover) – they could reduce their cover today if they so choose.

However, there is another possibility that funds would choose not to offer life insurance due to the higher costs of running voluntary insurance. Then, overall levels of cover would fall. We would not expect many individuals to replace lost cover outside the superannuation environment because this would require funding premiums from after-tax income.

2.4 Insurance needs

2.4.1 Financial hardship

The death of a working Australian has numerous financial impacts on their remaining family members, whilst their becoming disabled has impacts on both the individual and their family. The impact will depend on numerous factors including level of debt, which partner has died/become disabled, whether there are any dependents, age and number of children, current income levels and other insurances held.

The death of the individual will cause financial hardship to others in every one of these situations. Even if the individual lives alone without dependants, relatives may incur some costs and inconvenience in dealing with a deceased person's funeral and estate. The death of a breadwinner will lead to a loss of income for the family unit. Non-working parents perform duties which will need replacing on death (e.g. childcare).

The requirements on becoming totally and permanently disabled also vary depending on the actual disability concerned which, of course, cannot be predicted. For example, it will vary depending on:

- The severity of the disability. Some disabled people can still live by themselves and only require a period of training to adjust to the new lifestyle, while others may be severely disabled, cannot perform daily activities such as eating or dressing and require constant professional care.
- Life expectancy after disability. In some cases, the disabled person has a much shorter life expectancy because of their disability, for example, someone disabled with multiple sclerosis. In some other cases, the disability may not affect life expectancy significantly, for example, someone who is mentally disabled, but physically fit.

The disability of an individual will lead to incurred costs of personal care and the individual's future income from personal exertion will also cease.

Losses are ameliorated by Government support through social security benefits. However, these are generally means-tested and are set at basic levels.

2.4.2 Investment income

Any investments held (excluding the family home) and the income from them would be available to meet needs after the death of a parent. The extent of those investments will vary from individual to individual.

Superannuation investments in the accumulation phase are not usually accessible until Preservation Age and should be earmarked for retirement not for current needs. These investments are also ignored in assessing eligibility for social security benefits.

- Most Australians have little savings or investments other than their superannuation and possibly their home. The ownership of other savings and investments tends to be focused amongst high income earners².

² Rice Warner's *Personal Investments Report 2016* shows that personal wealth exceeds superannuation assets, but it is heavily concentrated amongst the wealthy and retired persons.

- Those people who have other net savings and investments are generally on incomes that make them ineligible for means tested social security benefits. For these people, the implicit assumption for the purposes of this report is that those savings will remain intact after the death of the partner concerned and the stated insurance need will be sufficient to ensure that they are not needed to support remaining family and dependants upon death.

2.4.3 Household costs and debt

One of the major household expenses is that required to cover accommodation. The snapshot of Australia data from the 2016 Census shows that 31% of households own their home outright, 34.5% own a home with a mortgage and 30.9% rent a home. These figures include households beyond retirement age so the percentages of those who rent or have a mortgage is much higher for the working age population.

Financial needs on the death of a working individual with dependants will therefore include repayment of the mortgage or, if the house is rented, a lump sum sufficient to pay future rent for the majority of households.

Data obtained from the 4 May 2017 Speech by RBA Governor Philip Lowe indicates that 20% of households have a debt to income ratio of 300%. Considering the census information showing 34.5% of households have a mortgage, this indicates that close to 60% of mortgage holders may have debt equal to more than three times household income.

The same speech stated that one third of loans have less than one month's mortgage repayment buffer. The implication is that without insurance, many individuals/families would need to sell their home. It is expected that some of those who rent would also need to move to lower cost properties. The flow-on implications include the need for children to change schools and the loss of social circles and support at a time when the stress of a death or disability is already impacting.

2.4.4 Dependant children

It is those relationships involving *dependant children* which are likely to be the most significant in the community when considering the financial consequences of the death or disability of an income producing individual.

Where there is minimal life insurance, the death of one parent can generate strong support from the community of relatives and friends. However, the surviving parent should not be wholly dependent on such support, at least to the extent of providing normal services on a continuing basis which could be funded by life insurance.

When a couple has dependent children, each partner is to some extent dependent on the other partner. Arguably, when the children cease to be dependant, the partners are no longer as financially dependent on each other (unless one is disabled in some way), although one partner may have low employment prospects through years of not working whilst looking after children.

On this basis, insurance needs are highest where there are dependent children.

Children's needs vary with the age of children. Children pursuing tertiary education will need support until at least age 21. Others under 21 will be school, working in low paid jobs, living at home, and will need continuing financial support from their parents.

Most families with dependent children are supported in part by social security benefits. In these cases, family disposable income is the sum of after tax earnings and social security entitlements.

3. Impact of life insurance premiums on retirement incomes

There has been much discussion and debate in recent months about the affordability of insurance within superannuation. Concern now exists, across both Retail and Group insurance markets, that rising insurance premiums are resulting in life insurance becoming unaffordable.

Default insurance cover within a superannuation environment has been the focus of recent media coverage in terms of affordability and the erosion of account balances. Providing an adequate level of insurance cover for members is often seen as competing with the overarching purpose of superannuation, which is to provide retirement income. Every dollar spent on insurance is one less dollar available to be invested for retirement.

3.1 Rice Warner *Affordability Study of Group Insurance in Superannuation*

Considering the above concerns, Rice Warner carried out its *Affordability Study of Group Insurance in Superannuation*, producing a report in December 2016. This report considers the affordability of default death, TPD and IP insurance cover provided to members through their Australian superannuation funds. The key aim was to assist Trustees to meet the covenant set out in Section 52(7) of the Superannuation Industry Supervision (SIS) Act to only offer to, or acquire insurance for, members if the cost does not inappropriately erode the retirement income of beneficiaries.

The report seeks to estimate the impact of insurance premiums on members' account balances at retirement under a range of different scenarios based on actual fund data. Our research uncovered the same issues for males and females, with the results being more pronounced for females due to average default premium costs being higher for females when taking into account death, TPD and IP default cover. We have therefore shown projections for females in this report. This study should be considered in conjunction with Rice Warners' *Underinsurance in Australia Report 2015* (which outlines insurance requirements in a variety of scenarios for individuals at all ages) to determine an appropriate level of insurance which balances these competing needs.

One measure of affordability is to take insurance premiums as a percentage of income. Some funds benchmark 1% of salary over the lifetime of membership as being a reasonable level. This corresponds to just under 10% of the Superannuation Guarantee (SG) contribution, which is considered reasonable, leaving a large portion of SG contributions to be invested for the member's retirement.

3.2 Default premiums by age

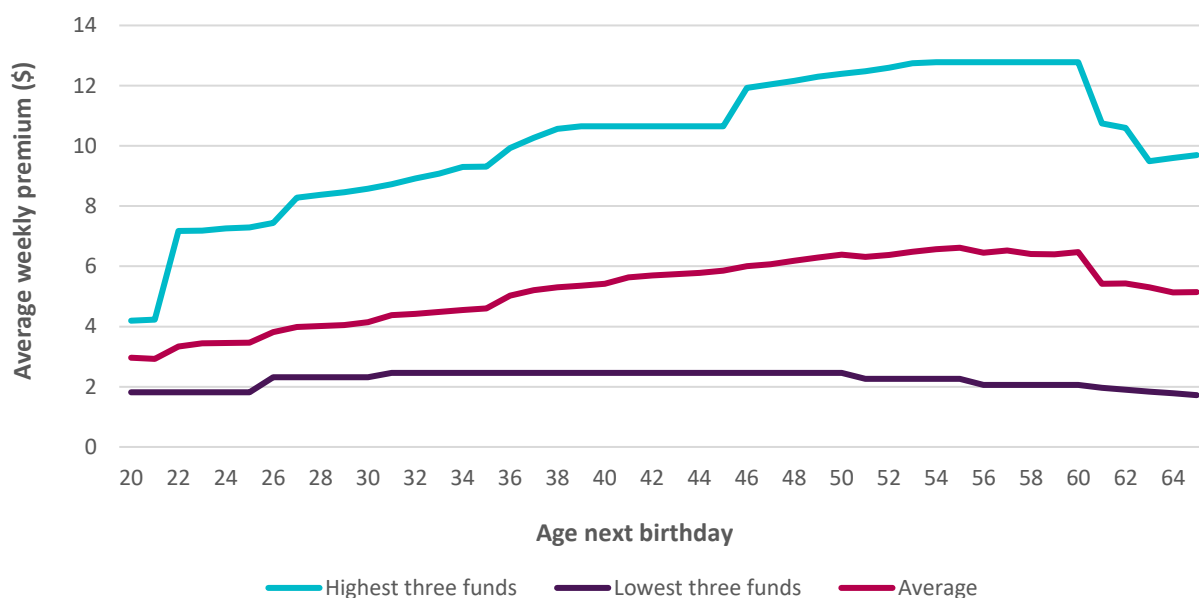
Rice Warner analysed default weekly insurance premiums for 21 funds which are predominately industry funds. The graphs provide a comparison of the average weekly default premium for all 21 funds, the highest three funds and the lowest three funds. All 21 funds offered default death cover, with one fund not providing default TPD cover and nine funds not offering default IP cover.

Graph 1 shows death and TPD rates for White Collar females and Graph 2 compares the cost of all default insurance (DTPD and IP) for both White Collar and Heavy Manual occupational groups.

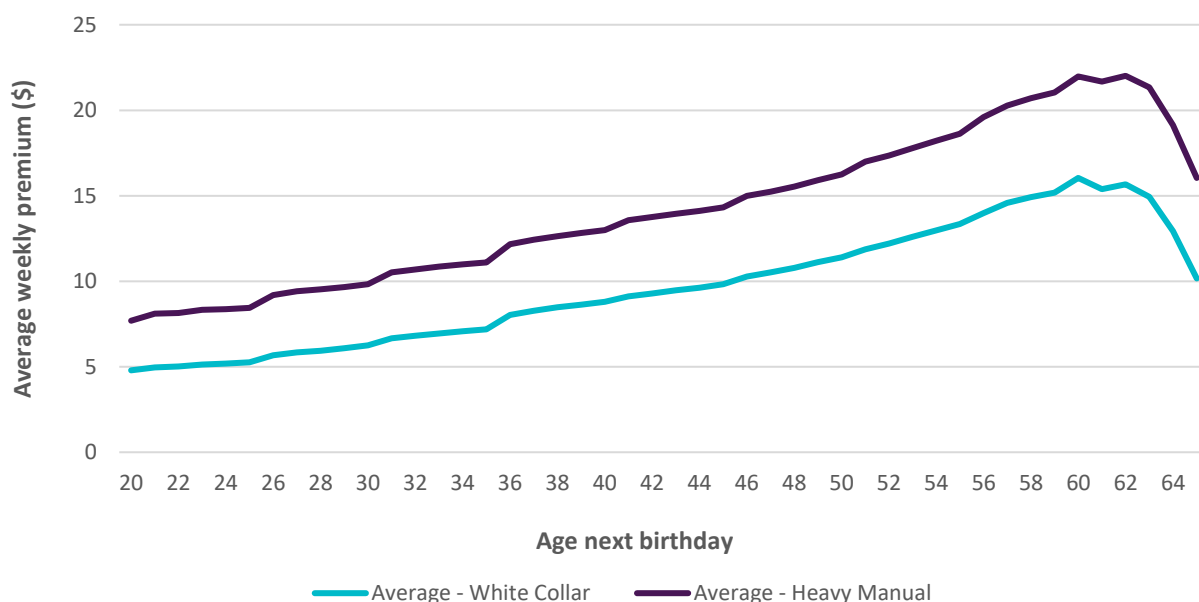
These graphs demonstrate the wide range of default premiums across funds. Due to the small number of members over age 65 with insurance we have excluded this data from the graphs.

Decreasing death and TPD premiums after age 61 are due to large reductions in default cover after this age in many funds. IP premium decreases reflect the reducing benefit period as members approach expiry age. Further, each occupation follows a similar premium shape with Heavy Manual occupations significantly higher due to the higher risks associated with manual occupations.

Graph 1. Death and TPD weekly insurance premiums for default cover - Female White Collar



Graph 2. DTPD and IP weekly premium for default cover – Female White Collar and Heavy Manual comparison



3.3 Affordability projections

To evaluate the impact of insurance premiums on retirement savings and affordability of cover, we have firstly calculated insurance premiums as a percentage of salary in the first year of membership and then over the lifetime of membership in the fund. Secondly, we reviewed the projected account balance at retirement age 65 on three bases; no insurance, death and TPD only, death and TPD and IP. The retirement balances are in future dollars, i.e. dollars at retirement date. Some of these results are included in this submission

Projections have been set out for females who on average, across the funds studied, have higher premiums than males. The results for males are similar although not as extreme. Details of the reduction in member account balances for members joining funds at various ages are shown for females in White Collar and Heavy Manual occupations in various scenarios to reflect the current situations of members.

The data for the projections was sourced from 21, mainly not-for-profit funds. Default premium costs were obtained from fund PDS documents with average account balance and contribution data collected in respect of a 12-month period ending 30 June 2015. For the purposes of our modelling, the average salary and account balance at each age has been aggregated across gender and occupational class for all funds combined.

3.3.1 *Insurance premiums as a percentage of salary for an average member*

This model uses the average insurance premium, salary and account balance at each age obtained from fund data to give an indication of the current situation for an average member, i.e. with average insurance premiums, average salary and average account balance.

Table 3 shows the cost of insurance as a percentage of salary in the first year of fund membership and the average cost over the lifetime of fund membership up to age 65.

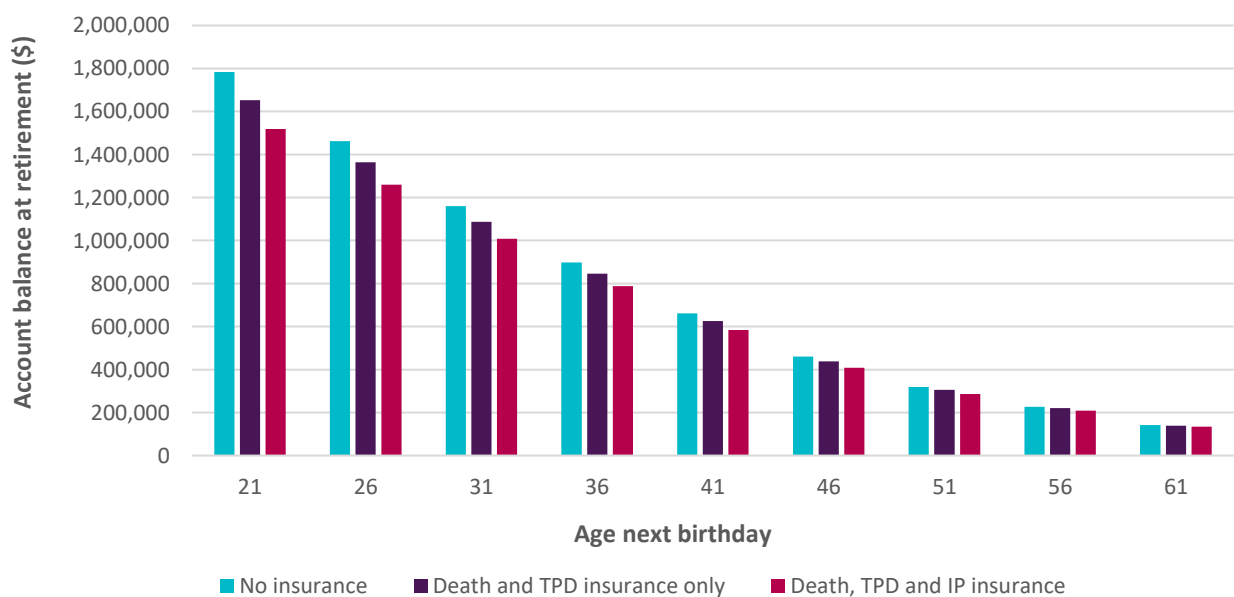
For White Collar and Heavy Manual occupations the average percentage of salary paid in insurance premiums over the individuals' fund lifetime is less than 1% of salary for death and TPD insurance only. With the addition of IP, the White Collar occupation premiums remain under 1% of salary for the younger ages. However, for a large portion of members in White Collar and Heavy Manual occupations, premiums are projected to take a higher percentage of contributions as members approach retirement.

Table 3. Insurance premiums as a percentage of salary

| Occupation | Age next birthday on joining | Death and TPD cover only | | Death, TPD and IP cover | |
|--------------|------------------------------|--------------------------|-----------------------|-------------------------|-----------------------|
| | | First year | Average fund lifetime | First year | Average fund lifetime |
| | | (%) | | | |
| White Collar | 21 | 0.72 | 0.52 | 1.24 | 1.02 |
| | 26 | 0.55 | 0.51 | 0.89 | 1.02 |
| | 31 | 0.49 | 0.51 | 0.84 | 1.04 |
| | 36 | 0.50 | 0.51 | 0.90 | 1.08 |
| | 41 | 0.54 | 0.52 | 0.99 | 1.13 |
| | 46 | 0.58 | 0.54 | 1.09 | 1.22 |
| | 51 | 0.62 | 0.56 | 1.27 | 1.34 |
| | 56 | 0.65 | 0.57 | 1.48 | 1.46 |
| | 61 | 0.58 | 0.56 | 1.74 | 1.55 |
| Heavy Manual | 21 | 1.00 | 0.74 | 1.98 | 1.54 |
| | 26 | 0.75 | 0.72 | 1.37 | 1.52 |
| | 31 | 0.68 | 0.73 | 1.28 | 1.55 |
| | 36 | 0.72 | 0.74 | 1.37 | 1.61 |
| | 41 | 0.80 | 0.75 | 1.52 | 1.68 |
| | 46 | 0.85 | 0.78 | 1.66 | 1.81 |
| | 51 | 0.90 | 0.80 | 1.91 | 1.98 |
| | 56 | 0.93 | 0.80 | 2.18 | 2.14 |
| | 61 | 0.83 | 0.78 | 2.51 | 2.29 |

Graph 3 provides a visual representation of the projected account balance at retirement with and without insurance for an individual in a Heavy Manual occupation based on joining the fund at various ages.

Graph 3. Projected retirement balances for the average situation – Heavy Manual – Future Dollars



3.3.2 Higher than average premiums

Further scenarios were carried out to test the affordability for an individual who is paying premiums equal to the average of the three most expensive funds.

For a member with death and TPD cover paying high premiums, the percentage of salary paid in premiums over their fund lifetime still remains reasonably affordable in a White Collar occupation - just tipping over 1.0% of salary to 1.1% of salary at the later ages.

For an individual in a Heavy Manual occupation with death and TPD cover only, the amount projected to be paid is above 1.0% of salary at all ages, but it remains at a reasonably consistent level of 1.3% to 1.4%. With the addition of IP, premiums exceed 1.0% of salary for all individuals regardless of occupation. The individuals in the Heavy Manual cohort are projected to pay premiums averaging 3.2% of salary over the range of age groups and up to 4.9% (Heavy Manual at age 61). In practice, some people in these occupations have high salaries and are likely to cut their insurance as they grow older.

3.3.3 No contributions

Our analysis indicated that a large portion of the membership has insurance premiums deducted without any contributions being made. Most the 21 funds continue cover for death, TPD and IP where there is sufficient money in the member's account to pay for premiums regardless of whether contributions are being received. A few funds set a minimum balance, which means that cover will cease when the account balance drops below a specified amount if contributions are no longer being received. For IP, a small number of funds cease insurance cover when no contributions have been received for a stated number of months.

Our model tests the affordability for members with no contributions into their superannuation account who continue to pay premiums.

We found a large impact on the retirement balance when insurance premiums continue after contributions cease. This is particularly evident for those at younger ages. For members with a Heavy Manual occupation, at younger ages the account balance is completely eroded; further, there is a significant impact at all ages, though cover reduces near retirement.

3.3.4 Removal of insurance cover at the earlier and later ages

Currently some funds have limited the provision of their standard default insurance offering to begin at later ages and to finish earlier. In some cases, only income protection is removed at these ages. To analyse the impact this has on retirement balances, we reviewed the impact for individuals only paying insurance premiums between the ages 26 and 55.

At all age groups, the average percentage of salary paid in premiums over the member's lifetime in the fund is below 1.0% for death and TPD cover, highlighting the positive impact that this restriction of insurance cover has on members' account balances. With the inclusion of IP, the average premiums exceed 1.0% but remain less than 1.5% of salary at all ages for White Collar occupations. For Heavy Manual occupations the percentage is higher, but still considerably lower than if cover was provided at all ages.

3.4 Conclusions

There is a wide differential in default premiums charged across the funds analysed. It is acknowledged that each fund has a different membership and that Trustees have designed benefits to suit the needs of their membership. This may involve offering:

- Only death and TPD cover as default or including IP cover.
- Differing amounts of cover.
- Differing eligibility and other policy terms such as disablement definitions and exclusions.

It is difficult for Trustees to determine a default insurance arrangement that meets the needs of every individual member - needs and circumstances differ substantially from member to member.

Our report has highlighted that for many portions of the membership, insurance is affordable, however, that for certain groups of members the cost of insurance may detrimentally impact retirement outcomes.

3.4.1 *Members with no contributions*

Our analysis indicates that where premiums are deducted from member accounts where there are no ongoing contributions, there is a serious risk of major impact to the account balance at retirement. Trustees must consider strategies to deal with this issue including cessation of all default cover shortly after contributions cease. Note that this will require careful communication to ensure members are aware when their insurance cover ceases. Special circumstances where continuation of cover is required could be recognised.

3.4.2 *Other key risk areas*

We expect the trend of increasing premium rates to continue given that insurer profit margins are not yet at the levels required by APRA. Whilst we do not expect the increases to be as high as those recently experienced by many funds, this trend highlights the need for ongoing consideration of insurance premium affordability.

We believe that focus should be on the following:

- Where funds have higher than average premiums, and for members paying high premiums due to being rated at the highest occupational classification, default cover should be reviewed with a view to providing lower levels of cover.
- Considering whether default IP cover is appropriate.
- Considering whether default cover is appropriate for members with low salaries, with intermittent contributions or with low account balances.

We believe that Trustees are well positioned to review and model the relevant situation for their members to understand the affordability of their insurance arrangements and to amend arrangements to suit the membership. Further guidance may be needed for some funds to assist with affordability for their members.

Some of the current issues have arisen due to the MySuper requirement to offer opt-out cover for all members. Amendment to these requirements could provide Trustees with scope to better tailor their cover to better meet the needs of members.

3.4.3 Voluntary Cover

Our *Affordability Study of Group Insurance in Superannuation* did not extend to non-default cover. Opt-in or voluntary cover makes up a small portion of cover in many funds and we would expect that most members with this cover will be aware that this cover is in place and of the level of premiums. More engagement is likely to lead to members making additional contributions where premiums are high. Trustees could consider mandating additional superannuation contributions above the SG level where additional cover exceeds a certain limit such as 5% of SG contributions.

4. Impact on Government and economy

When an Australian of working age dies, or becomes disabled, there are costs to the Government and the economy arising from:

- Lost taxation revenue from the person dying or becoming disabled and from their spouse where they need to cease work or reduce their working hours to care for family members.
- The provision of social security payments.
- Lost economic productivity and spending ability of the individual and their spouse.

All of the above costs are lessened where life insurance exists.

This section of the report sets out Rice Warner's estimate of the financial impacts of removing/reducing default life insurance from superannuation funds by placing a value on the cost to the Government and the economy of removing default insurance from superannuation funds.

To illustrate the possible impacts, we have modelled costs on two bases:

- **Basis 1:** All voluntary cover in superannuation is retained and all default cover removed (no changes to cover outside the wholesale superannuation environment). For the purposes of this calculation we have assumed that 10% of all death and TPD cover is voluntary cover and that one-third IP cover is voluntary.
- **Basis 2:** Total cover in the wholesale superannuation environment is reduced by 50%. This could occur if some members convert their default cover to voluntary cover. It is noted that for this to occur, it is likely that cover would either need to default to 'voluntary cover' or there would need to be very active campaigns to encourage individuals to act. This is based on current experience that only a small proportion of superannuation fund members actively move away from fund defaults (both for insurance and investments). Based on Rice Warner's review of nearly six million accounts less than 15% decide to move from the default. This situation of a 50% reduction in cover could also occur if default cover remains but at a lower level.

4.1 Reduced taxation revenue and reduced spending in the economy

In addition to the social security costs, there is a significant further cost on death through lost economic production and resulting income tax in respect of partners ceasing work to care for the family. Also, if everyone was fully insured, the Government would gain tax receipts in respect of investment income on invested insurance proceeds.

In addition to the social security costs borne by the Government, in the event of TPD and IP, there will be significant further losses in respect of partners ceasing work to care for the disabled person and any of their children.

Where a death, TPD or IP benefit is paid from a superannuation fund, the after-tax amount is available to meet the needs of the individual or their family. The APRA fund level statistics show the level of insurance payments made from funds over the financial year before tax. Therefore, the total amount paid in claims is a good approximation of the amount available as taxation revenue and money available for spending in the economy. We have taken these payments and adjusted them for the level of

estimated default benefits to derive the reductions in payments under Basis 1 and Basis 2 as set out in Table 4. Basis 1 and Basis 2 are described:

- **Basis 1 (Removal of all default cover in superannuation):** All voluntary cover in superannuation is retained and all default cover removed (no changes to cover outside the wholesale superannuation environment).
- **Basis 2 (Default cover in superannuation partially removed):** Total cover in the wholesale superannuation environment is reduced by 50%.

Table 4. Lost annual tax and spending capacity due to removal/partial removal of default cover

| | Basis 1 (Removal of all default cover in superannuation) | Basis 2 (Default cover in superannuation partially removed) |
|--|--|---|
| | (\$ million p.a.) | |
| Lost Tax and Spending Capacity due to reduced insurance claim payments | 4,040 | 2,240 |

In addition to the higher social security costs, the Government suffers further losses in respect of lost income tax as an outcome of partners ceasing work to care for the disabled person. As it is expected that low income earners are those most likely to cease work, the impact of this is less than the other impacts considered by this report and is therefore not included in this report.

4.2 Increased social security payments

4.2.1 Impact of social security entitlements on low income earners

For those on modest incomes, i.e. family income below \$41,390, social security benefits serve to reduce insurance needs substantially. Many such people have limited insurance as the Government provides a safety net. They are best served by the provision of modest levels of cover, together with advice at the time of death or disablement regarding the approach to maximising their social security benefits.

The Government is gradually rolling out the new National Disability Insurance Scheme (NDIS). It is not expected that this will have a large impact for working Australians and it will not provide income replacement.

4.2.2 Death cover

The social security cost to the Government of removing default death insurance is calculated as the difference between the current cost and the cost after removing default cover using Basis 1 and Basis 2 as previously described.

The cost is taken to be the present value of the cost to the Government of one year's deaths across the population. It is calculated as the sum, across the working age population, of:

- (the probability of death), *multiplied by*
- [the present value of (social security payments after death if fully insured, *less* social security payments after death if not insured) x proportion of people who do not have death cover, *plus*

- the present value of (social security payments after death if fully insured, less social security payments after death based on median level of death insurance) x proportion of people who have death cover using the percentages in Table 5.

The *ABS Life Table 2011 to 2013* has been used to determine the probability of death in Table 6.

Table 5. Proportion of people with death cover and median death insurance

| | Current Position (with Default Death Cover) | Remove Default Death Cover | |
|---|---|----------------------------|---------|
| | | Basis 1 | Basis 2 |
| | (%) | | |
| Proportion of people who have death cover of some kind | 95 | 29 | 58 |
| Current median level of death insurance as a percentage of basic needs for those with cover | 65 | 100 | 74 |

Table 6. Age dependent death rates

| Age | Male | Female |
|----------------|--------|--------|
| | (%) | |
| People aged 20 | 0.0506 | 0.0237 |
| People aged 30 | 0.0769 | 0.0358 |
| People aged 40 | 0.1365 | 0.0757 |
| People aged 50 | 0.2879 | 0.1779 |
| People aged 60 | 0.6631 | 0.4029 |

Given that the overall working age population is relatively stable, albeit increasing and ageing slightly, the same calculation, assuming no indexation of benefits and no discounting, gives a good estimate of the current annual cost to the Government of life underinsurance.

On the basis set out in this section, the current total cost to the Government in social security payments of death underinsurance across Australia is currently estimated to be **\$46.3 million** per annum.

The cost to the Government in social security payments after removing/reducing default death insurance has been calculated on the following bases:

- Basis 1 (Removal of all default cover in superannuation):** All voluntary cover in superannuation is retained and all default cover removed (no changes to cover outside the wholesale superannuation environment).
- Basis 2 (Default cover in superannuation partially removed):** Total cover in the wholesale superannuation environment is reduced by 50%.

The cost to the Government in social security payments after removing/reducing default death insurance completely would escalate to:

- **Basis 1: \$81.7 million per annum**
- **Basis 2: \$66.3 million per annum**

Hence the increased cost to the Government in social security payments due to the removal/reduction of default death insurance is:

- **Basis 1: \$35.5 million per annum**
- **Basis 2: \$20 million per annum**

4.2.3 TPD

The social security cost to the Government of removing default TPD insurance is calculated as the difference between the current cost and the cost after removing default cover using Basis 1 and Basis 2 as previously described.

The cost is taken to be the present value of the cost to the Government in social security payments of one year's TPD incidents across the population. It is calculated as the sum, across the working age population, of:

- (the probability of becoming TPD in a year), *multiplied by*
- [the present value of (social security payments after TPD if fully insured, *less* social security payments after TPD if not insured) x proportion of people who have no TPD cover, *plus*
- the present value of (social security payments after TPD if fully insured, *less* social security payments after TPD based on median level of TPD insurance) x proportion of people who have TPD cover using the percentages in Table 7.

The estimated average TPD claim incidence rate is in Table 8.

Table 7. Proportion of people with TPD cover and median TPD insurance

| | Current Position (with Default Death Cover) | Remove Default Death Cover | |
|---|---|----------------------------|---------|
| | | Basis 1 | Basis 2 |
| | (%) | | |
| Proportion of people who have TPD cover | 69 | 13 | 38 |
| Current median level of TPD insurance as a percentage of basic needs for those with cover | 19 | 30 | 21 |

Table 8. Age dependent TPD rates*

| Age | Male and Female |
|----------------|-----------------|
| | Combined (%) |
| People aged 20 | 0.0202 |
| People aged 30 | 0.0428 |
| People aged 40 | 0.1327 |
| People aged 50 | 0.3898 |
| People aged 60 | 1.5036 |

*These rates are estimated from historical claim rates for a number of industry superannuation funds, adjusted to remove the estimated impact of the modest selection that occurs on acquiring insurance at the time of entering such funds.

Given that the overall working age population is relatively stable, albeit increasing and aging slightly, the same calculation, assuming no indexation of benefits and no discounting, gives a good estimate of the current cost to the Government of TPD underinsurance.

On the basis set out in this section, the current total cost to the Government in social security payments of TPD underinsurance is calculated to be **\$952 million** per annum.

This amount is small compared with federal Government payments in assistance to those with disabilities (and their carers), which are budgeted to be \$25.5 billion in the 2017-18 financial year.³ There are two reasons for this:

- There are likely to be large number of people who are eligible for disability related social security benefits, but are not eligible to claim a TPD insurance benefit.
- For many people in households, where household income is less than \$41,390 per annum for a couple or \$11,820 for single parents, it is assumed that no TPD insurance is established as social security benefits are sufficient to replace lost income. These social security costs are included in the \$25.5 billion Government benefits, but will not be replaced by insurance.

The cost to the Government in social security payments after removing/reducing default TPD insurance has been calculated on the following bases:

- **Basis 1 (Removal of all default cover in superannuation):** All voluntary cover in superannuation is retained and all default cover removed (no changes to cover outside the wholesale superannuation environment).
- **Basis 2 (Default cover in superannuation partially removed):** Total cover in the wholesale superannuation environment is reduced by 50%.

The cost to the Government in social security payments after removing/reducing default TPD insurance is:

- **Basis 1: \$2.49 billion per annum**
- **Basis 2: \$1.81 billion per annum**

³ Source: Australian Government 2017-18 Budget Paper No1.15A, Table 2.1.1.

The increased cost to the Government in social security payments due to the removal/reduction of default TPD insurance:

- **Basis 1: \$1.54 billion per annum**
- **Basis 2: \$0.857 billion per annum**

4.2.4 Income protection

The social security cost to the Government of removing default IP insurance is calculated as the difference between the current cost and the cost after removing default cover using Basis 1 and Basis 2 as previously described.

The cost is taken to be the present value of the cost to the Government of one year's IP incidents across the population. It is calculated as the sum, across the working age population, of:

- (the probability of becoming temporarily unable to work for more than two weeks in a year), *multiplied by*
- (average duration of a claim), *multiplied by*
- [(the yearly social security payments after becoming disabled when insured to replace 85% of income, *less* the yearly social security payments after becoming disabled when not insured) x proportion of people who have no IP cover, *plus*
- (the yearly social security payments after becoming disabled when insured to replace 85% of income, *less* the yearly social security payments after becoming disabled when insured to replace 43% of income) x the proportion of people who have IP cover] using the percentages in Table 9.

The estimated average claim incidence rate for income protection due to accident or sickness with a two week waiting period is in Table 10.

Table 9. Proportion of people with IP cover and median IP insurance

| | Current Position (with Default Death Cover) | Remove Default Death Cover | |
|---|---|----------------------------|---------|
| | | Basis 1 | Basis 2 |
| | (%) | | |
| Proportion of people who have IP cover | 41 | 9 | 24 |
| The current average level of income protection as a percentage of income for those with cover | 40 | 86 | 50 |

Table 10. Age dependent income protection rates*

| Age | Male and Female |
|----------------|-----------------|
| | Combined (%) |
| People aged 20 | 0.1790 |
| People aged 30 | 0.1828 |
| People aged 40 | 0.2462 |
| People aged 50 | 0.3259 |
| People aged 60 | 0.4109 |

*These rates are estimated from historical insurer data, increased by 95% to allow for population rather than insured lives morbidity, and the recent market experience of increases in disability claim rates.

The average duration of an income protection claim with a deferred period of two weeks is estimated to be approximately six months.

On the basis set out in this section, the total cost to the Government of income protection underinsurance is calculated to be around **\$276.8 million** per year.

However, we do note that to the extent that those who are temporarily disabled may continue to receive sick leave benefits from their employer beyond the first two weeks of disablement, making them ineligible for social security payments, this figure may be over-stated.

The cost to the Government in social security payments after removing/reducing default IP insurance has been calculated on the following bases:

- **Basis 1 (Removal of all default cover in superannuation):** All voluntary cover in superannuation is retained and all default cover removed (no changes to cover outside the wholesale superannuation environment).
- **Basis 2 (Default cover in superannuation partially removed):** Total cover in the wholesale superannuation environment is reduced by 50%.

The cost to the Government in social security payments after removing/reducing default IP insurance is:

- **Basis 1: \$361.8 million per annum**
- **Basis 2: \$322.5 million per annum**

The increased cost to the Government in social security payments due to the removal/reduction of default IP insurance:

- **Basis 1: \$85.0 million per annum**
- **Basis 2: \$45.6 million per annum**

4.2.5 Increased cost to the Government in social security payments due to the removal of default insurance

The overall annual social security cost of removal/reduction of all default insurance is summarised in Table 11.

The cost to the Government in social security payments after removing/reducing default insurance has been calculated on the following bases:

- **Basis 1 (Removal of all default cover in superannuation):** All voluntary cover in superannuation is retained and all default cover removed (no changes to cover outside the wholesale superannuation environment).
- **Basis 2 (Default cover in superannuation partially removed):** Total cover in the wholesale superannuation environment is reduced by 50%.

Table 11. Annual social security cost of removal/reduction of default insurance

| | Basis 1 | Basis 2 |
|------------------------------|------------------|---------|
| | (\$million p.a.) | |
| Default death cover removal | 35.5 | 20.0 |
| Default TPD cover removal | 1,540.0 | 856.6 |
| Default IP cover removal | 85.0 | 45.6 |
| Removal of all default cover | 1,662.5 | 922.2 |

4.2.6 Reduction in stamp duty revenue due to the removal of default insurance

Stamp duty is payable on life insurance premiums in Australia. The amount of stamp duty varies by state/territory and by type of cover. In some instances, it is payable on all premiums and in others it is payable on first year premium only. It is estimated that the removal of default life insurance will result in a reduction of stamp duty revenue across all states and territories of \$270 p.a. for Basis 1 and \$154 p.a. for Basis 2. The stamp duty costs have been estimated as approximately five percent of the premium lost each year.

4.2.7 Comments

The cost to the Government in social security payments of removing default TPD insurance is greater than that for death insurance because:

- In the event of TPD, the family receives disability benefits in addition to additional family tax benefits, subject to means testing.
- TPD insurance has the effect of reducing social security benefits more than life insurance does:
 - The required sums insured (to meet the insurance objective) are higher for TPD than for life insurance.
 - The social security income and assets tests are stricter for disability benefits than for family tax benefit, the latter being relatively more significant upon death.

5. Possible improvements

5.1 Opportunity for improvement and progress to date

We acknowledge that insurance within superannuation is extremely complex. Many issues have arisen due to a combination of:

- Various pieces of legislation that have developed over time involving taxation, SIS Act, Corporations law, superannuation guarantee, workers compensation etc.
- Competition for business among insurers and funds.
- Changing work patterns.
- New illnesses and treatments.
- Developments in rehabilitation and return to work strategies.
- Increasing mental health issues.
- The interaction and possible overlap with other sources of disability benefits such as social security, workers compensation, sick leave, employer insurance policies and personal policies.

This complexity sometimes makes solutions difficult. We consider that in the main the industry is self-correcting and many improvements have been made over recent years such as:

- Tightening eligibility conditions and other policy terms to reduce the risk of anti-selection and ensure those with the greatest need receive benefits.
- Increasing premiums to levels which match the risk.
- Many funds reducing benefits for younger members to avoid over-insurance.
- The Insurance in Super Working Group is covering many of the aspects of insurance inside superannuation that require addressing, including erosion of account balances due to insurance premiums, communication and data. Rice Warner has contributed submissions in response to its review.

However, there are a number of areas where improvements could be made.

5.2 Insurance for young members

In our previous submission to the Productivity Commission on Alternative Default Models⁴, we recommended that younger MySuper members (say, under age 25) not be provided insurance by default. This would reduce the number of young members who are subject to over insurance, especially those who hold multiple accounts. Members would still be able to opt-in to insurance cover if they would so choose and this would ideally be provided on the same basis as previous default arrangements (e.g. limited or no underwriting).

We maintain this recommendation in this submission.

⁴ http://www.ricewarner.com/wp-content/uploads/2016/11/Final_Rpt_Submission-to-the-Productivity-Commission-re-Alternative-Default-Models.pdf

5.3 Removal of income protection as a default benefit

Income protection cover is a valuable benefit for employees. However, the cover within superannuation is generally at low levels. Further, cover is often restricted to two year benefit periods which does not protect the employee who has a long-term injury or sickness.

As shown in our earlier analysis of affordability, where default income protection is included, balances are likely to be eroded further than if only death and TPD cover is provided. There are areas of concern such as younger ages or those with intermittent contributions where the member has not built up a substantial balance. It is also important to note that IP premiums increase substantially from about age 40.

Income benefits are reduced by other sources of income so where a member is receiving a workers' compensation benefit or has a payout from another policy, such as a life policy held outside superannuation, there may be little real benefit receivable from the IP cover in superannuation.

We note that premiums for income protection cover held outside superannuation are generally tax deductible to individuals and employers. For those employees wanting to maximise their contributions as they get older, they will want to steer as little as possible into insurance premiums. For these members, holding the cover outside superannuation is beneficial.

Consideration should therefore be given to removing default IP cover from superannuation funds. Voluntary cover could be retained as an option, but we question whether funds would want to maintain the administration. In some circumstances, employers might be prepared to pay for the cover.

5.4 Insurance and account consolidation

Each member has on average 1.75 superannuation accounts. Whilst much of this is due to inaction of members to close accounts when they move to a new employer with a different superannuation fund, a small proportion of individuals maintain multiple accounts to retain insurance cover provided by each of their funds. When this occurs, the individual has made an active choice, sometimes with the assistance of a financial planner. This is unlikely to be a concern unless the member does not review their cover over time, thereby maintaining cover at an increasing cost which erodes their superannuation balance.

Many funds offer transfer of cover which means that they will provide members with the level of cover provided by their previous fund, if cover is cancelled. This could be a mandatory requirement for death and TPD cover. Alternatively, funds could be required to offer a personal policy with the same level of cover when the member leaves the fund. In either case the member would not be expected to provide medical evidence to continue their cover. To mandate these changes, agreement would be needed from all life insurers, and the likely impact is increased premiums for everyone.

We recommend further investigation into the extent of this problem to determine whether changes are needed. However, funds could cease all cover within a period of a few months once a member leaves a fund, unless the member specifically requests cover to continue.

5.5 Delays in receiving death benefits

One of the concerns raised regarding having insurance cover in superannuation is the delay in paying death claims. This can result in hardship for beneficiaries, who need to pay for a funeral and day to day living costs. Whilst Trustees are focused on this issue, the reason for the delay is the time taken to ensure that the payment is going to the right person. This is an important service that the Trustee provides.

Various solutions have been implemented by some funds which all contribute to improving the situation for beneficiaries. Binding death nominations mean that the member can nominate who the Trustee must pay benefits to and this works in many situations but not where the member has nominated a person who is not a dependant.

The Trustee can choose to pay the death benefit to the estate. Where the estate is complicated or has a large debt, funds may not be released to those requiring it. One possible solution for consideration is paying all death benefits to the estate but with legislation that quarantines the superannuation benefit from the rest of the estate. This would remove the administration from the fund.

We believe that a small amount (say \$10,000 to \$15,000) of the death benefit could be released quickly to meet funeral expenses. This would be an advance of the death benefit which would be deducted from the final benefit once paid.

Appendix A Data sources

A.1 Research – Rice Warner *Affordability Study of Group Insurance in Superannuation*

This report includes projections and data contained in Rice Warner’s December 2016 *Affordability Study of Group Insurance in Superannuation*.

A.2 Research – Rice Warner *Underinsurance in Australia*

For the purposes of this report we have used the model, data and assumptions from Rice Warner’s 2015 *Underinsurance in Australia Report* with minor adjustments only.

A.3 Key sources of data

- ABS including census data - this report largely makes use of 2011 census data with some allowance for population totals set out in the recently issued 2016 census data.
- National Centre for Social and Economic Modelling (NATSEM).
- RBA’s Hilda Release 15.0, Securitisation System.
- APRA Annual Fund-level Superannuation statistics as at 30 June 2016.
- Social security, tax and superannuation guarantee legislation current as at 1 August 2017.
- Rice Warner superannuation *fund and insurance data*.
- Social Security Benefits considered:
 - Family Tax Benefit Part A
 - Family Tax Benefit Part B
 - Parenting Payment
 - Child Care Benefit
 - Child Care Rebate
 - Estimating average hours of childcare
 - Disability Support Pension
 - Pension Supplement
 - Carer Payment
 - Carer Allowance
 - Carer Supplement
 - Sickness Allowance.