



## THE EFFICIENCY AND COMPETITIVENESS OF THE SUPERANNUATION SYSTEM

### Submission to the Productivity Commission on the Superannuation Competitiveness and Efficiency Draft Report

This Submission is a joint submission of:

- the Consumer Action Law Centre, a campaign-focused consumer advocacy organisation based in Victoria,
- Berrill & Watson Lawyers, a national consumer legal firm practicing exclusively in superannuation and insurance,
- the Chronic Illness Alliance, a peak body representing 55 state and national disability organisations in health policy and health services for all people with chronic illnesses

#### 1. Introduction

This submission is limited to commentary on the terms of reference regarding insurance in superannuation.

We do not have access to much of the relevant data as to the matters raised by Treasurer Morrison. However, hopefully we can provide some information and commentary which may assist the Productivity Commission in assessing how to improve the efficiency of insurance within superannuation, including default insurance cover.

#### 2. The History of Insurance in Superannuation

Insurance has been an integral part of Australian superannuation funds for decades.

Employer-sponsored defined benefit funds and government pension schemes included permanent incapacity lump sums or pensions with some underwritten or reinsured by life insurers. The 1980's saw the introduction of award superannuation which heralded the birth of superannuation industry funds. Together with traditional retail funds, they provided life, Total and Permanent Disability (TPD) and income protection insurance benefits under group contracts funded by premiums deducted from occupational superannuation contributions.

The introduction of compulsory employment superannuation in 1992 continued this trend with millions of Australians obtaining life insurance for the first time.

Modest default death insurance cover upto \$50,000 was mandated as part of the introduction of Choice of Fund legislation in 2005 and default death and TPD cover and optional income protection insurance cover were included as minimum standards for MySuper funds in 2014.

The vast majority of Australian workers now have life insurance in some form, with employment superannuation the dominant mechanism through which it is provided. A Rice Warner report in 2014 found that 71% of death cover, 88% of Total and Permanent Disability (TPD) cover and 59% of income protection insurance was sourced through group insurance policies under superannuation.<sup>1</sup>

Superannuation fund members can increase or add to their insurance cover and they can also reduce or opt out of cover altogether under the default MySuper regime.

There are currently approximately 28 million superannuation accounts spread across nearly 15 million Australian workers, meaning that many Australians have duplicate accounts. However, that number has fallen from a height of 33 million accounts some 7 years ago following the impact of mandatory account consolidation under the 2013 Stronger Super reforms and changes to the Lost Super rules which took effect from December 2012.

Many Australians with multiple superannuation funds also have multiple insurance cover largely because of a shift in the last decade from contribution-based insurance cover to continuing account-based cover. This resulted in many inactive superannuation accounts (those without ongoing contributions being paid) still having active insurance cover with premiums deducted from member account balances. In some cases, premiums and administration fees have eroded inactive accounts to nil.

It is the erosion of superannuation fund accounts by rising insurance premiums and media reports about denied insurance claims that has led some to question the value of insurance within superannuation.

### 3. The Value of Insurance in Superannuation-Reduced Social Security reliance

So why is life insurance part of superannuation in Australia and does it represent value for money for fund members?

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<sup>1</sup> Rice Warner "Insurance Administration Expenses" 2014, page 2.

Benefits for death and disability come within the ambit of the sole and ancillary purpose tests respectively under the Superannuation Industry (Supervision) Act 1993, namely benefits that are related to the provision of retirement incomes. TPD benefits, typically lump sums, top up the retirement incomes of members whose working lives are cut short because of disability such that they would otherwise not have accumulated enough money to live off in retirement.

Death insurance benefits are designed to top up the benefits payable to a deceased member's dependents, again on the basis that premature death would likely leave dependents short of monies they would otherwise have depended upon from the deceased.

The correlation between insurance and retirement incomes policy is less clear with regard to top up temporary incapacity or income protection payments, except perhaps as a means to support a fund member to return to the productive workforce and thereby resume the accumulation of retirement incomes.

Without such insurance benefits, Australians whose working lives are cut short because of disability would likely not have adequate retirement incomes and would be dependent on the Australian welfare system as age or disability support pensioners.

Rice Warner in a report in 2014 estimated that insurance within superannuation saved the Australian taxpayer \$403 million per annum or up to \$10 billion since the inception of compulsory superannuation.

Insurance in superannuation is a means of ensuring self-funded retirement for people with disabilities which is consistent with retirement incomes policy.

Insurance in superannuation also operates as the biggest hedge against the substantial life underinsurance problem in Australia.<sup>2</sup>

Loss ratios for group insurance death and TPD claims are currently approximately 85%<sup>3</sup>, indicative of the cost effectiveness and successful targeting of group insurance. Such loss ratios compare very favourably with other types of insurance.<sup>4</sup>

Accordingly, insurance fits well in superannuation and has contributed to the retirement incomes of tens of thousands of Australians. It has also reduced the burden on the Australian taxpayer to provide age and disability support pensions, again consistent with retirement incomes policy.

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<sup>2</sup> See Rice Warner report "Underinsurance in Australia" 2016.

<sup>3</sup> See Productivity Commission Inquiry "How to Assess the Competitiveness and Efficiency of the Superannuation System" Submission 31, Mercer Consulting (Australia) Pty Ltd at page 29.

<sup>4</sup> See for example the APRA General Insurance Supplementary Statistical Tables, June 2013, which compared the gross earned premiums and incurred claims across classes of general insurance business (although not a direct comparison, it provides an indicator of low loss ratios across some classes of business).

## 4. The Impact of Insurance Premiums on Retirement Incomes

Insurance comes at a cost to the accumulation of members' superannuation through premiums necessary to fund the insurance.

For many years those premiums were small, typically no more than a few dollars per week, albeit for comparatively modest benefits.

Group insurance premiums were levied at wholesale rates on the healthiest sector of the population, namely people in work "receiving" employment superannuation contributions. Economies of scale and lower compliance obligations (such as the provision of less tailored information and documents) with few individual underwriting assessments meant that administration costs of group life policies were significantly lower than for individual retail products.

In addition, the claims experience of most funds and insurers was flattened by a lack of member awareness, a substantial shift in state-based compensation schemes away from lump-sum redemptions (with a greater emphasis on rehabilitation) and relatively narrow interpretations by the courts of definitions of TPD.

The result was a benign claims experience and low insurance premiums, much lower than for retail products.

However, this changed approximately 5 years ago. A combination of heightened member awareness, due in part to advertising by lawyers, poor pricing by life companies bidding for market share with large superannuation funds after the introduction of Choice of Fund laws, and lax claims and underwriting practices led to a spike in claims and payouts which substantially reduced the profitability in the sector.

This attracted the attention of APRA and led to insurers increasing premiums, tightening claims processes and narrowing policy terms and conditions.

In some cases, group life premiums increased substantially<sup>5</sup> and some insurers amended definitions of TPD to add retraining clauses or provided limited benefits to members in 'high risk' occupations requiring that they satisfy a much harsher 'activities of daily living' test.

Average insurance premiums are currently approximately \$250-\$350 per annum<sup>6</sup> although these figures have plateaued or even dropped in the last 12 months.

Rejected claims attracted the attention of the media and insurance in superannuation was swept up in the Fairfax expose of CommInsure's claims practices.

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<sup>5</sup> See SuperRatings Report 2016 which reported that default death and TPD insurance premiums increased by an average of 10% p.a. in the previous 4 years with median rises of 50% in 2015/16.

<sup>6</sup> See SuperRatings Report 2016 which reported that average death and TPD insurance annual premiums were \$239 for a 40-year old and \$243 for a 45-year old (or 3.3% and 3.4% of Superannuation Guarantee contributions respectively).

The Willis Towers Watson Report "Super Watch Default Insurance Design" September 2016 reported that the median default insurance costs for members were \$240 pa at age 25, \$260 pa at age 35, \$324 pa at age 45 and \$395 pa at age 55.

Not surprisingly this has led to some questioning the efficiency of insurance in superannuation and whether the current default system needs changing so that insurance premiums don't excessively erode workers' account balances.

## 5.Improvements in Default Cover Through Superannuation

### 5.1 Capping Premiums

Whilst insurance in superannuation is consistent with retirement incomes policy, there is undoubtedly a tipping point beyond which it is not efficient and does not deliver value for money for members. ie. a cost effective hedge against inadequate retirement incomes in the event of premature death or disability.

Every dollar taken from a member's account balance compounds as a reduction in monies to be invested and the ultimate retirement income of the member. Accordingly, it is important that insurance premiums are capped at a modest proportion of superannuation contributions, at least in the default settings.

Compulsory superannuation guarantee contributions are currently static at 9.5% of an employee's Ordinary Time Earnings (OTE). They are due to progressively rise to 12% of OTE between 2021/22 and 2025/26. The average superannuation account balance is currently upwards of \$100,000.<sup>7</sup>

It has been suggested that insurance premiums should not exceed a modest percentage of superannuation guarantee contributions and should not be deducted from accounts that have been inactive for more than 12 months and fall below \$6000, the latter being consistent with the current Lost Super thresholds.

These seem to be reasonable safety nets against account erosion whilst accommodating reasonable levels of default insurance cover.

Some categories of members such as young members and those close to retirement age may require further safety net protections such as lower superannuation guarantee percentage caps or perhaps a partial shift to opt in for death cover only for young members.

The Insurance in Superannuation Working Group (referred to in paragraph 5.3 below) is currently undertaking a detailed analysis of premium caps, which it is suggested would be worthwhile to take into consideration.

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<sup>7</sup> See Association of Superannuation Funds of Australia "Superannuation account balances by age and gender", December 2015 which reported that the average account balance in 2013/14 was \$76,000, inclusive of accounts with nil balances. Excluding accounts with nil balances, males has accounts with an average of \$135,000 and females had accounts with an average of \$83,000.

## 5.2 Account Consolidation

There is also the issue of multiple superannuation accounts with duplicate insurance under which members' accounts are eroded by premiums without any worthwhile benefits. This is particularly true of accounts providing duplicate income protection insurance payments which are invariably offset one against the other. It is less of a problem with TPD and death insurance benefits which are not usually offset although in a small number of cases the total cover may exceed a person's retirement income needs.

There is a clear efficiency need to avoid unnecessary duplication of insurance cover, specifically with respect to income protection insurance.

The question is how to best avoid unnecessary insurance duplication. Given the variation in benefits and terms and conditions, it would be very difficult to design insurance comparators to address policy duplication.

For example, if a member has two superannuation funds, both with income protection cover, they may have differing benefit periods, monthly sums insured, eligibility requirements, offsets and exclusions. Whilst it may be appropriate to cancel one of the policies, the design of a default option or the identification of a preferred option by a member who was unlikely to be "engaged" such as to be in a position to make an informed decision would be problematic.

Duplicate insurance arises because of multiple accounts, one or more of which is likely to be inactive. Inactive accounts are often indicative of a lack of income from personal exertion, which is an eligibility threshold for income protection insurance. In other words, it is possible that premiums paid for income protection insurance on inactive accounts will not yield any net benefit to members in the event of disability.

Accordingly, targeting inactive superannuation accounts may be an appropriate measure to avoid unnecessary insurance duplication. In this regard, the Stronger Super reforms included a three-step legislative program to consolidate inactive superannuation accounts. The first two tranches were legislated but the third tranche was not. Under the third tranche, a new employee would choose his/her superannuation fund and the trustee of that fund would then identify the member's other accounts and would consolidate those accounts into the new fund on a member opt out basis.

It is submitted that this automatic consolidation measure should be revisited. With added consumer protections to avoid the cancellation of non-replicated cover (or a no disadvantage test limited to default death and standard TPD cover) and appropriate communication measures, duplicate insurance policies with little or no value could be a thing of the past.

## 5.3 The Insurance in Superannuation Working Group

The life insurance and superannuation industries have recognised the above problems and have set up the Insurance in Superannuation Working Group (ISWG) to develop best practice product designs.

Premium caps, account consolidation, standard definitions and avoidance of duplicate insurance cover are key elements of reforms the ISWG is undertaking.

Particular attention has been given to make it easier for fund members to vary, reduce or opt out of their default insurance. Some superannuation funds have been criticised for inefficient and cumbersome procedures for the variation or cancellation of insurance cover. Streamlined and seamless electronic mechanisms to accommodate member choice is an important piece of the ISWG's work.

Together with enhanced member education, information sharing and a superannuation and insurance code of practice to deal with sales, claims and complaints, the ISWG's work represents the largest suite of reforms to insurance in superannuation ever undertaken in Australia.

The insurance in superannuation code of practice follows on the heels of the life insurance code of practice which commenced operation on 1 July 2017.

The insurance in superannuation code is being developed with consumer input and will, in all likelihood, be overseen by a Code Compliance Committee with audit and sanction powers. The code is due to be finalised by the end of 2017 and commence operation in 2018.

The codes will require harmonisation for insurance in superannuation claims and complaints to be dealt with effectively and it will be important to review the codes after a year or two of operation. However, codes of practice represent a significant step forward for the life insurance and superannuation industries in consumer protection and enhancing the efficiency and cost-effectiveness of insurance in superannuation.

#### 5.4 Opt-out, Opt-in Default cover

One issue which is receiving some attention is whether default death and TPD insurance cover in MySuper-compliant funds should remain opt out or should be switched to opt in.

The Stronger Super reforms of 2014 recognised the reality that most superannuation fund members were not actively engaged with their superannuation and set minimum standards for default products, including balanced investment portfolios, bans on commissions and default death and TPD insurance cover.

The Cooper Review, which led to the reforms, acknowledged the importance of insurance in superannuation but stressed that the amount and type of suitable insurance cover would vary from one fund to another depending on membership demographics and the needs of particular members. Accordingly, the Stronger Super legislation mandated that trustees develop and regularly review insurance strategies and ensure that insurance premiums do not inappropriately erode the retirement incomes of beneficiaries.<sup>8</sup> They also mandated that funds must give members the ability to reduce or opt out of insurance cover.

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<sup>8</sup> See Section 52(7) of the Superannuation Industry (Supervision) Act 1993.

It is fair to say that, in the periods before and after the commencement of MySuper, some superannuation funds lost their way in fulfilling these obligations and some insurance has, of recent times, not been value for money and has led to unnecessary account erosion.

So, should we move to opt in?

The short answer is no, because to do so would spell the end of insurance within superannuation.

A significant proportion of all employment superannuation is held in MySuper-compliant funds, a percentage that is rising sharply as workers change jobs or enter the workforce and “choose” a superannuation fund.<sup>9</sup>

Past consumer behaviour informs that only up to approximately 10% of workers will actively choose their insurance in superannuation<sup>10</sup>, a fact acknowledged by the Cooper Review in aligning default insurance with MySuper.

It is because of member behaviour and an acknowledgement of the importance and value of default insurance in superannuation that current insurance penetration rates are so high.

If the switch was made to opt in, member behaviour would be unlikely to change significantly, at least in the short to medium term. This would translate to the penetration rate of insurance in superannuation falling from the current very high levels to something approaching the rate of members who currently exercise choice (i.e. from approximately 90% to as low as approximately 10%).

Within a short period of time, millions of Australians would lose the only life insurance they hold, with many having no idea they had lost their insurance and most not having made an informed decision to drop the cover.

Of the small percentage of members who elect to opt in, there would be a substantial anti-selection risk for insurers which would inevitably lead to increased underwriting requirements, whether by way of medical health checking or including exclusions or limitations for pre-existing conditions.

Because the membership pool would be much smaller, the risk profile of members compromised and the underwriting and compliance costs higher, premiums would inevitably rise. This would in turn reduce the membership pool further as insurance became less affordable and put group insurance in superannuation into a death spiral.

The end result would be a major disruption to the Australian life insurance market with a dramatic exacerbation of the under-insurance problem. This would in turn increase pressure on the welfare system with superannuation fund members who leave the workforce prematurely because of disability more likely to be dependent on Social Security payments.

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<sup>9</sup> See APRA Quarterly Superannuation Performance, June 2017, which reported that total assets in MySuper products was \$594 billion, a 25.5% increase on the 2015/16 financial year.

<sup>10</sup> See APRA Quarterly MySuper Statistics June 2017 which reported that across all MySuper accounts, only 5% of people exercised their choice to opt out of death, TPD or income protection insurance cover.

Of some of the large funds, the opt out rate for members of REST was 6% for death cover and 11% for TPD cover and for Australian Super was 8% for death cover and 11% for TPD cover.



## 6. Summary

Superannuation has delivered life insurance to millions of Australians in an efficient and affordable pathway. It has had its problems over the last five years, problems that are in need of rectification to protect the integrity of the retirement incomes system.

The superannuation and insurance industries have recognised the importance of insurance in superannuation and through the ISWG are moving towards improvements in product design, streamlined implementation of member choice, education, data sharing and claims handling. These measures should significantly improve the efficiency and cost-effectiveness of the system.

It is our strong submission that it would be throwing the baby out with the bathwater to move default superannuation to an opt in insurance model. It would put the retirement incomes of thousands of Australians at risk and add to the burden on the Australian taxpayer.

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August 2017.