

Submission to the Productivity Commission

Inquiry into the Competitiveness and
Efficiency of the Superannuation System

2017



For further information, please contact:

Jeremy Houghton

Head of Strategy and Corporate Affairs

Ph: +61 3 9009 4000

Email: AUCorporateCommunications@AIA.COM

This document © AIA Australia Ltd. All rights reserved.



**WE'RE
FOR LIFE**

Executive Summary

The Productivity Commission's Superannuation inquiry is an opportunity to ensure all Australians attain the best value from their superannuation. As one of the largest life insurers in Australia, protecting over 3.5 million people, AIA Australia recognises the importance of a competitive and efficient superannuation system in helping Australia meet the economic and fiscal challenges of an ageing population. This includes the important role of insurance in the system.

We are proud of the work we do supporting individuals and families during difficult times. AIA Australia paid over \$900 million in claims to group insurance members on over 13,000 claims in 2016. The industry paid \$4.94 billion in claims for group insurance in the same year.¹ In the five years to 2016, 81 cents in every dollar collected in premiums was paid back through claims to members.² This shows the significant level of financial support that group insurance efficiently provides to individuals and their families. However, we believe that if even one individual or family has a bad experience, this is a critical issue that needs to be addressed.

Given the importance of what we do, the standards we set ourselves as an industry must be of the highest nature. We must continually look to improve our products and services to meet the needs and expectations of Australians. Unfortunately, many Australians do not understand or know about the cover they have. As an industry, we need to better engage with Australians on the importance of life insurance, understanding the cover that they have, and the cover that they need.

Following the introduction of MySuper, we believe the overall policy settings for insurance in superannuation are correct and are achieving their intended purpose. Default opt-out insurance in superannuation provides significant benefits to members, their families and broader society.

The provision of default cover has fostered significant breadth of coverage for working Australians, providing a safety-net should an unfortunate event occur. Modelling by RiceWarner shows that the proportion of working Australians with some form of life insurance would reduce significantly if the provision of default cover were removed:

- For Death cover, from 95% to 29%;
- For TPD cover, from 69% to 13%; and
- For IP cover, from 41% to 9%.

This shows that changes to the system could result in a substantial reduction in breadth of coverage, leaving many without financial protection.

As our population ages, Government is under increasing pressure to deliver the Age Pension, disability, carer payments and home care. Superannuation and insurance help to ease this increasing pressure on the taxpayer. Insurance in superannuation provides a private sector solution to minimising taxpayer costs when an individual suffers an unfortunate event or death by transferring risk and funding responsibility from the public purse to the life insurer.

With the current breadth of coverage, the cost to the Government in social security payments caused by underinsurance is \$1.276 billion a year. The removal of default cover would increase the cost of social security by a further \$1.661 billion a year. When factoring in lost tax, lost spending capacity and lost economic production, the total cost of removing default cover to the Government and economy is over \$5.7 billion a year, and over \$17 billion across a three year Government reporting period.³

This demonstrates the financial value of insurance in superannuation not only to individuals, but to the broader society. We look forward to working with the Productivity Commission, Government, the industry, stakeholders and members so that we can consider opportunities for refinement that enhance member outcomes and the member experience. Any proposed enhancements must balance proposed solutions against the risk of reducing the current breadth of coverage that provides significant support to individuals and their families when they need it most.

In our view, there are opportunities to further improve value for members and their experience.

The industry is addressing many of these opportunities through the Insurance in Superannuation Working Group (ISWG). The work of the ISWG will culminate in the release of a Code of Practice and Good Practice Guidance. The development of the ISWG Code and Good Practice Guidance shows the commitment of the industry in working together to improve member outcomes and this will sit alongside the FSC Life Insurance Code of Practice as part of our industry-wide promise to Australians.

Codifying a minimum set of standards that Australians can expect from trustees and insurers will promote greater consistency, and improved trust, confidence and understanding. This will complement the individual work of trustees and insurers to continually improve the experience for their members. The ISWG Code will also provide guidance on appropriate premium levels for default cover to assist in the challenge of balancing financial protection and protecting member balances.

¹ Annual Fund-level Superannuation Statistics June 2016 edition (issued 1 February 2017)
² APRA Statistics Summary 2011 to 2016

³ Rice Warner – Impacts of Removing Insurance From Superannuation 2017

We recommend that the Productivity Commission closely considers the work of the ISWG when analysing competition and efficiency within the superannuation system. The Code and Good Practice Guidance are still in the process of being finalised and implemented, and accordingly the impacts will not be reflected in the member surveys and data collection on the experience to date. Consideration of how the measures being implemented by the ISWG will improve the current state will provide a more holistic analysis of the system.⁴

Careful consideration of reform opportunities is necessary. Superannuation is a complex and interdependent system. Subtle changes to this system and the role of insurance within this system may have significant unintended consequences for Australians, their families and society, and undermine confidence in the system.

Key recommendations and observations

1. Default, opt-out insurance is the correct policy setting for insurance in superannuation.
2. Insurance is a key feature of the superannuation system and supports the objective of superannuation 'to provide income in retirement to substitute or supplement the Age Pension'.
3. The broader benefits to society of default, opt-out insurance must be considered in assessing the superannuation system, including its role as a safety-net, particularly for those who are least likely to consider their insurance needs.
4. Better education, awareness and engagement on superannuation, insurance and general financial literacy will improve member outcomes.
5. Prevention and early intervention are important initiatives that support improved health and wellbeing outcomes for members, and help to reduce costs. Government should explore opportunities to remove legislative barriers that prevent insurers from funding medical treatments where it is in the best interests of the member.
6. Premium Adjustment Mechanisms are an innovative way to promote the sustainability and affordability of insurance in superannuation.
7. As an industry, steps are being taken to increase efficiency in several areas of insurance to improve member outcomes. The work of the ISWG and FSC should be considered as part of the Productivity Commission's assessment.
8. Trustees are best placed to determine the appropriateness of the benefit design for their member cohort, including the provision of default IP and cover for younger members.
9. The tendering process for group insurance contracts is highly competitive, driving affordability of premiums.

10. The proportion of APRA-regulated institutions switching insurance providers should be considered in conjunction with existing legislative requirements help ensure premiums are appropriate for members.

Promoting the Objective of Superannuation

Default, opt-out insurance is the correct policy setting for insurance in superannuation.

Insurance is a key feature of the superannuation system and supports the objective of superannuation 'to provide income in retirement to substitute or supplement the Age Pension'.

As noted in the Issues Paper released by the Productivity Commission, 'what is efficient ultimately depends on what you are trying to achieve, that is, the objectives of the superannuation system.' Accordingly, it is appropriate that the Commission has developed its system-level objectives with reference to the overarching objective of superannuation 'to provide income in retirement to substitute or supplement the Age Pension'.⁴

The Murray Report recommended that a purpose for superannuation be enshrined in legislation and that reporting should be required on how policy proposals are consistent with achieving the enshrined objectives in the long term.⁵ The rationale behind this recommendation was that it would provide a framework for evaluating the efficiency and effectiveness of the superannuation system, contributing to greater long-term confidence and stability for the superannuation system through agreed objectives against which proposals could be assessed.⁶

The Super System Review in 2010 recognised that insurance is a key element of the superannuation system, noting that for a significant number of members each year, they or their dependents need to call on superannuation much earlier and for a longer period than expected due to death, partial disability, or total and permanent disability. The Super System Review found that insurance is crucial in allowing those needs to be met.⁷ The Super System Review resulted in the MySuper reforms and the introduction of mandatory default opt-out insurance for members.

Insurance is a key component of superannuation and plays a critical role in achieving its overarching objective. Insurance seeks to guard against the risk that an individual may be stopped, by an unfortunate event or injury, from continuing to build a sufficient superannuation balance to support themselves and their dependants. Financial protection during a working

⁴ Superannuation (Objective) Bill 2016

⁵ Financial System Inquiry: Final Report (Murray Report) November 2014

⁶ Ibid.

⁷ Super System Review: Final Report – Part Two: Recommendation packages (2010)

life, provided through insurance, and a comfortably funded retirement provided through superannuation savings, are interwoven elements of a sound financial plan.

However, the cost of premiums must be balanced against the opportunity cost to members of premiums paid against the compounding retirement benefit they would have received had those premiums not been subtracted. Achieving the correct balance between these interwoven elements is critical in order to meet the stated objective of superannuation to 'provide income in retirement to substitute or supplement the Age Pension'. Examining the role of insurance in superannuation necessitates consideration of the role it plays in helping to achieve the overarching objective.

- TPD cover helps workers to self-fund their retirement by insuring against the risk that their accrual period is cut short. This helps to support the objective of superannuation by supplementing balances.
- Life cover is important in assisting families to adjust to having one less income stream, and helping to provide for the dependants of the deceased.
- Income Protection cover often includes payment of Superannuation Guarantee contributions for the cover period, directly contributing to retirement savings. Income Protection may also assist individuals to re-enter the workforce, for example by allowing them to undertake rehabilitation, and then continue to save for their retirement.

Insurance within superannuation works in tandem with accumulation to safeguard individuals and provide income that reduces reliance on the Age Pension as well as other forms of social security. Without insurance, the deficit caused by an unfortunate event of injury would be borne by family, community and the social security system whom may not have the resources necessary, particularly where an individual is forced to leave the workforce prematurely and requires long term financial assistance. The contribution of insurance to the overall objective of superannuation should be considered alongside the wider assessment criteria as part of this review.

The Objective of Insurance inside Superannuation

The broader benefits to society of default, opt-out insurance must be considered in assessment of the superannuation system, including its role as a safety-net for those who are least likely to consider their insurance needs.

The Commission has contended that 'what is efficient ultimately depends on what you are trying to achieve'. This approach should equally be applied when considering and assessing the role of insurance in superannuation.

In our previous submission to the Productivity Commission, we noted our concern that the proposed system level objective for insurance was too narrow and did not adequately recognise the broader policy objectives within superannuation, particularly the role of insurance in superannuation in reducing underinsurance. Accordingly, we recommended that the system level objective include reference to the value and protection it provides for the community.

Whilst the system level objective has been amended, reference to the broader benefits to the community has not been included. The Commission has come to the conclusion that the policy objective of insurance within superannuation system is 'unclear' and 'difficult to articulate'.⁸ The Commission has also determined that underinsurance is 'not an explicit policy objective of insurance within superannuation... and the commission therefore considers issues relating to perceived underinsurance to be out of scope'.⁹ Therefore, broader benefits to society and its role in combatting underinsurance will not be considered as part of the report.

Unlike superannuation, there is no proposed legislated subsidiary objective for insurance inside superannuation. There were many submissions during consultation of the objectives of superannuation that highlighted the absence of a subsidiary objective for insurance.¹⁰ We are not proposing to reopen this debate, however these discussions should provide further guidance to the Productivity Commission in their assessment of the competitiveness and efficiency of insurance in superannuation. This would help to promote long term confidence and stability for members with respect to their insurance needs in line with the rationale underlying the recommendation from the Murray Review.

The Government was quite explicit as to the reasons for introducing default opt-out insurance in superannuation. It was intended to provide a safety-net to members who are least likely to give consideration to their insurance needs.¹¹ This demonstrates that combatting underinsurance was a policy objective of default insurance. This is reiterated by the statement that it is not sufficient for trustees to simply release the member's accrued superannuation balance. Rather, the trustee must provide benefits by taking out an insurance

⁸ How to Assess the Competitiveness and Efficiency of the Superannuation System – Research Report

⁹ Ibid.

¹⁰ See, e.g. RiceWarner – Objective of superannuation submission to Treasury (April 2016); Mercer Superannuation (Objective) Bill 2016 Submission 20

¹¹ Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012 Explanatory Memorandum

policy.¹² Following MySuper, trustees are required to provide default life insurance and TPD insurance to all members of their fund on an opt-out basis.¹³ It was to protect members against the risk of not being able to accumulate sufficient retirement saving, for themselves or their dependents, due to having to cease work as a result of injury, illness or death.¹⁴ These objectives should have informed the development of the system level objective for insurance as part of the Productivity Commission's Inquiry.

This was highlighted in the appearance of the Productivity Commission at the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the life insurance industry. At this hearing, Senator Deborah O'Neill and Terri Butler MP noted that there are broader considerations, including the public interest in ensuring individuals have cover, rather than purely considering whether the insurance is value for money for individual members. Though value for money is critical, it is important to consider members in the context of the broader social and economic landscape in which they participate and with reference to the objective behind default opt-out cover.

Given these factors, we would ask the Productivity Commission to consider the broader benefits to the community of insurance in superannuation, including combatting underinsurance, in their assessment in order to truly reflect the efficiency of the system by reference to its objectives.

The Value of Default Opt-Out Cover

Insurance in superannuation is an efficient and cost effective way to provide broad coverage for Australians and helps minimise costs for Government and the economy.

Default insurance provided in superannuation provides significant value to individuals, their families and the community. Included in the MySuper reforms is the explicit obligation for trustees not to allow retirement incomes to be inappropriately eroded by insurance premiums, including demonstrating to APRA that they have an appropriate Insurance Management Framework in place.¹⁵ This package of reforms and other factors (including increased competition between group insurers) have resulted in a substantial improvement in the value for money of insurance in superannuation for members. In the five years to 2016, 81 cents in every dollar collected in premiums was paid back through claims to members.¹⁶

By distributing risk across the pool of members, it effectively forms a 'community rating' within the fund allowing for lower premiums, little underwriting (if any) and broader coverage. The auto-enrolment also allows for lower cost administration. Risk pooling through insurance in superannuation is also generally more efficient than self-insurance (setting savings aside by each individual) and is more reliable as non-insured savings are rarely sufficient to support individuals and their families over an extended period.

Insurance in superannuation also helps minimise the costs to Government and the economy caused by death and unfortunate events. Costs to Government and the economy include:

- Lost taxation revenue;
- Provision of social security; and
- Economic productivity.

By accepting the financial risk for unfortunate events and death, insurance companies help to minimise the costs to Government and broader society. RiceWarner have calculated that current underinsurance levels across key coverage types in Australia cost the Government in terms of Social Security is \$1.276 billion per annum. This is with the broad coverage that insurance in superannuation provides.

The removal of default cover in superannuation would increase the costs of underinsurance to Government for social security by a further \$1.66 billion. When the additional cost to the economy is factored in, the increased annual cost to Government and the economy from the removal of default cover in superannuation is over \$5.7 billion per annum in lost tax and spending capacity, economic production and social security payments, and over \$17 billion across the three year government reporting period.¹⁷

There is also a benefit in having the 'peace of mind' provided by insurance, reducing stress and anxiety. The AIA Healthy Living Index found that for 75% of respondents, finances were the main cause of stress.¹⁸ Insurance in superannuation helps to reduce this as it is not a further financial burden on post-tax income and provides a safety-net that members can rely on in times of need.

In addition, insurance will provide considerably higher benefits for individuals and their families than social security benefits, which will impact the standard of living for individuals and their families.¹⁹ A number of factors will inform the assessment of the impact on each individual and their family, including the existing level of debt, number of dependents, the age and number of

¹² Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012 Explanatory Memorandum

¹³ Ibid.

¹⁴ Ibid.

¹⁵ How to Assess the Competitiveness and Efficiency of the Superannuation System – Research Report

¹⁶ APRA Statistics Summary 2011 to 2016

¹⁷ Rice Warner – Impacts of Removing Insurance From Superannuation 2017

¹⁸ AIA Healthy Living Index

¹⁹ Rice Warner – Impacts of Removing Insurance From Superannuation 2017

children, any other insurance held, and the income level pre-event. The impact is likely to be most significant where there are dependent children, as the insurance needs are highest in these circumstances.

The AIA Life Today Study 2016 found that:²⁰

- 40% of respondents would feel the impact of losing the primary income earner's salary within a month of them not working;
- 74% saw the inclusion of insurance inside superannuation as a real positive; and
- 44% of respondents agreed that if it was not included they would not have cover.

This demonstrates the value that individuals place on default opt-out cover and that coverage would likely reduce significantly if not provided on a default opt-out basis. RiceWarner modelling shows that coverage by proportion of working Australians is likely to drop significantly were default cover removed:²¹

- For Death cover, from 95% to 29%;
- For TPD cover, from 69% to 13%; and
- For IP cover, from 41% to 9%.

This supports the contention that without relying on members to make a conscious decision, the system can ensure a far higher degree of coverage than would otherwise be the case. The system also helps provide a safety-net for individuals who may have low financial literacy or for whom English is a second language and may find it more difficult to engage with advice or direct channels. Higher coverage is also supported by spreading risks across the members of a fund, making it possible to insure individuals with higher risk profiles that may have made it impossible or prohibitively expensive to take out individual cover.

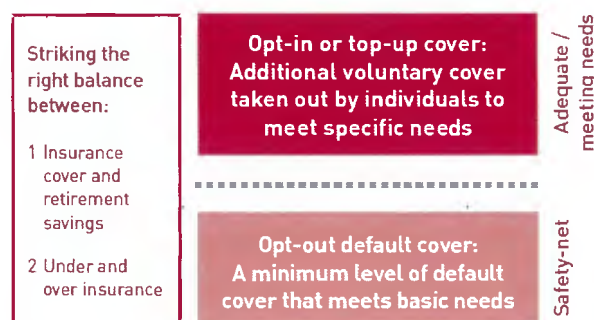
Do funds offer value for money insurance products to members?

Insurance in superannuation is a safety-net designed to provide a default level of cover that meets basic needs, aiming to strike right balance between provision of insurance cover and impact on retirement savings.

In the five years to 2016, 81 cents in every dollar collected in premiums was paid back through claims to members.²² This represents real value for money of insurance within superannuation.

The Commission has voiced concerns that the bundling of insurance within superannuation is prima facie likely to lead to allocative inefficiency, resulting from people being provided with cover they do not need, or going without adequate insurance under the assumption that their level of cover within superannuation is sufficient.²³

Insurance in superannuation can be thought of in two categories:



In line with the reframed assessment criteria, it is important to note that default cover is intended as a safety-net for individuals. This should be supplemented with additional engagement initiated by the superannuation fund in conjunction with the group insurer to encourage individuals to consider their specific insurance needs.

The AIA Life Today Study found that in relation to default coverage provided in superannuation, of the respondents:

- 4% wanted to reduce their cover;
- 4% wanted to remove cover altogether;
- 22% wanted to increase the amount of cover;
- 14 % didn't know; and
- 56% wanted to keep it at the same level.

These results show that the majority of respondents were satisfied with the level of coverage provided on a default basis.

We can draw similar inferences from a case study of one of our largest superannuation trustees, which showed that:

- Approximately 5% of members had increased their default cover;
- Less than 0.5% of members had decreased their default cover levels;
- Less than 0.5% of members had opted out of cover entirely;
- Approximately 2.5% of members had used online quote and application tools; and
- Approximately 57% of members had contacted the fund for other purposes.

These data points show that there is a low number of members who want or choose to reduce or remove their default cover. Proportionally, a much greater portion wish to increase their cover to better meet their specific insurance needs. Given the low rates of change, it could be inferred from these results that the majority of

²⁰ AIA Life Today Study 2016

²¹ Rice Warner – Impacts of Removing Insurance From Superannuation 2017

²² APRA Statistics Summary 2011 to 2016

²³ How to Assess the Competitiveness and Efficiency of the Superannuation System – Research Report

members are satisfied with their levels of cover and consider it to be value for money. However, the data also supports the commonly held belief that a significant portion of members are not engaged or may not have considered their specific insurance needs. This shows the value and effectiveness of the default opt-out system in providing a safety-net for those least likely to consider their insurance needs.

Duplicate Accounts

Persistence of duplicate accounts is a concern due to the duplication of fees and premiums that may erode account balances. Consideration should be given to the improvements flowing from existing initiatives and those proposed by the ISWG.

The Commission contends that the persistence of duplicate accounts suggests that some people have more cover than they require and are unduly eroding their retirement balance. They also state that in an efficient system the extent of duplicate insurance would be low and stable over time, or would decline as better information is provided and account consolidation becomes easier.²⁴

We believe that the persistence of duplicate accounts in the superannuation system is a concern due to the duplication of fees that may erode account balances, particularly where balances are low and/or contributions have ceased. Key causes of duplicate accounts and policies include low awareness and engagement, increased mobility and casualisation of the workforce, and account consolidation apathy.

There have been vast improvements made in the area of duplicate superannuation accounts over recent years. Consolidation of accounts has improved on a year-on-year basis, with the number of single account holders increasing. This indicates that a reduction in unintended duplicate cover and duplicate fees the success of initiatives such as Stronger Super Reforms, balance thresholds for transfer of inactive accounts to the ATO, Super Match, myGov, ASIC Money Smart, Single Touch Payroll and improved member engagement from superannuation funds.

It is estimated that the number of accounts per member has fallen from 2.1 accounts per member in 2005 to 1.86 per member in 2015.²⁵ It is expected that the number of accounts in the market, which peaked at about 32 million in 2014, to stabilise at approximately 26 million even against the backdrop of an expanding workforce.²⁶ However, there are data challenges in determining and identifying the existence of duplicate policies.

In our earlier submission we highlighted that it would be challenging to segment which members have multiple policies due to active choice, and those who have multiple policies because they are disengaged. We note that there may be some scope to identify this through the member survey question 'have you retained duplicate superannuation accounts for the purpose of retaining an insurance policy attached to a previous superannuation product?'

Though members will be paying higher premiums on aggregate, there is value to most members in the policies they hold in that they are able to claim against multiple TPD and Death policies. We wish to avoid sweeping reforms that limit consumer choice as this may have negative consequences for consumers. However, in some instances IP cannot be claimed on more than one policy due to offset provisions and this is of most concern from a value for money perspective.

Proposals currently under consideration by the ISWG include clear explanations on how off-setting arrangements operate, information around factors that should be considered when determining the best financial outcome from multiple policies, and premium refunds from the commencement of cover where IP is provided as default cover and is completely offset against another IP cover.

In addition, the ISWG is considering proposals to seek member permission to identify duplicate cover on their behalf and advise the member of the options available to the member and the impacts of different choices. Notification by employers in Super Stream of when employees cease work would also assist in tackling the proliferation of duplicate accounts.

Cessation

Cessation provisions are important tools to protect member balances, but significant improvements need to be made in communication with members. The ISWG's suggestion to require employers to update Super Stream when employment is terminated would greatly assist in managing this process.

Appropriate cessation processes are an important way to protect member balances, particularly where contributions have ceased or account balances are low as the savings of these groups are most likely to be impacted by the deduction of insurance premiums.²⁷

Currently, trustees must rely on proxies to identify where members have ceased employment. We recommend that employers be required to notify superannuation funds of the reasons for contributions ceasing through Super Stream. This would foster

²⁴ How to Assess the Competitiveness and Efficiency of the Superannuation System – Research Report
²⁵ ASFA, also RW Superannuation and Efficiency and Competitiveness Submission to PC 2016

²⁶ Superannuation Market Projections Report Rice Warner - 2016
²⁷ Affordability Study: Group Insurance in Superannuation Rice Warner December (2016)

engagement between funds and members to help minimise duplicate accounts and also erosion, as the member may be likely to cease contributing to this account when they cease current employment or choose to contribute to a new super fund.

Without notification from the employer, trustees rely on proxies such as lack of contributions to identify cessation of employment. There are challenges in using this approach as employers may not contribute to superannuation on a regular basis, casualisation of the workforce and contribution thresholds.

The ISWG is currently considering proposals to enhance this process through an industry standard time frame for policy cessation that will involve better communication with members and more advanced identification of where contributions have ceased.

Member superannuation and insurance literacy

There is significant opportunity for trustees and insurers to better educate members on insurance, including the proposals of the ISWG to simplify communication, and to introduce a Key Facts Sheet and Insurance Welcome Pack to improve the comparability of information between funds and insurers.

Ideally, all members would be engaged in considering their insurance and financial needs. However, many individuals find it complex and unpleasant to consider. As noted above, 75% of Australians identify finances as their key source of stress. This is an instance where it is important to consider the purpose of insurance in superannuation to act as a safety-net for those least likely to give consideration to their insurance needs. The default opt-out nature of the product is purposeful in design, recognising that there is a large proportion of people who will choose not to actively engage in consideration of financial planning and insurance needs.

Bearing this in mind, there are considerable improvements that superannuation trustees and group insurers can make to engage members effectively at appropriate junctures, and to make communication as consistent and easy to understand as possible.

The ISWG is developing minimum expectations on improved communication, with recommendations including:

- Use of appropriate and easy to understand information, focusing on plain language and limited jargon and acronyms;
- Improved communication leveraging behavioural economics and consumer testing;

- Timely, targeted and relevant communication; and
- Easy access to information resources to enhance understanding.

Central to the proposals of the ISWG is the introduction of a Key Facts Sheet for default insurance to be published on the trustee's website and included in other insurance related communication alongside the Super Product Dashboard. The Key Facts Sheet is designed to provide high-level information on insurance cover so that members can ascertain if the cover is relevant for their circumstances.

It is proposed that the Key Facts Sheet will be supplemented by an Insurance Welcome Pack initially provided with default cover that clearly identifies insurance specific information. The purpose of the pack will be to provide information on the types and level of cover, the purpose of insurance in superannuation, exclusions, premiums, options to opt-out or otherwise tailor cover to suit needs and other key information in simple, consistent language.

The Key Facts Sheet and Insurance Welcome pack are intended to be supplemented by targeted communication during the term of cover, including enhanced communication in the annual statement. It also proposes greater communication where the fund becomes aware that the member has changed employer, ceased employment or stopped contributing for a period of time.

These industry solutions will improve member awareness and understanding of their insurance cover and insurance needs. We expect the targeted communication at key events will be particularly beneficial in minimising duplicate cover and erosion of balances by prompting members to consider their insurance needs and superannuation.

We also support the calls of Senator John Williams, as articulated at the public hearings of the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the life insurance industry to improve financial literacy education in the high school curriculum.

Ease of opting out, amending cover, and making claims

In a well-functioning and efficient system the process to opt-out would be simple to understand, easy and quick to progress, and low cost.²⁸ Members would also be able to choose the insurance offerings that suit them.²⁹

In most cases, the process is relatively simple with members being able to opt-out or reduce cover through paper forms, online or over the phone. Increases in

²⁸ How to Assess the Competitiveness and Efficiency of the Superannuation System – Research Report

²⁹ Ibid.

cover may require underwriting which may involve a more complex process.

The ISWG is considering proposals to improve the consistency and promotion of opt-out procedures by including clear instructions in the Insurance Welcome Pack, on disclosure information, on the annual statement and on the website of the trustee. This would involve informing customers of the impact of the changes requested and confirming the date on which changes take effect. Proposals also include requirements for trustees to provide online, digital or phone options in addition to paper.

The intrinsic value of insurance is being able to make a claim when an unfortunate event occurs. This is evidenced by the high acceptance rate for claims made in the group insurance channel, which are overall comparable with retail-advised policies that are fully underwritten and managed with the support of financial advisers. ASIC Report 498 found that across 2013 to 2015 the decline rates for the group insurance channel were:

- Death cover: 2%;
- IP cover: 5%; and
- TPD cover: 16%.

The overall decline rate was 8%, compared with 7% for retail-advised. ASIC Report 498 further found that where a decision has been made, 90% of all claims (and 96% of death claims) are paid in the first instance, with only 2% of all claims likely to go through Internal Dispute Resolution and 0.9% of all claims likely to go to an External Dispute Resolution Scheme. Our experience has shown that only 13% of members are legally represented when making a claim. The high success rate, low rate of dispute and low level of legal representation are indicators that overall members are able to pursue a claim themselves with high levels of success. However, we are always looking for new ways to streamline process (including digital solutions) to make the process easier for claimants and support them through what can be a very challenging time. An example of this is our eClaims system, an online end-to-end tool with in-built intelligence that helps reduce the amount of paperwork required, enables faster payments, and helps to identify relevant rehabilitation and return to work services for members.

The report did find that the member experience varied widely between insurers. This demonstrates the importance for group insurer and superannuation funds to ensure their claims handling procedures and processes are up to date. It also highlights the need for a strong Claims Philosophy to underpin claims handling and claims decisions.

To improve consistency across the industry and provide a minimum set of expectations for consumers, the

ISWG is considering a number of proposals around claims handling. The ISWG is considering industry standards including foundation principles of compassion and respect, overseeing the process and providing guidance through the claims process, publishing a claims philosophy, and time frames for both trustees and group insurers to respond to member requests and determine claims.

There have been suggestions, for example at the public hearings at the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the life insurance industry, that the claims handling process could become more efficient if the duplication in claims assessment by the trustee and the insurer was removed. This is not suitable, as the review by the trustee is an important step in the trustee fulfilling their duty to pursue reasonable claims on behalf of the member and therefore promotes member interests and improved outcomes. It is intended that these timeframes will be consistent with those under the FSC Life Insurance Code of Practice that was effective as of July 2017.

The ability to assess and review claims is of critical importance, particularly with respect to TPD claims. Though group insurers and trustees should seek to make the experience as seamless and efficient as possible, this should not be at the expense of the ability to properly consider a claim. Group insurers and trustees pay valid claims on valid policies. There will be instances in which members do not fulfil the requirements to be entitled to a benefit. This is important because the claims experience will influence the risk assumptions of the cohort and future premiums, meaning that all members will be impacted by increased costs. If the premiums are not sustainable for the claims experience then this will impact the financial soundness of the group insurer, meaning they may not be able to fulfil their promise of financial protection for future customers when they need it most. Life insurance products can span a lifetime which is why business models need to be sustainable for the long term. Consideration of efficiency and reform options will need to appropriately balance these considerations.

Use of member information to inform design and pricing

Trustees are best placed to select the appropriate benefit design for their member cohort and are increasingly using member information to better tailor cover for segments of their cohorts based on factors such as age.

Trustees must seek to strike the right balance in offering insurance to protect against the risks of a working life being cut short, and protecting member balances. Life and TPD are inherently complex products and each fund has different demographics of members with

varying risks.³⁰ As articulated at the introduction of MySuper, it is for these reasons that a standard, externally-imposed approach to insurance (such as is applied for motor vehicle accident insurance) would be sub-optimal in the superannuation context.³¹

There has been a noticeable improvement in the quality of data that supports pricing decisions since the introduction of SPS 250: Insurance in Superannuation. With better data, insurers are able to have more confidence in their pricing and there is more capacity to tailor pricing and design to specific cohorts based on age and/or market segment.³² Trustees are increasingly seeking to tailor cover based on age and other factors.

The ISWG is currently considering proposals to promote consistency across the industry by specifying factors that will be taken into account in benefit design. Factors will include age distribution, gender, industry/occupation, work status, earning, claims history, insurability and member feedback/attitudes towards insurance.

These proposals also include a commitment to test the benefit design across different segments of the membership to ensure equitable treatment. Special consideration will be given to the appropriateness of benefit design for younger members, low income members, and members nearing retirement.

For younger members, the trustee will consider specifically that they may be less likely to have children, dependents and debt, the impact of premiums, working patterns, and levels of cross-subsidisation. This is not to say that younger members do not need protection, but they may need proportionally more TPD cover and less death cover. For members with low income, consideration will be given to their characteristics as a cohort, including working patterns, presence of multiple accounts and the impact of premiums. For members nearing retirement, consideration will be given to superannuation balances, which may be an indicator that less cover is needed, the level of premiums, and the focus on saving over protection at this life stage.

These measures are preferable to broad brush responses, such as removing default cover for younger members or removing the option to provide default IP. In 2016, over 60% of the claims paid in our group channel were IP claims, supporting people through periods of temporary disablement and helping them to return to the workforce.³³ This type of support is critical, given our AIA Life Today Study showed that 40% of respondents would feel the impact of losing the primary income earner's salary within a month of them not working.

These improvements will promote a consistent approach and increased consideration and tailoring of cover based on age and other factors by trustees, who supported by the fiduciary best interests duties are best placed to make insurance decisions on behalf of members.

Comparability of insurance product information disclosed by funds

The quality and comparability of information disclosed to members by funds about insurance is a complementary indicator for assessing whether the system provides value for money insurance – complex products and information are potential barriers to members making informed choices and exerting competitive pressure.³⁴

As discussed above, the proposed Key Facts Sheet and Insurance Welcome Pack being considered by the ISWG will improve the comparability of insurance product information disclosed by funds. The Key Facts Sheet, in particular, is intended to foster effective comparison between insurance cover across different superannuation funds.

These initiatives will be supported by plain language principles and annual reviews and good practice guides that will explain common technical definitions and how they will be applied. The work of the ISWG will build upon improvements over recent years, including improved PDS that are shorter and incorporate detail via external links, making it easier for members to engage with and encouraging better consistency and comparability across the system.

Are the costs of insurance being minimised for the level and quality of cover?

From 2012, trustees have been under an explicit obligation to not allow retirement incomes to be inappropriately eroded by insurance premiums, including demonstrating to APRA that they have an appropriate Insurance Management Framework in place.³⁵ In the five years to 2016, it was 81 cents in every dollar.³⁶ This low margin shows that overall is an indicator that the costs of insurance are being minimised for the level and quality of cover.

³⁰ Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012 Explanatory Memorandum

³¹ Ibid.

³² Superannuation Market Projection Report RiceWarner (2016)

³³ Percentage by claim count.

³⁴ How to Assess the Competitiveness and Efficiency of the Superannuation System – Research Report

³⁵ Ibid.

³⁶ APRA Statistics Summary 2011 to 2016

Innovation

Trustees and insurers should retain flexibility to innovate in their benefit design to improve outcomes for members and improve the affordability of cover for members.

The industry must maintain flexibility to innovate to find ways to continue to minimise the costs of group insurance in a sustainable manner.

Research undertaken by one of our superannuation partners in 2015 showed approximately 1 in 3 claimants that had previously been paid a TPD benefit had returned to work or were actively seeking work. Fortunately, their injuries turned out to be temporary. This shows that TPD definitions were not meeting their intended purpose to protect against the risk of individuals not being able to accumulate sufficient retirement saving, for themselves or their dependents, due to permanently ceasing work as a result of injury or illness. This is particularly important in the group insurance context as it would result in higher claims and consequently higher premiums that would ultimately be borne by all members of the fund.

To respond, we co-designed a new TPD benefit that paid in instalments, had shorter waiting periods and focused on rehabilitation and retraining. This allowed us to focus on helping individuals rehabilitate and return to work, while ensuring they were financially supported in the interim. These types of innovations were recognised by APRA in 2015 as some of the positive steps taken to address concerns around losses in claims experience and sustainable premium structures.

These innovation should be encouraged as a means of competition and as a way for group insurers to find new ways to reduce the costs of insurance for members. It would be unfortunate to see recommendations mandating set definitions, benefit types, or otherwise inhibiting innovation. The trustee is best placed to make decisions as to the most appropriate TPD definition and cover choices for their members.

Legislative barriers that prevent insurers from funding medical treatment where it is in the best interest of the member should be removed.

Further innovation in early intervention and prevention could be achieved through the removal of legislative barriers that limit the ability of life insurers to fund medical treatment where it is in the best interests of members. Payment for primary health care is currently prohibited by the operation of the Life Insurance Act and Private Health Insurance Act. This limits insurers to only providing occupational rehabilitation.

Supporting rehabilitation and eventual return to work, where feasible, is integral as it helps to minimise premiums, and more importantly supports the health and wellbeing of members.³⁷ Research indicates that if an employee is off work for 20 days, they have a 70% chance of returning to work. If they are off work for 45 days, the chance of returning to work reduces to 50%. After 70 days off work, the chance of ever returning to work is only 35%.³⁸ The cost of absenteeism on a national scale is \$32.5 billion annually in sick leave costs and lost productivity.³⁹ The ability to fund medical treatment could enable insurers to speed up member recovery for those on long public waiting lists, increasing their likelihood of returning to work. We have consistently seen investment in rehabilitation programs be realised in savings that can be passed back to members through better premiums and improved services. This highlights the importance of early intervention and rehabilitation programs and the need for further flexibility and reform in this space.

Premium Adjustment Mechanisms

Premium Adjustment Mechanisms are an innovative way for insurers and trustees to improve the affordability and sustainability of premiums.

Premium adjustment mechanisms are an important tool that insurers and trustees can use to minimise the cost of cover for members and ensure it is value for money. The Super System Review identified that some trustees have an arrangement with their insurer for a rebate of premiums so that the proceeds ratio on the group does not fall below 80 percent. They contended that this approach, if widely adopted, would deliver superior to outcomes.⁴⁰ This was also identified by RiceWarner as a way to improve the cost of insurance for members.⁴¹

Premium adjustment mechanisms are a contractual arrangement between insurers and trustees and are common in very large group insurance plans where the parties are exposed to significant pricing risks. Premium adjustment mechanisms provide flexibility to insurers and trustees to deal with the uncertainty of future claims experience and product changes, reducing reliance on contingency margins. Where the claims experience turns out to be lower than expected, money is returned to the fund, which uses this to the benefit of members, for example by funding a reduction in future premiums. This effectively caps the amount of profit that the insurer can make and reduces the risk of overcharging. As identified by the Super System Review and RiceWarner, this helps to deliver sustainable pricing outcomes for members.

³⁷ Superannuation Market Projection Report RiceWarner (2016)

³⁸ AIA Australia – A critical equation: balancing Australian worker health and company wealth (August 2013)

³⁹ DHS – Absence Management Report (2015)

⁴⁰ Super System Review: Final Report – Part Two: Recommendation packages (2010)

⁴¹ Superannuation Market Projection Report RiceWarner (2016)

Concerns have been raised publicly about the purpose of premium adjustment mechanisms and whether they create a conflict of interest on claims decisions.

The ISWG is considering number of proposals to improve the disclosure of premium adjustment mechanisms and provide guidance for their use and operation. The proposals include a publicly available Premium Adjustment Mechanism Policy that details (among other things) the arrangement, review processes, the establishment of an insurance reserve to which payments are allocated, and disclosure and reporting requirements. The proposals also include enhanced disclosure requirements through the fund's annual report and PDS, and considerations of appropriate and inappropriate uses to be included in Good Practice Guidance.

These initiatives will improve the function and understanding of premium adjustment mechanisms and allow group insurers and trustees to continue to explore innovative ways to minimise premiums for members.

Insurance premiums inside v outside for like for like

Insurance in superannuation is an efficient method of providing cover as trustees are well placed to obtain cover for members on good terms and at a relatively low cost without the need for members to complete forms or undergo medical assessments.

Similarly, tendering of insurance has fostered competition for superannuation business for group insurers. Pricing competition between group insurers was so significant that it contributed to reduced insurer and reinsurer margins and significant losses across the market for the years ending June 2013 to June 2014. Over the past three years premiums have risen to reflect the deteriorating claims experience and increased capital requirements. Other improvements have focused on better risk controls, improved claims management and effective use of early intervention and prevention rehabilitation.

The Productivity Commission has articulated that a reasonable expectation is for trustees to provide value for money group insurance to members – including at a materially lower price and better cover than could be obtained outside of superannuation – without unduly eroding member balances.⁴² Studies have shown that group insurance is better priced than retail cover across all age bands.⁴³ However, premiums must be both sustainable and affordable and this must be considered when assessing the system.

It is also important to note the challenge of like-for-like comparisons between retail and group products. Both products are complex, with multiple conditions and varying disclosure obligation on the part of the insured.

We support the Productivity Commission's approach of interpreting this in the greater context, including contextual evidence on pricing practices. We would suggest the broader social benefit of group insurance is also considered in line with the purpose of insurance in superannuation to provide a safety-net for those who are unlikely to consider their insurance needs.

Insurance premiums paid as a percentage of guarantee contributions

Previous studies have found that for most people, the cost of insurance benefits is the same as a reduction in the SG contribution of about 1.0% of salary.⁴⁴ Previously, trustees and insurers have used rule of thumb measures when determining benefit design and resulting premiums. Different funds have approached this question in different ways, for example by using relativity measures by comparing to other household expenditure items.

This is another area in which the ISWG is currently considering proposals, to provide guidance across the industry on premium caps. The ISWG will consider a variety of options, including employer contributions, percentage of salary or weekly earning, percentage of account balance, percentage of projected retirement balance, and a straight dollar limit.

This guidance will be useful in setting a community expectation on the level of premiums to be charged, and will need to include a level of flexibility that allows trustees to tailor based on specific categories relevant to their member base, for example those in high risk occupations and those with different employment patterns and high levels of casualisation.

Ratio of claims to premium revenue over 5 and 10 years

We support the Productivity Commission's decision to look at this over an extended period to minimise data distortions caused by the pricing cycle, timing of significant events, time lags between claims made and premiums paid and claims that have been incurred but not reported.

⁴² How to Assess the Competitiveness and Efficiency of the Superannuation System – Research Report

⁴³ ASFA Supplementary Submission to Productivity Commission 2016

⁴⁴ Affordability Study: Group Insurance in Superannuation Rice Warner December 2016

Proportion of APRA-regulated institutions switching insurance provider

The proportion of APRA-regulated institutions switching insurance providers should be considered in conjunction with existing legislative requirements help ensure premiums are appropriate for members.

The Productivity Commission has included this criteria as they believe that it will “provide insight into the extent they are prepared to shop around for the best deal”.⁴⁵ We have concerns over the use of this indicator. The ability to exert competitive pressure is important, but this is not necessarily indicated through a high rate of change. Further, switching insurers may have additional administrative costs that, in a holistic assessment, do not result in better outcomes for members. Trustees and insurers will often map out five year strategic plans that include significant investment in service or technology enhancements that improve the member experience. Both parties would generally commit to longer term partnership to leverage the value of these investments

In our experience, the group insurer’s understanding of the member base is likely to improve over time, enabling better pricing and tailoring of cover.

There are a number of existing regulatory mechanisms that require regular review of insurance arrangements to ensure that trustees are meeting their obligations.

SPS 250 requires trustees to have an Insurance Management Framework that includes an insurance strategy that outlines, among other things, how they have considered each of the factors in 52(7) of the SIS Act and the processes for monitoring, reviewing and renewing benefits. Specifically when selecting an insurer the trustee must have a selection process that involves a consideration of terms and conditions, claims philosophy, and the reasonableness of the premiums. The trustee is required to undertake a due diligence review of the selected insurer and be able to demonstrate the appropriateness of the selection process and due diligence review to APRA. It must also satisfy APRA that it is in the best interests of beneficiaries.

Funds use a variety of methods in order to adhere to these regulations, including: market full tenders, benchmarking and limited tender benchmarking. APRA also considers the costs and terms and conditions as part of LPG 270 and makes an assessment of the adequacy of premiums to cover risk they are quoting for as part of LPS 320.

These mechanisms help ensure that premiums are appropriate for members, and also involve a consideration of the broader proposition including

service, terms and conditions, claims philosophy, and cost. At the end of these processes, the trustee may determine that the existing insurer is the most appropriate. For these reasons, consideration of the proportion of funds switching should be balanced against the existing regulations and broader context.

⁴⁵ How to Assess the Competitiveness and Efficiency of the Superannuation System – Research Report

RICEWARNER

Insight like no other

Productivity Commission Issues Paper – Impacts of Removing Insurance from Super



30 August 2017

SYDNEY
Level 1
2 Martin Place
Sydney NSW 2000
P +61 2 9293 3700
F +61 2 9233 5847

MELBOURNE
Level 20
303 Collins Street
Melbourne VIC 3000
P +61 3 8621 4100
F +61 3 8621 4111

ABN 35 003 186 883
AFSL 239 191

www.ricewarner.com

Table of Contents

1. Executive summary	2
1.1 About this report	2
1.2 Impact on Government and economy of removing default life insurance	2
1.3 Impact on Individuals of removing default life insurance	3
1.4 Conclusions and suggestions	4
2. Background	5
2.1 Current levels of life insurance cover	5
2.2 Basis for modelling cost	6
3. Impact on Government and economy of removing default life insurance.....	7
3.1 Reduced taxation revenue and reduced spending in the economy	7
3.2 Increased social security payments	8
4. Impact on Individuals of removing default life insurance.....	16
4.1 Investment income	16
4.2 Household costs and debt	17
4.3 Dependant children	17
4.4 Erosion of account balances	18
Appendix A Data Sources	19
A.1 Research – Rice Warner Underinsurance in Australia.....	19
A.2 Key sources of data	19

This report constitutes a Statement of Advice as defined under the Financial Services Reform Act. It is provided by Rice Warner Pty Ltd. which holds Australian Financial Services Licence number 239 191. This report should not be distributed, in whole or in part, without Rice Warner's prior written consent.

1. Executive summary

1.1 About this report

Life insurance cover is a key feature of most superannuation funds. To comply with superannuation legislation, MySuper funds must provide automatic death and total and permanent disablement cover on an opt-out basis for default members when they join the fund (some exemptions apply). Some MySuper funds also provide automatic income protection cover on an opt-out basis.

This report sets out Rice Warner's estimate of the financial impacts of removing/reducing default life insurance from superannuation funds:

- Placing a value on the cost to the Government and the economy of removing default insurance from superannuation funds. 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%.
- Setting out the impact on claimants and their families.

1.2 Impact on Government and economy of removing default life insurance

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. Table 1 demonstrates the additional cost to Government and the economy. 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.

A further benefit exists to government through stamp duty revenue for default life insurance premiums, however, this has not been quantified specifically as part of this analysis.

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.

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 due to reduced insurance claim payments	3,636	2,016
Lost Spending Capacity due to reduced insurance claim payments*	404	224
Social Security	1,661	922
Total**	5,701	3,162
Total over 3 years***	17,103	9,486

*The receipt of insured benefits allows some family members to stay in employment following a claim event for another family member. The removal of the insurance benefit will thus result in a reduction in economic production but we have not estimated the amount of this reduction

** This figure does not include stamp duty benefits to State Government, which based on an average rate of 3% would equate to \$200 million per annum. For both Basis 1 and Basis 2, it would increase the totals shown by about 5%.

***The three year total amounts align with Government reporting periods. We have assumed that growth in lost revenue will be offset by discounting factors applied.

1.3 Impact on Individuals of removing default life insurance

The death or disablement of an individual can have a serious impact on family members. It is recognised that in many instances the default insured benefits within superannuation funds will provide considerably higher benefits than social security benefits. It is difficult to place a monetary value on the impact as it will vary considerably from one household to another.

One of the key financial consequences of a death or disability is the loss of the regular income the individual was earning prior to the event occurring. One of the biggest concerns is that debt levels have been increasing steadily and as at 2014 it is estimated that over 60% of mortgage holders have debt equal to more than three times household income. In addition, a 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.

On the other hand, removal of default life insurance will result in lower deductions from most members' superannuation accounts, resulting in larger retirement balances for those who do not die or become disabled before retirement.

1.4 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.

This report was prepared and peer reviewed by the following consultants.

Prepared by

Peer Reviewed by

Andrea McDonnell
Senior Consultant

Geoff McRae
Senior Consultant

30 August 2017

2. Background

2.1 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 income protection cover (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 the majority of the cover for death, TPD and income protection is insured via wholesale superannuation funds. It is estimated that 50% of all death cover and income protection cover in Australia is default cover provided by superannuation funds and 70% of TPD cover is default superannuation cover.

As such, removal of default cover will make a significant dent in the level of life insurance cover of Australians. Provided Australians would still be permitted to hold life insurance cover within the superannuation environment, it is expected that some members may choose to retain their cover (or a portion of their cover) if default cover were removed.

However, there is another possibility that funds choose not to offer life insurance due to the higher costs of running voluntary insurance.

2.2 Basis for modelling cost

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, based on an analysis of the spread of cover for several large funds, we have assumed that 10% of all death and TPD cover is voluntary cover and that one third of all 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 take action. 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% make a decision 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.

It is not expected that many individuals would replace lost cover outside the superannuation environment because this would require funding premiums from after-tax income.

3. Impact on Government and economy of removing default life insurance

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. 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%.

We have not included the benefits to State Government flowing from stamp duty on default insurance, estimated at \$200m per annum based on an average rate of 3% of premiums. We have also not attempted to place a value on the economic benefit of the *peace of mind* provided by the insurance *safety net*. 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.

3.1 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 premiums made by funds over the financial year. Therefore, the total premium amount less an adjustment for profit and expenses is a good approximation of the amount that would be payable in claims and therefore available as taxation revenue and money available for spending in the economy. We have calculated net premium after profit and expenses to be 75% of the total premium. We have taken

these amounts 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 3. 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 3. 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 due to reduced insurance claim payments	3,636	2,016
Lost Spending Capacity due to reduced insurance claim payments*	404	224

*The receipt of insured benefits allows some family members to stay in employment following a claim event for another family member. The removal of the insurance benefit will thus result in a reduction in economic production but we have not estimated the amount of this reduction

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.

3.2 Increased social security payments

3.2.1 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 4.

Table 4. 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

The *ABS Life Table 2011 to 2013* has been used to determine the probability of death in Table 5.

Table 5. 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**

3.2.2 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 6.

Table 6. 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

The estimated average TPD claim incidence rate is in Table 7.

Table 7. 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 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 year¹. 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**

¹ 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**

3.2.3 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 8.

Table 8. 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

The estimated average claim incidence rate for income protection due to accident or sickness with a two week waiting period is in Table 9.

Table 9. 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**

3.2.4 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 10.

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 10. 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	1540.0	856.6
Default IP cover removal	85.0	45.6
Removal of all default cover	1,660.5	922.2

3.2.5 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. We have not calculated the amount of the lost revenue to Government from this source but the amount is modest compared with the additional social security costs (see Section 3.2.4) and the costs from the lost taxation and spending capacity due to reduced insurance claim payments (see Section 3.2.1).

3.2.6 NDIS Rollout

The Government is gradually rolling out the new National Disability Insurance Scheme (NDIS) to assist disabled members of the population with a range of support services. It will not provide income replacement and thus the families will still require financial support.

3.2.7 Comments

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

- Fewer people have TPD cover.
- 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.

4. Impact on Individuals of removing default life insurance

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 as a result 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.

4.1 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 earners.
- 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.

4.2 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 we would expect the percentages of those with rents or a mortgage to be 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 the 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%. Taking into account the census information showing 34.5% of households have a mortgage this means that over 60% of mortgage holders have debt equal to more than three times household income.

The same speech stated that a 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.

4.3 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 dependant 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 *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 dependant children.

Children's needs vary with the age of children. Children pursuing tertiary education will need support until at least this age, others under age 21 often work in low paid jobs, live at home, and/or need some 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.

4.4 Erosion of account balances

The deduction of insurance premiums from member accounts does lead to a smaller amount available for members' retirement needs. Therefore, removal of default life insurance will result in larger retirement balances for those who do not die or become disabled before retirement.

Appendix A Data Sources

A.1 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.2 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.