SUPERANNUATION COMPETITIVENESS AND EFFICIENCY

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

This Submission is a joint submission of:

-the Consumer Action Law Centre, a campaign-focused consumer advocacy organisation based in Victoria,

- Berrill & Watson Lawyers, a national consumer legal firm practicing exclusively in superannuation and insurance,

- the Chronic Illness Alliance, a peak body representing 55 state and national disability organisations in health policy and health services for all people with chronic illnesses

6.4 The System Provides Insurance That Meets Members' Needs at Least Cost

As the Draft Report identified, insurance benefits within superannuation come at a cost to members' retirement income balances through premiums charged by insurers and the administration costs incurred by funds.

Any assessment of ensuring that these costs provide consumers with value for money must involve an understanding and assessment of the benefits provided by insurance within superannuation

What Insurance?

The benefits available through group insurance within superannuation are life, Total and Permanent Disability (TPD), income protection and terminal illness cover. Life insurance (or death insurance as it is sometimes called) satisfies the sole purpose test under section 62 (1)(a)(iv) of the Superannuation Industry (Supervision) Act 1993 (SIS Act) by providing death benefits for dependents or the Legal Personal Representative of a deceased member. Terminal illness insurance benefits are aligned to life cover as the pre-payment of the life insurance benefit.

TPD and income protection insurance benefits satisfy the ancillary purpose test under section 62 (1)(b)(ii) of the SIS Act by providing benefits following the cessation of work because of ill-health.

Benefits such as critical illness or trauma benefits do not satisfy the sole or ancillary purpose tests under section 62 of the SIS Act and cannot be offered by regulated superannuation funds.

The benefits are typically provided by life insurance companies although trustees can now enter into group contracts with general insurers. In practice, however, this is rare.

Group Insurance-Providing Retirement Incomes

An initial question is the extent to which types of insurance benefits available in superannuation are consistent with and add value to Australians' retirement incomes.

It has been argued that there is an insufficient nexus between some insurance products and retirement incomes and that some insurance products detract from the ability of the superannuation system to promote self-funded retirement and reduce reliance on the age pension.

With respect, this is not correct, at least in relation to TPD insurance benefits. The benefit design of TPD insurance within superannuation is to 'top up' the inadequate superannuation that a person has accrued when his/her working life is cut short because of ill-health.

Insurance is by its very nature a cross-subsidisation of the few by the many. However, a superannuation TPD insurance benefit is designed within the framework of ensuring that all workers have the opportunity of an adequate self-funded retirement income, thereby reducing the burden on taxpayers. It insures workers against the risk of leaving the workforce prematurely and becoming a long-term burden on the taxpayer through reliance on the disability support and age pensions.

The analysis is more problematic with respect to income protection insurance which provides income replacement during a person's working life and not their retirement. However, there is a nexus with a retirement income if the income protection payments include payment of Superannuation Guarantee contributions to a superannuation fund for the period of the income replacement. There is also the argument that temporary income support assists in a person's rehabilitation into the workforce thereby enhancing the person's capacity to accrue an adequate retirement income.

With respect to life insurance, the analysis is that a life insurance benefit tops up the otherwise inadequate accrued superannuation of a deceased member thereby providing for the dependents of the deceased. Although this complies with the sole purpose test, the nexus with retirement incomes is less clear.

Underinsurance

The Draft Report raises the issue of underinsurance in Australia and the extent to which this is alleviated by group insurance in superannuation.

The Report points to the KPMG report in 2013 and the Rice Warner report in 2014 as clear evidence of the big underinsurance problem.

This has recently been confirmed by Rice Warner's latest Underinsurance in Australia 2016 report. The report states that the median underinsurance gap between the amount of cover required and that actually held was 63% for income replacement (down from 58% in 2014), 87% for TPD (86% in 2014) and 84% for income protection (no change from 2014).

The 2014 Rice Warner report also confirmed the proportion of total life insurance held within superannuation funds—71 % of death cover, 88% of TPD cover and 59% of income protection benefits—is held within superannuation funds. Whilst some of that insurance is held by individuals under planned arrangements, the vast majority is held by employment superannuation funds under group insurance arrangements and most of that insurance is at default cover levels.

Accordingly, as Rice Warner said in their 2014 report, "…the under insurance gap is large, but would be much larger if cover was not provided through superannuation funds."

These default arrangements, under which a member is automatically covered for some/all of death, TPD and income protection insurance, usually on a voluntary opt-out basis, have been commonplace since the introduction of compulsory superannuation in 1992 and indeed existed in most employer-sponsored and government defined benefit funds for decades before.

With the introduction of MySuper from January 2014, death and TPD insurance cover was mandated for any MySuper product, subject to the trustee determining that the insurance was obtainable at reasonable prices and without unreasonably eroding members' retirement accounts. The SIS Act also requires that members have the option to opt out of cover if they so choose, again subject to reasonable market availability.

The above arrangements support the availability and affordability of insurance within superannuation whilst providing freedom for members to adjust or opt out of cover to meet their individual needs.

As the data from the above reports clearly indicates, any adjustment to that setting would have huge adverse consequences for the number of life insurance policies held by Australians and severely exacerbate the underinsurance problem in Australia.

Given that life insurance in superannuation can top up a person's retirement income and mitigate against enforced reliance on age and disability pensions, any reduction in the level of insurance within superannuation would be passed on to the Australian taxpayer by way of increased underinsurance.

The question therefore is, as the Draft Report suggests, how to make the superannuation system with the default insurance arrangements work as efficiently as possible to meet members' needs.

Bundling insurance in superannuation

Group insurance within superannuation invariably bundles death, TPD terminal illness and/or income protection insurance on a wholesale basis with automatic acceptance cover up to specified limits.

This promotes efficiency by providing members with cheaper premiums that the bargaining power of big superannuation funds are able to obtain with automatic insurance cover without individual underwriting, which is particularly advantageous in industries with higher risk memberships. It also facilitates insurers offering automatic insurance cover by spreading the risk across the membership of a superannuation fund in contrast to individual retail life insurance which is invariably underwritten.

There are efficiency savings in compliance and administration costs relating to underwriting assessments, providing policy documentation, ongoing reporting and information and claims and complaint handling. Group insurance, with its economies of scale and automatic acceptance limits, has substantial cost advantages in the delivery of life insurance.

Whilst there is an efficiency cost in placing people into products that don't meet their specific needs, given the above underinsurance problem, death and TPD insurance cover is rarely outside the needs of a member and it is rare that group death and TPD insurance is offset against any other cover.

However, the same cannot be said for income protection insurance products which typically include offsets or top-up clauses for other income protection cover. In that respect, there is a case to prescribe and tailor the type of income protection insurance that can be offered in superannuation to optimise the benefits and prevent any unnecessary overlap.

Whilst bundling insurance in superannuation promotes efficiency, the type and level of some products may be worthy of some prescription to meet member needs and minimise the cost of insurance.

Optimal Cover

The Draft Report raises the question as to what optimal insurance cover should be provided in superannuation.

In theory, the answer should be insurance sufficient to top up a member's superannuation to provide an adequate retirement income. This is, after all, the policy setting behind insurance within superannuation.

Accordingly, from a design perspective, the optimal cover would be level premium cover pursuant to which death and TPD insurance cover reduces as members age and (presumably) their account balances increase. It is noted that most superannuation funds do indeed have such insurance arrangements in place.

While some members may have insurance outside superannuation, the 2014 Rice Warner report confirms that this is very much the exception with most life insurance held within superannuation.

Duplicate Insurance

A related issue is whether there is an inherent inefficiency in the Australian superannuation system by allowing for duplicate insurance across multiple superannuation accounts. Data indicates that the average Australian has more than one superannuation account and a substantial proportion of inactive accounts have insurance cover at some point in time.

The Draft Paper raises the issue of some people having more insurance cover than they require across multiple accounts and suggests that in an efficient system, the extent of duplicate insurance would be low.

Whilst this is correct in theory, given the substantial underinsurance problem in Australia, the overwhelming likelihood is that a member would still have insufficient insurance, and insurance across multiple accounts would, at best, reduce the likelihood of insufficient insurance to meet the retirement income needs of disabled workers or dependents. As is detailed above, this only applies to death and TPD insurance and not income protection insurance which is invariably offset from one policy to another.

Member Awareness and Behaviour

A key factor in ensuring members' insurance needs are met is improving members' awareness of the type and level of insurance cover they have and need so that they can make any necessary adjustments to default cover to meet their specific needs.

Compulsory employment-based superannuation was introduced in 1992 because of an acknowledgement that Australians had not and in all likelihood would not voluntarily accrue sufficient savings during their working lives to self-fund their retirements.

Along the same lines, group insurance was introduced as a default option by most superannuation funds because of an acknowledgement that, initially at least, members would be unlikely to take out sufficient insurance to cover their retirement income.

The introduction of MySuper in 2014, with the mandating of minimum design features for default superannuation including opt-out death and TPD insurance cover, was a further acknowledgement of agnostic member behaviour.

The compulsory nature a superannuation had represented a challenge for trustees to promote member engagement and awareness and this has certainly applied to life insurance. That said, as members' account balances have increased and communication techniques and materials have improved over the years, so member awareness has gradually improved. In relation to insurance, this is perhaps best illustrated by the significant increase in claims many funds and insurers have experienced over the past 3 to 4 years, a trend noted in the Draft Report.

Although the adverse claims experience of some insurers has caused some consternation in the industry, it does provide some encouragement that members are becoming more aware of the type and level of their insurance. This can in turn lead to greater efficiency as members can elect to increase or reduce their default cover to suit their individual circumstances.

Increased member awareness is a slow-burn but the signs are encouraging and the enhancement of targeted and concise information is important for the efficiency of the superannuation system and its default insurance arrangements.

Nevertheless, education, particularly targeted to the most disengaged superannuation consumers eg young workers, is crucial in the development of superannuation fund members' needs.

Tailored Insurance Products

In the promotion of member awareness and insurance tailoring products, it is vital that members are able to easily compare insurance products and performance. This includes access to information about types of insurance, premiums and claims data.

The 2013 Stronger Super legislative changes significantly enhanced data collection and reporting obligations of trustees, as well as requiring the development and implementation of an insurance strategy consistent with the demographics of fund membership coupled with a specific statutory requirement not unreasonably erode members' retirement accounts.

However, there remains the problem of the impenetrability of some insurance policies and Product Disclosure Statements which compromises the ability of superannuation fund members to compare products and make decisions about their needs.

One solution is to introduce standard cover group life insurance across death (and terminal illness), TPD and income protection cover whereby insurers offer cover with prescribed standard terms and conditions consistent with consumer expectations of such products but with the ability to offer non-standard terms subject to an obligation to clearly inform members of the deviation from the standard terms.

Standard cover exists under the Insurance Contracts Act 1984 with respect to retail general insurance policies such as home building and contents, motor vehicle, travel, and sickness and accident insurance but has never been in place with respect to life insurance products.

Standardised terms such as definitions of TPD consistent with the "permanent incapacity" definition in the SIS Act for early access to superannuation and conditions prescribing exclusions and income protection benefit offsets would promote efficiency by ensuring that members' expectations of benefits are met. The ability to deviate from standard cover would allow insurers, trustees and members to tailor products to meet insurers' commercial and members' personal needs and promote efficiency.

Fund Activity

The ability of members to identify their default insurance and then tailor their cover to meet their individual needs is in part dependent on the seamlessness with which members can navigate changes to their insurance, whether that is to vary cover or to opt out altogether.

Most superannuation funds allow members to increase their default cover up to automatic acceptance limits albeit with limited underwriting, and potentially beyond with full underwriting.

Most, but not all, funds have group insurance arrangements pursuant to which members can opt out of insurance cover, although there are sometimes limitations on these options such as a member may not opt out of death cover whilst retaining TPD or income protection cover.

These limitations on member choice, whilst not necessarily inconsistent with the requirements under the MySuper legislation, do detract from allocative efficiency and should be removed where possible. Although insurers traditionally bundle insurance cover, there does not appear to be any good commercial reason why disability cover for income protection and/or TPD cannot be offered without death cover. This would be optimal for most younger workers who do not have dependents and for whom death cover is of little utility.

It is a common criticism of superannuation that account balances of young workers are unreasonably reduced by fees and charges, including death insurance premiums when they do not have any dependents. An efficient system to allow such persons to opt out of death cover would be an important measure to promote members' needs at least cost. Indeed, there is a reasonable case to remove the default arrangements with respect to death cover for those members under say 30 years of age.

The ease with which members can interact with and make alterations to their individual accounts within superannuation has improved over recent years with technological advances, including SuperStream. This is an important efficiency measure to allow members to adjust their default insurance to meet their needs.

Insurance Premiums and Costs

The Draft Report correctly identifies that group insurance premiums have risen significantly in the last few years and that these increases are attributable to a market correction following a period of intense price competition, poor underwriting and increased member awareness.

These factors are not indicative of a long-term trend but a shorter term correction, at least to some degree. Therefore, some caution must be taken in making assumptions about the cost of group insurance without a longitudinal study.

Anecdotally, insurance premium rises appear to be plateauing following a reaction from insurers to poor claims experiences. That reaction saw some insurers increase previously underpriced premiums substantially, amend policy wording, reduce default and automatic acceptance limits and tighten claims processing.

Some of those changes are appropriate adjustments. For example, a move by insurers towards instituting rehabilitation and retraining programs for disability claimants is laudable and entirely consistent with returning members to the workforce to resume superannuation contributions for their retirement.

Whether the recent and current insurance arrangements continue to be optimally cost-effective is a matter of judgement which must include consideration of loss ratios, ongoing premium increases as a proportion of superannuation contributions and account balances, the extent of any underwriting and policy terms and conditions.

With respect to loss ratios, we understand that the industry figures for the group insurance market is in the range of 85 to 90%, which compare very favourably with the individual retail life insurance loss ratios and also compare favourably with other (general) insurance products brackets (see the Australian Prudential Regulation Authority, General Insurance Performance Statistics, June 2016).

Summary

It is our opinion that in general terms, group insurance has and continues to offer comparatively generous benefits at competitive premiums, with substantial automatic acceptance limits and reasonable terms and conditions. It provides an important social benefit enabling Australian workers to obtain life insurance as they progress through their working lives and also provides persons whose working lives are cut short because of disability or death with the opportunity to accrue a sufficient retirement income.

Group insurance in superannuation is also an important buffer against underinsurance.

Improvements such as those detailed above can and should be made to improve the efficiency of the default insurance regime to ensure that insurance does indeed meet members' needs at least cost.

The delivery of improvements and the efficiency of superannuation generally and insurance within superannuation could and should be periodically reviewed.