

## FINANCIAL ROUNDTABLE REPORT SERIES

# Super: Implications for the Life Insurance Industry

FRRS 2010 - 2

September 16, 2010

*This report is based on a roundtable (and subsequent) discussion organised by ACFS and involving the following participants: Tom Cincotta (Comminsure), Jules Gribble (ASFA), Michael Skully (Monash Uni and Unisuper), Peter Hay (KPMG), Robert Bergin (AXA Asia-Pacific), Andrew Taylor (AIA) and Deborah Ralston and Kevin Davis of ACFS. The report summarizes issues arising from those discussions and, except if indicated, none of the views should be attributed to individual participants.*

### 1. Introduction

The growth of superannuation has (and will continue to have) significant effects on the life insurance industry. First, life offices with a large retail wealth management business such as AMP or AXA, as providers of superannuation, now have the substantially greater part of asset holdings reflecting superannuation (savings) liabilities rather than risk business. Second, as more individuals move into the drawdown phase of superannuation, there may be more demand for “longevity insurance” products such as lifetime annuities (although current tax-transfer arrangements have contributed to the current demise of that market). Third, the provision of life, total and permanent disability (TPD), and income protection insurance cover through superannuation funds has become big business, involving changes in product designs, accessibility for consumers, distribution channels, and the nature of industry competition.

The focus of this report is on that third effect, although the issues and implications for super funds and insurance are often intertwined. More generally, there are significant public policy issues involved including consumer engagement, underinsurance, and access to financial advice.

## FINANCIAL ROUNDTABLE REPORT SERIES

### 2. *Individuals: their awareness of, and demand for, insurance in super*

It is generally acknowledged that most individuals have little awareness of the extent (or even existence) of insurance coverage provided as part of superannuation. It is the requirements under the SIS Act for a minimum level of life insurance to be offered by employer sponsored funds as a component of superannuation that have been the primary factor leading to life insurance coverage provided via superannuation. But both superannuation trustees and the insurance industry have played a role, with life offices noting the potential of super funds as a distribution channel for expanded business, and trustees determining that provision of insurance is a valuable service to members. There is a diversity of approaches across super funds to the level of coverage offered above the compulsory minimum, and also whether TPD insurance is offered.

Determination of the default level of coverage by trustees is particularly important given behavioural biases which tend to lead to individuals not shifting from a default option. A tripling of the default level by one scheme, while also giving members the right to opt out, was reported to have seen only one per cent opting out. But there are also difficult issues involved in determining the appropriate life insurance requirements across individuals with different characteristics and through their life-cycles, and thus in setting default options. The trustees' lack of knowledge of member insurance coverage outside of super is relevant here. But also important is the consideration which trustees must give to the impact of payments out of the fund for higher insurance contributions on fund accumulation for ultimate retirement savings.

Currently, offering of life insurance is the compulsory element in superannuation specified by the SIS Act. On the basis of historical experience regarding the extent of injury enforced absences from work, it can be argued that income protection and/or TPD insurance are sufficiently important to warrant also being a compulsory element in superannuation. So also may be trauma insurance.

*Analysis of the variability of insurance offerings across super funds, and its determinants, is worthy of study, as is analysis of optimal setting of default insurance levels and types of benefits.*

It can be argued that the packaging of life (and TPD) insurance within super, rather than as explicit separate products, is one reason contributing to the lack of awareness of insurance

## FINANCIAL ROUNDTABLE REPORT SERIES

coverage. The past restrictions on super funds providing financial advice may also have contributed to less awareness of the availability of insurance within super.

Although reliable public data is not available, the same lack of awareness appears also to be found in the self managed super fund (SMSF) sector, even though some SMSF trustees will take out significant life or TPD insurance policies through their fund. The tax deductibility (against contributions tax) of life insurance premiums in the super fund is a relevant factor here, although where benefits are paid to a non-dependent these may be subject to taxation. Within the SMSF sector, the fact that most advisers and accountants who provide advice and administrative services to such funds are focused on the investment and tax aspects, rather than being in the “risk” business may also contribute to a lack of focus on this option.

At the same time, there are some individuals who are aware of their insurance needs and who may maintain membership of multiple super funds as a cost-effective way of obtaining desired insurance coverage. *But it is unclear overall how the availability of insurance via super has affected the demand for super via other channels, and this is worthy of further analysis.*

### **3. Implications for the insurance industry**

One of the main implications of “insurance in super” for the life insurance industry lies in the growth in importance of this distribution channel and implications for competition and pricing. Whereas, historically, life insurance was predominantly sold as individual policies via agents and, more recently, through financial advisers, there is now much more use of “group” policies sold to super funds to provide coverage to their members. (For the “retail” funds operated by the large life companies their superannuation business is, of course, an important mechanism for distributing their risk products). Winning a mandate from a large super fund to be the provider of such group insurance is a significant event for insurance companies. In principle, while super funds would seem to face low “switching costs”, there are a number of impediments to making such a change. These include administrative costs associated with systems and advising members etc., as well as “legacy” issues arising in subsequent claims when the precise coverage offered by a new supplier differs from that which was previously offered to members. For trustees, assessment of alternative group life insurance offerings needs to include both price and anticipated service quality – since “actuarially fair” pricing based on expected

## FINANCIAL ROUNDTABLE REPORT SERIES

mortality patterns of the membership group would not be expected to vary much across suppliers.

The growth of insurance delivered via super experienced over the past two decades reflects two main influences. The first determinant of growth was due to super bringing many non-insured workers into the insurance market – albeit often unknowingly. While super balances are set to continue to grow, this does not flow automatically through to premium growth for two reasons. First, the default level of insurance in super is determined as a dollar amount (premiums or coverage) often inversely linked to the age of the member. Second, with an ageing membership, the average default amount of coverage is likely to decline because of that linkage. Partly counteracting this effect is population growth (and possibly increasing labour force participation rates) bringing more individuals into the super system.

The second influence, reflected in continued strong growth over the last five years, is the recognition by the industry of the potential strengths of this distribution method for insurance products, and trustee awareness of potential benefits to members from improved access to, and pricing of, insurance products. Within group policies sold to super funds, many insurers provide *automatic acceptance limits* which enable a member to readily increase their level of coverage. Those limits appear to have increased substantially in recent years with some arrangements allowing for virtually automatic access to life cover levels of up to as much as \$1 million. While take-up of such options by super fund members is currently relatively low, this is a potential avenue for future growth, if member awareness and demand for insurance can be increased. However, as with any self-selection option, the risk of adverse selection and implications for future claims experience must be borne in mind.

Bringing techniques of direct marketing and web-based applications developed initially for the retail insurance market into the group insurance superannuation based sector is a key area of current and future development. The relationship between the super fund and its members, and between the fund and a group insurer, places the fund in an obvious potential role to market insurance products available through its group policy to its members, should the trustees see this as beneficial to members. There is a complex set of principal-agent relationships involved here, including remuneration of fund employees engaged in marketing such products, but where the insurer pays for costs incurred and pays commissions to the fund, there is potential for net benefit to the fund and its members. Providing web based applications incorporating

## FINANCIAL ROUNDTABLE REPORT SERIES

expert systems on a fund's website which link directly to the insurer's application processing system, may reduce some of those agency issues and facilitate member demand-driven access to insurance products. In both cases, the opportunity to leverage the extant relationship into insurance products for the member and family which are purchased outside of the superannuation scheme is an important incentive for insurance companies.

The ability of super funds to now provide financial advice to members increases opportunities in this area, but introduces questions about incentives and the nature of appropriate fee/commission relationships between the fund, insurance company and member. While for "mutual" funds such as industry funds, any commissions flow in aggregate to the membership pool and thus are a zero sum game (when considered in conjunction with effects of commissions on premium rates), there are still distributional effects. *Whether there are particular undesirable impediments to insurance companies leveraging off extant, indirect, relationships with super fund members who they insure in order to offer further products is worth consideration.*

One challenge for the industry is designing and pricing "optimal" group policy packages which reflect the demographic characteristics of super fund membership. While it is generally accepted that there is "underinsurance" (both from a private and social perspective)<sup>1</sup>, and thus scope for convincing trustees of the merits of greater default levels, it is less clear that this is common across all ages and household types. For example, no, or little, life insurance for young, single, individuals may be optimal although TPD insurance has clear merits (but is potentially relatively costly given long expected remaining life spans). At other stages of the lifecycle, quite different insurance packages are likely to be preferable, and some insurers have already proceeded down this path with arrangements linked to life-cycle stages. *Analysis of how default insurance options vary with life-cycle characteristics across super funds, and assessing their optimality, would be worthy of further study.*

Another competitive challenge for individual life companies lies in the prospect of further mergers within the super industry, reducing the number, but increasing the size, of potential super fund purchasers of group policies. While it is in principle possible for funds to choose

<sup>1</sup> This would appear to be supported by the low ranking (17<sup>th</sup>) of Australia for insurance premiums/GDP in league tables constructed by SwissRe ([http://media.swissre.com/documents/sigma2\\_2010\\_en.pdf](http://media.swissre.com/documents/sigma2_2010_en.pdf)), although it is not clear whether these figures are affected by inter-country differences in types of policies commonly used which may include a savings component as well as a pure risk component (such as occurs with whole of life or endowment policies).

## FINANCIAL ROUNDTABLE REPORT SERIES

several providers of different types of coverage (eg life v income protection v TPD) or to provide member choice for insurance above the default coverage, this is unlikely to happen for administrative cost reasons. Where mergers between super funds with different insurance providers occur and lead to the removal of one of those insurers from future business, there are also potential legacy issues associated with changes in the coverage now provided to members of one of those previous funds.

It is widely accepted that the lower distribution costs of group policies and competition for such substantial amounts of business have led to lower premiums. But also relevant has been the effect of compulsory insurance through super expanding the overall volume of business, and reducing the aggregate degree of underinsurance, by reducing the number of “uninsured”.

However, the Cooper Review<sup>2</sup> notes that there are significant differences between types of super funds in the ratio of premiums paid to claims proceeds (in the same year), that this ratio seems relatively low, and appears to have fallen somewhat over time. (They also note differences in the price of coverage across types of funds, and consulting firm Chant West suggest that the ratio of highest/lowest premium for the same coverage is in the order of ten)<sup>3</sup>. Comparing premiums with claims paid in the same year is an extremely simplistic indicator of “value” and in a growing market is unlikely to be an accurate indicator. *Further analysis of the reasons for apparent differences in the “claims/premiums and coverage/premiums value” of group insurance across super funds seems warranted.*

One of the resulting risk management issues for insurance companies arises from the problems in determining the number of “incurred but not reported” claims, because of information and processing deficiencies in the links between individuals, super funds and insurance companies. Individuals may cease making contributions to a particular fund for a variety of reasons including unemployment, change of employment and enrolment in a different fund, or death. Unless, or until, advised by a deceased member’s estate, the super fund may be unaware of the need for payout of super and insurance benefits, and the default will typically involve continuation of the insurance premiums on behalf of the member. The insurance company will be unaware of the impending claim, and the lags between death and payout may thus be significant. There may also be risks associated with potential beneficiaries not being aware of

<sup>2</sup> [http://www.supersystemreview.gov.au/content/downloads/final\\_report/part\\_two/Part\\_2\\_Chapter\\_5.pdf](http://www.supersystemreview.gov.au/content/downloads/final_report/part_two/Part_2_Chapter_5.pdf)

<sup>3</sup> [http://www.chantwest.com.au/sysViewPDF.aspx?PDFFile=Media\\_Release\\_-\\_2010\\_Insurance\\_Report\\_Jun10.pdf&PDFType=PDFFile](http://www.chantwest.com.au/sysViewPDF.aspx?PDFFile=Media_Release_-_2010_Insurance_Report_Jun10.pdf&PDFType=PDFFile)

## FINANCIAL ROUNDTABLE REPORT SERIES

the insurance coverage (or even the super account), and reliant upon the trustees of the fund to act proactively in initiating a claim. *Whether the current structure of administrative arrangements and responsibilities between super funds and insurance companies in identifying member deaths and initiating claims payments is optimal is worthy of examination.*

One challenge for the life industry lies in the growth of the SMSF sector and in finding suitable distribution channels to penetrate that market. While there may be many individuals who are “aware” and who will access product offerings directly (such as via the internet), the role of advisers and service providers to SMSF trustees appears significant. With the impending ban on commissions from financial product providers, but an exemption from that ban for life insurance products, there may be enhanced interest shown by such advisers in life insurance products. Because pricing of individual risk products is critically dependent on the personal characteristics of the individual (unlike group products where averaging can, to some extent, be relied upon) mechanisms for assisting individuals (or their advisers) in choosing between competing supplier offerings are important. Whether this will be best served by insurance brokers or through web-based portals enabling individuals to seek bids from participating suppliers is a moot question, but the recent and anticipated growth of direct access policy sales is relevant in this regard.

*This Financial Roundtable Report was prepared by Prof Kevin Davis, Research Director, ACFS and Professor of Finance, University of Melbourne.*  
[kevin.davis@australiancentre.com.au](mailto:kevin.davis@australiancentre.com.au)

The *Financial Roundtable Report Series* assemble the expertise and thoughts of leading individuals on topics of interest to the finance sector. Through the use of roundtables, ACFS develops its thought leadership role by facilitating discussion among academics, industry practitioners, policymakers and regulators, to contribute to public policy debate and identify areas where further research is desirable.

For more in this series, please visit our website at

<http://www.australiancentre.com.au/category/publications/financial-roundtable-report-series/>