2016 ALUCA TurksLegal Scholarship - Winner

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Question

DOES FINANCIAL SECURITY HAVE TO COME AT THE PRICE OF RETIREMENT SAVINGS?

One of the fiercest debates in recent times about insurance in superannuation has been about balancing the financial protection that insurance provides with the possible depletion in the member's retirement benefit that comes with paying the cost of the premium.

We would like you to examine the various public statements by prominent commentators on this subject and present a survey of the debate as well as your conclusions and thoughts about the best way forward.

Evidence of broad research coupled with well-reasoned and informed conclusions will be highly regarded by the judges.

INSURANCE IN SUPER: HOW TO CREATE A SUSTAINABLE INSURANCE DESIGN

1. Overview

This paper will investigate whether insurance continues to have a meaningful role to play within superannuation and provide a guide as to how trustees can balance the need to provide financial protection to members and the possible depletion of a member's retirement income.

After reviewing a diverse range of insights and commentary from insurers, regulators, law firms, wealth managers, consultancies and trustees, this paper will conclude that creating a sustainable benefit design requires an in-depth understanding of member demographic data and the development of a position as to what constitutes the inappropriate erosion of retirement income.

The best way forward in developing sustainable insurance designs is for trustees to actively engage with their group insurer, legal adviser, employers and financial advisers to develop a comprehensive change management plan which adequately address the risk associated with amending existing designs and ensures financial security does not come at the price of retirement savings.

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3. What is the value of insurance inside superannuation?

The ‘fierce debate’ about insurance inside superannuation is largely being fought between trustee directors in board rooms across the country. On one hand, trustees face disgruntled default members who were unaware they had insurance, whose retirement income has been eroded, whose claims have not been paid and who demand refunds for a product feature they did not want.

On the other hand, there are members who maintain superannuation accounts solely for the insurance, members who see value in protecting their income, and members who, forced to retire early due to disability, call their trustee about early release of superannuation and discover they are eligible for a life changing benefit.

The decision whether to have life insurance within superannuation was resolved for trustees by the regulatory obligation[1] to provide (opposed to offer) members with a limited ‘safety-net’[2] level of default cover on an opt-out basis.

The real debate now relates to what **kind, level and cost** of insurance inside superannuation is appropriate for members. These three key determinants of appropriateness are express legislative requirements[3] and should be considered throughout the insurance design and review processes. APRA Deputy Chair, Helen Rowell, has made abundantly clear that trustees are expected to strike a balance ‘*between providing benefits that adequately meet members’ needs and ensuring that the cost of insured benefits is not unduly high’*[4] which can create a *‘real tension’*[5] between competing trustee obligations to provide cover without eroding retirement income.

KPMG has described the level of cover for the majority of working Australians as less than adequate[6]. Leading consultancy Rice Warner has also suggested that default cover meets about 30% of a member’s needs.[7] This indicates members have a need for death and disability insurance. However, whether superannuation is the solution, Christopher Sozou, Head of Wealth at Virgin Money, has noted that *‘in trying to solve an under-insurance issue, we have added cost and complexity to superannuation for both product providers and members’*[8].

This cost and complexity does have some value provided the cover is appropriate – such as protecting the member’s income in the event of disability, reducing government expenditure on disability pensions, the reduced cost of insurance relative to the cost outside superannuation, automatic acceptance without underwriting, large scale discounts and potential tax benefits.

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[1] *Superannuation Guarantee (Administration) Regulations* (Cth) reg 9A; *Superannuation Industry (Supervision) Act* 1993 (Cth), s.68AA.
[2] Explanatory Memorandum, Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012 (Cth) at 2.15.
[3] *Superannuation Industry (Supervision) Act* 1993 (Cth), s. 52(7) (a).
[4] Helen Rowell, ‘*The Super System – What is on APRA’s Watch List*’ (speech delivered at the AFR Banking & Wealth Summit, Sydney, 29 April 2015).
[5] Sally Rose, ‘APRA’s Helen Rowell says super failing on member’s insurance’, AFR (online), 20 July 2016 <http://www.afr.com/business/banking-and-finance/financial- services/apras-helen-rowell-says-super-failing-on-members- insurance>.
[6] KPMG, *Underinsurance – Disability Protection Gap in Australia* (January 2014) <http://www.fsc.org.au/downloads/file/ResearchReportsFile/FSCKPM G_UnderinsuranceDI_lowres.pdf>.
[7] Rice Warner, *Australia’s Persistent Life Underinsurance Gap* (24 June 2015) <https://ricewarner.com/australias-persistent-life- underinsurance-gap/>.
[8] Christopher Sozou, ‘‘Does insurance belong in super?’, Cuffelinks (online), 29 August 2014 <https://cuffelinks.com.au/insurance-belong- super/>

4. When are the kind, level and cost of insurance not appropriate?

The statutory obligation on trustees to only offer insurance '*if the cost… does not inappropriately erode the retirement income of beneficiaries*[9]' is unhelpfully vague and requires trustees to conduct their own investigations without the assistance of any explicit industry or regulatory guidelines as to what cost may be inappropriate. Given the correlation between benefit design and the depletion of retirement income (as, subject to large cover discounts, higher levels of cover means higher cost) the cost cannot be examined in isolation from the kind and level of cover.

The key message to trustees is that the appropriateness of the kind (i.e. Death, TPD or TSC) and level of cover will largely depend on key demographic factors of the members (such as members' age, gender, occupation and smoker status) and that the cost of premiums should be examined relative to the proportion of a member's superannuation guarantee (SG) contribution, salary or superannuation balance.

Where a high proportion of members are above the benchmark, reconsideration of the insurance redesign is likely to be necessary.

Trustees must ensure that the erosion benchmarks relied upon are not arbitrary. This may mean that the benchmark needs be adjusted to consider the member's age and changing insurance needs (e.g. a life cycle approach similar to some MySuper investment options) or estimated retirement income (which may involve consideration of concessional contribution caps).

As a starting point, trustees should consider the average percentage of a member's SG contribution going towards premiums at their fund level. The standard combined death and disability cover for MySuper members was $170,000 for an average premium of $5 per week.[10] By way of an example, AustralianSuper has indicated that the maximum amount members should be paying is either $10 a week or 10% of their SG contribution[11] and SuperRatings has suggested less a cost of less than 5% of SG is appropriate[12].

The Department of the Treasury has previously estimated that '*a 20- year-old with $1,000 in superannuation can unknowingly have their super savings eroded to just $418 after five years by a range of fees and deductions*'[13]. Whilst not limited to premiums, this example illustrates that the reduction of a member's superannuation balance by as little as $2.30 per week may still be material and constitute inappropriate erosion of retirement income. On the other end of the erosion spectrum, ASIC Report 413[14] identified cases where members were paying premiums in excess of 100% of their SG contribution which ASIC concluded may '*prevent the client from meeting their retirement objectives*'.

[9] *Superannuation Industry (Supervision) Act* 1993 (Cth), s. 52(7)(c).
[10] Selecting Super, *Making sense of Your Fund's Insurance Cover* <http://www.selectingsuper.com.au/learning_centre/make_sense_of_your_funds_insurance_cover>.
[11] Sally Patten, 'Why super funds are slashing insurance premiums for members' AFR (online), 25 April 2016 <http://www.afr.com/business/banking-and-finance/why-super-funds- are-slashing-insurance-premiums-for-members-20160421-gobwpe>.
[12] SuperRatings, 'Insurance – when is enough, enough?' (Media release, 2 May 2016).
[13] Explanatory Memorandum, Treasury Legislation Amendment (Unclaimed Money and Other Measures) Bill 2012 (Cth), at 4.10.
[14] ASIC, 'Review of Retail Life Insurance Advice' (Report 143, 2014), 187.

Consultancy ChantWest has stated that '*every dollar that is spent paying for insurance is a dollar that is not invested and growing the member's nest egg*'.[15] Figure 1 below shows the premiums payable by a typical member in two different funds:

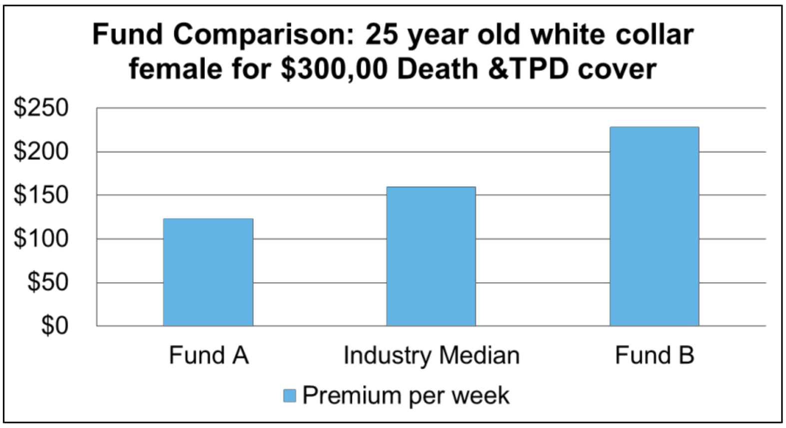

Figure 1: Premium Comparison (Source: ChantWest)

The retirement income of the member in Fund B would be approximately $15,000 (in today's dollars) less than that of a member in Fund A. The impact on retirement income is likely to be higher where a member has multiple superannuation accounts.[16]

Each of the erosion examples cited above is based on the member level experience. Yet the prohibition on offering an arrangement which inappropriately erodes retirement income is actually '*at the <u>level of the entire membership</u> of [a trustee and does] not apply to the circumstances of individual members*' (emphasis added).17[17] The guidance within the Explanatory Memorandum does not adequately recognise that a trustee will have multiple products or plans within a fund each with different insurance designs which may have to be reviewed to accommodate membership groups with different demographics.

Appropriateness must also be considered at the member level by asking what kind, level and cost of cover is appropriate for a 35 year old male blue collar member on a salary of$35,000 opposed to a 44 year old female white collar member on a salary of $135,000? This process of reviewing the suitability of the kind, level and cost insurance in light of demographic data gives rise to the Holy Grail of a 'sustainable benefit design' or what the Productivity Commission refers to as '*smart defaults*'.[18]

Trustees have another undefined statutory obligation: to promote the financial interests of MySuper members.[19] This duty is likely to transcend the procedural nature of the best interest duty and may require trustees to actively ensure that cover is in the member's financial interest (based on annual net returns after premiums are deducted) which arguably goes further than not providing an insurance arrangement which inappropriately erodes retirement income.

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[15] Chant West, 'Insurance Premium Survey' (Report, August 2014) 2.
[16] For more information, see Jim Minifie, 'Super savings' (Report number 2015-1, Grattan Institute, April 2015) 12.
[17] Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations And Prudential Standards) Bill 2012 (Cth) 1.96.
[18] Australian Government Productivity Commission, 'How to Assess the Competitiveness and Efficiency of the Superannuation System' (Draft Report, August 2016) 69 (footnote 6 of the report).
[19] *Superannuation Industry (Supervision) Act* 1993 (Cth), s. 29VN (a).

Each trustee will have a different view as to what is sustainable. Andrew McLeod of Good Super asks '*if you are 25 years old, with no dependent children, do you really need life insurance? The answer is, in your circumstances, probably not*' however this position fails to consider the same member's need for TPD cover which is often provided on the condition of having Death cover. Richard Weatherhead of AustralianSuper suggests '*members are generally happy to have insurance [inside superannuation] because they know it is a great way of getting it*'.[20]

Conversely, a sustainable design for an insurer is one which is properly priced to cover costs, margin and capital requirements and informed by accurate data. Unsustainable pricing led to what Alex Dunnin of investment website, Financial Standard, described as the 'bizarre situation' of APRA goading insurers to lift prices[21] whilst also reminding trustees of their obligations.

Industry Super Australia has questioned how '*super fund boards reconcile commercial interests … with the best interests of super fund members?*'[22] and the answer is that the two are not incompatible. A sustainable benefit design which a trustee can demonstrate is price appropriate and tailored to the demographic needs of members while providing the necessary return to the insurer for taking on the risk is likely to be an appropriate arrangement for both parties even where those parties are related.

5. Can trustees amend an existing design to ensure sustainability?

The recent increase in claims experience across the industry and the underlying reasons have been well documented[23] and have resulted in premium increases which have exceeded 150% for some plans.[24]

APRA has recommended that trustees 'consider the steps that can be taken to mitigate increases in insurance costs' and suggests a number of potential levers such as 'design changes, enhanced claims management practices and improvements in data integrity'[25] as well as reduced automatic acceptance limits, reconsidering underwriting processes, removing features of limited value, reducing guarantee periods[26] or, as SunSuper and their insurer AIA have recently done[27], move towards income stream rather than lump sum TPD products. Each of these measures represents a potentially valuable tool available to trustees to improve the sustainability of an existing insurance policy. Similarly, transforming claims management based on the health benefits of work can be equally as important to the sustainability of an arrangement.[28]

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[20] Lucia Stein, 'Super-savvy: Experts warn young workers to check superannuation fine print to avoid paying premiums' ABC News (online) 30 October 2015, <http://www.abc.net.au/news/2015-10-30/super-savvy-experts-warn-young-works-to-check-fine- print/6900040>.
[21] Alex Dunnin, 'Honey, my insurance swallowed the super fund' on FS Super (4 August 2014) <http://www.fssuper.com.au/blogs/view/42241243>.
[22] David Whitely, 'The banks' divided loyalties are super's true governance problem' on Industry Super Australia (29 May 2015) <http://www.industrysuperaustralia.com/media/opinions/the-banks- divided-loyalties-are-supers-true-governance-problem/>.
[23] For further information, see APRA Insights Issue 1 (2015), 36 <http://www.apra.gov.au/insight/Pages/default.aspx>.
[24] Above note 14, 4.
[25] Above note 4.
[26] Helen Rowell, 'APRA's expectations of superannuation fund trustees' (Speech delivered at ASFA Unpacks: the future of insurance in superannuation, Sydney, 29 April 2014); Above note 22, 40.
[27] Ben Power, 'Where has all the innovation gone?' *Investment Magazine* (online), 9 August 2016 <http://investmentmagazine.com.au/2016/08/where-has-all-the- innovation-gone/>.
[28] Petrina Casey and Ian Cameron, 'Principles of Best Practice in Occupational Rehabilitation for AIA Australia' July 2014 <www.aia.com.au>

Trustees must also consider the potential detriment to MySuper members who have maintained their account solely for the insurance cover as well as potential liability from disadvantaged members.

In the Manglicmot[29] case, a member had claimed that by changing insurer and the associated disability definition he was not eligible for a benefit which he otherwise would have been. Manglicmot reinforced the necessity of considering the best interest of members holistically while being wary of the litigation risk created by imposing adverse changes at the member level.

The best solution to address the potential liability of trustees, which has also been advocated by both APRA and TurksLegal, is for trustees to undertake comprehensive 'change management plans'[30] with proper business planning, risk analysis and due diligence prior to the effective date of the change. In Manglicmot, the receipt of legal advice was also relevant in determining whether the trustee met its obligations.

6. Is sustainability relevant when tendering for new business?

APRA also expects that trustees 'will consider broader sustainability objectives when tendering for and assessing group insurance arrangements'.[31] Historically, the financial advisers, brokers and employers who ultimately decide the outcome of these tenders (and pay the premiums in slightly over 50% of cases[32]) have focused on attaining the highest level of cover with the most features at the lowest cost. While there is a prudential guide which encourages group insurers to consider the 'sustainability of the premium rates and terms and conditions of the insurance contract[33]' there is no such guidance or regulatory obligation for advisers, brokers or employers which would assist in aligning the priorities of all stakeholders.

A further difficulty in tendering for new business on an amended, sustainable design is the 'equivalent rights' requirements of a successor fund transfer.[34] To address this regulatory barrier to sustainability, APRA has indicated it expects 'that benefit redesign, and other solutions to address increasing insurance costs, are proactively explored and actioned within appropriate timeframes agreed between the insurer and trustee rather than allowed to drift'.

When tendering existing businesses, it is good practice to ensure that the request for tender document and any criteria used to assess tenders considers the 'sustainability of both the insured benefits to be provided by prospective insurers and the insurer itself'.[35]

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29 *Manglicmot v Commonwealth Bank Officers Superannuation Corporation Pty Ltd* [2011] NSWCA 204.
30 TurksLegal, '*TPD clauses and super trustee's duties*' (September 2011) <https://issuu.com/corinda/docs/tpd_clauses?>; Turks Legal, '*Client Update: Change Management Plans*' (8 March 2011) <https://issuu.com/corinda/docs/change_management_plans/1>.
31 Above note 25.
32 AON Hewitt Consulting, '*Superannuation and Insurance Pulse Survey* (September 2014), 9 <https://www.aonhewitt.com.au/Home/Resources/Reports- surveys/Superannuation-and-Insurance-Pulse-Survey-Australi>.
33 APRA, Prudential Practice Guide, LPG270 (October 2014), page 6 < http://www.apra.gov.au/lifs/Pages/Prudential-Practice-Guide-LPG-270-Group-Insurance-Arrangements-October-2014.aspx>
34 See APRA, '*Equivalent Rights' For Members In Successor Fund Transfers*' (Superannuation Circular No I.C.4, February 2001) <http://www.apra.gov.au/Super/Documents/I-C-4-Equivalent-Rights- for-Members-in-Successor-Fund-Transfers.pdf>.
35 APRA, '*Superannuation Prudential Guide 250 (SPG250) - Insurance in Superannuation*' (July 2013) 8 <http://www.apra.gov.au/Super/PrudentialFramework/Documents/Pru dential-Practice-Guide-SPG-250-Insurance-in-Superannuation-July-2013.pdf>; See also above note 22.

7. How can trustees compare the cost of insurance to ensure it is sustainable?

ChantWest[36] deemed insurance to be *'the worst disclosed area of superannuation*' as '*funds disclose insurance premiums in different ways, which makes it very difficult to compare premiums on a fair, apples-with- apples basis*'.

Unlike members of a fund, it is essential that trustees have the knowledge and market experience to effectively navigate premium disclosure issues. This enables trustees to compare the premiums payable by members against other arrangements which would meet the insurance needs of relevant member demographic.

While a premium rate comparison is useful, the actual premium payable by members is impacted by unique plan level factors, such as claims experience, which cannot be readily distilled from a product disclosure statement. APRA has suggested that good practice requires trustees to use an 'independent adviser to benchmark insurance arrangements on a triennial basis to ensure they remain appropriate and in members' best interest'.[37]

An alternative means of testing the sustainability of premiums is to request quotes from an alternate insurer or run a full market tender which would provide a similar outcome to independent benchmarking. Trustees requesting quotes or running a tender solely as a means to negotiating better rates with an existing insurer should make this clear as part of the request for tender to avoid alienating the limited pool of insurers available for future tenders.

[36] Above note 14, 10.
[37] Above note 22, page 44.

8. Conclusion: the best way forward

This paper has argued that to ensure an insurance design is sustainable, the following steps should be considered by trustees:

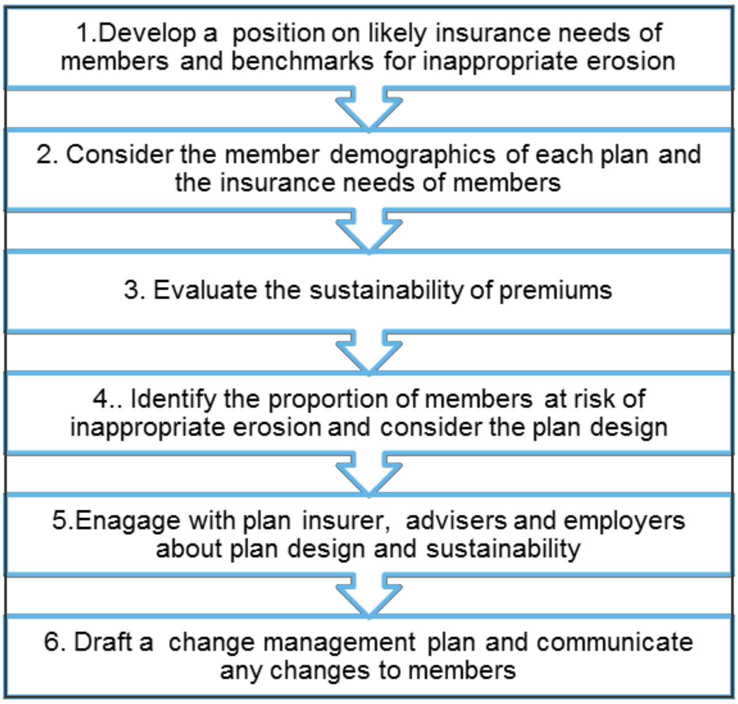

Figure 2: Process map for creating sustainable designs

The debate around the role of insurance in superannuation will continue to rage as member awareness of insurance grows and trustees become more sophisticated in their approach to managing their obligations. By understanding how to create a sustainable benefit design which reflects the underlying member demographics and the trustee's position on what is inappropriate erosion, trustees will be able to effectively implement change management plans, address the 'real tension' between competing obligations and ensure financial security does not come at the price of retirement savings.

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