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The origins of *Protecting Your Superannuation*

The inclusion of insurance in superannuation is a unique feature of the Australian retirement system that ensures that the majority of working-age Australians have some form of protection. The provision of insurance has been a mandatory part of all default superannuation funds since the *MySuper* reforms instituted in 2012 (Commonwealth of Australia, 2011). This cover includes life and total and permanent disablement (TPD) and optional salary continuance insurance (SCI) that is, in most cases, paid for through deductions from the balances held in individual members' superannuation accounts.

Over time, if sufficient contributions are not made to a member's account these insurance premiums will naturally erode the balance that is available for retirement. Because of this, default cover has come under criticism from many quarters leading in part to a 2018 *Productivity Commission* review (Berrill, 2018). The review concluded that many members' retirement savings were being eroded by unnecessary insurance. A factor highlighted by the review as contributing to this erosion is that many workers hold multiple accounts that that pay duplicate fees.

To address these findings, and a perceived lack of industry response to this issue, the government introduced the *Protecting Your Superannuation Act* (PYS) to parliament (Parliament of Australia, 2019). This Act passed in March 2019 with the support of the Greens and after a third of the most contentious reforms were dropped (Kehoe, 2019). With the very short timeline from its passing to the effective date of 1 July 2019, superannuation funds are still in the midst of advising members of the PYS changes and assessing the full impact that this will have across the industry.

The key reforms are:

1. **A requirement to cancel insurance in superannuation accounts that are inactive (i.e. no contributions received) for 16 months or more <u>unless the member opts-in.</u>**
2. **Consolidation of inactive superannuation accounts (via the Australian Taxation**

Office (ATO)) with balances of under $6,000 resulting in default insurance being cancelled in those accounts.

Impact on members

The large populations and lower administrative expenses historically made group insurance a less-expensive option than underwritten retail cover. The premiums for insurance in superannuation are paid from members' concessional contributions further increasing their affordability. These lower costs enabled superannuation trustees to substantially increase the levels of default cover offered over the last decade. The average benefits paid in 2016 were $124,000 for life and $103,000 for TPD, both significant sums for many members (KPMG, 2017). As this is a passive benefit from which members must actively opt-out, it uses an aspect of behavioural science to 'nudge' all workers into having a basic level of insurance thereby overcoming the human tendency towards inertia when making financial decisions.

Because the employer-mandated contributions into superannuation are based on salary, a disproportionate number of those with inactive and low account balances have lower incomes or are unemployed. The impact of PYS on these individuals means that it inadvertently targets certain vulnerable groups including:

- Indigenous Australians who are overrepresented in the ranks of low income Australians, the unemployed and those with medical conditions (Collett, 2018).
- Young workers who are more likely to have lower incomes due to working part-time or casually and being at the start of their careers.
- Women who are not earning an income because they are on maternity leave or working part-time due to having young children.
- Carers who are not earning an income because they looking after an ill family member.

Persons with low incomes, aboriginal Australians and the unemployed are also more likely to have health issues yet they are amongst the least likely to have taken out retail insurance. If these members should lose their default cover, they may find underwritten insurance difficult to obtain or unaffordable should they apply for it in the future (Bainbridge, 2019). The ability to hold multiple accounts with default cover has provided some of these individuals in poorer health with the only viable and affordable means of getting appropriate levels of insurance for their households.

For younger workers and women on maternity leave health issues are not as likely to be a barrier to obtaining cover. For these members it is the invincibility of youth and the obstacle that this creates to planning for the future, including the need for insurance. Whilst the majority of young workers may not yet have significant family obligations, in the 2016 tax year there were nearly 300,000 households headed by a person under 25 years of age which included nearly 60,000 children (ASFA, 2019). A death or disabling event at such an early stage in life would have a long-term financial impact on these young workers and their families. Whilst the rationale behind PYS is to protect retirement funds, it also results in denying easily-obtained and affordable insurance to exactly the members who are least likely to have it.

Impact on insurers and trustees

All insurance cover is predicated on sharing risk through the concept of 'pooling'. In the case of guaranteed acceptance insurance, as is found in superannuation, members of the insurance pool are not charged premiums that reflect their true mortality and morbidity costs. This creates a cross-subsidy whereby those who are older, in poorer health or higher-risk occupations pay less than their actual claims cost whilst conversely those who are younger, healthier or in lower-risk occupations pay more. This pooling necessitates that there is a balance of both younger and older persons paying premiums to cover future claims and that the pool continually adds new members to replace those who leave.

PYS will disproportionately affect the younger demographic who are needed for the cross-subsidies of insurance pooling to work. As younger members are removed from default cover the average age of the insurance pool will increase thus invalidating assumptions that were used to set pricing. As one would expect, insurance premiums will have to be reassessed based on the claims experience of an older population meaning that they will increase.

As premiums rise the remaining younger and healthier lives will be more inclined to drop their cover. This leads to an insurance 'death spiral' as cascading increases in premium lead to more and more members opting out of group cover for more affordable options (Harris). Contributing to this PYS-induced death spiral is the 'adverse-selection' that the opt-in provision for inactive accounts creates. Those who have serious health issues are more likely to be aware of their need for insurance and because of this it can be expected that a proportion of those who 'opt-in' to default cover will have medical conditions that would preclude them from getting insurance elsewhere. As these persons are more likely to claim, additional upward pressure will be placed on premiums and eventually the group will be left with only those who need cover because they are otherwise uninsurable.

This means that the pool of insured lives will be not just of a higher average age but will also contain a higher proportion of individuals who are in poorer health. Some superannuation funds have already announced that their premiums are increasing as a result of the demographic change that PYS will bring (Vergara, 2019). For those superannuation funds that have historically targeted a younger employee base this will constitute a profound change to their costs. As the full impacts of spiralling premium and claims increases eventuate, more and more insurers will be obliged to change their pricing and the products that they offer.

Superannuation trustees are under the spotlight following the recent financial services *Royal Commission*. Further erosion of account balances from demographic change and resulting premium increases will draw more scrutiny to the industry. To fulfil their 'best interest' duty towards members, trustees will be forced to either reduce default insurance levels or dilute product design to bring down costs. As the quality of the insurance products in superannuation decreases whilst the fees increase it is inevitably that default cover will be seen as less and less of a valuable benefit to members. This will lead to demands for further change to superannuation from politicians and the community. Any resulting industry reviews would include recommendations to remove the requirement for default insurance completely. This would mean that all Australian workers who benefit from this cover would be at risk of losing a valuable and affordable financial protection.

Has the government got it right?

The government's response is genuinely attempting to address community concerns regarding the stability of superannuation as a retirement vehicle. For many members the reforms will help to preserve their retirement savings, however, this legislation comes with a number of unintended consequences that were not fully considered before it was passed. To start with the hurried nature of this change has not allowed for a sufficiently visible campaign to inform the public that they are at risk of losing their insurance. Many members, especially the young, will be unlikely to be following changes to the industry or to be reading notices that come from their superannuation fund nor will they understand the implications if they have health issues. Because of this lack of publicity, 44% of superannuation fund members are unaware of the reforms implying that a significant number of people will be unaware that they are now uninsured (riskinfo, 2019).

As PYS targets lower income groups, an entire segment of the population is being denied the benefit of an affordable method of ensuring economic stability for themselves and their families. This cohort are unlikely to have other financial means during a disabling or tragic life event meaning that there will be long-term consequences for the social welfare system. Whilst funding a comfortable retirement is the primary goal of superannuation, the insurance that it provides is an additional safety net that reduces reliance on the government. Australian social welfare is means-tested therefore those who are permanently or temporarily disabled are in many cases not eligible for government assistance if they access insurance payments (Spies-Butcher, 2010). For example, the benefits offered under default SCI disqualify recipients from being entitled to a full *Disability Support Pension* (DSP). This has provided an estimated savings to the Commonwealth of between $3 billion to $4.2 billion over a period of 10 years (KPMG, 2017). The PYS reforms mean that government expenditure on an array of social programmes undoubtedly will increase when members no longer have the ability to rely on insurance.

Additionally, insurance can provide members with better assistance than would the social welfare system. As an example, many TPD funds have benefits that enable claimants to make alterations to their homes as well as reducing the stress of paying for living expenses after becoming disabled (ASFA, 2019). Those members who have default SCI will have access to insurer-funded rehabilitation services to support their return to work and reduce the length of their disability. These benefits assist both members and society by minimising the duration and financial impact of a disablement.

Without insurance, a death or incapacitating event can be devastating to household incomes but it also has a direct influence on government taxation receipts. The financial strain of such an event can necessitate that families make dramatic changes to their spending patterns. When individuals have insurance cover they are able to maintain their lifestyles and their everyday expenditures. Default cover reduces the financial stress of a tragic life event on members whilst also protecting government revenue that otherwise would be impacted from reduced spending.

If PYS leads to the destabilisation of group insurance pools resulting in default group insurance disappearing, then the well-known underinsurance problem in Australia will be greatly exacerbated. The loss of default cover will destroy a level of financial protection against disability or death that has been available to all working-age Australians. This will have implications across society as the government will be expected to fill the holes in the social safety net left by the absence of this insurance.

The future of the industry

The *Putting Members' Interests First* bill scheduled for later this year will re-introduce some of the more divisive reforms that did not make it into PYS (Fry, 2019). These include a requirement to make insurance 'opt-in' for those who are under age 25 or who have a balance under $6,000 whether the account is inactive or not. These additional changes will amplify the exit of young members and will accelerate premium increases. When one considers that these will be on top of record premium rises in the group market over the last several years it is not unthinkable that some insurers will exit the market completely in the next few years (KPMG, 2017).

The poor publicity that has surrounded the industry can be expected to worsen as the full effects of these reforms become evident. Not only will there be the negative stories as a consequence of premium increases but also those regarding members who have lost their default cover. It is conceivable that there will be many members who attempt to make unsuccessful claims on insurance that has been cancelled due to PYS. When these claims are unsurprisingly declined, the media attention will further hamper attempts for the industry to rebuild its damaged reputation.

The PYS legislation can be seen as a response to the *Financial Services Royal Commission* and the government's need to show that it is responding to those findings. Though the industry did have many issues that were legitimately concerning, this rushed and politicised response could potentially destroy default group insurance rather than reforming it. This should prompt a concerted industry effort to educate politicians, the media, consumer groups and the wider community about the good that this default insurance brings. This needs to include promoting the industry's response to the problems that have been exposed such as instituting a *Code of Practice*. It should also actively inform members of their ability to address their concerns with industry regulators such as the *Australian Financial Complaints Authority*. If such actions are not urgently taken, this unique by-product of superannuation, which contributes to the prosperity of Australian society, may have a very limited future.

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