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Darren Kennedy
Manager, Regulatory Framework Unit
Retirement Income Policy Division
The Treasury
Langton Crescent
Parkes ACT 2600

Email: superannuation@treasury.gov.au

Dear Darren

Subject: Protecting Your Super Package Consultation

Thank you for the opportunity to participate in the consultation.

We strongly support the Government's objective to reduce account balance erosion.

We believe a key design principle to support that objective is that members should have only one superannuation account with insurance being provided from it (unless they choose otherwise).

We believe the Insurance in Super Voluntary Code of Practice was a carefully considered response to this key issue. The scope of the proposed legislation exceeds the measures proposed in the Code of Practice and this results in some unintended consequences (including some members not having any cover at all).

This letter identifies areas where we think that the proposals can be strengthened to ensure that there are fewer unintended consequences and better achieve the Government's objectives.

We would be delighted to discuss this feedback and answer any questions that you may have.

Yours sincerely

Barry Rafe
President

Institute of Actuaries of Australia
ABN 69 000 423 656

Level 2, 50 Carrington Street, Sydney NSW Australia 2000
t +61 (0) 2 9239 6100 **f** +61 (0) 2 9239 6170
e actuaries@actuaries.asn.au **w** www.actuaries.asn.au

Recommendations to strengthen the proposals:

- The most significant unintended consequences arise from the under $6,000 component of the proposal (i.e. s68AAB) for new members. We suggest this section be deleted.
- To protect low balances from erosion due to cross subsidies, we recommend APRA amend SPS /SPG 250 (for Trustees) and Life Prudential Guidance LPS 270 (Group Insurance) to include additional obligations for trustees/ insurers in relation to cross subsidies.
- In respect of 13 months inactivity (s 68AAA) - we suggest legislating the provisions of the Insurance in Super Voluntary Code of Practice in respect of the cessation of cover rules for inactive members. That is, using 13 months inactivity AND an account balance of less than $6,000 as the criteria. This is also consistent with Part 3B of the draft legislation (for inactive low balance consolidation).
- Utilise the existing ATO infrastructure (SuperStream data reporting and Single Touch Payroll) to identify instances of multiple insurances and use this is a trigger for automatic consolidation into an active account (unless otherwise specified by the members).
- We suggest trustees be provided with discretion to offer default disability cover for the under 25s. In s68AAC (1) change as follows
    - From "ensure that a benefit is not provided" to
    - "ensure that a ***<u>death</u>*** benefit is not provided"
- Utilise the definition of "Automatic Insurance Member" from the Voluntary Code of Practice in the legislation and relate the new requirements to those Automatic Insurance Members only (to avoid unintentionally removing cover from those who have made an active decision).
- Remove the 1 July 2019 "opt back in" model and instead apply the transitional provisions that apply to under 25s (s68AAC); that is, apply the provisions only if the member begins to hold the product on or after 1 July 2019.
- Change the implementation date from 1 July 2019 to 1 July 2020 and allow funds to stagger their opt-in arrangements to allow the administrators and insurers sufficient time to be able implement the arrangements.
- We suggest Treasury quantify the budgetary impact of removal of claim payments from the economy and factor these into the forward estimates.

Detailed Commentary

Unintended consequences for large numbers of members

Our estimate is that more than one in three working Australians will have to make active decisions to maintain their cover before 1 July 2019. This varies by fund, with some funds having over 50% of members affected by the provisions. While this will result in an appropriate reduction of cover in many cases, an unintended consequence is that a large proportion will have cover removed completely or significant restrictions introduced into cover, including potential price increases for remaining members (discussed below).

In aggregate, the largest driver of the reduction in cover is the low balance (<$6,000) provision (although this varies by fund).

The changes disproportionately impact on women, part timers / casuals, those on parental leave (and other career breaks) and those on low incomes. In other words, those groups who are most in need of default cover (as they would find it hardest to obtain retail insurance cover without restriction) are the very ones that trustees will be prevented providing default cover to.

Cover Commencement for low account balances (s68AAB)

We understand the Government's intention behind the proposal to prohibit default cover until a member reaches an account balance of $6000 was to allow new entrants into the workforce to build up adequate super before having larger deductions from their account.

However, we believe the "under 25 rule" adequately deals with that situation. Applying the $6,000 rule to all members and not just young people, has the unintended consequence that older members (even with accumulated super in other funds) may no longer have cover when they start a new job.

For anyone that starts a new job (and has new super membership as a result), under the proposed s68AAB, default cover will not be provided immediately, and it is uncertain as to when it will actually start.

Under the proposed rules (s68AAB(2)), cover will not start until the account balance reaches $6,000. This means for a new member of a fund on average weekly earnings (based on full time and part time workers is approx. $62,000), it will take around 14 months before the account balances grows to $6,000. For low income earners or part timers this could be much longer before cover starts.

The typical member takes around 3 years to reach $6,000. This is longer than the time mentioned above since people can change jobs (and therefore fund), reducing the chances a balance will reach $6,000 (and that "average" figures tend to be skewed by those few members with higher incomes).

The start date for cover may be dependent on things completely beyond the member's control:

- An employer who is slow or late paying contributions – meaning the account balance doesn't reach $6,000 as expected. A related question is will the employers be exposed to liability for slower payment of contributions?
- People with irregular income face the same problems.

- Poor investment markets (a market downturn could lead to lower balances and hence delays in cover commencing).
- Other fees and charges on the account.

This uncertain start date means members will not have the peace of mind that they are covered.

In addition, tougher commencement of cover rules are likely to apply than currently is the case (due to reduced confidence that people are healthy when the cover first starts). This will inevitably mean fewer people end up with coverage.

Operationally, this will be challenging. In our experience, most of the operational risks in respect of insurance relate to similar rules applying to cessation of cover mainly because of the irregular nature of contributions (and potential backdating). The consequence of this include increased administration cost and members incorrectly being led to believe they have cover when they do not.

Recommendation: *The most significant unintended consequences arise from the under $6,000 component of the proposal (i.e. s68AAB) for new members. We suggest this section be deleted.*

A better approach to low balances – removing cross subsidies

One of the key drivers of account balance erosion for young people is that young people are often paying too much in premiums with the result of that they cross subsidise the premiums of older members.

In recent years, the levels of cross-subsidies have been removed or reduced in many funds. However, in some funds, a member under the age of 25 may pay between 50% - 100% more than is required to fund the true cost of their cover.

The reasons as to why this practice has arisen is many and varied and includes competitive pressures from benchmarking premiums for key (older) age groups and administration limitations and charging arrangements.

Another source of cross-subsidy is that the disability claim rates on “lost” policies are often lower than average. It is possible that members are no longer aware of their potential benefits and do not claim.

The Voluntary Code of Practice sought to address by this recommending that trustees consider “fair treatment, taking into account whether there is cross subsidy” when determining benefit design. We believe a stronger approach can be given effect through APRA Prudential Standards and guidance.

Recommendation: *APRA amend SPS /SPG 250 (for Trustees) and Life Prudential Guidance LPS 270 (Group Insurance) to include additional obligations for trustees/ insurers in relation to cross subsidies.*

Inactive Account Balances – ideas for further reducing erosion

The Government's proposals around "reuniting your super" will hopefully make a meaningful difference to the number of multiple accounts and reduce the need for such far - reaching measures in respect of insurance.

To make the insurance proposals (s68AAA) in the legislation consistent with Voluntary Code of Practice and Schedule 3 of the draft legislation in respect of consolidation of Inactive low balance accounts we suggest the following.

Recommendation: *In respect of 13 months inactivity (s 68AAA) - we suggest legislating the provisions of the Insurance in Super Voluntary Code of Practice in respect of the cessation of cover rules for inactive members. That is, using 13 months inactivity AND an account balance of less than $6,000 as the criteria.*

However, we suggest additional changes to those proposed in the legislation to further reduce account balance erosion.

The reuniting your super proposals only apply to those accounts that have been inactive for 13 months. If the ATO has data (through SuperStream) to indicate a new active account has been established with insurance, the ATO could utilise this data as a trigger for automatic consolidation sooner than 13 months. Consolidating accounts sooner (using data) would further reduce account balance erosion.

Recommendation: *Utilise the existing ATO infrastructure (SuperStream data reporting and Single Touch Payroll) to identify instances of multiple insurances and use this is a trigger for automatic consolidation into an active account (unless otherwise specified by the members).*

People under 25 need cover (s68 AAC)

The erosion of accounts for under 25s is more a case of inappropriate design rather than a systemic issue. There are many examples in the industry where needs-based design has resulted in only very low levels of premiums being deducted for younger people while still providing good levels of cover (e.g. NGS super, where a 20-year-old member pays less than 38 cents per week for death and TPD cover).

While a reasonable case can be made that death cover is less important for many under 25s who do not have any dependants, the same cannot be said about disability cover. (Although it should be noted that a significant proportion of under 25s in country areas and those with lower levels of education, for example, have dependent children).

Younger people who are permanently disabled will often have a longer time to live with their disability so their need for insurance is arguably greater than older people.

Recommendation*: We suggest trustees be provided with discretion to offer default disability cover for the under 25s. In s68AAC (1) change as follows*

- *From "ensure that a benefit is not provided" to*
- *'ensure that a **death** benefit is not provided"*

Impact of the 1 July 2019 opt in requirements (s68AAA, s68AAB)

Effectively from 1 July 2019, those members with a balance of less than $6,000 or who are inactive for more than 13 months will have cover cease unless they provide written notice to opt back in.

The most important matter that arises is that many members that need insurance will be unknowingly deprived of the benefits. We are uncomfortable with the ethical issue arising from pressures that will be created when people come to claim thinking that they are covered.

Even with an expensive publicity campaign, it is likely that many members who need the insurance will not opt back in. The reality is that it is very difficult to engage superannuation members on any matter. It is a widely accepted that more than half of the documents and emails sent to members go unread and are often unopened. Because of a lower opt in there will be lower coverage across the population. The consequence of this lack of cover include increased hardship and higher social security costs.

The Voluntary Code of Practice gave members the option to cancel their insurance by contacting their fund – in writing, by email or telephone. We think that this is a more appropriate approach.

Those that do opt back in are expected to have a substantially higher claim rate due to the selection effect (those members who feel they have a potential claim are much more likely to opt back in). This effect is regularly observed by insurers when “opt in” offers are made to group insurance members. This will mean; either:

- premiums are likely to increase for those who remain insured; or
- not everyone who opts back in will be able to have cover on the same basis than if the ban did not apply. Insurers are likely to impose additional risk controls (e.g. active at work tests, pre-existing conditions clauses and / or risk control questions) which are more stringent than is currently the case, meaning some members will effectively lose cover even if they want to keep it.

Recommendation: *Remove the 1 July 2019 “opt back in” model and instead apply the transitional provisions that apply to under 25s (s68AAC), that is apply the provisions only if the member begins to hold the product on or after 1 July 2019.*

Another concern with the 1 July 2019 opt in arrangements is that the way the legislation is currently drafted, members who have made elections prior to 8 May 2018 (i.e. have already made active decisions about life insurance) will need to make a further election or will have cover removed.

Recommendation: *We suggested inserting the definition of “Automatic Insurance Member” from the Voluntary Code of Practice in the legislation and relate the new requirements to those Automatic Insurance Members only (to avoid unintentional removing cover those who have made active decisions).*

Concerns with Timeframe

Before any notices can be sent to members every group life policy will need to be repriced (premiums determined based on an actuarial assessment of the new risk profile), with terms and conditions renegotiated with the trustee.

This can only really commence when there is certainty over the legislation, which will be later in the year. There is simply not enough capacity within the insurance industry to complete this prior to April when trustees have an obligation to start the communication process.

Further, the fund administrators will need to compile accurate data to assess which members are affected, the impact on pricing and prepare for notices to be sent. This will happen for every one of their clients nearly simultaneously. In our experience, even the process of extracting data and ensuring it is accurate can take months for a large fund, let alone for every fund.

Substantial numbers of additional call centre staff will need to be hired and trained with appropriate levels of knowledge to handle a massive influx of questions which will inevitably veer into personal financial advice.

These factors suggest that a 1 July 2019 timeframe is simply not achievable.

Recommendation: *Change the implementation date from 1 July 2019 to 1 July 2020 and allow funds to stagger their opt-in arrangements to allow the administrators and insurers sufficient time to be able implement the arrangements.*

Other unintended consequences

Premium Rates are likely to increase

Premium rates are likely to increase for remaining members whose coverage is unaffected by the legislation. This is due to a few factors:

- As discussed above, while welcome, removing cross subsidies will inevitably mean that premiums rates will need to increase for other members.
- The increased uncertainty in pricing. Group insurance schemes are assuming that the past experience is a reliable guide to the future. Removing large portions of members mean this experience may not be a credible guide to the future. Insurers are likely to introduce contingency margins for this uncertainty until the effects of the changes become apparent.
- The selection impacts mentioned above are likely to lead to increase claims rates.
- Fixed expenses (for both insurers and fund administrators) being spread over fewer members.
- Potentially higher reinsurance costs due to the potential withdrawal of overseas capacity because of lack of confidence in the market.

While these impacts are still being analysed, these premium increases are likely to be material for some funds.

Budget Impact

The impact on forward estimates contained in budget paper 2 appear to show only the impact of reduced tax deductibility due to lower premiums. Higher social security costs (e.g. disability support pension, carers' allowances, reduction in tax revenue) should also be factored into the estimates – the removal of cover for such a substantial part of the working population will inevitably lead to increased hardship and a greater call on social security benefits.

Methodology and approach was detailed in a paper by Rice Warner in a submission to the Productive Commission *"Productivity Commission Issues Paper – Impacts of Removing Insurance from Super"*

Our initial estimate is that there will be at least $1bn pa fewer claims paid because of the proposal. This will have measurable impact on social security expenditure.

Recommendation: *We suggest Treasury quantify the budgetary impact of removal of claim payments from the economy and factor these into the forward estimates.*

Transition between insurers more complicated

Today, funds can change insurers based on an agreed industry protocol (FSC Guidance Note 11 Group Insurance Takeover Terms). The centrepiece of the guidance note is clear responsibilities between the old and new insurers based on whether a member is at work on the day of the takeover.

The budget proposals mean the application of Guidance Note is unclear as it relates to the "at work" test. For example, if a member with an account balance under $6,000 was not at work on the day of the takeover, it is not clear which insurer would be responsible for the future insurance of that member.

This uncertainty with the transfer arrangements will mean trustees and insurers will be reluctant to participate in tenders until a new industry protocol can be agreed.