RICEWARNER

Insight like no other

Insurance Administration Expenses

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1. Executive Summary

1.1 Introduction

Rice Warner has been commissioned by the Association of Superannuation Funds of Australia (ASFA) to assess the costs of providing insurance benefits within superannuation.

The recent Financial System Inquiry (FSI) interim report questioned the cost of the superannuation system and drew its criticism heavily from the Grattan Institute research paper on fees which compared the Australian system to a number of international systems.

The Australian system is unique and has several characteristics which need to be considered when comparing it to other jurisdictions. Some of the differences occur in:

- asset allocation
- system design (defined contribution vs. defined benefits)
- member investment choice
- intra-fund advice
- provision of life insurance benefits.

This report discusses the last of these points. It examines both the benefits of including insurance in superannuation and the additional costs that are incurred by doing so.

1.2 Benefits of insurance within super

There are a number of benefits of providing insurance to Australians through superannuation, including:

- Life insurance coverage in voluntary systems is not high, resulting in many people having inadequate cover – that is, there is an underinsurance gap. Insurance within super reduces the size of the underinsurance gap.
- Rice Warner estimates that there is a reduction in social security cost to the government of about **$403m** p.a.
- Default insurance within superannuation provides a basic level of cover to those who would otherwise have no insurance. Insurance within superannuation funds represents the majority of total life insurance sums insured in the market:
  - 71% of total death benefit sums insured
  - 88% of total TPD sums insured, and
  - 59% of total income protection monthly benefits.
- Insurance tends to be cheaper within superannuation, reflecting:
  - tax efficiency
  - absence of high cost distribution (and commissions to insurance advisers)
  - simple product design
  - wholesale contracts which provide economies of scale.

1.3 Costs of administering insurance within super

Insurance within superannuation has numerous benefits for individuals, the government and society. However, the costs of providing the benefits are not recognised when making comparisons of expenses internationally.

We estimate that insurance administration costs make up 19% of total fund base administration expenses, being about $200m a year. Most of these costs are for claims and underwriting administration.

There are a number of other related expense items which add costs for funds but are not quantifiable as they are generally not segregated from other expenses. These include:

- consulting/legal/tax advice (around insurance)
- record establishment
- record updating
- reporting
- communication/disclosure
- compliance.

1.4 Conclusion

Insurance is an integral part of the superannuation industry of Australia and contributes largely to reducing the underinsurance gap. Including insurance within superannuation funds does add an additional administration expense to funds. It is important to recognise these expenses when benchmarking the Australian system against international peers.

This report was prepared and peer reviewed for ASFA by the following consultants.

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2. Benefits of insurance within super

2.1 Background

It is often stated that life insurance is sold rather than bought. Few Australians allocate an allowance for it in their personal budgets. This explains why a relatively low percentage of Australians purchase life insurance through traditional retail channels compared with the number of Australians purchasing insurance to protect their cars and homes.

This apathy towards obtaining adequate cover for death and disability risks largely contributes towards the current underinsurance gap resulting in an increased burden on the government in the form of social security payments for families who lose a breadwinner or individuals who become disabled.

Insurance within superannuation is now a dominant part of the life insurance market in Australia. It results in more Australians having cover and contributes substantially to reducing the size of the underinsurance gap.

2.2 Market share of group insurance

Insurance within superannuation makes up a large portion of the current life insurance market. In terms of annual premium revenue, insurance in superannuation represents:

- 48% of total premiums for death benefits ('Term')
- 75% of total premiums for TPD benefits, and
- 35% of total premiums for income protection.

Note that Trauma cover is prohibited by legislation from being paid from a superannuation balance as it does not meet a condition of release.

Table 1. In-force business at 30 June 2013 – annual premium income

Market	Term		TPD		Trauma		Income protection		Total
segment	($million)	(%)	($million)	(%)	($million)	(%)	($million)	(%)	($million)
Superannuation									
Corporate Funds	51	1	45	2	n/a	n/a	50	2	146
Adviser superannuation	1,310	22	435	22	n/a	n/a	184	6	1,930
Industry Funds	895	15	565	28	n/a	n/a	570	17	2,030
Public Sector Funds	296	5	187	9	n/a	n/a	179	5	662
Employer Master Trusts	333	5	291	14	n/a	n/a	174	5	798
Total Super	**2,885**	**48**	**1,523**	**75**	**0**	**0**	**1,157**	**35**	**5,566**
Ordinary									
Corporate Standalone	75	1	48	2	1	0	372	11	495
Adviser non-superannuation	1,937	32	378	19	985	93	1,681	51	4,981
Direct	1,178	19	70	3	69	7	81	2	1,397
Total Ordinary	**3,190**	**52**	**496**	**24**	**1,055**	**100**	**2,134**	**64**	**6,873**
Total market	**6,075**	**100**	**2,018**	**100**	**1,055**	**100**	**3,291**	**100**	**12,439**

2.3 Current levels of cover within superannuation

Total sums insured for each sector of the market are shown in Table 2. Superannuation sums insured represent a greater proportion of total cover than superannuation premiums. This reflects the fact that premium rates within superannuation tend to be lower than those in retail.

- 71% of total death sums insured ('Term')
- 88% of total TPD sums insured, and
- 59% of total income protection monthly benefits.

Table 2. In-force business at 30 June 2013 - sums insured/ monthly benefits

Market	Term		TPD		Trauma		Income protection		Total	
segment	($ million)	(%)	($ million)	(%)	($ million)	(%)	($ million)	(%)	($ million)	(%)
Superannuation										
Corporate Funds	66,165	1	57,507	2	n/a	n/a	463	2	77,286	1
Adviser superannuation	795,881	18	328,692	12	n/a	n/a	827	4	815,725	16
Industry Funds	1,572,907	35	1,313,597	49	n/a	n/a	7,137	35	1,744,188	33
Public Sector Funds	406,563	9	357,524	13	n/a	n/a	1,911	9	452,415	9
Employer Master Trusts	369,663	8	319,930	12	n/a	n/a	1,944	9	416,324	8
Total wholesale	**3,211,179**	**71**	**2,377,250**	**88**	**0**	**0**	**12,282**	**59**	**3,505,938**	**67**
Ordinary										
Corporate Standalone	92,319	2	55,831	2	355	0	3,981	19	188,210	4
Adviser non-superannuation	719,172	16	214,981	8	196,970	93	4,129	20	1,015,235	19
Direct	486,476	11	43,471	2	15,247	7	203	1	506,592	10
Total retail	**1,297,967**	**29**	**314,283**	**12**	**212,572**	**100**	**8,313**	**40**	**1,710,037**	**33**
Total market	**4,509,146**	**100**	**2,691,534**	**100**	**212,572**	**100**	**20,594**	**100**	**5,215,976**	**100**

Insurance within superannuation accounts for the majority of life insurance cover measured by sums insured/monthly benefits for Death, TPD and income protection.

Average levels of cover by Market Segment are given in Table 3.

Table 3. In-force business at 30 June 2013 - average sums insured or monthly benefits per policy

Market	Term		TPD		Trauma		Income protection	
segment	($)	(%)	($)	(%)	($)	(%)	($)	(%)
Superannuation								
Corporate Funds	219,330	89	220,678	91	n/a	n/a	4,297	133
Adviser superannuation	472,067	191	497,301	204	n/a	n/a	4,553	140
Industry Funds	211,734	86	207,941	85	n/a	n/a	2,043	63
Public Sector Funds	217,849	88	223,394	92	n/a	n/a	3,514	108

Market segment	Term		TPD		Trauma		Income protection	
	($)	(%)	($)	(%)	($)	(%)	($)	(%)
Superannuation								
Employer Master Trusts	212,508	86	224,989	92	n/a	n/a	4,300	133
Total wholesale	**246,593**	**100**	**231,677**	**95**	**n/a**	**n/a**	**2,570**	**79**
Ordinary								
Corporate Standalone	328,995	133	331,017	136	55,404	23	4,827	149
Adviser non-superannuation	413,998	168	480,559	197	246,214	104	6,108	188
Direct	149,755	61	239,608	98	172,218	73	2,757	85
Total retail	**246,481**	**100**	**394,129**	**162**	**237,529**	**100**	**5,280**	**163**
Total market	**246,559**		**243,389**		**237,529**		**3,242**	

Note: The percentages in Table 3 are the average sum insured (or monthly benefit) for the particular market segment, as a percentage of the average for the market overall.

Table 3 demonstrates that cover tends to be higher in non-superannuation policies (excluding direct). This reflects the fact that most of these policies are sold by financial advisers who deal with those on higher incomes. The benefits are also targeted to the insured person's needs.

2.4 Underinsurance

2.4.1 Life underinsurance gap

Rice Warner regularly measures the level of underinsurance as part of its *Underinsurance in Australia Report.* The estimated mean and median size of the life underinsurance gap is given in Table 4.

Table 4. Underinsurance ($ billion)

	Basic life cover	Income replacement life cover	TPD cover	Income protection cover per annum
Mean underinsurance				
Insurance need	4,341	6,715	12,526	808
Current insurance	4,130	4,130	2,751	237
Underinsurance	210	2,584	9,775	571
Current insurance as percentage of need	**95%**	**62%**	**22%**	**29%**
Median underinsurance				
Insurance need	4,341	6,715	12,526	808
Current insurance	2,788	2,788	1,733	129
Underinsurance	1,553	3,927	10,793	679
Current insurance as percentage of need	**64%**	**42%**	**14%**	**16%**

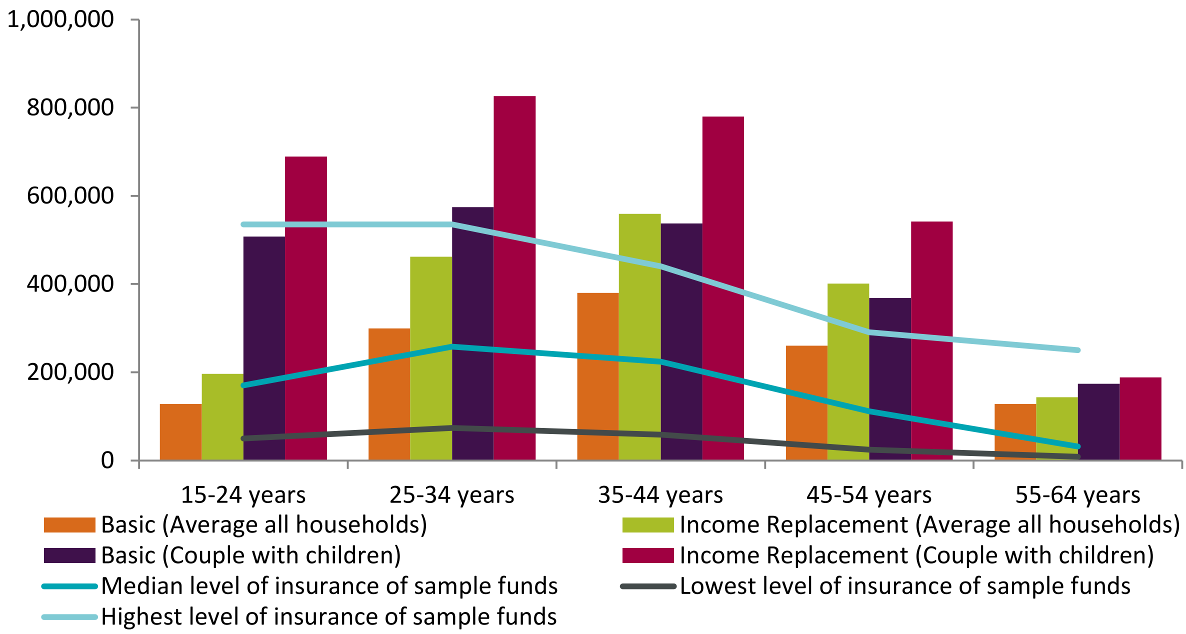
The underinsurance gap is large, but would be much larger if cover was not provided through superannuation funds.

2.4.2 *Comparison with insurance needs*

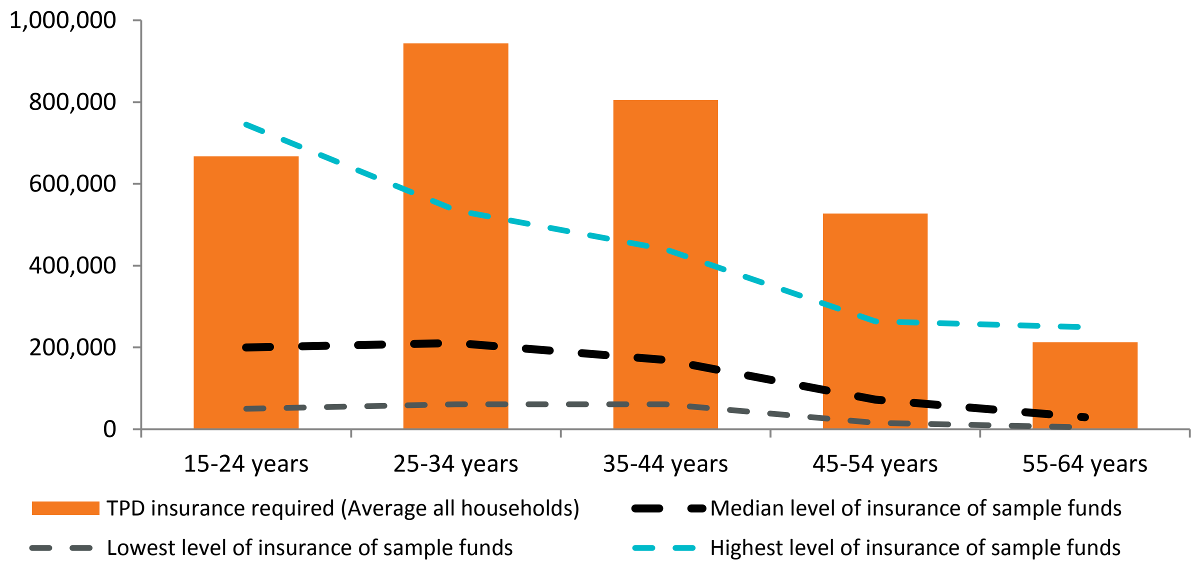
Graph 1, Graph 2 and Graph 3 illustrate the insurance required by age for a family with children and for the average of all households, compared to the median default insurance cover of a sample of superannuation funds.

The graphs also contain the range of the sums insured; being the funds in our sample with the highest and lowest default insurance cover levels.

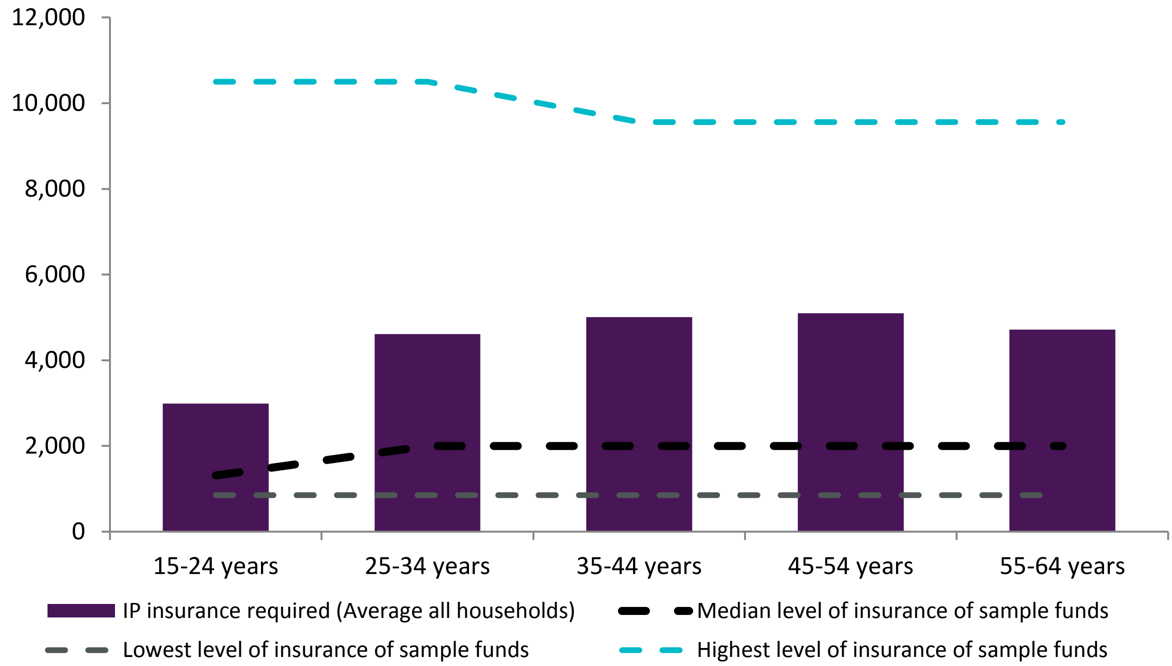
Graph 1. Life insurance needs versus median insurance cover of sample funds



Graph 2. TPD insurance needs versus median insurance cover of sample funds



Graph 3. Income Protection insurance needs versus median default insurance cover of sample funds



2.5 Cost to the government of underinsurance

Rice Warner estimates the cost of underinsurance to the government by calculating (for each benefit type):

- The probability of claim (death, TPD, total disability)[1], multiplied by
- The present value of [social security payments after claim if fully insured, less social security payments claim if not insured] x (1-y)%, plus
- The present value of [social security payments after claim if fully insured, less social security payments after claim if x% insured] x y%
- Where x% is equal to the median level of life insurance as a percentage of needs and y% is the percentage of the working population with insurance cover.

The current cost to the government of underinsurance is measured in Table 5. Without any group insurance this cost would balloon to **$1,956 million p.a.** Consequently, we can state that insurance within superannuation reduces the annual cost of social security by about $403m a year.

[1] ABS Life Table 2009 – 2011 was used to estimate mortality statistics

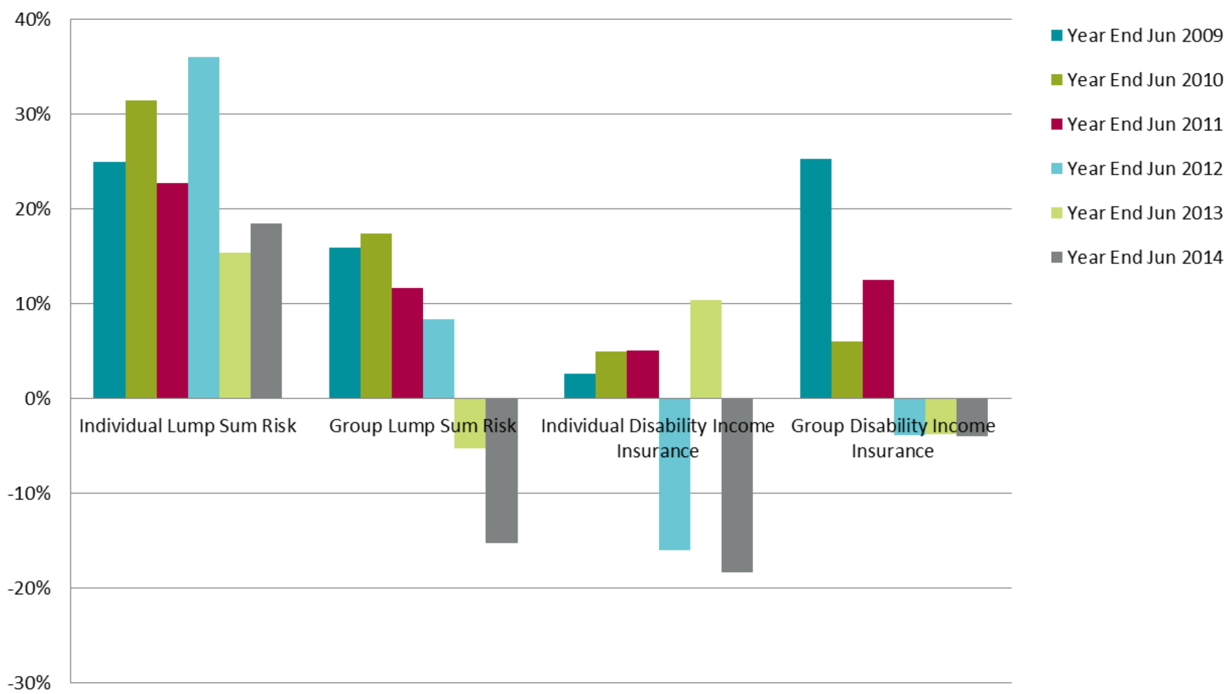
Table 5. Impact of underinsurance on social security payments by government 30 June 2013

Cover Type	Cost of underinsurance ($ million p.a.)	Cost of underinsurance without group insurance cover ($ million p.a.)
Death	46	99
TPD	1,260	1,527
Income protection	247	330
Total	**1,553**	**1,956**

2.6 Claims vs. premiums - recent trends

ASFA has requested that Rice Warner comment on recent trends in claims payments vs. premiums collected and the impact on the underinsurance gap. Rice Warner can confirm that in recent years experience in the group insurance market has been poor, resulting in negative profits realised by group insurers. This is illustrated in Graph 4.

Graph 4. Insurer profit margins (post tax profit as percentage of premiums)



There are a number of reasons why this has occurred:

- Claims experience - as sources of deterioration in claim experience, we can identify:
  - Poor death claim experience between 2008 and 2010, thought to be connected with the GFC.
  - The increased incidence of mental illness and cancer claims.
  - The increased incidence of heart related medical conditions, possibly reflecting the growing obesity problem.

- Increases in default sums insured over recent years, combined with an increased propensity to claim as sums insured increase.
- The involvement of legal firms which appears to be pushing up the incidence of claims.

- Product Design
- Greater awareness amongst customers of the ability to join superannuation funds and obtain substantial amounts of life insurance cover, often with the only requirement being that they are at work when they join and receiving employer contributions. This anti-selection is a result of Member Choice where employees can shop around for the most suitable fund – and those who are sub-standard risks can game the rules.
- The enhancement of benefit features and disability definitions to levels approaching those of the retail market has increased the value of benefits (at no extra immediate cost).
- The provision by the life insurers of three year premium rate guarantees which caused extended losses even when it was seen that experience was deteriorating.
- Price War
  - The very high premium income under group life contracts for large funds led to a price war where life companies were attracted to the size of the accounts. They expected continuing improvements in mortality and were slow to notice the deteriorating trends in claims.

We note that although high claims vs. premiums payout ratios are generally good for customers, ratios that result in negative profit margins are unsustainable and are already resulting in premium increases for many funds.

3. Additional costs of maintaining insurance within super

3.1 Administration costs

Administering insurance within superannuation creates an additional layer of cost which is ultimately passed onto members in the form of additional fees. Some aspects of this additional cost are difficult to separate from other administration costs such as benefit processing, member communications and account creation.

3.1.1 Insurance expense components

Rice Warner has identified the following areas where the administration of insurance within superannuation does create an additional administrative burden:

- claims
- underwriting
- consulting/legal/tax advice (around insurance)
- record establishment
- record updating
- reporting
- communication/disclosure
- compliance.

3.1.2 Quantifiable costs

Claims and underwriting costs are the largest components of insurance costs which are directly quantifiable and are often provisioned for separately via an additional insurance administration fee which is added to premiums.

Rice Warner estimated, as part of its superannuation expense survey as at 30 June 2013, that insurance administration expenses made up 19% of total base administration expenses in 2013, a median expense of $6.36 per account. This is equivalent to about $204m a year.

Graph 5. Administration expenses per member by component as at 30 June 2013 (Peer group)

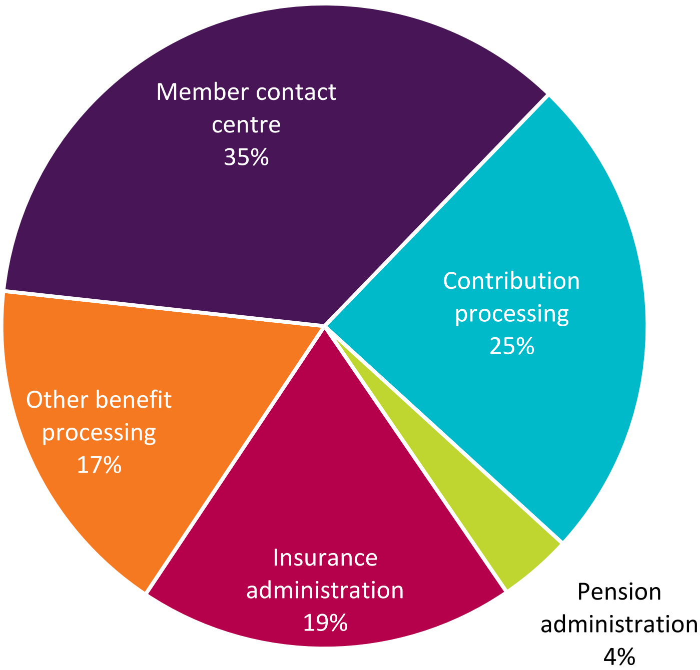


Table 6. Administration expenses per member by component (Peer group only)

Expense component	Median
Contribution processing	8.00
Pension administration	1.42
Insurance administration	6.36
Other benefit processing	8.02
Member contact centre	12.86
Total	**33.35**

Note that numbers may not reconcile as the sum of median components is not the same as the median of the total

3.1.3 Unquantifiable costs

Other aspects of insurance administration costs are not readily quantifiable. This arises because they form a part of other administrative activities and are not separately provisioned but are bundled into the overall administration fee.

Table 7. Unquantifiable expenses related to insurance

Expense	Description	Why it is difficult to quantify
Consulting/legal/tax advice (around insurance	Advice provided by external parties around insurance.	Consulting costs are usually bundled with compliance/trustee support expense items.
Record establishment	Checking eligibility for default cover; generating welcome letters; offering increase in cover, etc.	This is bundled with other record establishment expenses e.g. setting up investment, account creation.
Record updating	Increase or decrease in cover.	This expense is not segregated and is included in 'other benefit processing'.
Reporting	Generating annual statements – on insurance and other features.	Marketing and communication expenses are bundled. This would be accounted for in Printing Costs and Member regular communications.
Communication/disclosure	Significant event notices, disclosure materials PDS, website, contact centre answering member queries regarding insurance.	Marketing and communication expenses are bundled. This would be accounted for in Printing Costs, Member regular communications and Member Contact Centre.
Compliance	Producing insurance management framework (APRA); board committees; claims underwriting committees etc.	Compliance costs are usually combined e.g. a single compliance / risk officer may be responsible for multiple compliance functions, not just insurance.

3.2 Note on plaintiff lawyers

The industry has recently seen an increased involvement of plaintiff lawyers seeking a resolution to claims before internal reviews are undertaken or before an SCT review would be possible.

Rice Warner recognises that the vast majority of these claims would be paid regardless of the involvement of plaintiff lawyers. The inclusion of lawyers in the process increases costs for the trustee and also reduces the benefits paid to members (due to legal fees being deducted). Anecdotal evidence suggests these fees can be as high as 40% of the insured benefit.