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SUPERANNUATION COMPETITIVENESS AND EFFICIENCY

Submission to the Productivity Commission on the Superannuation Competitiveness and Efficiency Draft Report

About us

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

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Introduction

CHOICE appreciates the opportunity to provide the following comments to the Productivity Commission's Draft Report into Superannuation Competitiveness and Efficiency (the Draft Report).

CHOICE is broadly supportive of the proposed approach set out by the Productivity Commission in its Draft Report. For the next stage of this process, the Commission should explore more detailed models for better member engagement and conduct a close assessment of how well aligned current approaches to insurance are with the goals of the superannuation system.

CHOICE's new qualitative research into consumer engagement with superannuation, funded by the Financial Literacy Association, shows that there is room for more nuance when assessing consumer engagement with superannuation. Consumers are not engaged or unengaged but sit on a spectrum of engagement. There is an opportunity to change frames of reference around super and provoke unengaged consumers but this requires a significant shift in the way in which funds and intermediaries communicate with consumers about super.

One area of superannuation that is not working well for consumers is group insurance. The common line from all sections of industry is that consumers are underinsured and default insurance is required to cover people appropriately. We strongly question this assumption. Right now, policies don't necessarily meet consumer needs and default insurance is poorly targeted.

Consumers are potentially paying for insurance they don't need instead of being underinsured. Four in five consumers have never analysed the type and amount of life insurance that suits their own circumstances.[1] Many consumers will not realise they hold insurance policies within superannuation. Fewer still will realise what they're covered for.

Assumptions underpinning group insurance need to be challenged. Why can't someone hold TPD without also paying for death cover? Why should a young person have death cover by default when they have no dependents? And why should a system be set-up so that consumers with multiple accounts automatically pay multiple insurance premiums, further eroding their total funds?

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[1] Zurich Australia, 2014, 'Australians and Life Insurance: Misinformed, Misinsured?', Sydney.

New ideas about insurance within super are needed. For example, could default death cover only commence around the age of 30? On average, people won't have children until 33 (for men) or 31 (for women).[2] And many young people will have multiple accounts, with potentially multiple default insurance products. We cannot continue to let young peoples' retirement balances erode due to this poorly targeted and duplicate policies.

Beyond default settings, the Commission should consider the role standardised terms in insurance could play to increase consumer confidence and allow better comparisons of policies. CHOICE believes that standard cover should apply to group life insurance across death (and terminal illness), TPD and income protection cover. This would require insurers to offer cover with prescribed standard terms and conditions consistent with consumer expectations, only deviating from these standards if it is necessary for fund members and the changes are fully communicated.

[2] ABS, 2015, 'Births, Australia, 2014' available at: http://www.abs.gov.au/ausstats%5Cabs@.nsf/0/8668A9A0D4B0156CCA25792F0016186A?Opendocument

Member engagement

Demand-side characteristics (members and member intermediaries)

CHOICE is encouraged by the use of behavioural economic research throughout the Productivity Commission's analysis. Traditional assessments of competition have too often tended towards consideration of the supply side and focussed little on how consumers engage with markets.

Product switching

As the Commission identifies, there is a need for caution before crudely applying criteria that sees member engagement necessarily leading to a more competitive and efficient superannuation system. For example, one indicator of member engagement may be the level of switching between providers. However, switching can increase costs if it is being driven by expensive advertising and commission-based sales strategies.

For example, switching based on poor financial advice is not evidence of effective competition. The Australian Securities and Investment Commission's (ASIC) research into the life insurance advice shows that the way an adviser is paid (e.g. under an upfront commission model compared to a hybrid, level or no commission model) has a statistically significant bearing on the likelihood of their client receiving advice that does not comply with the law.[3] The research shows that some consumers are being moved into new products fairly regularly – they are being churned into new products, not for their own benefit, but because an adviser will be paid a higher commission for the switch.

Switching may also require funds to keep a higher portion of funds in liquid assets, which tend to offer lower performing returns. As the Financial System Inquiry (FSI) found, improving portability of funds may distort asset allocation and lead to greater levels of investment in liquid assets than is optimal.[4] This is not to say member engagement and product switching should not be encouraged, but it needs to facilitate quality consumer decisions with a long term view.

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[3] ASIC, 2014, 'Review of retail life insurance advice', Report 413, available at: http://download.asic.gov.au/media/2012616/rep413-published-9-october-2014.pdf

[4] Murray, D., Davis, K., Dunn, C., Hewson, C. and McNamee, B., 2014, 'Financial System Inquiry: Interim report', Canberra.

In other cases, switching may bear no relationship to engagement. The Draft Report highlights that there is no consensus in the evidence on the rate of switching in superannuation. At one extreme Roy Morgan research puts the rate at only 3.2% a year while other evidence points to rates of switching as high as 9% annually.[5] More interesting is the reason for switching, with the research indicating that 50-80% of switching was simply due to a change of jobs or their employer changing default funds.[6] This leaves very little room for a causal relationship between increased switching and more competitive offerings on the part of providers. Rather, it is indicative of the low levels of consumer engagement with superannuation.

Investment switching

Research from Roy Morgan shows that consumers can experience a range of negative outcomes due to the wrong type of engagement, for example switching investment options during times of market fluctuations can lead to the crystallisation of losses.[7] While this research found very low rates of investment switching, those that had switched during the global financial crisis tended to lock in their losses by moving investments out of shares right as the market reached a low point.

It has been put that default options are further increasing disengagement because they require less work on the part of members.[8] Given the limits on constructive member engagement with their funds this minimal involvement model is a design feature rather than a criticism. Also, membership of a default fund doesn't necessarily indicate a lack of engagement; consumers may actively choose to remain in a default after weighing up the alternatives.[9]

The Draft Report points to the fact that many traditional indicators of engagement are ambiguous. This may be a result of the strange balance in the superannuation system between taking some decisions away from consumers (e.g. enforced savings), and in other

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[5] Roy Morgan Research, 2016, 'Over $35 Billion in Superannuation Switched but Nearly One Third of Switchers Didn't Get Any Advice' available at: http://www.roymorgan.com/findings/6617-over-35-billion-in-super-switched-but-nearly-one-third-didnt-get-advice-201601052255 ; Colmar Brunton 2010, 'Investigating Superannuation: Quantitative Investigation with Superannuation Consumers', Final Quantitative Report, prepared for the Australian Taxation Office, Canberra.
[6] Fear, J. and Pace, G. 2008, 'Choosing Not to Choose: Making Superannuation Work by Default', The Australia Institute and Industry Super Network, Sydney ; Cooper, J., Casey, K., Evans, G., Grant, S., Gruen, D., Heffron, M., Martin, I. and Wilson, B., 2010,' Super System Review Final Report - Part One: Overview and Recommendations, Final Report', Canberra.
[7] Gerrans, P., 2012, 'Retirement savings investment choices in response to the global financial crisis: Australian evidence', *Australian Journal of Management*, vol. 37, no. 3, pp. 415–439.'
[8] Productivity Commission, 2016, 'How to Assess the Competitiveness and Efficiency of the Superannuation System', p.37
[9] Butt, A., Donald, S., Foster, D., Thorp, S. and Warren, G., 2015, 'Delegation, Trust and Defaulting in Retirement Savings: Perspectives from Plan Executives and Members', Working Paper No. 065/2015, Centre for International Finance and Regulation, Sydney.

circumstances expecting them to make good decisions on their own (e.g. account consolidation).

CHOICE research overview

CHOICE has conducted research to better understand the nature of engagement which we believe can add further nuance to the Commission's understanding of why some consumers currently do not engage, whether this leads to poor outcomes and what steps might be taken to increase engagement.

CHOICE agrees with the Commission's assessment that further evidence is needed to better understand how Australians make decisions about superannuation and link these decisions to specific outcomes. Through a research project funded by Financial Literacy Australia, CHOICE has examined the decision making of three distinct groups of consumers: young people, new mothers and pre-retirees.[10] While this research was unable to link consumer decisions to specific outcomes, we are hoping to use the strategies identified to better assist consumer decision making and map the outcomes in future research.

The qualitative research focussed on people unengaged with their superannuation. It attempts to understand why they are not engaged and what interventions are most likely to lead to useful engagement. These groups (young people, new mothers and pre-retirees) were chosen because each is at a particularly important stage in their life cycle, where the right engagement with superannuation will reap significant benefits in retirement.

The research found that disengagement with super is intimately connected with peoples' deeply held beliefs about money, which prioritises immediate financial needs. Disengagement is being driven by people's negative expectations of dealing with super funds, particularly where funds have failed to establish a personal and trusting relationship or meaningful communication with their members. People who were disengaged with their superannuation also displayed a high level of 'unconscious incompetence'. Put simply, they don't know what they don't know about superannuation. This has a paralysing effect on people who know that they should be doing something about their superannuation.

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[10] CHOICE, 2016, 'Project Superpower – Informing a strategy to engage people with their superannuation', Pollinate Research commissioned by Choice. [soon to be released]

Super engagement model

Within the three target demographics there was not a clear divide between the ‘engaged’ and ‘unengaged’ people. Rather, there were levels of disengagement. The research described these levels of engagement using a model levels based around the seats of a car.

The car driver tended to be engaged, felt in control and was able to make decisions. The front passenger was unengaged but curious, they were generally aware of the direction they were headed, had some ideas about where to go, but weren’t sure how. In the backseat levels of engagement decreased, they tended to put off decisions about superannuation and were happy for others to take control. The most disengaged were those in the car boot who had no interest in engaging at all.

Segmenting consumers based on levels of engagement/disengagement may be useful to the Commission in the next phase of its research. One of the Commission’s assessment criteria asks whether active members and member intermediaries have sufficient countervailing power to drive demand side competition. The model used in our research indicates that while the bulk of consumers may not be engaged enough to drive competitive pressure, there is at least a base level of interest among some disengaged people that may see them either be led by drivers or be provoked in to further action if the right strategies are used. The research found that conflict and tension about superannuation lay just below the surface; once some of the basics were unveiled people became quickly agitated and interested.

In stage two of the research CHOICE sought how to better unveil this latent interest and drive positive engagement. We separated participants into life stages to uncover the messages which would most appeal to their demographic.

Young people

Young people needed superannuation to be reframed from being about the future and brought to the present. The types of messages which cut through were focussed on the money they were wasting today by not engaging (e.g. consolidating accounts) and engendering a sense of being ‘ripped-off’ by the system.

New mothers

New mothers responded strongly to a sense of inequality about the long term financial cost of time out of the workforce. For young people and new mothers, there was a strong need to back up these triggers with personalised, accessible tools to facilitate decision making and action.

Unengaged consumers were attracted to independent and impartial advice on what to do about their super (and how to do it), without wanting to be 'educated' about superannuation.

Pre-retirees

Despite being the oldest group, pre-retirees still saw retirement as far off, with many daunted by the idea of ever retiring. This group showed high levels anxiety about planning for retirement but this fear was not necessarily leading to action. There were high levels of cognitive dissonance as people avoided thinking about retirement security. Many had keenly felt losses during the global financial crisis and had developed a sense of cynicism when it came to superannuation.

It was much more difficult to identify strategies which would appeal to this group compared to the other two groups. Although there was some possibility to reframe thoughts through reassurance that 45-50 was not too late to do something about super and that they still had choices.

The research showed there was an opportunity to change frames of reference around super and to provoke unengaged consumers. As noted above, the next step will be to implement some of these engagement strategies and map their outcomes. We hope to feed in this next level of analysis into the later stages of the Productivity Commission inquiry.

Insurance

It is essential to consider insurance costs and quality when assessing superannuation. As the Draft Report identified, insurance benefits within superannuation come at a cost to members' retirement income balances through premiums charged by insurers and the administration costs incurred by funds.

Funds are legally required to offer life and total and permanent disability (TPD) through MySuper products on an opt-out basis. The reason for this policy setting appears to stem from an understanding that behavioural biases, lack of affordability or lack of quality advice lead people to underinsure. Therefore a default option of opt-out insurance is preferable as it allows for choice, but maintains a level of insurance over those who have not made a choice.

However, it is important that the Commission interrogate the idea of underinsurance if it is to better understand if funds are offering insurance products that meet members' needs at minimal cost.

Is underinsurance really an issue?

The Draft Report presents two industry-backed studies in to the rates of underinsurance. Both found large rates of underinsurance.[11] There are two core assumptions within these studies that must be tested to determine if funds offer insurance products that meet members' needs.

The first is the assumption that the rational decision in the face of risk is to buy an insurance product. This ignores the fact that some consumers believe there is a role for social institutions, whether that be family, community or the social security system, to play in providing support in times of need.

Secondly, these studies assume a 'desirable' level of insurance that may well be above what a rational consumer decides will meet their needs. For example, a consumer may deem it is reasonable to live off a single income or they may have other assets they can draw upon, for example workers or accident compensation payouts, on the chance that death or disability impacts their family.

[11] KPMG 2013, Underinsurance - Death Protection Gap in Australia, Report for the Financial Services Council ; Rice Warner, 2014, Insurance Administration Expenses, Report for ASFA, http://www.superannuation.asn.au/policy/reports

In the context of a product where very few people appear to be making active decisions an opt-out policy needs to lead to good outcomes for the majority of consumers. Without further independent research it is difficult to determine if this is currently the case or if there are more nuanced approaches that could be taken to better target consumers who need insurance.

Case study: Hesta Income Protection insurance

The idea that insurance within superannuation is adequately targeting 'underinsurance' proves weak when the fine print of actual insurance policies is examined, particularly in relation to Income Protection products which do not allow simultaneous claims on two policies. HESTA's default Income Protection (IP) product goes further, reducing or totally offsetting claims in a range of circumstances:

"IP benefits you may otherwise be entitled to receive will be reduced or may be totally offset if you get certain other payments, such as:

- workers' or accident compensation
- payment for loss of income (under legislation or otherwise)
- payments under any statutory accident compensation scheme
- payments under any other disability, injury or sickness insurance policy (except for lump-sum benefits received for total and permanent disablement under such a policy)
- payments from settlement or commutation amounts or common law settlements made in respect of loss of past or future income
- payments from settlement of disputed claims in relation to any of the above.

These payments are offset against the maximum 85% of pre-disability income cover."[12]

Regardless of the level of cover obtained this policy fails to cover 100% of pre-disability income, and may cut out where a consumer has alternative sources of income. Where consumers have purchased extra units of insurance, suitable for someone on a higher income, products like this tend towards over rather than under insurance.

Is there equity in insurance costs?

Default insurance within superannuation is sometimes justified as a communal sharing of risk around a set of circumstances (e.g. death or disability) which could strike anyone. While it seeks

[12] HESTA, 2016, 'Insurance Options', available at: https://www.hesta.com.au/Media/docs/PDS-Insurance-Options-010916-772a4656-04a1-42de-8a6f-62ba98b8801a-24.PDF

a similar status to a universal social security scheme, it ignores the long tradition of social security schemes being paid for through equitable taxation systems.

ASFA, for example, contends that bundling insurance with superannuation has led to higher levels of cover and potential spill over benefits to society where the costs of underinsurance would otherwise be borne by governments and in turn taxpayers.[13] This analysis leaves out the cost of insurance and importantly how premium costs are levied across a society. Whereas taxation is broadly levied on an equitable basis, default insurance is not. Insurance within superannuation is a user pays system commonly charged in set units which relate to set levels of cover. By contrast taxation schemes are generally set up to levy based on a progressive scale according to the means of the person being taxed. This allows for a more equitable system and supports a social security scheme that is capable of supporting people on incomes below the tax free threshold.

Taking account of members needs

The proposed primary objective of the superannuation system is to provide income in retirement to substitute or supplement the age pension.[14] This objective is a useful starting point to assess if funds offer insurance products that meet members' needs at minimal cost.

Given the high rate of duplicate accounts and the policy setting of opt-out insurance on MySuper products, there is a strong indication that multiple insurance may be an issue in the system. Further data is needed which tests the rate of duplicate insurance across various demographics.

An efficient system would have low rates of duplicate insurance. The Australian Taxation Office (ATO) data indicates that 45% of people have more than one superannuation account, with 19% having three or more.[15] Meanwhile, 53% of APRA regulated institutional fund accounts have at least one type of insurance.[16] The evidence suggests that about four in five consumers have never analysed the type and amount of life insurance that suits their own circumstances.[17] This indicates that the system is leading to the creation of multiple accounts with multiple

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[13] ASFA, 2016, 'Superannuation Efficiency and Competitiveness – Response to Productivity Commission Issues Paper', available at: http://www.pc.gov.au/__data/assets/pdf_file/0004/199912/sub042-superannuation-competitiveness-efficiency.pdf
[14] Superannuation (Objective) Bill 2016
[15] ATO, 2016, 'Super Accounts Data Overview', available at: www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Super-accounts-data-overview'
[16] APRA, 2016, 'Annual Superannuation Bulletin', June 2015, Sydney.
[17] Zurich Australia, 2014, 'Australians and Life Insurance: Misinformed, Misinsured?', Sydney.

insurances where consumers have little idea of their level of need for this insurance or the impact that multiple policies have on their retirement income.

Modelling from the Financial System Inquiry found that removing duplicate accounts could increase superannuation balances at retirement by around $25,000 and retirement incomes by up to $1,600 per year.[18] About two thirds of this cost or $16,000 was due to duplicate insurance.

Given the potentially high rates of duplicate insurance, coupled with examples where fine print exclusions limit double claims, such as HESTA's IP insurance mentioned above, it is difficult to see how funds or the system are responding effectively or efficiently to member needs in relation to insurance within superannuation.

Case study: low-balances and insurance in superannuation

An illustrative example is that of the family of Garrath Donaldson and their battle to gain a life insurance payout after he took his own life at age 22.[19] Garrath had a life insurance policy through his superannuation fund, REST. The $92,000 claim was rejected by REST and the insurer AIA on the basis that Garrath's account had fallen below $1,200 and no contributions had been received for at least 62 days. This was despite REST continuing to take premiums from his account up until his death.

This problem of insurance premiums eroding the balances of dormant accounts alone is an indication of how poorly aligned the design of insurance is with member's needs. Coupled with the fact that fine print terms are barring claims in situations where premiums are paid up, this points to a serious misalignment between how insurance is structured within superannuation and members' needs.

Structuring insurance around members' needs

Opt-out arrangements for a product with low consumer engagement, like superannuation, are not always the best way to deliver quality outcomes. More nuanced approaches would take account of the actual needs of members. For example, more could be done to make sure insurance is actually appropriate to the needs of consumers at various life stages.

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[18] Modelling prepared for the Financial System Inquiry using Treasury models, October 2014. Based on assumptions of 37 years of work with an average of 2.5 accounts over a person's working life, fixed fees of $80 per account and $140 for insurance per account per annum (in 2014 dollars).
[19] SMH, 2016, 'Devils are in the detail in super life insurance', Adele Ferguson, available at: http://www.smh.com.au/business/consumer-affairs/devils-are-in-the-detail-in-super-life-insurance-20160805-gqlnlk.html

The major reason for taking out a life insurance policy is to protect dependents. Given people are generally entering relationships and having children later, there are now longer periods in a consumers working life where they are without dependents, but continue to pay for life insurance policies through their superannuation. For example, in 2013 the average age men (31.5) and women (29.5) got married was higher than in 1993, at 28.8 and 26.4 respectively.[20] Also, by the time the average father (33) and mother (30.9) have children they have likely been paying for default life insurance through their superannuation for several years.[21]

Structuring default life insurance to only commence around the age of 30 would be a policy approach better attuned to members' needs. Given the prevalence of multiple accounts and the possibility that these may continue over many years in the workforce, there are potentially large portions of retirement balances which are being eroded due to poorly targeted and duplicate policies. Introducing default life insurance part way through a person's working life would also provide another trigger at which to engage consumers around lost super and the benefits of fund consolidation.

Insurance product information requirements

In the promotion of consumer awareness and tailoring of insurance, it is vital that consumers are able to easily compare products and performance. This includes access to information about types of insurance, premiums and claims data.

The 2013 Stronger Super legislative changes significantly enhanced data collection and reporting obligations of trustees, as well as requiring the development and implementation of an insurance strategy consistent with the demographics of fund membership coupled with a specific statutory requirement not unreasonably erode members' retirement accounts.

However, there remains the problem of the impenetrability of insurance policies and Product Disclosure Statements (PDS). For many consumers the length and complexity of a PDS compromises their ability to compare products and make decisions about their needs.

One solution is to introduce standard cover group life insurance across death (and terminal illness), TPD and income protection cover. This would require insurers to offer cover with prescribed standard terms and conditions consistent with consumer expectations. There may

[20] ABS, 2014, 'Marriages and divorces, Australia, 2013', ABS cat. no. 3310.0. Canberra: ABS.
[21] ABS, 2015, 'Births, Australia, 2014' available at: http://www.abs.gov.au/ausstats%5Cabs@.nsf/0/8668A9A0D4B0156CCA25792F0016186A?Opendocument

still be room for policies which deviate from these set definitions, so long as consumers are adequately informed of the differences between default and insurer designed products. Any deviation should be targeted to meet member needs, for example, accommodating the requirements of a group of people in a highly risky profession such as the armed forces or police work.

Standard cover exists under the *Insurance Contracts Act 1984* with respect to retail general insurance policies, such as home building and contents, motor vehicle, travel, and sickness and accident insurance, but has never been in place for life insurance products.

Standardised terms, such as definitions of TPD consistent with the "permanent incapacity" definition in the SIS Act, would promote efficiency by helping to ensure that consumers' expectations of benefits are met. This "permanent incapacity" definition is currently required for early access to superannuation and it prescribes exclusions and income protection benefit offsets, but sets a reasonable standard for general application. The ability to deviate from standard cover would allow insurers and trustees to tailor products further; so long as adequate disclosure was made for consumers who chose these products and that the changes were necessary to meet the needs of fund members.

Fund product structures

The ability of consumers to identify their default insurance and then tailor their cover to meet their individual needs is, in part, dependent on the seamlessness with which consumers can navigate changes to their insurance, whether that is to vary cover or to opt out altogether.

Most superannuation funds allow members to increase their default cover up to automatic acceptance limits, with limited underwriting and potentially beyond with full underwriting.
Most, but not all, funds have group insurance arrangements which allow members to opt-out of insurance cover, although there are sometimes limitations on these options such as not allowing an opt-out of death cover while retaining TPD or income protection.

These limitations on consumer choice, whilst not necessarily inconsistent with the requirements under the MySuper legislation, do detract from allocative efficiency and should be removed where possible. Although insurers traditionally bundle insurance cover, there does not appear to be any good commercial reason why disability cover for income protection and/or TPD cannot be offered without death cover. This would be optimal for many younger workers who do not have dependents and for whom death cover is of little utility.