

THE *facts*

Life Insurance in Australia

Demystifying Life Insurance

The life insurance industry plays a significant role in our lives. However, it seems very little is known of how it operates, or its value to the community. The rise in consumer sophistication, and the acknowledgement that life insurance plays a fundamental role in financial planning and protection, has led to IFSA's aim to raise awareness and understanding of life insurance.

This fact sheet is also intended to educate consumers and industry associates on some of the operational aspects of life insurance companies, with a particular emphasis on underwriting. It is essential that all consumers be aware of the factors that life insurers consider when making an assessment of risk, or in other words, when deciding to offer cover to an individual applicant. This information is also discussed in other IFSA fact sheets.

The Marketplace

The life insurance industry in Australia is extremely competitive and in recent years has been subject to rapid change, with a consolidation of a number of companies. Further market rationalisation is expected, although it is probable that some smaller insurers would continue to operate as niche players.

Current trends indicate that life insurance companies are broadly aligning themselves as either niche players or full financial services operators. The latter have emerged from the blurring of services offered by the banking and insurance industries.

In 2004, there are 39 registered life offices, though it is estimated that the 10 largest life insurers issue more than 85% of new policies each year. Around 6.3 million Australians are protected by life insurance policies, with claim payments in excess of \$1 billion made by life insurers each year.

The Role of the Life Insurer

The life insurance industry in Australia is operating in a mature market and is subject to tight regulatory controls. In essence, life insurers function as an operator or manager of a risk pool. They collect contributions (premiums) from members of the pool to help meet the financial needs (pay claims) of individuals (lives insured) who suffer an unexpected illness, serious injury or death, to benefit the individual or their family (beneficiaries).

Life insurance premiums should be adequate, reasonable and equitable, and must be sufficient to pay the benefits as promised, as well as the expenses of administering the policy.

Consumers and industry associates should gain confidence from knowledge of life insurers' community obligations. The key principles being that:

- Life insurers are obliged to act in 'utmost good faith', a basis codified by law through the Insurance Contracts Act;
- Life insurers have to meet regulations that ensure that they remain financially sound and able to meet claims;
- Privacy legislation requires all insurers to act more diligently to ensure the proper collection, storage, use, correction, disclosure, access and transfer of personal and sensitive information;
- All life companies must be registered under the Life Act 1995 and are regulated by the Australian Prudential Regulation Authority (APRA).

Financial Planning and Protection

In the event of death, or a disability that prevents an individual from working, it is generally recognised that social security benefits will not be sufficient to maintain a person or their family's standard of living.

Insurance is therefore an essential part of a person's financial plan and one way in which the risk of potential financial losses from premature death, prolonged illness or disability can be minimised.

When determining the type and level of appropriate cover, it is always suggested that an individual or business seek independent professional advice. Adequate life insurance in this situation means that a person and/or their beneficiaries will not be burdened with debt and will be protected from selling assets to pay outstanding debts or to cover living expenses.

We recommend consumers consider obtaining professional advice from a licensed adviser. The advice provided should ensure that choice of product type and level of coverage is based on an individual's unique financial situation and objectives. This is particularly important as premium costs, definitions, exclusions and optional benefits vary considerably both between insurers, and between products offered by the same insurer. Types of optional benefits include CPI indexed premium and sum insured increases, guaranteed future insurability, and waiving of premiums at time of claim.

Taxation of premiums varies according to the type of product and circumstances of purchase, another reason why professional advice is important. To illustrate the complexity in this area, life insurance benefits are usually tax free although their premiums are not, whereas income protection benefits are usually taxable but their premiums are tax deductible. However, life insurance benefits when bought with superannuation may be taxable, whereas the premiums are usually tax deductible.

Life Insurance Products

Life insurance policies cover a wide range of events that people can be exposed to during their lifetime. The products available can generally be grouped into the following categories:

- Lump Sum protection covering death (otherwise referred to as 'Term Insurance'), Total and Permanent Disablement (TPD), and Trauma (sometimes referred to as Crisis) insurance. Essentially these types of policies provide cover for death, disablement and serious illness or injury and generally pay lump sums.
- Policies covering inability to work as a result of disability, usually referred to as Income Protection and, in the case of small business, optional Overheads Expenses Protection.
- 'Traditional' life insurance, such as Whole of Life and Endowment policies, both of which have life cover combined with a savings or investment component. These types of policies were popular prior to the development of 'unbundled' policies (separate investment and insurance components) in the 1970's.
- Life investment contracts, either capital guaranteed or linked to a range of investments, which may also be referred to as investment accounts or savings plans. These contracts do not usually provide life insurance cover other than the value of the investment at the date of death.
- Retirement products, namely allocated pensions and annuities. These policies are designed to generate income streams during retirement. The Federal government through changes to legislation has approved a new type of pension that will allow retirees to invest their superannuation savings into growth assets. This new pension is referred to as a 'Term Allocated Pension' (TAP). All these different products do not usually provide any life insurance cover.

Superannuation Business at a glance

Superannuation is a logical application for life products, as it embraces the elements of a structured savings or investment vehicle, as well as the option of including life insurance cover. By providing a range of products and services, life insurers have become a major player in the superannuation industry.

In Australia, when people retire they will typically use their accrued superannuation to buy themselves a retirement income, usually through an annuity or an allocated pension. Despite this, however, around 74% of those aged between 65 and 69 still require financial support through the aged pension.

Superannuation business has increased largely due to the ageing population, the concessional tax treatment of superannuation money and the mandatory Superannuation Guarantee legislation.

The Concept of Underwriting

'Underwriting' is a term used by life insurers to describe the process used to decide the terms on which cover is offered. 'Underwriter' is the term used to describe the individuals within the insurance company office who underwrite new requests for insurance cover. Put simply, underwriting involves assessing a risk and setting a price (premium) for that risk.

The underwriter assesses the risk based on what are referred to as 'risk factors', such as the person's age, sex and smoking status for the type of policy chosen. Additional risk factors that may impact the assessment are usually identified from the information disclosed in the application for insurance and findings from independent medical examinations and/or test results. These additional risk factors relate to the person's own health and family history, occupation, income and employment history. Other risk factors can include residency and pastimes.

The main aim of underwriting is to accurately identify the degree of risk each applicant presents and to either:

- Issue a policy as applied for;
- Offer a reduced amount of cover or different policy terms;
- Offer cover with a higher premium and/or an exclusion; or
- Defer or decline the application.

Duty of Disclosure

The underwriter assesses the risk by considering the information disclosed in the application and the personal statements. Consumers at the time of applying are informed of their legal responsibility and duty to disclose every matter that they know, or that a reasonable person could be expected to know, that may be relevant to the insurer's decision as to whether to provide cover, and if so, on what terms. This duty of disclosure (covered under the Insurance Contracts Act of 1984) is concerned with the quality of information provided by people in their applications for insurance.

Life Insurance Industry Developments

Recent developments that have affected life insurers and the manner in which they differentiate between applicants include: the establishment of the Human Rights and Equal Opportunity Commission; the introduction of the Disability Discrimination Act; anti-discrimination legislation in the various States; the development of new genetic tests; the increasing community concern with regard to privacy; and the new regulatory framework imposed by the Financial Services Reform Act.

Consumer Rights

The life insurance industry has operated under a Code of Practice that dealt with inquiries, complaints and disputes since September 1995. This Code has now been replaced by the amendments to the Corporations Law by the Financial Services Reform Act, which took effect from 11 March 2004.

This Act formalised the Code of Practice and set in place the legal system now operating in Australia that insurers are governed by. This legislation impacts on the way insurers relate and communicate with consumers. As well as regulating how advice is given (described below), it has legitimised the industry's internal and external complaints systems.

Legislation

In Australia, the operations of life insurers are regulated by the legal system, most of which is Commonwealth legislation. Two regulatory bodies administer the key legislation that governs the life insurance industry; the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC).

APRA is responsible for the administration of the Life Insurance Act 1995 while ASIC administers the Insurance Contracts Act 1984 and the Financial Services Reform Act.

Since March 2004, the Financial Services Reform Act has imposed standards that protect consumers whenever they deal with financial institutions, including insurance companies, or with people such as financial planners, insurance brokers or agents. Individuals who now provide advice are referred to as 'Authorised Representatives'.

Authorised Representatives who give advice or sell financial products must provide their clients key documents about their services, advice and the products, including:

- Financial Services Guide
- Statement of Advice
- Product Disclosure Statement.



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Investment and Financial Services Association

All businesses that offer 'financial services' must hold an Australian Financial Services Licence. All licensed businesses must:

- operate efficiently, honestly and fairly
- ensure staff and representatives are properly trained and supervised
- have proper complaints handling procedures in case anything goes wrong and must belong to an independent complaints scheme that consumers may use at no cost.

Advice

The Financial Services Reform Act's focus is on correct advice. Advice obtained will help consumers to identify their risks, the level of protection needed, and the right type and combination of life insurance products to cover the risks identified.

Life Insurance Cover

Surveys¹ undertaken on the Australian market by both overseas and local research houses clearly indicate that the number of Australians with life insurance is low by international standards, and that, on average, the level of cover is inadequate.

Other Fact Sheets in the Series

How Life Insurance Works
Life Insurance and Privacy in Australia
Life Insurance and Hepatitis C in Australia
Life Insurance and Genetic Testing in Australia

¹Sigma Report UK April 2004,
Joint study on underinsurance by AXA and Dexx&R July 2004, and
Australian Attitudes Towards Life Insurance - Financial Advice Centre August 2004

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