FSC
FINANCIAL SERVICES COUNCIL

FINANCIAL SYSTEM INQUIRY – PHASE TWO

CHAPTER TWO

CONSUMER OUTCOMES

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OUTLINE

This chapter outlines our recommendations on how the life insurance and financial advice sectors could be reformed to improve consumer outcomes and also meet public sector fiscal challenges.

We believe that the existing insurance regulatory architecture will not be fit to address the risks the Australian community will face by 2030.

We share the interim report's view that further reform of the financial advice industry is required to improve consumer clarity and confidence

This chapter also considers disclosure. We believe that disclosure has not yet been mastered. It has been repeatedly demonstrated that the length and language used in disclosure documents is inappropriate for most Australians. We therefore make recommendations to improve the disclosure framework.

1. LIFE INSURANCE

Australians are heavily underinsured. Rigidities in Australia's insurance regulatory architecture have contributed to underinsurance as providers have not been permitted to develop a wide array of innovative products. Underinsurance was one of the key drivers of the government's establishment of the National Disability Insurance Scheme as a significant insurance market intervention.

Despite this background, the interim report has not yet assessed why underinsurance has occurred, and whether current policy settings are the most cost-effective and outcomes focused way of providing insurance to Australians.

Existing regulation has not promoted product innovation in the insurance sector.

Despite the best of intentions, current public policy settings governing welfare and disability payments contribute to underinsurance. Public policy settings may lead people to incorrectly assume that they can rely on welfare and government disability payments as sufficient to meet their needs.

A more effective regulatory framework would allow better priced and more consumer focused product offering. This would improve the efficiency and effectiveness of insurance markets in Australia by minimising regulatory compliance costs. Improving these market rigidities would assist in reducing the level of underinsurance in Australia and alleviate the need for such a substantial cost and risk to the Government's balance sheet through existing public policy settings.

Underinsurance of disability risks

To determine the level of underinsurance, a definition of the adequate level of insurance is necessary. We believe that an adequate level of disability insurance would ensure that a family is not forced to sell its home or belongings due to the inability to make mortgage repayments, and would cover the family's needs until any children become adults and if relevant, provide ongoing rental support until the partner retires.[1]

We believe that the figures quoted on the level of underinsurance in the interim report are understated. A number of studies have demonstrated that underinsurance is a major issue in Australia. Perhaps the most complete and conservative estimates of the level of underinsurance for income protection is a recent analysis by KPMG that provides 'bookend' estimates of underinsurance (see Box 2.1).

According to this research, 35% of employed people in Australia have no private disability insurance at all and 19% of families do not have any life insurance. In total, the level of disability underinsurance is estimated to be $304 billion per annum while the level of underinsurance of the lives of employed people against premature death in Australian families is estimated to be $800 billion.[1]

Table 1.13 in our first submission shows the proportion of adequate insurance levels held by individuals for disability and Table 1.14 shows the same for premature death.

Alarmingly, employed Australians aged 45-64 are the most underinsured with an average of just 23% of their "adequate" insurance needs met by private disability insurance cover.

[1] The definition implies that a healthy partner would be expected to return to work. We acknowledge that other definitions of underinsurance may also be reasonable depending on community expectations. This means that the level of underinsurance determined based on this definition may not be the maximum level of underinsurance.
[1] KPMG, Death and Disability Protection Gap in Australia, 2014

Box 2.1 KPMG's methodology and data sources for determining the level of underinsurance against long-term future income loss in the event of disability

KPMG's study Disability Protection Gap in Australia seeks to determine if there is any underinsurance in protecting family or individual income in the event of a disability or death.

To achive this they adopt a top down approach where:

Underinsurance= Adequate level of protection-Actual level of insurance

And:

Adequate level of protection = Income x Percentage of income protected

The quantitative assumption for the adequate level of disability income insurance consistent with the qualitative definition previously mentioned is 84 per cent of the individual's income (which consist of 75 per cent of salary and 9 per cent superannuation).

A person's retirement age is assumed to be 65. Using the working age population limits the estimated insurance needed to persons employed between the ages of 18 to 64 – roughly 9.5 millions Australians or 44 per cent of the population.

In deriving the level of actual disability insurance, the KPMG study included only long term comprehensive disability income insurance, but converted TPD cover into an equivalent income stream. At an aggregate level, the actual level of insurance is tied back to APRA statistics, adjusted where necessary for this purpose. Detailed data (by age, benefit period and gender) come from three separate studies:

a. For insurance provided in industry funds, a bespoke data collection of 6 large group risk insurers
b. For insurance provided by the retail channel: the FSC-KPMG retail disability income study,
c. For insurance provided in corporate funds and master trusts: the KPMG Group life study.

Why underinsurance is occurring – regulatory constraints on product development

Innovation in insurance product offerings is driven by the demand of consumers. However the ability of the insurers to create the products demanded is driven by the combination of regulation, legislation and risk profile of the companies themselves. The regulatory architecture therefore determines the level of product innovation which can occur. Innovation of life insurance products will help keep insurance relevant in the ever changing financial services market and assist with reducing the need for costly government interventions such as the NDIS.

A Deloitte study, commissioned by the FSC, compared cross border regulatory arrangements and found Australia operates under a highly segmented insurance framework. This framework is stifling innovation in insurance products and the ability of insurers to meet consumers needs. Further details on the study are provided below (see Box 2.2).

FIGURE 1

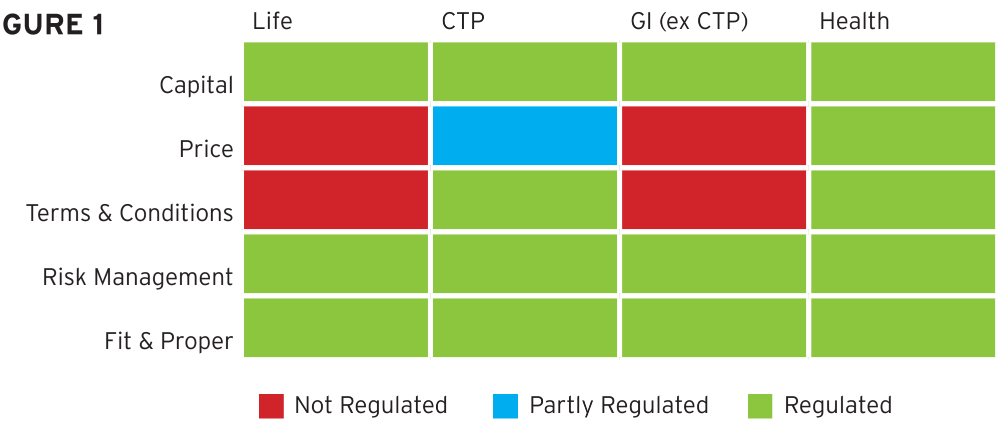

Figure 1 illustrates that the current prudential framework is divided across product types, meaning that individual products types (Life, CTP, GI (ex CPT) and Health) each require a separate license. This limits the ability of providers to provide multi-purpose products.

Box 2.2 Background of Deloitte global comparative review of international insurance markets

For the second phase of this inquiry, FSC engaged Deloitte Access Economics to undertake a global comparative review comparing the Australian legislative and regulatory landscape with that of four major international markets.

The countries reviewed covered a range of regulatory markets and markets undergoing differing levels of change following the GFC. The countries covered were Canada, Germany, South Africa and the United Kingdom.

The Deloitte review of the international markets was conducted through a two stage process with interviews of insurance regulation experts, working with and for insurers in each of the countries. Deloitte also utilised its international offices to gain an understanding of the depth of regulation and its effects on the business.

The review covered a range of areas of regulation as well as a full spectrum of insurance products. The areas of focus included the following:

- The level of capital requirements
- The hindrance to innovation from regulatory oversight
- The depth of the regulatory and legislative oversight
- The variation in regulation and legislation across insurance product types.

To minimise regulatory compliance costs and help insurers create innovative products which better services the population's need, streamlining regulations across insurance products is important.

RECOMMENDATION

The Australian insurance framework is currently siloed. This impedes innovation and may not meet the needs of future policyholders.

Development of innovative insurance products could be fostered under a streamlined, consolidated prudential framework.

Why underinsurance is occurring – a failure to consider private sector solutions

As noted in the interim report, life insurance products play an important role in the community as they protect the insured and their dependents against the financial risks associated with premature death, permanent and temporary disability, as well as various specified critical medical conditions.

The interim report states: "In addition to the negative effect of non-insurance or underinsurance on the consumer where they suffer loss, costs can be passed on to Government and the non-government organisation sector…"

In order to assist with the sustainability of the federal budget, a viable private disability insurance product is imperative. Internationally the market for long term care insurance, at both an aged care level and a whole of life market are successful when the products are mandated or incentivised by the government.

Private disability life insurance which protects against the economic risks of disability is an under-utilised policy device in Australia. This policy device could reduce Commonwealth budget pressure arising from increasing disability-related welfare costs.

Just as superannuation is the private sector solution to the costs of an ageing population and private health insurance is a private sector solution to managing health care costs, so too life insurance can be the private sector solution to the increasing budget costs of welfare.

Government policy has failed to consider relaxing impediments to private sector solutions, instead opting for large and unfunded social insurance programs.

The National Disability Insurance Scheme NDIS will cost the Australian Government $19.3 billion over seven years from 2012. It is timely to consider whether the costs of the NDIS could be partially defrayed through private disability insurance provided by the private sector.

We also believe that the costs associated with welfare expenses including the Disability Support Pension (DSP) could be reduced. Higher take up of private disability insurance would reduce pressure on public finances and should deliver a higher standard of living for disabled Australians.

According to research conducted for the FSC by KPMG, roughly 9.5 million Australians, or 44% of the population, could mitigate the economic risks of disability through private disability insurance.

Disability insurance can provide a regular income replacement benefit if an individual suffers an illness or injury and is incapable of working either temporarily or permanently.[2]

Research noted above has consistently shown that Australians are significantly underinsured against the social and economic impacts of disability. Underinsurance means that the government picks up the tab when someone acquires a disability. Further, the impact of public policy settings governing welfare and disability payments are important factors and that their impact on underinsurance is more nuanced than the interim report suggests.

A private sector solution to underinsurance

Disability care is a growing area of concern around the world. The costs of long term disability, not just age related disability, are a large strain on the government budget. In Australia this market is fragmented and the insurance cover is currently provided by a combination of life insurers, with income protection and TPD policies, health insurers with rehabilitation and sometimes general insurers with accident policies.

Germany and South Africa have an active market for private disability care benefits. The German model is based around the mandatory nature of long term care insurance, for which disability care is a subset of this. South Africa on the other hand, has means tested the government benefits as well as not hindering innovation of insurance products covering the disability care benefits. By having an active private disability insurance market, both South Africa and Germany are reducing the fiscal burden on their respective governments to care for disabled. In order to demonstrate the potential for the life insurance industry to privatise the costs of some disability-related welfare in Australia and to reduce the long-term burden on the Budget, the FSC commissioned

[2] KPMG, Underinsurance – Disability Insurance Protection Gap in Australia, 2014

Deloitte Access Economics to undertake further, extended research[3].

This research involved a modelling study that considered the potential for cost savings to be achieved through the introduction of appropriate financial incentives and disincentives aimed at improving the level of coverage of private disability insurance.

The following provides an overview of the level of Commonwealth expenditure in these areas and key findings from both the KPMG and the Deloitte Access Economics studies.

Disability Support Pension

There is a direct link between the Commonwealth outlays associated with disability payments and underinsurance.

Social security and welfare spending is the most significant federal budget expense accounting for 35%, or around $138 billion of government expenses in 2013-14.[4] DSP accounts for around 11% of this expenditure or $15.5 billion.

DSP expenditure is projected to increase by 15% to almost $18 billion by 2016-17.[5] In excess of 800,000 people receive DSP benefits and over the past 20 years, DSP recipient numbers have grown more than recipient numbers in any other government income support program.[6] In 2012-13 there were 51,418 new DSP claims granted.[7]

The FSC is concerned about the sustainability of growing DSP expenditure at a time of increased budget pressure. We believe there are options available to the government, which may not have been previously considered, to transfer risk and the associated budget expense to the private insurance sector.

With more employed Australians adequately insured against the economic risks of disability, fewer would need to rely on the DSP as a safety net should they suffer an illness or injury and be unable to work. Social outcomes could be expected to improve as income replacement from insurance would enable the standard of living (in economic terms) to be broadly maintained.

In addition to the social outcomes, further analysis showed that, based on current DSP means-testing, every dollar of income received from

[3] Research commissioned by the FSC undertaken by Deloitte Access Economics, Expanding the coverage of private disability insurance to reduce the economic burden of social disability insurance, March 2014
[4] Australian Government, 2013-2014 Budget Paper No. 1, Statement 6: Expenses and Net Capital Investment
[5] Australian Government, 2013-2014 Budget Paper No. 1, Statement 6: Expenses and Net Capital Investment, Table 3.1
[6] 2011-12 Budget Review, Disability support pension reforms
[7] 2012-13 Annual Report, Department of Human Services

private insurance can be expected to reduce the DSP by 50 cents through reduced eligibility if all employed Australians were adequately insured.

This translates to a government cost saving in the first year, if Australians are adequately insured, of at least $340 million for each cohort of new disability pensioners even before the tax revenue foregone is taken into account.

According to the FSC's research, the cumulative annual savings effect of adequate disability insurance is estimated to be $2.5 billion per annum in the 10th year, as measured by lower DSP payments.

National Disability Insurance Scheme

The National Disability Insurance Scheme (NDIS) and the National Injury Insurance Scheme (NIIS) will provide funding for long term, individualised care and support services for those with a significant disability such as attendant nursing care, rehabilitation and home and vehicle modifications.

However, the NDIS and NIIS will not provide an ongoing income replacement benefit where a disability is acquired as provided by adequate disability insurance. Such benefits enable an individual to maintain his or her standard of living and continue to meet financial obligations such as mortgage payments, rent, daily living expenses and education costs for the children in the family.

The Australian Government has committed $19.3 billion over seven years from 2012-13 to fund 53 per cent of the cost of the NDIS with the states and territories to fund the remaining cost. Eligibility for the NDIS will not be means tested and financial support will be available to those who are born with or acquire a permanent disability.

The FSC supports the establishment of the NDIS and the NIIS. However, we submit that the existing funding model is likely to be unsustainable and may ultimately place pressure on the Scheme's long-term viability. We note that the development of the NDIS and NIIS has not placed any emphasis on the role of life insurance or addressing underinsurance generally.

Deloitte Access Economics Modelling Study

To consider ways in which to address underinsurance and reduce the public sector costs of disability, the FSC engaged Deloitte Access Economics to undertake modelling by assessing private disability insurance alongside the NDIS and DSP.

The Deloitte study considered the potential for budgetary cost savings in the NDIS and DSP through an enhanced role for private disability insurance. Central to the study is a consideration of the net financial impact of the introduction of appropriate financial incentives and disincentives to achieve improved levels of cover.

The study is based on policy settings on private health insurance which could be expected to encourage Australian taxpayers to hold private disability insurance in an analogous manner.

The policy settings around private health insurance are a well understood and easily transferable policy solution to encourage Australian taxpayers to hold private disability insurance. By encouraging higher rates of PHI coverage, the government has shifted the burden of delivering hospital services to the private system, as well as shifted some of the costs of delivering these services from public budgets to health funds and their members. The PHI rebate, the Medicare Levy surcharge and Lifetime Health Cover Loading all promote the take-up of PHI and improve the risk profile of the insured pool.

Policy settings analogous to private health insurance for disability insurance would meet or exceed the benefits offered through the NDIS while providing sufficient income replacement in the event of illness or injury rendering them ineligible for DSP benefits.

The study demonstrates the potential savings that could be achieved by government if NDIS eligibility for those who acquire a disability was means tested and by extension, reduced eligibility for DSP benefits, while ensuring social policy objectives of the Scheme and other disability-related welfare programs would continue to be achieved through privatisation of the risk.

The research was undertaken based on the principle of the historical role of private health insurance in Australia in reducing public healthcare expenditure.

The Australian Government has a policy principle of universal entitlement for health services – through funding public hospital services and national programs and providing subsidies to medical and pharmaceutical services.

This mainly occurs through the Medical Benefits Scheme (MBS) and Pharmaceutical Benefits Scheme (PBS) – funded in part through a Medicare Levy on all taxpayers, and a Medicare Levy Surcharge (MLS) that incentivises higher income individuals and families to take out private health insurance hospital cover.

In addition, the Australian Government offers a rebate for private health insurance premiums which is also means-tested. The rebate levels applicable for 1 July 2013 to 30 June 2014 are outlined in Figure 2[1].

FIGURE 2

Singles Families	< $88,000 < $176,000	$88,001-102,000 $176,001-204,000	$102,001-136,000 $204,001-272,000	> $136,001 > $272,001
Rebate				
< age 65	30%	20%	10%	0%
Age 65-69	35%	25%	15%	0%
Age 70+	40%	30%	20%	0%
Medicare Levy Surcharge				
All ages	0.0%	1.0%	1.25%	1.5%

The private health insurance rebate (originally at a standard 30% rate) and MLS were introduced in the late 1990s, along with introduction of differential private health insurance premiums for those taking out and maintaining private health insurance cover before the age of 30 years (Lifetime Health Cover).

The effect on private health insurance coverage in Australia was to increase rates of cover from around 30% in 1997 to around 45% by 2001.

In December 2013, 47 per cent of Australians held private hospital cover and almost 55 per cent held general treatment cover.[2]

The study uses the principles of existing policy mechanisms that operate for Australian taxpayers for private health insurance as the basis for considering private disability take up through a range tax incentives (i.e. rebates) and disincentives (i.e. additional surcharge).

Disincentives

Deloitte research suggested that the introduction of a "Disability Levy

[1] Australian Government, Private Health Insurance Ombudsman website, http://www.privatehealth.gov.au/healthinsurance/incentivessurcharges/insurancerebate.htm, accessed March 2014
[2] Private Health Insurance Administration Council, Membership Statistics, 2014

Surcharge" (DLS) would perhaps be the strongest underinsurance policy lever that would 'push' individuals to take up private disability cover.

A DLS would be a disincentive or a 'stick' for those earning over a specified income, in the base case over $88,000, to take out private disability insurance cover.

In the new modelling, the DLS was based on current policy for the MLS which includes a surcharge of up to 1.5% on taxable income (in addition to the 2.0% Medicare levy) for those without the appropriate level of cover.

Deloitte's base case models the potential savings for government with an assumption that 10 per cent of the total population were covered by adequate insurance.

That represents an assumption that all taxpayers earning above the income threshold and therefore subject to the DLS would take out cover to avoid the "stick".

Incentives

The introduction of rebates is assumed to be necessary to avoid underinsurance, as in a private health insurance setting, as a lever to assist with the affordability of cover.

In this modelling, the rebate level is assumed to be the same as the private health insurance policy. That is, between a ten per cent and 30 per cent rebate for those aged less than 65 with annual taxable income less than $136,000 for individuals and $272,000 for households.

The modelling shows that through these incentives and disincentives improving the level of private disability coverage could generate net savings over five years to 2019, the NDIS of $10.3 billion and to the DSP $3.4 billion.

This includes combined savings from both programs of $3.7 billion for the Commonwealth Government (after accounting for the incentive expenditure $5.2 billion) and $4.8 billion for state and territory governments.

Figure 3 demonstrates the potential savings that could be achieved through improved levels of private disability insurance coverage alongside the NDIS.

FIGURE 3

Parameters	Savings / (Expenditure) (billion)
Savings to the governments programs	**$**
National Disability Insurance Scheme	$10.3
Disability Support Pensions	$3.4
Gross Savings	$13.7
Commonwealth Rebates	**($5.2)**
Net savings to governments	
Commonwealth	$3.7
States and Territories	$4.8
Total net savings	$8.5

The research also concluded that:

> From a policy perspective, private disability insurance, supported by a broader base of consumers, would potentially provide a more equitable distribution of the financial burden of disability insurance across people who can afford to pay and need not fall back on the safety net provided by the NDIS. It would also avoid the crowding out of private expenditure among those who can afford to pay, and reduce financial risk to the Australian government (and by extension, taxpayers).[3]

The modelling of the financial benefits of improved levels of private insurance coverage is supported by the findings of consumer polling recently completed for the FSC by GfK.

When those surveyed without disability insurance were asked to indicate the most persuasive messages to act in relation to taking out income protection cover, the most motivating message to act was the government providing a tax incentive to have insurance (the carrot approach), while the second most motivating messages was a minimum level of insurance required to avoid extra taxation (the stick approach adopted for private health insurance).[4]

Pulling it all together

With the increase in costs around the NDIS and the ongoing strain on the government budget of the DSP, the ability of a private market Permanent Disability Insurance (PDI) product to contribute in this sector is becoming more important.

[3] Research commissioned by the FSC completed by Deloitte Access Economics, Expanding the coverage of private disability insurance to reduce the economic burden of social disability insurance, March 2014, p. ii
[4] GfK, A review of consumer attitudes and behaviour in relation to financial protection: Instilling behavioural change to counter under-insurance in the Australian life insurance category, February 2014

Through updating the existing insurance acts and creating further detail around the NDIS, the private sector may be able to assist the government and the consumer.

To create innovative products such as a private market PDI product, the streamlining of Australian prudential legislation and regulatory oversight is needed. New legislation to enable insurers to offer products across current business lines, without having to have multiple licences and statutory reserves for an individual product, would minimise compliance, duplication of work and therefore costs.

The FSC believes that an expanded, complementary role for the private insurance sector in managing some of the risk that would otherwise remain a public liability would encourage innovation. Particularly in relation to product and services that could be developed to meet the evolving needs of consumers.

It is likely that new long term disability products would need to be developed to provide the same or superior benefits to those available through the NDIS.

Products designed to address underinsurance as discussed above are not be possible under the current segmented life, general and health insurance licensing framework in Australia.

RECOMMENDATION

Public policy settings governing welfare and disability payments contribute to underinsurance.

There is significant scope for the life insurance industry to reduce the costs associated with underinsurance.

The insurance prudential and licensing framework should be streamlined to promote innovation

Sustainability

In recent times, however, there has been significant upward pressure on premiums and increased policy lapse rates that are symptomatic of a number of life insurance sustainability challenges.

Issues such as greater acceptance of mental health as a legitimate health issue, widening of grounds on which a person may be declared totally and permanently disabled under a policy and extensive legal involvement in claims relating to older occurrences has led to higher than expected claims payouts.

The default superannuation market has also placed significant emphasis on lower premiums in the short term to meet expectations under tendering processes at the expense of medium to longer term premium stability. These practices all contribute to upward pressure on premiums leading to lower insurance affordability and to an adverse cycle of rising lapse rates. High lapse rates shrinks the pool of insured persons placing greater pressure on premiums.

In addition to rising premiums, the reasons for falling take-up are likely to include limited consumer engagement with life insurance, lack of suitable simple products, limited access to advice, premiums that increase with age that make the product unaffordable in later years, and lack of product innovation.

Introduction of a reasonable time periods for lodging claims from incident should assist the management of extensive legal involvement. This would be not unlike statutory limitations for actions commonly applying to areas such as motor accidents, work injuries and victim's compensation.

To promote premium stability in the default superannuation market, broader engagement between regulators, superannuation trustees and life companies on insurance sustainability could assist in expanding the focus to include a better risk framework.

The industry could also collaborate on better training and education of underwriters and claims assessors and to provide a clearer definition of disability related terms of conditions to assist consumers and providers. Developments in medicine should also be incorporated into policy terms and conditions.

Changes could be considered to the *Private Health Insurance Act 2007* to allow life insurers to compensate for medical expenses for rehabilitation after accident or illness. This is currently prohibited making early intervention in the case of disability difficult.

RECOMMENDATION

Improving the sustainability and efficiency of the market will likely require a combination of innovation by suppliers, some regulatory intervention, together with collaborative industry efforts and support from regulators and legislators.

Underwriting

The interim report refers to underwriting numerous times. Evidence-based underwriting takes into account an individual's risk profile to ensure an equitable treatment of all lives insured. To achieve this, the premiums paid by a specific policyholder reflect the relative risk the insured person brings to the insured population compared to the other existing insured lives.

As a fundamental principle of voluntary insurance and the insurer's duty to all policyholders, insurers assess an individual's application for life insurance based on a range of relative-risk criteria. These criteria would include, among other things, the applicant's age, present state of health, past health history, relevant familial medical traits, recreational activities and various socioeconomic factors. Prudent, evidence-based underwriting and risk assessment of applicants by life insurers is essential to ensure life insurance products remain affordable and accessible for consumers and that the industry remains sustainable.

In addition to individual risk-rated insurance described above, consumers in Australia are also able to access life and disability insurance through their superannuation.

Group insurance offered through superannuation generally does not require an individual to complete comprehensive underwriting in relation to their individual circumstances as it uses a risk rating pooling criteria based on the employees within the group scheme, unless additional voluntary top-up cover is obtained. As a result, the majority of employed Australians have access to life and disability insurance regardless of their personal circumstances.

The process of risk-stratification is fundamental in ensuring that all policyholders are treated equitably. By the very nature of risk-stratification, an exemption provided in the Disability Discrimination Act (DDA) in relation to the provision of voluntary insurance and superannuation is therefore essential. As such, it is important to ensure that there is regulatory certainty and clarity on the matter.

The current exemptions under the DDA permit insurers to assess risk and make distinctions on the basis of disability. Such exemptions are governed by conditions that strike an appropriate balance between competing interests of those already insured and those seeking insurance. Ultimately it achieves the fundamental purpose of protecting the rights of all Australians. Under the exemptions, there is a requirement that where an insurer makes a distinction on the basis