



Death and Disability Benefit Design in a Dysfunctional Insurance Market

Jeff Humphreys

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Overview

1. Dysfunctional market
2. Some misconceptions
3. Design
4. Needs based design
5. Default design
6. Right level of premium



Dysfunctional Market

David Murray pointed out recently that the financial system has:

- Some unhealthy concentration areas
- Areas in the superannuation system that “aren’t a very big group” and “do they all act in the same way? Is there genuine competition?”



Dysfunctional Market

The advantage of having the private sector provide a service is that the competitive forces it delivers drive:

- Efficiency
- Innovation



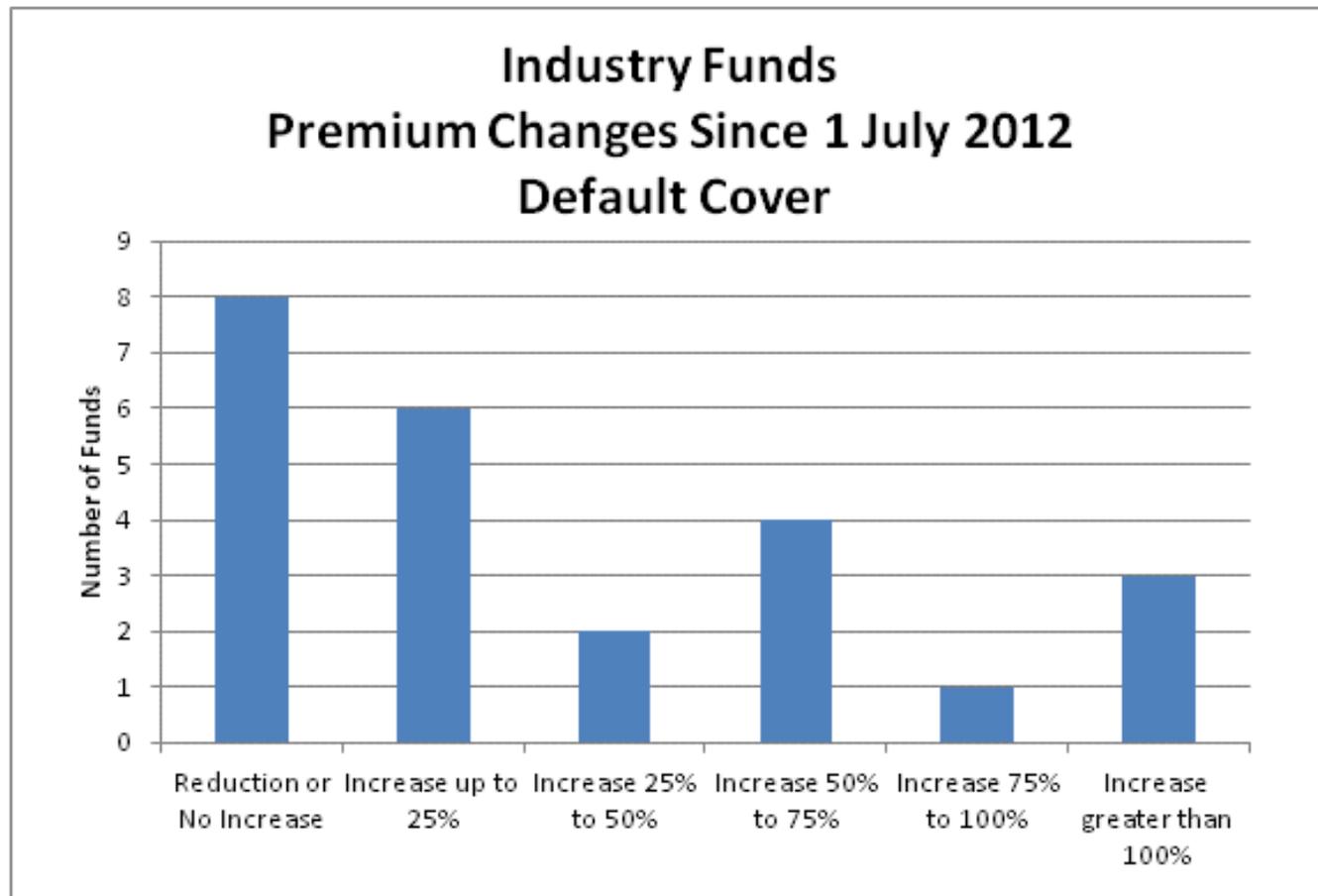
Dysfunctional Market

Group insurance

- Currently lacks any form of competition
- Driven by:
 - (Reinsurer) mispricing in 2009/10
 - A poor TPD experience (and poor design features)
 - Panic
- Regulator that
 - is anti competition
 - anti innovation
 - has failed when tested against its own Mission Statement
 - has failed the people paying for it



Dysfunctional Market





Dysfunctional Market

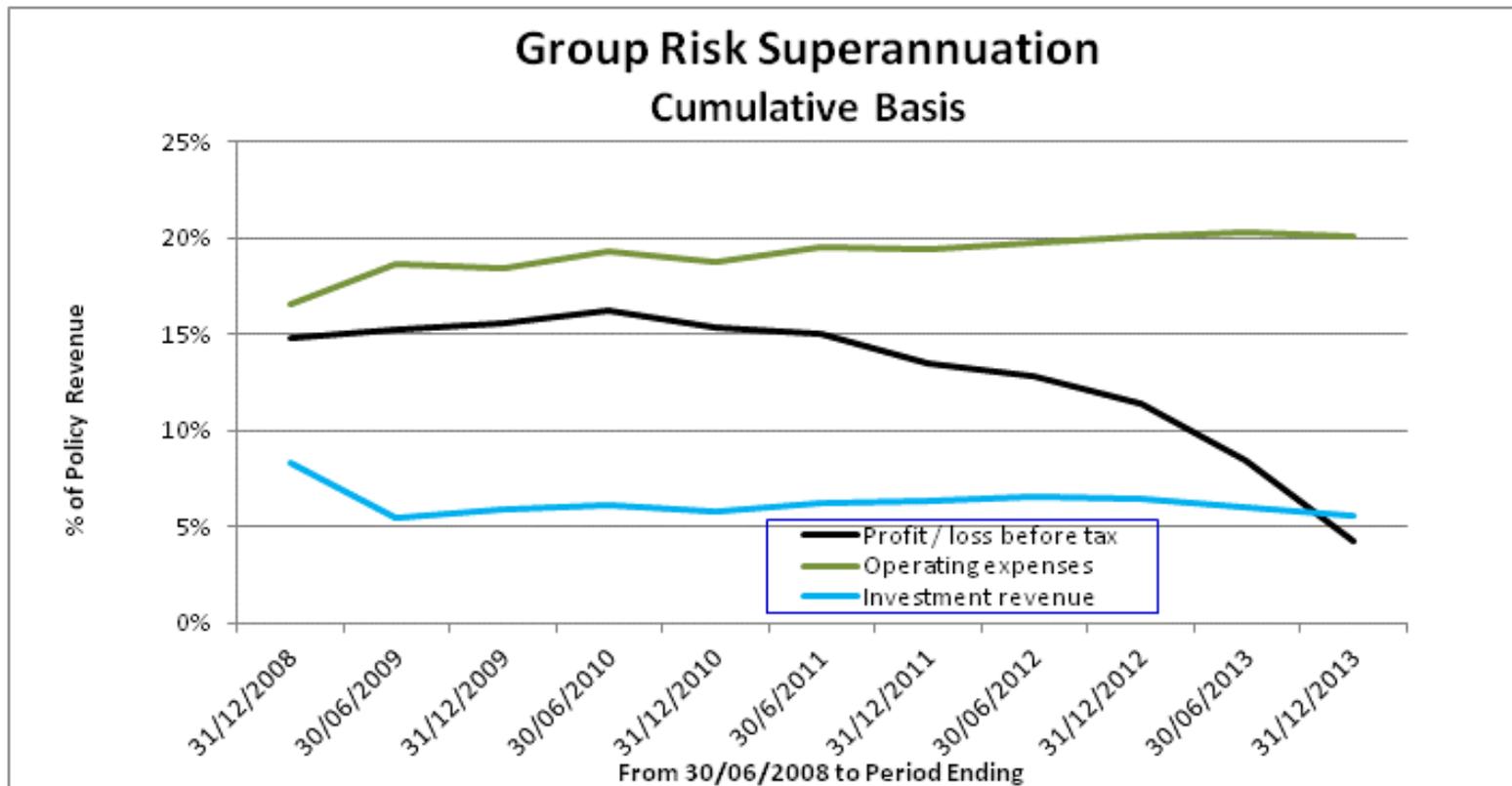
APRA Statistics show over the last 5.5 years:

- Group super premium of \$16bn
- Group super insurer margins of \$5bn or about 25% of premium
 - 20% expenses and increasing
 - 5% profit and falling

Until 2013, 5% profit = 15% return on capital



Dysfunctional Market





Dysfunctional Market

On a rapidly growing premium, there is an increasing margin for expenses going to insurers when most costs are fixed



Dysfunctional Market

Increases in rates for 4 of the largest funds would alone have turned this around

- representing additional profits of around 10% to 15% of the premium of the total market
- If there has been no further deterioration



Dysfunctional Market

Insurer damage through:

- Reputation
 - super profits and profit gouging and
 - overstating past losses
- Business and profit
 - Trustees reduce benefits where there is gouging as it would breach SIS to continue to provide them



Dysfunctional Market

Some insurers are sometimes still providing a fair premium and guarantees in the circumstances of the fund:

- consider the risk being put before them
- do not fall back on generalities regarding market conditions, market trends, or APRA to rationalise excessive conservatism and an excessive price
- Find ways around the reinsurer roadblock

These are the insurers that will retain long term relationships



Misconceptions

“ APRA notes that much growth in group insurance business in the past had been generated from changing benefit designs and structures to better meet superannuation members’ needs. This strategy may be nearing exhaustion as it now seems that trustees are redirecting their attention to the impact that the cost of insurance premiums are (sic) having on members’ retirement benefits, particularly as prices increase.”

APRA Insight Issue 3 2013



Design

Great example of misconceptions:

1. Meeting members' needs

- Is not a strategy – is a requirement of the law and of a good trustee
- Exhausted?
- Do needs based designs cost more? More than what?

2. Costs and members' retirement benefits

- Very narrow view of cost – death and disability cover is risk management for the individual, not a cost that is simply borne as reduced age retirement savings
- Very narrow view of retirement



Design

Retirement is the permanent exit of a person from the workforce

Retirement occurs in 2 ways:

- Voluntary or “age retirement”
- Involuntary – Disability and Death

Retirement savings are for both forms of exit from the workforce not just voluntary

Sole purpose test recognises this



Design

Not uncommon attitude of dismissing needs based designs as:

- too hard
- cost members too much
- not worthwhile
- not at this time

But are they??



Design Tradeoffs

Trustee is seeking to marry:

- Value for money (rates fair to insurer and members for the benefits provided)
- Affordable (a reasonable balance between saving for unexpected and expected retirement)
- Equity (rates broadly reflect expected risk)
- Needs based design (optimises the economic benefit for members)
- Simple / logical



Design Tradeoffs

Trade-offs

- Trustee responsibility to balance these for the overall benefit of their members

Limitations in product provided by insurers



Design Trade-offs

Trustee is seeking to marry:

- Value for money (rates fair to insurer and members for the benefits provided)
- **Affordable** (a reasonable balance between saving for unexpected and expected retirement)
- Equity (rates broadly reflect risk)
- **Needs based design** (optimises the economic benefit for members)
- Simple / logical



Design – Need for a Philosophy

Philosophy should drive design

- Gives clarity
- Gives consistency of purpose and message
- Provides answers to difficult design trade-offs
- Not right and wrong



Design - Philosophy

Examples

- Should you do more than provide a payout for the disabled member?
- Should you do more than provide a payout for the spouse if a member dies?
- Has a disabled member who cannot ever work again retired from the workforce?
- ...and the member who dies?
- Are these more severe forms of retirement than age retirement
- Collectivism v individualism
- Competitive position – what does it mean when no two funds have the same design? Does it matter?



Needs Based Design

Needs based design is optimal:

- the most robust and sustainable as it is based on replacing economic loss so reduces selection effect and lapse risk
- The most efficient design as it focuses the premium and there is lower over and under insurance
- Best value proposition for members
- Meets legislative requirements where other designs fail



Needs Based Design

Legislative requirements:

- SIS Covenants require designs that address (S52 (7)(a)(iii))
 - “the basis for the decision to offer or acquire insurance of those kinds, **with cover at that level or levels, having regard to the demographic composition of the beneficiaries of the entity**”
- Demographic – age, sex, family status and income



Needs Based Design

A needs based design is much more attractive to an insurer with an open mind than the typical existing design



Needs Based Design

Key elements of a needs based design

1. Replace economic loss
2. Minimise economic loss
3. Cover transition expenses

Disability is not death

Indemnity not agreed value

Applies at the default and personal level



Needs Based Design

Key elements of a needs based design
Philosophy

Set cover at a level that will enable the member and member's dependents to broadly maintain their lifestyle following death or disablement of the member.



Needs Based Design

Economic loss = salary and super

Or = expenditure and super where
expenditure = salary x (1 – saving rate)

but ABS statistics show most people spend
all their salary particularly if we exclude
purchase of the family home



Needs Based Design

Key elements of a needs based design

Philosophy

salary projected to a maximum of
retirement age taking into account
the probability of payment



Needs Based Design

Economic loss is not:

- The mortgage
- Private school fees



Needs Based Design

Salary is an income stream

Benefit should:

- be an income stream to the extent possible, so long term IP for disability
- allow for super contributions to continue
- Increasing to maintain living standards
 - Current (CPI) not as good as Community (AWOTE)



Needs Based Design

Death Benefit should allow for

- remarriage rates (for widows and widowers not divorcees) as the economic loss “ceases” on remarriage
 - Remarriage rates vary by age and gender
- unused retirement savings of the deceased member (50% of account balance)



Needs Based Design

Allow for dependent children and their age of ceasing dependency

For IP set waiting period having regard to unused sick leave

For disability, TPD covers transition costs and any shortfall in IP



Needs Based Design

Include assets and debts

Exclude family home and super



Default Design

For the default design the trustee has good age, gender and salary data

Can readily surmise family status by age and gender



Default Design

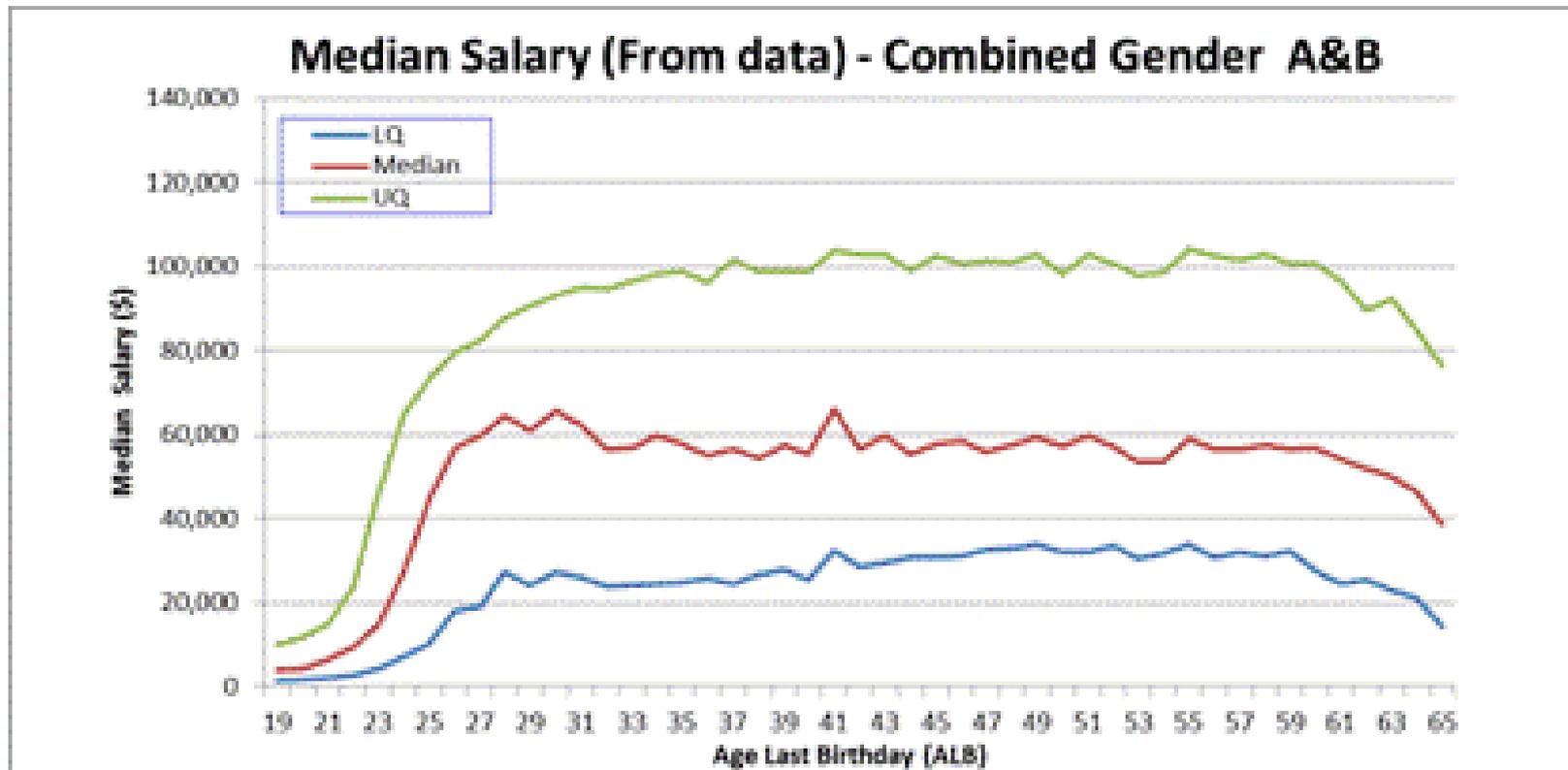
The costs of care for severely disabled members are met by DisabilityCare Australia (formerly NDIS) and the NIS though the later will take several years before it is operational.

No allowance is made for Centrelink benefits

Apply Government Minimum

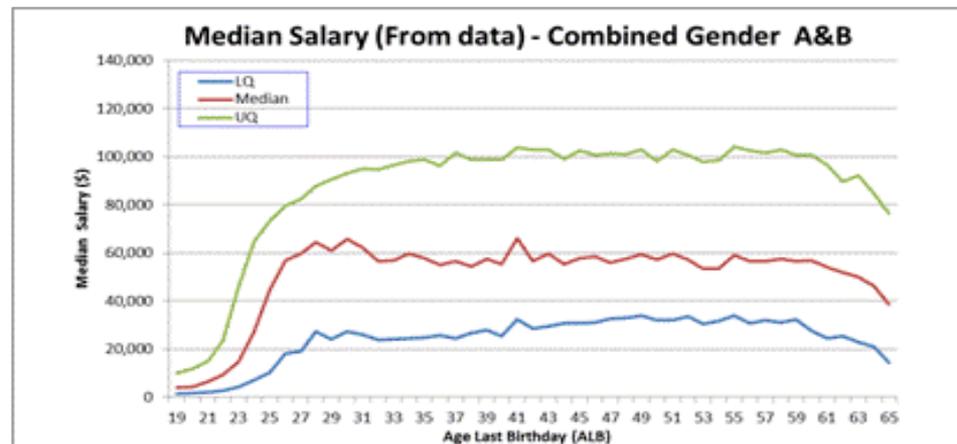


Default Design – Salary Structure





Default Design – Salary Structure





Default Design

Age based

- choose a retirement age

Choose a member profile for each age

- Family status moves from
 - Single to
 - Married to
 - Married with children
- Member's income from personal exertion
 - Reflect members' earnings



Default Design

Death cover is for members with financial dependents

Young members are generally inappropriately insured and when they die this creates family issues

Small amount to retain cover options going forward

For death, choose a gender or gender mix

For death, choose a gender or gender mix



Default Design

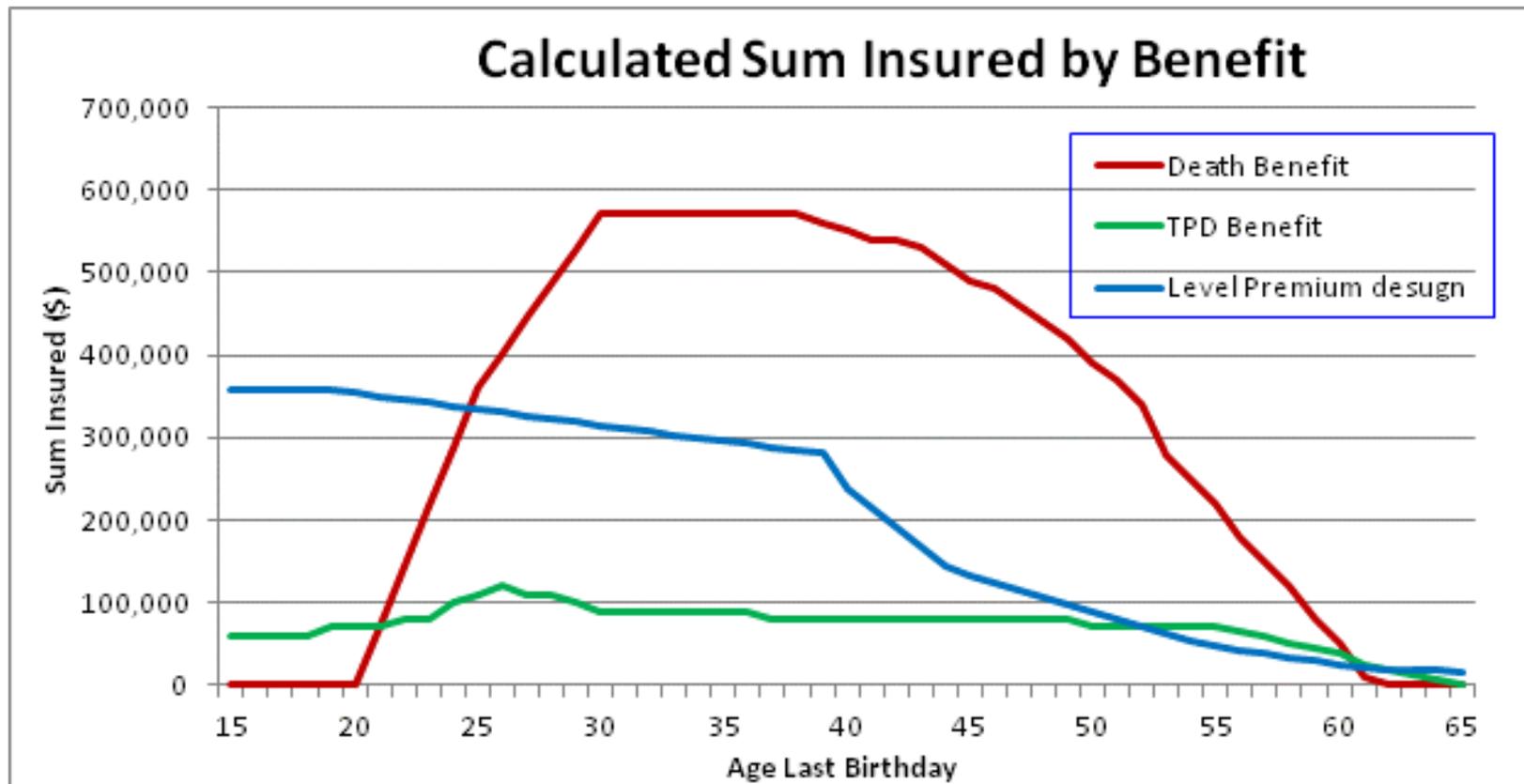
IP is primary disability benefit and long term (if available)

TPD is made up of several elements

- Amount to cover transitional costs for the member (eg retraining, excess medical, home modification), say \$60k
- IP shortfall if any to retirement age
- IP shortfall if any from retirement age



Default Design





Default Design - Premium

What is the Right Level of Premium?

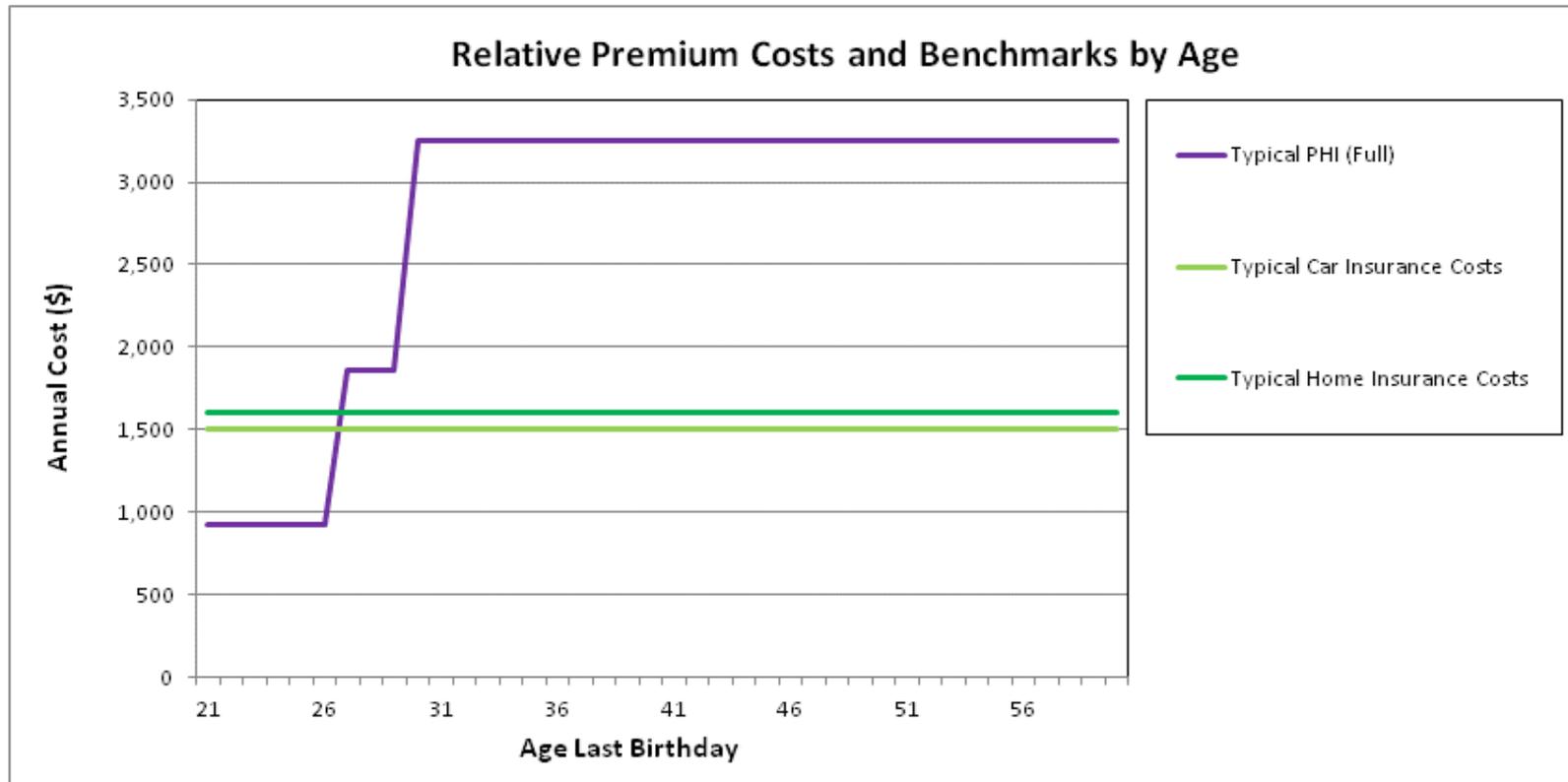
Benchmarks

- Amount spent by members on other financial risks
- The original \$1 pm pw
- Proportion of contribution
- Proportion of account balance

Does it vary by age?

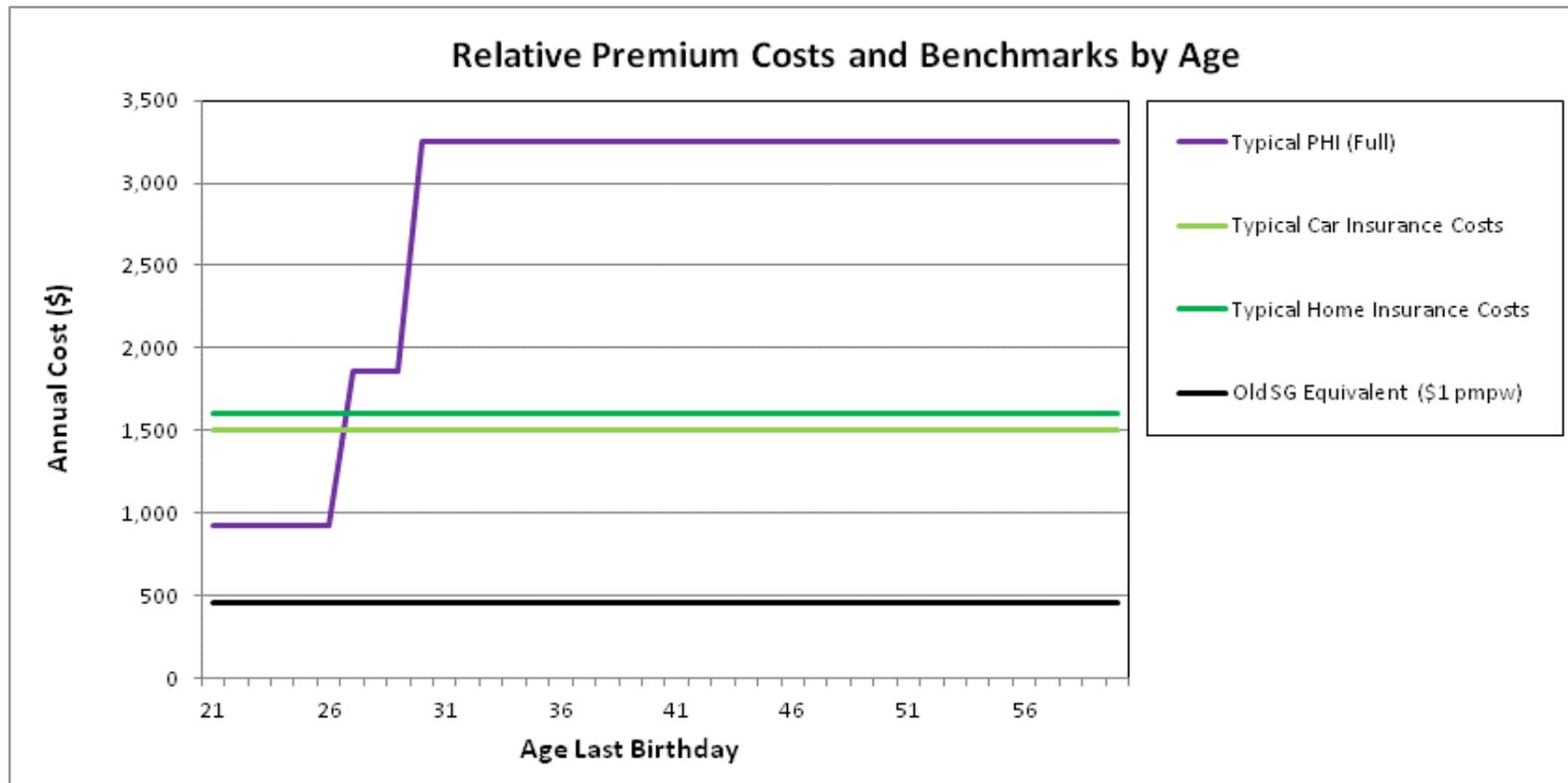


Default Design - Premium



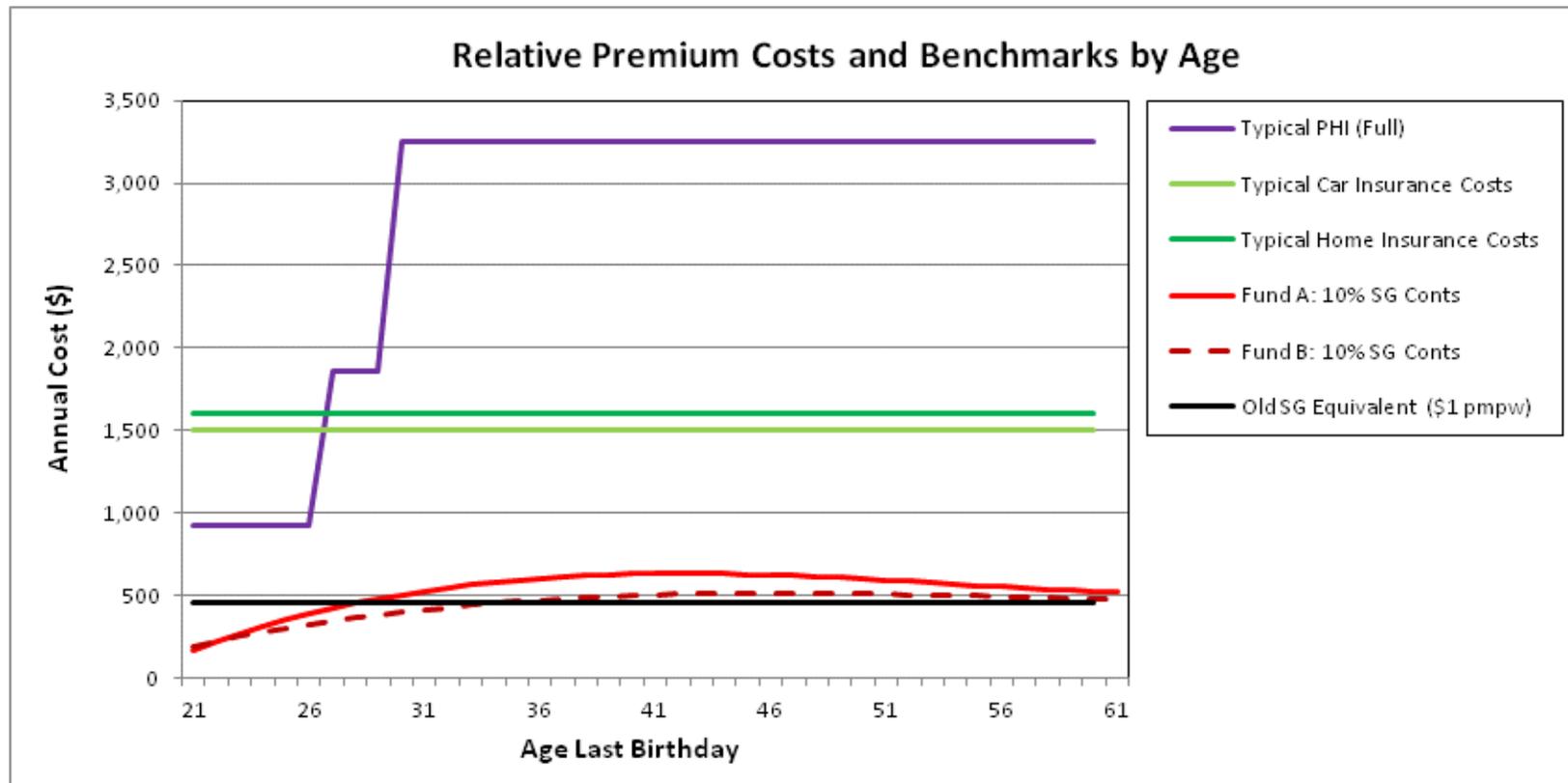


Default Design - Premium



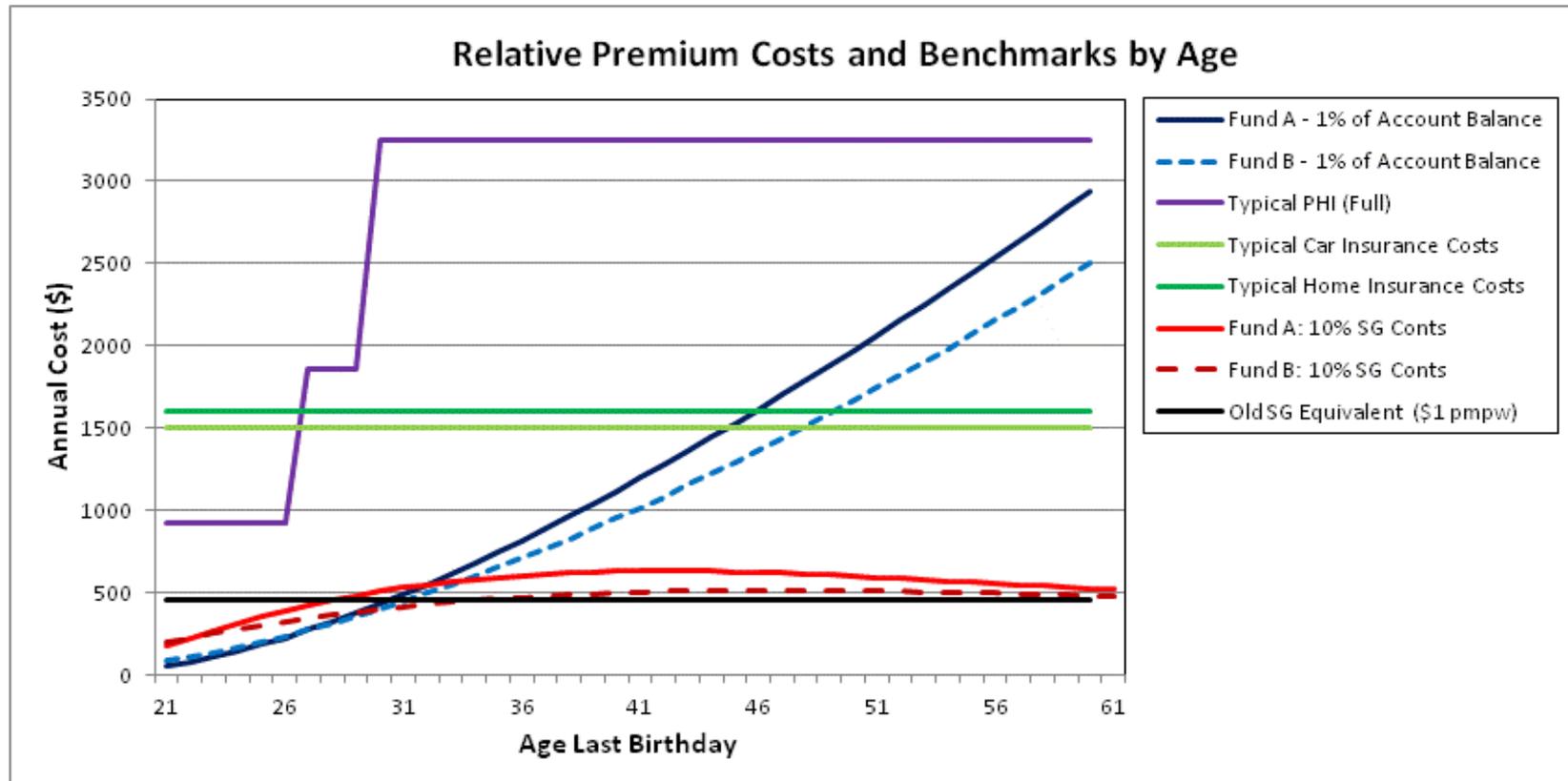


Default Design - Premium





Default Design - Premium





Default Design - Premium

Most appropriate premium benchmark is account balance:

- This is what is being protected, particularly for younger members
- Other benchmarks take too much at younger ages
- Meets legislative requirement
- Fits needs based costs very well



Summary

1. It is not hard to move a design to needs based
2. It is a legislative requirement
3. It can be implemented over time
4. It can be implemented despite the current market