

# SUPERANNUATION AND THE *cost of insurance*

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*We compare the premiums paid by members of superannuation funds to the benefits received, and investigate whether the ‘relatedness’ of the trustee and insurance provider has an impact on members’ net insurance costs. We find that, when the trust deed establishing the superannuation fund required the trustee to use a related insurance provider, fund members tended to obtain greater insurance coverage and at a higher net cost.<sup>1</sup>*

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Superannuation trustees are heavily dependent upon service providers to whom key functions are outsourced (Liu and Arnold, 2010a). In that many of these outsourcing arrangements involve related-party service providers, we examined the impact of the ‘relatedness’ of the service provider on member cost. We found that retail superannuation funds’ outsourcing to affiliated service providers, particularly in respect of administrative services, resulted in significantly higher costs for members. On that basis, for some retail funds, outsourcing did not appear to be a function of cost-efficiency; instead, we concluded that outsourcing was an integral part of the revenue model.

Based on this research, we turned to the topic of insurance purchased by individual members through their respective superannuation funds. We investigated whether the net cost of insurance to fund members was higher where the trustee nominated a related insurance provider. While we found that the members of funds with related insurance providers purchased more insurance, and at a higher net cost, we did not find conclusive evidence that insurance arrangements within the superannuation sector systematically are not in members’ best interest.

## **Insurance in the superannuation sector**

All large superannuation funds offer insurance coverage for members. A low amount of cover is compulsory for default funds, and a member is allowed also to increase coverage in keeping with general insurance practices (such as submitting to a physical examination in order to obtain coverage over a certain amount). The policy itself is owned

by the fund trustee, but the premium is paid out of the member’s account, and the policy benefits are distributed or credited directly to the member or their nominated beneficiaries.

While the decision to obtain coverage above any compulsory minimum isn’t made by the trustee, but by each member of a superannuation fund, the trustee’s selection of the insurance provider is important. When acting through a fund, members often have access to lower group rates. Furthermore, there can be a tax advantage to insuring through a superannuation fund. These benefits effectively give the nominated insurance provider the opportunity to extract economic rent from fund members.

Insurance offered through superannuation funds falls into three main categories. Term life policies pay a lump-sum benefit if an insured member dies during the (annual) term of the policy. Total and permanent disablement cover (‘TPD’) pays a lump sum upon a diagnosis of a condition that prevents an insured member from working ever again. The third is income protection (‘IP’), which provides replacement income to a member who is unable to work because of a temporary illness or injury. Most policies provide IP benefits for a period of up to two years, while some provide for payments until retirement age.

The superannuation sector has become increasingly important to the life insurance industry. Currently, superannuation-related policies account for 42 per cent of all term life and disability (TPD and IP) premium income. When looking solely at group policies, the superannuation sector accounts for 87 per cent of gross revenue (APRA 2012a, Table 3b).

## Data and methodology

The data was drawn from annual returns lodged by superannuation funds with assets greater than \$50 million, for fiscal years ending 2005 through 2010 inclusive. The return data consisted of four items:

- > gross premiums paid by the fund (inclusive of both life and disability coverage)
- > premiums rebated to the fund
- > benefits received by members in respect of term life coverage
- > benefits received by members in respect of disability coverage.

From these data, we calculated a 'net insurance cost' to superannuation fund members, equal to the surplus of net premiums paid (gross premiums less rebates) over benefits received.

Of those funds reporting insurance activity (funds that do not offer a default option are not required to offer insurance), many funds did not identify the insurance provider, or identified a party other than a licensed insurer. In these cases, we reviewed the fund's annual report and/or product disclosure statement to identify the insurer. We then determined whether the insurer was related to the trustee through the parties' Australian Corporation Numbers. From this exercise, we established that relatedness is relevant only in the retail sector. Of 146 not-for-profit funds suitable for inclusion in the analysis, only four corporate funds had nominated a related insurance provider.

The summary nature of the data imposed a number of constraints on our analysis. First, in that the funds reported only a single premium figure, all three lines of coverage had to be examined simultaneously. Thus a statistically significant effect relating to a single line could conceivably be obscured by being combined with the others. Second, the benefits received are not identified by the year of the policy to which the benefits relate. Accordingly, a portion of the benefits received in a given year are

likely to relate to premiums paid in previous years, while the premiums paid in a given year give rise to benefits likely to be received in following years. This introduces measurement error, where the net insurance cost does not necessarily equal the actual cost of insurance in a proper accrual sense.

To minimise the impact of measurement error, we calculated the multi-year net insurance cost, equal to the aggregate net insurance cost across all six years in the study period. We then identified a balanced panel of 52 retail funds which reported in each year from 2005 to 2010 and, in relation to which the key explanatory variables remained unchanged over the entire period (see Table 1). Collectively, panel funds reported paying \$565 million in insurance premiums in fiscal 2010, which represents 20 per cent of premiums paid by superannuation funds reporting to APRA, and 39 per cent of premiums paid by retail funds.

## Analysis and findings

For 20 of the 52 retail sector superannuation funds, the trustee was related to a licensed insurance company. Our primary explanatory variable, then, was a relatedness dummy.

From the outset, we were aware that the cost of insurance is heavily dependent upon the channel by which the insurance coverage is obtained. Individually underwritten policies cost more than group policies, largely because these policies pay sales commissions. An individually underwritten policy can also include an element of personal service, the value of which may offset some or all of the higher cost. Because APRA's data does not break out group and individual coverage, we were sensitive to the fact that differences in the cost of insurance could be attributable to different policy/channel types, and perhaps to different levels of service or other non-insurance benefits. Accordingly, we tested a number of variables seeking to control for the prevalence of individually underwritten policies compared to group policies. For example, we examined the average

**TABLE 1: Panel selection**

	Number of funds
Funds lodging returns	151
Funds reporting insurance activity	119
— where the reported insurer was an insurance company	72
— where the insurer could be identified manually	47
(Less:) Funds dropped *	(12)
Funds suitable for inclusion in the analysis, of which	107
— data was available for five or fewer years, or status changed over the six years	55
— data was available and status was consistent for all six years	52

\* Some of the funds were dropped because data relating to control variables in the regression analysis were missing or meaningless. Four corporate funds which acquired insurance from a provider affiliated with the employer were also dropped due to data confidentiality considerations.

**TABLE 2: Comparing funds – regression estimates for median funds**

Fund type	Fund assets	Members	Members over 65	Premium paid	Benefits received	Total loading	Premium/\$1 benefit
Retail non-related	\$298m	10,832	3.38%	\$115.25	\$73.64	\$41.61	\$1.57
Retail related, non-bound	\$3,049m	23,064	14.98%	\$139.85	\$79.63	\$60.22	\$1.76
Retail related, bound	\$2,743m	108,443	4.75%	\$252.36	\$92.94	\$159.42	\$2.72
Not-for-profit	\$387m	11,880	1.00%	\$141.53	\$76.85	\$64.68	\$1.84

Notes: Annual premium is calculated as the simple average of estimated premiums paid for each fund member under 65. (Members over 65 years generally are ineligible to purchase insurance.)

Benefits received, also calculated as a simple average, refers to amounts received in the calendar year, inclusive of benefits from previous policy years, but exclusive of benefits from the current policy year to be received in subsequent calendar years.

Total loading is calculated as the difference between annual premium and benefits received.

Premium/\$1 benefit is the annual premium paid per each dollar of benefit received.

member balance (which we took to be a proxy for member wealth), on the premise that higher-balance members might be more likely to purchase more and/or more expensive insurance.

Our preliminary finding was that coverage obtained from related insurance providers was more costly than coverage obtained from non-related providers. However, none of the controls intended to capture different patterns of individually underwritten relative to group coverage proved statistically significant.

#### **Bound insurance providers**

Upon a review of the initial findings, our colleagues on APRA's Life Insurance Industry Group brought to our attention an interesting fact pattern. We had observed that, in 19 out of 20 cases, retail trustees with related insurance companies nominated the related party. However, we learned from our colleagues that in some cases the trustees did not select the insurance provider. Instead, the trust deed establishing the fund specified the insurance provider from the outset. If the concern were that the selection process was not in the best interests of members, the fact that some trustees had no choice might be relevant to the analysis.

We then examined the trust deeds of the 20 funds, and found that eight required the trustee to use the related insurance company; the trust deeds of the other 11 related funds had no such binding instruction. We therefore added a second explanatory variable in the form of a 'bound' dummy. Adding this second dummy leached the significance from the 'related' dummy, while simultaneously increasing the explanatory power of the model. We found that members of bound funds, where the trustee is required to use a related insurance provider, paid more for insurance coverage than members of funds without a binding link.

Having satisfied the test for statistical significance, we then tested for economic significance. We did so by estimating the amount of insurance coverage and the net insurance cost of four categories of funds.<sup>2</sup> The results are set out in Table 2.

A member of the median bound fund pays average annual premiums of \$252 or roughly twice the average across all other types of funds. However, the benefits received by the fund are only approximately 20 per cent more on a per capita basis. Expressed as the ratio of premiums paid to benefits received, \$2.72 in premiums is collected for every dollar of benefits received by the median bound fund. For the median funds in the three non-bound categories, the same ratio ranges between \$1.57 and \$1.84. Thus not only do members in bound funds purchase more insurance, their coverage is by way of higher-cost products.<sup>3</sup>

We note that the loading referred to in Table 2 (i.e. the excess of premium paid over benefits received) should not be conflated with the insurance providers' gross profits. With individually underwritten policies, a substantial portion of the premium is remitted to financial planners and other sales agents. Nor, from the fund member's perspective, should the loading necessarily be considered a deadweight cost, as members may receive benefits from more personalised service or advice on a wider range of financial topics. That said, if the insurance arrangements of a given superannuation fund effectively increase the uptake of higher-cost insurance products, best practice requires that the value proposition to fund members be transparent.

#### **Insurance-only accounts**

Our Life Insurance Industry Group colleagues raised a second fact pattern relevant to the analysis. Insurance coverage is available either within or

without the superannuation environment. In many cases, an individual may decide to obtain coverage upon advice from an insurance agent or financial planner. As part of the process, often the individual is given the choice of whether to purchase the coverage within the superannuation system. If the individual so elects, the insurance company arranges for a new membership account to be created. General industry practice is for these new accounts to be established in bound funds.<sup>4</sup> This is not, then, a case of the trustee selecting the insurance provider (properly or not), but the insurance provider selecting the trustee.

This also raises the issue of transparency. The concern is that the business model invites the trustee to promote the uptake of higher-cost insurance products, irrespective of a member's true insurance needs. However, under an insurance-only arrangement, the individual determines the type and extent of coverage before the relationship with the trustee is even established, and then agrees to a price. The trustee/insurance provider has no commercial advantage prior to the sale, thus there is no prima facie reason to suspect that the policy does not represent value for money.

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*These accounts consist of individually underwritten policies, which are by nature more expensive than group policies. Accordingly, there is an element of self-selection in the insurance cost of bound funds which accounts for some or all of the higher net insurance cost.*

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## Conclusion

Thus we find that there is a statistically and economically significant difference in the net insurance cost to members of bound funds. However, bound funds count virtually all of the system's insurance-only accounts in their membership. These accounts consist of individually underwritten policies, which are by nature more expensive than group policies. Accordingly, there is an element of self-selection in the insurance cost of bound funds which accounts for some or all of the higher net insurance cost. ■

## Notes

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1. This is an abridged and modified version of an APRA Working Paper, 'Superannuation and insurance: Related parties and member cost', 1 November 2012, available at [http://www.apra.gov.au/AboutAPRA/Documents/SA\\_WP\\_SIRPMC\\_102012\\_ex.pdf](http://www.apra.gov.au/AboutAPRA/Documents/SA_WP_SIRPMC_102012_ex.pdf).
2. Our ordinary practice to estimate the economic impact is to use a reduced-form model (eliminating all but the statistically significant explanatory variables) and median values of the relevant characteristics. While the reduced-form model often has a lower explanatory power, the estimation emphasises the impact of the variable of interest. Here, however, the four categories of funds exhibited little or no overlap in the values of the explanatory variables; the median values across the entire sample often fell outside of the range of one or more of the sub-samples. Accordingly, we used the median values for each type of fund.
3. The difference in the total loading between the three 'non-bound' categories is due to differences in fund size, average balance, and the number and age of members, and not to the relationship between trustee and insurance provider.
4. In all eight cases, the administrator of the bound fund is the insurance company.

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