# Evolution of disability cover in superannuation

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This paper comprises excerpts from MLC Life Insurance Discussion paper: *Evolution of disability in super*, February 2024.

The interplay between insurance in superannuation and public schemes such as the National Disability Insurance Scheme (NDIS) and state-based workers compensation underscores the need for a more cohesive approach to disability support. A streamlined system could ensure seamless transitions between private and public support, preventing members from falling through the cracks.

Considering these complexities, a collaborative effort is needed to develop a more equitable and sustainable framework for supporting members with a disability, especially those with mental health-related disabilities. This framework should consider income stream alternatives within superannuation, address the lengthy claim assessment process, and enable interaction between private and public support schemes.

## The importance of insurance

Life insurance is key to the history of superannuation, dating back to the 1950s with life insurers providing superannuation products to the public sector. Since the introduction of compulsory superannuation, insurance has remained a key feature of Australia's world-class superannuation system.

Existing legislative settings mandate that superannuation funds provide death and permanent incapacity benefits to most members of a MySuper product by providing automatic Death and Total and Permanent Disablement (TPD) cover, generally provided on an opt-out basis.

Death and TPD cover provide a base level of protection for members when they are unable to ever go back to work due to injury or illness, or to beneficiaries in the event of a member's death.

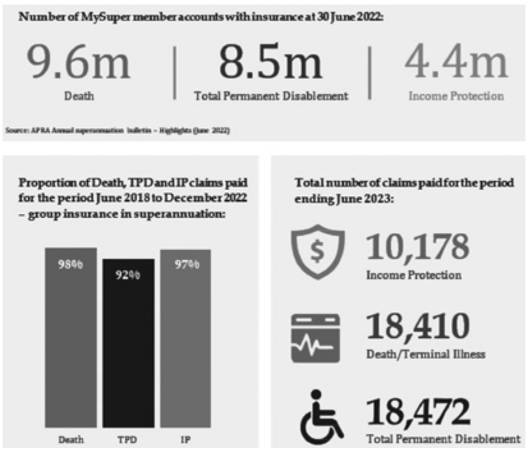
Through insurance in superannuation, members are typically also able to top up their default cover with additional, underwritten insurance which provides them with tailored insurance for their specific circumstances.

Further to death and TPD, Income Protection (IP) is the third main type of insurance that can be offered through superannuation. It protects members who are unable to temporarily generate an income due to injury or illness and is offered either as a default or tailored product.

Unlike death and permanent incapacity cover, it is not an obligation in law for superannuation funds to provide IP insurance—but it is a key type of insurance for superannuation members. Trustees are becoming less inclined to provide IP cover to members by default and many members rely solely on TPD cover in the case of disability.

Figure 1 on the next page highlights the significance of insurance in superannuation and its role in safeguarding members' retirement balances in the face of unforeseen events such as injury, illness or death. The sheer scale of insurance coverage within superannuation emphasises its critical position in providing financial protection to a substantial portion of the Australian population.

**Figure 1. Insurance in superannuation by numbers**




*Source: APRA Life Insurance claims and disputes statistics (December 2022)*

**Policy and regulatory environment**

The policy and regulatory settings that mandated the provision and maintenance of life and TPD products have discouraged the development of alternative disability designs. The regulatory framework compels funds to prioritise TPD cover as the primary default design, even though this may not always align with the specific needs of their typical membership. In effect, it has resulted in a disincentive for product innovation.

In 2019, the Australian Securities & Investments Commission (ASIC) released its Report 633 *Holes in the safety net: a review of TPD insurance claims* (REP 633) that focused on improving claims outcomes for members, in particular with respect to restrictive definitions within default TPD policies. This report resulted in many trustees working with their insurers to broaden TPD definitions and increase acceptance rates. While the changes resulted in more generous outcomes for some members, it has also created upward pressure on premium rates for TPD.

Also introduced in 2019 were the legislative packages: *Protecting Your Super (PYS)* and the *Putting Members' Interests First (PMIF).* These significant changes sought to minimise the erosion of superannuation balances from 'unnecessary' insurance fees and unintended duplicate accounts.

While unintended duplicate cover has no doubt been reduced, these changes have resulted in a marked reduction in the insurance pool, further putting upward pressure on TPD premiums and leaving cohorts of members without cover.

Regulatory concerns over value for money of life insurance products were highlighted by ASIC in Report 675: *Default insurance in superannuation: Member value for money* (REP 675) where it outlined several measures of value for money that funds and insurers should consider, including unit price, claims ratios and claims handling indicators. This report is important as it highlighted weaknesses in showing cost alone, which may not reflect the benefits of a default product.

The regulatory focus on value for money has led to concerns about the cost of IP insurance, particularly in comparison to TPD insurance. This has made it challenging for some trustees to justify including IP insurance in default insurance offerings, even if they recognise its potential benefits for certain members.

Further pricing sustainability concerns of income protection products have exacerbated the shift in focus towards standalone TPD disability products, but similar sustainability challenges of TPD products should encourage further thinking as to whether lump-sum disability benefits are the most effective default mechanism to help members who are unable to generate an income due to injury or illness.

The combination of policy and regulatory settings has, therefore, driven the market for disability insurance in superannuation further away from types of cover that incorporate income replacement benefits, increasing the difficulty for superannuation trustees to design insurance benefits that are better suited to members.

**Best financial interest duty and the sole purpose test**

The shift in policy and regulation towards cost efficiencies in the superannuation system, marked by further enhancements to the best financial interest duty (BFID) in superannuation legislation, has resulted in a blunt framework of insurance in superannuation that focuses mostly on minimising premiums for lump sum products.

Restrictions imposed by BFID understandably lead to premium levels being the key consideration when designing a disability product, beyond the compulsion via MySuper. This has resulted in the industry's self-imposed focus on maintaining overall premium levels below 1% of a member's salary—based on average salary for the fund—despite any prescriptive threshold or cap under superannuation law or regulation to do so.

The enhanced BFID, combined with the well-established sole purpose test enshrined in superannuation law, creates an environment where trustees are cautious about introducing product design innovation unless they are confident the change will result in reduced premiums or contribute to retirement. While this focus on cost control is understandable, it can inadvertently stifle innovation, potentially hindering the development of disability cover products that could offer members improved quality, effectiveness and value.

To further encourage innovation, insurers need to support trustees by providing the necessary evidence of the value of alternative designs, demonstrating the potential for improved member outcomes while maintaining financial sustainability.

## Member-centred design

The superannuation policy changes previously outlined, and the impetus behind them, provide context for how the market for life insurance in superannuation has de-

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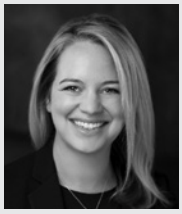

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Alison is a seasoned professional with more than 25 years' industry experience leading the Group Product & Proposition team at MLC Life Insurance.

**The quote**

*Default insurance through superannuation forms an essential part of the wider safety net for all Australians, and a more coordinated approach is needed to support members with a disability.*

**Table 1. Alternative default product designs**

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|---|---|
| ***TPD by instalments***<br>• Splits the TPD sum insured into a number of smaller amounts, payable over an extended timeframe.<br>• Could be anywhere from 2-6 separate payments.<br>• Member would need to satisfy TPD test for each payment.<br>• Expectation is that the member engages in rehab/ retraining during overall claim duration. | ***Default IP linked to deferred TPD benefit***<br>• Member is insured for default IP cover, for example a 2-year benefit period payable after a 45-day waiting period.<br>• A smaller TPD benefit is also available but can typically only be accessed once the 2-year IP benefit has been paid out in full.<br>• Allows a fund to describe IP and TPD as a single disability benefit, IP payments will commence first and if the condition deteriorates or persists a TPD benefit would subsequently become available.<br>• Early access to the TPD benefit can still be provided for serious injuries and illnesses. |
| ***Hybrid 'bucket' disability benefit***<br>• Member is insured for a pooled amount of 'disability' cover.<br>• They can draw down that pooled amount in a way that best suits the specifics of the illness/ injury they have.<br>• For example, they might start with $300,000 in 'the bucket'. They take $40,000 as IP payments over a period of 6 months, so $260,000 remains.<br>• A year later, the member suffers a recurrence of that condition which renders them TPD. They can access the final $260,000. | ***Severity or condition-based disability benefit***<br>• A tiered benefit structure determined by the type and severity of disability.<br>• Could include a range of benefits such as lump sum payments, income replacement and rehabilitation expenses deemed as appropriate for the condition.<br>• Removes lump sum challenges for certain types of disability such as mental illness.<br>• Provides higher payments for most significant disabilities. |

*Source: MLC Life Insurance: Evolution of disability cover in super, February 2024*

veloped and how regulation inadvertently discourages innovation, as concerns about retirement balance erosion remain central to the thinking about BFID.

Policy changes in superannuation should enable innovation towards solutions that better address the needs of members during times when they are unable to work due to injury or illness. A lump sum approach can be appropriate based on the injury or illness, but imposing this as a blanket approach risks gaps for those whose injury or illness requires early support which can help them return to health and work. TPD default levels differ greatly between arrangements and are becoming increasingly inadequate as trustees lower default levels in the interests of reducing costs for the preservation of retirement savings.

In the context of BFID and the sole purpose test, insurance in superannuation should enable superannuation funds to focus on the protection of retirement balances arising from unexpected events that prevent members from generating an income. This focus should go beyond default TPD products and include more appropriate types and levels of default products that contribute to a member's retirement balance in the event of an injury or illness and are better tailored to the membership.

This includes products such as income protection benefits, which often provide better support for members as they allow timely access to rehabilitation and retraining and increase the likelihood and speed of a member returning to paid work.

Income protection benefits can also be supplemented with super contribution benefits that replace lost superannuation payments. Other alternative default product designs are explored in Table 1.

Revisions to the superannuation prudential framework such as Australian Prudential Regulation Authority (APRA) Prudential Standard SPS 250 *Insurance in Superannuation* (SPS 250) and the Retirement Income Covenant (RIC) have prompted superannuation funds to enhance their understanding of their members.

Recent engagement by APRA with the superannuation industry regarding the sustainability of life insurance in superannuation via a letter to all licensees and group life insurance chief executive officers: *Sustainability of life insurance in superannuation – December 2023*, strongly encourages collaboration between regulated entities to improve the way data is collected and used. This improved membership data can aid, in designing more effective default products that cater to their members' needs in a cost-efficient manner.

Evolving demographic factors such as home ownership, life expectancy, changing work patterns and a volatile economic environment require a re-imagining of default insurance products in superannuation to ensure they continue to meet regulator expectations and consumer needs.

By prioritising improved data collection and use, and by adapting to the evolving needs of their members, superannuation funds can deliver life insurance products that are sustainable, affordable, and meet the needs of members for the long term.

#### The objective of superannuation in the context of insurance

The proposed objective of superannuation is to 'preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way'.

This objective seeks to holistically capture the fundamental role of superannuation to the Australian economy, and the broader context of the objective includes the wide-ranging benefits to members, including group insurance. The value insurance in superannuation provides to the community, and how it helps members achieve a dignified retirement, means now, more than ever, is the time to consider ways in which group insurance can remain consistent with superannuation's objective and not only protect but enhance retirement outcomes.

Group insurance meets the following objective principles:

- Dignified retirement: helps members who are unable to generate an income through injury or illness.
- Delivering income: provides members with an income stream when they are unable to generate an income temporarily through injury or illness.

These principles should also drive insurance product innovation, enabling the provision of insurance products that are 'fit for purpose' and help deliver on the objective of superannuation.

#### Appropriate default disability insurance in superannuation

The way that disability benefits in superannuation are traditionally designed assumes that illnesses and disabilities are straightforward in making an individual permanently disabled. The approach alienates members who need help but are not permanently disabled, and encourages a permanent diagnosis when, in fact, rehabilitation, re-training or other forms of assistance are more likely to help a member return to health.

Proposed changes to the NDIS following the recent [2023] independent review of the system: *Working together to deliver the NDIS*, suggest a return to the principle that eligibility should be based first and foremost on functional impairment rather than medical diagnosis. This shift in focus aligns with the need for disability support to acknowledge the complexities of contemporary disability experiences.

Disability insurance was originally designed to provide a financial safety net for members who became permanently unable to work due to injury or illness. This model was based on a clear link between physical impairments, the inability to perform specific job duties, and a resulting loss of future income.

However, the landscape of work and health has changed dramatically. The increased diagnosis of mental health conditions, alongside evolving work patterns, challenges the traditional framework of disability insurance.

Mental health conditions often manifest in temporary or fluctuating impairments that may not meet the rigid criteria for permanent disability. Consequently, many individuals with mental health challenges face difficulties in securing adequate support during periods of work absence, often exacerbating their condition. In the absence of adequate support, many members go on to successfully claim TPD, creating added pressure on premiums and, therefore, sustainability and affordability for the wider membership.

A default benefit design that provides a lump sum alone can inadvertently incentivise members to focus on meeting these strict criteria rather than prioritising their recovery and returning to work. This emphasis on severity may also discourage members from seeking early intervention and support services that could potentially help them manage their condition and maintain their employment.

Enabling improved return to health outcomes through better designed disability products is likely to result in improved retirement outcomes for members, as otherwise they would not have the support necessary to return to work. Lump sum disability benefits tend to have the effect of incentivising claimants to meet the definition of total and permanent disablement, imposing a superficial barrier to seeking help. In addition, claimants are left without a support network once a lump sum benefit is paid, leaving members to fend for themselves.

Evidence from NSW's State Insurance Regulatory Authority (SIRA) suggests several factors affect an individual's ability to return to work, one of which is insurance. SIRA indicates that an insurance scheme with a claims management framework that commences support and intervention as soon as practicable will result in better return to work outcomes.

For progressive injuries or illnesses, the design of TPD benefits inherently requires members to get worse to become eligible. This means that they do not access the support required to get better, affecting their recovery expectations, perceived work ability and, ultimately, their health and wellbeing.

Furthermore, where TPD benefits are paid the existing framework does not address the barriers members may face in managing a lump sum benefit. The lack of an appropriate advice framework for claimants that is cost effective, simple and in line with their needs further deepens the challenges inherent in current TPD designs.

There are examples of public schemes where the provision of disability benefits is coupled with support to individuals in receipt of benefits. For example, the NSW Lifetime Care and Support Scheme helps victims of severe motor vehicle accident injuries manage compensation for care and treatment. These are frameworks that could serve as a blueprint for the sector in helping members in receipt of benefits optimise financial outcomes in retirement.

**The quote**

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**Insurance and the broader safety net**

Individuals with disabilities face significant challenges in understanding and navigating the complex landscape of government and private support systems available to them. The maze of workers' compensation, Medicare, private health insurance, life insurance and the NDIS can be overwhelming, leading to delays in accessing essential support services and financial assistance. This complexity is exacerbated by the lack of clear and accessible information, and often labyrinthine application processes.

The independent review of the NDIS which engaged with people with disability, their families, carers and providers recommended that the disability system must be looked after as a whole, stating "you can't fix the NDIS without fixing everything around it." This emphasis on the interconnectedness of the disability support system highlights the need to consider disability insurance design in superannuation as part of a holistic healthcare framework, including its interaction with public schemes like the NDIS, WorkCover, and the private healthcare system.

The overarching and shared goal should be to improve outcomes for people with disability, contributing to healthy individuals, a robust workforce, and a healthy society. This goal aligns with superannuation's BFID by enabling members to return to paid work through improved health outcomes and continue to build up their retirement balances where possible.

Insurance through superannuation is an essential part of the wider safety net for Australians, providing protection, support, and peace of mind for superannuation members. It forms part of the public and private mix that reduces the risk of an individual falling through the cracks between public and private health schemes. Shifting towards a holistic approach to policymaking in this space opens the door for ongoing cooperation between life insurers, superannuation funds, and the Government to improve outcomes for superannuation members with disability while balancing protection of retirement outcomes.

## What the future looks like

The superannuation system has reached maturity – it is a well-established, world-class system with many benefits to the Australian economy. Insurance has been and continues to be a key element of this system.

Default TPD insurance has proved essential in helping members with disabilities. But 30 years on from compulsory superannuation, we need to think differently about insurance in superannuation. Disability looks different now than it did 1993, but TPD insurance has remained the same.

There is a need for the industry to keep considering diverse ways to improve outcomes for members with a disability and to improve support systems that will ultimately contribute to members' retirement outcomes. This includes allowing for innovation in products that better suit members' needs and resetting policy frameworks to enable innovation rather than stifle it. **FS**