Member value: Income protection in superannuation

Insurance in Super Sub-Committee

Income Protection (IP) offsets play a crucial role in managing insurance premiums and benefit payments within superannuation funds, ensuring the sustainability of the IP cover.

However, while IP offsets assist with in ensuring cover is sustainable, they also pose potential challenges for superannuation funds and their members. This paper discusses:

- the purpose of IP offsets in superannuation
- the outcomes for members
- some of the factors that may be considered when deciding a suitable offset design, ways to manage the chosen design and understand potential issues that may arise with offsets.

Superannuation funds offering IP cover—also known as group salary continuance (GSC) or salary continuance—provide an income for a period of time if an insured member cannot work because of disability caused by illness or injury.

IP cover within superannuation is indemnity cover, designed to replace a substantial portion of a member's lost income if they become disabled.

IP offsets in superannuation refer to a provision in superannuation funds' IP policies that allows the insurer to reduce the amount of IP benefit payable to the member by taking account of the amount of other disability income the member may be receiving during their period of disability.

Where the member receives other disability income support as well as the income from the IP cover provided by the fund, a limit is applied to the total income the member may receive so the member does *not* receive more while disabled than they earned while working and ideally a financial incentive remains for the disabled member to return to work. The calculation is usually made with each monthly IP benefit payment.

IP designs where the insured member receives more income while disabled than they did before they were disabled are unsustainable, as there is a financial penalty for the member if they return to work. Premiums under this design will be substantially higher and likely continually increase, compared with a design where there is no financial disincentive to return to work.

IP designs extend this principle so that there is a positive financial incentive to return to work, generally expressed as benefit less than 100% of salary—for example 75% of salary.

The effect of the offset is that it maintains the integrity of the design and helps to ensure that there is not a continual premium rate spiral and ensuring the IP cover is value for money for members.

Offsets allow the premium to be targeted more efficiently to meet members' needs, optimising the premium to meet those needs. Trustees have an important duty to ensure that premiums do not inappropriately erode retirement income under section 52(7)(c) of the *Superannuation Industry (Supervision) Act 1993*. Providing a benefit in excess of the financial needs of the disabled member may *not* meet this test.

IP offsets and their treatment differ between superannuation policies. Examples of benefit offsets that may apply include income or lump sum disability payments from:

- Centrelink and other government benefits
- workers compensation
- motor accident compensation/Transport Accident Commission (TAC)
- insured benefits under IP policies held with other superannuation funds
- insured benefits under IP policies held outside superannuation
- sick leave and ex-gratia continued employer income
- Department of Veterans' Affairs (DVA) disability benefits
- mortgage and credit card disability insurance benefits.

The size of the offset is usually calculated to ensure that the total amount of disability income received by the claimant from all sources of disability income does not exceed a predetermined percentage of pre-disability income (PDI). This is known as the replacement ratio. The percentage can vary, but a common replacement ratio is 75% of PDI. Some funds also add a preserved superannuation contribution benefit of, for example, 10% of PDI to compensate for the loss of the superannuation guarantee contributions from the member's employer.

The absence of offset provisions may also lead to:

- higher levels of anti-selection as members have a financial incentive to keep multiple IP policies – especially when they expect to make a claim in the near future
- longer periods of disability as claimants have less financial incentive to rehabilitate, retrain, recover and return to work
- higher claims costs – leading to higher premiums, which may lead to affordability issues for members. Trustees in these situations are likely to reduce or withdraw default IP cover.

What is not an offset?

Offsets only relate to the impact on the amount of the IP benefit of other disability income.

There may be other terms and conditions that reduce the IP benefit payable to a member, however, these are not offsets due to other disability income. These other terms and conditions include:

- Where the IP benefit is expressed as a fixed dollar monthly IP benefit and this exceeds the disabled member's replacement ratio (e.g., 75% of PDI), the benefit is reduced accordingly.
- When a member suffers an illness or injury, but can perform partial duties on a reduced income, then the IP benefit may be reduced to ensure that the combined benefit entitlements—from their IP benefit and their reduced salaries/wages—do not exceed the replacement ratio.

These are often described as offsets but are not offsets as they do not relate to other disability income.

What happens when there are multiple sources of disability income?

When a member has IP cover with more than one fund or IP cover outside superannuation, there is usually communication between insurers to confirm which insurer is to offset the other's benefit.

Should the member have more than one insured benefit with an insurer, for instance a retail policy and a superannuation fund policy, dialogue between claims assessors may occur to determine where the offset should be applied. If the member is receiving a disability benefit (e.g., workers compensation or Centrelink disability benefit) in addition to having two IP policies with two insurers, both insurers would ensure that all disability benefits are considered when determining the amount of the offset.

Ideally, all benefit entitlements are identified upfront at the claim stage so that, if the offset provision applies, the claimant does not have to pay back some of the amounts already received. If this is not the case, then any overpayment of benefits will be offset against future benefit amounts paid until the overpayment is recouped.

In such scenarios, there are multiple independent entities—Insurer 1, Insurer 2 and Centrelink—that need to communicate with one another to ensure that:

- member expectations of cover are met, and their benefit entitlements are calculated correctly and paid on time
- the application of offsets is correctly applied between the independent entities to ensure that member benefits do not lead to over payment.

Generally, where there are multiple policies, the policy that was in effect first, pays and the more recent policies will apply the offset.

Member impacts and outcomes: claims

Default death and disability cover is provided to members of superannuation funds provided they meet several conditions.

Seven of the 20 largest superannuation funds provide default IP cover as part of their disability default benefit design. Approximately 3.4 million members have default IP cover.

Some members have IP cover other than default IP cover.

At a member level, actual offsets vary significantly between:

- individual claims (0% to 100%), due to the financial and family circumstances of the member
- funds, as the detailed offset conditions vary significantly under the policies provided by insurers
- different claim years, due to benefits from other sources changing over time.

Additionally, the impact of offsets can vary materially between different cohorts of members/claimants. For example:

- The impact of the workers compensation offset is expected to be higher for blue-collar workers compared to white-collar workers, as the former is more susceptible to workplace accidents.
- Employees who are provided with relatively more generous sick leave entitlements from their employers would see relatively higher offsets than those employ-

The quote

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ees with regular sick leave entitlements or no sick leave entitlements at all, where sick leave is offset.

The premium for the different cohorts will typically reflect the offset cost reduction.

Certain offsets – for example, the Centrelink Disability Support Pension (DSP) – are complex in nature resulting in operational difficulties for insurers and poor member experience.

The DSP is a fortnightly benefit whereas IP benefits are paid monthly. Centrelink reduces the DSP where the member earns income from another source—such as an IP policy—by reducing the DSP by 50 cents for each dollar above a fixed amount earned from another source.

This unique offsetting rule from Centrelink, combined with the fortnightly payment from Centrelink, can lead to delays in benefit calculations, higher rates of calculation errors and member complaints.

Member communication

The offset provision is disclosed to members in the Product Disclosure material issued by the superannuation fund so that members can understand the application to their circumstances.

While IP offsets may be an appropriate means of ensuring that insurance benefits are aligned with needs and insurance premium costs are optimised, they can also create issues for members and trustees:

Lack of understanding: The terms and conditions of IP offsets may be complex and difficult to understand. They may not be expressed well in member communication or may not be sufficiently prominent for a member to read them.

Arithmetic calculations may be complex and difficult to understand: These combined with a lack of understanding of IP offsets may make it challenging for members to know exactly how much they will receive in benefits and how different income sources will affect their payments. This may lead to confusion and frustration for members who may be surprised to find that their benefits are reduced.

Inconsistency between policies: Not all superannuation policies (or retail policies) have the same terms and conditions for IP offsets, leading to inconsistency in the treatment of members.

Difficulty applying offsets at claim time: The insurer may face difficulties in obtaining details of other income paid, such as other disability payments from another insurance policy or sick leave entitlements from the employer. This can result in the overpayment of initial benefits that will need to be recouped from future benefits and can result in the member receiving no income for some periods. There can also be difficulty in determining which insurance policy will offset the other.

Late lodgement or late notification of workers compensation claims: The late notification of workers compensation claims for the same period of disability, when offset, will require an assessor to recalculate past payments and reduce future payments. This can also discourage employers or members from lodging workers compensation claims.

Perceived inequity: Fund members may consider that IP offsets result in inequitable treatment of members with different sources of income. For example:

- Members who have access to sick leave may receive a lower IP benefit compared with those who have no sick leave cover entitlement or have used all their sick leave.
- IP offsets may disproportionately affect certain groups of members, such as those with lower incomes or those who are more likely to receive other forms of income during their period of disability.

It is important to explain to members that differences in potential benefit payments between different groups of fund members in different circumstances are allowed for in pricing. A good, simple example is to explain that the product is designed to top up workers compensation when the illness or injury is covered by workers compensation and to provide a higher income replacement benefit otherwise, with the result being lower premiums than would be the case if the higher benefit were to be paid in all cases.

Limited coverage: IP offsets apply to disability income such as workers' compensation or sick leave but not to investment income that is received regardless of the health status of the member. This can create perceived inconsistencies in the application of offsets and lead to confusion for members.

Offset provisions can discourage individuals from taking out IP cover in superannuation, as they may feel that the benefits they receive will be reduced if they are also receiving other forms of financial support if they become disabled. To alleviate these concerns, adequate education and communication is required to ensure that members are fully informed and understand the cover they have.

Member impacts and outcomes: premiums

Insurers look at past claims experience of the superannuation fund as a guide to setting future premium rates. If the level of benefits paid is historically lower than expected due to higher offsets, then this will directly reduce the premium rates paid by members in the future. Competitive pressures in the group insurance market should ensure that the claim cost saving from applying offsets is reflected in the premiums charged by the insurer and they are not a source of hidden additional insurer profits. That is, the claims cost reduction is passed back to members in the form of lower premiums.

The level of offsets is a key assumption in setting premium rates for members. The higher the offset assumption, the lower the overall premium. For this reason, trustees and their actuarial consultants may review the offset assumption set by insurers to ensure that it is a fair reflection of expected future experience.

Trustees' ability to reduce offsets

Over time, trustees have worked with insurers to reduce the number of offsets applicable to member benefits, which has served to improve the overall the member experience for claimants and for the membership generally. For example, some trustees:

- have removed Centrelink DSP benefits as an offset to reduce the administration burden and complexity surrounding this offset.
- have designed their IP benefit to commence once a member's additional policy expires. For example, if a member has two five-year benefit policies with a 90-day waiting period, the second policy would commence after five years and 90-days—provided the member is still disabled. This feature would come at a cost to members for the more generous benefit.
- do not apply an offset for lump sum disability benefits received by the member.

It should also be noted that legislation such as "Protecting Your Super" and "Stapling" have or are likely to lead to a reduction in multiple accounts and a reduction in the number of members with multiple IP policies. This is likely to lead to a reduction in the number of IP policies that will require the application of the offset provision.

Simplified example of an IP offset

Consider the following offset clause:

"A member's monthly IP benefit will be reduced where the combined amount of disability income exceeds 75% of pre-disability income (PDI)."

Member 1:

- Annual salary of $60,000, so a PDI per month of $5,000.
- IP benefit is 75% of the member's PDI (i.e. $3,750 per month) in the event of an illness or injury after a one month waiting period, with a maximum benefit period of two years.
- The member is ill for a period of 12 months.
- The member has a sick leave entitlement that will be fully used in seven months.

Upon making a claim:

- The member is entitled to a $3,750 IP benefit per month (prior to any application of offsets) after the first month.
- The member is also entitled to their full salary for seven months, given their sick leave entitlements.
- Total received per month while ill and before tax:

  Month 1:
  - $5,000 salary (IP benefit has not commenced)

  Months 2 to 7:
  - before application of offset: $5,000 salary + $3,750 IP benefit
  - after application of offset: $5,000 salary + $0 IP benefit

  Months 8 to 12:
  - before application of offset: $0 salary + $3,750 IP benefit
  - after application of offset: $0 salary + $3,750 IP benefit

  Total benefit over 12 months:
  - before application of offset: $35,000 salary + $41,250 IP Benefit = $76,250. This is significantly more than the member was earning prior to becoming sick ($60,000 p.a.)
  - after application of offset: $35,000 salary + $18,750 IP Benefit = $53,750

    Total disability income as a proportion of salary over the period of disablement 90%.

Member 2:

- The same circumstances as Member 1 but with accrued sick leave that will be fully used in two months.

Upon making a claim:

- The member is entitled to a $3,750 IP benefit per month (prior to any application of offsets) after the first month waiting period.
- The member receives their full salary for two months given their sick leave entitlements.
- Total received per month while ill and before tax:

  Month 1:
  - $5,000 salary, IP benefit has not commenced

  Month 2:
  - before application of offset: $5,000 salary + $3,750 IP benefit
  - after application of offset: $5,000 salary + $0 IP benefit

  Months 3 to 12:
  - before application of offset: $0 salary + $3,750 IP benefit
  - after application of offset: $0 salary + $3,750 IP benefit

  Total benefit over 12 months
  - before application of offset: $10,000 salary + $41,250 IP Benefit = $51,250
  - after application of offset: $10,000 salary + $37,500 IP Benefit = $47,500

    Total disability income as a proportion of salary over the period of disablement 79%

Member 3:

- The same circumstances as Member 1 but with no accrued sick leave. This may apply to a member who works as a casual or a member who works as a permanent but has used up all their sick leave or a member who has just commenced permanent employment with their employer.

Upon making a claim:

- The member is entitled to a $3,750 IP benefit per month (prior to any application of offsets) after the first month waiting period.
- The member receives no salary while disabled.
- Total received per month while ill and before tax:

  Month 1:
  - $0 salary, IP benefit has not commenced

  Months 2 to 12:
  - before application of offset: $0 salary + $3,750 IP benefit
  - after application of offset: $0 salary + $3,750 IP benefit

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Offset provisions can discourage individuals from taking out IP cover in superannuation, as they may feel that the benefits they receive will be reduced if they are also receiving other forms of financial support if they become disabled.

The quote

Offset provisions are a very important design feature that is nevertheless complex and needs to be well communicated to members and at claim time calculated accurately and in a timely manner.

Total benefit over 12 months

- before application of offset: $0 salary + $41,250 IP Benefit = $41,250
- after application of offset: $0 salary + $41,250 IP Benefit = $41,250

  Total disability income as a proportion of salary over the period of disablement 69%.

So, what next?

Income Protection (IP) offsets play a crucial role in managing insurance premiums and benefit payments within the superannuation funds, and the associated benefits and challenges for both funds and their members need to be understood.

All superannuation funds offer IP cover either as a default or as an option. For actuaries assisting superannuation funds with their IP design, offset provisions are a very important design feature that is nevertheless complex and needs to be well communicated to members and at claim time calculated accurately and in a timely manner and again well communicated to the claimant.

While offset provisions can discourage individuals from taking out IP cover in superannuation, adequate education and communication can help ensure that members are fully informed and understand the cover they have. **FS**

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