Joint IFSIB, AIST and ISN submission

'Deductions for the cost of total and permanent disability insurance provided through superannuation' Consultation Paper June 2011

July 2011

IFS Insurance Broking

Industry Super Network

Australian Institute of Superannuation Trustees

Background

Following is a joint submission from IFS Insurance Broking (IFSIB), The Australian Institute of Superannuation Trustees (AIST) and Industry Super Network (ISN) in relation to the contents of the 'Deductions for the cost of total and permanent disability insurance provided through superannuation' Consultation Paper June 2011 ("The Paper").

IFS Insurance Broking

IFS Insurance Broking was established in 1995 by Industry Fund Services Pty Ltd (IFS) to provide a range of insurance services to Industry Superannuation Funds and associated network entities.

IFS Insurance Broking is also a subsidiary of the Industry Super Holdings Group of Companies which is owned by 35 major superannuation funds. The Group employs approximately 1,000 staff and manages over $32 billion in funds under management.

Our philosophy is built on advocating our client's interests in the insurance market. We are engaged by clients to understand their needs and activities and develop effective strategies to transfer risk to insurers in exchange for a competitive premium. We are also engaged to ensure that our client's programmes maintain currency with changing markets and developments.

We currently manage insurance programmes with a combined annual premium flow of over $450 million.

AIST

The Australian Institution of Superannuation Trustees (AIST) is a national not-for-profit organisation whose members are superannuation fund trustee directors and officers of industry, public sector, and corporate superannuation funds who operate with a representative Trustee Board of Directors.

AIST advocates on behalf of its members, it undertakes research, develops policy and provides professional training, consulting services and supports trustee directors and staff to help meet the challenges of managing superannuation funds and advancing the interests of their fund members. AIST members manage $450 billion of retirement savings for Australian workers.

ISN

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. Industry Super Network is part of Industry Super Holdings (ISH), a group of 35 industry super funds.

ISN plays an active role on behalf of ISH shareholders and their sponsoring organisations in advocating their views to the community, government and regulators.

ISN manages collective projects on behalf of a number of Industry Super Funds with the objective of maximising the retirement savings of five million industry super members.

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Recommendations

To whom it may concern

Our three organisations welcome this Paper and agree with its intent. On the whole, we are generally supportive of this, particularly with regards to reducing cost to superannuation funds in the provision of insurance services to their members as stated in section 1. There are, however, some points where we believe further fine-tuning would lead to real benefits.

We have provided feedback in relation to the contents raised within the Paper. Our comments below address the information sought in section 3.3 of the Paper regarding:

- Industry's views in relation to the specified percentages and policy descriptions;
- Relevant pricing differences between various types of TPD insurance policies; and
- Any other commonly used policies that should be included in the schedule of prescribed percentages.

This submission argues that the proposed deductible percentages do not appropriately reflect the underlying pricing of premiums based on historical claims or likelihood of claims meeting multiple policy definitions. Specifically because of these factors, it is argued the proposed deductable percentages are too low.

Relevant contextual information

Significant variations in the definition of Total and Permanent Disablement (TPD) exist from fund to fund depending on such things as:

- The combination of clauses which ultimately make up the total TPD definition to apply under a Fund's Policy;
- The actual wording of the TPD definition clauses used within the Policy and how closely aligned they are to the descriptions adopted within the Regulations;
- Fund size;
- A specific Industry within which a particular Fund may operate;
- The membership base i.e. employed, unemployed, spouses, contractors, casuals etc;
- The type of Fund i.e. Corporate, Master Trust or Industry Fund;
- Occupational profile of the membership;
- Gender profile of the membership;
- Insurers agreeing to different definitions based on their risk management objectives and needs.

Definitions used throughout the industry are covered in detail in Appendix A.

Throughout this document, where we refer to an 'Any Occupation' definition, this refers to a definition that would be equivalent to the definition of 'disability superannuation benefit'.

Detailed views in relation to the specified percentages and policy descriptions

Outcomes

Section 3.1 of the Paper highlights that the key outcome from the new arrangements is to streamline the process for claiming tax deductions for the cost of superannuation based TPD insurance, by specifying a default deductible portion of premiums for the various TPD insurance policies within the regulations. The overall aim is to reduce the need for funds to incur the cost of engaging an actuary to determine the deductible portion of the TPD premium.

Following are some of the criteria that we feel would need to be considered when determining the most appropriate percentage levels to prescribe in relation to each of the TPD definition clauses, to ensure that a majority of superannuation funds are able to adopt the arrangements, rather than seeking to engage an actuary.

Definitions

It is difficult to apply generic percentages based on assumed TPD definition clauses that are to apply to all Funds, as there are likely to be significant variations from Fund to Fund.

With respect to specifying prescribed percentages we are of the view that this could be useful provided that:

- The TPD definitions used are consistent with current insurance industry TPD definitions and practices;
- Commentary is provided within the Regulations that canvass some common and possible variations to the clause wordings used within the final table so as to provide guidance as to the criteria that funds should consider in deciding whether the wording of their specific policy definition is consistent with the intention and spirit of the definition clause covered by the table;
- The percentages used within the table are actuarially determined and based on a series of clearly defined demographic parameters, such as fund size, gender, occupational profile mixes etc.
- The prescribed percentages take into consideration the net impact of the various TPD clauses, against a benchmark definition such as the ‘Any Occupation’ definition. That is, the prescribed percentages should reflect the percentage of total TPD premium that is not deductible due to claims that would be paid under that clause that would otherwise not meet the requirement of the ‘Any Occupation’ definition, as opposed to the percentage of premium that is paid to fund the cost of all claims expected to meet the definition. This recognises that many claims considered under a “non-deductible” criterion would nevertheless also meet a deductible criterion.

Prescribed percentages

Based on our experience and on discussions that we have had with a range of group insurers with respect to a number of our client funds, the suggested prescribed percentages, as shown within the discussion paper, are generally not consistent with our expectations and those of insurers. In our view, and the insurer estimates support this view, the percentages quoted in the discussion paper as being deductible, are significantly lower than warranted.

Where the prescribed percentages are not representative of a fund’s expectations, this is likely to result in a perceived detrimental impact on the Fund’s tax position. This is likely to lead to a fund engaging an actuary rather than adopting the prescribed percentages specified within the regulations, as the cost of obtaining this certification is certain to be more effective than the loss in tax deduction that would otherwise be incurred by adopting the prescribed percentages. This would therefore tend to work against the core objectives of the regulations as prescribed in the paper.

This is particularly significant for large industry superannuation funds where the TPD premium can easily exceed $50 million per annum.

In order for the regulations to be effective, the quoted percentages must be set at a level that will provide funds with confidence that by adopting the prescribed percentages they will get a similar or better result to that which they would anticipate could be derived from seeking their own actuarial certification. Failure to achieve this will defeat the intention of the legislation which is to reduce costs.

There will always be exceptions to the rules and in these cases the fund involved will need to undertake their own cost benefit analysis as to whether they should adopt the prescribed percentages or seek their own certification. The intention however, should always be to seek to get the majority of funds to adopt the prescribed percentages and therefore maximise the streamlining effect for the industry. This approach, we submit, would be consistent with the core objectives of the regulations as prescribed in the consultation paper.

Appendix B summaries the details of four of IFSIB's client funds, including:

- Which of the various TPD definition clauses that are available within the market actually apply within each fund;
- The various funds insurer's approximation of the percentage of total TPD premium that relates to uncertain liabilities and which therefore would not be tax deductible;
- The estimated annual TPD premium paid by each fund;
- An estimate of the expected additional tax that would be payable by each fund should actuarial certifications confirming these impacts be eventually obtained.

The appendix confirms that the level of additional tax expected to be collected, with respect to these funds at least, is extremely small when compared to the size of the actual premium being paid. We suggest therefore that the majority of funds will expect to continue to be able to claim a tax deduction for almost all, if not all of their entire TPD premium as they presently do.

The appendix further confirms that the industry superannuation funds generally have a significant degree of tailoring in their terms and conditions when compared to many corporate superannuation funds and this tailoring extends to the structure of the TPD definitions. The table in Appendix B confirms that across the four funds considered, they all have very differently structured definitions and yet each of the insurers has estimated a grossly negligible impact in relation to the undeductible portion of the total TPD premium.

Relevant pricing differences between various types of TPD insurance policies

In Appendix A, we have detailed nine of the common clauses that form part of standard TPD definitions within group insurance policies for many industry, public sector and corporate superannuation funds. Within this table, we have related the various clauses back to the Draft Taxation Ruling TR 2010/D9 where that clause was specifically referenced and provided some commentary regarding whether that clause will lead to a 'Certain' liability or an 'Uncertain' liability and therefore be eligible to claim a full tax deduction on that part of the TPD premium. Where the clause was not specifically referenced within the Draft Taxation Ruling, we have provided commentary as to whether, in our opinion, that clause will lead to a 'Certain' or 'Uncertain' liability and therefore whether the Fund will be eligible to claim a full tax deduction on that part of the TPD premium.

There are numerous key areas of concern regarding the sample table in the paper. These are discussed below.

1. Consistency with Draft Taxation Ruling TR 2010/D9

The TPD definition clauses and the impacts / interpretations applied within the paper are not consistent with those as outlined within the Draft Taxation Ruling TR 2010/D9.

For example, it was suggested within the Ruling that the Activities of Daily Living (ADL) definition would meet the Superannuation Disability Benefit definition and would therefore result in a 'Certain' liability. This would suggest that premiums relating to the provision of this risk would be 100% tax deductible.

However, this is inconsistent with the suggested prescribed percentages outlined within the discussion paper which indicates there would only be 60% tax deductibility in this case. This is also inconsistent with Industry practice which suggests that, due to the degree of disability required to satisfy the ADL part of the TPD definition, the person is highly likely to also satisfy the 'Any Occupation' part of the TPD definition.

2. Policy definition add-ons

The discussion paper describes a number of the TPD definition clauses canvassed as add-on's. In many cases this is not the situation. Generally the standard fund TPD definition will be composed of a combination of various clauses and the entire definition will apply to all members under the Fund. These clauses are not usually offered as add-on options to members that can be chosen separately from the other clauses. They are also often not priced separately by the insurers.

One exception to this may be where an 'Own Occupation' definitions applies. In this case this definition would generally apply to an identified group of members within the fund e.g. professional occupation groups, and may be costed separately as an add-on.

Leading on from this, it is unclear from the discussion paper as to the basis on which the prescribed percentages have been determined. For example the discussion paper suggests that only 90% of the TPD premium for a standard 'Any Occupation' definition with a 'Loss of Limbs' add-on would be tax deductible.

We interpret this as suggesting that 10% of the fund's premium is being utilised to pay for claims relating to 'Loss of Limbs' where the member would otherwise not have met the 'Any Occupation' part of the definition, as opposed to 10% of the fund's premium is being utilised to pay for claims relating to 'Loss of Limbs'.

If the latter basis has been applied then we would argue that the tax deductible portion is being understated as we would expect a proportion of members who qualify under the 'Loss of Limbs' clause would also qualify under the 'Any Occupation' definition.

In any case, we suggest that the 90% tax deductibility is understated. It may be appropriate for some funds, particularly where the occupational rating may be weighted heavily towards an office or professional occupational group, to have a lower prescribed percentage, than a fund which predominantly caters for blue collar occupational groups, although we would not expect the differential to be as high as 10%. This illustrates why the prescribed percentages need to be relevant to the broad demographic profile of the fund and suggests that multiple tables may be required.

3. Certain vs uncertain liabilities

As insurance premiums for Group arrangements are set by insurers, and as they need to be actuarially determined and certified, consideration should be given within the Regulations to specifying that insurers need to certify to the Trustee the proportion of total premium that is attributable to the provision of 'Certain' and 'Uncertain' liabilities i.e. the proportion of TPD premium that relates solely to the provision of cover which would otherwise not meet the requirements of a Superannuation Disability Benefit. This would apply in situations where a combination of clauses makes up the Fund's TPD definition and where there was no separation of premium for each clause type.

Where a TPD Definition clause is considered to be no less stringent than the 'Any Occupation' clause then one would expect that there would be no undeductible portion of the combined premium. Where a clause is more lenient, then the differential in pricing should only reflect the additional pricing of the risk to that which is provided for an 'Any Occupation' definition.

Where there are add-ons, and each add-on is priced separately, then the additional pricing for the add-on should reflect the additional cost of that add on above that of the 'Any Occupation' definition i.e. that portion which results in the payment of claims which would otherwise not meet the Any Occupation requirement.

This approach would require the categorisation of the various TPD definition clauses into 'Certain' and 'Uncertain' liabilities as was implied within the Draft Taxation Ruling. If an additional cost was applied and the clause was categorised as 'Certain', then all of the additional cost for the add–on would be tax deductible. Where the additional cost of the add-on was classified as 'Uncertain', then only that portion of the add–on cost that related to the 'Certain' liability would be deductible.

The impact on costs

Although the additional tax burden as a consequence of this legislative change may not be significant for some funds, it will have a direct impact on the potential retirement savings of members as their account balances will be directly reduced by this additional tax burden.

The greatest impact as a consequence of this legislative change is likely to arise not from the additional tax burden, but rather from a combination of the following:

- The additional administrative burden that these changes will create for superannuation funds, their administrators and insurers;
- The impact of additional actuarial costs to determine the tax deductible portion of the TPD premium if the fund decides not to use the prescribed percentages or where the circumstances applicable to the funds are different to those contemplated within the Regulations;
- The significant system changes that are likely to be required to administer the impact of the change in tax deductibility for TPD premiums, leading to cost impacts for funds in having to implement these system changes. In many cases the system costs incurred by funds is likely to be significantly greater than the additional tax burden itself. Further, these system costs are likely to be an ongoing expense as it's possible that there will be a requirement to regularly (annually?) amend the percentage that is undeductible;

- The cost for funds to implement these changes, both to administration systems and the communications process, is likely to result in increased costs for members, through increased administration fees, further eroding member retirement savings;
- Funds may try to avoid the reduction in the tax deductibility of TPD premiums by amending their TPD definitions to ensure that there is a certain liability in all clauses. This may result in a reduction in TPD cover for members;
- An increase in the number of legacy products for funds resulting in additional complexity in the claims management and administration processes of insurers, fund administrators and fund trustees;
- Complexities in communicating the potential TPD cover changes and additional costs to members may result in increased disputes and complaints.

All of the impacts arising from these legislative changes add to the complexity and cost of administration for superannuation funds. This seems to be inconsistent with the aims of the Superstream and MySuper initiatives which aim to streamline processes and reduce costs.

Appendix A – Common parts of TPD definitions in Industry Superannuation insurance policies

Part	Definition	Description	Referenced in TR 2010/D9	Certainty of Liability	Comment, including our interpretation of the Draft Ruling
A	Any Occupation	Generally assesses whether a member is unlikely/unable ever to engage in ANY occupation for which they are reasonably qualified by education, training or experience	Yes	Certain	This part of the definition, including the variations that may exist in different insurance policies, is equivalent to the definition of 'disability superannuation benefit'.
B	Own Occupation	Usually only available to members employed in a Professional capacity. It generally assesses whether a member is unlikely/unable ever to engage in their OWN occupation based on their current area of expertise or specialty.	Yes	Uncertain	In some cases, due to the degree of disability, a member may meet the less restrictive definition of **Own Occupation** AND also satisfy the definition of 'disability superannuation benefit'. However, in other cases a member will meet the definition of **Own Occupation** but not satisfy the definition of 'disability superannuation benefit'.
C	Specific Loss	Generally based on a loss of, or loss of use of, limbs and/or sight.	Yes	Uncertain	Where an 'Any Occupation' test is not included in this part of the definition, in most cases, due to the degree of disability required to meet the definition of **Specific Loss**, the member is **likely** to satisfy the definition of 'disability superannuation benefit'. However, it is possible that in limited cases a member will meet the definition of **Specific Loss** but not satisfy the definition of 'disability superannuation benefit'.
D	Activities of Daily Living (Loss of independence)	Generally assesses the member's ability to permanently and irreversibly be unable to perform at least two of five or six normal daily activities such as bathing, dressing, feeding, toileting, mobility, continence etc.	Yes	Certain	It is accepted that the degree of disability required to meet the definition of **Activity of Daily Living** would mean that a member is **highly likely** to satisfy the definition of 'disability superannuation benefit' and therefore this would give rise to a 'certain' liability.

Part	Definition	Description	Referenced in TR 2010/D9	Certainty of Liability	Comment, including our interpretation of the Draft Ruling
E	Unpaid Domestic Duties (Home Duties)	Generally assesses the member's ability to be unable to perform their normal home or domestic duties and that it is unlikely that they'll ever be able to perform those duties again. Some funds definitions also impose a further test to determine the likelihood of the member ever being able to perform any other occupation for which they are reasonably qualified by education, training or experience.	Yes	Uncertain	Where an 'Any Occupation' test is not included in this part of the definition, in most cases, due to the degree of disability required to meet the definition of **Unpaid Domestic Duties**, the member is **likely** to satisfy the definition of 'disability superannuation benefit'. However, it is possible that in limited cases a member will meet the definition of **Unpaid Domestic Duties** but not satisfy the definition of 'disability superannuation benefit'.
F	Permanent Impairment	Generally requires the member to have suffered a permanent impairment of at least 25% of whole person function as defined in a guide to impairment approved by the insurer. Some funds definitions also impose a further test to determine the likelihood of the member ever being able to perform any other occupation for which they are reasonably qualified by education, training or experience.	No	Uncertain	Where an 'Any Occupation' test is not included in this part of the definition, in most cases, due to the degree of disability required to meet the definition of **Permanent Impairment**, the member is **likely** to satisfy the definition of 'disability superannuation benefit'. However, it is possible that in limited cases a member will meet the definition of **Permanent Impairment** but not satisfy the definition of 'disability superannuation benefit'.

Part	Definition	Description	Referenced in TR 2010/D9	Certainty of Liability	Comment, including our interpretation of the Draft Ruling
G	Cognitive Loss	Generally requires the member to have suffered a total and permanent deterioration or loss of intellectual capacity and will likely require permanent ongoing continuous care and supervision by another adult person.	No	Certain	Our interpretation is that the degree of disability required to meet the definition of **Cognitive Loss** would mean that a member is **highly likely** to satisfy the definition of 'disability superannuation benefit' and therefore this would give rise to a 'certain' liability.
H	Everyday working activities	Generally assesses the member's ability to permanently be unable to perform at least two of five everyday working activities without someone's help, despite the use of appropriate aids. The activities include mobility, communicating, vision, lifting and manual dexterity. There may also be an additional condition that tests the likelihood of an eventual return to gainful employment	No	Uncertain	Our interpretation is that the degree of disability required to meet the definition of **Everyday Working Activities** would mean that a member is **likely** to satisfy the definition of 'disability superannuation benefit'. However, it is possible that in limited cases a member will meet the definition of **Everyday Working Activities** but not satisfy the definition of 'disability superannuation benefit'.

Part	Definition	Description	Referenced in TR 2010/D9	Certainty of Liability	Comment, including our interpretation of the Draft Ruling
I	Terminal illness	Terminal Illness has previously been a common part of TPD definitions where a member diagnosed with a terminal illness could have their TPD insurance claim approved without necessarily having permanently ceased work. More recently, funds are moving to having a separate definition for terminal illness with the payment linked to pre-payment of the death sum insured. The assessment of the Terminal Illness part of the TPD definition is generally based on two medical practitioners certifying that the member is suffering a sickness that despite reasonable medical treatment will lead to the member's death within 12 months.	No (see comment)	Unknown	This part of the definition is not specifically referenced in the Draft Ruling and in fact, the ruling specifically states that the deductibility of premiums paid for terminal illness cover is not explained in the ruling. However, in this case the premium for the Terminal Illness coverage forms part of the TPD premium. From our interpretation of the regulations, where the Terminal Illness part of the TPD definition is aligned with the definition of 'terminal medical condition' as defined under SISR, it satisfies a condition of release. However, if the 'terminal medical condition' as defined in SISR does not also constitute a 'disability superannuation benefit' then there is uncertainty as to the tax deductibility of the proportion of the TPD premium that relates to the terminal illness coverage. We suggest that should a taxation ruling imply that a 'terminal medical condition' is not a 'disability superannuation benefit' then this would create an inconsistency between the treatment of terminal illness as a pre payment of a death benefit and treatment as part of a TPD benefit which we believe is not the intended outcome. Should this situation arise an option for funds to ensure full tax deductibility of the premium relating to terminal illness coverage would be to unlink the terminal illness benefit from the TPD definition and link it to a pre-payment of the death sum insured.

Appendix B – Actual data for four industry funds

Fund	TPD definition parts (Refer Appendix A)	Insurer estimation of portion of TPD premium relating to Uncertain liabilities [4]	Approximate Membership	Approximate Annual TPD claims numbers	Approximate Annual TPD claim payments	Approximate Annual TPD premium	Approximate additional Annual Tax
A	A, C, D, E, F, G, H	< 1%	530,000	340	$22 million	$65 million	$97,500 [1]
B	A, B [2], C, D, E	0% to 0.45%	120,000	60	$12.5 million	$17 million	$11,500 [3]
C	A, C, D, E, F, G	0%	90,000	40	$3 million	$4.7 million	$0
D	A, C, D, E, F	0.1%	55,000	25	$1.6 million	$3.4 million	$510

Notes

1. Based on worst case scenario of 1%.
2. This fund has a more restrictive version of the traditional ‘Own Occupation’ definition, i.e. more claims are likely to be ‘Certain’ liabilities than would be the case under the standard ‘Own Occupation’ definition.
3. Based on worst case scenario of 0.45%.
4. The four funds are insured by four separate group insurers. Each insurer has assessed the undeductible portion of the TPD premium as negligible based on their experience with the actual claims experience of the funds. These four funds represent a wide range of industries and occupational groups, from the professional to the blue collar worker.