GRATTAN Institute

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Submission to the Senate Economics Legislation Committee inquiry into the Treasury Laws Amendment (Protecting Your Superannuation Package) Bill

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Summary

We welcome the opportunity to make a submission to the Senate Economics Legislation Committee inquiry into the Treasury Laws Amendment (Protecting Your Superannuation Package) Bill. This submission draws on work by Grattan Institute on various aspects of superannuation.

We support the Bill both in principle and in detail.

The Bill will substantially reduce the costs of superannuation. It will constrain inappropriate income protection, life and total & permanent disability insurance (TPD), resulting in higher superannuation balances at retirement for many Australians. And it may increase competition between superannuation providers a little, lowering superannuation fees. However much more still needs to be done to reduce the excessive costs of superannuation, which currently exceed $30 billion a year[1] (excluding insurance premiums), almost 2 per cent of Australia's GDP.

[1] Productivity Commission (2018), p.131.

1 Principles

The Bill proposes a number of changes to defaults for insurance through superannuation, the consolidation of accounts, and permissible fees.

Common principles should be applied to thinking about these changes.

Defaults should be set so that they are appropriate for most people who do not make an active decision. Inevitably the default outcome will not be the best outcome for *every* person to whom it applies. But a default should be set to provide the greatest benefit at the least cost. In rare circumstances the benefits of setting the default in one direction for a smaller number of people may outweigh the benefits of setting the default in the other direction for a larger number of people. But this is likely to be the exception.

Of course, in theory, community wellbeing could be maximised through more complex rules that navigate these trade offs with more precision. But such an approach may conflict with the next principle.

Systems should trade-off optimal outcomes against lower complexity. More complex rules will often appear to result in more appropriate outcomes for a greater number of people. But 'kludgeocracy' – increasingly complex government rules – have hidden costs. [2] Complexity imposes additional costs on individuals, businesses and government administrators. It discourages innovation. More worryingly, complexity makes it easier for vested interests to extract rents by lobbying for rules that benefit them. The complexity and detail both obscures the impact to all but insiders, and exhausts the limited resources of those representing the public interest.

When these and other principles are taken into account, reforms proposed in this Bill would substantially improve our superannuation system.

[2] The term 'kludgeocracy' was coined and described in Teles (2012)

2 Insurance

The Bill proposes to change insurance in superannuation so that individuals are not 'defaulted in' to insurance if they are under 25, their account is inactive, or they have less than $6,000 in their superannuation account.

2.1 Cross-subsidisation in insurance through superannuation

Insurance should aim to pool risk rather than cross-subsidise. The fundamental purpose of insurance is to share risk between people. People would often prefer to be slightly worse off if they can thereby avoid an unlikely catastrophe.

Under 'group insurance', premiums vary with age, but otherwise people with different risk levels all pay the same premium. The rationale is that the costs of accurately underwriting and assessing risk outweigh the size of the cross-subsidies. Relatively low risk customers may obtain cheaper insurance even if they cross-subsidise high risk customers, provided that they avoid the costs of determining that they are in fact lower risk. This trade-off is more likely where there is little adverse selection as a result of low risk customers selectively opting out, and high risk customers selectively opting in. If a particular cross-subsidy is inherently desirable, then government should mandate it explicitly.

The current system appears to have very substantial cross-subsidies. Analysis by both Rice Warner and KPMG in submissions to this Committee claim that the proposed changes to default insurance would lead to large increases in insurance premiums.[3] This strongly suggests that those who are young, have inactive accounts, or small balances, are cross-subsidising everyone else. It is not obvious why it is desirable for there to be an insurance cross-subsidy for those who are old or have large balances.

2.2 Hard defaults in insurance through superannuation

Defaults and options are not black and white. A default may be more or less obvious to a customer – who may therefore be more or less likely to exercise their own choice. Options can be easier or harder to exercise.

Under the current system, defaults are particularly likely to drive whether someone obtains insurance through superannuation. The default is triggered whenever a person obtains a new superannuation account – almost invariably when they begin a new job. At this point, they are relatively unlikely to focus on whether they want insurance.

Opting out of insurance through superannuation is relatively difficult for some members. Some funds do not allow members to opt out at the time that they are enrolled in the superannuation fund when they start work – instead can only opt out once the first superannuation contribution has been made, often several months later. Superannuation funds do little to highlight to members that they have an option to discontinue insurance. And the process of opting out of insurance may be difficult in practice.[4]

The proposed changes would both leave many people out of insurance, and make the default insurance much more obvious

[3] KPMG (2018); Rice Warner (2018).

[4] Productivity Commission (2018), p.337-338.

and easier to decline. If employees only qualify for insurance once they turn 25, and their balance exceeds $6,000, then most employees will only be defaulted into insurance well after they have started to work. As a matter of practice, superannuation companies will have to notify employees that they are being defaulted into insurance. Because this will be separate in time from the initial employment and enrolment in the superannuation fund, people are more likely to notice that they are acquiring insurance, and so more likely to consider whether they really want it. Only giving people a product if they think it is appropriate to their needs is desirable - unless the objective is to compel people to insure (in which case a compulsory system would be much more efficient).

2.3 No default insurance for under 25s

The Bill proposes that employees under 25 would not be defaulted into insurance. They are likely to have lower incomes, and so insurance premiums are more likely to erode their superannuation balances. More importantly, the insurance is less likely to be relevant to their needs.

Life insurance is unlikely to be appropriate for most under 25s, who are unlikely to have dependents. Only 6 per cent of people aged 23-24 and in employment have a child.[5] If a 23 year old dies, it is unlikely that any partner would depend on income support from them for the rest of their lives.

Of course there will be exceptions – but as discussed in section 1, defaults should be appropriate for the bulk of those affected rather than less likely cases.

Income protection and TPD insurance can be more relevant to under 25s. But it is arguable that many people – particularly those on lower incomes who are typically younger workers – would rationally prefer to rely on the social safety net of the Disability Pension in the unlikely event that they are unable to work as a result of an accident not related to employment (which would attract workers compensation benefits). And in the meantime their superannuation balances are not eroded.

2.4 No default insurance for small balances

The Bill proposes that employees with balances under $6,000 would not be defaulted into insurance. There is concern that this will lead to a substantial number of people with dependents being uninsured.

But given the proposed legislation, in practice those over 25 are likely to have at least one superannuation account with more than $6,000. On average earnings of around $45,000, compulsory superannuation contributions will create a balance of over $6,000 within a year and a half. A person over 25 is only likely to have no superannuation account with $6,000 if they have multiple unconsolidated accounts. The current default regime would provide such a person with multiple insurances – probably involuntarily. Some of the insurance may be worthless because the person would be unable to claim on it.[6] But the consolidation of inactive accounts proposed by the legislation will reduce this risk – and also make it much more likely that an over 25 year old will have at least one account with a balance over $6,000.

[5] Grattan analysis of ABS, *Survey of Income and Housing 2015-16.*

[6] For example, income protection insurance can typically be claimed against only one policy and only when members are working (Productivity Commission, p.21).

If default insurance only commences once an account reaches $6,000, rather than at the beginning of employment, it is more likely that an employee will actively turn their mind to consider whether insurance is appropriate for them (see above section 2.2)

2.5 High risk industries

There is concern that those working in higher risk industries will struggle to obtain group insurance outside of superannuation.[7] If insurance is opt in, insurers may be more wary of adverse selection, and insist on underwriting to assess an individual's risk more carefully.

But the primary need for insurance is typically for incapacity unrelated to work. It is no coincidence that all the examples cited around this issue involve illnesses or accidents unrelated to work. Workplace injuries are usually covered by workers' compensation schemes that typically pay benefits an order of magnitude larger than the amount paid under default superannuation insurance.

Nevertheless, insurance through superannuation typically covers both workplace injuries, as well as incapacity unrelated to work, and so is much more costly for the insurer in higher risk industries. The problems could easily be remedied by writing insurance that did not cover incapacity covered by workers compensation. Those in high-risk industries are unlikely to have more illnesses or accidents outside of work. It is unlikely that the problems of adverse selection in this situation would be any greater than for workers in low risk industries.

In the meantime, those working in higher risk industries are typically defaulted into insurance, which is relatively highly priced because it is insuring against workplace accidents – a risk that is already covered to a much greater extent by workers compensation schemes.

[7] Industry Super Australia (2018).

3 Account consolidation

The Bill proposes to consolidate accounts that are “inactive” (that is, where no contributions are made for 13 months) and that have balances less than $6,000. It proposes to compulsorily transfer such accounts to the Australian Tax Office (ATO), which will then endeavour to reunite the funds with a taxpayers’ active account.

This is a sensible reform that will substantially reduce the costs of administering and managing superannuation.

3.1 Definition of “inactive” account

The Bill defines an account as “inactive” if no contributions are made for 13 months.

It has been suggested that an account should be considered “active” if a person conducts *any* activity on an account such as changing investment strategy, beneficiaries or their address.

But none of these activities imply an intention to keep a superannuation account operating separately. By definition an account of less than $6,000 with no contributions for 13 months is sub-scale. Most people with such accounts will be better off if their account is consolidated – whether or not they keep up with their paperwork by amending the beneficiaries or their address. And this is the fundamental purpose of the reform – to consolidate accounts that are small and unlikely to grow.

There are arguments that an account should only be considered inactive if there are no contributions for 16 or 24 months. The cut-off is ultimately a question of degree. On the one hand, if accounts are consolidated later, there will be fewer instances of a person returning to the workforce. On the other hand, if accounts are consolidated earlier, many people who have in fact changed jobs will benefit.

3.2 Lack of insurance when there is no active account for consolidation

The biggest concern is that this regime will result in people being uninsured if they leave the workforce – particularly if caring for children.

However, the Bill appears to provide that an account should not be consolidated if it is providing non-default insurance. If an account is only providing default insurance, then a fund should have ample opportunity to identify that contributions are not being made, and to contact the customer to encourage them to “opt out” of consolidation.

3.3 Mechanism of transfer via ATO

Some have suggested that accounts should be consolidated by direct transfer from one superannuation fund to another.

However, the existing experience of member-initiated transfer suggests that automatic consolidation to the ATO is preferable. When a member requests one fund to move their account to another fund, the fund surrendering the account has ample motive to find administrative reasons to slow down the transfer in the hope that it can convince the member to leave the account in place. But where a person initiates a transfer via the ATO, the process is typically much quicker and less bureaucratic – perhaps because the ATO’s use of tax file numbers and *Mygov* provides ample verification of the person’s identity.

It is also claimed that issues will arise because the ATO only provides returns at the RBA cash rate rather than investing the funds at a higher yield.

The concerns about lower returns while accounts are being held by the ATO should be kept in perspective. An account of under $6,000 is unlikely to yield more than $500 per year – *before* fees. Fees are likely to be relatively high given that the account is sub-scale. Absent the fee cap proposed by the Bill, in many cases the net return at the ATO might be higher. But in any case the difference is unlikely to be more than about $100 per year. This may not be trivial to a person on a lower income, but a more complex administrative solution is unlikely to be worth pursuing given that the ATO will probably consolidate most accounts fairly quickly.

4 Fees

The Bill proposes maximum limits for fees, no matter how small an account. And it intends to ban exit fees altogether.

Again these are sensible reforms. Any danger of some fund members cross-subsidising costs incurred by others is outweighed by the danger that funds will simply over-charge.

The current arrangements create incentives for funds to encourage a multiplicity of small accounts, each paying a minimum fee. Inevitably this increases the total costs of the industry.

The proposed fee caps will align the incentives for funds more closely with the interests of their members. The caps will encourage funds to seek out small accounts and ensure they either grow quickly, or are consolidated.

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