Australia's Life Underinsurance Gap: Research Report

Prepared for The Financial Services Council

NMG Consulting
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Contents

Context, Objectives and Scope

The life insurance market, as part of broader financial services and financial advice industry, has experienced significant changes in recent years. One of the consequences of this has been a heightened awareness within the industry and policymakers of Australia's underinsurance gap.

More recently, the government has recognised that the cumulation of significant regulatory change over the last few years has resulted in a system that means it is very difficult to provide financial advice (and any related products to support that advice) in a cost-effective manner. This has culminated in a review of the financial advice industry ('Quality of Advice Review'), which is due to report at the end of 2022.

As part of the review, the Financial Services Council (FSC) on behalf of life insurers, wanted to have a better understanding of the underinsurance gap in Australia and to project the size of the gap based on current and potential regulatory settings.

As a result, the FSC commissioned NMG to undertake research to support its submission to the Quality of Advice Review, and to:

- Understand the impact that regulatory changes (especially the Life Insurance Framework) have had on the overall life insurance market
- Prepare a research paper on
  - The level of underinsurance within Australia today
  - How the gap in underinsurance may develop in different scenarios; and
  - What changes could be made to reduce the level of underinsurance.

Reliance and Limitations

The analysis, observations and opinions set out in this Report are based on primary research into community attitudes and international peer markets (conducted specifically to inform the development of this Report), on NMG's proprietary information resources and consulting experience in Australia and relevant international markets, and on a range of cited third-party sources.

NMG has relied upon certain information provided by the industry working group members, in relation to premium and portfolio composition, segmentation of lapse rates and claims, and interactions with financial advisers. NMG has also referenced public information sources including data reported by regulators or by industry bodies in Australia and international markets, as well as third-party research publications. NMG has taken reasonable steps to ensure that all information referenced and relied upon is correct at the time of inclusion but cannot ultimately warrant the completeness or accuracy of third-party information sources.

This Report draws conclusions on the industry today and looking forward but does not make any recommendations or advocate specific actions or responses. The analysis and findings are complex and require an integrated reading (individual references or data points should not be taken out of context).

About NMG Consulting

NMG Consulting is a multinational specialist financial services consultancy focused on the insurance, reinsurance, and investment industries.

NMG provides strategic consulting services to financial institutions in Australia and across major international markets (including those covered in the international market studies in this Report).

NMG also runs periodic research and analytics studies including in relation to consumer, adviser and corporate attitudes to life insurance and aggregation, and analysis of industry stock/flow and profitability metrics (both internationally and in Australia). NMG's Australian life insurance studies form a key part of the information base supporting the analysis and conclusions in the Report.

Executive Summary

In Australia today, around 15 million people are currently insured, collectively paying a total of $17.3 billion in group life and individual insurance premiums each year. However, consumers expect Australians to have more life insurance.

Applying the community standard by age and income cohort (and reflecting home ownership and patterns of child dependency) highlights a level of variation in cover by life stage, and the importance of choice, access, and flexibility in revisiting levels of cover with changes in life stage.

While most Australians have some level of life risk cover through their super fund (default group insurance) for both Death / TPD and, to a lesser extent, Income Protection, there are significant gaps in coverage and benefits in the status quo system relative to the community standard, particularly among middle age/high dependency demographics.

As a community good, most life risk policies are placed (i.e. recommended by a third party). This means that life risk sales are heavily dependent on broader advice policies.

While life insurance sales have fallen in recent years, underinsurance is predominantly a function of how many policies are currently held by Australians. However, the relative gap between lapsing policies and new business will slowly cause changes to the underinsurance gap over time.

Further, despite the introduction of the Life Insurance Framework, commissions on advised life risk insurance remains an important component of adviser remuneration (with less than 10% of life risk advice being placed without any commission).

Under the current system, particularly with the projected flattening of adviser exits, ongoing lapses and the focus on higher value clients, the total number of in-force advised policies is expected to continue to decline, which will increase the underinsurance gap with a fall of 17% of in-force policies by 2027. Further, if adviser commissions were to be removed, this would significantly reduce the level of adviser sales, and is estimated to result in a decline of 32% of in-force policies by 2027.

To reduce Australia's level of underinsurance, two different elements need to work together:

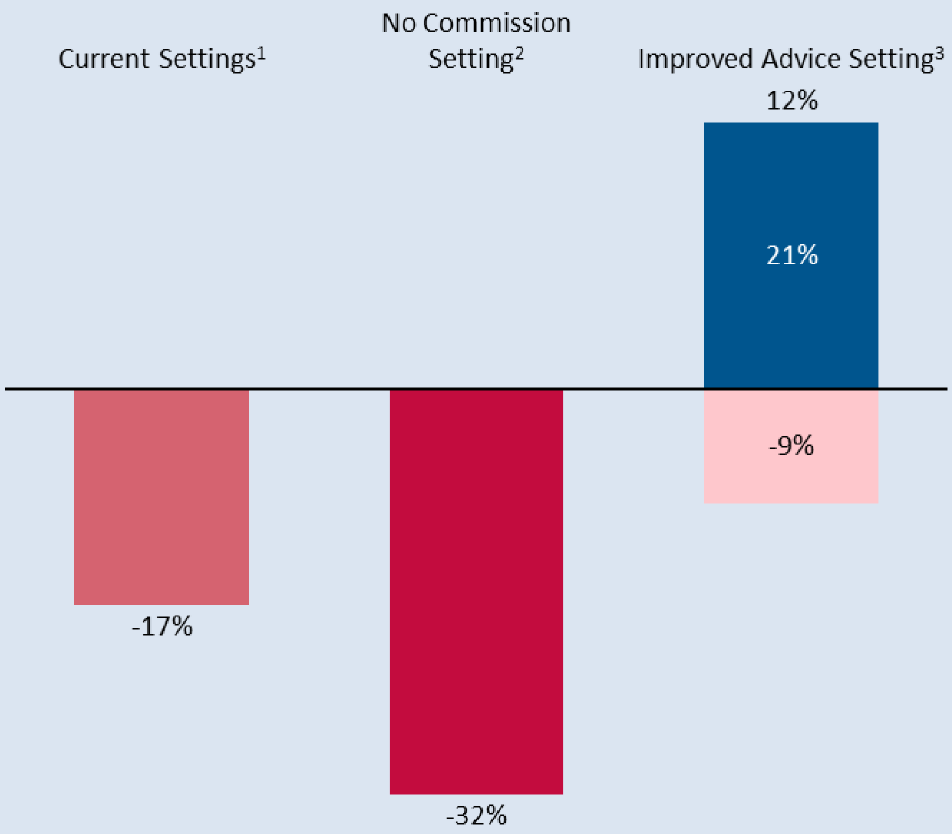
1. Group insurance (within the super system) needs to continue to provide a base level of cover, with options for consumers to easily upgrade their cover if their circumstances require.

   The strengthening of the group insurance regime will provide a base level of cover for most, and options for additional insurance for those who need it.

2. Advised sales of insurance need to increase with both an efficiency of comprehensive advice providing life risk advice and a simplified risk advice model where consumers do not need comprehensive advice.

   Combined, these are expected to see a 12% increase in the number of advised life risk policies over the next 5 years and start to reduce the underinsurance gap (although the gap could take over 10 years to be resolved).

Estimated fall in # advised life insurance policies (%, Dec 2021-27)



Notes: The estimated fall is the mid-point of a range of outcomes (of potential consumer behaviour) in each scenario with the following characteristics:

1. Current setting projects a bottoming of life risk advised sales in 2022, and then growing at 4%p.a. (with no change in lapse profile).
2. No Commission setting projects a 60% decline in advised risk sales due to removal of commissions, and 50% increase in lapses from reduced re-broking and lower partial lapses
3. Improved Advice Setting adopts FSC's recommended improvements to financial advice resulting in a 32% efficiency, and impacts of a new risk only advice designation.

Source: NMG Risk Distribution Monitory Study, NMG Market Model, NMG estimates

Definition and Role of Life Insurance

Key points

- Life risk insurance pools the risk of low probability, high consequence events over many people, to avoid or mitigate the cost of individual hardship
- Life insurance should be regarded as a 'community good' – that is, the benefits of individual participation accrue substantially to parties other than just the participant
- 'Community goods' typically exhibit relatively low consumer appeal, but deliver maximum benefit to the community when there is broad participation at scale
- The tension between community benefit and low consumer appeal creates a critical role for government in facilitating participation, making the question of 'adequacy' important in assessing the scope and format of policy settings
- The question of the adequacy of a community good is best assessed relative to community expectations

Life insurance involves an individual or group entering a long-term contract with a life insurer and paying regular premiums in return for a future benefit contingent on a low probability, high consequence life event (such as death, disease, or disability). Life insurance effectively levies a risk weighted community price on individual life risks, mitigating the exposure of individuals, families and the broader community to financial hardship arising from these low probability, high consequence life events. Effective life insurance frameworks therefore deliver a substantial community benefit to the community in addition to the benefit to individuals and families.

In Australia, life insurers are focused on 'life risk insurance' in which almost all premiums fund life risk benefits.

This Report focuses on life risk insurance and life risk benefits (including those within bundled categories), and largely excludes consideration of investment-focused life insurance (where a life insurance policy is used to wrap long-term savings, pensions, or retirement income). As such, the term 'life insurance' should be read as 'life risk insurance' throughout this Report unless otherwise stated.

Life insurance is best regarded as a 'community good', in that the benefits of individual participation accrue substantially to parties other than just the primary participant.

The obvious beneficiaries of life insurance are the person insured and their dependants (partner/spouse and/or children). However, there are second-order benefits to friends, family and even to business partners or co-workers, including avoiding strain on support networks and fracturing of societal networks due to death, disability, or illness.

Community goods are different from consumer or public goods.

Community goods sit between consumer and public goods, as shown in Figure 1.

Figure 1 | Community Goods vs. Public- and Consumer Goods

	Public Goods	**Community Goods**	Consumer Goods
Characteristics	▪ Government pays ▪ Public benefit ▪ Universal participation ▪ Government pricing	▪ **Individual mostly pays** ▪ **Community benefits** ▪ **Prompted participation** ▪ **Hybrid pricing**	▪ Individual pays ▪ Individual benefits ▪ Voluntary participation ▪ Market-based pricing
Requirements	Govt. pricing model Representation	Broad-based adoption Government facilitation	Competition Consumer protection
Examples	Public school Infrastructure Emergency services	Long-term care **Life risk insurance** Third-party liability Private health insurance	White goods Clothing wear Consumer credit

In addition to the 'community benefit', community goods are distinguished by 'who pays' (governments may act to subsidise through the tax or pension systems or bundling with other products) and the basis for pricing (with a level of individualisation within a community framework, relative to public goods but not to the extent of consumer goods).

Community goods exhibit several additional characteristics:

- Benefits of broad adoption: the value proposition to individual participants is heavily dependent on the participation of others (scale and diversification drives cost efficiency and reduces exposure to individual events)
- Explicit cross-subsidisation: even with individualised risk pricing, some level of residual cross-subsidy is inevitable (between age cohorts or conditions; at the extreme non-claimants ultimately subsidise claimants)
- Low consumer appeal: in the case of life insurance, reflecting immediate/certain cost to enter a long-term and complex contract against an uncertain future benefit (and then a benefit that may accrue substantially to others, in circumstances that most would hope to avoid)

The tension between community benefit realisation from broad adoption but low consumer appeal implies a critical role for government.

With the right policy settings to facilitate participation, government can deliver a material community benefit without any direct funding or assumption of risk. However, the scope, direction and level of government facilitation is inevitably controversial. Defining the appropriate threshold for government intervention and outcomes – driving the optimal benefit outcome aligned to community expectations for the lowest public assumption of cost or risk – is therefore a critical question in community goods generally and for life insurance in particular.

The question of the adequacy of the life insurance market is a critical issue that must be considered against Australian community expectations.

In a community good category, the ultimate standard for measurement must be the attitudes and expectations of the community.

We know that life insurance (like other community goods) is characterised by low consumer appeal but high community benefit, and therefore we cannot effectively assess community expectations via a traditional consumer research survey based on ‘own intention’. Rather we need to construct a methodology that engages with individuals as community members to test expectations of what should happen to friends, family, and neighbours when adverse life risk events happen. We need to assess whether the community expects individuals and families (and ultimately communities) or else government to absorb the costs of individual and family hardship; and if not, then to quantify the community standard of protection whether through life insurance (risk pooling backed by a financial institution) or some alternative mechanism.

Community Expectations of Life Insurance

Key points

- Community attitudes show a high level of endorsement of the community benefit of protecting individuals and families from financial hardship associated with life risk events (death, disease, and disability). They also endorse the role of financial institutions rather than government, families, or individuals, in delivering life risk insurance protection
- Overall, there is a high degree of consensus among the community as to the standard of protection required to mitigate the risk of financial hardship on individuals, families, and communities (enabling reset and future choices, but not extending to providing financial security for life)
- Community expectations of risk issues marginally increased during the Covid-19 pandemic, as consumers became more aware of the potential reasons for needing protection against adverse events
- However, the community standard is not generous, and should be regarded as a minimum standard or safety net (not an aspirational standard or cap)
- Applying the community standard by age and income cohort (and reflecting home ownership as well as patterns of child dependency) highlights the level of variation in cover by life stage, and the importance of choice, access, and flexibility in revisiting levels of cover with changes in life stage

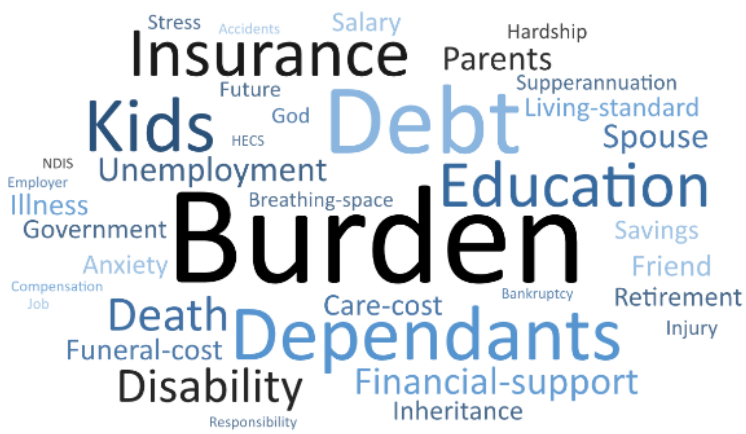
As a community good, community attitudes and expectations are the appropriate measure for adequacy.

There is a risk that a traditional consumer research methodology focused on 'own intention' will reflect low consumer appeal, high complexity, or the reluctance to engage objectively with risks to self (refer to Appendix 1). We have therefore adopted a differentiated research methodology to assess the attitudes and expectations of individuals as community members in relation to community expectations (what should happen to family, friends, neighbours directly affected by death, disease or disability) to quantify the community standard of protection (the minimum level required to mitigate financial or psychological strain on individuals and families and potentially spilling over into the community) and the mechanisms to deliver this protection (who and how).

This 'community research' focused on understanding attitudes to intuitive concepts (death and disability) and to protection outcomes (paying off debt - especially on the family home – and meeting cost-of-living expenses, such as funding children's education, etc) rather than anchoring questions and responses in insurance terminology. The study explicitly excluded trauma and considered disability broadly as a category (rather than asking specifically about disability income versus lump sum covers).

Approaching community attitudes in this way saw consumers recognise the value of life insurance and how adverse life events have the potential to be a burden by not being able to meet home and other debt repayment and support dependants / family (refer to Figure 2).

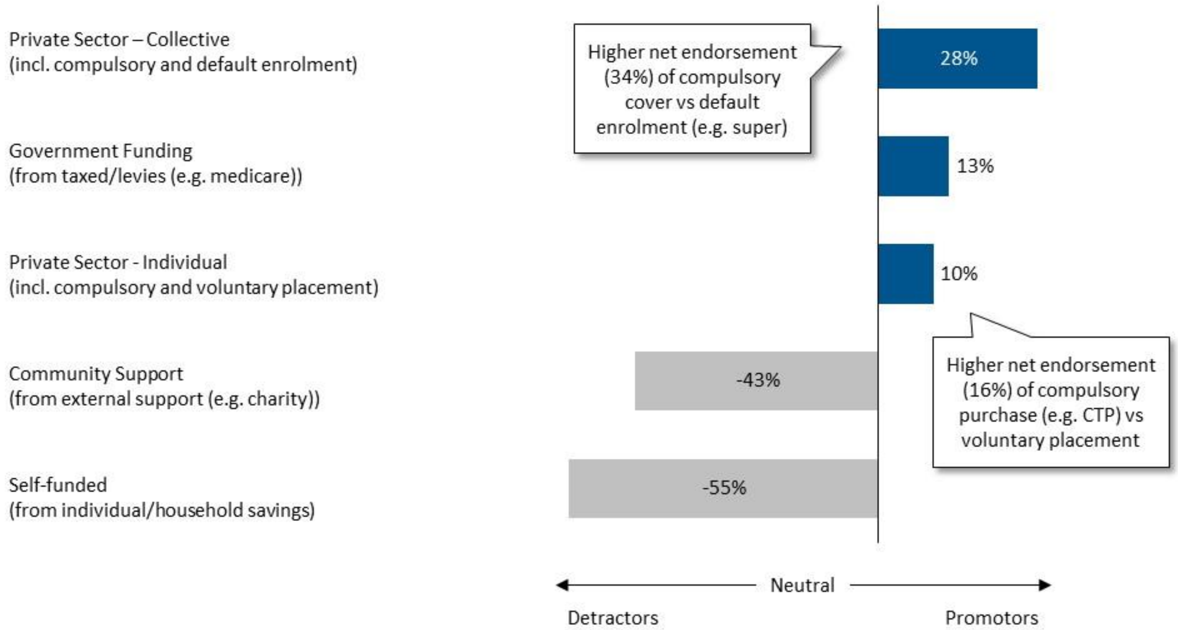
Figure 2 | Top-of-Mind Consequence of Adverse Life Events



Source: NMG Community Expectation Study[1]

Consumers also exhibited a high degree of consistency in terms of how protection against adverse life events should be provided, with broad support for the role of financial institutions pooling risk - as opposed to government funding or households funding on a non-pooled basis per Figure 3. However, there is some evidence of expectations that NDIS and Medicare coverage of 'disability' is broader than is actually the case. This may potentially lead to some understatement of expectations from the life insurance system.

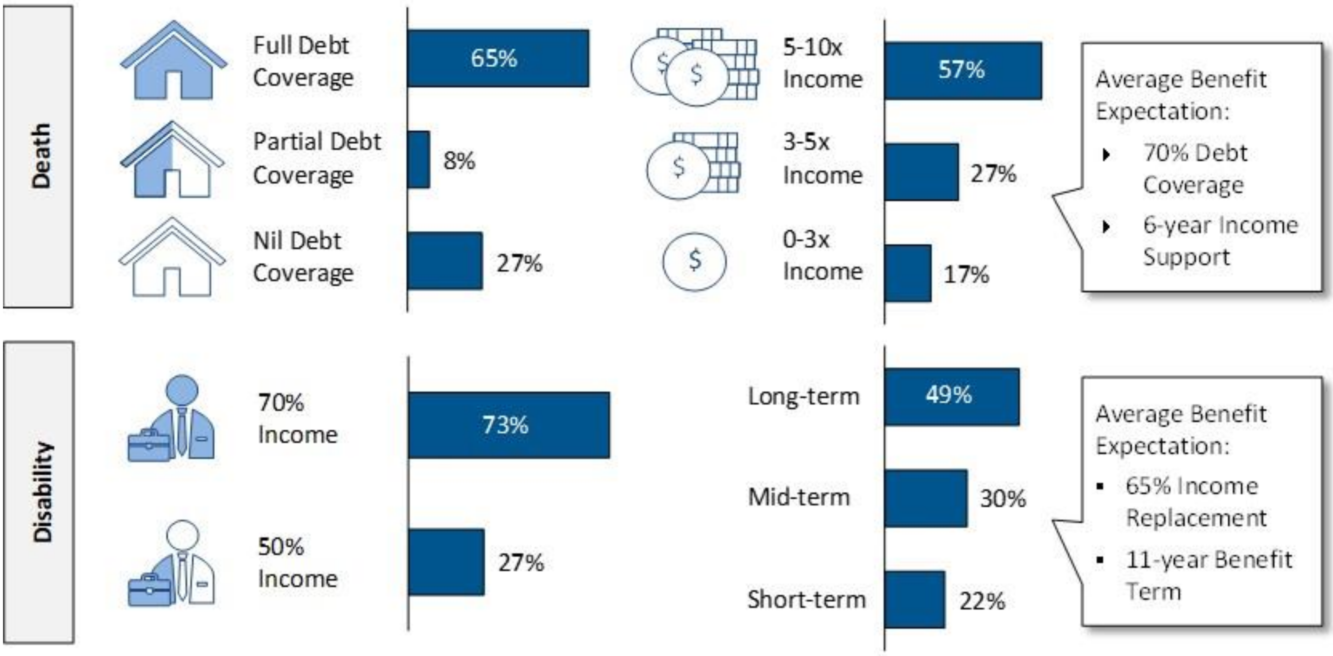
Figure 3 | Community Expectations – Provision of Life Risk Protection (Net Endorsement %, 2021)



Source: NMG Community Expectations Study 2021 [1]

Figure 4 below illustrates the aggregate community expectation of protection outcomes mitigating individual and community exposure to the risks of death and disability (but not illness).

Figure 4 | Community Expectations - Death and Disability Benefits

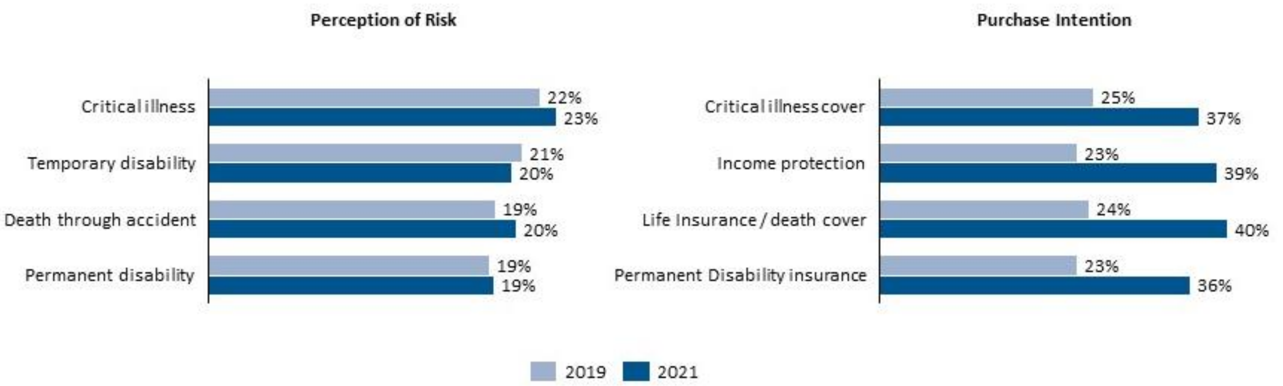


Source: NMG Community Expectations Study 2021 [1], NMG Estimates

Community perceptions of risk marginally increased during the Covid-19 pandemic, as people became more aware of the risks and the potential consequences of not being insured.

Figure 5 below shows how consumers have, following the pandemic, a heightened awareness (and expectation of occurrence) of adverse events requiring insurance, which has resulted in a considerably higher intention to purchase.

Figure 5 | Community Perceptions of Risk and Purchase Intentions (2019 vs 2021)

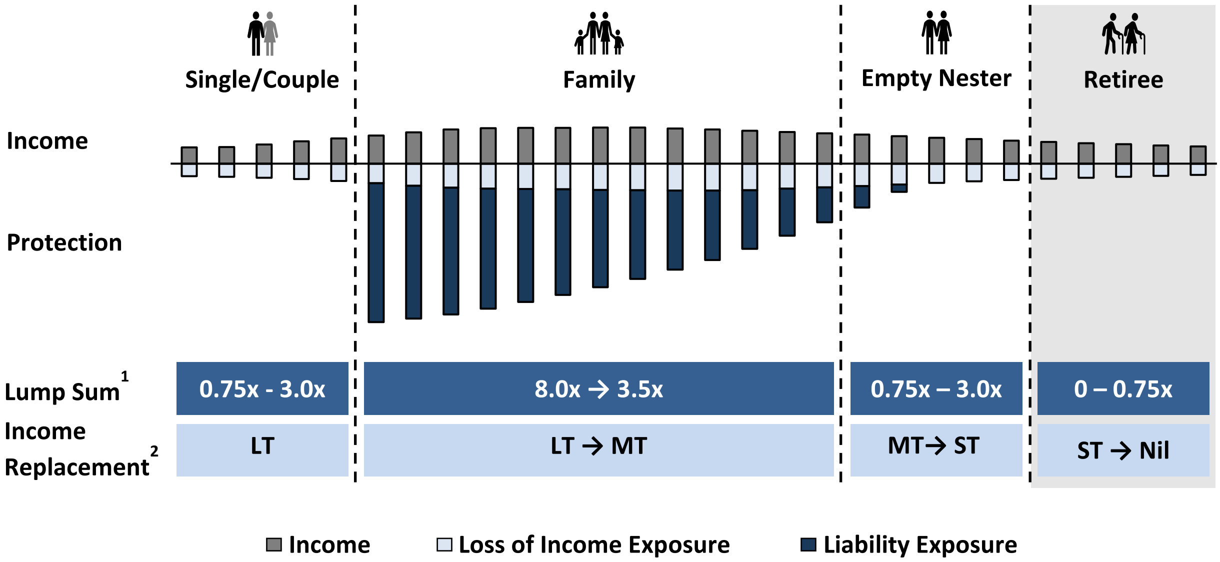


A relatively uniform community standard of protection outcomes linked to debt and dependency, implies significant variation in cover and in benefit level by life stage.

'Paying off 75% of debt' and 'replacing income to age 65' imply very different levels of benefit based on life stage, age, and income, even before considering the cost of covering dependants implied in the qualitative responses (notably continuing children's education).

Figure 6 illustrates the variation in cover required for an 'average model point' household through different life stages: from primarily disability cover needs (Total Permanent Disability (TPD) and income protection) from young single through increasing levels of death cover aligned to family and mortgage needs through to retirement. This illustration does not consider post-retirees; however, we acknowledge the very real needs and gaps for post-retirement segments in the market today, notably in respect of long-term care.

Figure 6 | Community Expectations - Implied Variation in Cover Requirements by Life Stage



Note: [1]Lump sum benefits reflect the benefit amount of Death and TPD protection, which is illustrated as a multiple of primary earner income,[2]Income replacement benefit terms include long-term (LT), mid-term (MT), and short-term (ST)

Source: NMG Community Expectations Study, NMG Estimates, ABS Data [1]

This life stage illustration underlines:

- The relevance of mechanisms to provide a ‘base’ level of cover and benefit broadly applicable through all life stages (lump sum benefits of up to 10x annual income and disability income benefit of 0.75x annual income)
- The critical importance of access, choice, and flexibility supporting individuals in making periodic and informed decisions, enabling revisions of cover both up (in the shift to ‘peak debt’ and family commitments) and down (charting an appropriate glide path into retirement)
- The implicit need for broad-based access to ‘advice’ (being expertise, guidance, and comparison rather than purely limited to the ‘personal advice’ standard as defined in Australia) for middle and lower income as well as wealthy segments of the community, supporting periodic and informed decision-making through life stages and based on individual variation in need

In understanding community expectations of adequacy, we focused on the key life events (death and disability; we did not attempt to cover ‘critical illness’) and the desired protection outcome expressed in terms of outcomes (covering cost-of-living, replacing income, and paying down mortgage debt).

We asked respondents to force rank gradations from minimal (short-term income replacement) through to maximum (outstanding debts paid off and long-term income replacement), with option to choose among different debt coverages, multiples of current income and benefit periods.

The results are as summarised in Figure 7 on the next page (based on consolidating responses of high, medium, and low). It is perhaps unsurprising that we see a level of polarisation with clusters at the upper and lower ends. We note that younger respondents were disproportionately represented in lower outcome responses, which might reflect having less direct experience of having a mortgage or expenses for dependants.

The implied community standard is by no means generous (a safety net, not an aspirational goal or cap).

While the community research showed a relatively consistent community expectation and standard of protection, the level of protection implied is by no means generous:

- Community expectations are anchored in avoiding hardship (especially when impacting broader family or social networks), rather than fulfilling long-term lifestyle or security ambitions
- Focusing on children (education), on the family home (paying off debt), on meeting costs of living and on putting beneficiaries in a position to be independent in future
- Maintaining mid-term living standards and supporting an orderly re-structuring of cost of living, debt, and employment arrangements (return to work), rather than providing financial security for life

Figure 7 | Model Point Illustration of Needs and Cover Levels under Community Standard

Model Point A

Age:	30 years old
Household Status:	Non-single
Personal Income p.a.:	$65,000
Dependant(s):	Spouse

Type	Death & TPD	Income Replacement
Cover ($)	374k	42K p.a.

Model Point B

Age:	30 years old
Household Status:	Single
Personal Income p.a.:	$65,000
Dependant(s):	Nil

Type	TPD only	Income Replacement
Cover ($)	49K	42K p.a.

Model Point C

Age:	40 years old
Household Status:	Non-single
Personal Income p.a.:	$110,000
Dependant(s):	Child & spouse
Debt:	$400,000

Type	Death & TPD	Income Replacement
Cover ($)	1,050K	71.5K p.a.

Model Point D

Age:	40 years old
Household Status:	Single
Personal Income p.a.:	$110,000
Dependant(s):	Nil
Debt:	$400,000

Type	TPD only	Income Replacement
Cover ($)	200K	71.5K p.a.

Model Point E

Age:	50 years old
Household Status:	Non-single
Personal Income p.a.:	$70,000
Dependant(s):	Spouse
Debt:	Nil

Type	Death & TPD	Income Replacement
Cover ($)	402.5K	45.5K p.a.

Model Point F

Age:	50 years old
Household Status:	Non-single
Personal Income p.a.:	$70,000
Dependant(s):	Spouse
Debt:	$100,000

Type	Death & TPD	Income Replacement
Cover ($)	475K	45.5K p.a.

Note: Generalised rules for community standard set out in Reference 2

Source: NMG Community Expectations Study 2021 [1], Life insurance PDSs of superannuation [5], NMG Estimates

Overall, the community standard is regarded as an appropriate measure against which to assess adequacy (underinsurance) but should be regarded as the level below which individual risk impacts the broader community (thus the minimum standard, not a cap or maximum).

We should therefore encourage individuals and families choosing to purchase benefits above the community standard and consider whether policy settings support doing so. Equally we should ensure that higher levels of benefits held by certain community segments do not distort aggregate comparisons aligned to community expectations.

An effective system will support individuals in buying up higher levels of benefit aligned to need, exposure, and affordability. We know that older Australians have higher premium rates for risk, but may also have greater capacity to pay, and may have individual needs given self-employed or partnership status or specific circumstances (children, parents, or spouse) requiring a higher level of death or disability cover than the average implied by the community standard.

It could be argued that the conservative approach to quantifying the community standard, understates the level of underinsurance in the system today.

Applying the patterns of group life adoption of income protection, or the current market standard of comprehensive income protection cover would show a materially larger aggregate underinsurance gap at all ages (but would not change the observations as to older age coverage and pockets of very high cover). Further we note that the community standard is likely to be understated due to a broad-based over-estimation the general public has of the scope of the NDIS, WorkCover and health insurance systems in respect of disability coverage.

Taking a conservative approach to quantifying the community standard is appropriate, however the analysis does suggest the need for a broader availability of 'scaled' benefit options and an ability to access these through a personal advice model improving choice, access, and flexibility. Similarly, the analysis endorses a more proactive approach to informing superannuation members of the benefits available through group insurance (including opt-in).

Australia’s Life Insurance Cover & Underinsurance Gaps

Key points

- Our analysis highlights significant gaps in coverage and benefits in the status quo system relative to the community standard (despite the consistently conservative approach in establishing the standard), particularly among middle age/high dependency demographics.
- Most Australians have some level of life risk cover through their super fund (default group insurance) for both Death / TPD and, to a lesser extent, Income Protection.
- While some older people may insure beyond the community standard (for a variety of personal reasons outlined above), this is part of a well-functioning market to cater for those with higher needs, although “fullness of insurance” may indicate lack of flexibility in options
- In total, there are 1.0m Australian’s estimated underinsured for Death/TPD and 3.4m underinsured for Income Protection

By considering actual wealth, income, and demographic data on Australian consumers we were able to take the community expectations and create three summary categories of consumer needs for death, TPD and income protection insurance:

- No need: those who do not need any insurance (e.g. no debt, no dependants)
- Default need: those where the average default level of group insurance is sufficient
- Higher needs those who need cover above the default level of group insurance

We can then compare these needs against what cover Australian’s currently have to identify the proportion of people in different age cohorts who are sufficiently insured, over-insured and underinsured versus the community standard. This dual level segmentation allows for the separation of gaps in insurance levels arising from cover levels above/below the community standard for those holding insurance from gaps arising where there is no cover in place when the community standard indicates a need.

This analysis highlights significant gaps in coverage and benefits in the status quo system relative to the community standard (despite the consistently conservative approach in establishing the standard)

The proportion of Australians by age-cohort with different needs and coverage levels are shown below in Figure 8 for death / TPD insurance and Figure 9 for income protection.

The majority of Australians have some level of life risk cover via their super fund (default group insurance) for both Death / TPD and, to a lesser extent, Income Protection.

Figure 8 | Australian's death / TPD needs and cover (by age cohort)

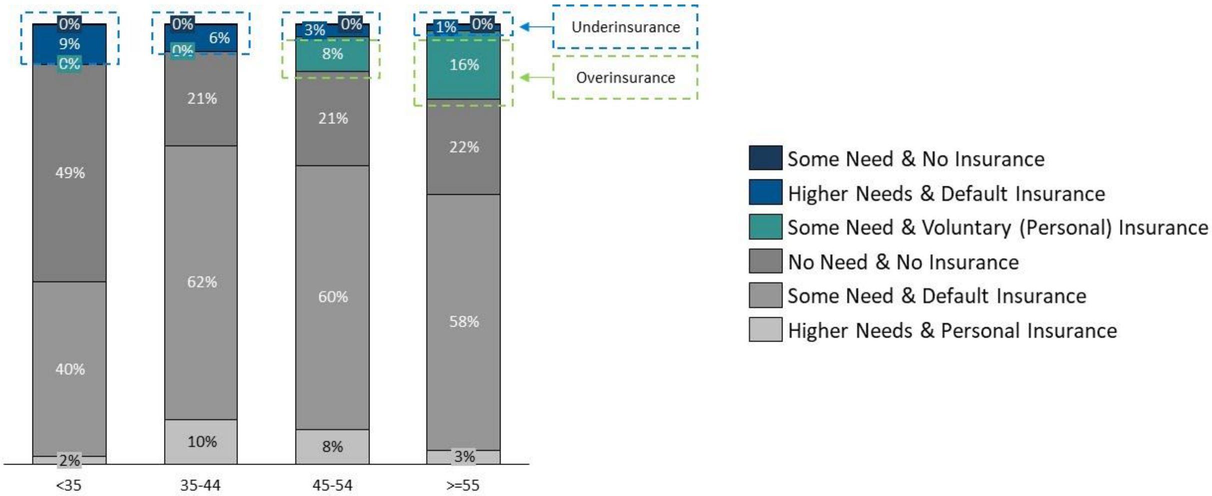
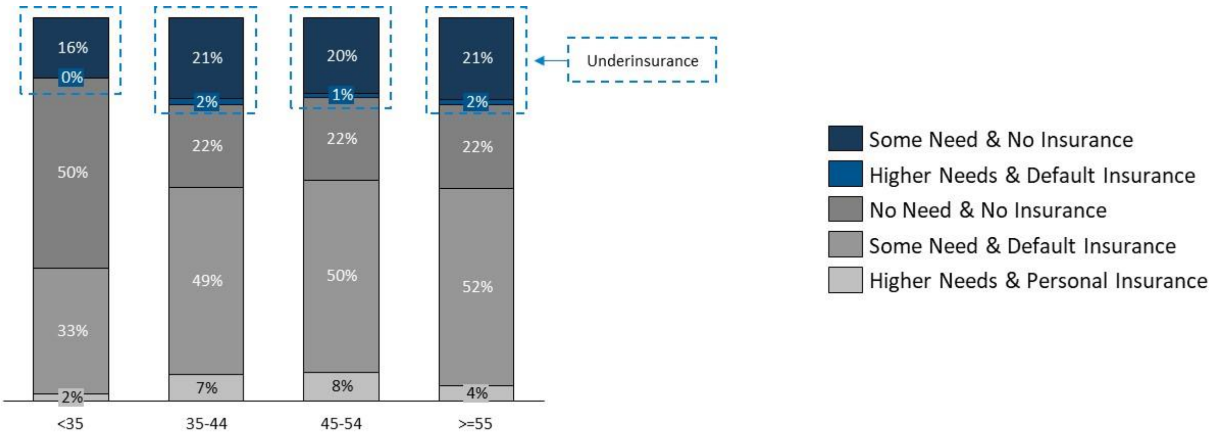


Figure 9 | Australian's Income Protection needs and cover (by age cohort)



This analysis of needs and cover illustrates several points about Australia's current insurance cover:

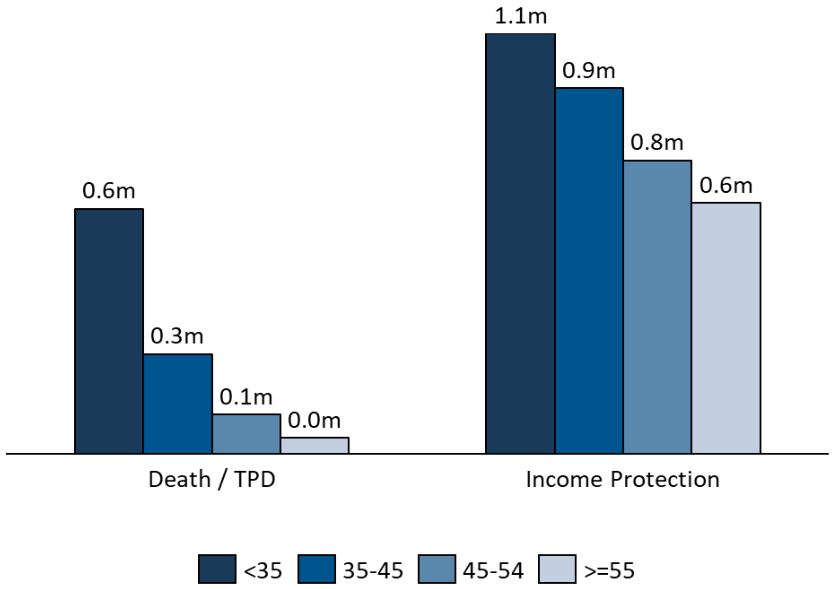
- Default group settings are the primary determinant of participation and cover level for most of the Australian population.
- Material gaps are present at cohort level and for specific benefit categories (particularly where a benefit category is not offered as default within group, where default group benefits fall short of the community standard, and where affordability or the advice capacity of the market challenge access to obtaining adequate cover)

- There are some pockets where individuals have insurance cover greater than required by the community standard. It is important this 'over insurance' is not used to offset lower coverage or benefits in another segment when assessing Australia's overall insurance coverage. As outlined earlier, there are several reasons why this over-insurance to the community standard is required by some people in specific circumstances. However, this may reflect a lack of access, flexibility, and choice in some sub-segments (for example, a difficulty in getting advice on decreasing insurance cover as individuals move towards retirement)

It should be noted that even where the analysis shows the needs implied by the community standard is matched by the coverage acquired, there may be further gaps in some sub-cohorts of age, income, dependents, debt levels, etc.

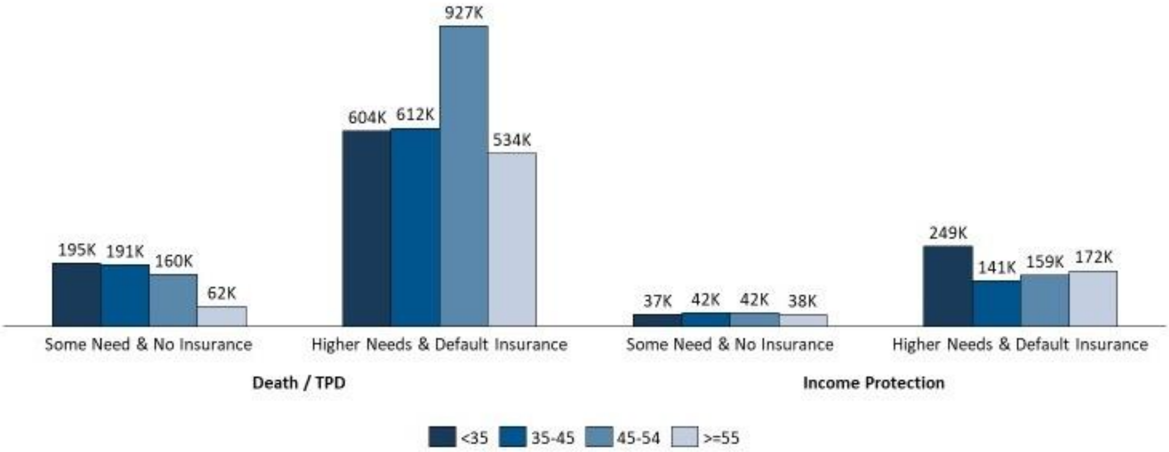
In total, this means there is an estimated 1.0m Australian's who are underinsured for Death/TPD and 3.4m who are underinsured for income protection. Figure 10 shows the number of underinsured Australians by product type and age cohort.

Figure 10 | Number of Underinsured Australians by age cohort and product type



Like coverage, the level of underinsurance (the difference in benefit implied by the community standard and actual coverage) varies for different segments, as illustrated in Figure 11.

Figure 11 | Average benefit gaps by gap type, age cohort and product ($ gap)



Those with the largest gaps are those who have higher needs but are reliant on default cover, either due to being unaware of their higher needs, or unable to access advice to identify their higher needs (be it via additional group cover via their super fund or personal insurance, such as from a financial adviser). This cohort is naturally higher income / wealth, with higher debt, more significant dependant requirements, but can place a significant burden on the community to reset after a life event.

Importantly, there are still significant gaps in benefit cover for those who do not have insurance, who are often in lower socio-economic categories (who will therefore be more likely to rely on government). It should be noted that some trustees have been trading-off benefit levels in default cover in exchange for higher members' retirement savings, resulting in a higher underinsurance gap, even for those who have default cover.

It should also be noted that these amounts are the average size of the underinsurance gap for that segment, and there will be significant variations of the underinsurance gap within these cohorts.

Furthermore, the conservative basis used in establishing community expectations implies that where gaps are present, they are likely to be significant and material gaps to current insurance levels – and even if further considerations such as wealth or social support offsets were to be considered, they are unlikely to address the gap across all age and wealth cohorts.

Observations about Australia's Underinsurance Gap

Before considering how to address Australia's underinsurance gap, it is worthwhile summarising several observations the underinsurance analysis has identified, and (where relevant) compare Australia's system to global best practice.

The majority of working Australians have default risk cover through Australia's retirement system, which results in Australia's population having broader life insurance coverage than many global peers, but with lower benefits than other markets (with the global market typically based on employment benefits).

Whilst this system provides a strong foundation for risk cover, there are some potential shortcomings:

Firstly, employment-based systems are typically characterised with:

- data on employees focused on their insurance characteristics,
- incentives and simplified processes for members to voluntarily upgrade their insurance benefits (either to voluntarily increase and/or add additional benefits for their specific circumstances)

In contrast, Australia's superannuation-based group system captures very limited information (usually a 'single line' about number of lives insured at agreed premium rates by age / policy type) for insurers to understand insured members. This makes it almost impossible for life insurers to identify circumstances where members reach certain life-stage events which would usually align to increases and decreases in insurance cover.

In addition, while fund membership used to be largely employment based, the slow shift away from employment-based member cohorts (which, over time, will be further exacerbated by recent stapling regulatory changes) results in a lack of pricing capability for insurers, which can cause higher prices for some cohorts.

Furthermore, the lack of incentives or a simplified process to upgrade benefits means the take-up of voluntary additional cover within Australia is much lower than global peers (especially in relation to additional benefits which are otherwise unable to stand-alone due to the high cost of customer acquisition).

Finally, trustees of superannuation funds must manage the direct conflict between the superannuation system's sole purpose to focus on members' retirement benefits and providing an appropriate level of default insurance benefits to suit its members. This has caused trustees to steadily reduce the cover for members. This works better for most but increases the number and extent to which those who experience adverse life events are exposed to poor financial outcomes.

For those who need additional cover, Australia has considerably lower coverage than global best practice. This gap is growing as a result of a lack of significantly lower and bias towards ongoing incentives in Australia compared to global peers.

Global insurance systems typically recognise the role that commission provides to generate the desired level of sales of community goods (especially life risk insurance). Further, these commission arrangements are aligned to where the work / activity occurs (that is, focussed on initial / upfront activity, given the focus on placement, and limited ongoing activity (excluding claims).

Australia's regulatory and political opinion has already deemed that the need to address the risks of poor life risk sales practices inherent in an upfront sales model means that larger upfront commissions are unpalatable. Therefore, to identify ways to help consumers identify what level of insurance is required for their circumstances (which is often higher than default levels they have via superannuation), we are required to focus on opportunities to simplify how the Australian sales and advice model for life insurance can operate to allow simplified direction or advice to consumers.

Addressing Australia’s Underinsurance Gap

Key points

There are multiple access points and different levels of insurance need within Australia’s population. While default group life arrangements provide a default level of many Australians, most new life risk policies are placed by advisers, which means addressing Australia’s underinsurance requires increasing the number of new policies recommended by advisers

As a result, there are two components which need to be addressed concurrently.

1. Group insurance must continue to provide a solid foundation of cover for most Australians, at an appropriate level of cover, with easy options to upgrade if their circumstances require.

2. Personal life risk advice (as the key contributor to new life risk advice policies) must be made more efficient across both comprehensive advice and with a more simplified risk advice proposition.

As detailed within this report, there is a continuum of life insurance needs among Australians which are addressed by different access points, coverage levels and product types.

From group live risk cover in super providing a default level of death / TPD (and to a much lesser extent income protection), through to individuals purchasing personal life risk advice policies either directly or through advice.

Given Australia has already taken the view that increases in life risk commissions to be commensurate with global levels are unpalatable in Australia (due to the potential for poor life risk sales practices), there are two key components of life risk advice that must be addressed to help reduce Australia’s current underinsurance gap.

Component 1: Preserve Current Group Life Risk Cover

Within Australia’s group life system, there are two aspects that need to be addressed to maintain the coverage and support or enhance current benefit levels.

Firstly, super fund trustees face an ongoing conflict to both maximise members’ financial retirement benefits and provide sufficient insurance to protect members against the risk of adverse events. Ongoing regulatory pressure and the rising cost of life risk insurance continue to put trustees under increasing pressure to reduce benefit levels for members[1] . Without addressing this trend, Australia will end up with a moving target of underinsurance (i.e. more consumers receiving a lower level / no default insurance cover), and an increasing underinsurance gap over time.

[1] Annual NMG Group Risk Study, which interviews ~100 super fund executives and intermediaries, where respondents acknowledge pressures in increasing cost of insurance for default members.

To address this, improved guidance is required. This should provide a clear guidance on which factors trustees can use to recognise what level of default cover is required and cost is appropriate for their members' circumstances.

This clarification will provide a baseline for each trustee's insurance strategy and reduce the number of super fund members that in future have their cover reduced (or worse, not provided). Going forward, clear guidance will underscore the role that default group insurance plays in a superannuation system that continues to mature over the next two decades.

Secondly, there are many circumstances where consumers have a need for additional cover beyond their default levels of cover (without the need for personal advice). Currently, these upgrades only happen on individual consumer requests, requiring consumers to identify their enhanced needs on their own and then take action themselves (and therefore rarely occurs).

To suit consumers in these circumstances, there needs to be a better way to support them undertake voluntary upgrades in cover that suit their individual circumstances. Recognising super fund trustees will remain focused on retirement benefits, the take-up of voluntary benefits could be better undertaken by both insurers and employers (as an employment benefit as in many other countries). To support these voluntary upgrades, insurers and employers need more sophisticated access to member data, to identify members where enhanced voluntary cover may be warranted, and a simple sales process (within appropriate boundaries) to engage with those individuals. Furthermore, these interactions between employer-based benefits and the default super system must seamlessly support combining and blending of benefits within and outside the super system.

Component 2: Enhanced personal life risk advice models

To date, most of Australia's personal life risk advice has been provided under a comprehensive advice framework. This is suitable for some, but not all, and there are two areas within personal life risk advice to be considered.

Firstly, the current comprehensive advice model must be simplified. As has been detailed in other reports (and will not be repeated here), the cost and complexity of running a financial advice business (particularly due to a proliferation of compliance obligations at every step of the process) is too high. This cost is ultimately borne by consumers of advice, which results in the cost being too high for most Australians. When combined with the cap on life risk commissions, it is often not profitable for financial advisers to provide life risk advice to many consumers, and results in life risk advice being left to higher value scenarios and being provided by risk specialists.

Simplifying comprehensive advice can be achieved by [2]

- Abolishing complex Statement of Advice for a simpler, consumer-focussed 'Letter of Advice'
- Break the nexus between financial product and advice, and
- Abolishing the safe harbour steps for complying with the Best Interests Duty.

[2] See the *White Paper on Financial Advice* issued by Financial Services Council (October 2021) for full details.

Reducing the complexity and cost of providing comprehensive personal advice would assist in making sure those who have higher life risk needs continue to receive appropriate advice on their circumstances.

Secondly, there is a need to support simpler consumer needs (with a relatively simple assessment of the amount of income required, debt to be paid down otherwise unserviceable and provision for any dependants). Consumers should be able to receive simple advice on these issues to assess the right level of insurance for their circumstances.

Allowing a simplified advice model would meet the needs of consumers with these relatively simple life risk needs. It would be done via a simplified advice model that allows for life risk advice only advice, which is the cover required beyond default cover levels, on a restricted (and competitive) product set.

Such a simplified advice model would address the gap we see today in super funds not broadly proactively engaging with consumers to meet any enhanced life risk needs above their default cover, at a lower cost than complex life risk and/or comprehensive advice.

Future Scenarios for Increasing the Number of Advised Life Risk

Key points

- While life insurance sales have fallen in recent years, underinsurance is predominantly an in-force issue (that is, how many policies are currently held by Australians). However, the relative gap between lapsing policies and new business will slowly cause changes to the underinsurance gap over time.
- Ongoing lapses and advisers focusing on higher value clients, means that the total number of in-force advised policies is expected to continue to decline, which will increase the underinsurance gap with a fall in the number of advised in-force policies of 17% by 2027.
- If adviser commissions were removed, this would significantly reduce the level of adviser sales, and is estimated to result in a decline of 32% of in-force policies by 2027.
- The recommendations proposed will steadily increase the total number of in-force policies, with the level of comprehensive advised sales still falling, but not as far as today's scenario, which will by more than offset by a simplified life risk advice model creating additional new policies.
- However, given the dynamic between lapsing policies and new business, even with these changes in place, it is expected to take at least ten years to address the underinsurance gap.

Underinsurance arises from consumers having less cover (or no cover at all) than the community standard. This means while that sales are important in impacting the long-term policy coverage over time (both people covered and benefits), in a single-year sales have a relatively small impact on the overall number of people covered. Underinsurance is based the number and value of policies that are currently in-force and the number that will be in-force in future under different scenarios.

Future industry regulatory settings are therefore critical to understand the extent that this underinsurance gap can be expected to improve or worsen over time. The current industry settings rely heavily on default group insurance to provide cover to most, although that typically does not cover the largest underinsurance gaps. These are largest where consumers do not have income protection or where they do not get the additional cover that they need to meet the community standard.

We have considered three future scenarios, and the cumulative impact they could have on the life risk market through to 2027:

- A continuation of the current regulatory framework
- The removal of commission on advised life risk advice
- Improvements to Australia's current low number of life risk sales (outlined in prior section)

While within each of these scenarios there is growth in the value and number of new sales, the total number of advised policies falls, as illustrated in Figure 12 on the following page.

Given the changes experienced within the advice channel over the last few years (resulting in significantly less advisers in the industry, and a lower proportion of advisers providing advice on life risk), we have seen advised sales dramatically decline in the last few years.

However, adviser exits due to recent regulatory changes have now largely plateaued and adviser numbers are expected to slowly increase as licensees and practices employ new-to-market advisers to satisfy the increasing demand for advice. This will see the value of advised life risk new sales bottom out at current levels and then slowly improve over time. However, the current industry focus will see the number of lapsed policies (often from previously advised clients) exceed the number of new to market policies for at least the next 5 years. This will result in a 17% fall in the number of in-force advised life risk policies and will cause a significant growth in underinsurance.

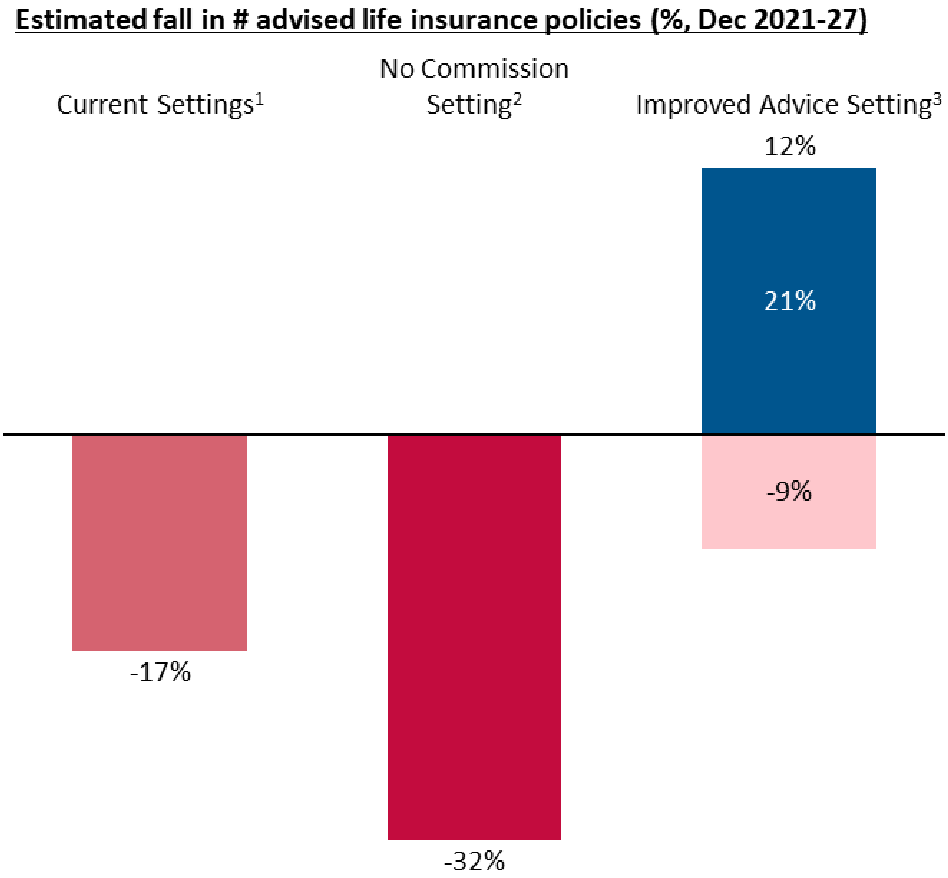
Commissions on advised life risk insurance remains an important component of adviser remuneration (with less than 10% of life risk advice being placed without any commission, and most consumers not being willing, or able to afford, to pay an upfront fee for life risk advice). The removal of commission would result in significant decline in advisers advising on life risk and can be expected to dramatically reduce advised life risk sales (both in terms of updating policies to maintain best / appropriate cover for consumers, and for new consumers). While some advisers would switch to a customer direct fee model, most advisers would follow the path of many other advisers from recent regulatory change and stop providing life risk advice. This would result in many more people relying on their default group insurance even where the consumer has higher needs. In addition, this will result in many advisers not being available to help clients if they need assistance during claims.

We estimate that removing commissions would reduce advised life risk sales by 60% (and increase lapse rates). By 2027, this would result in a 32% decline in the overall number of in-force advised life risk policies, significantly increasing the Australian underinsurance gap.

Simplifying the provision of life risk advice with both a simplified comprehensive life risk advice and a simpler way of delivering risk advice will steadily increase the number of new life risk sales, and slowly reduce Australia's underinsurance gap each year. The simplification of comprehensive advice is expected to improve adviser efficiency by 32%[3]. This would still see a reduction of in-force advised life risk policies, but by only half as much as the current scenario (a 9% reduction by 2027). The introduction of a simpler way of delivering life risk advice would, however, see an increase of an estimated 21% of advised life risk policies. Overall, this would see a 12% increase in the number of advised life risk policies and would be a start to reducing the underinsurance gap. However, given the current gap, even these changes are expected to take at least 10 years (once implemented) to address current levels of underinsurance.

[3] *White Paper on Financial Advice* issued by Financial Services Council (October 2021)

Figure 12 | Projected changes to total advised in-force life insurance policy coverage under different scenarios



Notes: The estimated fall is the mid-point of a range of outcomes (of potential consumer behaviour) in each scenario with the following characteristics:

1. Current setting projects a bottoming of life risk advised sales in 2022, and then growing at 4%p.a. (with no change in lapse profile).
2. No Commission setting projects a 60% decline in advised risk sales due to removal of commissions, and 50% increase in lapses from reduced re-broking and lower partial lapses
3. Improved Advice Setting adopts FSC's recommended improvements to financial advice resulting in a 32% efficiency, and impacts of a new risk only advice designation.

Source: NMG Risk Distribution Monitory Study, NMG Market Model, NMG estimates

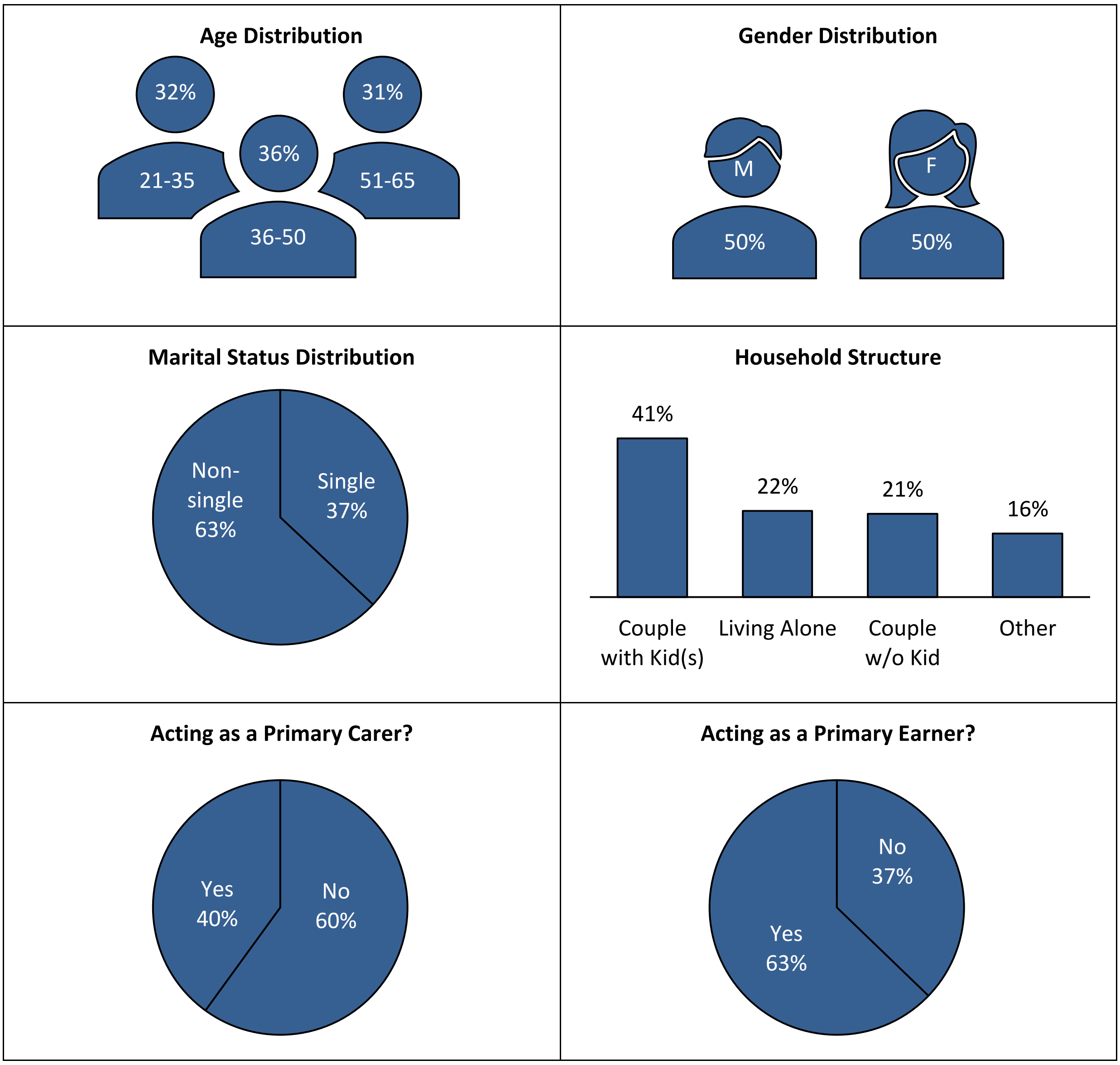
Appendix: References

Reference 1 | Community Expectations: Research Sample

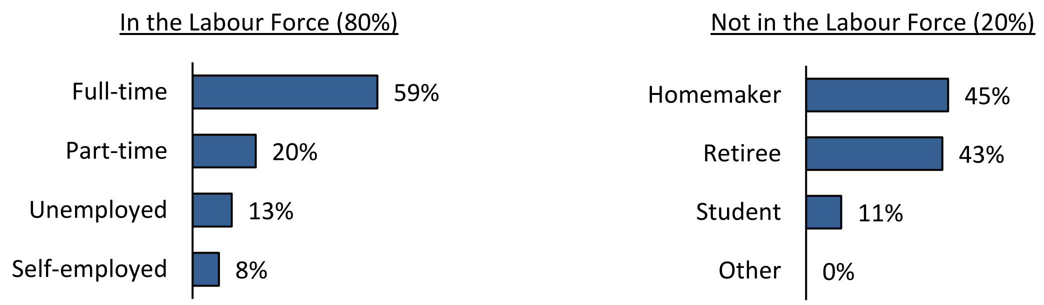
The survey was facilitated by Colmar Brunton Research and focused on consumers broadly representing the Australia insurable market for life insurance advice, being Australians aged 21 to 65 with personal income between $20,000 and $150,000.

An important element of the survey was to ensure that it included participants who had experience with financial advice, those that did not but still purchased life insurance and participants that had not purchased life insurance (outside of superannuation). 1,000 individual responses were obtained.

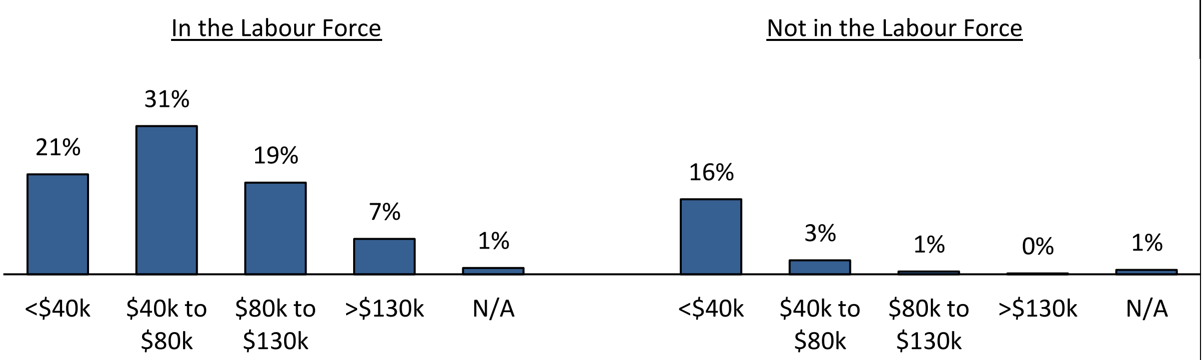
Figure 13 | Survey Demographics



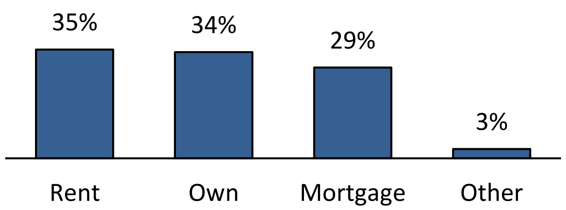
Employment Status Distribution



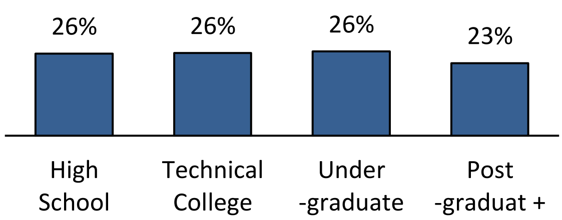
Personal Income Distribution



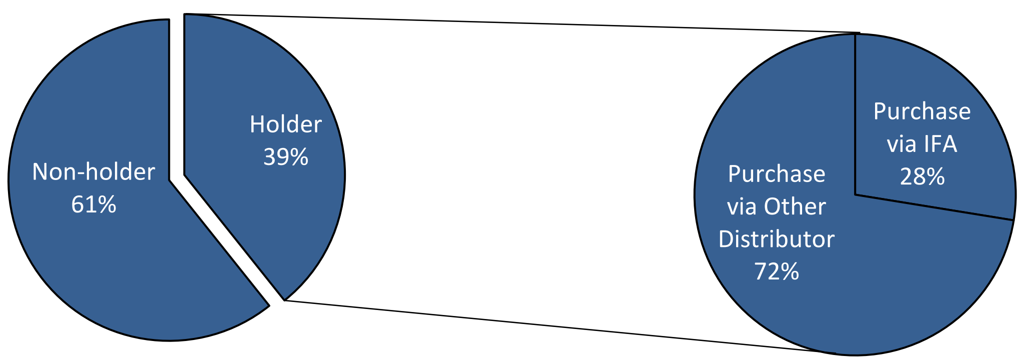
Home Ownership



Education Level Distribution



Holders vs. Non-holders of Life Insurance Policies



Source: NMG Community Expectations Study 2021 [1]

Reference 2 | Establishing the Community Standard and the 'Gap' to Current Insurance Holdings

In establishing the community standard and implied premium and participation patterns, we've built on the quantitative and qualitative results from the community expectations survey to establish a rules-based approach to determining broad insurance needs as a function of key socio-, economic-, and demographic markers.

Specifically, the following rules were applied as the 'community standard' for participation and cover:

Benefit Type	Demographic Markers	Rule
Death	Mortgage; Dependants	75% of outstanding debt of primary residence + Min (5, no. of years to retirement) x annual income
	Mortgage; No dependants	Nil
	No mortgage; Dependants	Min (5, no. of years to retirement) x annual income
	No mortgage; No dependants	Nil
TPD	Mortgage; Dependants	Max ($30,000, 50% of outstanding debt of primary residence)
	Mortgage; No dependants	Max ($30,000, 50% of outstanding debt of primary residence)
	No mortgage; Dependants	Max ($30,000, 37.5~75% annual income)
	No mortgage; No dependants	Max ($30,000, 37.5~75% annual income)
Income Replacement	All Incomes	Benefit amount: 65% income Benefit period: to age 65

To establish the distribution of insurance needs for the Australian population, these rules were then mapped onto a population matrix, reflecting age, income, primary residence mortgage debt, and household dependants (adult and child), where these population matrixes were aligned to ABS [1] and ATO [2] data.

We subsequently move to quantify this benefit distribution in terms of premium through establishing first whether, for a given model point in the matrix, group cover would suffice, or whether the model point would require individual cover, or whether a combination would be appropriate; and then apply the average group, individual, or combined, premium as appropriate to the model point at standard rates (i.e. with no additional risk loadings).

The rules for channel selection are laid out in the table below:

Benefit Type	Cover Level Trigger	Demographic Trigger	Channel Selection
Death or TPD	Nil	N/A	N/A
	<$600,000	< 55	Group
	>= $600,000		Group + Individual
	<$300,000	>= 55	Group
	>= $300,000		Group + Individual
Income Replacement	N/A	Annual Income < $140,000	Group
	N/A	Annual Income >= $140,000	Individual

*IP standard rates discounted by 33% to reflect product simplification.
**We acknowledge there is a gap in terms of benefit period aligned to community expectation for most group IP however, shorter terms and the simpler products are more closely aligned to the direction of APRA guidance on DII.

To establish the distribution of participation and cover in current insurance holdings, data from the proprietary NMG Risk Distribution Monitor database as well as publicly available APRA statistics on Insurance and Superannuation were mapped onto the population matrix.

Reference 3: Selected Model Point Comparisons of community standard and current cover

In the tables below green figures represent access in-line with- and benefits above that implied under community standard, grey figures represent no significant difference in cover (less than 10%) compared to that implied by the community standard, and red figures represent limitations to access- and benefits below that implied under the community standard.

Community Standard		**Comparison to Current Insurance Holdings**					
Age		**40**					
Income (Annual)		50th Percentile: A$68k		50th Percentile: A$68k		95th Percentile: A$169k	
Default Group IP		No		Yes		NA	
Adequacy Assessment		**Access**	**Cover**	**Access**	**Cover**	**Access**	**Cover**
Financial Status		Dependant: No; Mortgage: No					
DTH	Nil	✓	$261K	✓	$261K	✓	$144.5K
TPD	75% x income	✓		✓		✓	
IP	Benefit Amount: 65% income	✗	($44K)	✓	($17K)	✓	($6K)
	Benefit Period: To age 65	✗		✗		✓	
Consumer Choice (access & flexibility)		Lack flexibility in terms of standalone TPD and lack of access to default IP		Limitations to flexibility in terms of standalone TPD and long-term IP		Better accessibility and flexibility in retail cover	
Financial Status		Dependant: No; Mortgage: Yes					
DTH	Nil	✓	$129.5K	✓	$129.5K	✓	$208K
TPD	50% x debt	✓		✓		✓	
IP	Benefit Amount: 65% income	✗	($44K)	✓	($17K)	✓	($6K)
	Benefit Period: To age 65	✗		✗		✓	
Consumer Choice (access & flexibility)		Lack flexibility in terms of standalone TPD and lack of access to default IP		Limitations to flexibility in terms of standalone TPD and long-term IP		Better accessibility and flexibility in retail cover	
Financial Status		Dependant: Yes; Mortgage: No					
DTH	5 x income	✓	($78K)	✓	($78K)	✓	$51K
TPD	75% x income	✓		✓		✓	
IP	Benefit Amount: 65% income	✗	($44K)	✓	($17K)	✓	($6K)
	Benefit Period: To age 65	✗		✗		✓	
Consumer Choice (access & flexibility)		Lack of access to default IP		Limitations to flexibility in terms of long-term IP		Better accessibility and flexibility in retail cover	
Financial Status		Dependant: Yes; Mortgage: Yes					
DTH	5 x income + 75% x debt	✗	($482.5K)	✗	($482.5K)	✓	$74.5K
TPD	50% x debt	✗		✗		✓	
IP	Benefit Amount: 65% income	✗	($44K)	✓	($17K)	✓	($6K)
	Benefit Period: To age 65	✗		✗		✓	
Consumer Choice (access & flexibility)		Lack of access to advised or individualised cover (affordability)		Lack of access to advised or individualised cover (affordability)		Better accessibility and flexibility in retail cover	

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