Protection

Learning Outcome 7

By the end of this learning material you will be able to demonstrate an understanding of the range, structure and application of critical illness insurance to meet financial protection needs.

7 Introduction

Critical Illness cover is designed to pay out a lump sum on diagnosis of a specified illness within the term of the plan and subject to the terms and conditions of the policy.

Some advisers will recommend critical illness cover instead of income protection and others will advise it in addition to income protection cover.

Someone under the age of 65 is 5 times more likely to suffer a critical illness than die.

Some plans pay out a reduced sum assured for some critical illnesses – so the payment may depend on the severity of the illness. There can also be additional payments made if the illness becomes more severe or progresses beyond a certain stage – this is known as "Severity-based cover".

7.1 Policy Types

Standalone Critical Illness Cover

- Can be written with Guaranteed or Reviewable premiums
- Can be written as a unit-linked plan
  - A guaranteed policy provides a fixed sum assured for a fixed and guaranteed premium
  - A Reviewable policy is similar to reviewable term assurance. The premiums can increase at future reviews as a result of bad claims experience or poor investment performance
- Some providers have plans that pay regular instalments of the capital sum assured rather than one lump sum. This can often work out cheaper
- Some providers offer various options on their plans
  - Increasability options – generally on certain life events eg marriage/house moves etc
  - Index-linking
  - Waiver of premium
- Critical Illness Cover carries a higher risk for the Life Assurance Company and so the premiums are higher than those for straightforward life cover
- The underwriting terms may be much stricter
- Some policies are for a limited term, others are "whole of life" CIC plans

Combined Life Assurance and Critical Illness Cover

If critical illness cover is combined with life cover it becomes "an accelerated death payment" – this means that the payment is made during the life assured's lifetime and not in addition to the death benefit.

- The sum assured is paid out on diagnosis of a specified illness within the term OR on death within the term
- If the policy pays out on a critical illness event – it does not then pay out on death as well
- Some providers offer a facility for the policy holder to effectively "buy back" their life cover after a successful critical illness claim, after a waiting period – generally at least two years from the date of the CIC claim
- The premium for buying back the cover is based on the rates for the life assured's age – despite the fact that a critical illness claim has been made – and their health would normally mean it would be difficult or even impossible to get life assurance
- Where CIC is added to a unit-linked policy, the morbidity risk premium is usually paid for by cancellation of units as happens with the mortality costs

Reviewable Critical Illness Cover

Reviewable CIC is becoming more common and popular – generally because the initial costs are lower than those for guaranteed premiums

- Reviewable premiums can be up to 50% cheaper than guaranteed policy premiums
- The policies are generally reviewed every 5 or 10 years – and any premium changes would be based on general advances in medical science and diagnostic techniques and claims experience of the provide and the wider industry. It will not be based on individual circumstances or on the individual policyholder's own state of health
- Instead of buying a policy offering "accelerated death benefit" – an alternative is to buy separate critical illness cover and separate life cover. This may work out only a little more expensive than a combined plan – but it then offers the potential for a payout on diagnosis of a critical illness and a payout on death
- This can also give the life assured the opportunity to have different sum assured amounts for each plan – which can also reduce the costs

7.2 Market Developments for Critical Illness Insurance

Medical developments have a serious impact on critical illness rates and design of the products.

At the end of 2002 there were substantial increases in the premium rates for CIC – due in the main to higher than expected claims cost. Some reinsurers withdrew their guaranteed rates and costs also increased due to a reduction in the market for CIC.

The number of guaranteed rate policies fell and the majority of insurers changed to reviewable premium products.

Since 2004 more reinsurance capacity has become available so more insurers are offering guaranteed rates. These rates tend to be much higher than before and some of the illness definitions have been tightened and others removed from the specific list – again in line with medical developments.

In order to "future proof" critical illness cover against developments in medical science – a new Association of British Insurers (ABI) Statement of Best Practice for Critical Illness Cover came into effect from April 2007, which is updated from time to time.

This is designed to ensure that CIC still pays out for the conditions it is designed to cover, but adds greater certainty to illness definitions and to avoid future situations where an individual might have a condition diagnosed many years before it had any affect on their life.

Following publication of the draft Statement – in December 2006 – 2 cancers that were previously in the Statement as examples of pre-malignancy (2 very rare blood cancers) were removed from the list and so are now covered. That resulted from new medical evidence that suggested that the cancers may be malignant.

The move illustrates that the industry is prepared to consider changes to further future proof the Statement if there is good cause to do so.

In February 2011 the ABI published an updated Statement of Best Practice to improve customer understanding when making a claim. This was after a period of extensive consultation and research into what customers need and where there have been problems with claims in the past.

For example, the 2011 Statement of Best Practice includes

Total and Permanent Disability (TPD)	A new set of standard definitions with more descriptive headings which will make the cover clearer, support an education plan to improve understanding and reduce the number of claims declined
Definitions	A change in wording to the terminal illness definition in the light of changing medical science and clarity improvements to the cancer and Parkinson's disease definitions
Standardisation	The standardisation of the pre-existing conditions exclusions for children's critical illness insurance. For some insurers this condition is in the top 5 causes of claim, most for children diagnosed with leukemia

This adds clarity and should improve customer understanding at the point of sale and at the point of claim.

More than half of all TPD claims are declined – whereas overall – more than 90% of all CIC claims are paid according to the latest ABI statistics.

The Statement goes further than previous ABI Statements in that it provides a series of model critical illness definitions rather than just stating which illnesses should be covered. The Statement includes these definitions for all the illnesses listed later in the text.

This does not mean that all providers must cover all these illnesses – nor is it an exhaustive list. Where an illness not listed in the Statement is included – then the life office must provide a definition of the illness to a similar level of detail.

A further update was published by the ABI in December 2014. This provided updates to 'model' definitions for a number of specified critical illness conditions, as well as clarification on additional and partial payments, and additional cover.

Another development being adopted by an increasing number of insurers related to excluded conditions.

Traditionally if a customer had cancer in the past then all cancer cover would be excluded but the customer would still pay the normal premium or any higher premium imposed by the underwriter. Now, some insurers accept that were a condition is excluded, the premium should be reduced accordingly – although any extra premium for underwriting reasons would still apply. This is a fairer system for customers.

The issues around critical illness have led to product providers looking for ways to improve the concept of critical illness. The most prominent among these has been the development of "Severity Based Cover". This type of contract covers many more illnesses but pays out only a pre-specified proportion of the sum insured on diagnosis. It does, however, add the benefit of allowing more than one claim if an illness is progressive. The best example of this is with cancer claims. In the past some cancers were covered fully by critical illness policies and paid out in full on diagnosis of cancers that were fully treatable or relatively minor in nature. Under severity based cover, a proportion of the sum insured is paid out on diagnosis, but as the illness progresses - if it does – then further proportionate claims can be made.

7.3 Critical Illness Premiums and Underwriting

Critical Illness underwriting looks at morbidity risks for the illnesses covered. It is similar to the underwriting process for Income Protection rather than the process for life underwriting. Previous medical history is a very important factor.

Premiums are based on morbidity statistics with expenses being less important and investment of minimal importance.

Premiums cannot be based upon the sex of the applicant since the EU Gender Directive took effect in December 2012.

Actuaries may have to consider developments in medical diagnosis techniques – as many illnesses can be detected earlier than before and treated before they become "critical".

This has led to new definitions of critical illnesses for new policies and this process will continue in the future.

The definitions of an illness when a policy is issued will continue for the life of that policy.

Definitions

Each critical illness policy will specify exactly what illnesses are covered. The scope of cover can vary from office to office but offices cover most or all of the following conditions

Alzheimer's Disease	**Aorta Graft Surgery**
Benign Brain Tumour	**Blindness**
Cancer	**Coma**
Coronary Artery By-pass Grafts	**Deafness**
Heart Attack	**Heart Valve Replacement or Repair**
HIV Infection	**Kidney Failure**
Loss of Speech	**Loss of Hands or Feet**
Major Organ Transplant	**Motor Neurone Disease**
Multiple Sclerosis	**Paralysis of Limbs**
Parkinson's Disease	**Stroke**
Terminal Illness	**Third Degree Burns**
Traumatic Head Injury	

Each office will have its own definition of illnesses covered, but the ABI model definitions have to be used as a basis.

- There is a trend toward giving increasingly wide cover
- A few offices have a menu-style contract – enabling customers to choose from a list of conditions for which they would like cover
- Very few offices cover AIDS or HIV in general terms – although a number will cover these conditions if they are contracted by a medical professional, fire-fighter, or police officer in the course of their duties, or as a result of a blood transfusion in a UK hospital
- If there is no life cover, most offices require the life assured to survive diagnosis usually by 14/28/30 days before the claim is payable
- Single and joint life cover is available. Some offices extend cover to the life assured's children under 18 years but over 30 days old. This is usually available without any extra underwriting. The sum assured is usually limited and the number of conditions covered may be less
- The responsibility lies with the policy holder to prove that a CIC claim is payable and the appropriate medical evidence will be required at the policyholder's expense
- CIC is available as a standalone contact or as an optional extra on a term assurance, whole of life policy or occasionally on private medical insurance
- The ABI has a Statement of Best Practice for CIC to help insurers provide clearer product information and to enable different types of policies to be compared. This has standard definitions for commonly covered illnesses
- Some offices will allow additional illnesses to be added to the cover, but most will not
- Some policies include a buy back facility whereby, after a claim is made, the policyholder can buy back cover so that a further claim could be made if a new critical illness event arose in future

Claims

The policy pays out a lump sum on diagnosis of a specified illness within the term of the policy.

- The provider will need to check that the diagnosed illness is covered by the policy
- They will check that it was not a pre-existing condition
- They will check that the policy holder has disclosed everything that was relevant to the policy at inception
- The onus is on the policyholder to prove the claim
- Only if all these conditions are met will the policy proceeds be paid out
- This has led to criticism that critical illness contracts are underwritten twice – at proposal and at claim but this is done to safeguard all policyholders
- Most providers publish their claim statistics
- This is a direct result of the negative press that has implied that providers try not to pay out claims

Taxation

- Payment of critical illness benefit is not a chargeable event
- This means there is no income tax liability on payment of the sum assured – even if the insured is a higher rate or additional rate taxpayer
- Critical Illness Policies are not subject to Capital Gains Tax

Trusts

Where there is a sum assured to be paid on death as well as critical illness cover, it is possible to write the policy under a specific type of trust – sometimes it is called a Split Benefit Trust, or the life company's normal trust will include a standard provision for any critical illness benefit.

- Under a conventional flexible or discretionary trust used for life assurance, the settlor (insured person) would not usually be a beneficiary under the trust
- Under a CIC policy – the aim is for the insured person to benefit if they were to suffer a critical illness and their beneficiaries to benefit if they die. This can be achieved using a Split Benefit Trust – under which the death benefit if held in trust for beneficiaries and the critical illness benefit is held for the absolute benefit of the insured person if there is a claim.
- Changes to trust law in the Finance Act 2006 have resulted in most insurers now recommending a discretionary trust for the life assurance element
- Previously a flexible interest in possession trust was likely to be used but this is less flexible than a discretionary trust and now has no IHT advantages over a discretionary trust.

Group Schemes

This is an expanding market. Employers can buy group critical illness cover for their employees but it will not be part of a registered pension scheme.

- Employees normally have to be aged 21 – 65 to be eligible
- There is normally reduced underwriting – although pre-existing conditions are often excluded
- Cover can be fixed or a multiple of salary
- The illnesses covered will be the same as those on individual policies
- Cover will cease on leaving service or retirement
- Claims are usually only paid if the employee survives for 30 days after diagnosis
- Payment is usually made direct to the employee and this means that if the premium is paid by the employer – this is a taxable benefit–in-kind on the employee
- The benefit itself is tax free
- These policies cost the employer more than group life assurance and the levels of cover offered tend to be lower than for group life.

Income Protection or Critical Illness Cover

The 2 types of policy are complementary rather than alternatives

- CIC provides a lump sum on diagnosis of a specified critical illness
- IPI provides an income after a deferred period if the insured person is unable to work because of some disability
- IPI covers significantly more conditions than CIC – notably mental illnesses and conditions like back trouble that can disable without counting as a serious illness as defined by a CIC policy.
- On that basis, IPI is likely to be a higher priority than CIC for most people
- IPI has limitations – the deferred period means that there if often a delay in the benefit being paid.
- The amount of cover is generally limited and can be topped up by CIC
- The provision of a lump sum also helps by paying for capital items such as mortgage or loan repayment or alterations to a home to help a disabled person live more comfortably.

Protection Learning Outcome 7 (PROT7) – End of Module Test

Multiple Choice Questions

Question	Answer	
7.1 - David made a claim under his combined life assurance and critical illness policy. After a year he recovered and returned to work. Which ONE of the following describes the most likely outcome?	A.	The critical illness cover is automatically reinstated at no cost.
	B.	The policy continued to provide identical life and critical illness benefits but at a higher premium.
	C.	The policy ceased when the critical illness claim was paid.
	D.	The policy automatically continued providing life cover only.

7.2 - Critical Illness Cover is least suited to which of the following purposes?	A.	Alterations to living accommodation
	B.	Provision of specialist medical equipment
	C.	Repayment of a mortgage
	D.	Replacing lost income

7.3 - Which of the following best describes Critical Illness Cover?	A.	A policy which pays out a regular income to an insured person who is not able to work due to a critical illness.
	B.	A policy that pays out a lump sum benefit to the children should the policy holder die of a critical illness.
	C.	A policy which pays a lump sum benefit to the insured person on diagnosis of a specified critical illness.
	D.	A policy that pays the insured the costs of medical treatment and care incurred through suffering a critical illness.

7.4 - Which of the following is UNTRUE in respect of a CIC plan?	A.	Can usually add waiver as an option
	B.	Reviewable CIC is cheaper initially than Standard
	C.	Premiums are lower than those for straightforward life cover
	D.	Policies can be single or joint life

7.5 - Most stand alone CIC plans have a survival period after diagnosis before admitting the claim…..which of the following most closely reflects that period?	A.	1 month
	B.	3 months
	C.	6 months
	D.	12 months

7.6 - Which of the following is NOT a reason for a provider increasing premiums on a reviewable critical illness policy?	A.	Changes in individual circumstances.
	B.	Advances in medical science.
	C.	Developments in diagnostic techniques.
	D.	General claims experience of the insurer and the industry.

7.7 - Which of the following conditions is more likely to be covered by an income protection policy than a critical illness cover policy?	A.	Coma.
	B.	Stroke.
	C.	Mental illness.
	D.	Heart attack.

7.8 - Which of the following best describes the buy back option under a critical illness policy?	A.	The option to cover pre existing conditions
	B.	The option to refund the premiums for periods of no claim on the policy
	C.	The option to re-instate life cover after a critical illness claim.
	D.	The option to delay paying premiums until the end of a deferred period, then buy the cover retrospectively

7.9 - Which of the following is NOT a factor used in the calculation of the premium for critical illness cover?	A.	Morbidity.
	B.	Age
	C.	Previous medical history
	D.	Mortality.

7.10 - Which of the following is TRUE about the taxation of a group critical illness cover plan where the premiums are paid by the employer?	A.	When a claim is paid, the benefit received by the employee is taxable.
	B.	The premium is taxed as a benefit in kind against the employee.
	C.	When a claim is paid, the benefit received by the employee is only potentially taxable if the employee is a higher rate or additional rate tax-payer.
	D.	The employer cannot treat the premium as a business expense for tax purposes.

- **End of Questions -**

Answers

Question	Answer	
7.1 - David made a claim under his combined life assurance and critical illness policy. After a year he recovered and returned to work. Which ONE of the following describes the most likely outcome?	C	The policy ceased when the critical illness claim was paid.
7.2 - Critical Illness Cover is least suited to which of the following purposes?	D	Replacing lost income
7.3 - Which of the following best describes Critical Illness Cover?	C	A policy which pays a lump sum benefit to the insured person on diagnosis of a specified critical illness.
7.4 - Which of the following is UNTRUE in respect of a CIC plan?	C	Premiums are lower than those for straightforward life cover
7.5 - Most stand alone CIC plans have a survival period after diagnosis before admitting the claim…..which of the following most closely reflects that period?	A	1 month
7.6 - Which of the following is NOT a reason for a provider increasing premiums on a reviewable critical illness policy?	A	Changes in individual circumstances.
7.7 - Which of the following conditions is more likely to be covered by an income protection policy than a critical illness cover policy?	C	Mental illness.
7.8 - Which of the following best describes the buy back option under a critical illness policy?	C	The option to re-instate life cover after a critical illness claim.

7.9 - Which of the following is NOT a factor used in the calculation of the premium for critical illness cover?	D	Mortality.
7.10 - Which of the following is TRUE about the taxation of a group critical illness cover plan where the premiums are paid by the employer?	B	The premium is taxed as a benefit in kind against the employee.