Protection

Learning Outcome 6

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

6 Introduction

Despite the fact that statistics show that a person of working age is 5 times more likely to be off work as a result of illness or incapacity than to die – only 4 million people have income protection – either personally arranged or via their employment.

6.1 Types of policies, features and uses, comparative costs, benefits and disadvantages

- Income protection insurance (sometime known as Permanent Health Insurance) is a long term policy that pays a regular weekly or monthly income when the insured is unable to work due to long term illness or disability
- IPI is classed as long term insurance which means that as long as premiums are maintained and conditions complied with – the insurer cannot cancel the policy or increase the premiums - no matter how many claims are made.
- Most IPI is "Pure Protection" and comes under the ICOBS rulebook
- IPI should not be confused with PPI – Payment Protection Insurance which is a short term policy where the benefits are usually only payable for 12/24 months. PPI is usually associated with mortgage or loan payment protection
- Care needs to be taken as some providers may market a policy as "income protection" when it is really PPI
- Recent court action over the mi-selling of PPI has raised the profile of all types of income and payment protection
- Income Protection Insurance and Critical Illness Insurance are complementary in the cover they provide. Many people need some of each type of cover – which means that each individual situation needs to be examined before a recommendation is made.
- Some life offices now offer menu products which allow for a combination of covers e.g. death cover, income protection and critical illness all on one policy. The amounts of cover can be tailored to meet each individual client's needs.

Waiver of Premium

- Similar to IPI but it only covers the payment of the premiums for the pension or protection policy it is connected to
- If the policy holder suffers an illness or accident that stops them working - the insurance company "waives" the premiums at the level they were at when the period of incapacity started, possibly with indexation.
- Some waiver contracts also cover unemployment
- WOP is costed in the same way as IPI – but the rates are usually higher. The charges vary depending on age and occupation and are typically 2 – 5% of the insured premium
- WOP uses incapacity definitions, deferred periods, exclusions and claims procedures that are like IPI although often the terms are less attractive.
- WOP will continue until the earlier of return to work, expiry of the policy or a specified age – normally 60 – 65.
- Underwriting is normally streamlined
- Most protection policies offer WOP as an option and most IPI incorporate WOP automatically
- WOP was offered on personal pension plans until 6 April 2001. Policies taken out prior to that date can continue and will still get the tax relief for the WOP part as they do for the main pension contributions.

- Personal Pension WOP contracts taken out since 6 April 2001 and all pension plan WOP contracts taken out since 6 April 2006 have to be provided as separate contracts and the premiums do not qualify for tax relief.

Need for Income Protection Insurance

Income Protection Insurance aims to provide a replacement income for the insured in the event of sickness or accident

- Earners need to protect their income against disability since the loss of their earnings for any length of time will cause great hardship – it may even mean the loss of their home
- Personally set up IPI should be high on the consideration list for anyone not covered by a group scheme and who is in an eligible occupation
- The self–employed need the shortest possible deferred period. For the employed, the deferred period should match the period that the insured received sickness benefit from their employer.
- If the employee has a mix of full pay and half pay – then it is usually possible to tailor the benefit periods and amounts to fit in with this.
- The amount of cover should be based on the level of expenditure while the person is incapacitated – less any other income that might be received. This could include
    - Earnings that do not stop – e.g. Royalties, earnings of the partner/spouse, investment income including any rental income, pension income

Product Features

Deferred Period

- This is the initial waiting time from when the claim is made until the benefit is paid
- Typical deferred periods are 3/6 months – many other periods up to a year. Some policies state the deferred period in weeks rather than months
- Some deferred periods may be as short as 7 days and may be "back to day one cover" – which means that each day off work is covered after being off work for a week.

The Benefit

- May last for a short term e.g. 2- 5 years or to a pre=-determined maximum age or to retirement age. Normal would be somewhere between 50 and 70.
- Premium rates are normally higher for longer payment terms
- In the case of short benefit periods - there may be no further benefit at the end of the term or a lump sum may be paid if the customer is still incapacitated or a stricter definition of disability may apply – with reduced benefits

Permanent Policy

IPI is also known as permanent health insurance (PHI) because it is a permanent policy - rather than a plan that is renewed each year and can be cancelled by the insurer in the event of bad claims experience.

- If the insured is incapacitated, makes a claim and then goes back to work, they will still be covered.
- The exception would be if they changed their occupation – then the insurer may impose a rating or even discontinue cover altogether.
- Some policies have guaranteed premiums
- Some policies have reviewable premiums – that means the insurer can periodically (usually every 5 years) review its terms and increase or decrease premiums based on experience and expected trends

Rehabilitation and Proportionate Benefits

- If the insured has made a claim and returned to their old job but at a lower earnings level, they may receive a rehabilitation benefit
- Rehabilitation benefit is a level of benefit that is proportionately reduced according to the ratio of their current earnings to their insured earnings.
- Proportionate benefit is payable if they return to another occupation and are paid less

Benefit Limits

- The usual limit for the level of benefits is in the region of 50 – 60% of the previous year's earnings, after making a deduction for the basic level of employment and support allowance (ESA)
- All IPI plans have limits, so you cannot obtain 100% of earnings by arranging 2 policies, each covering 50%
- It is important to check the limit for each individual insurer, some insurers who deduct for state benefits have moved from deducting for incapacity benefit to ESA.
- In the case of low or no earnings e.g. a house-person, the insurance company may set a level of benefit that it would be prepared to pay out.
  It is likely to be in the region of £15,000 per annum
- Some budget policies aim to cover mortgage costs only. While these cost less – the insured could find themselves unable to support their current lifestyle if they became ill or disabled.
- Another popular budget policy is short-term income protection – not to be confused with PPI or ASU insurance. It is a long term permanent policy but with a limited maximum payment term, usually 2 – 5 years.
- Where benefits are paid to the employer e.g. a group scheme, the benefit level may be higher, up to 75% of salary. This is because tax will be payable on any benefit received from the employer. Where an individual has IPI cover and their employer has group IPI cover on their life, then the employer may use its benefit to pay for a "locum" or replacement or other costs if the insurer allows this.
- Benefit levels are usually underwritten when the policy is taken out and also when a claim is made - although some insurers do not underwrite at claims stage

Employment Insurance

Some insurers offer additional employment insurance as part of their income protection proposition. This is usually written as a monthly or annually renewable policy and is underwritten by a separate insurance company.

It is important to note that while IPI is a permanent insurance, employment insurance terms and conditions and premiums can be changed at the next policy renewal date, and insurers often have a right to discontinue cover altogether or otherwise change terms and conditions (as well as premium rates) at other times e.g. subject to 6 weeks notice.

Some policies also have an initial waiting period – which means that a claim cannot be made until a specified number of weeks or months have elapsed from the start of the policy.

Employment insurance is generally written as a separate general insurance policy marketed alongside a long-term protection policy even though, from the customer's viewpoint, they are likely to see this as a single proposition with a single application form, terms and conditions and payment system. The employment insurance is often written by a separate insurance company too

Additional Financial Benefits

- There may be an automatic or discretionary payment to help the claimant return to work
- Alternatively, an additional payment may be made if they are hospitalized
- Even if there is no provision to pay in the policy terms and conditions – an IPI insurer may be prepared to pay e.g. for treatment or rehabilitation that would help the claimant return to work
- A payment may also continue once a claimant has returned to work to help cover any additional costs e.g. to help pay for changes needed in the workplace to accommodate a new disability.

Non-financial or 3rd party benefits

Many IPI insurers look to provide practical help as well as money e.g. an insurer may work with an employer and the employee to set up and fund a rehabilitation programme, offer cognitive behavioral therapy (to help manage stress), advise on ways to change a workplace or job to suit someone with a disability and provide help through a helpline or through counseling.

- Such benefits may not be very clear in the product literature as the help given will depend on the individual circumstances of the claim and is usually at the discretion of the insurer
- Policies may also include 3rd party benefits e.g. helplines and employee assistance programmes

Increasing Cover

- Benefits and cover under IPI policies can have some inflation protection
- The amount of cover may be level or increase annually or at set periods without further underwriting
- The amount of cover may increase automatically in line with a set percentage or possibly with the prices or earnings indices
- The benefit paid out after a claim can also be level or it can be linked to a set annual increase or an index
- Policies may also include guaranteed insurability – allowing the benefit to increase up to a pre-set limit without further underwriting on specific life events such as job promotion, marriage, childbirth or taking out a new mortgage

Reviewable and Guaranteed Policies

- Traditional policies provided guaranteed premium rates – which once set did not change
- Reviewable premiums may offer lower premium rates initially but the insurer has the right to review premium levels periodically in the light of general claims experience

Renewable Policies

- Some policies have a short initial term e.g. 5 years and have guaranteed renewal at the expiry of the initial term.

6.2 Definitions, Exclusions, premium calculation factors

Definitions of Incapacity

Insurance companies have different definitions of incapacity, usually depending on the individual's occupation. Typical wordings are

Own Occupation	Suited Occupation	Any Occupation
• Unable to perform their own occupation and not following any other employment. This is the widest definition and provides the highest level of cover	• Totally unable to follow any occupation to which they are suited by reason of education, training or experience	• Totally unable to follow any occupation whatsoever, which is the tightest definition

If the insured is not in paid occupation, then the benefit is usually payable on failing a number of activities of daily working or living (ADW or ADL) or on a functional ability test (FAT). This tends to be a stricter definition than most occupation based definitions.

In some cases the definition may change once a claim has been paid for a certain time e.g. there may be an own occupation definition initially but after a claim has been running for 2 years, that changes to a suited occupation definition

Proportionate Benefit

Usually the benefit stops when the insured goes back to work. However, it may be that the illness is so serious that the insured cannot return to his previous occupation. The definition of incapacity means that it would probably be financially better for the insured to stay sick rather than seek a less demanding and less well paid job.

In order to encourage claimants to go back to work, many providers include a proportionate benefits clause in their policies.

- This means that , the insured having been incapacitated from the previous occupation engages in another occupation then benefit will continue proportionate to the reduction in earnings

- A number of providers will also provide this benefit where the insured returns to part time work
- This makes up the loss of earnings involved in the rehabilitation process
- They define the level of previous earnings for this purpose, usually in terms of the average earnings for the year or 6 months prior to incapacity

Limitation of Benefit

Most offices put a limit on the benefit payable to ensure that an insured will not be better off financially by claiming.

- This operates regardless of the nominal benefit insured
- The usual limitation is that the monthly benefit is limited so that the total of all IPI benefits will not exceed a specified limit between 50% and 75% of the insured's average monthly earnings in the year prior to incapacity
- Some companies also add state incapacity benefits and sick pay from an employer to the definition of the total IPI benefits
- For very large policies, the limit may be reduced to a lower level, e.g. 25 to 35%
- This can mean that, although the benefit insured might be £2,000 per month, if this is excessive in relation to the insured's earning, the limitation clause can operate in order to reduce the claim payments to the specified level.

Exclusions and Conditions

Normally the insured is required to inform the life office if there has been a change in occupation. The office can then decide if it will continue the insurance – and if so, at what premium and on what terms. If the insured has changed to a riskier job – then the premiums are likely to increase and other policy terms may change e.g. a change of disability definitions.

Most policies also have exclusions

- Disabilities arising from events such as war, invasion, act of foreign enemy, riot or military or usurped power
- Participation in criminal activities
- Taking alcohol or drugs other than under the direction of a registered medical practitioner
- Intentional self-inflicted injury
- Pregnancy, childbirth or any complications arising from them
- Aviation other than as a fare-paying passenger on a normal flight
- AIDS and
- Failure to follow medical advice

Foreign Residence and Travel

Benefit will be payable only while the insured is permanently resident within areas known as free limits. The free limits vary from office to office but will be

- At least the UK and the Republic of Ireland
- Usually extended to the EU or Western European countries
- Often extended to the USA, Canada, Australia and New Zealand

It is common for offices to continue to provide cover if the insured travels or resides temporarily outside the free limits, but benefit will not then be payable for more than typically 3 or 6 months. It is fairly normal to provide for cancellation of the policy if the insured lives outside the free limits for more than a year.

Change of Occupation

Most offices stop cover if the insured engages in an occupation additional to, or instead of, that shown in the policy, unless the office agrees to continue it, possibly with an appropriate increase in premium.

- This is to allow for the insured taking up a new occupation which carries a greater risk
- Some companies don't have this condition and have to underwrite the risk at outset
- Most offices treat unemployment as a change of occupation

6.3 Underwriting

The underwriting of IPI is different from that for life assurance and is more exacting

- The chances of being too ill to work are much higher than the chances of dying
- It is not necessary to be terminally ill to be unable to work, nor to be unable to work for the rest of your life
- IPI providers publish lists of occupational groups that are uninsurable and arrange insurable occupations in risk categories. The higher the risk, the greater the cost
- The underwriter is looking at morbidity risks, rather than mortality risks. Morbidity is defined as the relative incidence of a particular disease
- IPI proposal forms may well have more questions about health, occupation and income than life proposals
- Hazardous sports and pastimes would also be more relevant for IPI than life policies

IPI Premiums

IPI premiums are based on morbidity statistics, of both the individual life office and the population in general. Rates vary with age, occupation and deferred period.

- An important change to legislation came into effect from 21 December 2012 which changed how the market could price Income Protection products
- Insurance companies can no longer use gender to calculate insurance premiums.

- Gender used to be one of the 'rating factors' that companies used to assess a customers risk as statistically females suffer more ill health than males. The EU Gender Directive has meant that this is no longer allowed
- Morbidity rates increase with age – so IPI premiums also increase
- The longer the deferred period the cheaper the premium, as the frequency and duration of claims is reduced
- The longer the term – the higher the premium

Occupation Classes

Occupation is crucial in determining IPI premium rates

Some occupations have a higher risk of incapacity than others – and it is easier to return to work with some degree of incapacity in some occupations than others. Most offices have a rate structure based on occupation.

Class 1 Managerial, executive, clerical, administrative and professional workers	Class 2 Shop workers, skilled light manual workers in non-hazardous jobs, hotel and catering workers
Class 3 Skilled workers in non-hazardous manual jobs	Class 4 Skilled workers in hazardous jobs and heavy manual workers

Age.

Rates are higher for older insured people

6.4 Claims

Claims Experience has deteriorated in recent years. IPI also attracts more false claims than life assurance – there is more certainty that someone is dead than they are suffering from back or neck pain. IPI is also unusual in that benefits may be scaled back if the insured's income immediately before a claim is lower than it was when they took out the plan

Because IPI is basically risk based insurance with no element of investment – morbidity risks are by far the biggest element, followed by expenses – with the investment element being minimal. Any policy with escalation or indexation will inevitably cost more than a level policy. Guaranteed rates will tend to be higher than reviewable rates.

- It is important that the insured person makes the claim as soon as they are incapacitated even although the deferred period has still got weeks or months to go.
- The insurance company has to decide if the incapacity fits the definition in the policy
- Most insurance companies have the right to examine the individual – which they generally do if the claim is large or there could be grounds for suspicion.
- The company usually requires periodic medical certificates for the period of the claim and some companies use counselors to help claimants' rehabilitation and to monitor claims generally
- Some IPI insurers have incapacity counselors to monitor claims and visit claimants to help their rehabilitation
- Most policies continue to pay benefit for as long as the incapacity or the period of cover lasts. Some policies will apply a different (usually stricter) definition of disability after 1 or 2 years in claim
- If the insured person is not expected to recover from their incapacity – the insurance company may offer a commuted lump sum rather than continue to pay the benefit on a regular basis for the rest of the claim period

State Benefits on Illness and Incapacity

- The structure of state benefits for the incapacitated is complicated.
- Some benefits are given regardless of other income and capital – but many are means tested

6.5 Taxation treatment

Benefits under individual income protection policies are usually paid gross and are not subject to income tax.

- Where the policy premiums qualified for tax relief as a deductible business expense – then any benefits will be taxable as business receipts. It will still be paid gross
- For most Group IPI schemes – the claim payments are made to the employer without deduction of tax – but these are taxable in its hands as income
- Where the payment is passed to the employee – then it is taxed under PAYE and thus allowable to the employer as a business expense.
- This means that the employer will not pay tax on the claim. The employee receives the payment net of tax and NICs under PAYE
- To compensate for the tax, a higher maximum benefit may be offered by the insurer

6.6 Group schemes policies

Some employers provide income protection for employees

- The policies generally have a higher maximum benefit – up to 75% of income
- The benefits are paid to the employer who then pays the employee
- These benefits are taxed as income in the hands of the employee
- Some policies may also pay an additional benefit to the employer to compensate for the extra costs they may incur when an employee is off work long term

These contracts are offered to employers but cannot be part of a registered occupational pension scheme as IPI is not an allowable benefit

- Most employees are eligible
- Employers cannot be selective, they must ensure that all employees within a defined category e.g. all full time employees join the scheme
- Most of the terms will be similar to individual IPI although underwriting will be simplified
- The company is the policyholder and pays premiums which are not benefits-in-kind for the employees
- Cover is usually based on a percentage of pay and will stop on leaving service or retirement
- The deferred period is normally 26 weeks to match approximately the statutory sick pay period of 28 weeks
- If employees become unable to follow their own occupation due to illness or accident – the benefit will be payable until recovery or normal retirement date, whichever is earlier
- Due to increasing costs and poor claims experience, there is a trend towards having a maximum claim period e.g. 5 years. This reduces the premium
- On a claim – the life office pays the employer, who then pays it to the employee who pays tax on this in the same way as normal pay
- Exclusions tend to be fewer than on individual policies and their scope wider. However, there can be specific exclusions for some occupations
- Underwriters usually offer "free cover" i.e. the amount of insured benefit allowed without medical underwriting as long as all eligible employees join the scheme

Where a keyperson's absence gives rise to particular costs, keyperson cover can be taken out by the employer. The maximum benefit may be higher, typically to compensate for loss of profits. Benefits received by the employer would be taxable as a trading receipt. More detail on keyperson insurance in Chapter 10.

Protection Learning Outcome 6 (PROT6) – End of Module Test

Multiple Choice Questions

Question	Answer	
6.1 - Which of the following is NOT a benefit to Group IPI over an individual arrangement?	A.	Tax Free Benefits.
	B.	Higher Maximum benefits payable.
	C.	A level of free cover.
	D.	Wider scope of cover.

6.2 - Which of the following is normally the most important consideration in the pricing and underwriting of Income Protection Insurance?	A.	Postcode
	B.	Occupation
	C.	Earnings
	D.	Age

6.3 - Which of the following is a feature of Income Protection Insurance (IPI)?	A.	Men generally pay more for cover than women.
	B.	If the claims experience is poor, the insurer retains the option to cancel cover at renewal
	C.	The policy will pay a proportionate benefit if the insured takes a lower paid job due to the disability.
	D.	Defined capital benefits are paid in the event of loss of a limb or eye.

6.4 - Henry has been told that for underwriting purposes he is a class 3 Occupation. He is most likely to be applying for?	A.	Convertible Term Assurance
	B.	Low Cost Endowment Assurance
	C.	Mortgage Protection Assurance
	D.	Income Protection Insurance

6.5 - Which one of the following statements regarding waiver of premium on an Income Protection Insurance Policy is UNTRUE?	A.	Some waiver contracts cover unemployment
	B.	The typical cost of waiver of premium is an additional 2% - 5% of the premium
	C.	Waiver of premium is usually an automatic feature of the plan
	D.	Benefits usually commence immediately

6.6 - Which of the following is NOT a premium calculation factor for income protection insurance?	A.	Age of the customer.
	B.	Occupation of the customer.
	C.	Mortality risk statistics of the provider.
	D.	The deferred period selected.

6.7 - Which of these countries will ALWAYS fall outside of the free limits?	A.	USA.
	B.	Italy.
	C.	South Africa.
	D.	Republic of Ireland.

6.8 - Which of the following definitions of incapacity is likely to provide the highest level of cover?	A.	Own occupation.
	B.	Suited occupation.
	C.	Any occupation.
	D.	Activities of daily living.

6.9 - Which of the following best describes the taxation of benefits under income protection insurance, in the hands of the individual?	A.	For both individual and group arrangements, the benefits will ultimately pass to the individual net of income tax.
	B.	For both individual and group arrangements, the benefits will ultimately pass to the individual gross and free of any tax liability.
	C.	For individual arrangements, the benefits will ultimately pass to the individual gross and free of any tax liability. For group arrangements, the benefits will ultimately pass to the individual net of income tax and national insurance contributions.
	D.	For individual arrangements, the benefits will ultimately pass to the individual gross and free of any tax liability. For group arrangements, the benefits will ultimately pass to the individual net of income tax.

6.10 - Which of the following is NOT a feature of group income protection insurance?	A.	The employer must ensure that all employees within a defined category, such as all full time employees, join the scheme.
	B.	Underwriting is simplified (compared to individual income protection insurance).
	C.	The benefit will normally be paid until the earlier of attaining normal retirement age or recovery or the end of the maximum claim payout period e.g. 5 years.
	D.	The deferred period is normally 3 months.

- End of Questions -

Answers

Question	Answer	
6.1 - Which of the following is NOT a benefit to Group IPI over an individual arrangement?	A	Tax Free Benefits.
6.2 - Which of the following is normally the most important consideration in the pricing and underwriting of Income Protection Insurance?	B	Occupation
6.3 - Which of the following is a feature of Income Protection Insurance (IPI)?	C	The policy will pay a proportionate benefit if the insured takes a lower paid job due to the disability.
6.4 - Henry has been told that for underwriting purposes he is a class 3 Occupation. He is most likely to be applying for?	D	Income Protection Insurance
6.5 - Which one of the following statements regarding waiver of premium on an Income Protection Insurance Policy is UNTRUE?	D	Benefits usually commence immediately
6.6 - Which of the following is NOT a premium calculation factor for income protection insurance?	C	Mortality risk statistics of the provider.
6.7 - Which of these countries will ALWAYS fall outside of the free limits?	C	South Africa.
6.8 - Which of the following definitions of incapacity is likely to provide the highest level of cover?	A	Own occupation.

6.9 - Which of the following best describes the taxation of benefits under income protection insurance, in the hands of the individual?	C	For individual arrangements, the benefits will ultimately pass to the individual gross and free of any tax liability. For group arrangements, the benefits will ultimately pass to the individual net of income tax and national insurance contributions.
6.10 - Which of the following is NOT a feature of group income protection insurance?	D	The deferred period is normally 3 months.