Sustainability measures of individual disability income insurance

The Joint Associations Life Insurance Task force[1] (**joint taskforce**) is a cooperative group comprising life risk specialist members from the AFA and the FPA in support of the future of Life Insurance and the value of financial advice to everyday Australians.

We are making a joint submission with the objective of articulating the financial planner/adviser (**adviser**) and customer view of the impact of the proposed measures around Individual Disability Income Insurance.

The joint taskforce understands and accepts the need for APRA to take such measures towards the life insurance sector. Further we acknowledge the intention of these measures and that they are unprecedented. We also want to inform APRA that these measures will also have negative impacts on both current and future policy holders (consumers) and life risk specialist advisers.

The joint taskforce is therefore approaching this consultation on behalf of the consumer and the adviser to provide APRA with recommendations that we believe both deliver on the imperative that the proposed measures intend, but also ensure a fair and equitable outcome for the Australian public who rely upon the protection these contracts are intended to provide.

Finally this submission will also address some of the unintended consequences that the current proposed measures will have on both existing IDII policy holders and the life risk specialist adviser professionals and their businesses.

[1] **Joint Taskforce Members include**: *Philip Kewin, Phil Anderson, Marc Bineham, Marisa Broome, Dante De Gori, Ben Marshan, Mark Everingham, Andrew Proudfoot, Gary O'Sullivan and Michael Nowak.*

Feedback questions:

1.(a) Is 12 months an appropriate time frame to determine income at time of claim?

No, 12 months is not enough time to sufficiently account for seasonal or one-off impacts on income which are common for farmers, self-employed people and contractors, and which could result in an inequitable benefit being paid for a claim. In the case of farming, where the success of the business, in any year, is heavily impacted by the risk of longer term drought, world markets and other environmental factors, 12 months is a very short timeframe. Other key segments that would be impacted by this 12 month proposal include:

- Self employed people working in a sector that is cyclical, such as the construction industry, or businesses that support cyclical industries.
- People who work on a long term contract basis, who may have extended gaps between contracts.
- People who leave the workforce voluntarily for a period, such as for parental leave or to care for a family member or to undertake further study.
- People who are made redundant and take some time to find new employment.
- People diagnosed with an injury or illness that has a progressive impact, and where they endeavor to remain working for as long as possible, during which period their income may decline.

A more acceptable approach would be to look at income over a period of three to five years and either look at the best 12 months over this period or an average income over this period. Alternatively, it may be appropriate to exclude periods of unusually low income.

Taking a longer term approach will also assist in the claims process where proof of most recent income can be problematic where the claimant is incapacitated. Poor or prolonged claims processes not only have a negative effect on the claimant and their family, but also serve to create reputational damage for companies and the broader insurance industry.

1.(b) What protections should be considered for policy owners whose income fluctuates due to reasons such as unpaid parental leave or contract work?

There are a range of possible policy responses to ensure people with fluctuating income are treated fairly under IDII.

Where the fluctuations in income are the result of planned events, such as the policy owner taking unpaid leave, the income should be assessed as the full income that the person was receiving immediately prior to the event that reduced their income. Policy owners should not be penalised for taking leave or for initially returning to work, after maternity leave, on a part-time basis, if they intend to eventually revert to full-time work.

There is a more challenging task in accounting for income fluctuations that are not planned. For example, the impact on self-employed people and farmers from economic shocks, seasonal variations and other external factors.

Consideration needs to be given to how a claim can be initiated and payment commenced at the crucial early stages. The lack of any agreed value contract means that evidence of income would need to be provided at the time of claim, however this can be extremely problematic for self-employed and small business operators. This will be particularly challenging for people having difficulty coping at the time of the claim or where their financials may not become available until they complete their tax return, which could be many months later.

In these cases, income should be assessed on the basis of the best 12 months over the last 3 years, or on the basis of the average over a longer period of around three to five years. It would need to contain terms that allowed for the averaging of income over this period and adjustments to remove the impact of one-off, unexpected events.

The focus on these terms should be to provide an equitable outcome that reflects the level of income protection that a policy holder expects to receive and for which they have paid premiums over the life of the policy.

One option that we would like to have considered is the payment of an agreed value amount for the first year of the claim, after which the payment would revert to an indemnity measure. This would provide immediate certainty, without the need to provide evidence straight away, yet not pose a long-term sustainability issue.

Another consideration is the payment of a minimum safety net amount, for people who have paid premiums for a period of time yet find themselves disadvantaged at the time of claim, due to a period of reduced income.

2.(a) Is six months an appropriate time period for a higher initial income replacement ratio?

We would favour the higher income replacement ratio applying for the first 12 months. A higher replacement ratio for the initial 12-month period, after a claim, provides assurance that support will be available to a policy owner while they are recovering from an injury or illness. There are often significant additional expenses in this initial period, including the costs of medical treatment, purchase of equipment, home modifications, and support with childcare or home care.

A drop in the replacement ratio after this period acts as an incentive for the policy owner to return to work.

2.(b) Is 75 percent of earnings at time of claim an appropriate limit, and should the limit be varied for different income levels and/or claim durations?

The joint taskforce agrees that 75% is sufficient, however we recommend that this should be expanded to include SGC contributions into super.

Further we recommend that standard wording for income determination should be included to ensure that this is applied on a consistent basis.

2.(c) Is $30,000 per month an appropriate limit?

No, the benefit paid should reflect the amount of cover and the actual income of the policy owner. There is no reason to impose a cap on IDII payments, given that Agreed Value contracts will no longer be available. Such a cap would effectively prevent higher income earners from managing their income risk.

Another reason why it is not an appropriate limit is that it does not account for the correlation between income and expenditure. For example an insurance event may have a greater impact upon a household with higher levels of debt and material expenses that are less controllable such as private school fees.

There is no known data or analysis (that has been provided to industry and the public) on the rationale of why APRA has chosen $30,000 as the amount for this cap. Is there evidence to suggest that policy holders with benefits of greater than $30,000 are a material contributor to the current problems?

There are some products in the market that provide for reduced income replacement ratios above a certain figure. This might be restricted to 50% for the amount above $30,000. The joint taskforce would strongly recommend an approach based upon a reduced income replacement ratio for higher payout amounts.

We also ask for clarity on whether this proposed cap would be indexed over time as incomes increase across the community.

3.(a) Is five years an appropriate time period to have fixed terms and conditions?

No. The joint taskforce believe that a 5 year period for fixed terms and conditions is not appropriate and presents a significant reputational issue for the Life Insurance market.

Paying premiums for 5 years, and then having your policy terms substantially changed could have a significant detrimental impact on a client's confidence in life insurance and the prospect of actually being paid a benefit.

This part of the reforms is particularly significant, as it fundamentally changes the entire concept of life insurance in Australia, which is that life insurance cover is guaranteed renewable, which means that you can keep it as long as you continue to pay the premium.

The joint taskforce, while accepting that change is needed, would recommend introduction of other measures to control claims. Options that we propose include:

- The benefit changes from own occupation to any occupation at 10 years; and
- The income replacement ratio declines to 65% at 10 years and 50% at 15 years.

The joint taskforce believes that the above recommended measures will provide the client (policy holder) with advanced notice and understanding of the changes to the terms and conditions of their cover. This will provide certainty and trust in the life insurance policy and more broadly the life insurance industry.

In the absence of these other measures, we would favour the timeframe for renewal to be extended to 7 years. A 7 year time horizon has a correlation with the time required for life Insurance products to recoup costs for producing and issuing the policy.

The joint taskforce recommends that should APRA not resile from the 5 year fixed terms and conditions, then the changes to policy terms and conditions must be based on a class of policy holder and not targeted at an individual. There also needs to be more clarity on what factors can be considered in a review and that these are clearly disclosed to the consumer through the PDS.

Insurers should also provide transparency on the impact of a review on IDII premiums, given they will be able to adjust policy terms and conditions to manage risk more easily.

As an example, the joint taskforce has a concern about the implications for a policy holder who has a change of occupation, particularly where they move into a more dangerous occupation. Other concerns relate to how insurance companies will actually implement financial underwriting. Is there a genuine risk that they may no longer be able to retain their existing insurance cover?

Finally, the joint taskforce has concerns about the implications of this measure on premiums and in particular the continuation of level premium options. For example, if a 5 year fixed terms and conditions measure is implemented, then there will be no guarantee of the continuation of cover, therefore resulting in the question from the consumer (policy holder) as to why they would continue to pay on the basis of a level premium in the early years. If this measure was to be introduced for a 5, or 7 year period as we suggest, then we believe there should be an appropriate improvement in the certainty of premiums as a result.

This may be more of an individual Life Insurer product pricing issue, but consideration should be given to a guarantee of premiums during this period. This would address one of the key issues impacting existing clients and retention at the moment, being uncertainty around future premium increases. Without any guarantees, clients could be subject to premium increases after just one year, or multiple increases over a period of years, depending on the pricing cycle of the insurer. If there was a review of terms after 5 or 7 years, then perhaps a guarantee of premiums during this time should be offered.

3.(b) Are there alternative approaches to achieve the objective of not having fixed terms and conditions for periods exceeding five years?

As discussed above, the joint taskforce recommends the following options:

- The benefit changes from own occupation to any occupation at 10 years; and.
- The income replacement ratio declines to 65% at 10 years and 50% at 15 years.

4. What controls would be effective in managing risks associated with long benefit periods?

As discussed above, long benefit periods with high income replacement levels, provide an incentive for policy owners to stay on claim. This risk can be addressed in a number of ways, some of which have been discussed above.

Reducing the income replacement level over time can provide an incentive to return to work. However, this should be accompanied with better management of rehabilitation, training for alternative career paths and early (pre-claim) support to maximise the likelihood of a successful return to work.

There also needs to be a safety-net for those policy holders who are permanently disabled and unlikely to ever be able to return to work.

Unintended consequences and other feedback:

The Impact of Ceasing Agreed Value Contracts

The joint taskforce want to highlight to APRA that while we understand and support the need for urgent action and measures to ensure a sustainable and viable life insurance sector, there is also a need to ensure APRA completely understand the impacts of these said measures.

For example, though these measures will play a part in the equation for ensuring sustainability for the life insurance companies, this ignores the other part of the equation which is the policy holder and the life risk specialist adviser.

Agreed value contracts provide real benefit and assurance for millions of self-employed individuals and small business owners, this is due primarily to their variable/cyclical income streams and fluctuations in the environment that they operate within. The recent bushfires and ongoing drought is a real example of how Agreed Value Contracts provide certainty and assurance to those individuals – farmers and small businesses.

The joint taskforce is not aware of any data or evidence that identifies Agreed Value contracts alone as the cause of the current IDII problem and the joint taskforce recommends that APRA reconsider this measure.

Specifically, we request that APRA consider other measures that we believe will achieve the objective desires by APRA without the need to remove Agreed Value contracts all together. For example, the consideration of Agreed Value contracts being limited by caps on benefits and lower replacement ratios.

Protecting the Interests of Existing Income Protection (IDII) Policyholders

The joint taskforce is concerned that once this measure of no new Agreed Value Contracts (should it proceed) is implemented, that there will be material increases in the premiums paid by existing policyholders.

It is our understanding that life insurance companies will significantly increase the premiums of existing Agreed Value Contracts as there is no competition concerns of the policy holder (consumer) being able to 'shop' around for a better premium on an alternative Agreed Value Contract with another provider.

The joint taskforce is recommending that APRA, ASIC and the ACCC consider how they will protect existing policy holders from life insurance companies who may unconscionably force them to lapse their policies through unrestrained premium increases.

The Impact on Providing Advice to Income Protection Clients

The Joint taskforce, while understanding the role of APRA and the objective of these proposed measures, is concerned that no consideration (as we understand it from our discussions with APRA representatives) was given on the impacts of the measures on the financial advisers and their obligations in providing personal advice support to existing clients (policy holders).

For example, existing clients (existing policy holders), the consideration of moving to one of the new products will be an important factor. They will need to understand and weigh up the prospect of continuing significant premium increases in their existing policies – but the certainty of Agreed Value - versus a significant decline in the quality of the product and the uncertainty of future cover in the new product.

Existing policy holders do not understand these changes and without financial advisers many will likely just cancel or let their existing policies lapse due to the premium increases not appreciating the significance of their Agreed Value contracts and that this will not be available to purchase in the future.

The joint taskforce respectfully recommends that APRA consider a longer transition – until 30 June 2020 – to allow for financial advisers to communicate with and provide advice to their clients (existing policy holders) in a reasonable time frame.

The Joint Associations Task Force welcomes the opportunity to engage with APRA and other key stakeholders and contribute to ongoing dialogue for a sustainable and competitive life insurance market.

Should you wish to discuss further or if you have any questions please do not hesitate to contact either Philip Kewin (Philip.kewin@afa.asn.au) or Dante De Gori (dante.degori@fpa.com.au)

Regards
Joint Association Life Insurance Taskforce