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The Future of Income Protection

Presented by:

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Advice

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Our speakers

Scott Hoger

Scott joined TAL in 2013 and has over 15 years' experience in financial services. At TAL, Scott's responsible for providing strategic advice solutions to advisers and licensees.

Scott has a strong technical knowledge base, having worked as a financial adviser and business development manager in a number of large banking institutions and insurance companies.

He's also run his own financial planning business, specialising in personal and business insurance.

01 Introduction

02 APRA timeline

03 What is changing?

Agenda

Background – APRA changes

In December 2019, APRA announced that they are intervening in the life insurance market and will be introducing a series of measures to address flaws in product design and pricing that are contributing to unsustainable practices in the Individual Disability Income Insurance (IDII) market. ($3.4billion in losses over 5 years)

https://www.apra.gov.au/sustainability-measures-for-individual-disability-income-insurance

Introduction

IDII products are no longer fit for purpose; customers are often better off on claim. The resulting moral hazard has led to extended claim durations and subsequently IDII losses and affordability pressures.

APRA IDII Roadmap

31/3:
Agreed Value submissions to cease

1/7:
Deadline for implementation of product changes

30/6:
- Deadline for finalisation of AV apps

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Background- APRA Changes

- The removal of Agreed Value benefits from the market by the 1st of April 2020
- At the same time, insurers may elect to make additional product changes with a view to the future
- From July 2021, insurers will be required to align their product to meet with APRA's 2021 expectations

What immediate changes we will see

- Some IP changes to take effect from April 1st, others by July 2021
- APRA have applied additional capital charges for insurers and requested the removal of Agreed Value Income Protection benefits from March 31st 2020.
- APRA's measures will help to improve sustainability of this product and ensure Australians can continue to access disability income insurance , these include:
  - Income at risk
  - Income replacement ratio
  - Policy contract term
  - Benefit period

Advice Implications – existing clients

- Though financial advisers will not be able to recommend new ‘agreed value’ policies, client’s with existing contracts will not be impacted
- Consider the advice implications for existing clients
- Financial advisers are obligated under Corporations Law to provide advice that is in the ‘best interests’ of their clients

Advice Implications – existing clients

- The FASEA Code of Ethics which commenced 1 January 2020 provides an ethical overlay to an advisers Corporations Law and other obligations
- The FASEA Code of Ethics has a wider interpretation of ‘best interest’ that advisers must consider when providing personal advice
- There will need to be support from the industry and the regulator in respect to ‘switching’, as to ensure an adviser can still meet their best interest obligations (including the Code)

Advice Implications – existing clients

- Generally speaking, a ‘switching’ recommendation requires the financial adviser to demonstrate that a net benefit to the client exists as a result of the switch
- ASIC as the regulator look the cost, the benefit and the consequences of the switch as a way determine whether a net benefit has been achieved – in relation to income protection switches:
- It is likely that the premiums for a new ‘indemnity’ policy will be less expensive than an existing ‘agreed’ policy
- It is likely that the research houses will rate the new ‘indemnity policies’ as inferior to existing agreed value policies – it is unlikely that you will be able to demonstrate any additional product benefits as a result of the switch
- There will be significant consequences to the switch that will need to be disclosed to the client

Switching Example
Poll One

David is an existing client with an ‘endorsed agreed value’ income protection policy. At the time of policy inception, David was an employee, and was able to provide a letter from his employer to prove his income (endorse), and set his benefit at $6,000 per month.

David is now self-employed, and is earning after expenses and add-backs a total income of $3,000 per month. David goes on a total disability claim, how much is he entitled to under is ‘agreed value’ contract?

a) $6,000
b) 75% of $6,000
c) $3,000
d) 75% of $3,000

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Switching Example
Poll Two

David is a new client with an ‘indemnity’ income protection policy. At the time of policy inception, David was an employee, and was able to prove his income and set his benefit at $6,000 per month.

David is now self-employed, and is earning after expenses and add-backs a total income of $3,000 per month. David goes on a total disability claim, how much is he entitled to under is ‘indemnity value’ contract?

a) $6,000
b) 75% of $6,000
c) $3,000
d) 75% of $3,000

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APRA Proposed 2021 requirements

- APRA expects that income at risk for all new IP contracts be based on annual earnings at the time of claim, not older than 12 months
- Insurance benefits do not exceed 100 per cent of earnings at time of claim for the first six months of the claim, taking account of all benefits paid under the IP product as well as other sources of earned income; and, after the initial six months, insurance benefits are limited to 75 per cent of earnings at time of claim
- The initial contract is for a term not exceeding 5 years; and there is a right for the policy owner to elect to renew the contract for further periods (not exceeding 5 years) without a medical review on the terms and conditions applicable to new contracts that are then on offer by the life company. Changes to occupation and financial circumstances should be considered on renewal
- Insurers should have effective controls in place to manage the risks associated with long benefit periods

Income at risk

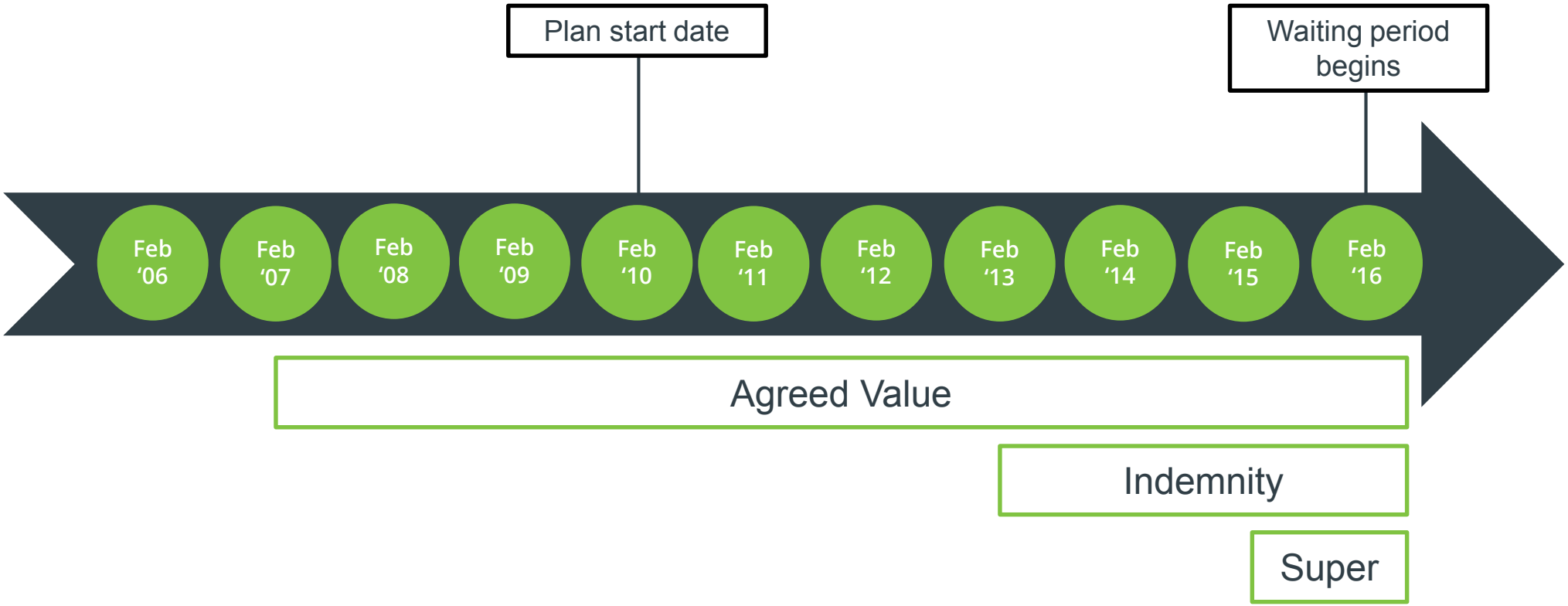
APRA considers it imperative that claim payments should be linked to income at risk at time of claim, i.e. indemnifying losses. Allowing claim payments to exceed the income at risk is inconsistent with the principle of indemnity. This gives rise to moral hazard, heightens risk and impedes sustainability. A specific application of this principle relates to agreed value (and endorsed agreed value) contracts, where the insurance benefit is based on earnings at policy application and not on earnings at time of claim.

APRA measures:

To address the above issues related to income risk, APRA is taking the following measures:

- With the effect from 31 March 2020, APRA expects that life companies discontinue writing IDII contracts where insurance benefits are not based on income at time of claim, including agreed value (and endorsed agreed value) from contracts
- With the effect from 1 July 2021. APRA expects that income at risk for all new IDII contracts be based on annual earnings at the time of claim, not older than 12 months

Income at risk – contemporary PDE definition



Income at risk

Feedback questions:

- Is 12 months an appropriate time frame to determine income at time of claim?
- What protection should be considered for policy owners whose income fluctuates due to reasons such as unpaid parental leave or contract work?

Question

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Income replacement ratio

- Current IDII products have features and ancillary benefits that can cause the insurance benefit to exceed earnings at claim. Evidence shows that returning to work is usually in the best interest of claimants, and the incentive to return to work is undermined by excessive income replacement ratios. Offering IDII products with excessive income replacement ratios can also result in consumers paying extra premium for insurance cover that they don't need. Product characteristics with adverse impact on the income replacement ratio include:
  - Features, including indexation, that increase the amount of insurance benefit to exceed earnings at claim, either permanently or for a given period of time; and
  - Features that allow the insured to earn income from continued work, with no offset to the insurance benefit being paid.

Income replacement ratio

APRA Measures:
To address the risk of an excessive income replacement ratio, APRA expects that, with effect from 1 July 2021, new IDII contracts will be designed so that:

- Insurance benefits do not exceed 100 per cent of earnings at time of claim for the first six moths of the claim, taking account of all benefits unpaid under the IDII products as well as other sources of earned income; and
- After the initial six months, insurance benefits are limited to 75 per cent of earnings at time of claim (subject to a dollar maximum of $30,000 per month)

Feedback questions:

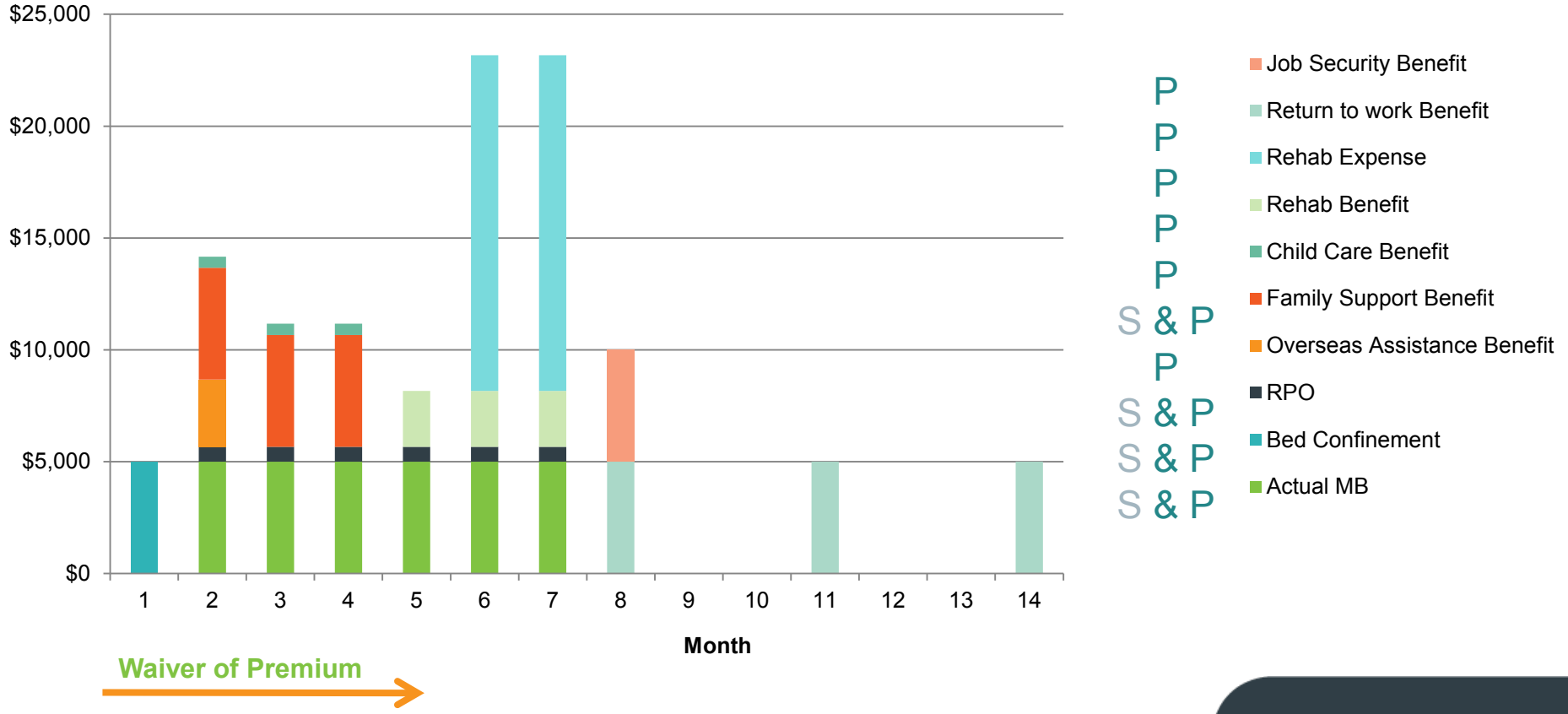
- Is six months an appropriate time period for a higher initial income replacement ratio?
- Is 75 per cent of earnings at time of claim an appropriate limit, and should the limit be varied for different income levels and/or claim durations?
- Is $30,000 per month an appropriate limit?

Ancillary Benefits Can Be Substantial

- $5,000 monthly benefit
- 30 day waiting period
- Totally Disabled for six months.

Total IP Standard Claim - $54,000

Total IP Premier Claim - $116,000



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Policy contract term

IDII policies in the market are Yearly Renewable Term contracts, where the life company has the most right to change the premium every year. The underlying contract terms and conditions are however set for an extended period of time, typically until retirement age.

Guaranteed renewability for such extended periods causes significant difficulty in designing products that will remain sustainable and appropriate for consumers.

APRA therefore wants to ensure that there is an appropriate mechanism to keep products in step with changing external and consumer circumstances, and moderate the extent of premium increases that may otherwise be needed.

APRA views it as not appropriate for life companies to offer IDII contracts with fixed terms and conditions exceeding five years.

Policy contract term

APRA Measures:

With effect from 1 July 2021, APRA expects that life companies will only offer new IDII contracts where:

- The initial contract is for a term not exceeding five years; and
- There is a right for the policy owner to elect to renew the contract for further periods (not exceeding 5 years) without a medical review on the terms and conditions applicable to new contracts that are then on offer by the life company. Changes to occupation and financial circumstances should be considered on renewal

Feedback questions:

- Is five years an appropriate time period to have fixed terms and conditions?
- Are there alternative approaches to achieve the objective of not having fixed terms and conditions for periods exceeding five years

Policy contract term

Currently, the majority of the IDII policies sold have long benefit periods, typically to retirement age. If the risks associated with long benefit periods are not managed appropriately, they can detract from claimants' motivation to return to work and have an adverse impact on claim duration. Long benefit periods also exacerbate the impact of other problems that may exist with product design and controls.

APRA Measures:

With effect from 1 July 2021, APRA expects that life companies:

- Have effective controls in place to manage the risks associated with long benefit periods (e.g. having a stricter disability definition for long benefit periods); and
- Set internal benchmarks for new IDII products with long benefit periods which reflect the risk appetite and the effectiveness of the controls

Next steps

01

There are two key dates, April 1 2020 and by July 1 2021 which will see a new breed of income protection offered by insurers

02

Financial advisers will need to consider these changes as they become public to help redefine their advice process and advice recommendations

03

APRA will consider submissions from interested parties which may result in some change

04

Consider the impact of 'switching' to new policies where the client has an existing (pre April 1 2020) policy

05

Compliance is key – talk to your licensee about their expectations for the advice document and associated compliance requirements

Poll Three

What broad measures are APRA taking to improve the sustainability of and access to individual disability income insurance products?

a) Income at risk, income replacement ratio, policy contract term, benefit period
b) Income at risk, income replacement ratio, policy contract term, waiting period
c) Income at risk, income replacement ratio, standardised product definitions, benefit period
d) Sustainable pricing, income replacement ratio, contract term, waiting period

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Poll Four

From April 1 2020, insurers will no longer be able to offer which of the following individual disability income insurance benefits?

a) A) Guaranteed renewable contracts
b) Benefits that are paid during the waiting period
c) Endorsed agreed and agreed value definitions
d) Monthly benefits that exceed $10,000 per month

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