The income protection pivot

The structure and procedures regarding income protection cover underwent significant change from 1 April 2020. Rob Lavery details the rule amendments and their implications.

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Change comes at trustees and their advisers from a number of different angles, particularly in these uncertain times. In April, one major change hit the insurance industry and SMSFs from a surprising source and greatly alters one strategic option available to SMSF members.

The Australian Prudential Regulation Authority's (APRA) instruction to insurers to abandon agreed-value income protection policies, as well as the subsequent changes with planned implementation on July 1 of next year, warrant a closer look to determine what they mean for SMSF members.

Direct and indirect effects

While not all SMSFs hold income protection cover for their members, all funds are required to have an investment strategy that considers members' insurance needs, both inside and outside super. This means any amendment to the insurance market has an effect on all SMSFs, even those that don't hold cover.

Letters and numbers

Last December, APRA wrote to all life insurers requiring they make major changes to new income protection policies from 31 March 2020. While a surprising and somewhat unprecedented move, APRA's concern over insurers wearing major losses on this type of insurance should not come as a shock.

In May 2019, the prudential regulator wrote to insurers requesting they proactively move

to prevent the large losses they had experienced on their income protection products. At the time, the regulator had identified $2.5 billion in losses on such policies industry-wide in the preceding five years. The lack of insurer response to this first letter gave rise to December's more prescriptive missive.

While it may seem counterintuitive for a regulator to be concerned about insurers losing money on insurance (or, to look at it another way, consumers making money from insurance), the logic is sound. APRA has expressed concern these losses will result in consumers receiving nasty shocks when premiums are reviewed and potentially dramatically increased. On the more extreme end of the scale, the prospect of an insurer being unable to pay claims under the weight of income protection losses would be disastrous for consumers and the industry overall.

So what has APRA requested insurers do?

Agreed value dismissed

APRA has stated it expects insurers to no longer offer agreed-value income protection policies from 31 March 2020. Any income protection claim on a new policy from that date will rely on income not older than 12 months before the date of claim.

What does this mean?

The days of a fund or policyholder proving the insured's income at the time of underwriting and not having any burden of proof come claim time are over (for new policies at the least). Some insurers accepted applications for agreed-value policies right up to the cut-off date. Some even accepted paper applications after that date, provided they were dated and signed prior to April.

Members and SMSFs with agreed-value income protection policies in place, or applied for, before April can maintain such policies, subject to contract provisions and insurer policies. Strategically the change means grandfathered agreed-value policies may become more valuable.

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That said, such policyholders may find their premiums rise more steeply than expected. Insurers will have little incentive to keep the premiums competitive when the policyholder can no longer purchase a comparable product. Furthermore, if insurers are making the level of losses identified by APRA in its correspondence, they will need to lift its premiums on agreed-value policies to shore up their bottom lines.

Tough decisions needed

Those SMSFs with an agreed-value income protection policy, or whose members directly hold such a policy, will have difficult decisions to make about whether to retain the policy. This situation will only be made more challenging where the insured's health situation has changed since the policy was purchased. Is it worth paying potentially rapidly increasing insurance premiums in order to keep greater cover than would be available in the marketplace?

A simplified marketplace

The question of whether a currently uninsured fund member would be better suited to an agreed-value or indemnity income protection policy is gone. Issues around agreed-value policies in SMSFs and whether they fully meet the temporary incapacity condition of release (and whether the premiums are fully deductible) will also slowly disappear as grandfathered policies end and indemnity policies predominate.

An unintended consequence

The 12-month income verification period may cause some unintended consequences for the insured. For those with irregular income, a major bonus or income spike may come after the date of claim, and hence be excluded from the income verification period. This issue may capture a wide range of people, from farmers who have income spikes depending on seasons and markets to members of a sales force who typically have the potential to receive large bonuses at set points in the year.

Members who have irregular incomes need to understand the limitations of new income protection policies when it comes to fully replacing their income.

The 75 per cent ceiling

APRA has also stated it expects insurers to limit income protection benefit amounts from 1 July 2021. New policies written from that date will not be permitted to pay more than 100 per cent of earnings for the first six months of the claim, and 75 per cent of earnings thereafter (up to a maximum of $30,000 a month).

What does this mean?

The limit for the first six months will likely not have a great impact. Few insurers would offer such a high percentage of income as a benefit – commonly insurers have kept benefit amounts below 100 per cent to provide an incentive to the insured to go back to work. The 100 per cent limit also aligns with restrictions imposed by the temporary incapacity condition of release.

The 75 per cent limit thereafter would cause most insurers to reduce the insured amounts they offer on their income protection policies. Benefits of over 80

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per cent are available in the marketplace currently.

The wording of the APRA letter uses the term 'earnings' rather than 'income', which could be interpreted as including things like employer superannuation benefits and non-cash payments.

Many insurers offer add-on benefits, such as a superannuation guarantee benefit that pays an additional 9.5 per cent on top of the standard percentage. If limited to 75 per cent of earnings, such a benefit would need to be reduced or restructured.

Example
Beryl earns $100,000, plus $10,000 in superannuation guarantee contributions from her employer, in 2021/22. If her earnings including super are $110,000 (and APRA interprets them to be that amount), the maximum 75 per cent income protection benefit would be $82,500 a year.

It is important to note not all add-on benefits to income protection policies align with the temporary incapacity condition of release.

Similarly, automatic benefit indexation during a claim could result in the 75 per cent rule being breached shortly after a claim commences. Insurers may need to remove such indexation from their terms on new policies unless APRA specifically allows it.

Example
Carl earns $100,000 in the 12 months up to his temporary disablement. The income protection policy in his SMSF pays 75 per cent of his pre-disability income, with an annual indexation of benefit payments. For the first year of payment, Carl's income protection benefits will not exceed APRA's 75 per cent limit. On the first anniversary of his claim, his benefit will increase by the consumer price index. This will result in the benefit payment exceeding APRA's limit of 75 per cent of pre-disability earnings.

Under the new rules, APRA would not allow his income protection benefit amount to be indexed.

No guarantee of renewal

APRA will require insurers to limit contract terms on income protection policies from 1 July 2021 as well. Initial contract terms will be limited to five years, with those insured able to renew the contract for a period not exceeding a further five years on updated terms offered by the insurer.

What does this mean?

Currently, most insurers offer income protection policies with terms allowing the insurer to amend the premium each year while also allowing the insured to accept the premium on the same contractual terms as the previous year. This can be a good or a bad thing for both the insured and the insurer, depending on whether the updated terms used by the insurer are broader or more narrow (or a combination of both).

By removing this guaranteed renewability, APRA is making sure insurers don't insure people on a wide range of contracts. Every five years (at the maximum) the insured's contract will be brought into line with the insurer's most recent set of terms.

Maximum contract terms will require policy owners, including SMSFs, to reassess the contract critically at least every five years. SMSF members, as led by their advisers, should be doing so anyway to ensure their policy remains a suitable one for them given the alternative market offerings.

Limit on long benefit periods

While less prescriptive, APRA also states in its letter an expectation that insurers put in place controls to limit long benefit periods on income protection policies from 1 July 2021.

What does this mean?

This is harder to determine. The obvious target of this request are policies with benefit periods up to an age (be it 60,

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65, 70 or beyond). How insurers interpret the request, and practically apply it to the policies they offer, is unknown. APRA seems to want insurers to employ definitions of disability that grow harder to meet the longer the insured is on a claim, thus encouraging the claimant to return to work.

It is quite possible insurers will implement this request as it could serve to limit their claim liabilities. That said, no insurer will want to be the first with a tougher disability definition. Based on prior experience of APRA asking for action in a non-specific fashion, it would come as no surprise if insurers did little until asked to do so in a more prescriptive manner that is enforceable industry-wide.

Knowledge of insurers' terms critical

The only way to manage these reforms is for advisers to stay up to date with insurers' changing contract terms. Planners need to refamiliarise themselves with insurers' contract terms if they haven't done so since 31 March 2020. Similarly, they will need to go through this process again on 31 July next year.

One of the difficulties in managing this change is that APRA's letter is not legislation, nor is it currently in the form of a regulator policy, and detailed issues will need to be addressed by the regulator itself. How APRA communicates its opinion on these detailed issues will be key to informing members and advisers about the changes.