The impact of individual income protection on universal credit and the implication for policyholders

A report by the New Policy Institute
for the Association of British Insurers

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Executive summary and conclusions

This report has been commissioned by the Association of British Insurers to inform the industry about universal credit (UC) and the Government and others involved with UC about individual income protection (IIP).

Individual income protection and universal credit

IIP is a form of private insurance bought by individuals to provide them with an income if they become unable to work due to illness or injury.

148,000 policies were sold in 2018, up more than 50% on 2014. In 2017, some one million policies were in force. At the start of 2018, there were 10,600 claims in payment.

UC is becoming the main means-tested social security benefit for working-age adults. A means-tested benefit is one in which the amount paid out depends on how much income a household has from other sources.

By the time it is fully rolled out in mid-2024, UC is expected to have a caseload of some seven million working-age households. UC is paid to households in work as well as households where no one is working.

It is in the interest of both the Government, employers, and the insurance industry to incentivise claimants to return to work after a period of sickness. Although there are important differences between IIP and UC, IIP has the twin aims of providing financial support for those who are unable to work and practical support to help individuals return to the workplace as soon as possible.

Focus of the report

The purpose of this report is:

- to explain the demographics and economic characteristics of individuals who purchase IIP;
- to explain the associated interaction between IIP and UC; and
- to set out why it matters.

Demographic and economic characteristics of IIP policyholders

We have analysed anonymised data on the age, sex and earnings for a sample of some 260,000 policyholders with four companies. Most of these policies were written from 2016 to 2018.

Compared with the working population aged 25 to 64:

- the sample of IIP policyholders is younger, with four in five being under 45-years-old;
- the proportion of IIP policyholders who are paid more than £50,000 is no higher – two-thirds of policyholders earn between £10,000 and £40,000;
- more policyholders own their home with a mortgage or are tenants; fewer own outright.

The average value of an IIP benefit is 45% of the policyholder's earnings.

The impact of IIP on UC

54% of all IIP policyholders are estimated to have an entitlement to UC if they become unable to work due to illness or injury and have no IIP to support them.

UC regulations prescribe that as a form of unearned income, an IIP benefit reduces UC entitlement £ for £. When account is taken of the IIP in payment, it is estimated that:

- 39% of all policyholders would have their entitlement to UC ("without IIP") removed by IIP;
- 15% of all policyholders would continue to be entitled to a UC award alongside their IIP.

The impact of UC on IIP

A UC award has no impact on the cash value of IIP but it does have an impact on its net value, that is, the amount by which a policyholder is better off with IIP than without. This "better-off" calculation compares a notional UC award in the absence of IIP with the cash value of the IIP benefit.

About 1 in 5 of all IIP policyholders are estimated to be no better off at the point of claim if they have IIP than if they do not. Put another way, a significant minority of policyholders could decide, at the point of claim, that their policy has little or no monetary value.

A purely financial calculation takes no account of the other differences between IIP and UC. It cannot therefore be definitive but it does place a question mark over IIP. This doubt about IIP seems easy to grasp because it is about money alone.

Other principal findings

Uncertainty about future household circumstances amplifies the problem. At the point when people are considering whether to take out an IIP policy, often years in advance, more than 1 in 5 could reasonably worry that they might be one of those whose policy turns out to have little or no monetary value should they come to claim on it.

Since the decision to take out a policy is usually made on the basis of a recommendation from a financial adviser, it is not just uncertainty in the mind of the potential policyholder that matters but also the uncertainty in the mind of the adviser.

The clarification regarding mortgage repayments helps address the problem of uncertainty: so long as their repayments qualify, a policyholder will now always be better off with IIP than without. But the clarification does not benefit tenants who are the majority of those whose IIP policies have little or no monetary value.

It is possible that some policyholders with an IIP benefit in payment may find their support from state benefits drop as they migrate from a legacy benefit (such as tax credits) to UC or lose the transitional protection attached to their UC award.

Having no entitlement to statutory sick pay, those who are self-employed are more likely to have a need for IIP as soon as they become unable to work, even if that need is only temporary. But as unearned income, IIP is treated less favourably by UC regulations than SSP which is earned income.

Why this matters

From the point of view of current policyholders, the question mark hanging over IIP is a clear problem with obscure roots. They could not have been expected to have anticipated this problem when purchasing their IIP, nor is there anything they could have done about it. The factors that influence it are either uncertain or beyond the control of the policyholder when they take out their policy.

From the point of view of the Government, IIP saves it money by reducing UC (saving around three quarters of the UC that would have been paid to policyholders if they did not have IIP). A retreat from IIP by low- and middle-income earners would push up public spending on social security.

The private and wider public interest in an insurance-based benefit like IIP is that it is better at promoting long-term resilience. Being more stable and certain than UC, IIP's net value may rise over time for someone who cannot work for a prolonged period. Additionally, unlike means-tested support, IIP does not discourage or limit savings.

Conclusion

The two-thirds of policyholders earning between £10,000 and £40,000 confirms that IIP is in no way confined to high earners. The 54% of policyholders with a potential UC entitlement if they could not work confirms the importance of the UC-IIP overlap. Yet policyholders, and especially potential policyholders, face uncertainty about what an IIP policy might turn out to be worth if they need to claim on it.

This report was produced to enable the Government and the insurance industry to understand better the current consumer demographics and economic characteristics. The question mark over IIP is clearly a problem for IIP providers but there appears to be the basis for a dialogue with Government about it.

A suitable objective would be to ensure that IIP should always have a positive net value for policyholders.

The clarification around mortgage payments appears to do this but it cannot help tenants. Something with a similar effect to the treatment of mortgage repayments but designed for tenants would offer consistency across housing tenures.

The potential of IIP to serve as an alternative to SSP for those who are self-employed may be limited by the different ways they are treated under UC, as unearned and earned income respectively.

Whether the process of migration from legacy benefits to UC over the next four years will cause problems for policyholders already receiving a benefit is uncertain. Industry and the Government should keep the matter under joint review.