



Association of British Insurers

WELFARE REFORM

FOR THE 21ST CENTURY

The role of income protection insurance

Contents

3	Introduction
4	Executive Summary
7	Understanding the problem
13	The impact of serious illness or injury
15	Income Protection
18	Barriers to buying IP
20	The role of employers and the workplace
21	International and alternative models
23	Looking to the future
24	Summary

Introduction

The purpose of this paper is to consider options for further welfare reform, and the role that Income Protection insurance (IP) can play in a new welfare framework. The paper explains how IP works, including its interaction with the current welfare system. We address the impact of employee ill health on productivity, household income and the economy, and explain how IP provided through the workplace supports all three through better management of employee absence due to ill health or injury.

Alternative models of combining state and private insurance are explored, including some more innovative international models. The case is made that it is time to think differently and create a new framework that will make it easy for people to see how much support they will get from the state and their employer, and put in place their own safety net that meets their needs.

This paper will be of interest to anyone engaged in the policy debate on welfare reform; household financial resilience; the impacts of ill health or disability on households, businesses, and the economy; the benefits of early healthcare rehabilitation; the role of employers; and the role of income insurance.

‘It is time to think differently about welfare, income protection insurance and what is required to ensure more households can cope with unexpected financial shocks.’

Executive summary

It is now widely recognised across the political spectrum that economic and demographic factors are creating irresistible pressure for further reform of the UK welfare system, to reduce the cost of the welfare budget to a level that is affordable and sustainable for the UK economy.

Yet even under existing levels of welfare spending many working age households in the UK have little or no safety net to fall back on if their income falls significantly, for example if one earner in the household is unable to work for more than a few weeks due to illness or injury.

The reality is that millions of UK households relying on income from employment have not put in place a realistic safety net.

- Each year one million workers suddenly find themselves unable to work due to serious illness or injury.
- Around 250,000 people leave employment each year due to ill health, around 1% of the workforce. 60% of these are the main household earner.
- There are a very large number of middle income working age households that would see their household incomes fall substantially if the main earner left work due to ill health.
 - 10.8 million households – more than 60% of working families - would see their income fall by more than one third if the main earner had to stop work due to ill health, and they have no insurance to give them a financial safety net if this happens.
 - Of these, 6.6 million households – about 40% of working families - would see their income fall by more than half without insurance to provide a safety net.

Policy under future governments needs to be much more effective in motivating greater personal responsibility and self-sufficiency in managing the balance between household income and spending. Government needs to communicate very clearly and consistently that the welfare system is a safety net against absolute poverty – it does not exist to replace income from employment.

THE UK WELFARE SYSTEM IS BASED ON A FUNDAMENTALLY FLAWED ASSUMPTION THAT HOUSEHOLDS THAT WILL GET LITTLE OR NO SUPPORT FROM THE STATE RECOGNISE THIS, AND ACT TO PUT IN PLACE THEIR OWN SAFETY NET.

EACH YEAR ONE MILLION WORKERS SUDDENLY FIND THEMSELVES UNABLE TO WORK DUE TO SERIOUS ILLNESS OR INJURY.

Private income protection insurance (IP) should form an important part of the solution to further welfare reform, both to help reduce the cost of welfare and increase household income safety nets. IP is a form of contributory benefit. Households that are covered by IP receive an income from the insurer that replaces their employment (or self-employment) income – at a level they need - when they are unable to work due to illness or injury.

The challenges of improving working age financial security, while preventing the cost of state support spiralling out of control, are very similar to the challenges that led to fundamental reform of pension provision, and to current policy on meeting the growing costs of long term care. As a nation we have recognised that the model of state provision we have relied on for decades is not economically viable for the future, and new approaches are needed. Pension reform is an important first step on that journey, but now we need to continue the journey to address working age income insecurity.

Households need a system that will give them a crystal clear understanding of:

- how much income support they can get from the state if they have to stop work due to ill health;
- how much income support they will get from their employer; and
- how they can top up their income safety net to the level they need.

There is clear potential for the insurance industry to contribute to building and delivering new models combining state and private provision that are fit for the future. In particular we see great potential for greater use of insurance based income safety nets through the workplace as part of the solution.

The ABI is engaging with policy makers, employer representative bodies, and other interested stakeholders to develop detailed proposals for a greater role for employers in providing insurance based income safety nets through the workplace.

Income risks facing households and government

Ideas and opinions abound about how the welfare system should be reformed. Some ideas focus on refining the existing welfare model, others advocate more radical reforms. There is growing political support for creating a stronger contributory element to give households that contribute the most a higher level of support in return.

But in order to create solutions that will work in practice to deliver a fair, effective and economically viable model, a strong evidence base and understanding of the problem and the challenges involved is needed.

Current welfare policy – and indeed policy over recent decades – assumes that households that would get a poor income replacement rate from the State will realise this and take action to put in place a private safety net. The reality is that relatively few households in this situation have put an adequate safety net in place. In part the problem is caused by households not having a clear and accurate understanding of how much income support they would be entitled to, from the State and from their employer, if they were to need it.

The welfare system is extremely complex (and will remain so even with the full implementation of Universal Credit) but no government has made any concerted effort to inform households about the level of support they can expect from the State if they fall on hard times. The picture is confusing even for professionals. For individuals and families, it is all but impenetrable. In addition, most people do not adequately consider the potential risk of something preventing them from working, or the impacts of the loss of employment income on their household finances.

There are powerful psychological and behavioural factors that have a negative influence on households putting in place an adequate safety net to protect themselves against these risks:

- Optimism and confirmation biases – “Nothing really bad will happen to me or my family”;
- Excess confidence and low accuracy in ability to assess the probability of future events;
- Difficulty in judging trade-offs between the

present and the (uncertain) future. Greater weight is given to the (certain) present – such as the cost of an insurance premium – than the (uncertain) future benefit of income from a claim on that insurance;

- Emotions such as fear of loss and regret (loss aversion) often have a stronger influence over decisions than an objective assessment of costs and benefits.

Even for households that decide they want to put in place a greater safety net than the State will provide, there are complex interactions between private safety nets and State support.

Policy makers must recognise that the assumptions underpinning current welfare policy are flawed. If further welfare reform is to achieve its objectives it must be informed by an accurate understanding of household income risks, as well as household behaviour in managing them. It must also ensure that the interaction between private, State and employer income safety nets is easy for households to understand and produces clear, predictable and appropriate outcomes.

How can insurance contribute to new safety net solutions?

This paper builds on the growing debate about the role of the welfare system and the right balance between State and self-provision of safety nets. It aims to contribute to the evidence base and the understanding of the problem, but also to illustrate how greater use of private insurance based solutions can contribute to further welfare reform, particularly through the workplace.

Insurance based solutions can play an important role in providing the right type and level of safety net that diverse modern households need, but which a taxpayer funded State model struggles to provide. Indeed, it is difficult to see how it is possible to both reduce the cost of the welfare budget to taxpayers and, at the same time, increase safety nets for households through a tax and National Insurance funded State model.

In order to reduce the cost of the welfare budget, many more households need to have a safety net outside of the welfare system. IP is a private contributory safety net. It replaces lost employment (or self-employment) income when an individual is forced to stop work due to serious illness or injury.

Parliament has already recognised the power and importance of innovative workplace solutions in overcoming the psychological and behavioural forces that inhibit people acting to support their financial wellbeing in retirement, by introducing workplace pension automatic enrolment.

The current Government has recognised the important impact of early health and rehabilitation support on how fast and how far someone recovers from illness or injury, and therefore their ability to return to work. In light of this, the Government is reforming State support for those who sign off work due to ill health, by implementing the main recommendations of the independent review into sickness absence led by Dame Carol Black and David Frost¹, 'Health at work – an independent review of sickness absence'. The new 'Health and Work Service' is to be implemented as a result of recommendations from the Black/Frost Review and will provide advice and signposting to those off work for health reasons for more than a month. It will be funded through the abolition of a previous subsidy for employers with high levels of sickness absence (the Percentage Threshold Scheme). The service will not, however, go so far as to provide or arrange rehabilitation support. This will be left to the individual, hopefully with the help of their employer or GP. This contrasts with rehabilitation services provided by insurers for those IP claimants where it is judged that rehabilitation support can make a significant difference to recovery.

Given the context of institutional welfare reforms, the shrinking income safety net available through the State, and the potential for greater use of rehabilitation services to support recovery, it is time to review the role of IP, the interaction between private and State insurance, and the role of employers in building necessary and affordable income safety net solutions.

“For many households with moderate incomes, ESA will no longer provide a long-term safety net against ill health or disability.”

¹Black, C. and Frost, D. (2011) Health at work – an independent review of sickness absence, Department for Work and Pensions

Understanding the problem

The ABI asked the Centre for Economic and Social Inclusion (CESI) to conduct research and analysis to identify what impact loss of employment income has on households' income, taking into account entitlement to State income support through welfare and tax credits. (Through the rest of the paper we will use 'welfare' to refer to all forms of State income support.) The ABI asked CESI to focus their work on loss of employment income due to serious illness or injury impacting ability to work, and to identify types and numbers of households that would experience a significant drop in income, and those that would not. We then asked them to compare the impact on household income with - and without - IP.

The objectives of this work were to:

- Identify the types and numbers of households that would (and would not) have a significantly better income safety net with IP;
- Identify the nature and scale of the issues;
- Build the evidence base around the fit between IP, State welfare and household risks;
- Provide a basis for more informed debate on the role of private and State insurance in meeting households' income safety net needs; and
- Scope out key areas for future policy development.

CESI assessed the direction of travel for welfare, including reforms already introduced under Universal Credit. Changes made to put a time limit entitlement to contributory Employment Support Allowance (ESA) are particularly important when considering the potential role of private insurance. For many households with moderate incomes, particularly those with two or more employed earners, ESA will no longer provide a long-term safety net against ill health or disability.

BY 'INCOME REPLACEMENT RATE' WE MEAN HOUSEHOLD INCOME AFTER AN INDIVIDUAL HAS STOPPED WORK, INCLUDING ANY INCOME FROM STATE SUPPORT, AS A PROPORTION OF HOUSEHOLD INCOME WHEN THAT INDIVIDUAL WAS WORKING.

CESI used the Family Resource Survey and other sources of data to divide the employed population into 200 household types, and welfare entitlement calculator software to model income replacement rates from welfare and tax credits in the event of losing employment income due to ill health or disability.

By 'income replacement rate' we mean household income after an individual has stopped work, including any income from State support, as a proportion of household income when that individual was working.

CESI focused on long term absence from work, so modelled incomes after the expiry of Statutory Sick Pay (SSP) and Contributory Employment Support Allowance (ESA). The CESI research showed that for those who fall out of work due to ill health or disability, where previous earnings were low and other household income is nil or low, the State system will generally provide a decent income replacement rate. The State provides little or no support – and a low income replacement rate – for those with moderate or higher earnings, and other household income.

However, the picture is far more complicated for middle income households. Entitlement to State support is based not only on income, but also on whether the household has children, savings, a second income, and whether the home is owned or rented. Two households with a similar level of income can therefore receive very different levels of State support based on these factors.

CESI found that there are 10.8 million middle income households in the UK that would be entitled to relatively little or no State support if the principal earner had to stop work, and would see their income drop substantially if they rely on State support alone as their income safety net.

What happens if an employee leaves work due to ill health?

When an employee leaves work due to ill health or disability, employers are required to pay Statutory Sick Pay (SSP) for up to 28 weeks. SSP pays just under £90 per week for up to 28 weeks. But nearly half (43%) of employers offer some form of sick pay provision over and above minimum statutory requirements in the form of Occupational Sick Pay (OSP). At the point where SSP is no longer payable, if an employee does not have access to further OSP they can submit a claim for State welfare benefits. If they have paid National Insurance for at least two years they can claim contributory Employment and Support Allowance (ESA).

The Carol Black and David Frost 'Health at Work Review' estimated that around 110,000 people move from SSP or OSP to claiming ESA each year – i.e. they were unable to work for more than 28 weeks - with a further 140,000 moving straight from employment to claiming ESA.

ESA is paid initially for 13 weeks at around £70 per week, during which there is a Work Capability Assessment to determine whether the individual is entitled to the benefit. Around one third of ESA claimants end their claim before the assessment is complete, most because they get better and return to work. A further third are judged 'fit for work' and so not entitled to benefit. They can submit a claim for Jobseeker's Allowance, which has tougher conditions and is paid at £70 a week. The remaining ESA claimants receive around £100-110 per week, and about half are required either to join the Government's 'Work Programme' or attend regular interviews at Jobcentre Plus.

As a result of recent welfare reforms, contributory ESA can be claimed for only one year. After this time (and for those who do not qualify for Contributory ESA), income-based

ESA is available. This pays at the same rates but is very tightly means-tested. Those living in households with no other source of income will usually qualify for income-based ESA, but other sources of income (earnings, savings, pension and insurance income) are usually deducted £ for £ from the amount of ESA claimable.

Self-employed people are not entitled to SSP, so if they do not have other forms of protection (like IP) they can immediately claim ESA if they are unable to work. Around 80,000 per year are estimated to do so.

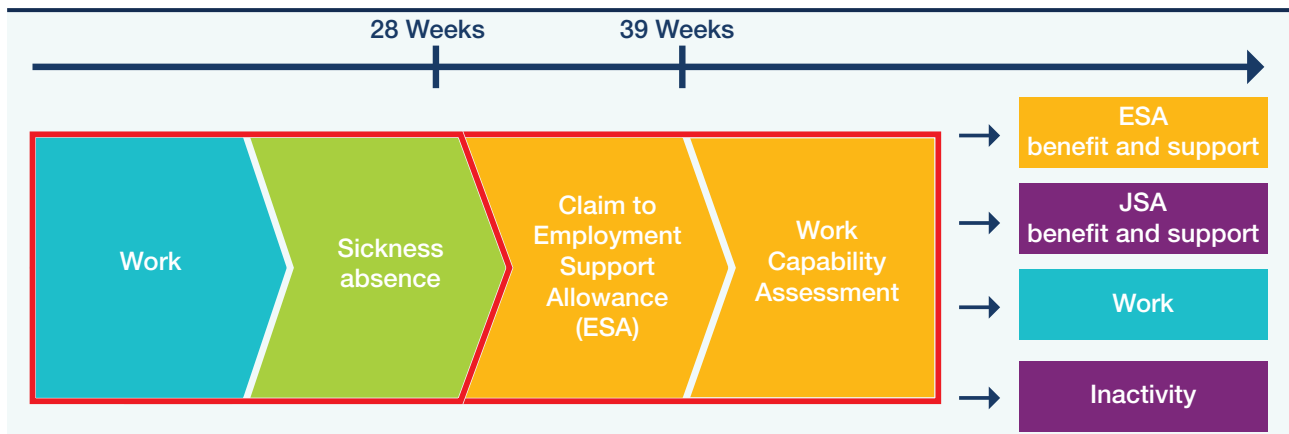
In addition to Employment and Support Allowance, the welfare system provides the following means-tested support for those on low incomes:

- **Tax credits** provide financial support for those with children, and for some workers on very low incomes without children;
- **Housing Benefit** provides (partial) support for the costs of renting accommodation; and
- **Support for Mortgage Interest** provides time-limited support for mortgage holders.

The Personal Independence Payment also provides non-means-tested financial support to disabled people who meet qualifying criteria related to their care and mobility needs. This has recently replaced the Disability Living Allowance, which continues to be paid to existing claimants.

The 'journey' through statutory occupational and state support is set out below. As this illustrates, many of those leaving work due to ill health will only engage with structured, State-funded support after being off work for a year or more, if they receive support at all. Overall, IP does not fit easily into this State welfare 'journey'. Group IP policies (GIP) effectively occupy the space before an ESA claim is made; while individual policies (IIP) run alongside, and interact with, all stages of the welfare journey.

The journey through occupational and State support (Source: Black / Frost Review, 2011)



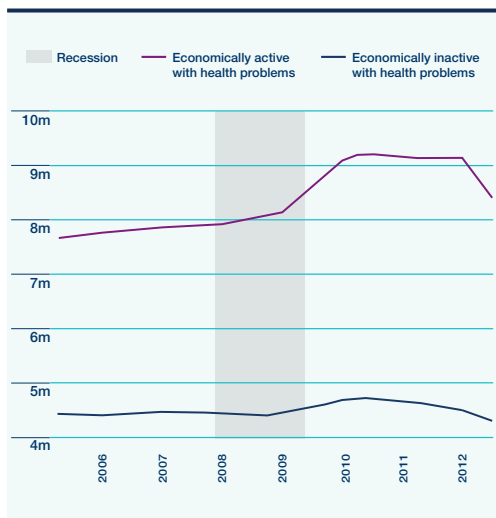
Trends in Health and Work

The Black / Frost 'Health at Work Review' found that every year 140 million working days are lost due to sickness absence, equivalent to 2.2% of working time with a cost to employers of £9 billion per year. Most of this absence is short term, but each year one million workers are off sick long term (for more than four weeks).

Although high, sickness absence levels have been in decline in recent years. A 2013 CBI survey of employers echoed the findings that absence (not just sickness absence) levels are at record lows, currently 5.3 days per employee per year.² On the other hand, CESI's analysis of Labour Force Survey data suggests that the incidence of poor health among the working population has not declined – and may even have increased. This is illustrated below.

Number reporting health problems, by economic status

(Source: Labour Force Survey & CESI analysis)



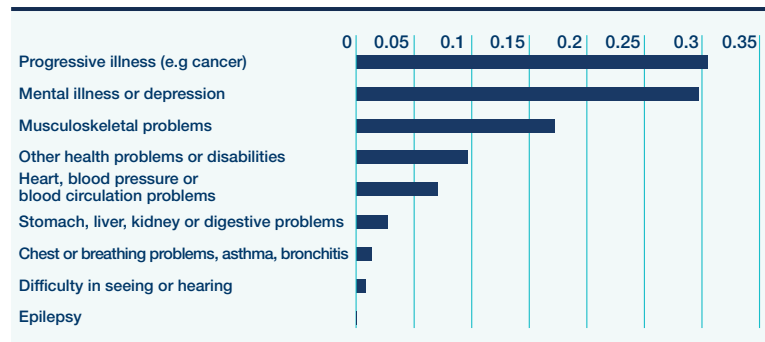
These trends show a steady increase in the number of people in work with health problems (the dip at the end most likely reflects sampling variations) while the number out of work with health problems is broadly flat. This may reflect employers and employees getting better at managing health conditions in the workplace, or a greater pressure on employees to stay in work when ill or injured.

'Economically active' includes people who are currently unemployed but looking for employment, or required by the State to look for employment to qualify for certain welfare benefits. So part of the growth may be accounted for by reforms that have made it harder to claim ESA, which in turn means that more people who might previously have been on ESA are instead on JSA, and required to actively look for employment.

CESI's analysis finds a strong workplace growth in mental illness (which has more than doubled since 2005) and depression/ anxiety, with growth also in progressive illnesses (e.g. Cancer, Multiple Sclerosis, Parkinson's Disease, Muscular Dystrophy, Diabetes).

Reason for IP claims

(Source: CESI / ABI data collection)



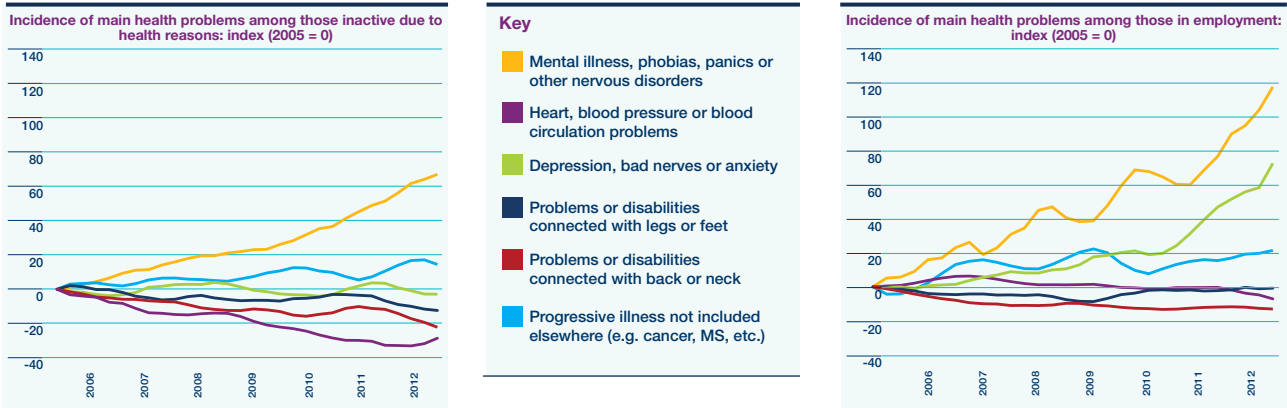
²CBI (2013) Fit for Purpose: Absence and workplace health survey 2013

An OECD report published in January 2014 found that mental ill health costs the UK economy £70 billion a year - the equivalent of 4.5% of GDP – through lost productivity, State welfare benefits and healthcare payments. For those out of work, there is similar but smaller growth in both depression and progressive conditions. This is illustrated in the figure below.

“6.6m households would see their income fall by more than half if the principal earner left work due to ill health.”

Change in incidence of main health problems

(Source: Labour Force Survey & CESI analysis)



Characteristics of people that leave work due to ill health

CESI found that around 250,000 people each year leave employment due to ill health – equivalent to around 1% of the workforce. 60% of these are the main household earner.

Those who leave work due to ill health are generally lower paid than the workforce as a whole, with an average salary of £15,000 (and hourly pay of £8.60 on average). This group are

somewhat more likely to be working part time, but no more likely to be women than men. These lower wages are also reflected in the broad occupational groups of those leaving work due to ill health. The figure below shows the relative likelihood of individuals in different occupations leaving work due to ill health.

Proportion of workforce each quarter who are inactive due to health reasons one year later

(Source: Labour Force Survey & CESI analysis)

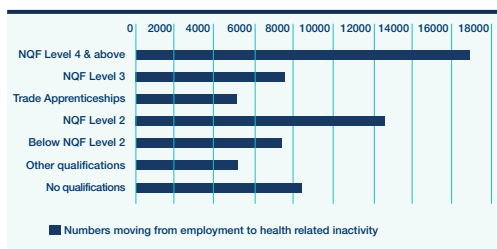
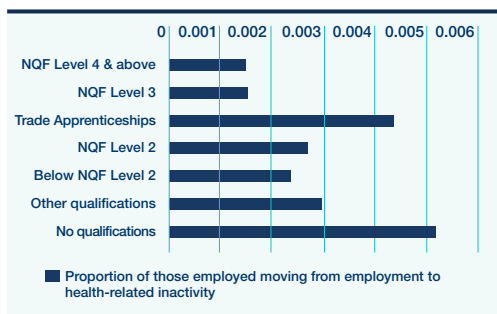


This clearly shows that risks are greater in lower level occupations than in those that are more senior – with someone in an elementary occupation at least four times more likely to leave work due to ill health than someone in a senior profession. However, those in skilled trades and middle-level occupations also have above average likelihoods of leaving work. We see similar trends in individuals’ qualifications – with those with low or no qualifications (and those with trade apprenticeships) around twice as likely to leave work due to ill health as those with A Levels or degrees.

However, it is important to note that the absolute number of people with degrees that leave work due to ill health are substantially higher than the number with lower qualifications.

The number and proportion leaving work due to ill health, by highest qualification held

(Source: Labour Force Survey and CESI analysis)

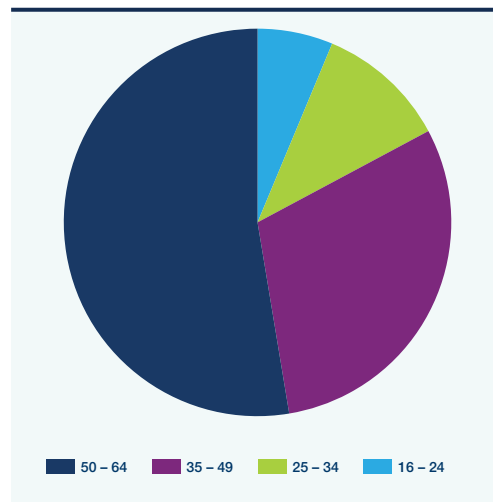


Around 2.2 million people of working age are economically inactive (not in work, looking for work, or available to work) primarily due to ill health. This number has fallen by around 10% since 2005, but most in this group have been inactive for at least 5 years, and are substantially more likely to be older, with more than half aged over 50.

This presents an economic problem in light of the need for many people to continue working later in life to meet living costs, save for retirement, and delay drawing on pension savings. It also presents a social and healthcare problem, given the ample evidence – as highlighted in the Frost / Black report – that continuing to work as late as possible in life produces enormous benefits in physical and mental wellbeing.

Economic inactivity for health reasons by age

(Source: Labour Force Survey and CESI analysis)



The Nations and Regions of the UK

There is a clear national and regional dimension to the likelihood of leaving work due to ill health. As shown in the diagram below, those living in Wales are twice as likely, and those in the North West around 50% more likely, to leave work due to ill health than in almost any other nation or region of the UK. The South West and the North East also have relatively high probabilities of leaving work. For all other nations and regions, less than 1% leave work each year.

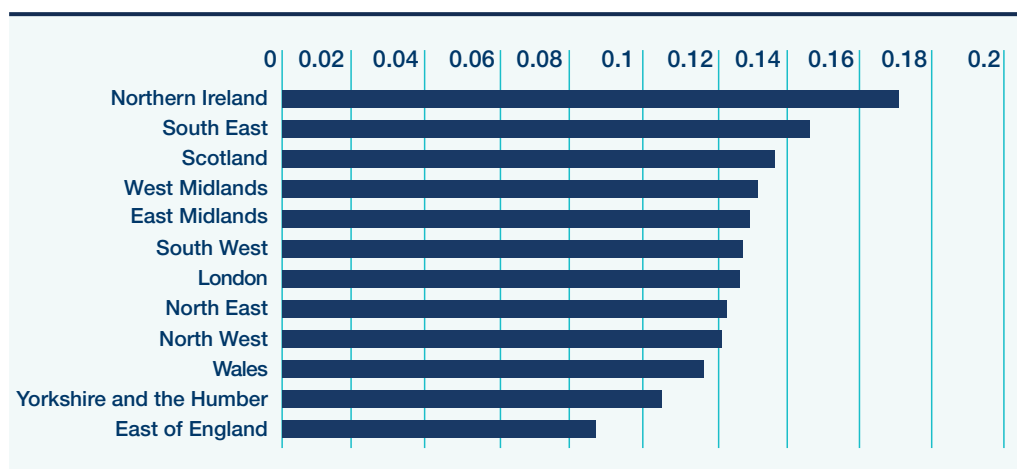
Number and proportion leaving work due to ill health, by Nation and Region

(Source: Labour Force Survey and CESI analysis)

Region	Numbers moving from employment to health-related inactivity per quarter	Proportion of those employed moving from employment to health-related inactivity per quarter
North West	10,365	0.33%
South East	8,018	0.19%
London	7,578	0.20%
South West	6,447	0.26%
Scotland	5,533	0.22%
Wales	5,184	0.39%
Yorkshire & Humberside	4,612	0.19%
West Midlands	4,529	0.19%
East of England	4,415	0.16%
East Midlands	3,843	0.18%
North East	2,960	0.27%
Northern Ireland	1,244	0.16%

By comparison, the following figure shows the estimated proportion of the workforce with IP by nation and region, and demonstrates a particularly strong mismatch between need and use of IP in Wales and the North West.

(Source: CESI / ABI data).



The impact of serious illness or injury

In addition to the obvious financial impacts of losing an employment income, households often face additional expenses as a result of a serious illness or injury. Evidence from Macmillan, for example, highlights the costs of cancer of someone suffering cancer.

Macmillan 'Cancer's Hidden Price Tag' survey report published April 2013³ shows that:

- 4 out of 5 cancer patients were hit by the financial cost of cancer, which averaged around £570 a month for those affected. This is comparable to the average monthly cost of a mortgage.
- 85% of cancer patients experienced extra expenditure costs, averaging around £270 a month. Typical extra costs included travel to and from medical appointments, appointment parking costs, treatment prescription costs, home help or live-in support.
- 54% of cancer patients experienced higher day-to-day living costs as a result of their diagnosis (e.g. higher fuel bills as they spend more time at home), which cost them on average £63 a month.
- 51% of cancer patients were in work when diagnosed with cancer. 33% stopped working permanently or temporarily, while 8% reduced their working hours or took unpaid leave.
- 30% cancer patients experience a loss of income - because they are unable to continue working or need to reduce their working hours - which costs an average of £860 a month for those affected.
- 47% of cancer patients' financial situation gets worse after diagnosis.

42% COULD SURVIVE ONLY A COUPLE OF MONTHS ON THEIR SAVINGS. ONLY 26% COULD SURVIVE ONE YEAR OR MORE.

Are savings a safety net?

Multiple sources of research tell us that many households have very little or no savings to fall back on, to replace lost employment income. For example, the Scottish Widows 2013 Protection Report⁴ and 2014 Savings Report⁵ showed that:

- 19% of people have no savings
- 23% of 35-49 year olds have no savings
- 22% of 18 to 34 year olds have no savings.
- 14% of people aged 50+ have no savings.
- 15% don't know how much savings they have
- 55% have between £1 and £50,000 in savings
- 12% have over £50,000 in savings.
- 47% have savings under £20,000
- Only 21% have savings over £20,000

When the Scottish Widows survey asked how long do you think your savings would last, responses were:

- Less than one month: 14%
- One month: 7%
- A couple of months: 21%
- Six months: 15%
- One year: 10%
- A couple of years: 16%

So 42% could survive only a couple of months on their savings. Only 26% could survive one year or more.

The obvious conclusion is that it is unrealistic for the vast majority of households to rely on savings as a safety net against loss of employment income. Savings take a long time to build up. They are often dipped into for planned and unplanned expenses. Contrast this to IP, which provides the level of income replacement chosen from day one of the contract.

³Macmillan (April 2013) 'Cancer's Hidden Price Tag', <http://www.macmillan.org.uk/Documents/GetInvolved/Campaigns/Costofcancer/Cancers-Hidden-Price-Tag-report-England.pdf>

⁴Scottish Widows (April 2013) 'Protecting our Future report - Britain's Protection Landscape'

⁵Scottish Widows (2014) 'Savings Report 2014'

The financial impact of low savings

Households that do not have large savings, or a source of income to replace the lost income, find themselves in serious financial difficulties, unable to meet financial commitments such as, mortgage or rent and other credit repayments. Increasing use of credit to make ends meet, but which they can not afford to repay, can lead to them spiralling into unmanageable debt.

The Citizens Advice Bureau report⁶ that

Illness and disability was the third major reason for debt problems given by clients in in the 2008 survey (24% of clients gave this as a reason for their debt). In many cases, the debt had arisen when the client had to give up work because of their ill health. In other cases, the client had to give up work to care for an ill or disabled relative. Not only do the clients' income drop, but also their expenditure may rise because they need to keep the heating on for longer or require a special, more expensive diet".

It also matters to the economy. Households in this situation are unable to pay their bills in full. They have to substantially reduce their spending and therefore, the money they contribute to the economy through purchasing goods and services, providing savings that can be used for investment, and through income tax, VAT and National Insurance Contributions.

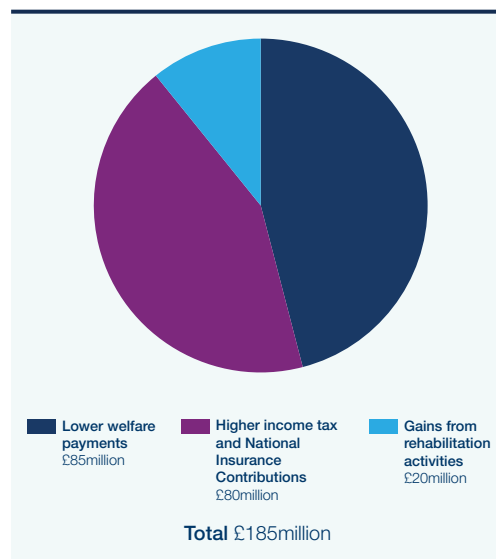
In May 2014 the CBI reported⁷ that in 2012 the direct costs of absence to the economy were estimated at over £14 billion. Total public sector spending on incapacity, disability and injury benefits in 2012-13 was over £36 billion, with Employment Support Allowance being claimed by 2.47 million people in August 2013.

The Malcolm / Zurich report showed that IP claim payments mean that the State pays out less in welfare payments and receives higher taxes than when IP is not in place. Overall UK taxpayers already gain around £165 million annually from the presence of GIP policies (£85 million from lower welfare payments and £80 million from higher income tax and National Insurance Contributions). Individuals with higher incomes also gain by £190 million than in the absence of IP. If UK coverage of IP reached the same level as that seen in the US, the gains to UK taxpayers would be around £725 million.

THE CITIZENS ADVICE BUREAU REPORT THAT:

"ILLNESS AND DISABILITY WAS THE THIRD MAJOR REASON FOR DEBT PROBLEMS GIVEN BY CLIENTS IN THE 2008 SURVEY".

Gains for taxpayers



In addition, financial difficulties create intense stress, and over recent years have contributed to a substantial increase in the numbers of people experiencing mental illness, with the obvious knock on effects on workplace productivity, family and social problems, and pressures on the healthcare system. The Frost / Black report noted that "Stress and mental health disorders are one of the biggest causes of long-term absence and, according to a number of business surveys, are on the increase as a reason for absence. It is estimated that each year 1 in 6 workers in England and Wales is affected by anxiety, depression and unmanageable stress".

An OECD report published in February 2014⁸ reported that "mental ill-health has become a major driver for labour market exclusion in the UK. Each year mental ill-health costs the UK economy £70bn a year – the equivalent to 4.5% of GDP – through lost productivity, social benefits and healthcare costs. Mental disorders have become the most common reason for a disability benefit claim, accounting for 38% of all new claims."

⁶A life in debt – the profile of CAB clients in 2008', Citizens Advice Bureau, February 2009

⁷CBI (May 2014) 'Getting Better – Workplace Health as a Business Issue'

⁸OECD (February 2014) 'Mental Health and Work: United Kingdom, OECD conclusions and recommendations'

Income Protection

There are 17.4 million working households in the UK. The IP market in the UK is small relative to this group, and by international standards⁹. The ABI estimates that there are 1,185,000 people covered by Individual IP (IIP) policies, meaning that individuals buy the insurance cover themselves, typically through a regulated financial adviser. IIP may be particularly attractive to the self-employed, who do not have entitlement to SSP.

Almost twice as many people - 2,016,000 – are covered by Group IP (GIP), meaning policies that are arranged and paid for a group of employees by an employer¹⁰. GIP policies effectively pay the Occupational Sick Pay described above, through the payroll.

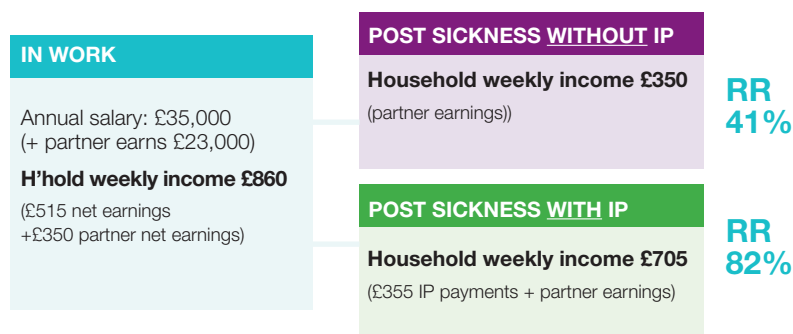
IP policies vary in terms of the level of income replacement they provide – typically between 50% and 75% of earnings before illness / injury. Income from an IIP claim is treated by the government as ‘unearned income’ and is therefore not subject to income tax or National Insurance Contributions. For this reason IIP income replacement is always below 100% of the previous gross earnings. IIP is designed to ensure that a claim does not result in a net individual income that is higher than before the claim. Income from a GIP claim is paid by the employer, through the payroll, at a level equal to or below income before the illness / injury. It is treated by the government as ‘earned income’, subject to income tax and National Insurance Contributions.

When buying IP the consumer or employer can choose what length of ‘deferral period’ they want. The ‘deferral period’ is the time between the individual stopping work due to illness/ injury and when the policy starts paying the replacement income. Deferral periods typically range from 3 months to 2 years, although different IP providers offer different options. The consumer or employer may decide they can use other means to cover short term income loss, but want insurance to cover them if serious illness or injury prevents work for a long period. The length of time for which

replacement income is paid also varies. Some policies will pay until 60 or 65, while some pay for only 1 year, 2 years or 5 years.

Having IP enables households to maintain income levels at, or close to, previous earned income if they have to stop work due to ill health or disability. This is illustrated in the case study below. This is for a working couple without children, who own their own home and moderate to high earnings. Around a quarter of a million families have similar characteristics and earnings to this. In this case, the household has a relatively low income replacement rate (RR) without IP (41%). They are not entitled to any State benefits because of the partner’s earnings, so have to rely entirely on their partner’s earnings. But with IP their income remains much closer to its previous level, with a replacement rate of 82%.

Young couple, healthy, both working, no children, own their own house with a mortgage; IIP at 65%, deferred period of one year - £18.35 per month premium



ABI claims data¹¹ shows that in 2013 insurers paid a total of £138,443,000 in IIP claims to 12,004 households. The industry paid 91% of IIP claims in 2013, which is substantially greater than the one third of ESA claims that lead to a full ESA award.

Around one third of IP claims are due to a progressive illness. A further third are due to mental health problems – such as depression, anxiety or stress. Around one in six claims relate to a musculoskeletal condition.

⁹Wind-Cowie, M. (2011) Of mutual benefit: Personalised welfare for the many, Demos

¹⁰Black, C. and Frost, D. (2011) Health at work – an independent review of sickness absence, Department for Work and Pensions

¹¹<https://www.abi.org.uk/News/News-releases/2014/05/270-families-helped-every-day-by-Life-Critical-Illness-Income-Protection-insurance-payouts-2013>

Interaction between IP and State Welfare

Entitlement to welfare support is subject to means testing – i.e. an assessment of the household’s financial position and needs. Under the current (pre Universal Credit) welfare system income from an IIP claim is treated as ‘unearned income’. This means it is taken into account in calculating entitlement to means-tested welfare benefits, but not in calculating entitlement to tax credits. For every £1 of unearned income a household receives, they lose £1 in entitlement to welfare support. GIP claim income is treated as ‘earned income’ by the government in assessing the individual’s entitlement to welfare benefits. For every £1 in ‘earned income’ entitlement to welfare benefits is reduced by 65 pence. Tax Credits are withdrawn at a rate of 40 pence for every £1 above a threshold, which varies according to household circumstances.

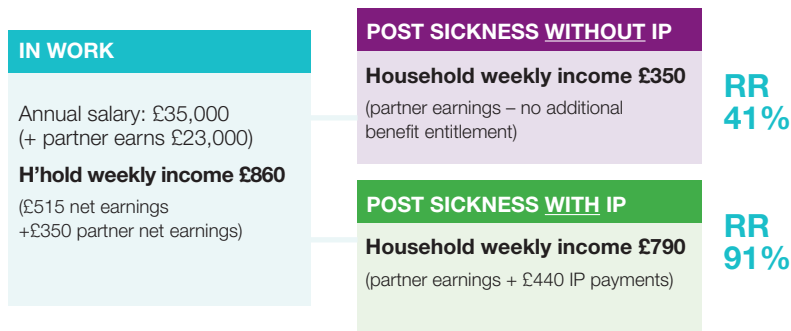
The key factors that determine a household’s replacement rate from State support are:

- Previous earnings – i.e. the income that is being replaced;
- Children;
- Housing tenure – i.e. renting vs. home ownership (including with a mortgage);
- Other household earnings;
- Household savings, which are deemed by the State to provide a source of income.

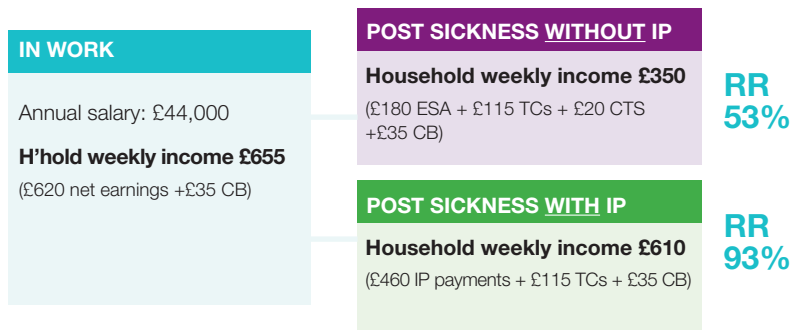
The combined impact of these factors on entitlement to State support, results in wide variations in income replacement rate from State support, even within income bands. For example a household that loses employment income of £25,000 will have a much lower income replacement rate if they have no children and a mortgage than a household that loses the same amount of employment income but has children and rents their home. 3.06 million households with total earnings below £50,000 have a replacement rate of 50% or lower from State support. Households where the principal earner has an income of £60,000 or more have poor replacement rates from State support regardless of their household circumstances.

Under Universal Credit the impact of income from an IP claim on entitlement to welfare benefits and tax credits will change. Across the working population as a whole, the CESI modelling and analysis estimates that income

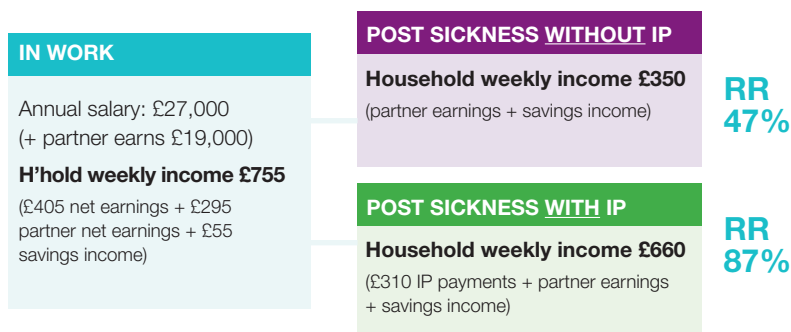
Young couple, healthy, both working, no children, own their own house with a mortgage; IIP at 65%, deferred period of one year - £18.35 per month premium



Single, two children, owns with mortgage; IIP at 55%



Older couple, health problems, both working, no children, mortgage, savings income; IIP at 60%, deferred period one year - £31.40 per month premium

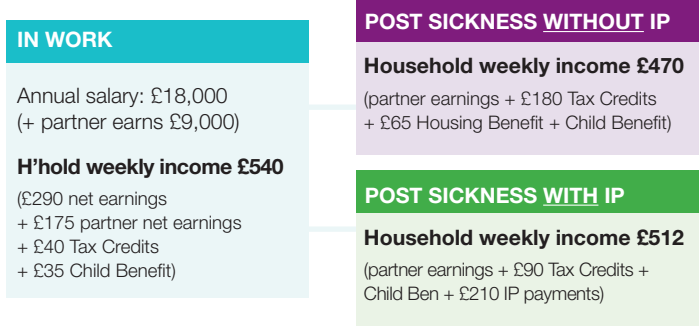


replacement rates under Universal Credit will on average be slightly lower – 57% compared to 60% now - but the variations between household replacement rates will be greater. This is because the equivalent of Tax Credits will take income from IIP into account in calculating entitlement.

The following CESI case studies demonstrate the range of outcomes faced by different types of households (“RR” = income replacement rate).

¹¹<https://www.abi.org.uk/News/News-releases/2014/05/270-families-helped-every-day-by-Life-Critical-Illness-Income-Protection-insurance-payouts-2013>

Couple, both working, two children, renters; GIP at 65%



RR 87%

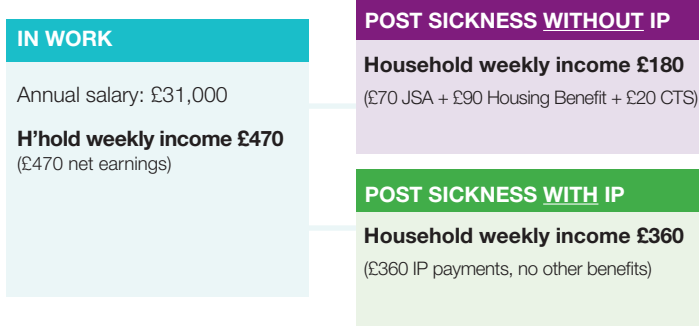
RR 95%

Rehabilitation benefits of IP – getting people back to work faster

In a March 2014 report for Zurich on group IP, Kyla Malcolm highlighted that as well as providing income benefits while individuals are unable to work, GIP insurers also offer early response rehabilitation services that can help individuals return to health and work faster than they otherwise would¹². The success of rehabilitation depends on a range of complex factors including the nature of the disability, the role of the employer, and the motivation of the individual.

A study by the Work Foundation¹³ of 13,000 employees in Madrid with musculo-skeletal problems found that referring employees for specialist treatment after 5 days reduced temporary work absence by 39%, and permanent absence by 50%. It is estimated that 35 million work days are lost across the EU to musculo-skeletal problems each year, at a cost of 2% of EU GDP. The Work Foundation report estimated that if the UK had a similar system, employees would be able to work an extra 62,045 days a year.

Single, no children, renter, self-employed; IIP at 60%



RR 38%

RR 76%

While precise impacts from rehabilitation are difficult to identify in all cases, the annual gains from return to work activities are estimated at around £20 million for taxpayers, £5 million for individuals and £15 million for employers. Taxpayers, individuals and employers are all better off by getting people back to health and back to work as quickly as possible.

CESI's modelling and analysis of households across the UK showed that there are 10.8 million households that would see their income fall substantially if the principal earner left work due to ill health.

- 10.8 million households – more than 60% of working families – would see their incomes fall by more than one third if the principal earner lost employment income due to ill health, even after taking into account entitlement to State support;
- Of these, 6.6 million households – around 40% of working families – would see their incomes fall by more than half.

Building on the recommendations of the Black / Frost review, there are potentially substantial benefits to be gained from increasing the availability of rehabilitation services for employees experiencing serious illness or injury. Rehabilitation will not help in all cases, but for those for which it is effective the benefits are substantial for employee and employer, in terms of faster and fuller recovery to fitness and return to work.

However, robust and statistically significant evidence on the impact of rehabilitation in the UK is lacking. The ABI and CESI see this as an area that merits further evidence gathering and analysis. We also see the potential for the IP industry (and rehabilitation providers) to work with the government's Health and Work Service to gather and assess evidence on the impact of rehabilitation, particularly to assess which types of rehabilitation intervention are most effective. This evidence could then be used to ensure rehabilitation resources are efficiently targeted where they can have greatest impact.

¹² Kyla Malcolm (2014) 'Income Protection – Working together to improve take-up', Zurich
¹³ The Work Foundation, Bevan (2013) 'Reducing temporary work absence through early intervention: the case of MSDs in the EU'

Barriers to buying IP

Research from CESI and other sources identifies four principal reasons for low take-up of IP: perceptions of value, complexity, trust and inertia.

Perceived value

Research suggests that many people simply do not consider that a loss of work due to ill health would happen to them. For example, ABI consumer research (conducted through YouGov) finds that two fifths of consumers had never even thought about what they would do if forced to stop working by a long-term illness or injury¹⁴. For those that do consider the impacts and consequences, the perceived cost of insurance is cited as the most common reason for not taking out a policy.¹⁵ Of course it is true to say that not everyone will experience a serious illness or injury that prevents them working for a significant period. This happens to only 1% of people in work each year. But none of us know if it will happen to us, or someone in our family.

While it is very easy to see the cost of the insurance, it is more difficult for people to anticipate – and therefore weigh up the cost against – the likely benefits of claiming on the insurance. The likelihood and financial impact of a serious illness or injury, and therefore the amount of income that may be received from the insurance, is unpredictable.¹⁶

In reality, this is a more deep-rooted problem than a rational consideration of the costs of premiums against the value of benefits. There is extensive evidence from behavioural science that individuals put more weight on losses than gains (so-called 'loss aversion'), and we place less importance on ("discount") future benefits than we do benefits and costs we can see today.

Complexity

Complexity is created primarily by a combination of the risks and impacts we are asking consumers to understand, and the interaction between IP and State welfare support. The uncertainty and complexity inherent in the welfare system – and in its interaction with IP – contribute to poor understanding of risks.

It also contributes to difficulties in evolving the design of IP to make it simpler and more appealing for consumers. For example, households buying IP want to know how much replacement income they are buying, and how much net income they will have as a result of the insurance. But the complex interaction between State and private insurance makes it all but impossible for many households to calculate the net impact of IP on their household income, taking into account the impact that income from an IP claim would have on their entitlement to State support.

Universal Credit will simplify the welfare system somewhat, but it will remain a complex picture. Replacement rates under Universal Credit will be lower on average than under the current welfare system – 57% rather than 60% now - but the variations in income replacements rates will be even greater.

¹⁴ABI Consumer Survey Q3 2012 results

¹⁵http://protectionreview.co.uk/events/event/the_syndicate_press_release_october_2011

¹⁶*MINDSPACE: Influencing behaviour through public policy"; Cabinet Office, 2010

Trust

Various pieces of consumer research – including a 2012 ABI consumer survey – show that consumers estimate that somewhere between 38% and 50% of IP claims are paid. The reality – as demonstrated by 2013 claims data published by the ABI – is that 91% of individual IP claims were paid in 2013. The ABI publishes annual industry-wide claims data for protection insurance products to demonstrate that consumers can trust IP and other types of protection insurance to pay claims.

Inertia

A range of research sources identify that in many cases individuals either simply do not consider what they would do in the event of long-term illness, or do not get around to buying insurance. This, in turn, is driven by the other factors described above.

As Defaqto put it in their own review of the IP market¹⁷, Independent Financial Advisers report that “people simply cannot envisage themselves being sick for any length of time; many believe that the State will provide if they are; and some have or believe they have sufficient collateral to tide them over.”

The ABI is working with the Money Advice Service to increase consumer understanding and engagement with household income risks, entitlement to State welfare support, and what households can do to put in place an income safety net that meets their needs.

However, the challenge here is much greater than the industry and the Money Advice Service alone can overcome. The lessons of pension reform have shown very clearly that telling people they should do something because it will be good for them is not sufficient to persuade many to do it. Inertia is a powerful force. Innovative solutions – particularly through the workplace - are needed to be effective in changing behaviour.

“ABI claims data for 2013 showed 91% of individual IP claims were paid out”.

¹⁷Defaqto (2012), Income Protection – The way forward

The role of employers and the workplace

A recent survey by the Chartered Institute of Personnel and Development (CIPD) estimates that 11% of employers offer GIP to all staff¹⁸, and a further 4% offer it to at least some staff. Swiss Re research¹⁹, on the other hand, estimates that only 2% of employers offer and pay for IP for their employees, while another 6% of employers offer to arrange IP cover for their employees but the employee has to pay for it if they want it. Swiss Re also estimate that in 2013 there were 17,193 workplace GIP schemes, covering 2,039,059 employees²⁰.

However, the factors negatively influencing use of IP apply to employers as well as individuals. Many more employers than currently use group IP could benefit from the support it provides. Some employers do not provide group IP for their staff because of concerns about the cost and value for money, that it may not be appropriate to their needs, or they simply do not get round to it.

Group IP protects both the employer and employee from the impacts of serious illness or injury. The employee benefits from their employer continuing to pay their salary even when they are unable to work. The employer benefits from the insurance reimbursing them for the cost of paying the salary of an employee who is not productive. Many group IP policies also provide additional support such as paying for replacement staff, staff absence management services, and rehabilitation services which help employees return to fitness and work quicker than would otherwise be the case.

SWISS RE ALSO ESTIMATE THAT IN 2013 THERE WERE 17,193 WORKPLACE GIP SCHEMES, COVERING 2,039,059 EMPLOYEES .

Employers have a central role to play in supporting employees back to work. Through the cross-government Health, Work and Wellbeing Initiative, a range of approaches have been tested – in particular ‘Functional Restoration Programmes’ that attempt to support those with chronic or long-lasting pain to stay in work - and have been shown to improve the speed at which people return to work²¹. Among insurers that offered such intervention in the United States, it was found to be 43 percent more effective than non-intervention.²² A more recent two-year trial by the Royal Mail led to three quarters of those off work returning to work, with a rate of return of £5 for every £1 invested.²³

The factors that led to the introduction of workplace pension auto enrolment, and the lessons that have been learned from the experience of designing and delivering it, demonstrate that the workplace offers great potential as a means of increasing access to, and use of, IP.

Lessons can also be learned from experiences in other countries such as Australia and the Netherlands, that have already implemented reforms to the role of employers in managing the impacts of ill health on the ability to work.

¹⁸CIPD (2013) Absence Management 2013: Survey Report

¹⁹Swiss Re (2013) ‘Connecting Generations, Protecting Generations’

²⁰Swiss Re (2014) ‘Group Watch 2014’

²¹S.A Burke, C.K Harmes-Contas and P.S Aden, ‘Return to work and retention outcomes of a functional restoration program. A multi-center, prospective study with a comparison group, European Spine

²²Journal, September 1994, <http://www.ncbi.nlm.nih.gov/pubmed/7997919?report=abstract>

²³Quoted in Demos, Of mutual benefit, statistic taken from the studies above.

²⁴Health and Safety Executive, <http://www.hse.gov.uk/msd/experience/restoration.htm>

International and alternative models

In the Netherlands the system for replacing income for those who leave work due to illness or injury rests on employers' shoulders. Employers are mandated to pay their employees sick pay for at least two years, at a minimum of 70% of prior earnings. The state also enforces clear requirements on the employer and employee as to how they must work together to support the return to work. Employers are penalised if they do not ensure a strict and effective rehabilitation and return to work process and plan, or the state thinks too many of their employees are returning to work after two years of sick absence ('the Gatekeeper Protocol'). Research by De Jong, Thio and Bartelings (2005), and van Sonsbeek (2011) found that this reduced the flow of people onto state disability benefits by 15-33%.

In addition, employer contributions fund the long-term state disability benefits that individuals flow onto if they reach the end of their sickness benefit period, and employers have to pay higher contributions if the number of their employees that move onto these benefits crosses a threshold ('Experience Rating'). Research by Koning (2004)²⁴ and van Sonsbeek (2011)²⁵ found that this measure reduced the flow of people onto state disability benefits by 13-15%.

This significant risk to employers, both in terms of paying sick pay and contributing to state disability benefits, has created an active market for private insurers to protect businesses against this risk. This, in turn, has mobilised significant efforts towards preventative and rehabilitative work with employees, to minimise the employer costs associated with short- and long-term sickness absence.²⁶ This has also led to significant resources being directed into preventative health measures. The 2011 van Sonsbeek evaluation found that the combined effect of these measures reduced the long-run forecast disability benefit caseload by 50%.

In Australia IP (known there as 'Group Salary Continuance', GSC) is mainly available as a non-compulsory option within the compulsory 'Superannuation' workplace pension system. IP awareness has been raised by placing it in the

context of employer-organised retirement savings, and employers offering GSC are seen as better employers to work for. Total Permanent Disability (TPD) is a compulsory part of an employer's Superannuation scheme. However, it is now becoming apparent that claims on the product are much higher than the industry anticipated or priced for, as a result of factors including collective bargaining on premiums, price competition, lack of a claim time limit, and increased consumer awareness of the ability to claim. The experience demonstrates both the benefits of IP as part of the workplace retirement savings system, as well as the risks and challenges.

CESI have proposed two further possible models for building the role of IP through the workplace into future welfare reform:

Time-based collective insurance

This model would broadly go with the grain of contributory insurance models (as found in Scandinavia) but with a strong market element more in line with the approach taken in Australia and the US.

The model could work broadly as follows:

1. Require all employers to put in place insurance that provides full income replacement for all employees for up to one year of serious illness or injury.
2. Individuals/ employers would then be expected (through auto-enrolment) or required (through compulsion) to have some form of income insurance to cover further absence up to a specified limit – for example 5 years.

This could be limited to employees for whom the state would provide an income replacement rate of less than 2/3

3. After 5 years of absence due to illness or injury, the state would provide an income safety net (for those that meet certain conditions), potentially at a higher replacement rate than now.

²⁴Koning, W.P.C. (2004) 'Estimating the impact of Experience Rating on the inflow into disability insurance in the Netherlands.'

²⁵Van Sonsbeek, J.M. (2011) 'Estimating the long term effects of recent disability reforms in the Netherlands', VU University.

²⁶Black, C. and Frost, D. (2011) Health at work – an independent review of sickness absence, Department for Work and Pensions

If the second tier were auto-enrolled - for example with a lower rate of NICs as an incentive – it would need to be underpinned by a basic state safety net for those that choose to opt-out. This could follow the model of a basic flat rate state pension.

If the second tier were compulsory, commercial insurance providers would need to compete within a regulated market to offer collective insurance to individuals and employers. Clearly this would be a big step from the current system. The experience of introducing a similar approach in Australia offers the potential to learn lessons about what would be needed to make this kind of approach workable in the UK.

A further option could be a compulsory tier for higher earners, with an associated NICs rebate. However as the CESI research has shown, the benefits of IP are not entirely determined by earnings but also by household circumstances.

This model would need to be simple enough for employers, advisers and individuals to explain clearly and convincingly the benefits of staying in an auto-enrolled scheme.

Individual income replacement insurance

Another option could be to introduce voluntary or compulsory 'individual accounts' which individuals would pay for through their own - and perhaps also employer - contributions alongside their pension and other workplace benefits. This could be an auto-enrolment opt-out model, with NICs incentives.

This would go with the grain of pension auto-enrolment policy, as well as the recent removal of the requirement to annuitise pension pots. It could also build on extensive academic debate on how insurance and retirement policies could be better aligned (for example in the US²⁷ and more recently on its application in Scandinavia²⁸). This argues that we should take a 'life course' approach to managing financial security - smoothing income over the working life, by borrowing when young against future higher incomes, building up a safety net while we can afford to, and then drawing on it when we cannot work. Individual accounts could support this, by simplifying the system and incentivising individuals to make provision for themselves.

As with the collective option above, this approach would require the issues around awareness, complexity and perceived value to be addressed, and would need simplification of the welfare system to ensure that the benefits of insurance for individuals were clear. In addition, there would likely need to be additional state top-ups or 'credits' for those that could lose out due to absence from work for caring responsibilities (as exists in state pensions) or long-standing health conditions.

²⁷For example: Feldstein, M. (1974) 'Social Security, Induced Retirement and Aggregate Capital Accumulation', The Journal of Political Economy, Vol. 82, No. 5, 905-926; Feldstein, M., & Altman, D. (2007) 'Unemployment Insurance Savings Accounts', Tax Policy and the Economy, Vol. 21; Stiglitz, J., & Yun, J. (2005) 'Integration of unemployment insurance with retirement insurance' Elsevier, vol. 89(11-12), 2037-2067

²⁸Bovenberg, A. L., Hansen, M. I., & Sorensen, P. B. (2012) 'Efficient Redistribution of Lifetime Income through Welfare Accounts', Fiscal Studies, The Journal of Applied Public Economics, Wiley, Volume 33, Issue 1, pages 1-37; Fölster, S., Gidehag, R., Orszag, M., & Snower, D. J. (2002) Assessing Welfare Accounts, Kiel University, Germany

Looking to the future

There are clearly many challenges in reforming the UK welfare system, but the need for substantial change is clear, including the need to ensure households top up welfare support with adequate private safety nets. This is vital not only to support solid economic recovery, but also to reduce the severity and impacts of future economic downturns.

At least 10.8 million households need a greater income replacement safety net than the State can afford to provide. Every household that relies on income from employment needs to be made aware of how far their income will fall if they have to stop work and rely on government alone for income support. They need a strong understanding of the fragility of their financial situation, and the motivation and confidence to increase their financial resilience. But there are powerful psychological, emotional and behavioural factors inhibiting purchase of IP by many individuals and employers who would benefit from the security it provides. Policy solutions must be effective in overcoming these forces. Or – as in the case of pension auto enrolment – working with them instead of ignoring them.

It should be a matter of serious national concern that so many households do not have an adequate income safety net. Yet despite the implications for millions of UK working households, there is a very low level of public debate and awareness on health, work and wellbeing, and little political debate on how to better support households to understand the risks and impacts of ill health and to prepare accordingly.

The next government will need to reform the welfare system to contain the rising cost of welfare, and to minimise economic inactivity among the working age population. Recent reforms to workplace and State pension provision illustrate the direction of travel that needs to be followed to increase working age financial resilience, while at the same time reducing and containing the cost to the economy of the State safety net. The insurance industry, Government, Parliament and stakeholders – such as national and sectoral employer representative bodies - need to work together to develop effective and economically

viable solutions using the workplace to build better household income safety nets and contain the rising costs of Welfare.

Where reforms have successfully been made in similar areas – for example, pensions reform in the UK and in Scandinavia – this has been based on a long process of building political and social consensus on the need for change. Political and public debate is needed now to build engagement with the problem, and build consensus to support effective solutions. The ABI is well positioned to play a key role in this.

In considering how to reform welfare to achieve these objectives, careful and well informed consideration needs to be given to how greater use of IP – and early, targeted rehabilitation – can form part of the solution.

Research by NEST finds that British money habits are changing:

“Money worries during the recession have given way to an increasing sense of personal financial responsibility. One of the most significant examples of this trend is the response to the government’s new automatic enrolment workplace pension reforms, with opt out rates significantly lower than many had forecast. Tim Jones, said:

“The recession has evidently changed consumer behaviour and for the first time we can see the impact it’s had on British attitudes as well. Many households are still feeling the pinch and people are worried about the future, but they clearly think tomorrow is worth saving for and automatic enrolment seems to be a welcome helping hand. Although it can be a struggle to find a few extra pounds each month, the money from employer contributions and relief at finally doing something has convinced more people to stick with saving than we ever expected in this economic climate.”

These changes in attitude and behaviour present an opportunity, which needs to be grasped quickly, to address failings in the current welfare model and working age household behaviour that result in 10.8 million households having no real income safety net.

Summary

In summary, as a society we need to:

- **Increase public debate, awareness & understanding of health related income risks;**
- **Develop a role for all employers in providing access to, and use of, IP through the workplace;**
- **Build and use evidence on the impact of rehabilitation, and what interventions have a significant impact;**
- **Explore the potential to expand rehabilitation services to help more people back to health and fitness – and back to work – faster, as well as minimising long term health and disability problems;**
- **Ensure the tax and welfare systems provide effective incentives and rewards for using IP;**
- **Achieve an easy to understand balance between State and private insurance.**

Notes

Notes

For more information

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