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INCOME PROTECTION AND THE ECONOMIC CYCLE

Greg Martin

Executive summary

Discontent is engulfing the retail income protection insurance sector. This is not surprising given income protection claims have doubled in the last ten years.

The steep trajectory of claims costs is making life insurers unhappy while rising premiums are making customers unhappy. Something is wrong here.

Although many, varied factors contribute to the industry's growing dissatisfaction including the onslaught of mental health- related income protection claims, the potential implications of genetic testing and concerns about so called 'gold plated terms', they don't address a key root issue.

These contributing factors are somewhat noise, distracting from a fundamental cyclical issue. Today's pattern of rising claims, rising premiums, rising claims, rising premiums is symptomatic of broad macroeconomic forces that seem to be generally ignored by the industry.

At the heart of the matter are cyclical determinants like slow wage growth, unemployment and the insidious issue of underemployment, fuelled partly by the current rate of technological change driving things such as the gig economy.

The role of individual differences is another big part of the income protection equation. People's coping mechanisms are being put to the test in the current economic and technological change environment. As a result, the workforce's health and well-being is under threat and claims are rising.

What to do? To combat this increasingly complex landscape, life insurers need to evolve their thinking and fight the temptation to fall back on what has historically worked and made sense.

Ongoing pricing cycles, for instance, are not helpful. We need a different perspective. There must be a circuit breaker to better understand and manage the product; and at an industry level.

This white paper delves into the economics of income protection. It draws on opportunities for better cycle management and increased control for providers.

It aims to explain the current economic cycle, and where we are positioned in that cycle, so meaningful changes can be made. It is possible to achieve better price stability, meaningful product changes (and maybe even innovation) and an improved customer experience. Contentment awaits.

The back story

Australians were introduced to income protection around 1960.

For close to 60 years, the product's strong premise has stayed the same although the value of income protection is often overlooked. For the majority of Australians, the loss of a regular income would result in financial (and psychological) distress, making it prudent to protect against this. Demand for income protection would be inelastic in an ideal world but Australians are more likely to protect their

The quote

Product design has stalled and adaptation to the changing societal environment has been too slow. Meanwhile there has been disconnect with customer needs.

car or their pet. In reality, demand for income protection and its claims rates are subject to the peaks and troughs of the economic cycle. This presents ongoing growth and profit challenges for the industry.

Growth, but not as it seems

The retail income protection growth story looks quite rosy on paper.

Alongside a cohort of other personal insurance products (like term life, total permanent disability (TPD) and trauma), income protection represents approximately 22% of the total retail risk premium, up from 21% a decade ago. As at 30 September 2018, this equated to around $2.3 billion with an average annual growth rate of 8.9% over the last decade.

The sector's performance sounds pretty good so far but for the last five years, growth has hovered around 1.9%. In fact new business has been stagnant in recent periods and in some circumstances, there has been a reversing trend (taking into consideration CPI indexation and age related increases).

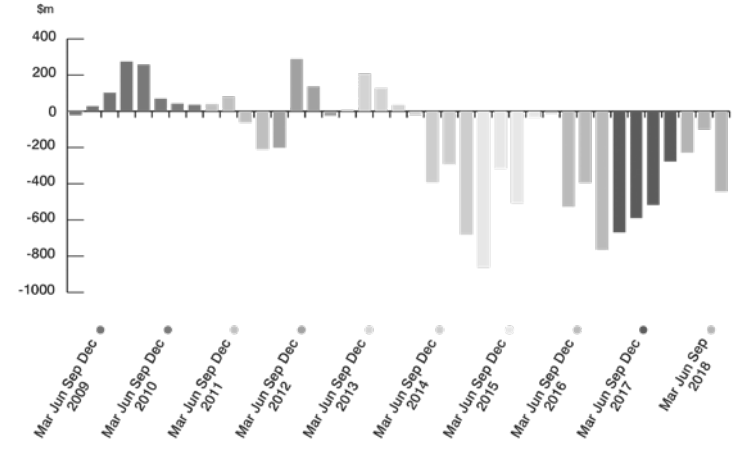
This subdued growth can be attributed to several factors including intense, ongoing media scrutiny of the life insurance and financial advice sector, leading to heightened regulation.

An already tight regulatory environment will be even tighter post-Royal Commission. Other factors include consumer distrust, disengaged customers and lack of product innovation.

What about profit?

Unlike the growth narrative, retail income protection profit margins have been on a steady decline for roughly a decade. Figure 1 shows the annual industry profit margins (pre-tax) for retail income protection (also known as disability income) over 12-month rolling periods; showing substantial losses in the last five years.

Figure 1. Australian retail life insurance - rolling 12-month income protection profit before tax



Source: APRA

Drivers of profit decline

Are product terms and systemic under-pricing the problem or is something else to blame?

The industry has attributed the profit decline (or increased claims cost) to the claims experience from ineffective product/benefit design. So called 'gold-plated terms' and loose disability definitions, and potentially anti-selective behaviour.

What are gold-plated terms?

This refers to excessively generous benefits and features that give customers the opportunity to claim more frequently or enable them to replace a greater proportion of their pre-disability income than needed under the income protection product.

Anti-selective behaviour is where customers with greater risks than average, such as pre-existing medical conditions and dangerous occupations and interests, purchase life insurance policies and obtain lower premiums for their risk or potentially claim more generous benefits, or both. This can occur where there is asymmetrical information about their risks. For example, the customer may not fully disclose (or may not have been asked about) all relevant risks to the life insurance provider.

Examples of design features that have contributed to rising claims costs include:

- The 10 hour or 20% income rule, where policyholders can work up to 10 hours per week or generate 20% of their usual income with no reduction in benefit payable. This is even more prevalent in the case of part-time workers where reduced thresholds apply.
- The one duty rule which says that the life insured is considered to be disabled where they are unable to perform at least one major income producing duty of their occupation. Alternatives include expanding the stipulation to where one or more duties of a person's regular occupation can't be performed and they are under the care of a medical practitioner.
- Generous built-in benefits such as the ability for policyholders to work for a certain timeframe during the waiting period; day one accident options; and more flexible claims options. Day one accident options allow individuals to receive income protection payments immediately, rather than after a defined waiting period, if the life insured suffers disability due to an injury.
- The occupational drift phenomenon, whereby policyholders change their mode of employment after policy inception. For example, shifting from desk-based to manual work. The rise of the gig economy could be implicated here.
- There has been a move towards a three-tier approach (see below) to disability definitions which has now been largely endorsed by providers.

However, these cost factors, don't reveal the whole

story. If the benefit design of income protection has been largely unchanged during the last 10 years, what accounts for the deterioration in profitability? For the answer, it is important to look at the bigger picture including societal and economic trends

What is a three-tiered approach?

The 'three-tier' definition of income allows the policy owner to choose the most advantageous outcome regarding the calculation of income protection benefit payments and offsets (reductions). There are three options (or tiers):

1. Calculating benefits based upon income earned;
2. Calculating benefits based upon hours worked; and
3. Calculating benefits based upon number of usual duties at work performed.

Depending upon the option selected, a policy holder may be encouraged to go back to work and still receive full benefits, effectively arbitraging the income protection policy to obtain the most financially advantageous outcome. In some circumstances the life insured who generates intermittent income (such as a contractor) but is working 40 hours per week may still receive income protection benefits. Where a person is totally disabled and unable to work at all, they would obtain full benefit payments.

The current playing field

Income protection, like other types of insurance, is an emotional purchase decision. Ironically, income protection is also sometimes seen as a luxury (despite the tax deduction incentive) compared to other cover types.

Unless a person has considerable accumulated savings, losing a regular income is likely to be a catastrophe for Australian households. The psychological phenomenon of individual differences means that people weigh up the pros and cons of income protection in different ways. There is a myriad of variables involved in the income protection purchase decision.

The claims environment is equally complicated. Suffice to say, the current landscape is placing additional pressure on insurers.

Societal trends

Times are changing. The workplace, home and social environment is vastly different to the start of the century – a mere 18 years ago. The advent of digital technology means people can connect and be online 24/7 with endless information at their fingertips. As a result, consumers are more knowledgeable.

On the flipside, technology – the very thing that is supposed to make our lives easier – is linked to rising anxiety levels. There is no longer an 'off' button. In fact 'being stressed' is now the norm. But technology is not the only contributing factor. There are many drivers across multiple domains.

For the purposes of this paper, let's focus on the work domain. In this age of connectedness people are working longer hours, for example, they're logging on at home to reply to emails and respond to urgent requests. But they are not getting paid more due to stagnant wage growth. They also have higher debt-to-income ratios, and minimal savings.

Many people are also facing a change to their work terms. The growing casualisation of workforce (note again the gig economy) has been well documented. This means less job security.

And this is just the work domain. If we factor in domains outside work, the weight of all this stress becomes clear.

Mental health commentary

One-in-five people will have depression/anxiety at any one time, and for Australians aged 16–85 years, almost half (45%) will experience a mental disorder at some time in their life (about 8.6 million Australians). The result is that Australia is faced with a rising incidence of mental health conditions across all population demographics. Consequently, mental health claims are rising.

What is the role of income protection in the midst of all this?

On the surface it would appear to be more relevant than ever yet product design has stalled and adaptation to the changing societal environment has been too slow. Meanwhile there has been disconnect with customer needs. Why then are there so few signs of positive change?

As a result of rising mental health claims, the sector is moving from a reactive stance and aiming to prevent mental health claims before they arise.

The customer journey increasingly incorporates prehab and rehab strategies. Organisations are bundling more value into their propositions. All this is good for the customer but at what cost?

Reflexive pricing involves providing income protection cover for what the client needs right now. It can be adapted dynamically as the client's circumstances change. For example some clients may be at a stage in life where they can cut back on work thereby needing less cover for their future. Alternatively, a client who has received a promotion and/or pay rise, should consider increasing their cover. The reflexive pricing adapts the premium charged to clients as their circumstances change. This prevents over-insurance and reduces the moral risk of individuals going on claim where their income protection benefits replace more than 75% of their income. We also know that when total life insurance premiums (including income protection) comprise more than 10% of disposable income, there is a significant increase in discontinuances and lapse of policies.

Cyclical drivers of income protection

Alongside the societal trends, it is unemployment, underemployment and slow wage growth that seem to have had some of the biggest impacts on retail income protection.

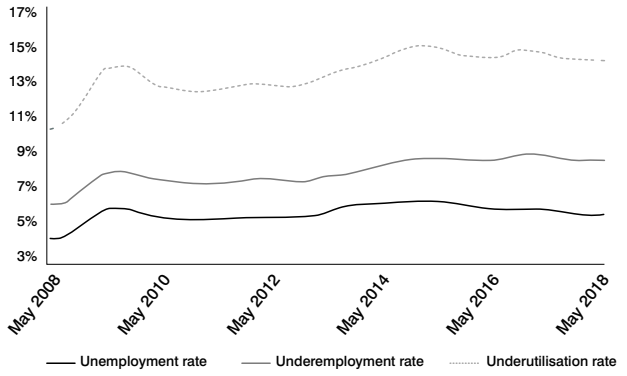
This paper posits that these three factors are the real story behind the decline in income protection experience; both growth and profit. Even more telling is their impact on income replacement ratios (**IRR**) and its effect on claims.

Income protection policies typically allow a maximum IRR of 75% of personal exertion income at policy commencement. With annual benefit indexation provided of 3% or more, the IRR can increase quite quickly in a low wage growth environment. Eventually this could cause notional IRRs to exceed 80%, 90% or even 100% of pre-disability income over time.

This may also occur if an individual changes jobs for a 'sea change' and the income they are earning becomes less than the income they had when they originally applied for their income protection policy, thus making the sum insured under the policy replace a larger ratio of the life insured's income.

Figure 2 shows the movement of economic factors in the last 10 years.

Figure 2. Unemployment, underemployment and underutilisation rates, May 2008 to May 2018



Source: Australian Bureau of Statistics, 6202.0 - Labour Force, Australia, November 2018

Impact on growth

These three factors have impacted growth:

Unemployment

Unemployment continues to track downwards. Latest ABS data had the trend unemployment rate for November 2018 at 5.1%. The income protection implications are straightforward. Higher unemployment results in lower rates of individuals owning income protection policies. With more people employed it should result in more people purchasing income protection insurance.

Underemployment

On the other hand, underemployment has continued to increase in the last 10 years. The International Labour Organisation (ILO) defines this as the underutilisation of the productive capacity of the labour force.

That is, someone who is not employed in their desired capacity. The most common example is a situation where a person is willing to work more hours but cannot gain full-time employment. They may often work two part-time jobs to make ends meet.

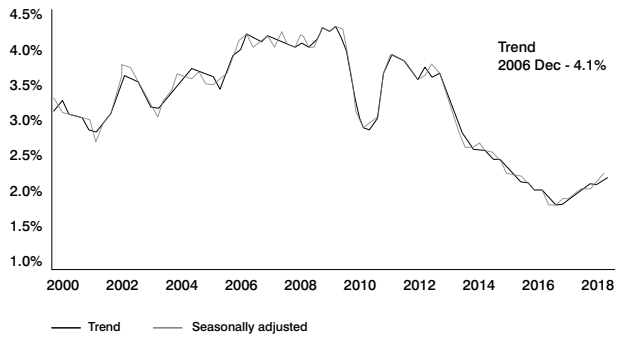
This stymies income protection rates further. In most circumstances, individuals must be working at least 20 hours per week for one employer in order to qualify for income protection. Having four jobs where the individual is working 10 hours per week in each job normally does not qualify for income protection insurance.

This means that more people who engage in the gig economy may increase the number of people who will not qualify for the traditional income protection policy, even though they may be working longer hours than a full-time employee.

Wage growth

Australians' average disposable income is being eroded due to high cost of living and low wage growth. In the last four to five years, wage growth has been below or tracking the Consumer Price Index (CPI). Recent personal tax cuts will give people a little more money but it won't lead to demonstrable wage growth. Whether the proposed company tax cuts could be a driver of wage growth is being widely debated on the economic front and remains to be seen.

Figure 3. Annual wages growth



Source: Australian Bureau of Statistics, 6345.0

Cyclical drivers and income replacement ratios: A new perspective

What does unemployment, underemployment and stagnant wage growth mean for income protection profits? One hidden explanation lies in the way those cyclical drivers interact with IRR and the impact of benefit indexation.

Benefit indexation is an important concept in the profit equation. For an agreed value contract, income information is typically only collected at policy inception and doesn't take into account changes (i.e. a change in employment status) during the life of the policy. A further flaw in the system is that income isn't verified at claim time (unless the information was missing in the first place). Depending on the insurer, the maximum monthly benefit or sums insured may increase at the greater of CPI or 3-5%. Keep in mind wage growth hasn't been at those levels for 10 years.

So what happens when policy benefit indexation outpaces wage growth and underemployment continues to rise?

There is a well-established, negative correlation between IP claims and economic conditions. Good economic conditions lead to low claims rates (people are very motivated to make hay when the sun shines); poor economic conditions lead to higher claims (people are less motivated to promptly return to work).

Stress from poor economic condition is part of this - which exacerbates mental health...and leads to higher cost claims. Higher IRRs contribute to any adverse conditions.

Most economists have talked about the good Aussie economy over recent years and pointed to things like lower unemployment. This should mean stable-to-good claim rates. In reality, workers are entrenched in a sub-optimal economy with high underemployment and stagnant wages. The economy as experienced by many individuals is not "good". It's not (as construed by some) a good economy frustrated

by gold plated terms and random mental health claims. The under-performing economy is driving poor claims rates to begin with. Stagnant wage growth, impacting on IRR is turbo-charging to this. Why rush back to work when there is no incentive to do so and you're being paid 90% (or more) of basic income to remain at home.

Income protection claims costs are associated with an anti-cyclical trend. This means that income protection claims costs increase as economic factors deteriorate and decrease as economic factors improve.

A fresh perspective

To reaffirm this point of view, correlation and regression analysis was undertaken which yielded significant findings.

In terms of correlation, our study found that underemployment and unemployment rates have a positive correlation with claims cost experience, whereas wage growth has a negative correlation. In a declining economy – where unemployment and underemployment increase while wage growth decreases – income protection claims experience deteriorates as well (i.e. more claims are paid).

The regression model used found that underemployment, unemployment and wage growth were significant factors in predicting variation in income protection claims experience. APRA quarterly statistics data provides further weight to this. The data shows that in recent years, net profits have been declining and loss ratios have been rising. This is consistent with the anti-cyclical relationship we identified and relevant to the Australian market. Anecdotal industry evidence is sure to corroborate.

Industry 'talk' of loose product definitions are a variable of influence in claims cost but are not the headline. Economic indicators (i.e. benefit indexation outpacing CPI and rising underemployment) will both increase IRR.

History buffs may draw parallels between the present-day cycle and the industrial revolution of the 1800s – the technology evolution that made workers' roles redundant, the presence of unemployment/underemployment along with slow wage growth. A good example of economic cycles repeating themselves.

Cycle management, a better way

Three steps towards cycle management

Three components will facilitate the economic management (not mismanagement) of income protection: integrity of data, reinsurance and reserving.

Data integrity

Given the importance of IRRs, the industry should be tracking:

1. How the average IRRs at policy commencement compare to the IRRs for people going on claim; and
2. The IRR of the portfolio at any point in time and provide guidance on how this may change in the future (for pricing and reserving purposes).

This currently does not happen. The industry collects limited data, leaving some gaping holes.

At policy commencement, financial evidence is only asked for guaranteed agreed value policies and beyond certain limits for other types of policies. There is nothing asked at renewal, so the IRR for the portfolio cannot be established.

More nonsensical is the fact that most income information for indemnity policies is obtained at claim time. However this is merely the highest 12-month average income over the three-year period prior to claims, not the income just before claim.

Put it this way. If a bank had no idea of the loan-to-valuation ratio on their loan portfolio, there would be uproar. This is akin to what's going on in our industry.

Reinsurance

Traditionally what happens is that during the good times (such as the mid-2000s), profits are made and both insurers and reinsurers drop prices. On the other hand, when times are poor, losses are made, there's a sense of panic and prices go up. The whole system becomes quite volatile.

Reinsurance can be used as a mechanism to reduce this volatility. One possible approach is to build an automatic credibility adjustment into the treaty. If you have a reinsured profit/loss in a particular year, this would result in an adjustment to the reinsurance premiums in future years.

Underlying this is the fact that direct insurer pricing is based on long-term expected claims and reinsurance premiums.

This can be best explained by an example.
Let's assume the long-term reinsurance premium is $100 and expected reinsured claims are $85.
In year 1, reinsured claims are $60, so the reinsurer makes a $25 profit (see graph on page 9).

This $25 profit would be used to drop future reinsurance rates, by spreading it over the average term of 10 years (i.e. reinsurance rates would drop by $2.50 p.a. to $97.50).

The year after a $10 loss is made (see graph on page 9). Now the premium increases by $1 p.a. from $97.50 to $98.50, but effectively the profit in year 1 means it is still less than the initial $100.

The quote

Our study found that underemployment and unemployment rates have a positive correlation with claims cost experience, whereas wage growth has a negative correlation.

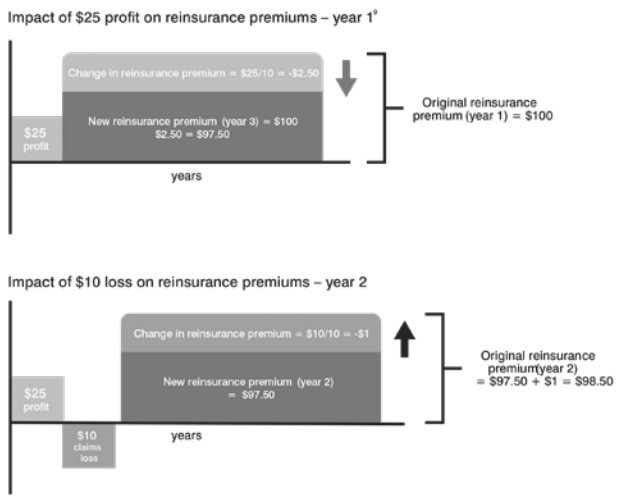
In reality, cycles will last for several years (and not just one year as shown in the example), but the whole concept is that reductions in reinsurance premiums in good years will help pay for increases in reinsurance premiums in economic downturns.

In addition, this can allow direct insurer pricing to be based on long-term expected claims and long- term reinsurance premiums as there is greater confidence that cycles will average out. This should make the whole pricing cycle less volatile.

This is juxtaposed to the traditional arrangement whereby the insurer and reinsurer negotiate what adjustments there should be each time.

From a reinsurer perspective this adds a bit more certainty, particularly when there are losses, as they can be more confident that there will be adjustments to future reinsurance premiums to cater for experience.

Figure 4. Changing reinsurance premiums



Source: ClearView, Income Protection – managing the cycle

Industry pool approach

The above approach will be helpful for insurers that reinsure a large proportion of their risks. It won't help those that don't and it won't help the industry as a whole if most insurers don't adopt the same approach. The industry should consider if a pooling mechanism such as the above should be implemented by all insurers as an industry (similar to the Health Insurer pooling mechanism) to help the whole industry manage the effects of the cycle for the benefit of it and its customers.

Reserving

Put simply, the industry must be more dynamic in terms of assumption setting. Insurers need to start allowing for mean reversion for both incidence and termination rates based on where items like wage growth, underemployment and unemployment rates sit relative to long-term trends.

It is fair to say that in previous cycles, the industry has failed to do this at an individual and group business level.

The argument for change

The way people respond to financial stress is linked to well-being. Financial difficulties create psychological distress, which affects coping mechanisms such as feeling in control and self-esteem.

Income protection insurance is the most important of all life insurances as it protects an individual's greatest asset, their capacity to earn money throughout their working life until retirement (for policies that pay benefits to age 65).

Based upon the average weekly ordinary time earnings (AWOTE), the amount of income at risk for a typical young Australian can be more than $3.2 million (40 years from age 25 to age 65 at $82,000 per annum). That income facilitates retirement savings, the purchase of the family home, and maintaining standards of living.

While other life insurance products such as death, TPD and trauma cover, provide lump sum payments in the event of death, permanent incapacity or suffering from a defined medical condition, respectively, no other life insurance cover provides protection for future earning capacity.

Individuals who do not have income protection insurance and are unable to work will be required to rely on existing savings or alternatively rely on Government support via Centrelink benefits. This adversely affects the standards of living for everyone: the individuals who are relying on Disability Support Payments (DSP) must survive on payments of less than $24,000 per annum, considering AWOTE is currently $82,000 per annum, this reduces income to less than 30%; Secondly, individuals who are principally reliant on DSP pay no tax, which means the ATO, Treasury, Government and society is deprived of taxation revenue that supports education, infrastructure, hospitals, and other social programs.

These are big numbers and big consequences for individuals; and more so for those on higher average incomes. Income Protection insurance is a critical insurance product to manage these risks.

Failing to fix the current problems with the product is not an option. Nor are suggestions that reducing benefits or adding exclusions satisfactory if this leaves many with inadequate cover, or no cover at all. The industry needs to step back on the genuinely excessive terms, become far more proactive on claims management, and better manage the actual underlying economic cycle impacts on the product and its claims variability, including considering industry wide pooling mechanisms.

Conclusion

The arguments presented in this paper present a somewhat contrary view on the retail income protection landscape. But as shown, they can be substantiated and are worth considering.

It's time for a different lens on this topic and to evolve the current thinking (and associated knee jerk reactions). The industry must pinpoint exactly what's really driving the performance in this product sector for all parties.

Despite widespread industry consensus, it's not predominantly product design or improper pricing. Income protection is primarily driven by economic cycles, not simple headline "GDP" growth or "unemployment rates", but underlying employment realities of wages growth and underemployment trends and their interaction driving income replacement ratios insured.

Income protection has undeniable virtues. The key is to get on the same page so its value can be shared by all. It's time to break the cycle. FS