Disability Income provides protection against illness or injuries preventing one from earning an income.

Disability Income in Australia – A cautionary tale

What started off as a meaningful insurance cover for the working community has turned into a sore point for insurers. What went wrong? How can the industry fix the problems? In this article we highlight the development of disability income in Australia and discuss what one can learn from the experience. It may serve as a case study of what could happen under intense market competition for business volume at the expense of profitability.

What is Disability Income?

Disability Income provides a monthly benefit if the insured is unable to work due to sickness or accident. It is sometimes called Income Protection or Salary Continuance.

Traditionally it has been sold by retail advisers. In recent time cover on a group basis and cover via the direct marketing channel have also grown somewhat. Disability income is a major product line for life insurance in Australia, representing about 26% of total new business premiums for retail (Source: DEXX&R Life Analysis Report June 2015).

Information as of January 2016

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Basic product features

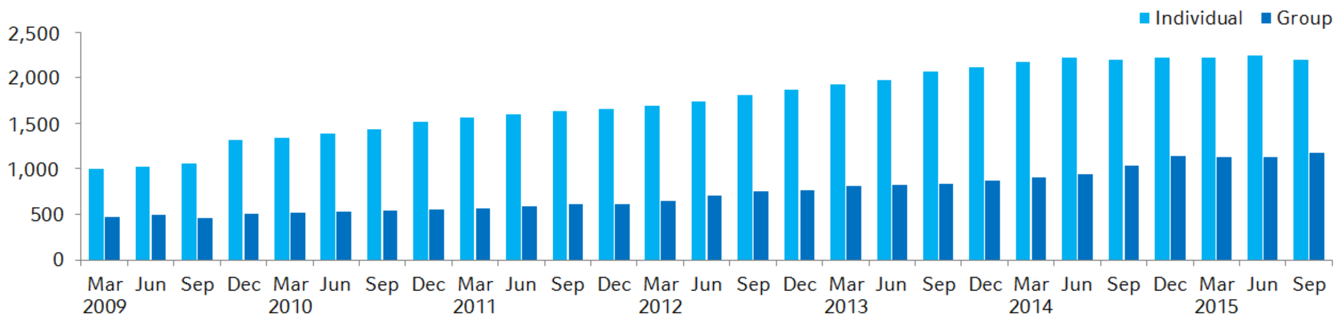
	Typical Parameters
Waiting period	30 or 90 days (during which no benefits are paid)
Benefit period	2 years, 5 years or Payable to age 65
Disability definition	"…unable to perform the important duties of your usual occupation…" plus a few other criteria
Rating factors	Age, gender, smoking status, occupation group (professional, white collar, supervisory/sales, light blue and heavy blue collar)
Benefit basis	Indemnity (benefit as a percentage of the income at time of disablement) or Agreed Value (benefit level agreed at time of policy commencement, regardless of income level at time of disablement)
Replacement ratio	75% of income, sometimes an additional 10% of income going into superannuation (retirement savings)

The key profit drivers are claim incidence rates and claim termination rates. A dominant part of the business is of long term benefit period e.g. income benefit payable to age 65.

For a large and mature portfolio, the life insurer not only has a large 'active life' portfolio i.e. in force policies not on claims, but also a large reserve for those policies that are on claim, known as disabled lives reserve or claims in the course of payment reserve.

These claims require active management in terms of claims monitoring and administration. The reserves also require active actuarial management and are sensitive to claim termination assumptions, the prevailing interest rates and inflation rate.

Graph 1: Disability Income net policy revenue[1] in AUD million (12 months rolling average)



1 Source: APRA Quarterly Statistics

Developments over the years

The good

The product concept first appeared in the Australian market in the early 1970's. It was a relatively simple product with the objective of providing protection against illness or injuries preventing one from earning an income. It gradually became more popular together with the other pure risk products when the bundled products lost favour in the Australian marketplace in the 1980's.

The product was generally profitable. The intermediaries then were mostly tied agents and they received good initial commissions.

Nowadays disability income still serves as an integral part of a comprehensive insurance package. The need to protect against loss of earnings for workers and the self-employed has not changed.

The bad

Over the years there have been a number of changes in society, consumer behaviour and the market environment leading to negative impacts on claims experience.

It has been shown that claims experience is correlated to the prevailing economic conditions, particularly the unemployment rate. For a self-employed person whose earnings have dropped significantly during an economic downturn, potentially leading to depression, the niggling back pain suddenly becomes a good reason to claim. When jobs are hard to find, a claimant is more likely to go on claim and stay on claim instead of going back to work.

Mental illness has been on the rise in the population generally and as a cause of claim. The genuine increase in incidence is probably exacerbated by the 'medicalisation of unhappiness'.

These claims hit the disability income insurers particularly hard because they tend to be of long claim duration and they affect the professional and the white collar more where the dollar claim size is larger. These claims are also difficult to gauge and manage in terms of its genuine impact on work capabilities.

These developments are also compounded by changes in societal attitudes to welfare and disability, with less stigma attached.

There have been many legal and court decisions on claim disputes being favourable to the claimants.

Many of them hinge on the interpretation of the definitions of disability. They set precedents and can lead to unintended claims.

...and the ugly

In the last three decades competition has been intense in the form of enticing life insurance advisers to recommend a particular company's products instead of the others. The 'recommended product list' of an adviser is usually based on the product rating by independent rating houses.

These rating houses rate each company product primarily by product features, claim definitions and price. It is therefore no surprise that there is a race by the product managers in the market to come up with the most attractive or generous product features (product creep) or at least to keep up with their competitors (me-too products).

The alternative would be a drop in sales.

So what are these 'dangerous' product developments?

Some of the key ones are highlighted below:

- **Loosening of the already subjective definitions of disability**
  Most definitions are based on the inability to perform your 'own occupation' instead of any occupation reasonably suited by education, training and experience. For example, if a surgeon cannot perform surgeries due to injured fingers but is capable of being a medical consultant, the surgeon would still be eligible to claim with benefit potentially payable to age 65!
  Some companies have a definition which is based on the inability to perform one important duty of your own occupation.

- **Partial benefits**
  In the event that a claimant can work part-time, a pro-rata benefit is payable. This could lead to the unintended consequence of the claimant receiving a combined income close to the pre-disability income. There would be little incentive to go back to full-time employment.

- **Agreed value benefit basis**
  This leads to the potential of the insurance benefit being greater than the actual income at the time of claim. This is often linked to an economic downturn. The likelihood of a claim termination would thus be low.

- **Lifetime benefit period**
  In the 1990's there was the option of a lifetime benefit period, plus claim indexation. This type of benefit became the de facto retirement benefit for the claimant when it was never meant to be the purpose of disability income.

- **Rising maximum benefit level**
  In some cases the benefit payable would be more than AUD 50,000 per month. The replacement ratios in some other cases exceed the standard 75%. Claims experience analyses consistently show that claim costs are correlated to high benefit level and/or high replacement ratio.

- **Accident benefit option payable from day 1 of accident**
  Claimants in these cases tend to return to work more slowly than the average.

- **Proliferation of other ancillary benefits**
  Examples include fixed dollar specified injury or trauma benefits (regardless of time off work), nursing benefit, bed confinement benefit, guaranteed future insurability benefit etc. They are often introduced with minimal price increases but soon there is a product creep effect. Products have become hard to understand and hard to manage.

Also in pursuit of market share, underwriting terms have come under pressure. One example is the introduction of takeover terms i.e. facilitating easier policy switching by reducing the underwriting requirements.

Meanwhile the running of the claims team could be seen just as an expense rather than as a mechanism to contain claim costs. This led to the claims team being under-resourced, prohibiting the chance to properly assess each case and to help the claimant go back to work.

In theory any negative development in claims experience should be reflected in pricing in a timely manner. (Note that the rates are generally not guaranteed even for in force policies.)

In practice, there is a significant time lag between the charging of premium and the corresponding finalisation of the long term claims from the same portfolio. For a period there was also a lack of timely industry claim experience analysis.

Coupled with the commercial reluctance to increase prices, disability income pricing has been surprisingly insensitive to deteriorating claims experience!

Claim case studies

Case 1: Bob a 55 year old Real Estate Agent

Bob has an agreed value policy for a benefit of AUD 18,000 per month. His Real Estate license was cancelled due to inappropriate business activities. At the same time he was also seeking treatment for depression and anxiety.

Although, Bob could return to work and is certified fit to resume part-time work he is choosing to remain on total disablement benefits relying on the policy wording of total disablement which focuses on him being unable to do one important duty of his occupation (too stressed to liaise with prospective clients).

In addition Bob has sold his business and no longer has a job to return to.

Case 2: Richard a 35 year old self-employed builder

Richard has suffered from a back injury. He has resumed work but is reporting to only working less than 10 hours a week. The structure of his business has changed from self-employed to a company. His income protection policy continues to pay him a total disablement benefit as long as he works no greater than 10 hours per week.

Although his business is growing he is reporting that this is not due to his personal exertion. On an analysis of Richard's claim and business it was established that he has changed his duties and no longer deals with the manual duties but is focused on promoting his business and securing new contracts.

Richard remains entitled to benefits due to policy wordings.

Case 3: Sharon a 43 year old senior partner at a top tier legal firm

Sharon has an income protection policy that covers her AUD 45,000 per month. She has been diagnosed with breast cancer. She had treatment and the cancer has been in remission for the last three years. Due to company restructuring her position is no longer available.

Sharon remains on claim and receiving full benefits. She argues that she is unable to undertake her own occupation being a senior partner in a top tier legal firm (but there is potential for her to work in a less demanding legal role). In addition the cancer treatment has left her with a cognitive deficit and she is unable to function at the high level of a senior partner.

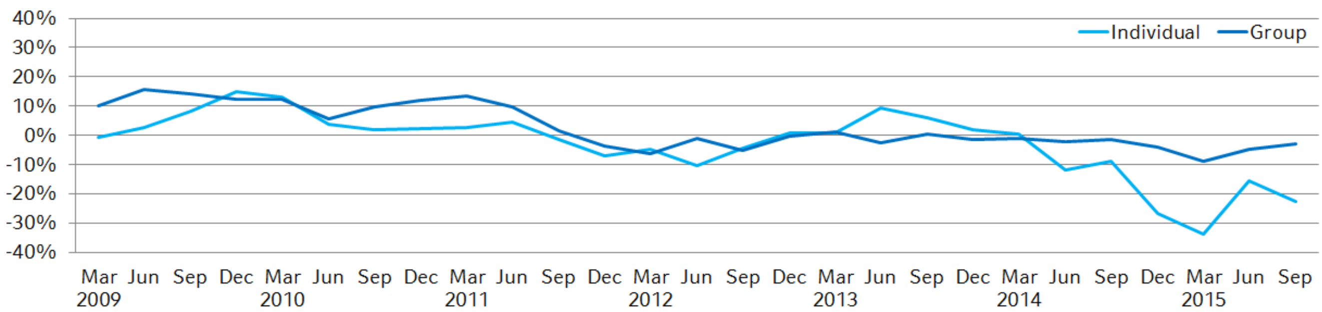
Bottomless pit?

Profitability has suffered in recent years

Graph 2 shows the combined industry profitability over recent years. The downward trends are consistent with some publicly listed companies disclosing their losses in disability income, with reinsurers taking more than their fair share of the losses!

It is too early to see if the losses have been arrested. Note that the reported profits or losses are heavily dependent on the reserving assumptions.

Graph 2: Disability Income net profit margin[2] (12 month rolling average)



2 Source: APRA Quarterly Statistics

Positive actions

The loss announcements by some companies in recent months coincided with the concerted effort by the market to address the issues. There has been a steady flow of positive actions taken by companies including:

- Investing in claims management such as seeking best practice, increasing resources and focusing on certain claims with a greater potential of termination.
- Greater facilitation of rehabilitation and retraining services, encouraging claimants to return to work.
- Incremental increases in premium rates, while always careful of the impact on sales and policy lapses.
- Possibilities of developing fundamentally different products, without the more toxic product features inherent in the current products.

Another positive development is the launch of a proprietary actuarial table which has been based on the actual experience in Australia. The new table will in time help actuaries price disability income and reserve for the liabilities more accurately and in a more granular basis.

How can Hannover Re help?

Hannover Re in Australia has been closely involved in disability income with our clients all these years. Through running projects to ratifying the poor claims experience, we have the in-depth experience in managing this line of business and the know-how in avoiding potential pitfalls.

The market has learnt its lessons from this case of intense competition coupled with products which have turned out to be fundamentally flawed. We can be your ideal partner for the next generation of disability income products.

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