ASISA

Considerations for Disability Insurance

1. Purpose and Scope

The following document is written by ASISA's Risk and Disability Committee and is intended to give an overview of the key issues that should be taken into account when purchasing disability income insurance. This document is written for those who have a background in the insurance industry and provides a broad overview of current industry practices. As different companies have different terms and conditions, please consult your financial adviser or the relevant company if you have any specific questions regarding their treatment of the benefits.

2. Introduction

In the South African insurance market, disability cover is provided in the form of lump sum benefits as well as disability income benefits. Lump sum benefits are specified at policy inception and may grow on an annual basis at an escalation rate selected by the client. Disability income benefits are typically related to the client's monthly earnings at policy inception but may also escalate at a specified annual rate.

3. Lump sum disability benefits versus income protection benefits

The interaction of these 2 methods of paying disability benefits and the rapid innovation of disability benefits has significantly complicated the considerations that must be taken into account by the financial adviser and client in meeting the client's needs. The 2 methods each have their own strengths and weaknesses.

The income protection benefits provide indemnity for loss of income as the client will receive a monthly payment until the selected retirement age. There is no need for the client to carry the investment risk. With lump sum disability benefits the investment risk lies with the client if the lump sum benefit is used to provide protection against loss of income. There is also a risk of over insurance at the older ages if the lump sum benefits are not adjusted.

The lump sum benefits are appropriate to settle debt whereas an income protection benefit only services debt as well as living expenses. Lump sum disability benefits are also more appropriate for key man protection as well as for other business insurance needs such as buy and sell agreements. A client may be temporarily disabled meaning that he will recover and return to his occupation within a specified period of time. When the client is permanently disabled it is not expected that the client will recover and return to his occupation within the foreseeable future. Income protection benefits provide protection for both temporary and permanent disability whereas the lump sum benefits, typically, only pay when a client is permanently disabled.

The tax treatment of the lump sum benefits and income protection benefits may also differ in respect of the tax deductibility of premiums and the taxation of the benefit payments-

a. Lump sum products are usually paid out tax free. Premiums for these benefits are not tax deductible.
b. Income Benefits:
    - Loss of Income benefits: the premiums are tax deductible whereas the monthly benefit payments are taxable.
    - Sickness benefits: the premiums are not tax deductible, whereas the monthly income benefit is paid tax free.

In order to claim under these benefits the client must be unable to meet some occupational definition or in some instances meet a medical impairment definition. The client must be unable to perform his or her own occupation for example or have stage IV cancer to qualify for a claim.

The rest of this document will concentrate on income protection type benefits sold individually and as part of group scheme protection.

4. Type of disability income benefit

There are two types of disability income benefits in the market.

1) The one benefit is a loss of income benefit where the client is typically required to provide proof of loss of income to receive a payment. The claim amount is often also determined by considering the actual loss of income.
2) The other benefit is a sickness benefit and the client will typically receive a payment if he is booked off for a specified period by a doctor.

These two benefits have different features that are expanded on below.

There has been a recent trend to combine the two benefits to provide the client with the best features from each of these benefits.

5. Level of income replaced by disability income products

Historically companies offered protection at 75% of pre-disability earnings for the duration of the disability (or shorter period if specified by the policy). Although this is still the norm, the client may select to insure themselves for a higher percentage of pre-disability earnings on either temporary disability, permanent disability or both. Therefore in comparing benefits, one needs to determine:

1. Percentage of income paid on temporary disability
2. Percentage of income paid on permanent disability
3. Any specified periods that these percentages apply to and whether these percentages change at any point in time or on any specified event.

6. Aggregation of benefits

Every effort should be made at underwriting stage and throughout the duration of the benefit to ensure the client has the appropriate amount of cover and are not over-insured. However, very often, the perceived level of cover that a client expects to be paid in the event of disability does not manifest in practice. This is largely due to the process of aggregation. Aggregation effectively combines all your disability insurance benefits as well as your post disability income to ensure that you do not receive more than 75%-100% of your pre-disability earnings while disabled. The rationale for this is to limit the incentive for opportunistic clients to start claiming. It also creates an incentive for claimants to return to work and earn their full income again, if they are able to do so.

There are several types of aggregation that should be borne in mind:

a. Aggregation with disability benefits provided by other insurers: insurers will ratio their payments down to ensure the sum of all payments does not exceed the agreed percentage of pre-disability earnings to be replaced.

Compare inter-company aggregation processes.

b. Aggregation with lump sum disability benefits: some insurers may aggregate your income benefits with your lump sum benefits. This is done by typically converting your lump sum to a monthly amount depending on your age at disability and expected duration to retirement and adding this to your disability income benefit to ensure income does not exceed the agreed percentage of your pre-disability monthly earnings. Check whether the insurer you are considering aggregates monthly income benefits and lump sum benefits.

c. Aggregation with Group Risk Benefits: most salaried employees belong to a Group scheme which provides them between 60%-75% of pre-disability earnings on a disability event. Should they purchase additional disability income benefits, they need to understand how the group and individual benefits dovetail. It is common to find that someone has group risk cover as well as individual cover and aggregation rules will result in reduced benefits being paid. However, it is important to also know whether the employer's group risk scheme allows for a continuation of cover on an individual basis should you leave the employer. If not, there may be good reason to have cover through your group and additional cover in your own capacity even if there is some element of over insurance.

d. Aggregation with post-disability earnings: it is often the case that the disability does not lead to full loss of income and the client continues to earn a partial income while partially disabled. In addition, the client may earn passive income from investments, rentals etc. It must be understood as to how the income earned post disability will be treated by the insurer.

e. No aggregation: sickness benefits are usually not aggregated against other post-disability earnings or disability benefits provided by other insurers.

   An example for aggregation with other policies may be:
   Suppose that a client with a monthly salary of R50 000 is insured for R20 000 with insurer A and R20 000 insurer B. Suppose too that insurer A stipulates that a maximum of 75% of pre-disability earnings can be replaced. This client is therefore over-insured as in total he is insured for 80% of salary instead of 75% of salary. The R20 000 benefit payment from insurer A may therefore be reduced proportionately by a factor to ensure that the client does not receive more than a total payment of R37 500 (i.e. 75% of salary) from both insurers.

   An example for aggregation with post-disability earnings may be:
   Suppose that a client with a monthly salary of R50 000 is insured for an income disability amount of R37 500 (i.e. 75% of salary). Suppose that on becoming partially disabled the client is still able to earn an income of R10 000. Suppose too that insurer A stipulates that a maximum of 75% of pre-disability earnings can be replaced. The insurer may then deduct the R10 000 from the income disability amount of R37 500 to ensure that the client does not receive more than a total payment of R37 500 (i.e. 75% of salary).

7. <u>Waiting Periods</u>

The waiting period is the period of time that a client has to be partially or fully disabled to be able to claim a benefit. Some products will pay retrospectively from day 1 of illness, while others will not. It is important to understand this as it has direct relevance to a client's cash-flow planning on becoming disabled. Selecting the correct waiting period on your income disability benefit is an extremely important part of the financial planning process. When choosing the waiting period, one should consider the period of time that one can be off work without losing an income. For example, many salaried employees will have at least 30 days sick leave and will only experience a loss of income after being disabled for more than a month. These individuals could select a 1 month waiting period on their policy which means it will only start paying in the event of being off work for more than a month – assuming the client doesn't have group cover. If a shorter waiting period is selected the sick leave payment will be aggregated against the benefit payment received – this will not apply to sickness benefits. The longer the waiting period one selects, the cheaper the premium will be for the income disability product.

Waiting periods are also relevant for lump sum disability benefits. Many products in the market have explicit general waiting periods of up to 6 months. The reason for waiting periods is that it often takes a long period of time to assess the permanence of a disability. In recent times, there has been a move away from having an explicit general waiting period to including the waiting period in the various definitions of disability. This can ensure that in cases where permanence is easily assessed (becoming a paraplegic), policyholders do not have to wait a mandatory period of time to receive payment.

8. Length of payment period

Since disability benefits are aimed at protecting policyholders against a loss of income from not being able to work, the period of time for which an individual expects to work becomes a very important factor. Traditionally, expiry ages for both income disability and lump sum disability products are chosen to coincide with the one's expected retirement age, typically age 60 or 65. With the recent trends of individuals living longer and hence having to work until older ages to ensure they can support themselves in retirement many insurers are now providing expiry ages of 70 for disability benefits.

There are also income disability benefits that only provide payments for a limited period of time often 12 to 24 months. These benefits are typically known as temporary income benefits as they only provide cover for a temporary period of time. The inference of the word 'temporary' does not relate to the temporary or permanent nature of a disability.

9. Definition of disability

The definition of disability may vary considerably between lump sum and income disability products as well as between individual and group risk benefits. Some products are based solely on occupation definitions, while others are based on medical definitions or a combination of the two. If the claim definition is based solely on occupational definition the client may be subject to reviews to show the client still qualifies for a payment.

As is the case with lump sum benefits, medical definitions may be included in the claims definition for certain income benefits to simplify the claims process and provide more objective criteria for the protection of the client. The objective medical definitions provide protection for a specified period based on waiting period and cover a range of conditions from severe illness benefits to bone fractures.

Benefits that only include medical definitions will not provide the comprehensive protection offered by benefits that include the medical definitions in combination with an occupational definition. The market also offers income disability benefits that are assessed on the client's ability to meet certain specified criteria known as activities of daily living or daily work.

Occupation definitions can vary considerably and will impact significantly on the premium charged for the policy.

The most common disability definition types are:
- Nominated occupation – most liberal definition of occupation which measures the ability of the insured to perform his/her nominated occupation
- Own occupation – this measures the ability of the insured to perform his/her particular occupation
- Own or any reasonable alternative occupation – this definition measures the ability of the insured to perform any occupation for which he/she is reasonably qualified, based on his/her training, education or experience.
- Any occupation – this definition measures the ability of the client to perform any occupation irrespective of his/her training, education or experience. This is the strictest definition as the client needs to be severely disabled to qualify under this definition.

It is very common for group risk benefits to provide an 'own' or 'nominated' occupation definition for a period of time, typically 2 years and then to move to an own or any reasonable occupation definition thereafter. This is a very important feature when considering the aggregation of individual policies with group policies as the client may qualify for payment during the initial definition period but may not meet the definition thereafter.

10. Definitions of Income

The actual definition of income in income disability products is of utmost importance. The most common definition of income for a salaried employee is a cost-to-company definition.

For business owners, income is typically either defined as the personal taxable income of the individual or the more robust definition of gross fees for services rendered less overhead expenses.

The exact definition of income should be carefully scrutinized with reference to one's particular occupation when selecting an income disability product. For clients with fluctuating earnings an average over a specified period is usually used to determine the payment amount. Passive incomes such as rent and investment income (other than remuneration in the form of dividends) are also often excluded when determining the payment amount.

11. Determining the claim amount under income benefits

The claim amount under sickness and loss of income benefits will be determined by considering one or more of the following:

- Ability to perform a specified occupation. For example someone who is booked off from work and is totally unable to perform the duties of his occupation (depending on the definition) will receive a full payment. Partial payments are also possible in cases where the insured life is only able to partially return to work or are only able to perform certain of his occupational

duties due to disability. This definition is usually used for sickness benefits and doesn't require the client to provide proof of loss of income.

- Loss of income. The claim amount will be determined by considering the actual loss of income suffered because the client is unable to perform the duties of his occupation (depending on the definition).
- The claim amount for objective definitions is usually related to the benefit amount irrespective of the loss of income or ability to perform the duties of his/her occupation. In some cases the payment term is also defined.

At inception of the policy, clients can also select the rate at which their benefit amount can increase pre and post claim. This increase percentage usually differs between pre-claim escalation and post-claim escalation rates. The claim escalation rate is often linked to CPI (often capped at a certain percentage) or at a fixed rate. A benefit that provides post-claim escalation at a rate of CPI ensures a client's claim amount maintains its value in real terms and should therefore be more expensive than a benefit that doesn't provide any claim amount protection. There are also instances where the post-claim escalation rate can be higher than inflation. This is particularly suitable for younger professionals who would expect fairly high future salary growth.

12. Conclusion

It is important that each individual's needs and circumstances are assessed when making a recommendation regarding the different options available to the client. The aim of this document is not to give advice, but only to highlight the different benefit options available.

October 2011