Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Consumer Panel Discussion Paper - Understanding the protection gap

Executive Summary

Introduction

It is widely acknowledged that many consumers have inadequate protection insurance such as life cover, critical illness or income protection. This leaves them and their families vulnerable to the effects of catastrophic life events such as early death or long-term illness.

The so-called 'protection gap' has been debated and researched for many years, to little effect. In recent times, legislative changes such as automatic enrolment, pension freedoms and the introduction of universal credit have taken centre stage, overshadowing the fact that two thirds (65%) of UK adults have no protection cover at all, and over seven in ten (71%) have no life insurance.[1] The policy focus has been on saving as a means of building resilience, rather than encouraging people to think about how they manage the risks they face in life.

The Financial Services Consumer Panel (the Panel) is concerned that the protection market (in particular the part of the market focusing on long term illness) is not producing good outcomes for consumers. We wanted to understand why consumers buy, or don't buy, protection insurance and identify what changes could be made to help plug this gap in consumers' financial resilience.

The Panel's research

In early 2018, the Panel commissioned Bdifferent to undertake qualitative research on our behalf.[2] Our intention was to:

- build a more in-depth profile of those consumers who have already purchased critical illness cover, including who they are, their employment status, their life stage and their attitude to risk;
- explore the main stages on the customer journey from considering critical illness cover to buying a particular product; and
- understand why critical illness products are more likely to be bought and sold than income protection

We also consulted mortgage intermediaries, insurers, a reinsurer and mortgage lenders to understand their perspective on the issues and the challenges they saw in the protection market.

[1] FCA Understanding the financial lives of UK adults: Findings from the 2017 Financial Lives Survey
[2] https://www.fs-cp.org.uk/sites/default/files/bdifferent_protection_research_final.pdf

Conclusions

Detailed findings from both the consumer research and our discussions with industry representatives can be found in the following sections. Overall, we were struck by how similar they were.

The benefits of income protection are hidden behind complex choices and caveats in the small print which mean advisers shy away from recommending it and consumers don't understand it, or believe it to be of poor value. There has been some product innovation in this market, but this hasn't translated to widespread take up. Many of the products available today have changed very little in the past three decades and don't meet the needs of today's workforce, which is more likely to be self-employed, in short-term employment or have high income volatility.

Product providers and intermediaries point to the adverse effect a pay-out can have on eligibility for means-tested benefits. The DWP has now confirmed that pay-outs under certain protection products paid directly to lenders to cover mortgage payments will be disregarded in the means test.[3] However, this is a limited concession as any pay-out from protection policies used to pay rent or other essential bills is still classified as income.

Lessons can be learnt from critical illness products, which seem easier for consumers to understand. Pre-defined conditions and one-off lump sum payments bring the peace of mind consumers want. They also perceive critical illness cover provides value for money. The problem is, critical illness products don't cover two of the main reasons people are off work on long term sickness i.e. musculoskeletal and mental health issues.

There are a number of remedies that could improve the protection market and provide better outcomes for its customers, but improvement needs the cooperation of the regulator, product providers, reinsurers, lenders and intermediaries.

However, the answer is not more education for consumers, or persuading more mortgage intermediaries to recommend income protection, or to continue recommending a product that does not provide adequate cover, because it is the easier sale.

There is no one silver bullet that can solve the 'protection gap' but offering more of the same is definitely not the answer.

But one thing is clear. It is time for the industry to develop less complex products that are designed for the needs of today's customers in the modern labour market.

[3] https://www.communities-ni.gov.uk/sites/default/files/dmg-vol9-chapter51.DOCX

Recommendations:

- Product providers should explore whether critical illness insurance can be extended to cover musculoskeletal injuries and mental health and remain affordable.
- The FCA should convene a working group to re-examine the proposals, templates and standards developed as part of the Sergeant Review of Simple Financial Products, concentrating on a hybrid of income protection and critical illness. The working group should include representatives of industry, consumers and the government. It should look at the development of simple industry-wide umbrella protection plans that can be accessed through the workplace, via affinity groups or purchased privately by employees or the self-employed. This group could also look at the pros and cons of indemnity commission and how this affects market practice.
- As part of the Financial Advice Market Review (FAMR) recommendation to provide workplace advice, the new Single Financial Guidance Body (SFGB) and the Association of British Insurers (ABI), through partnerships with employee benefit consultants, should use the ABI's protection calculator, currently under development, to encourage employers to provide clearer information to their employees about their sickness benefits and raise awareness of the impact a loss of income could have on an individual or household.
- However, providers of the standalone version of the protection calculator must make it clear to consumers that this is only part of the picture, and signpost to regulated intermediaries for advice.
- Government should examine the case for allowing all pay-outs (whether in the form of capital or an income) from income protection and critical illness policies to be disregarded in the assessment for universal credit or other means-tested benefits.
- The FCA should give mortgage lenders and intermediaries direction as to whether they should talk to borrowers about the impact of a lost or reduced income.
- The FCA, as part of its mortgage market study, should consider whether a borrower's ability to withstand a sudden or prolonged drop in income should be part of the assessment.

Findings

Consumer Research

In March 2018 Bdifferent, on behalf of the Panel, conducted qualitative research in the form of 45 individual and paired depth interviews and one focus group, among consumers holding critical illness policies. Participants were of varying ages (although at least five years before intended retirement age), geographical location and employment status. The aim of the research was to understand why these consumers had bought this product, and whether they fully understood it.

The research showed that few consumers actively seek out income protection or critical illness insurance. The most likely time for individuals to have a “protection conversation” is when they are taking on a large commitment such as a mortgage, or already reviewing or re-organising their financial affairs.

The consumers we spoke to were generally happy with their purchase and felt a sense of relief; they could ‘tick a box’ and move on. Few thought they would re-visit their policy unless they had to claim.

The need to cover a critical illness is understood

The research also showed that consumers could understand and relate to the need for critical illness insurance. It was common for our research participants to either know of someone who had experienced a serious illness, particularly cancer, or else to have seen adverts or charity appeals with ‘people like them’ suffering from a critical illness.

Participants said they liked the simplicity of critical illness insurance, understanding that they would get a lump sum pay-out in the event of a claim.

But not long-term sickness or income protection

In contrast, participants were suspicious of the legitimacy of long term sickness (for reasons other than a critical illness) and few participants could envisage any situation where they would be unable to return to work. No-one recognised that musculoskeletal or mental health problems could cause long term sickness from work.

When income protection was mentioned, participants were confused by the name and what an income protection product would cover. Some thought it would protect their income in the event they lost their job, others that it provided cover if their employer reduced their hours. They were unsure whether it would replace all or just some of their income and how it would help those working in the modern ‘gig’ economy with limited job security, multiple jobs, or no fixed income.

Over-confidence about employers’ sick pay

Most participants who were employed had no knowledge of their employer’s policy on sickness benefits, but generally believed that employers would give them sick pay should it be required. Most thought they would get paid for longer than the statutory minimum. These misconceptions may have led them to think there wasn’t such a need to maintain an income in the event of a long-term illness.

Findings

Intermediaries

In June 2018, The Association of Mortgage Intermediaries hosted a meeting for members of the Panel to meet senior representatives of the mortgage intermediary market.

Many agreed with the Panel's assumption that protection products tend to be 'sold', as they are rarely 'bought'.

All those we spoke to had, voluntarily, included a requirement to discuss protection products with mortgage customers within their internal processes – even though this was not a regulatory requirement. This meant that advisers within these firms were unable to complete the advice session without having a conversation about protection insurance. These firms had instigated these procedures as they felt that a discussion about how customers would cope in the event of the death or serious illness of a wage earner, especially when making such a large commitment as a mortgage, was essential and in the best interests of the customer.

However, since the introduction of the Mortgage Market Review, mortgage advice takes longer, and this left less time for discussions about customers' protection needs. It is possible that many intermediaries are not discussing protection for this reason.

There was some strong feeling that the FCA could do more to give direction and steer to mortgage intermediaries about the need to ensure customers are adequately protected. Also, that lenders, as part of their affordability assessment, should take more interest in how their customers would be able to repay the mortgage in the event of a financial shock.

All agreed that, while believing income protection is the right product for most people, it is not an easy sale. They confirmed that critical illness is the product that people understand, especially when combined with life insurance.

High on the list of issues for many of the industry representatives we spoke to, particularly intermediaries, is the fact that benefits paid out from privately purchased protection products affect eligibility for means-tested benefits. The recent clarification from the DWP that payments made directly to mortgage lenders will be discounted is welcomed but doesn't go far enough.[4] For example, it doesn't help families in rented accommodation.

A more detailed summary of the roundtable discussion with mortgage intermediaries is attached as Appendix I.

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[4] https://www.communities-ni.gov.uk/sites/default/files/dmg-vol9-chapter51.DOCX

Findings

Product providers and reinsurers

Product providers and reinsurers are key to reducing the protection gap.

The ABI told us it has concerns at how vulnerable the UK workforce is to the impact of long-term sickness absence, given that one in four adult workers will be out of work for a prolonged period of time at some point during their career. It confirmed that the insurance industry is committed to improving the financial resilience of individuals and households in the UK, and believes that greater take up of protection insurance products and services can play a strong role.

Swiss Re's annual Term and Health Watch 2018 reports some innovation in product development in the form of 'limited benefit' income protection plans, which now account for over half of standalone income protection business. These plans typically pay out for a maximum of two years, but are, on average, around 45% cheaper than full term policies which pay out until the policyholder returns to work or until retirement, whichever comes first.

The report also confirms that more protection is being sold within 'multi-benefit' plans which are single policies providing benefits across term life insurance, critical illness and income protection.

However, overall sales of income protection products in 2017 only increased by 2.8% from a low level. On their own, these limited innovations are not enough to solve the protection gap.

AIG Life added cover for severe mental health problems to its critical illness policy in July this year. However, conditions for a claim are very limited as the customer must be off work for at least a year and have spent 14 consecutive nights in a psychiatric ward. Although limited, it is encouraging that at least one provider is widening the conditions that can be covered by critical illness policies.

The protection calculator

The ABI commissioned Learning and Work Institute (L&W) and Policy in Practice (PiP) in October 2017 to develop an online 'protection calculator' that would set out for individuals a personalised estimate of their likely income in the event of having to leave work due to ill health or injury, taking into account applicable state benefits and entitlements. This follows on from proposals made by the ABI to the Government in 2016, in response to its Green Paper on work, health and disability.

The primary aim of the Protection Calculator is to increase individual's awareness of their financial vulnerability to income shocks and to assist them in making informed financial decisions about their protection needs. The ABI would like the Single Financial Guidance Body to support the inclusion of this tool on their website, and have discussed this with the Money Advice Service (MAS).

The Panel welcomes this work. If employers can be persuaded to host the calculator on their intranet it will provide some much-needed clarity for employees regarding their own sick pay scheme and how this interacts with state benefits. The standalone tool, however, will always only be able to provide part of the picture and will need some clear messaging and signposting towards further help.

The tool is still in development. However, without innovative products to fill any identified gap in protection, it is only a partial solution.

Findings

Mortgage Lenders

In July 2018, The Building Societies Association hosted a meeting for Panel members to meet senior representatives from mortgage lenders.

The lenders acknowledged that income protection is complicated and expensive. One believed there is no market for the current product offering and is working with a product provider to develop something simpler.

Lenders commented that, traditionally, the insurance market hasn't liked 'simple' insurance products as adding more 'bells and whistles' was more profitable. But they agreed that it is important to have something that is easy for consumers to understand and want to buy.

One lender asked how the FCA would react if, for example, they were permitted to offer a more favourable mortgage rate to customers who took out protection insurance? Customers willing to protect themselves are a lower risk to lenders, but would this be seen as applying undue pressure for direct lending? Alternatively, if having protection in place gave them a more favourable affordability assessment, would this be grounds for a lower interest rate?

One lender suggested that, when firms blame FCA rules for their lack of innovation, in reality it is often their own compliance department that is the culprit. The "compliance says no" comment is something the Panel has heard often from large firms. More guidance from the FCA in this area could provide clarity.

Lenders wondered whether there could be a subset of the affordability assessment, where the question of whether the borrower could afford protection could automatically be factored in. They commented that protection insurance is included in the ONS figures that many smaller lenders use for their affordability assessments.

At present lenders are required to stress test borrowers' ability to continue to repay if interest rates increase but are not required to stress test against an unexpected drop in income. Some lenders include a standard amount for protection insurance premiums in their affordability assessments, but these figures are drawn from national averages and include people who do not pay premiums as well as those who do, so the average understates the true cost facing those who have protection insurance. It is unlikely that the FCA will want to be more prescriptive than it currently is about the items that are used in affordability assessments, but lenders could be mandated to consider how the borrower would be able to sustain payments in the face of a drop in income.

Lenders also raised the question of whether advising consumers to shorten the term if they can afford to do so might be bad advice if this means no money is left for protection insurance. Again, some clarity on this from the Regulator would be helpful.

Smaller lenders who don't offer insurance try to refer borrowers to a financial adviser to discuss protection. However, by that point, the mortgage is agreed, so is this too late?

Lenders agreed that commission is a problem. There is a 4-year claw back on commission for protection insurance. But when times get tough, often the first thing a consumer will cancel is their protection policy. Lenders felt that non-indemnity commission would provide a better incentive to sell the most appropriate product and one that would be flexible enough to match customers changing needs. Although one lender commented that current products don't necessarily offer the required level of flexibility. A switch from indemnity to non-indemnity would also have financial implications for intermediaries.

Another problem cited by lenders is that there is very little continuing contact between insurers and customers with protection insurance, unlike, for example, building insurance. This means that customers often don't think about whether the insurance still meets their needs when other circumstances change. Lenders also believed that the General Data Protection Regulation (GDPR) stops them from contacting consumers to say they might want to think about protection.

One lender that provides an online guidance service for savings products has applied some of the lessons learned to protection and set up an in-branch protection tool which advisers can use to identify a protection need. They are currently working with an insurer on critical illness and life insurance but want to consider income protection next.

Some lenders thought a combined income protection and critical illness product would be helpful. Something simple, where it didn't matter what your occupation was – but where benefits were paid out if you were unable to work for three months or more. Policies would pay out a set amount per month until the individual was able to return to work or for a specified period, after which the policy would re-set.

Next steps

We welcome feedback on the discussion Paper and the research. Please send any comments to enquiries@fs-cp.org.uk. We intend to host a roundtable in the autumn, in order to continue the debate.

Appendix I

Summary of meeting with senior representatives from the mortgage intermediary market

In June 2018 members of the Financial Services Consumer Panel met with representatives of the mortgage intermediary market. Our thanks to the Association of Mortgage Intermediaries for arranging and hosting the meeting.

The comments recorded here were all made before Panel members discussed the results of its consumer research. Comments were made under Chatham House rules.

Attendees were senior level management from various firms and all were protection insurances specialists and enthusiasts – as well as mortgage specialists.

The Panel members attending had a number of questions.

Q: Is the protection discussion happening?

Intermediaries confirmed that with some firms this is happening. Some firms build this into their compliance process so that mortgage advisers are unable to get to the end of the appointment without having the conversation. These conversations are closely monitored so that advisers who might be struggling with the protection part of the advice session can be identified and assisted.

However, this was not a regulatory requirement and attendees acknowledged that it was unlikely this was widely practiced in the market.

Panel members asked whether things had changed since the Mortgage Market Review and attendees agreed that mortgage advice and processing is taking longer since MMR and this was very likely a reason why some firms do not talk about protection at all or if they do, it is a cursory conversation. The point was made that there was only so much information individuals can digest during an advice session – so it is difficult not to overload customers.

Q: What is the situation with the Regulator?

Intermediary representatives questioned why the Regulator had introduced stress tests for mortgage affordability but not for loss of income due to illness or redundancy, or the death of an earner. Many felt that the Regulator could do more to highlight the importance of protection insurance and encourage or even direct the market to have the protection conversation.

Possibly some formal guidance regarding the interaction between the mortgage sale and advising on protection insurance would be beneficial.

The majority of the intermediary representatives felt that introducing the concept of protection insurance ‘as you go’ was good practice and was a must if an adviser was to comply with the FCA’s requirements under ‘Treating Customers Fairly’.

Other areas of concern were in training. The mortgage qualification does have some content included on protection, but it is very product orientated. This could be improved. Minimum standards set by the Regulator are not high enough.

Q: Do Lenders require the mortgagor to have protection insurance?

This was a bone of contention with many of the intermediary representatives present. They confirmed that building insurance was a compulsory part of the sale as lenders were keen that their asset is protected. However, there is no requirement for the individual paying the mortgage to have cover. This is partly due to statistics i.e. only 2% of the mortgage population will die during a 25-year period so lenders don’t feel this is a high risk. However, 20% will have an illness or disability that keeps them from working.

Intermediary representatives feel this is wrong – almost unethical in some cases. They feel that lenders need to think differently and have more obligation (a duty of care) to their customers.

Intermediaries also felt that lenders should not deduct protection premiums from net pay affordability as this could reduce the amount of the mortgage and penalise those customers who were actually a better risk.

Q: Are critical illness policies easier to sell than income protection policies?

Panel members asked about the range of products and how easy (or not) they were to explain to customers and bring to a sale.

One intermediary mentioned that as a society, people don't like 'insurance'. They are distrustful of it and believe insurers won't pay out.

This isn't helped by the fact that many people are offered higher premiums after underwriting or even declined, for reasons that can seem trivial to customers.

Attendees commented that the industry process is 'clunky'. For most people, the right product is income protection but the policies available and the underwriting processes make them very difficult to sell. One adviser commented that if critical illness policies were underwritten in the same way as IP products, sales of critical illness would drop dramatically.

Representatives agreed that the concept of income protection was good, but many of the current products were not fit for purpose. They were complex and difficult for consumers to understand and the definition of illness could be different between products. There is also the issue of IP income affecting means tested benefits which is an ongoing and long-term issue.

People prefer the options and choice with critical illness. They understand the need for life insurance and CI seems a natural extension of this. People can imagine getting cancer or having a stoke.

One adviser commented that if you push too hard on the income protection sale you are likely to dissuade the customer from taking out any protection insurance. It's a difficult choice, but you have to weigh up the options.

All representatives agreed that there is much room for improvement in the IP market. Short term income protection was mentioned. Most advisers believed that there could be a protection solution, even on a tight budget.

One adviser confirmed that when asked, 9 out of 10 customers express an interest in income protection without knowing what it is.

They agreed that the name doesn't help. Illness protection might be a better name. The current name of income protection doesn't resonate with customers. It was suggested that the Income Protection Taskforce is looking to change the name of the product.

Attendees raised again the issue of benefits paid from protection insurance affecting eligibility for means-tested benefits. The level of nervousness this creates within the intermediary market should not be underestimated.

Q: Is there any innovation in the protection market?

Most representatives agreed there was minimal innovation in the protection market.

There was a belief that innovation in the form of 'robo-advice' would not work. All felt that the protection conversation would need a person to get the message across – even if this was a telephone conversation. Online only would not provide the solution. There was also some concern that if mortgage sales became an online journey only, this would completely eliminate any protection 'conversations'. There is much concern about non-advised sales of both mortgages and protection products.

However, more could be done in underwriting. There is some innovation in this area, but more is needed as this could have an enormous impact. Vitality was given as an example of innovation.

Some other areas where innovation could play a part were mentioned. For example, some advisers waive or reduce their mortgage fee if protection policies are purchased.

Summary and recommendations

The Advisers we met were all passionate about protection and were clear that including protection products was part of their mortgage compliance journeys. But it was not solely about compliance. They believed having the 'protection conversation' is good practice and is treating customers fairly.

However, all agreed that it is not an easy path. Many blamed complex product design (IP in particular), 'clunky' underwriting and processing and increased time in processing the mortgage which leaves less time to talk about protection insurance in the depth such a critical issue demanded.

Here are some solutions and recommendations put forward during the discussion:

- The intermediary market is keen for the FCA to do more. Not more regulation, but more guidance and steer on how the joint mortgage and protection sales and process should be 'managed' and the importance of including protection insurance within mortgage advice.
- There was a suggestion that the FCA could look at combining mortgage and protection illustrations.
- Advisers should be better trained in 'soft skills'. The mortgage qualification CeMap could be updated to be less product specific and more holistic when it comes to protection insurance.
- Providers need to re-think income protection. The name needs to change and the product needs to somehow be made far less complex and easier to underwrite. Intermediaries were keen to keep the concept of income protection, but with more of the simplicity of critical illness.
- There needs to be a discussion with government about the pay-out from protection insurance and how this interacts with means tested benefits (this is relevant for both income protection and critical illness).
- FinTech could help with providing further innovation, especially in the underwriting process.