Private Insurance and Social Security

What happens when they collide, why it matters and what could be done

A submission to the Work, health and disability consultation by the New Policy Institute

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1 Introduction and summary

Introduction and scope

1.1 This paper reviews how the benefits received from income protection (IP) insurance and other insurances taken out by individuals affect entitlement to social security. The immediate reason for researching this subject is the Government's Green Paper on work, health and disability entitled *Improving Lives*. The consultation on the Green Paper is not directly concerned with the interaction between IP and social security but it is a factor that insurers must take into account and so affects the role they might play in realising the Green Paper's objectives. This paper is both a response to the Green Paper and a resource upon which others can draw.

1.2 The Insurance benefits considered in this paper are:

- Individual income protection (IIP) which provides a regular payment. This is compared to Group income protection (GIP) which is a similar benefit provided via the employer.
- Critical illness and Terminal illness (CI and TI) which provide a lump sum benefit
- Mortgage payment protection insurance (MPPI) which provides a regular benefit to meet regular mortgage costs

1.3 The reason a review is necessary does not arise from the Green Paper but from the ongoing replacement of several means-tested social security benefits and tax credits ("legacy" benefits) by a single means-tested benefit, universal credit (UC). Since the treatment of IP varies between the different "legacy" benefits, it is inevitable that the introduction of UC would mean changes. These changes and their implications are the focus of this paper.

1.4 The most important finding from the research is that people entitled to UC and people with IIP do not inhabit different worlds but overlap with one-another. UC-IIP interactions are therefore not just a theoretical possibility. They deserve close attention from both policy makers and the insurance industry. The paper shows what the issues are and how big they are; further detailed research beyond this paper is certainly conceivable.

1.5 This research has been sponsored by Aviva, LV=, Scottish Widows, SCOR and Swiss RE and carried out under the auspices of the Income Protection Task Force and has been conducted in partnership with SAMI Consulting. The paper is not offering advice on insurance products. The interaction between social security and IP depends on family circumstances – the number of children, housing tenure and cost, earnings of partner, level of savings, etc. – at the point of claim. Many of these will have been uncertain or unknown when the policy was taken out. By contrast, the calculations of the financial value of a policy in this paper assume perfect information; nor in reality is financial value the only consideration. For example, most IIP products are written on the basis of "own occupation" (the capacity to return to the original job) which is less harsh than the work capability assessment used for social security purposes. IIP also offers support for rehabilitation in excess of what is usually available through the NHS.

Key findings from the research

1.6 UC replaces three sets of "legacy" means tested benefits, namely: income support and other income replacement benefits for working-age adults; child and working tax credits which supplement the income of some families with children; and housing benefit which meets all or part of the cost of renting a home. Support for children and rent can lift a family's entitlement to UC to several hundred pounds a week. Even if the partner of someone who is sick or disabled has above average earnings, the family can still receive some UC. UC is not just the preserve of those who are poor.

1.7 Financial support for children and rent drives up the amount of UC but the rules that affect its interaction with Individual IP (IIP) most closely resemble those for income replacement benefits for working-age adults. These rules – especially the way that other income, including IIP, reduces UC pound for pound – are harsher than those for the tax credits and housing benefit.

1.8 The adverse treatment of IIP contrasts with Group income protection (GIP) which is paid by the employer. GIP is treated under UC broadly as it was before. What appears to account for the different treatment of IIP and GIP is that UC treats unearned income (including IIP) differently from earned income (including GIP). Under the legacy system, there was not a distinction.

1.9 Anonymised data on 128,000 IIP policy holders provided by LV=, shows that one third earn less than the average for full time workers (£28,000 per year) while 60 per cent pay only basic rate income tax on their earnings. Although this is only a sample of all those with an IIP policy, it is indicative. It shows that IIP is not just the preserve of those who are well-paid.

1.10 The potential interaction between IIP and UC has been analysed using the government's Family Resources Survey. Applying this analysis to the sample of IIP policy holders suggests that up to half could be adversely affected by the UC rules. Up to 10 per cent could find that the financial value of their policy is fully offset by a corresponding reduction in UC. These estimates are only indicative: nevertheless, we believe it is robust to infer that a "substantial minority" of policy holders could be adversely affected of which a few will certainly find that cash paid out under their policy is fully offset by reductions in their UC.

1.11 The adverse treatment of IIP also contrasts unfavourably with the rules governing the use that can be made of the lump sums paid out under Critical Illness and Terminal Illness (CI and TI). The specific issue is whether such sums can be used to pay down a mortgage without impacting entitlement to UC. At face value the UC rules appear slightly easier than before. Since this really comes down to interpretation by an adjudicator, there may be no real difference; but it is certainly not worse.

1.12 Mortgage payment protection insurance (MPPI) is another insurance product adversely affected by the shift to UC. Under the current rules, MPPI is in effect excluded from the calculation of entitlement to "legacy" benefits so long as the money is used for mortgage purposes. Under UC, there is no such exclusion. MPPI payments reduce UC pound for pound.

1.13 The government is also about to convert Support for mortgage interest (SMI, a part of IS which pays a claimant's mortgage interest for them) into a loan. This paper does not consider the merits of the change to SMI but the combination of that change and the treatment of MPPI under UC is a double blow potentially striking at the same place. It certainly cannot be justified on the basis of the robust finances of those with mortgages, eight per cent of whom claim a means-tested benefit now. Should they lose their job, this proportion would rise to one in three.

Conclusion and recommendations

1.14 These complex interactions with the new state benefits system make it hard to assess the 'net value' an individual may ultimately obtain from an IP policy. The trouble with the way the UC rules have been framed is that they manage to cut through this fog with a wholly negative message: in some circumstances, a policy holder may find that when their policy pays out, the entire benefit accrues to the government, leaving the policy holder themselves no better off. What creates this possibility is the rule that reduces UC entitlement pound for pound with IIP and with no amount, however small, disregarded. Although we would expect this to happen to only a few policy holders, there will be some. A larger group of policy holders will have the net financial value of their IIP reduced because their entitlement to UC will be cut.

1.15 The clear, negative message can only serve as a disincentive to lower and even middle income households to take out such policies. To the extent that this may leave them wholly reliant on UC (instead of having some support from IIP) in the event of sickness or disability, that costs the government money. The net cost to the government of more generous treatment of IP is certainly less than the gross cost.

1.16 We make four recommendations:

- First, that the treatment of IIP in the UC rules should be revised, through the introduction of a taper, a disregard, or a combination of the two
- Second, that the question of why UC should not treat IIP the same as GIP should be considered explicitly.
- Third, that MPPI (and any successor IIP equivalent) product should, subject to long-established rules, be fully disregarded when calculating entitlement to UC.
- Fourth, that the treatment of lump sum CI, TI or hybrid CI/TI/IP benefits, if used to pay down mortgages and other debts, should be clarified.

2 Income protection and social security

Scope: IP products and social security benefits

IP products

2.1 Table 1 sets out the different types of private insurance product which pay out in the event of sickness or disability and which are considered in this paper. There are three basic types along with GIP which is included because it is important for comparison.

Table 1: private insurance products and their distinguishing features

Name	**Abbreviation**	**Purpose**	**Frequency of payment**
Individual income protection	IIP	Unspecified – to meet living expenses	Regular
Critical illness; Terminal illness	CI/TI	Unspecified – to meet living expenses	Lump sum
Mortgage payment protection insurance	MPPI	To meet mortgage payments	Regular
Group income protection	GIP	Unspecified – to replace wages	Regular

2.2 As can be seen from table 1, the first and the second (IIP and CI/TI) have in common the feature that the money paid out is not for any particular purpose and the policy holder is therefore free to do with it what they wish. By contrast, the second (MPPI) is at least nominally for the specific purpose of meeting regular mortgage payments. The common feature of the first and third (IIP and MPPI) is that there is a regular payment. By contrast, the second (CI/TI) pays out a single lump sum.

2.3 Further detail on each of the first three is as follows:

- IIP. Income protection insurance is a long-term insurance policy that will replace part of a person's income if they can no longer work due to ill-health. IIP policies will usually involve a regular payment that is a proportion of previous income until the person returns to work, retires, dies or the end of the policy term. IIP does not just provide a regular payment but also offers other important benefits such as rehabilitation and support as well as usually being paid on an 'own occupation' basis. Own occupation means that the insurance policy will pay a benefit if the person cannot continue to do the job they were doing when they took out the insurance rather than only paying a benefit if they cannot work at all.

- CI and TI. CI is a long-term insurance policy to cover specific serious illnesses listed within a policy. If a person develops one of the listed illnesses they will receive a one-off payment. It can be bought as a stand-alone product but the majority are bought with a life assurance policy. TI cover is similar in that it will pay out if a person is diagnosed with a terminal illness. It is a standard feature of the vast majority of life assurance policies. The lump sums paid under CI and TI can be used to pay down debt such as mortgage, which would reduce monthly outgoings for the policy holder, and as such is equivalently protecting the living standard of the policy holder in a similar way to IP. This is why we consider these lump sum payment products as well as regular payment products in this paper.

- MPPI. This is a type of insurance that in the event of a person losing their employment (through sickness or redundancy) the policy would cover their mortgage repayments. These payments usually start three months after earnings stop and the payments will be for a limited period only (typically one year and a maximum of two).

2.4 The fourth product, Group income protection (GIP) is included for the purposes of comparison with Individual income protection (IIP). These two both provide the same kind of benefit, namely a regular payment with no specified usage. They differ in the fact that whereas IIP is a policy taken out by, and paid for, by an individual, GIP is taken out and paid for by the employer. All four products provide support in the event of sickness absence to varying extents.

Social security benefits

2.5 Table 2 sets out the various social security benefits which interact with the private insurance products. They can be divided into four groups, namely: the “legacy” means-tested benefits which are being phased out (IS, JSA-IB, ESA-IR, HB, CTC, WTC); their single, means-tested replacement (UC); a means-tested benefit which is being replaced by a loan (SMI); and contribution-based benefits which for the most part remain unchanged (ESA-C and JSA-C).

Table 2: social security benefits that interact with private insurance

Name	Abbreviation	Purpose	Future status
"Legacy" means-tested benefits			
Income support; income-based job-seeker's allowance, income-related employment and support)	IS, JSA-IB, ESA-IR	Means-tested income replacement for working-age adults	Replaced by UC
Housing benefit	HB	Means-tested support to help with rent	Replaced by UC
Child and working tax credit	CTC, WTC	Income supplements for children and low income working adults	Replaced by UC
Replacement means-tested benefit			
Universal credit	UC	Single means-tested benefit covering income replacement, supplement and rent	Being introduced: all new claimants by end 2018; those claiming other benefits transferred from 2019 to 2022
Discontinued means-tested benefit			
Support for Mortgage Interest	SMI	An add-on to IS etc. to pay mortgage interest	Replaced by a loan
Contributed-based benefits (unchanged)			
Contribution-based jobseeker's allowance and employment and support allowance	JSA-C, ESA-C	Contribution-based income replacement for working-age adults, paid for a limited period and dependent on national insurance contributions	Unchanged

2.6 Further detail on the means-tested benefits that are being replaced or abolished are as follows:

- IS, JSA-IB and ESA-IR. These are benefits relating to unemployment and incapacity to work. They are means-tested, meaning that they take into account the income of the claimant and their partner to assess eligibility, in addition to other requirements. IS is largely a benefit for lone parents with a youngest child under the age of 5, working less than 16 hours a week. JSA is an unemployment benefit, requiring claimants to be actively searching and available for work. ESA is the benefit that replaces Incapacity Benefit, and is designed for those who are too ill, injured or disabled to work. Those that apply are medically assessed and then directed into either the work-related activity group (unable to work but capable of some activities, such as work-related interviews), the support group (not capable of work-related activities), or redirected onto JSA. As of May 2016, there were 1.4 million working-age adults on ESA, 400,000 on IS, and 500,000 on JSA.

- HB. This is a means-tested benefit designed to help cover rent costs. Again, it is assessed on the basis of family income rather than individual income, and the amount paid depends on whether it is for social or private rent. For social rent, it depends in part on assumed need for bedrooms relative to the number of actual bedrooms (the so-called ‘bedroom tax’). In the private rented sector, Local Housing Allowance determines the amount of support for rent, which is tied to the distribution of rents in the local area and the assumed need for bedrooms to determine the eligible amount, in addition to national caps on the amount of support that can be received. As of August 2016, there were 2.1 million working-age social sector claimants of HB and 1.2 million working-age private sector claimants. The HB caseload has increased by around one million since 2000.
- CTC and WTC. Introduced in 2003, these replaced and expanded upon Working Families Tax Credit. WTC provided in-work support for those with low earnings, provided they worked a certain number of hours, and was more generous for lone parents and disabled workers. CTC, which applied both in and out of work, was tied to the number of children in the family. 4.3 million families received child and/or working tax credits in 2014-15, with the historical peak in 2010-11 at 6.3 million. Much of the fall in numbers is due to the removal of a flat rate family element that was received by families with relatively high incomes. Despite this, 49% of families with children in 2014-15 were in receipt of tax credits, some 3.9 million.
- SMI. This helps to pay mortgage interest for homeowners in receipt of out-of-work benefits or UC. Eligibility for this comes after about 9 months on the out-of-work benefit or UC. It is paid directly to the mortgage lender using a fixed interest rate, currently 3.12%. For those on JSA, it expires after two years. In 2015-16, there were 73,000 working-age families receiving SMI. A definition change prevents a long statistical series, but in 2004-05 there were 120,000 working-age recipients.

2.7 UC, which replaces the six existing benefits (excluding SMI), is based on a single monthly payment transferred directly into a bank account. The monthly payment (the option to have it paid fortnightly will exist in Scotland and Northern Ireland) will include additions which will replace tax credits. These are: the child element, the disabled child addition and the childcare cost element which lets claimants claim back up to 85 per cent of their monthly registered child care costs up to a capped limit of £646 for one child and £1,108 for two or more children.

2.8 UC is being introduced in stages in different areas of Great Britain. By September 2018, it is expected that all new benefit claimants will receive UC, and between 2019 and 2022, all existing claimants of legacy benefits will be migrated onto UC. Currently, single jobseekers can claim UC in all jobcentres in Great Britain, and couples and those with children can in selected areas.

2.9 There are several other social security benefits which are relevant to sickness or disability. Although they don't interact with the insurance products, some do interact with the means-tested benefits considered here. They are:

- Carer's allowance (CA) is paid to people who care for someone who is severely disabled. It is not means-tested but claimants must not earn more than £100 a week. CA counts as income for the purposes of calculating means-tested benefits.
- Industrial injuries benefits (IIB) is paid if disablement is a result of an accident at work or a disease caused by one's job. It is not means-tested. It is not available to those who are self-employed. IIB also counts as income for the purposes of calculating means-tested benefits.
- Personal Independence Payments (PIP), which replaces Disability Living Allowance, is for adults with disabilities who need help getting around or with daily living activities. It is not means-tested or restricted to those out of work. PIP, whose rationale is to help met the additional costs associated with disability, is not counted as income for means-tested benefits.
- Statutory Sick Pay (SSP) is paid by the employer for periods of illness longer than four days provided the employee's weekly earnings exceed £112. Worth £88 (a legal minimum, employers may be more generous), SSP is paid for up to 28 weeks. Someone receiving SSP is not eligible for ESA.

Interactions between income protection and universal credit

Households benefiting from an IP product who are also entitled to UC

2.10 The focus of this report is on those who are receiving both a benefit from an income protection product and a means-tested benefit. Although there are exceptions, the receipt of an IIP benefit usually impacts the amount of means-tested benefit that can be received. There are two things to look at here. The first is what difference the IIP makes to the amount of UC: when UC is lower than what it would be without IIP, the difference can also be seen as a reduction in the net value of the IIP. The second is how that interaction differs as between the legacy means-tested benefits and UC.

2.11 A simple example is helpful here. The key terminology is as follows.

- Disregard (also known as a work allowance, or a threshold): a slice of other income which is ignored in the calculation of the amount of social security benefit to be paid.
- Taper (also known marginal deduction rate or MDR): the reduction in the amount of social security benefit to be paid as a percentage of other income in excess of the disregard. A 100 per cent taper means a pound for pound reduction.
- "Net value" of IIP: the face value of the benefit less the reduction in the amount of social security benefit paid.

2.12 By way of example to illustrate: a household with £200 a week IIP (its only other income) claims for a means-tested benefit which has a £50 week disregard on other income and a 41 per cent taper.

- The reduction in the amount of social security benefit paid (compared with the maximum that would be available if the household had no other income) = 0.41×(£200-£50) = £61.50.
- The net value of the IIP = £138.50 (£200 - £61.50).

2.13 If the taper were higher, the reduction in social security payable would be bigger and the net value of the IIP smaller. For example, with a 65 per cent taper, the reduction in social security would be £97.50 leaving the net value of the IIP at £102.50. A smaller disregard pushes in the same direction. Say it was just £20, then with a 65 per cent taper the reduction in social security would be £117 leaving the net value of the IIP at £83.

Insurance product/social security grid

2.14 Table 3 shows the interactions between social security benefits and insurance products in terms of the disregards and tapers which apply to each product for each of the benefits. The principal comparison is between the treatment of each insurance product under the legacy benefits and its treatment under UC. A second comparison is between IIP and GIP where the design of the table itself – a single description for IIP and GIP under each of legacy benefit but separate descriptions under UC – points to a crucial shift that has taken place.

Table 3: interactions between insurance products and social security

Benefit	IIP (regular payment)	GIP (regular payment)	CI/TI (Lump Sum)	MPPI (Regular payment)
Legacy means-tested benefits				
IS, JSA-IB, ESA-IR	Counted as income. Small disregard, ranging from £5 per week for a single adult to £20 a week for a lone parent. 100% taper.[i]		Ignored if used to pay a debt which legally must be paid. Else added to savings. [ii]	Money above "applicable amount" not used to repay mortgage counted as income. 100% taper.[iii]
HB	Counted as income. Small disregard, ranging from £5 per week for a single adult to £25 for a lone parent, plus an additional £17.10 for working and meeting other criteria such as disability. 65% taper.[iv]		As above.	n/a
CTC, WTC	Counted as income. Disregard of £123 per week for WTC and £310 for CTC. 41% taper.[v]		Ignored. Income from capital above £300 /year counted as income.[vi]	Money not used to repay mortgage counted as income. 41% taper.[vii]
Replacement means-tested benefits				
UC	Counted as unearned income. No disregard. 100% taper.[viii]	Counted as earned income. Work allowance if limited capability to work or with dependent children Then £44 per week if housing component received, otherwise £92. 63% taper.[ix]	Ignored if used to pay down debt – else added to savings.[x]	Counted as unearned income. No disregard. 100% taper.[xi]
Contributory benefits (unchanged)				
ESA-C	Disregarded [xii]	Counted as income. £85 disregard. 50% taper.[xiii]	Not counted as income.[xiv]	Not counted as income.[xv]

2.15 The simplest of the changes as between the legacy system and UC concerns the treatment of lump sum payment under CI or TI policies. The key issue here concerns the treatment of the lump sum or a part of it if it used to repay all or part of a mortgage or other debt. On the face of things, it appears as if the rules are being relaxed slightly, to allow any debt to be paid down rather than just one that is legally required to be paid (a concept surrounded by uncertainty).

2.16 If the lump sum is not used to pay off a debt, or is not allowable, the sum is added to savings. The rules regarding saving are the same under UC as under the legacy benefits. Savings of less than £6,000 are ignored while savings above £16,000 reduce UC entitlement to zero. In between, each £250 of saving above £6,000 reduces UC entitlement by £4.35 a month. However there is a diminishing notional capital rule so that over time notional capital may be treated as spent.

2.17 Turning to MPPI, the benefit paid under the policy is in effect ignored in the legacy system if the money is used to make mortgage payments. Any money left over is treated as income and subject to the taper for whichever means-tested benefit is appropriate.

2.18 By contrast, with UC, MPPI is counted as unearned income and deducted pound for pound from UC from the very first pound. Obviously, this produces a more adverse outcome for an MPPI policy holder than the legacy system. But it also means this: if an MPPI policy pays out more than the UC the household would get if it had no MPPI, then it wouldn't get any UC (and leaving the family with no income to live on) while if it pays out less, the family is no better off than it would have been without MPPI.

2.19 The same stark outcome also applies to IIP policies under UC. With a 100 per cent taper and no disregard, either the IIP is worth more than the UC – in which case there is no point in claiming UC – or it is worth less – in which case the IIP policy has not delivered any financial gain to the policy holder.

2.20 The arrangements for UC are very close to those for IS under the legacy system. But they are very different from how IIP is treated either for tax credits or housing benefit. A household whose IIP is greater than what its entitlement to legacy benefits would be if it did not have IIP can still be better off financially with both than just one or the other. This cannot happen under UC as it is currently designed.

Conclusion

2.21 On the face of it, the challenge to Insurance products caused by the shift from "legacy" means-tested benefits to UC can be seen as being made up of three, specific problems:

- IIP and the support UC offers for children: here the issues are both the lack of a disregard and the lack of a taper, both of which are far less favourable than when this support was provided through CTC;

- IIP and the support UC offers with rent: here the issue is the lack of a taper, again much less favourable than when this support was provided by HB; and
- MPPI and UC support for working-age: here the issue is the lack of any disregard (where previously under IS, MPPI could be disregarded entirely), compounded by the transformation of SMI into a loan.

2.22 At a detailed level, these are the elements of the UC that need to be amended. But focusing on the detail, at least too quickly, misses something more fundamental. The contrasting treatments of IIP and GIP offer a clue as to why IIP and MPPI have come to be treated as they have under UC. As table 3 shows, each of the legacy means-tested benefits treats IIP and GIP alike – although the treatment itself differs in each case. By contrast, under UC, IIP and GIP are treated differently. What is driving this is a change in the treatment of earned and unearned income: treated the same in the legacy system but differently under UC. From the point view of the product, it makes little sense to treat IIP differently from GIP. But once it has been decided both to treat earned and unearned income differently and – which is crucial – classify IIP as unearned and GIP as earned, then the different treatment emerges automatically. Whether it is right to treat IIP differently (or indeed whether it was really intended by government) needs further explicit consideration.

3 The scale of the interaction between IIP and UC

Scope of the chapter

3.1 Chapter two looked at the interaction between insurance products and IP products in particular, and the social security system without paying any attention to scale. If means-tested benefits were only open workers on low earnings while IP products were the preserve of those with above average earnings, the theoretical "problem" would have little practical significance. The purpose of this chapter is show that this problem is not just a problem in theory but a real. More specifically, it seeks to answer the following questions:

- What sorts of sum of money are available through UC, what are the main factors that influence this and how high can household earnings go before all entitlement to UC is extinguished? (Discussed in paragraphs 3.2 to 3.5).
- What proportion of people in the working population would likely have some entitlement to UC if they were to fall sick or become disabled – and what proportion would do so even if they had an IIP to the value of 60 per cent of their earnings? (Paragraphs 3.5 to 3.9).
- How does the distribution of earnings of a sample of IIP policy holders compare with the distribution of earnings across the whole working population? In particular, what proportion have average earnings or below? (Paragraphs 3.10 to 3.12)
- What proportion of people in the sample of IIP policy holders would likely have some entitlement to UC if they were to fall sick or become disabled, both if they still have their IIP policy at that point and if they don't? (Paragraphs 3.13 to 3.17).

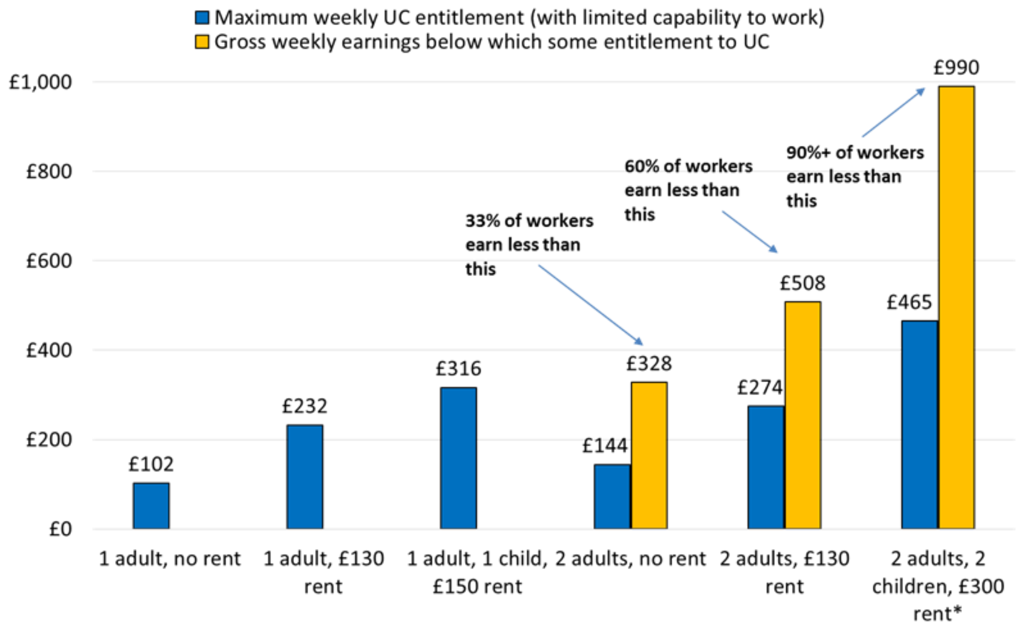
UC entitlements and gross earnings

3.2 Figure 1 shows the maximum UC entitlement for six different households, three with one adult and three with two. In the two adult households, it also shows the most the second could earn before entitlement falls to zero. The maximum weekly UC for a single adult (who is assumed to have a limited capability for work) ranges from £102 if there is no rent to pay, to £316 with weekly rent of £150 and one child. For two adult households, entitlement ranges from £144 (no children, no rent) to £465 (two children and £300 rent).[1] Once children and rent enter the picture, UC amounts can be substantial.

[1] The UC maximum for families with 2 adults, 2 children and £300 rent is £532. However, until family earning reach £430 per week, they are subject to the benefit cap which reduces it to £465.

Whilst household benefit receipt is now capped, this cap does not apply if someone in the household receives ESA-support component or disability cost related benefits, or if WTC is received, or if monthly earnings are £430.

Figure 1: maximum UC entitlements and earnings when some UC could still be received



Source: Analysis of the NPI Household Tax and Benefit model, Annual Survey of Hours and Earnings via NOMIS, ONS.

3.3 Figure 1 also shows how high the second adult's gross weekly salary can go (assuming the first to be sick or disabled and with limited capability for work) before all entitlement to UC is extinguished. Even in the two-adult household with no rent to pay, the earner has to be a third of the way up the salary scale (full- and part-time together) before all entitlement is extinguished. With two children and a high rent, the second adult could earn just shy of £1,000 a week (90 per cent of the way up the earnings scale) before all UC has gone. Once children and rent enter the picture, UC isn't just for the poor: those on middle income and sometimes even above can be entitled to support.

3.4 It could certainly be argued that someone on a salary well above the average wouldn't bother to claim UC for a few tens of pounds a week. And what about the number of people in the sort of situations depicted in figure 1: are there really all that many? Twenty years ago, perhaps not, but as figure 2 shows, the number of people in working families with children living in private rented accommodation (which is where the high rents are to be found) has been growing rapidly over the last 15 years, up from 1.5 million to 5 million in total and up from under one million to three over among those deemed to be "just about managing" (below average incomes above the poorest tenth). Working families with rent to pay – the group for whom the UC amounts are biggest – has been and is continuing to grow.

Figure 2: people in working families with children renting privately

Source: Households Below Average Income, Department for Work and Pensions. "Just about managing" families are defined as families with at least one person in work in the 2nd to 5th decile of the household income distribution.

The scale of the IIP/UC interaction: whole population

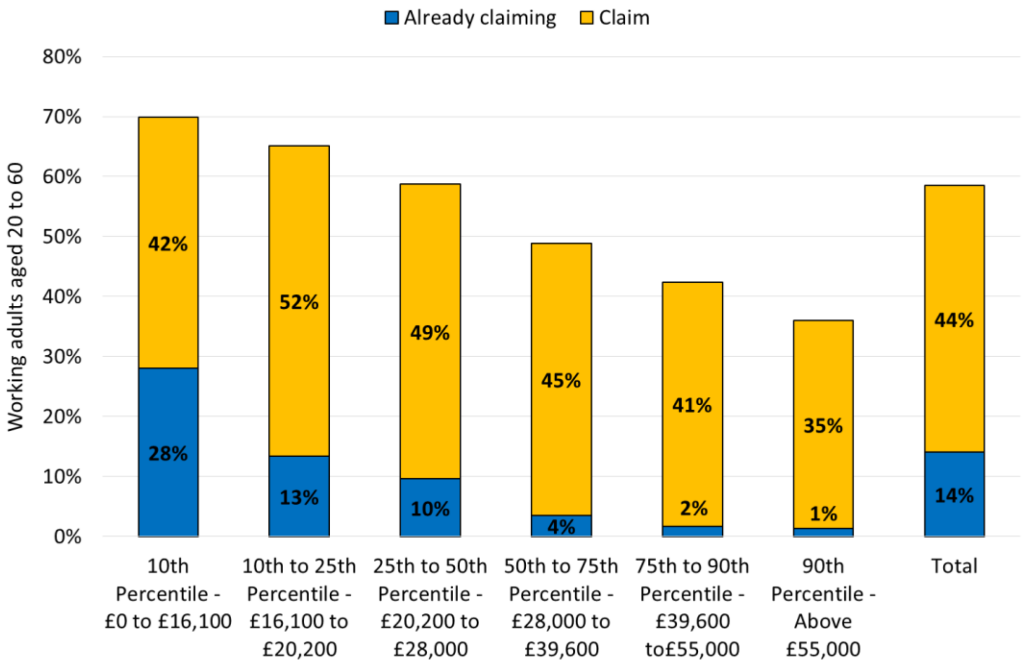
3.5 The government's Family Resources Survey is an annual survey of the detailed financial circumstances of some 30,000 households. We have used it here to estimate how many working households in which the adults are aged between 20 and 60 years would be entitled to means-tested benefits if one of their working adults were to fall sick or become disabled. To do this, working households have been divided into three groups:

- Those already claiming a means-tested benefit (on the assumption that the drop in household income as a working adult becomes unable to work does not remove the entitlement to means-tested support).
- Those not claiming a means-tested benefit now but who would become entitled to do so if a working adult becomes unable to work.
- Those not claiming a means-tested benefit whose other household income (chiefly a partner's earnings) means that they would still not be entitled to support even if a working adult becomes unable to work.

3.6 Figure 3 shows the estimated percentage of workers in each of the first two groups. The estimates are computed at the household level and take account of the number of adults and children, other household earnings and income, housing tenure (and where a tenant, the rent) and savings which remove entitlement if too high. The estimates also assume that the worker who has become unable to work has paid sufficient national insurance contributions to be entitled to contribution-based ESA. Since ESA is similar in value to Statutory Sick Pay, this assumption can be taken as a proxy for that too. In short, with savings, SSA and subsequently ESA, these are cautious estimates of entitlement to means-tested benefits. The results are presented according to where a worker's earnings puts them in the overall distribution of full time earnings. For example: half of full-time workers earn less than £28,000 a year, a quarter earn less than £20,200 while one in ten earn more than £55,000.

3.7 In total, 14 per cent of workers are already claiming a means-tested benefit. A further 44 per cent don't claim now but would be entitled to do so if they become unable to work. As would be expected, the lower the earnings the higher these percentages are. For example for the workers in the 10th percentile, 28 per cent are claiming means-tested benefits now while a further 42 per cent would be entitled to claim if they became unable to work. For the quarter of workers just below average earnings, the figures are 10 and 49 per cent. Although very few of those with above average earnings are claiming now, 42 per cent would be entitled to claim if they fell ill and those earnings ceased.

Figure 3: Workers whose households would be entitled to UC if they were unable to work and had no IIP: by salary



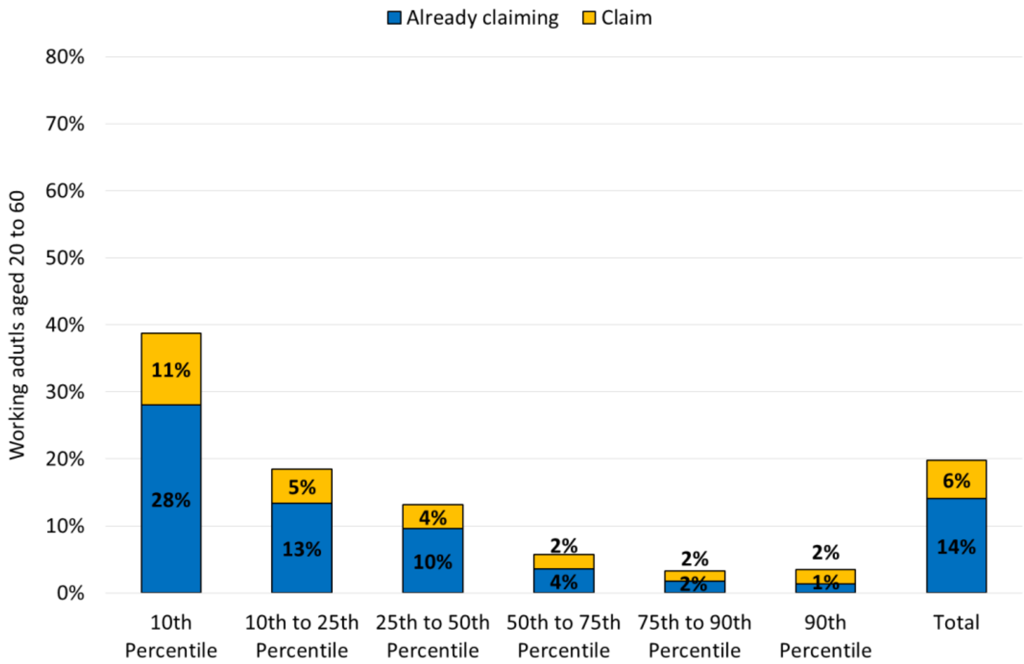
Source: Family Resources Survey, DWP. The data is for 2014-15.

3.8 Figure 4 answers a different question: how many of these workers would be entitled to means-tested benefits if they had an IIP worth 60 per cent of gross earnings on top of their other household income? The 14 per cent who claim those benefits even now continue to be entitled. Of the 44 per cent in figure 3 who would have been entitled without this notional IIP, six per cent remain entitled with IIP while the other 39 per cent are not. Putting the 14 and the six together gives a total of 20 per cent. These are the workers who would be entitled to UC were they to cease to work due to sickness or disability even if they had an IIP worth 60 per cent of their gross earnings.

3.9 Because of the way that IIP and UC interact – UC dropping pound for pound with IIP – both the 20 per cent and the 39 per cent can be interpreted in another way as well, namely:

- 20 per cent (2 in 10) get no net financial gain from having bought IIP
- 39 per cent (4 in 10) are lifted out of entitlement to UC by their IIP but net financial gain falls short of the full amount of their IIP benefit
- the other 41 per cent (4 in 10), who would have no entitlement to UC even without their IIP, receive the full value of their IIP benefit.

Figure 4: Workers whose households would be entitled to UC if they were unable to work even if they had IIP: by salary



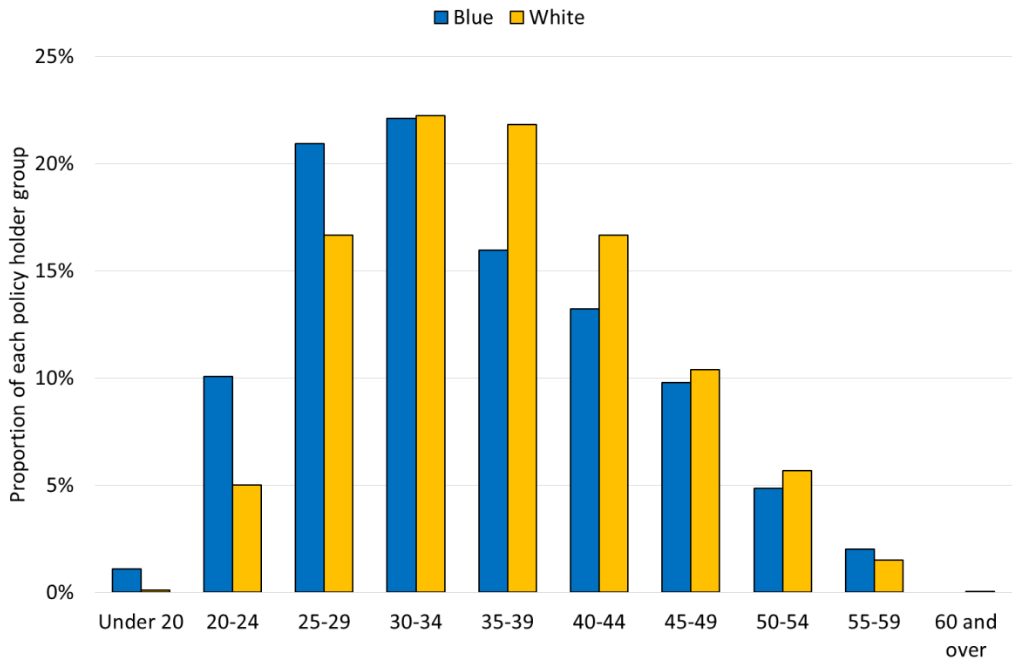
Source: Family Resources Survey, DWP. The data is for 2014-15.

IIP policy holders

3.10 Percentages which apply to the working population aged 20 to 60 as a whole are important when considering the goal of extending coverage of IP. They are also a stepping stone to estimating the percentages which apply just to existing IIP policy holders. In order to get there, data on IIP policy holders is needed which can then be linked to the whole population. As part of this study, we have been provided with skeleton data on the 128,000 IIP policy holders with LV=. By "skeleton" we mean only the age of each policy holder, their earnings, their sex and the date the policy began. There are around a million IIP policies in operation and the LV= data represents around 10 per cent of these. The sample is made up of two types of policy holder, namely "blue" which is designed for those in manual occupations and the self-employed and "white" which is typically taken out by white collar workers.

3.11 Figure 5 shows the policy holders by age when the policy was taken out. In reading this graph and the next, it is worth remembering that the blue make up about one quarter of the total and the white three quarters. More than 60 per cent of policy holders began their polices between the ages of 25 and 40. Six per cent of policy holders are under 25.

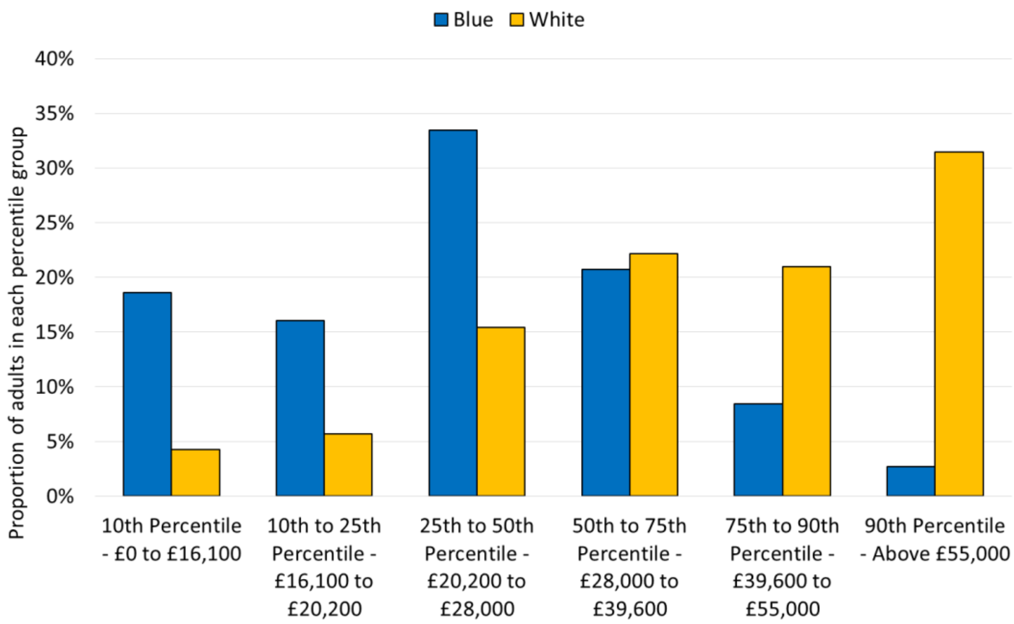
Figure 5: holders of IIP policies with LV=: by age



Source: Data provided by LV=

3.12 Figure 6 shows the policy holders by their position in the full-time salary distribution (the same presentation as figures 3 and 4 for the whole working population aged 20 to 60). While it is certainly true that a minority of IIP policy holders are towards the top of the earnings distribution, one third overall (and two thirds of those with "blue" IIP policies) have gross earnings below the average of £28,000. This is a significant minority.

Figure 6: holders of IIP policies with LV=: by salary



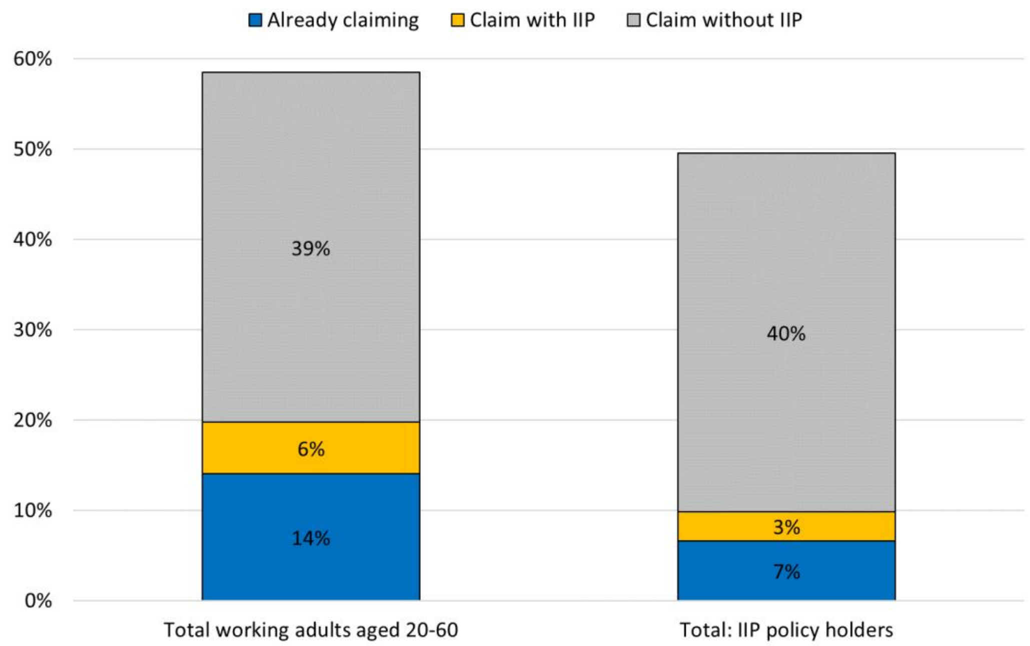
Source: Data provided by LV=

The scale of the IIP/UC interaction: IIP policy holders

3.13 Figure 7 both summarises figures 3 and 4 and shows the comparable percentage for the IIP policy holders derived from figure 6. The figures in the first column, for the working population aged 20 to 60, have already been discussed (para. 3.9). The figures in the second column are for the sample of IIP policy holders. They differ from those in the first because the underlying earnings distributions are different. For the IIP policy holders, it is estimated that:

- 10 per cent are either already claiming a means-tested benefit or, if they became unable to work, would have a claim for UC even with their IIP.
- 40 per cent are not claiming now and, if they became unable to work, would have a claim for UC but it would be less than the value of their IIP.

Figure 7: comparing UC-IIP interactions between working adults and IIP policy holders



3.14 The method by which these two estimates – the 10 per cent and the 40 per cent – have been obtained is deliberately straightforward. If more detailed data on actual IIP policy holders were available, estimates of a higher quality could certainly be produced. In its absence, it is just a question of which assumptions to make. We prefer simplicity.

3.15 Just as important as the method is the use that is made of the estimates. We would interpret the 10 per cent as indicating that while only a small number of policy holders (a "single digit percentage") would be in this position, it would not be none: "unlikely, but not zero". Similarly, we would interpret the 40 per cent as something like a "significant minority", an interpretation which would be just as serviceable if the truth was really 20 per cent – although not so if it were four or 64.

3.16 It also needs to be borne in mind that these percentages apply to what are serious situations. Given the way that UC drops pound for pound with IIP, we are saying that a single digit percentage of policy holders would find that their policy, in simple financial terms, was worthless to the extent the financial benefit has accrued entirely to the government and not at all to them. Although that outcome is unlikely, we are confident it will happen on occasions.

3.17 Our 40 per cent – the "significant minority" – face a situation where their IIP exceeds the UC they would have got had they had no IIP, in which case, it remains financially worthwhile for them.

Summary and conclusions

3.18 The chapter started with four questions. It is helpful, briefly, to summarise the answers.

- UC entitlements for the people under consideration here range between £100 and £465 a week. It is the support for children and help with the cost of rent that create the large sums. The gross earnings of the second adult in a two-adult household when the first has a limited capability for work can approach £1,000 a week before all entitlement is extinguished. In no sense is UC just the preserve of those who are poor.

- If they fell sick or became disabled, 59 per cent of those in work would have an entitlement to UC. With UC reduced pound for pound with IIP, 20 per cent would see no net financial gain from an IIP (their UC would be worth more). 39 per cent (4 in 10) would be lifted out of entitlement to UC by their IIP but the net financial gain would fall short of the full amount of their benefit.

- One third of the sample of IIP policy holders have annual gross earnings below the full-time median of £28,000. IIP is not in any way just something for those who are well-paid.

- Up to half of those policy holders could, if they became sick or disabled, have some entitlement to UC. Just as IIP is not confined to those with high incomes, so UC is not confined to those with low incomes. Because of the 100 per cent reduction rule, up to 10 per cent (1 in 10) of policy holders would be no better off financially than they would have been without IIP. A further 40 per cent (4 in 10) would be lifted out of entitlement to UC by their IIP but the net financial gain would fall short of the full amount of their IIP benefit.

4 Conclusions and recommendations

Discussion

4.1 These complex interactions with the new state benefits system make it hard to assess the ‘net value’ an individual may ultimately obtain from an IP policy. The trouble with the way the UC rules have been framed is that they manage to cut through this fog with a wholly negative message: in some circumstances, a policy holder may find that when their policy pays out, the entire benefit accrues to the government, leaving the policy holder themselves no better off. What creates this possibility is the rule that reduces UC entitlement pound for pound with IIP and with no amount, however small, disregarded. Although we would expect this to happen to only a few policy holders, there will be some. A larger group of policy holders will have the net financial value of their IIP reduced because their entitlement to UC will be cut.

4.2 The implications for the government of a negative message like this cutting through to members of the public are worth considering. From a financial point of view there is going to be a cost, as people who question the value of their policies may abandon them. Having done so, should these people then find they need financial support due to sickness or disability, they will be wholly reliant on state support. We don’t have the evidence to estimate how this increase in spending on UC compares with the original reduction in spending as a result of the shift from the “legacy” system to UC. But with up to 10 per cent (1 in 10) of policy holders set to be no better off financially than they would have been without IIP, the arithmetic is likely to be challenging.

4.3 There is also the question of what the government’s objectives should be. Long term sickness and disability is a significant risk. The *Resilient Households* Report showed how poorly placed many households are to weather a sharp downturn in their financial fortunes. Encouraging households to take steps to strengthen their resilience, rather than discouraging them, must be the right direction. It is worth spending some public money to achieve that. Altering the UC rules to increase the net value to policy holders of their IP policies is one channel through which that encouragement could be given.

4.4 The root of the problem is the rule that reduces UC entitlement pound for pound with IIP and with no amount disregarded. We suspect, however, that it is not just a question of arguing that the taper should be lower and the disregard higher. Rather, the fundamental question to address is whether IIP should really be treated as unearned income. When earned and unearned income were treated the same, this did not matter in practice. Now that they are treated differently, it matters a lot.

Recommendations

4.5 We make four recommendations. The first two concern IIP, the third concerns MPPI and potentially similar products insuring against a cost, while the fourth concerns the treatment of lump sums.

Individual income protection

4.6 Based on the finding that the present treatment of IIP in the UC rules is harmful, our first recommendation is that those rules should be revised, through the introduction of a taper, a disregard, or a combination of the two. In considering how they might be revised, one factor we would attach weight to in this discussion is how the effect of revised UC rules compares with effect of the rules in the "legacy" system. Adverse impacts for policy holders as a result of the shift from one system to the other should be minimised. Where that is not possible, the reasons should be made clear.

4.7 Our second recommendation is that the question of why UC should not treat IIP the same as GIP should be considered explicitly. The reality is that both IP and GIP are forms of deferred earnings. Both involve putting aside a small amount of earned income to make prudent provision for future loss of earnings. In the case of GIP this is facilitated by the employer whereas IP is set up by the individual. There seems no equitable reason why the latter course (which is the only route available to the self-employed and millions of other workers whose employers do not offer GIP) should be treated as less worthy than the former.

Mortgage payment protection insurance and others

4.8 Our third recommendation is that MPPI, or equivalent IIP products should, be fully disregarded when calculating entitlement to UC. This is a different recommendation than for IIP and there are several reasons for that.

- It is what happens under the "legacy" system. The detailed wording necessary to cover the necessary conditions exists within that system and could presumably just be imported into UC.
- Taking as the starting point a household with some entitlement to UC, allowing that household to use the benefit from an MPPI policy to meet its regular mortgage payment costs the government nothing. Should doing so help the household avoid losing their home, becoming homeless and/or moving into rented accommodation creating an additional UC entitlement, then it could save the government money.
- Against the background of the imminent conversion of SMI (support for mortgage interest) into a loan, the shift from the "legacy" benefits, where

MPPI could be disregarded, to UC, where it is not, is a second blow for low income owner occupiers with a mortgage. Such harsh treatment cannot be justified on the basis of the robust finances of those with mortgages, eight per cent of whom claim a means-tested benefit now. Should they lose their job, this proportion would rise to one in three.

- The principle that benefits to meet additional costs can exist alongside means-tested benefits without interacting with them is long-established in the social security system. For example, the Personal Independence Payment (PIP), a benefit designed to help meet the additional costs of disability, is neither means-tested nor does it affect entitlement to UC. Fully disregarding MPPI for UC (so long as the benefit from the policy is used to meet a mortgage payment) does not represent a new principle.

Lump sum payable under Critical Illness and Terminal Illness

4.9 Our fourth recommendation is that the treatment of lump sum benefits paid under CI and TI insurances, if used to pay down mortgages and other debts, should be clarified. On the face of it, the UC regulations appear to be slightly looser than those in the "legacy" system.

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[i] Child Poverty Action Group (2016) Welfare Benefits and Tax Credits Handbook 2016/2017. Child Poverty Action Group

[ii] Ibid

[iii] Department of Work and Pensions (2013) DMG Vol 9 Chapter 51: Income other than earnings. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/544444/dmgch51.pdf]

[iv] Child Poverty Action Group (2016) Welfare Benefits and Tax Credits Handbook 2016/2017. Child Poverty Action Group

[v] Ibid

[vi] Ibid

[vii] Ibid

[viii] Department of Work and Pensions (2013) Chapter H5: Unearned income. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/565515/admh5.pdf]

[ix] Department of Work and Pensions (2013) Chapter H3: Earned income – employed earnings. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/562453/admh3.pdf]

x Department of Work and Pensions (2013) Chapter H2: Capital Disregards. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/563902/admh2.pdf]

[xi] Department of Work and Pensions (2013) Chapter H5: Unearned income. Available at [https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/565515/admh5.pdf]

[xii] Child Poverty Action Group (2016) Welfare Benefits and Tax Credits Handbook 2016/2017. Child Poverty Action Group

[xiii] Ibid

[xiv] Ibid

[xv] Ibid