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Let's Get Technical: Beware the gap

From time-to-time financial advisers ask the question: 'Are there any issues if my client has a two-year group income protection or salary continuance policy funded by their employer and I'm looking to supplement this with an income protection policy with a two-year waiting period?'

The answer is: 'Potentially, yes.'

These days many employers understand and recognise the importance of their employees' financial wellbeing with practical measures, which not only benefits the employees but also employers, by assisting with retention strategies. This may include an employer paying for an employee-owned retail income protection policy, where the employer claims the tax deduction for the premium (under the 'otherwise deductible' rule), until such time as the employee leaves the employer, when the employee assumes payment for the premium and claims the tax deduction.

Another retention measure is the provision of group income protection or salary continuance. In popular advice parlance, salary continuance implies income protection inside super but this is not entirely true, as salary continuance can also be a non-super offering (for simplicity, we will refer to both offerings as group income protection). Although some of these policies do allow benefit periods to age 60 or 65, most of them are limited to a two-year benefit period.

There are several differences between the super and non-super ownership of group income protection, though product features and benefits are not generally one of those. One of the negative impacts of holding group income protection inside super is that any premiums paid for by the employer will count towards the employee's concessional cap. This particularly affects senior executives on a high income. As mentioned above, a fully featured self-owned income protection policy outside super would be preferable.

A couple of advantages of group income protection policies are that they generally have either automatic acceptance (no underwriting) or limited underwriting requirements and are generally paid for by the employer.

The usual strategy by advisers is to recommend that the group income protection policy be retained (if paid for by the employer) and a complementary second, retail income protection policy with a two-year waiting period and a benefit period to age 65 be taken out as a top-up.

So, what are the potential pitfalls for the group policies with a two-year benefit period?

A potential gap

Consider two scenarios for an insured person, Ringo, who has a group income protection policy with a 30-day waiting period and a two-year benefit period. This policy has a six-month recurrent disability (relapse) benefit. Ringo also has a retail income protection policy outside super with a two-year waiting period and an age-65 benefit period.

Scenario 1: Ringo becomes totally disabled indefinitely, so the first salary continuance payment will be made in the second month of claim (paid one month in arrears). The monthly benefits continue for two years, at which point there is a month overlap with the retail policy, which is offset. Benefits under the latter policy will continue until Ringo returns to work or turns 65.

Scenario 2: Ringo is totally disabled indefinitely. However, after one year, he feels better and returns to work. After two months, Ringo suffers a relapse and is unable to work (totally disabled) due to the same illness. Due to the relapse benefit, his group income protection policy waives the waiting period and he goes back on claim. Because this is a continuation of the original claim, only one year of benefits remain on his policy. Unfortunately, when he returns to work, Ringo's two-year waiting period under the retail income protection policy restarts. At the end of 12 months, he has a further 12 months to satisfy the two-year waiting period. Hence a gap of 12 months.

There is another potential drawback in the second scenario: How does the income protection policy to age 65 calculate Ringo's pre-disability earnings or income? In most cases, depending on the length of the initial disability period and whether the insured person has an existing agreed-value retail policy, it would be based on the monthly benefits paid for the initial claim, so less than the earnings used to calculate the initial group income protection benefit.

What is the solution?

Although the situation in Scenario 2 would be a rare occurrence, it is nonetheless feasible. For their clients that have the dual income protection structure, it is worthwhile for advisers to compare the cost of premiums for a 90-day waiting period versus a two-year waiting period for their consideration and to discuss with them the potential pitfalls of a worst-case scenario.

Note that ClearView, under its ClearChoice Income Protection offerings, is one of few insurers to have an inbuilt, no-cost income protection benefit – the Flexibility to Reduce Two-Year Waiting Period Benefit – which may be exercised if a client has a two-year waiting period with a benefit period to age 65, complementing an existing group income protection policy which provides a two-year benefit period. If the group income protection cover ceases, this allows a client to reduce the waiting period from two years to 90 days without the need to supply further medical evidence.

Summary

Advisers should make those of their clients who have group income protection or salary continuance policies with two-year benefit periods aware of the above potential pitfalls of taking a complementary income protection policy with a two-year waiting period and an age-65 benefit.

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