Protecting your income

If you were off work for several months due to illness or an accident, how would you cope financially?

Being unable to work for a prolonged period of time is a situation that everyone who works for a living needs to prepare for. Otherwise, how would you pay the mortgage and the bills, and feed the cat, not to mention the children?

There are currently 2.5 million people claiming incapacity benefit - the state benefit paid to those off work for more than 28 weeks (the government recently announced plans to cut this figure by one million). As of April, people on this benefit will receive between £57 and £76 a week, but would that be enough for your outgoings? If not, you need to have some form of protection insurance in place.

There is a bewildering range of insurance policies that pay out if your health suffers, all offering very different cover. The table on p32 explains the pros and cons of the different types of policies. It's important to be clued up on what cover you need, because you can't rely on advisers to sell you the right policy. For most people an income protection policy should be the first choice. However, it's one of the least sold. According to industry experts Munich Reinsurance, advisers in the UK sell six times as much critical illness cover as income protection. And yet, only about half of people off work for six months or more due to accident or sickness would receive a payout from a critical illness policy. This is because the main causes of long-term absence – stress and back pain – aren't covered by this type of policy.

STATE BENEFITS

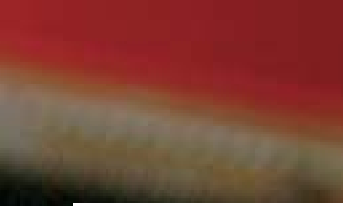
Regardless of whether you have a private insurance policy to protect your income, you will be eligible for some state benefits if you are off work ill. However, it probably isn't as much as you'll need.

Statutory sick pay (SSP)

If you are employed, aged 16 to 65 and off work for more than three consecutive days, you'll usually receive SSP. To qualify, you must have been earning an average of at least £79 a week (£82 after April) for the eight weeks before your sick leave began. You don't get SSP for the first three days of illness.

Insurance priorities

- An income protection policy should be your first choice, but check what's covered by your employer's sick-pay scheme first so that you don't overinsure yourself.
- If you are self-employed, income protection is crucial. Make sure you choose the right level of cover and an appropriate deferred payout period that you could manage on without an income.
- If you really can't afford full income protection cover, consider reducing the term of the policy or increasing the deferred payment period. This will reduce the premium.
- Critical illness insurance should be taken out only in addition to income protection insurance (either private or from your employer).
- Avoid taking out payment protection insurance on loans and credit cards. It offers little benefit.



The SSP rate is £66.15 a week (£68.20 after April – the rate rises in line with inflation each financial year). SSP is paid for a maximum of 28 weeks by your employer, with tax and National Insurance Contributions (NIC) deducted. Self-employed people are not entitled to SSP.

Incapacity benefit (IB)

Incapacity benefit is paid if you are off work for more than 28 weeks or if you're not eligible for SSP (the self-employed, for instance, and those who earn under £79 a week). It's not paid if you were over state pension age when you fell ill. To qualify, you must have paid NIC and been unable to work because of sickness or disability for at least four days. The amount you get varies according to how long you are off work. Up to 28 weeks, you get the short-term lower rate of £57.65 (tax free). If you are off work for between 28 and 52 weeks, you are entitled to the short-term higher rate of £68.20 which is taxable. For anything over 52 weeks, you'll get £76.45, also taxable.

These figures apply after April 2005. They increase annually with inflation and are means-tested, so the amount you get is affected by any other income such as a pension or other insurance policy (but not a mortgage payment protection policy). Your benefit is reduced by 50p for each £1 your income exceeds £85 a week. For more information on state benefits, see www.dwp.gov.uk.

WHAT YOUR EMPLOYER PAYS

By law your employer has to pay only SSP, but many are more generous. Most employers' sick-pay schemes give full pay for a set time (eight weeks is fairly typical) and some go on paying at a lower rate, such as half pay, after that. Once the sick leave period has ended, employers have a number of options. They can stop paying sick pay so the employee goes on to benefit; agree to extend the period of sick pay; offer alternative work or early retirement; or terminate the employee's contract.

The main causes of long-term absence aren't covered by CIC

Some companies offer group income protection as an employee benefit. This provides the employee with income protection without paying premiums or for a very small cost – a fraction of what an equivalent individual policy would cost.

Make sure you know what you're entitled to from your employer and the state before you buy any extra protection insurance, otherwise you might end up overinsuring yourself.

Overleaf, we've looked at the protection needs of three fictional case studies to help you work out the right cover for you. ■

Sick of complaining

Two years ago, Wendy needed a hip replacement operation, which, due to complications, meant several months off work to recuperate. Her employer's sick-pay scheme paid her full salary for 13 weeks and 75 per cent for a further 13 weeks. After that, her employer's private health insurance policy with Scottish Equitable paid her 75 per cent of her salary until she could get back to work.

Scottish Equitable caved in and admitted it had made a mistake

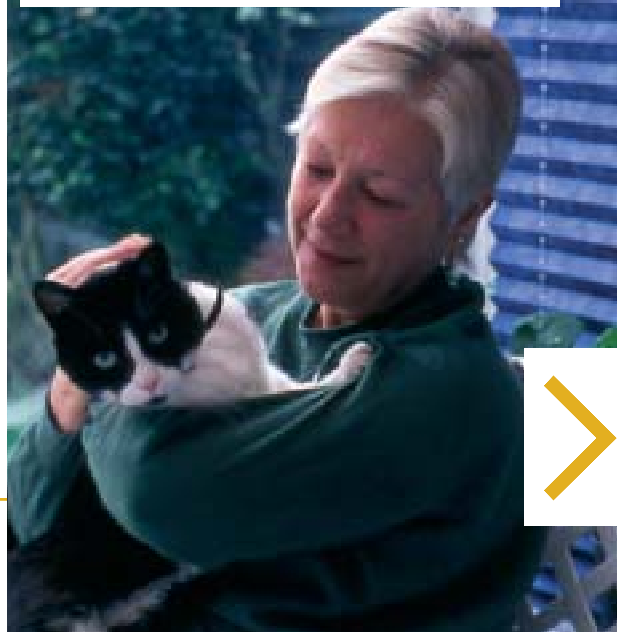
Wendy also had an MPPI (mortgage payment protection insurance) policy with Axa which she claimed on. Axa paid her claim without hassle, which meant her mortgage was covered while she was off work. But Wendy was shocked to find that Scottish Equitable reduced the amount she was entitled to from her employer's insurance by the same amount she was receiving to cover her mortgage.

But Scottish Equitable was wrong to do this. The terms and conditions of its group health insurance policy state that: 'Examples of other sources of income which may affect the benefit include occupational sick pay, early-retirement pensions and payments from other long-term insurance products if these are payable for more than two years.' Wendy's policy with Axa was payable for only 12 months and shouldn't have reduced her employer's benefit.

Wendy repeatedly queried this with her employer, but it was adamant that it was right. Wendy's income was reduced by a further £541 a month, having already been reduced by 25 per cent, leaving her with a very small budget to live on after all her bills had been paid and all the extra expenses incurred through her disability.

Late last year, Wendy queried this with us. We felt sure that Wendy's policy shouldn't have reduced her benefit from her employer, and encouraged her to put in a formal complaint.

Within two weeks of receiving her complaint, Scottish Equitable caved in and admitted it had made a mistake. It repaid Wendy £2,864.43 in lost benefit, plus a payment of £1,034.92 for interest, stress and inconvenience.



Wendy's insurance payouts were wrongly reduced when she was off work for a hip operation

PHOTOGRAPHY SARAH CUTTLE ILLUSTRATION PATRICK LEWIS

Our fictional case studies show the type of things you need to consider when working out what sort of protection cover is right for you

Single career girl

Aged 25, Claire is a human resources officer earning £26,000 a year. She is a single, non-smoker in good health. She's on a tight budget, with a mortgage of £60,000, a car loan of £4,000 and two credit cards with balances of £1,000 and £1,500. Her essential spending each month comes to around £1,200, leaving her about £260 a month for non-essentials like clothes and entertainment. So there's not much left over to spend on protection insurance.

CURRENT COVER

Claire was sold a critical illness policy when she took out her mortgage: £14 a month for £60,000 cover. She also has payment protection insurance on her car loan (£34 a month) and two credit cards (around £19 a month). Claire's employer's sick-pay scheme pays full salary for eight weeks. After then, she'd be eligible only for state benefits, but they would not cover even her essential spending.

Unless Claire had a serious illness that was covered by her critical illness policy, she'd have to find the money to pay her mortgage until she'd been off work for nine months, when state benefits would pay the interest (but not the capital repayments) on it.

WHAT SHE NEEDS

An income protection policy that pays 50 per cent of Claire's salary (£13,000 tax free) after eight weeks' sickness would be a good top-up to her employer's scheme and state

Women pay more than men for income protection

benefits. It would cost Claire between £33 and £64 a month, depending on the insurer.

Women pay more than men for income protection insurance as, statistically, they are more likely to go on long-term sick leave than men. A man of Claire's age would pay between £23 and £39 a month.

Claire could afford an income protection policy if she cancelled her critical illness policy and credit card protection insurance, saving £33 a month. If she also cancelled her car loan protection insurance, she'd save a total of £67 a month. She'd have to rearrange her loan, which might mean early-payment penalties, but it's worth her investigating this.

As the £14 a month premium for her critical illness policy is fairly low, she may as well keep it if she can afford to pay it. However, this should be only in addition to her income protection policy and not instead of it.

Working parents

Kevin, 33, and Sue, 34, have two boys aged three and six. Kevin is self-employed and runs a small central-heating installation business.

Kevin's income varies but he currently takes home about £40,000 a year. Sue works as a teaching assistant in a local primary school, and earns a salary of £13,000 a year.

Like many families with young children, their outgoings are high. Kevin's business is stable but he works long hours and the work is very physical. They have a £130,000 mortgage and credit card debt of around £1,000. The family are in good health, but both Kevin and Sue are smokers.

The family would struggle quite badly if Kevin was off sick

CURRENT COVER

Kevin and Sue have life insurance to cover the mortgage and Sue gets twice her salary as a death benefit from her employer – the local council. She belongs to the local authority pension scheme. Kevin has another life insurance policy and a personal pension.

Sue gets good sick-pay cover from her employer. It will pay her full salary for six months if she's off work and half pay for a further six. Although the family depend on Kevin's income, Kevin has no insurance protection should he fall ill.

Kevin could claim incapacity benefit of around £57 a week. But this won't help much as the family's outgoings are around £2,500 a month. Sue's take-home pay is just under £900 a month, so the family would struggle quite badly if Kevin was off sick for some time.

WHAT THEY NEED

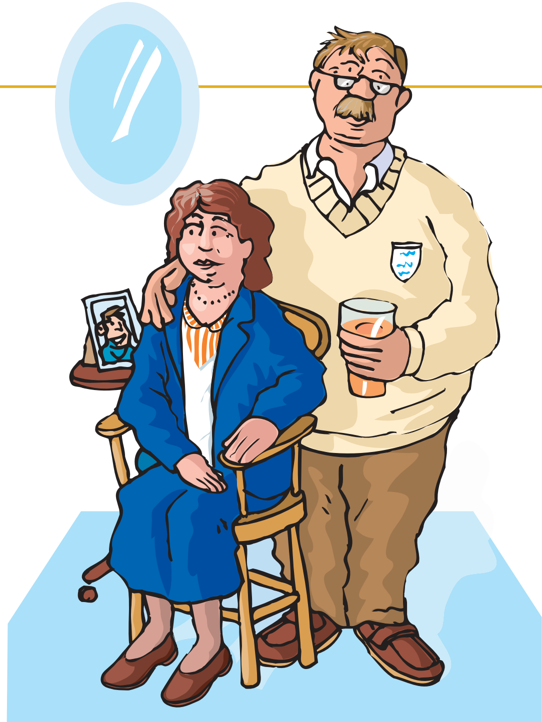
The priority is for Kevin to get income protection. But, because of his job and the fact that he smokes, this is not going to be cheap. One that pays out 50

per cent of Kevin's income after four weeks would cost between £200 and £235 a month, although this would drop to between £170 and £180 a month if Kevin didn't smoke.

Alternatively, Kevin could save up an emergency fund to see him through the first few months of sickness and get a policy that pays out after a longer period. One that paid out after 13 weeks would cost around £70 a month, or £62 if he didn't smoke.

The cost of Kevin's income protection policy means there's not much leeway for any extra protection. In any case, critical illness cover would be very expensive – around £80 a month each for £130,000 worth of cover because both Kevin and Sue smoke.

Comfortable couple



Gerry, 54, is a director of a paper firm, on £70,000 a year plus bonus and fringe benefits. His wife Mary, 48, is self-employed and runs a hairdressing business, part-time, earning around £12,000 a year.

They have one son at university whom they help out with £100 a month. Their mortgage of £30,000 has seven years to run. Their outgoings are high but not excessive. Neither smokes, but Gerry could benefit from reducing his weight and alcohol intake, which amounts to about 30 units a week.

CURRENT COVER

Gerry's firm's sick pay scheme would give him full pay for 26 weeks. He has private medical insurance that covers the whole family, as a benefit from his employer, and he's in the company's pension scheme.

Mary has no income protection in place but could claim short-term incapacity benefit as she pays National Insurance.

Gerry and Mary have adequate life insurance, and a couple of endowment policies. They also have payment protection on their numerous credit cards. Because they tend to pay the balance off each month, this costs only about £6 a month.

Their protection needs aren't too pressing as they have savings to use in an emergency. However, they would be vulnerable if Gerry was off work for more than six months. His firm takes a flexible attitude, but nothing is set in stone and Gerry could be on state benefits after that, or asked to retire early, which would result in a much-reduced pension.

WHAT THEY NEED

An income protection policy would top up their existing cover until Gerry retires. A policy paying out 50 per cent of Gerry's salary after his company scheme stops (after six months) would cost anywhere from £123 to £224 a month depending on the insurer. However, Gerry's weight and alcohol intake might up the premium a bit.

If Gerry felt that this was too expensive, he could opt for a policy that starts to pay out after a year's sick leave and rely on savings to get by for the six months he's not covered. This would cost between £112 and £220 a month on standard rates. However, for the difference of around £12 a month, it's probably worth going for the shorter payout period.

Gerry's weight and alcohol intake may up the premium a bit

His other option would be to choose a policy with a shorter term. The longer the term, the higher the premium. A policy to cover him until age 62 might be a good compromise and could reduce the monthly premium to around £80. If he was off work until retirement age, he'd have to start his pension early when he turns 62, unless he had enough savings to keep them going for another three years.

Gerry and Mary don't really need any other protection cover than this, but they could afford to get some more cover if they wanted added peace of mind.

Mary could get an income protection policy to pay 50 per cent of her earnings after 26 weeks for around £32 a month, or a policy that paid out after a year, from £27 a month. As with Gerry, for a few pounds more, the shorter payout period is much better value.

Alternatively, they could consider critical illness policies with cover to match their mortgage of £30,000 to run until retirement. Even with income protection in place, there would still be a fairly drastic income loss if Gerry had to be off work. A lump sum from a critical illness policy would help them to clear the mortgage.

Given their ages and hence their higher risk of critical illness, the premiums are quite reasonable. Gerry could get a ten-year policy for just under £30 a month. Cover would decrease as the mortgage is paid off. For Mary, it would be as little as £22 a month for a similar policy lasting 16 years. These are all for standard rates so, again, Gerry's premiums may be higher because of his weight and level of alcohol intake.

Although it costs only £6 a month, they should cancel the payment protection on their credit cards. As the table, overleaf, shows, these policies offer little benefit.

Types of protection insurance available

POLICY TYPE	WHAT IT IS	PROS	CONS
Income protection (IP), also known as permanent health insurance (PHI)	A core requirement for anyone who works for a living. It is designed to replace a proportion of lost earnings if you are off work due to sickness, accident or injury. Subject to conditions and cover level, this pays a tax-free monthly sum, usually between 50 and 65 per cent of earnings. Policies start to pay benefit after a number of weeks' illness, known as the deferred period.	You can choose different deferred periods from 4, 8, 12, 26 and 52 weeks. The longer the deferred period, the cheaper the policy. Most policies run until your retirement date but you can choose a shorter policy term if you want to reduce costs. IP is based on personal circumstances, so it's good value for people in good health and for certain occupations, such as non-manual, office-based or administrative jobs.	Premiums are based on the type of job you do as well as your health and lifestyle, so can be pricey for certain workers or those with health issues. Women pay more than men. State benefits and/or sick pay from an employer may be reduced if you have a private IP policy. Also your insurer can reduce the amount paid from the IP policy if your total income while you're sick goes over its maximum. Check what cover your employer offers before buying a private policy and review your cover regularly.
Mortgage payment protection insurance (MPPI)	MPPI policies pay out an amount equivalent to your monthly mortgage payment if you can't work because of accident, sickness or redundancy. Benefit is usually payable for 12 months, although some policies pay out for 24. Don't confuse with mortgage protection which is life insurance specifically to cover your mortgage if you die.	An MPPI policy won't affect any state benefits you're entitled to. It may be cheaper for older people, those with health problems, or people who work in hazardous occupations because plans are not individually underwritten. However, compare costs with a budget IP plan before deciding.	Policies have many exclusions so read them carefully. For example, you're not covered for existing medical conditions. Policies might reduce what you get from your employer's insurance depending on the terms and conditions – so check before you buy. Income protection cover is nearly always a better option and isn't always more expensive.
Critical illness cover (CIC)	Pays a lump sum if you get a serious or illness, such as cancer, or if you have a heart attack or stroke. A luxury, not core, product that should be bought only in addition to income protection cover (private or from your employer) if your budget allows. Premiums are reviewed every five years.	Can be used to pay off a large debt, such as a mortgage, if you're seriously ill. Very cheap for younger people as they are less likely to develop a serious illness and make a claim. Plans can be written so that cover remains level or reduces over time in line with a mortgage.	Only pays out for serious illness, not accident or injury. Even some conditions that most people would consider serious are excluded, so read the policy conditions very carefully before buying. Very expensive for older people, those with health issues or smokers. Often sold without advisers undertaking a full review of insurance needs so individuals may think they are fully covered when they are not.
Payment protection insurance (PPI)	Covers the cost of personal loan repayments or minimum monthly credit card payments if you are ill and unable to work or if you are made redundant.	There are no obvious benefits with this insurance.	Policies are full of exclusions. If you do make a claim, the benefit is often little more than the premium paid for the cover so the policies are very poor value. Often sold inappropriately to people who already have better cover in place. Only covers the cost of low-priority debts.

Which? says

Before buying protection insurance from an adviser, make sure you understand the differences between the different type of policy and that you know which is most appropriate for you. See 'Insurance priorities' on p28 and the table, left.

Income protection is almost always the most appropriate type of policy. If an adviser recommends you something else, be wary.

From January this year, sales of products such as income protection and critical illness became regulated. However, the regulation doesn't go far enough as it still won't protect people from being sold an inappropriate insurance product.

There are two levels of service financial advisers can give – information only or advice. Always take full advice when buying protection insurance. Only that way can you make a complaint if the product you're sold isn't suitable for you. Check which level of service your adviser offers before you meet with them. If it's information only, go elsewhere.

OUR RESEARCH

The example premiums given in this article were obtained from a selection of some of the larger insurers but not from the whole market.