The outcomes of the employee benefits system

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Healthcare benefits

By Kristin-Ann Cronjé

Contributions to medical schemes have been increasing faster than salaries due to rapid increases in the costs of healthcare. Very few employers still offer post-retirement medical benefits and individuals may find the ever-increasing contribution rates on medical schemes to be unaffordable. Employers should reconsider the current ways of communicating the importance and structure of medical scheme benefits to ensure that employers choose to participate in the most appropriate benefit options.

Adequate healthcare cover is a crucial contributor to financial, physical and mental health. However, over the last few years, the annual increases in medical scheme contributions have been well in excess of the Council for Medical Scheme's (CMS) guideline increase of CPI + 3%. This means that consumers are in a situation where their medical expenses, which include both medical scheme contributions and out-of-pocket payments, are using up a larger proportion of their income each year. A household paying 15% of their household budget towards medical expenses today may well be paying 22% in 20 years time, all other things equal[1].

The implications of the high increases
These high increases have a significant impact on the level of take-home pay and limit the current levels of other employee benefits due to affordability constraints.

The increases may also make medical scheme contributions themselves unaffordable, particularly for low-income earners, those with volatile incomes or those without an income due to strike action, as discussed in 'Strikes'. If contributions are unpaid, membership may be suspended or terminated. Membership can only be reinstated if the outstanding contributions are paid in full within 90 days of the lapse. If the individual later joins a medical scheme they may be subject to:

- Reduced cover for certain conditions for a limited time period.
- A permanent increase to the contribution rate via late joiner penalties.

There are also long-term implications for retirement funding. During the individual's retirement years, income is likely to reduce but their required level of medical cover is expected to increase.

By 2032, a married man retiring at the age of 60 would need to have saved R1.6 million in today's terms by his retirement date to fund medical scheme contributions on a comprehensive benefit option for himself and his wife throughout the retirement period. If he only has R900 000 available, he may be able to afford an intermediate option. However, even the most basic option would require savings of R650 000.

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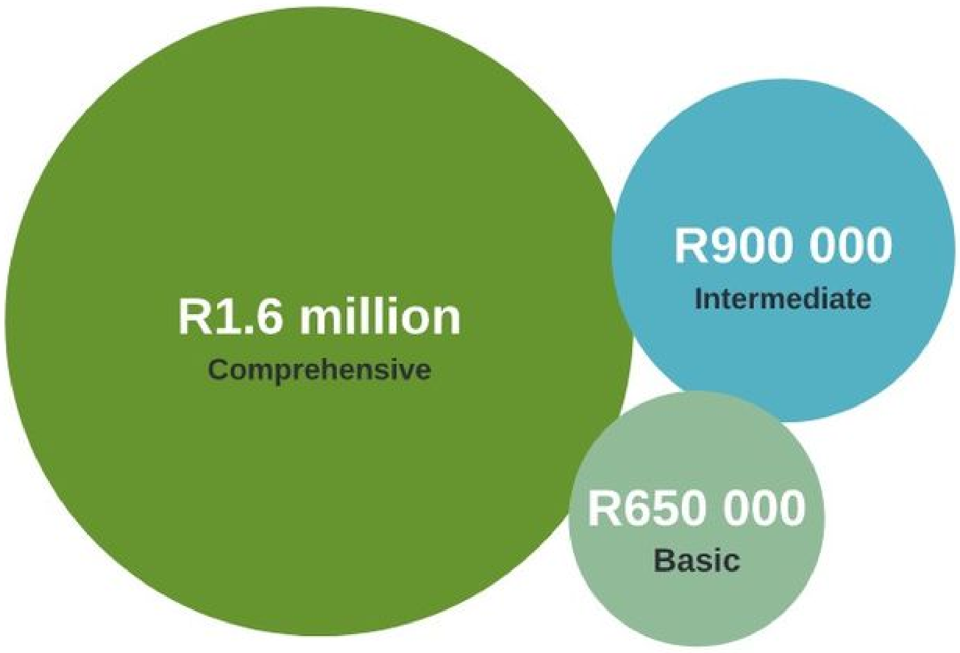
ACCUMULATED SAVINGS NEEDED TO FUND MEDICAL SCHEME CONTRIBUTIONS IN RETIREMENT

Source: Alexander Forbes Health



hen many South African defined contribution (DC) funds were designed, the employees' post-retirement medical costs. were funded separately by the employer. This is no longer the case, and retirement funds have not been adjusted accordingly, leaving the employee to fund this cost themselves.

Why medical scheme membership is so expensive

It is important to remember that medical schemes, as distinct from their administrators, are non-profit entities. Therefore higher than anticipated costs and expenses on medical schemes need to be funded through benefit cuts or higher contribution increases. The fact that medical scheme contributions are increasing so rapidly is a reflection of the losses that some medical schemes are experiencing. However, in addition to this, some of the regulatory requirements are also driving up costs. Firstly, prescribed minimum benefits (PMBs) are required to be paid in full, and this system is open to abuse. PMBs are a list of 270 medical conditions, 27 chronic conditions, and any emergency medical conditions, for which all medical schemes must pay claims in full without co-payments or the use of deductibles for all members[2].

The current interpretation of the PMB regulations means that the medical scheme must pay the full cost of the treatment, whatever is charged. This is open to abuse and fraud and although the use of designated service providers (DSPs) or other managed care initiatives can reduce this risk, this might be costly to set up and inconvenient for the employee. On a second and related note, there has not been an official tariff guideline in place since 2010 when the Department of Health's Reference Price List (RPL) was declared invalid and uncompetitive by the North Gauteng High Court[3]. This has allowed medical service providers to repeatedly increase their fees. In the case of PMBs, the scheme may be forced to pay these costs in an emergency or if DSPs are not in place. Thirdly, technological advances mean patients are being diagnosed with conditions that may previously have gone completely undetected or undetected for a much longer period.

This results in more patients being treated and sometimes for longer periods of time. In addition, new treatments can be very expensive. For example, biological drugs for the treatment of conditions such as cancer can cost hundreds of thousands of rands for a single patient. Fourthly, the CMS requires that solvency reserves of no less than 25% of the gross contribution income are held. This is a rather crude measure that takes no account of the size of the scheme or its risk profile. In addition, schemes that are growing their membership will have particularly large solvency requirements. These solvency requirements need to be met through contributions. Finally, high levels of non-healthcare expenditure, particularly fees to administrators, are also driving the contribution increases.

Individuals trying to manage costs should consider whether their current benefits are appropriate for their current needs.

What can be done?

Reducing the costs

At present, there are a number of systematic flaws that contribute to the high costs of medical scheme cover, many of which need to be addressed by policymakers and regulators. A more realistic solvency framework may reduce the burden on large, growing schemes. In addition, the implementation of a risk equalisation fund (REF) would eliminate or reduce the difference in contribution rates arising across different medical schemes simply because of different age and gender profiles. However, as much as this may assist in the open medical scheme environment, it may result in closed schemes with favourable risk profiles offering less value for money. Mandatory medical scheme membership for all who could afford it would broaden the risk pool and avoid members joining schemes only when they know they are ill, which worsens the profile of the current membership pool. On an individual basis, it does not make sense to participate in a benefit option that provides greater benefits than necessary for two main reasons:

- Medical schemes are priced on an annual basis.
- Unused contributions cannot be set aside to help the individual in later years when more comprehensive cover is required.

This means individuals trying to manage costs should consider whether their current benefits are appropriate for their current needs. For example, younger individuals may only require basic hospital cover with older individuals requiring more comprehensive cover.

Education

Along with the increasing costs associated with medical care, the medical scheme environment is becoming increasingly complicated. This makes it difficult for a member to choose their option and to understand their benefits. In order to help their employees, the employer may feel compelled to help interpret the benefits, which could introduce legal risks if the interpretation is not correct.

Using alternative products

Alternatives to medical scheme cover include hospital cash plans or occupational health products. These medical insurance products are not subject to the Medical Schemes Act[4], and as such are not obliged to offer the package of PMBs. This, therefore, allows the product design to focus on essential cover, usually including basic stated hospital benefits and primary level day-to-day benefits, which can be offered at much lower rates than the PMB package and are therefore accessible to lower-income earners.

Conclusion

Healthcare benefits are costly and complex. While it may be necessary for the regulatory authorities to address some of these issues inherent within the system, employees should also consider benefit efficiency levels and trustees should consider how post-retirement healthcare costs are factored into the objectives of the retirement fund. Appropriate communication of healthcare benefits will also be critical to ensure engagement.

Risk benefits

By John Anderson and Belinda Sullivan

An individual's risk benefits needs will differ according to their circumstances and will change over the course of their lives. However, the typical bundle of group risk benefits is static and structured for the average employee rather than being tailored for the individual. We propose that schemes offer choice in risk benefits or set defaults that better match the members' needs as they go through life.

> **Risk benefit costs are typically deducted from the employer's contribution to the retirement fund, which is typically fixed as a percentage of salary to manage the employer's cost and employees' take-home pay levels. This results in a trade-off between risk and retirement benefits.**

It can be argued that risk benefits are failing to meet employees' needs because the benefits themselves may be inefficiently structured. Risk-benefit costs are often deducted from the employer's contribution to the retirement fund, which is typically fixed as a percentage of salary to manage the employer's cost and employees' take-home pay levels. This results in a trade-off between risk and retirement benefits. This trade-off means that risk benefits may be selected on price as opposed to need. On the other hand, employees and their families have an expectation that the risk benefits will be enough to meet their needs in the event of disability and those of their dependants in the event of death.
Anecdotal evidence suggests inappropriate risk benefits can lead to significant reputational risk for the employer.

The rigidity of benefit structures

Most employers offer approved life assurance, monthly disability income benefits and funeral benefits. In some sectors, employees also have access to additional benefits such as:

- Dread disease or critical illness benefits
- Spouse's death benefits
- Lump-sum death benefits offered outside the retirement fund, termed 'unapproved' cover.

However, these additional benefits are offered by fewer than 10% of the employers reviewed[5]. The total death benefit in DC funds is the sum of these insured benefits and the accumulated credit. The level of insured cover is usually the same for all employees. The average, minimum and maximum insured benefits, expressed as a multiple of salary, vary across the retirement funds industry as shown in the table on the next page. This rigid bundle of benefits and the fixed benefit amounts are not necessarily appropriate for the needs of Different employees with varying jobs and demographic characteristics. For example, younger employees may be under-insured due to lower salaries at the outset of a career, lower accumulated benefits within a retirement fund, a potentially greater number of dependants and more debt. Conversely, older employees may be over-insured, resulting in a lower than necessary allocation to retirement savings

Risk benefit per sector

	MINIMUM DEATH MULTIPLE	MAXIMUM DEATH MULTIPLE	AVERAGE DEATH MULTIPLE
Construction	1.0	6.0	3.6
Energy	1.0	13.0	3.8
Fishing, forestry and agriculture	0.0	6.0	3.2
Manufacturing	1.0	7.3	3.4
Mining	1.0	12.6	3.9
Personal services	1.0	5.0	3.0
Professional and business services	0.0	6.0	3.4
Public sector	2.0	15.0	5.4
Retail, wholesale and hospitality	1.0	6.1	3.2
Transport and telecommunications	2.0	5.0	3.4
Retirement funds industry	**0.0**	**15.0**	**3.4**

Source: Member Watch 2012 data set

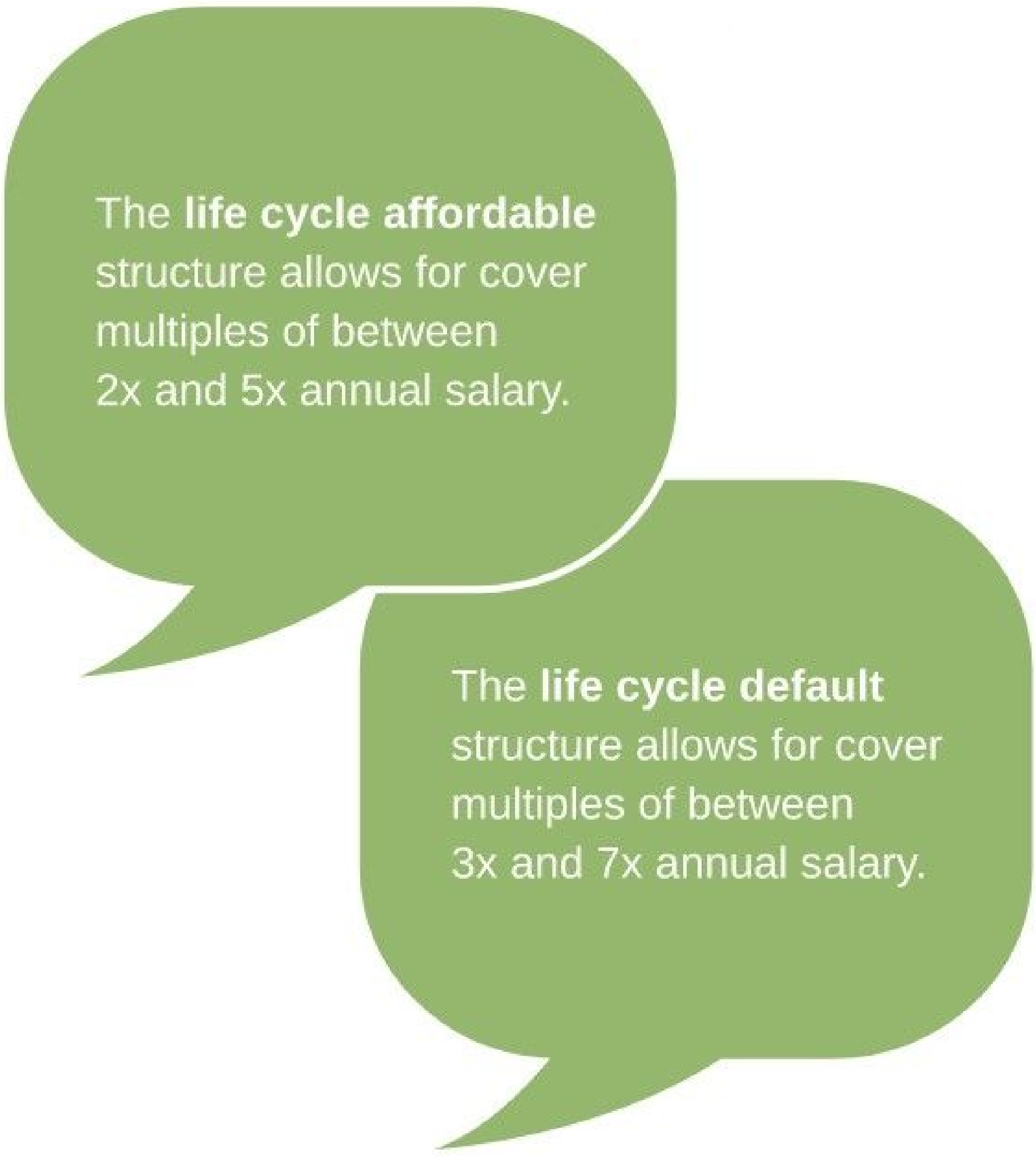
> **There's a delicate balance between having both the required level of risk cover and the required level of retirement funding at every age while ensuring that both the member and the employer can afford the total contributions.**

What can be done?

There's a delicate balance between having both the required level of risk cover and the required level of retirement funding at every age while ensuring that both the member and the employer can afford the total contributions. The closer the member is to having both their risk and retirement needs met, the more efficient the allocation of the contribution is deemed to be. Put differently, efficiency involves maximising benefits that engage the employee at that period of their life cycle, while providing minimum levels of cover on other benefits.

There are ways to improve efficiency, such as increasing the contribution rate, offering choice in risk benefits, setting more appropriate defaults or using a combination of all three. A sample of South African funds suggested that only 14% offered choice in risk benefits[6]. Funds could create more efficient solutions by considering life cycle solutions that tailor risk benefits and retirement fund contributions according to demographic profiles. This provides a default 'ball-park' balance between risk and retirement benefits that the individual can then tailor to meet their individual needs.

By improving the efficiency of a member's allocation at critical points in their life cycle, retirement and death-in-service outcomes can be improved. Creating this type of default option involves weighing up the relative importance of retirement and risk benefits over the employee's life cycle. The allocation to the more important benefit is then maximised subject to a minimum level of the others. The following exercise helps highlight the ways in which default options are not created equal.



Let's consider four death benefit structures:

- A fixed, flat multiple of salary
- Life cycle default
- Life cycle affordable
- A fully flexible benefit without an increase in the total contribution towards risk and retirement.

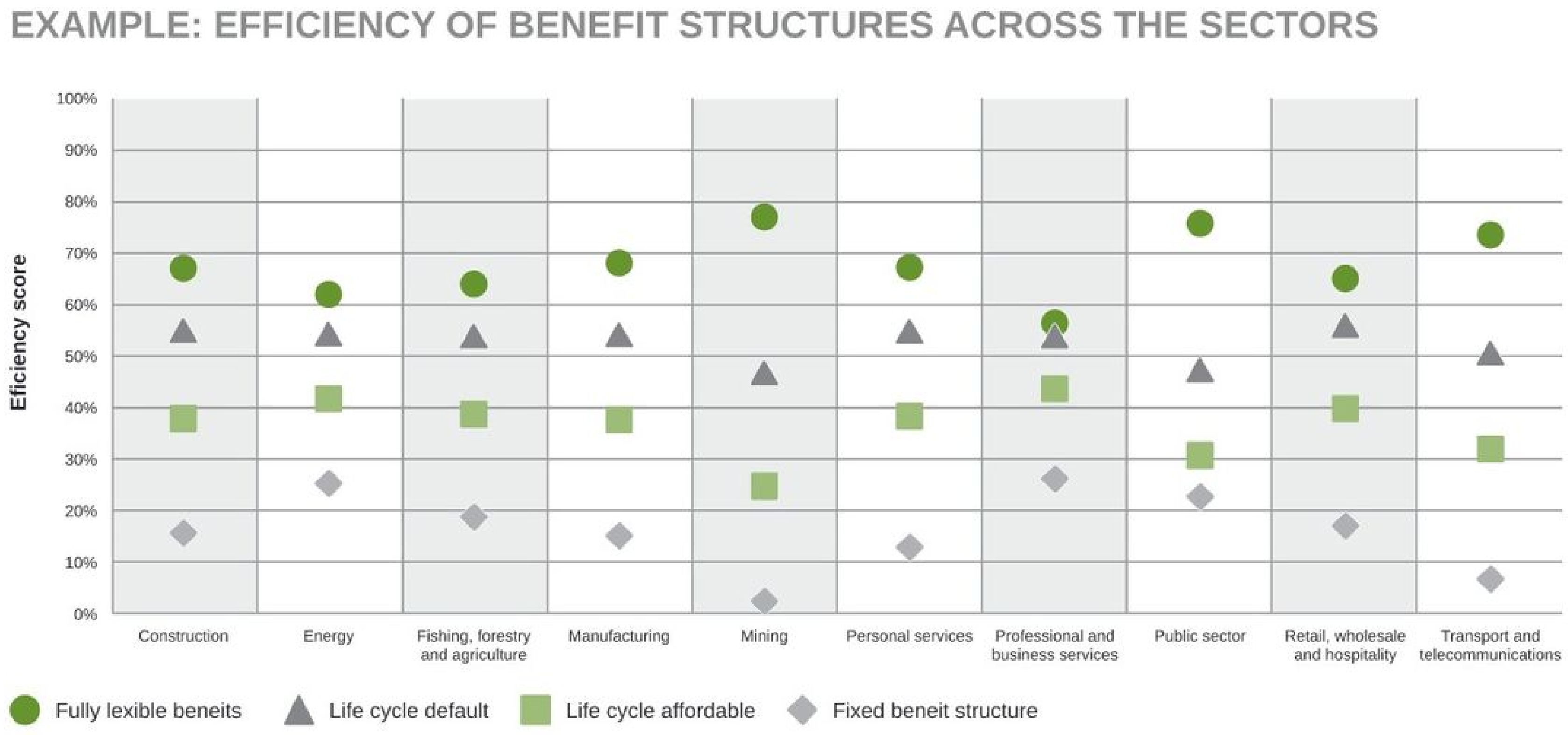
A life cycle death benefit pays a flat multiple of salary dependent on the member's age.

The death benefits are provided together with:

- A disability income benefit that replaces 75% of the employee's income while they are occupationally disabled or a lump sum permanent disability benefit.
- Retirement fund membership.

A 100% efficient outcome would mean that individuals match their disability, death and retirement needs throughout their life cycle. This is generally not possible due to the fact that the total retirement and risk contributions is usually fixed. Therefore the goal is to maximise the efficiency subject to this constraint. Because disability benefits are vital to sustaining the employee and their family through illness and injury, it is assumed that this benefit would always be prioritised and secured before allocating the remainder to retirement and death benefits.

Let's consider a male member aged 25 with a wife aged 21 with no children. Taking into account future events in the member's life such as having children, one can generate efficiency scores for each of the four risk-benefit structures. The efficiency score reflects the extent to which retirement and death benefits can be met from current contribution levels after buying disability income cover. Efficiency scores can be generated for the different sectors as illustrated below.



Source: Alexander Forbes Research & Product Development

The chart highlights the varying efficiency levels in the different sectors. In this example, life cycle and fully flexible death benefit structures offer more efficiency for this member than the fixed benefit structures.

With fully flexible benefits, the public and mining sectors can achieve a relatively high level of efficiency while the professional and business services sector would be relatively less efficient. The professional and business services sector performs so poorly because total contribution rates are relatively low at 13.3%. By contrast, the contribution rate in the public and mining sectors are 17.7% and 17.2% respectively, which provides
considerably more scope to structure benefits more efficiently. A fixed benefit structure in the mining sector delivers an inefficient result, as risk benefits are relatively expensive in this sector and so contributions towards death benefits are usually inadequate.

This has important implications. If contribution rates are too low, complex structuring will not make the benefit design truly efficient even though improvements in efficiency are possible. But conversely, a higher contribution rate does not guarantee greater efficiency. What is important is to allocate contributions to the areas where they are most needed.

Conclusion

Risk benefits are not only about paying death claims. They also offer important 'living benefits', such as accelerated death benefits in the event of total and permanent disablement, serious illness benefits in the event of a dread disease, education benefits for minors and a waiver of premium benefits in the event of temporary and total disability.

As previously stated, efficiency involves maximising benefits that engage the employee at different life cycle stages, while providing minimum levels of cover on other benefits. Efficiencies can be improved for the same total contribution level by having default options that are more tailored to the individual's position in their life cycle. However, this improvement can be very limited where the total contribution rate is grossly inadequate. So while there is always some benefit in moving to a more tailored default option, the hard truth is that in many cases higher contribution rates are required first. In addition, whatever level of benefits and flexibility are provided, individuals must assess their personal needs and address any gaps or shortfalls in their personal capacity where the employee benefits arrangement cannot cater for these fully.

Retirement funding

By Megan Butler, Anne Cabot-Alletzhauser and Michael Prinsloo

The current retirement savings environment is characterised by low expected investment returns, climbing annuity prices, inadequate contributions and a culture of low preservation rates. The fact that emphasis is typically placed on asset returns and not on managing assets to deliver a reasonable retirement income has exacerbated the problem. The result is a retirement benefit that is insufficient to meet the needs of pensioners, and that many savers perceive as having little value relative to the satisfaction of immediate needs.

Contribution rates, retirement ages, investment strategies and exit processes all need to be revisited to address this. Employers should be more involved in guiding employees towards more responsible decisions.

> **The average retirement fund member retiring at 65 is on track to replace just 39% of their pensionable pay.**

The ultimate aim of retirement funding is to save during your working life to finance consumption when you are too ill or too old to work. From an employee's perspective, this is not an exciting prospect. Young workers have tremendous difficulty with the long-term commitment required, as discussed in 'Young workers'. Older workers, however, become discouraged by poor projected retirement benefits[7]. And projected retirement benefits are very poor indeed.

Projected retirement benefits are typically expressed as a replacement ratio, defined as the ratio of income in the year after retirement to income in the year before retirement. According to the Member Watch™ 2012 data set, the average retirement fund member retiring at 65 is on track to replace just 39% of their pensionable pay. This is relative to a replacement ratio target of 100% if they want to cater for all their needs including their healthcare needs in retirement[8]. As the chart on the next page shows, many South Africans may be en route to very reduced circumstances.

Distribution of members' projected replacement ratios per age band: Retirement funds industry

Source: Member Watch 2012

It is important to note that this projection:

- Uses actual retirement fund member data and member-specific contribution rates and reflects projected outcomes for real members.
- Does not take into account other savings outside the current retirement fund that may have been preserved from a previous fund. However, given low preservation rates, these other savings are unlikely to be significant.
- Does not factor in any future non-preservation and so may even be regarded as optimistic. It is troubling that only 5% of workers under the age of 40 are expected to have replacement ratios of 75% or more when they retire at age 65. People in this age group are also the least likely to have additional savings and have the most opportunity to make bad benefits decisions later in life.

Recent retirements reflect low retirement incomes that are consistent with the projections for the next generation. Overall, the actual average replacement ratio for retirements during 2011 was 31.7% with lower income earners having the worst outcomes. In theory, having enough income in retirement requires:

- Sufficient contributions net of expenses.
- An investment strategy geared to delivering an adequate pension income, as opposed to just a high return.
- Benefits being preserved when changing jobs rather than taking cash.

- Choosing an appropriate annuity at retirement.

But why do South Africans struggle in each of these four areas?

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The contribution crunch

The average member contributes 16.4% of their pensionable salary towards their retirement fund24. Foregoing 16.4% of pensionable salary may sound like a big sacrifice but after paying for risk benefits and expenses only 13.5% makes its way into retirement savings[9].

The global transition to a lower interest rate and lower investment return environment means that savings accumulate more slowly. This means pension pots are expected to be smaller at retirement. In addition, lower interest rates lead to more expensive annuities, so the income you can buy with the pension pot is even smaller.

Ten years ago, a 13.5% contribution rate from the age of 25 to 65 would have been more than enough to secure a pension of around 75% of your pre-retirement salary. Based on this contribution rate, a 25-year old entering a retirement fund in September 2012 has an expected retirement income of only 38% of his pre-retirement pensionable salary if he retires at 65[10]. To make matters worse, the pensionable pay is usually lower than the full salary and high salary inflation levels expected in future years will also reduce replacement ratios. The implications of these factors are discussed in more depth in 'Pensionable pay' and 'High salary inflation'' respectively, but note that the actual drop in income experienced may be significantly larger than what our modelled results suggest.

Investments: The reality of liability management

The impact of low contribution rates is exacerbated by the fact that investing for a DC fund is largely regarded as an asset-management problem as opposed to an asset-liability problem. Common investment objectives in DC retirement funds include:

- Preservation of capital, which may appeal to funds with low-income earners.
- Maximising risk-adjusted return.

Ultimately, both can be ineffective when you are investing for an individual trying to secure an adequate income stream to replace their salary income when they retire. It is this postretirement income stream requirement that constitutes the member’s liability.

The interesting dynamic is that the retirement income is a function both of the accumulated credit at retirement and the cost of the annuity to provide the income stream. Annuity prices change with long-term bond yields and longevity assumptions. So funds could provide the best possible inflation-beating returns and still miss the target, if inadequate attention is paid to the pricing of annuities. Let’s use the Pensions Index to illustrate this point.

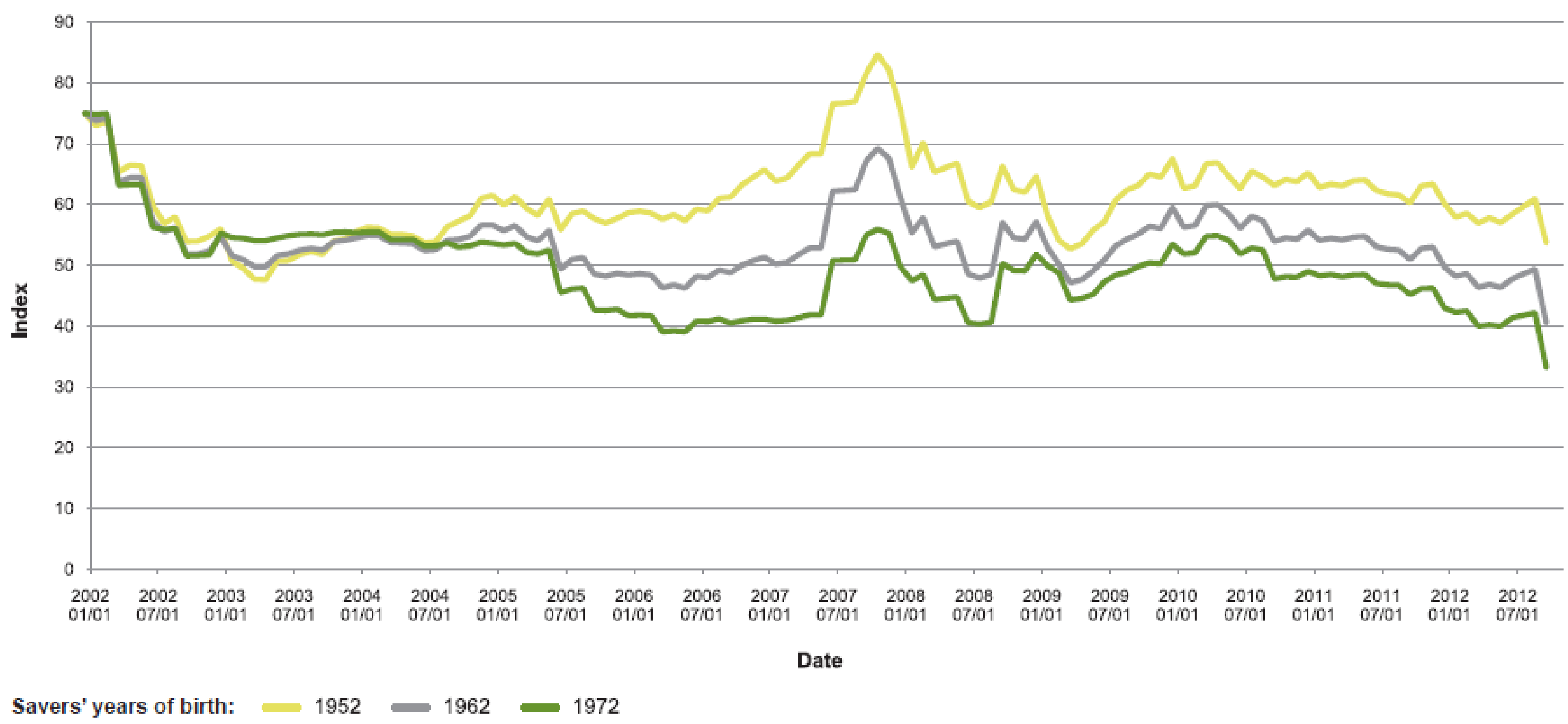
The Pensions Index considers three savers, one born on 1 January 1972, another on 1 January 1962 and the third on 1 January 1952, making them 30, 40 and 50 years old respectively on 1 January 2002. As the index moves through time, it captures several dynamics:

- The returns of the median Large Manager Watch asset manager.
- Salary inflation over the time period
- The projected cost of buying an annuity that is managed with the aim of providing inflationary increases in income, but does not guarantee these increases.

The Pensions Index indicates the percentage of each individual's income they are projected to be able to replace at retirement at age 65. On 1 January 2002, all three were expected to afford a pension providing them with 75% of their pre-retirement income when they retired and so they had index values of 75. All three contributed 13.3% of their pensionable earnings to the retirement fund. And yet, despite excellent market returns between 2002 and 2012, the Pensions Index continued its downward slide in the third quarter of 2012. As at 30 September 2012, the index values were 53.7, 40.5 and 33.1 respectively. In other words, the 40-year-old saver born in 1972 now has an expected replacement ratio of 33.1%.

The South African stock market was at all time highs at the end of September 2012. How could the Pensions Index possibly be going down if markets were so strong? Simply put, because assets and liabilities were not managed together, accumulated credits grew, but by less than the cost of securing an adequate income in retirement. This analysis throws into question exactly what form of member choice, if any, retirement funds should offer. Member choices that allow investors to pick which 'manager of the moment' they believe can offer them the highest returns would completely miss the point of liability management.

Pension Index as at 30 September 2012



Source: Alexander Forbes Research & Product Development

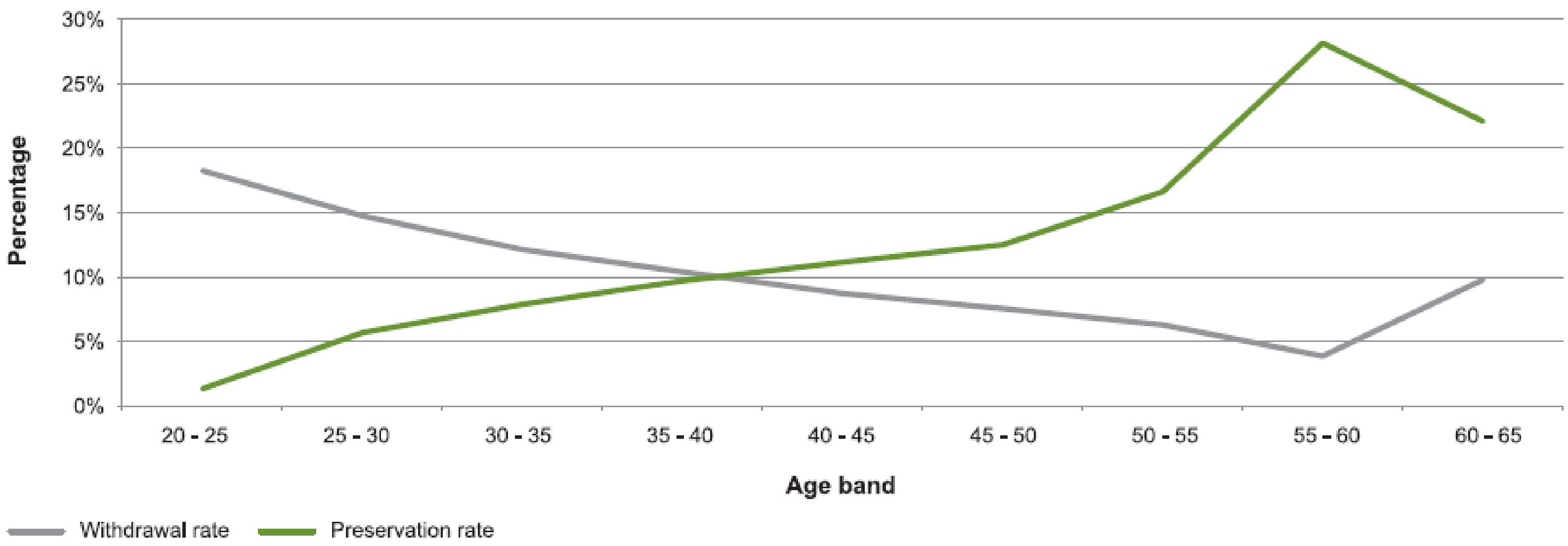
Low preservation combined with higher withdrawal rates at younger ages can have dire consequences for retirement income levels. Factoring in actual preservation rates would halve projected retirement incomes for members under 35.

The preservation problem

Under South African law, members of a retirement fund only have access to their retirement savings before retirement if they withdraw from their current employer fund through resignation, dismissal or retrenchment. Alternatively, as part of a divorce order, some or all of the retirement savings may become due to a former spouse. At this point, benefits could be taken in cash or kept earmarked for retirement through transfer to another retirement fund or to a preservation fund designed as a 'parking bay' for these benefits until retirement. However, despite the limited circumstances under which members have access to their accumulated benefits and the choice available to preserve, there is still significant value destruction occurring through non-preservation.

Younger members are most likely to withdraw their retirement savings[11]. They are also the least likely to preserve. Retirement savings in the early years contribute significantly towards retirement income levels due to the effect of compounding on investment returns. Low preservation combined with higher withdrawal rates at younger ages can have dire consequences for retirement income levels. None of the projected retirement benefits in this book account for benefits leakage. Factoring in actual preservation rates would halve projected retirement incomes for those members under 35. At higher ages, where withdrawal rates are lower, the preservation rate is still relatively modest, with over two-thirds of retirement savings being lost. The higher the turnover rate the more relevant the preservation statistic is. The withdrawal and preservation rates are charted below.

WITHDRAWAL AND PRESERVATION RATE FOR THE RETIREMENT FUNDS INDUSTRY



Source: Member Watch™ 2012 data set

The preservation rate of retrenchments over the 18 months to June 2011 was around 10% and for non-member spouses on divorce, who should have less pressing needs, this was only around 3%.

On average, members preserved only 7.7% of their benefit on withdrawal. Interestingly, even after age 55 approximately 5% of members withdraw from the fund instead of retiring, which may have a significant tax implication for them. This could indicate that members choose to resign rather than retire to take their full benefits in cash. Although it is understandable that individuals in a financial crisis may need the cash benefit, the reality suggests that the low preservation rates have little to do with financial need. The preservation rate of retrenchments over the 18 months to June 2011 was around 10% and for non-member spouses on divorce, who should have less pressing needs, this was only around 3%[12]. We do know from Alexander Forbes withdrawal data that members who do not preserve tend to:

- Come from funds with high turnover, reflecting either poor job security or fake withdrawals by members to access retirement funds.
- Have low retirement fund credits, which tend to be costly to preserve in terms of both fees and time.
- Have low-income levels.
- Come from funds where there is little or no member financial education activity.

In some funds, not a single member preserves on withdrawal!

Various solutions have been proposed including compulsory preservation of all or part of the benefit on withdrawal or allowing leakage only in certain life events. The focus has prompted the National Treasury to publish a technical discussion paper setting out policy proposals to improve preservation[13].

Steps can also be taken at a fund level to improve the preservation experience. These include:

- Making use of default preservation options.
- Showing withdrawing members the impact of non-preservation using their specific personal information.
- Education campaigns around preservation.
- Working together with HR personnel to review and improve the resignation, retrenchment and dismissal processes.
- Reviewing options to make financial advice more accessible to members.
- Reviewing options to make preserving benefits easier for members.

Employers may need to consider their strategies with care, particularly in light of the reason for withdrawal. Withdrawal because of retrenchments, liquidation of the employer or other mass withdrawal will require special consideration, as discussed in 'Mass exits'.

The retirement and annuitisation decision

During retirement, many people rely solely on their retirement fund income to sustain them. DC members can choose to retire at any age after 55 without penalty. At retirement, members choose how much income to annuitise subject to statutory requirements, tax considerations and which type of annuity to buy.

The average age at retirement during 2011 was 60.9 years[13]. This is slightly higher than the 60.4 average during 2008 and this may reflect the deteriorating retirement outcomes that members experience, which may have reduced instances of early retirement.

> **People retired six months later, on average, in 2011 than in 2008.**

Nearly a third of retirees exited before the age of 60. There is an approximate 6% to 8% increase in the buying power of a pension for every year that retirement is delayed, so someone retiring at age 55 and not 60 may have sacrificed an increase of 25% to 30% to their pension in real terms. This is due to making contributions for longer, earning investment returns for longer and the cost of annuity benefits decreasing with age. Given the generally low retirement benefits and projected retirement incomes, members should be encouraged to delay retirement as much as possible and employers should be encouraged to facilitate this as discussed in 'Longevity'.

Currently, at retirement, pension fund members can take up to a third of their retirement fund benefit as cash while provident fund members can take the full benefit as cash[30]. They must use the balance to buy a conventional life or living annuity. The decisions as to the amount of cash to take and which annuity to buy are often irrevocable. However, most members have not made a single decision about their retirement funding before this point!

Despite the limits on the size of the cash benefits, if we considered pension and provident fund members together, the average member takes about 60% of their benefits in cash at retirement. This is due to the tax incentive structure, the OPG means-test that encourages cash benefits and simply not understanding their options. Members need advice and guided processes to nudge them towards responsible choices or appropriate defaults if they are unable to choose for themselves.

Conclusion

The current retirement savings environment is characterised by retirement benefits that are insufficient to meet the needs of pensioners and that many savers perceive as having little value relative to the satisfaction of immediate needs. This is despite the many hours' employers and retirement fund trustees invest in managing and monitoring retirement benefits. To avoid this time and energy going to waste and the employees depending on the government in old age, employers should be more involved in the decision-making process and guide or even default employees towards responsible decisions.

Where it is clear that the retirement fund alone will not meet members' requirements, trustees and the employer should consider ways to change these outcomes, including:

- Increasing the retirement age
- Increasing the contribution rate
- Increasing the pensionable pay percentage
- Automatic preservation
- Automatic annuitisation

In addition, retirement savings investments should better match the way in which liabilities move.

Where the situation cannot be resolved by the retirement fund alone, employers should offer 'financial wellness' programmes that help members who realise their level of savings is not going to see them through their retirement years to develop effective budgeting skills and financial literacy.

Financial education

By John Anderson, Megan Butler and Michael Kirkpatrick

Low and declining household savings rates illustrate the lack of engagement that individuals have with their future financial needs. At the heart of the problem is the lack of financial advice relating to effective planning and budgeting on offer at the right place, and at the right price. For many individuals, financial education will be accessed only through the workplace. Employers should be more actively involved in finding the right medium of delivery and the right messages.

> **2.7 million of the 19 million credit-active South Africans have court judgments and administration orders against them.**

2.7 million of the 19 million credit-active South Africans have court judgments and administration orders against them[16], indicating that they cannot manage their debt. Reserve Bank data shows that for the last seven years, South African households have had more debt than savings[17]. Low levels of savings relative to debt is a global problem and the reasons for this phenomenon are complex. However, Australian research[18] offers some possible reasons including:

- Living for today.
- Aspirational spending.
- Spending to feel better.
- Financial disengagement, defined as no interest in managing finances and a lack of monitoring or responsibility.
- The use of credit as an additional income.
- The attitude that credit is 'mine' as opposed to money that needs to be repaid.

Financial education is one of a complex web of factors that can assist in changing attitudes and behaviours that result in indebtedness and distress[18]. One of the recommendations of the Organisation for Economic Cooperation and Development (OECD) around financial education is that all stakeholders, including unions, employers and the government, contribute to improve levels of financial education.

What is 'financial education'?

The definition of 'financial education' as per the OECD (2005) is the process by which consumers:

- Improve understanding of financial products, concepts and risks.
- Through information, instruction and objective advice, develop the skills and confidence to:
  - Become more aware of financial risks and opportunities.
  - Make informed choices.
  - Know where to go for help.
  - Take other effective actions to improve their financial well-being.

Offering objective advice and communicating this information effectively, so that employees can make informed choices, are key components of education.

How well are employers delivering on financial education?

Financial education is a long-term process and the world is constantly changing, so it is often difficult to assess what makes an education programme effective at changing behaviour[19].

> **Email as a form of communication is just not working, even though it's the easiest way to communicate these days.**

A number of studies have shown that education and individual counselling are helpful in combating employee behaviour that could lead to financial distress[20]. For this approach to be effective, what is said and how it is said, need to be carefully considered.

Content

Statistics from over 1 100 member education seminars conducted by Alexander Forbes's Member Education department during 2011 indicate that employers are offering financial education but this centres around employee benefits instead of the more basic and important topics of financial literacy. Only 16% of the seminars related to general financial wellness. Almost three-quarters of the seminars were focused on the retirement fund, giving an overview of employee benefits or preservation.

Delivery

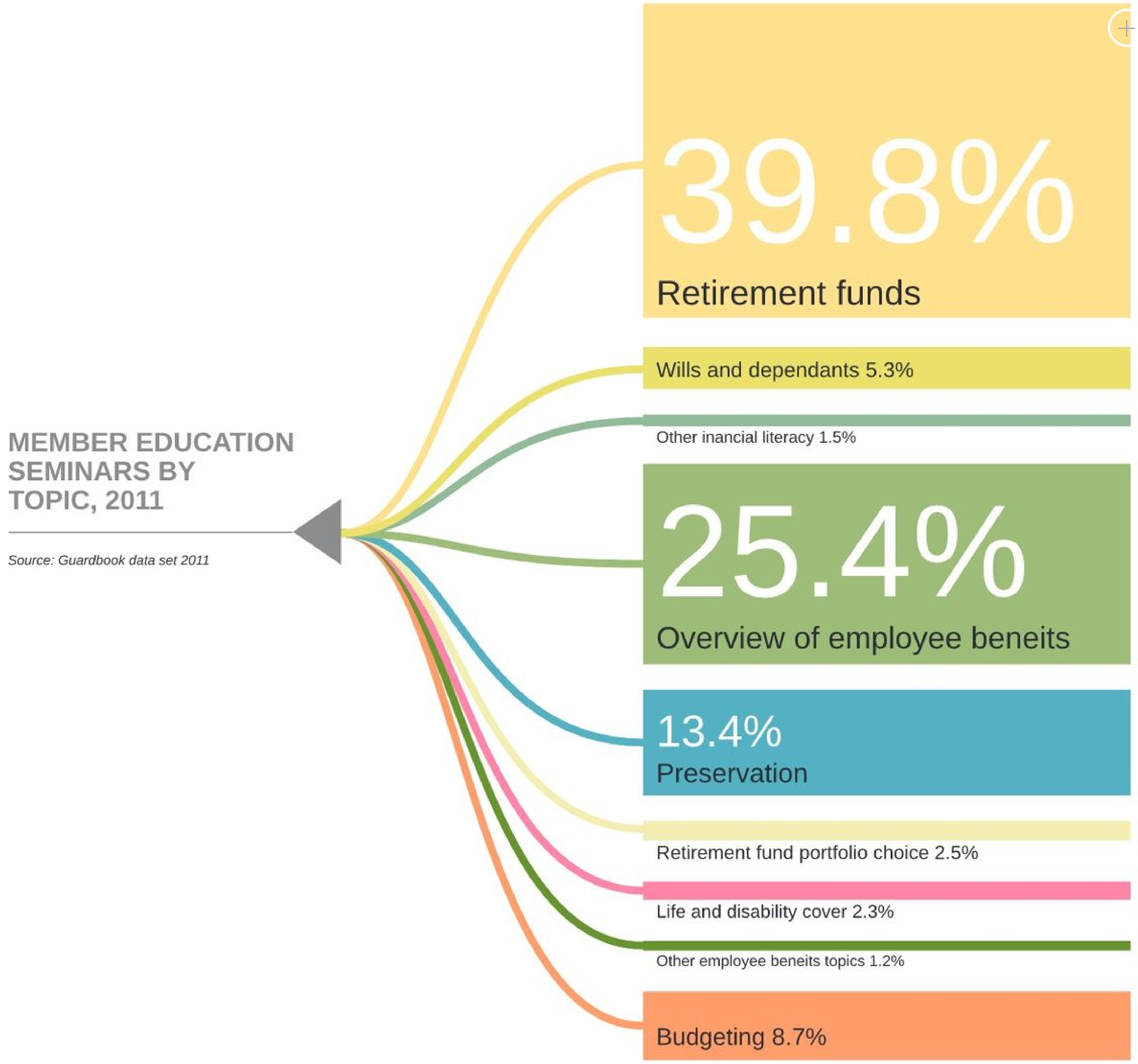
Education can take the form of group seminars, online tools and printed material. Employers need to concern themselves with improving the use of the most effective means of delivering this content. When we asked employees at some of our larger clients about their employee benefits communication, a number bluntly stated that they were aware of communication but did not read any of it[21].

Why is financial education and communication so ineffective?
Firstly, the medium used to convey messages may make a significant difference to their usage. Email communication is prevalent but 66.8% of email traffic in South Africa is spam[22].

So, given that employees are bombarded with irrelevant emails, it is no surprise that they seldom read employee benefits communication. One member complained about the 'plenty emails' received about the benefits while another summed it up as "email as a form of communication is just not working, even though it's the easiest way to communicate these days[23]" Younger members who were interviewed for our survey were particularly critical of current modes of delivery[23].

With the growing recognition that people learn at different paces and in different ways and that it's critical to repeat messages, experts recommend using a variety of different media to convey consistent messages[23]. A number of pilot programmes in Poland[23] have shown that short television segments featuring celebrities and an online film portal featuring three-minute segments were particularly effective at reaching younger and older people. In addition, levels of financial understanding continued to improve after viewings, possibly due to the discussions that they provoked[23].

Secondly, understanding was a key problem. One respondent told us that because the initial communication about benefits was so poor, employees did not bother to open subsequent messages.



> **People trust me with [my job] and I trust [my employer] with my provident fund.**

Thirdly, there was not clarity on responsibility for the benefits and there were high levels of financial disengagement. One woman working in professional and business services summed it up as, “People trust me with [my job] and I trust [my employer] with my provident fund.” Further investigation revealed that she was a member of a DC fund with choice as to the level of the contribution rate and the investment portfolio. Her comments revealed that not only did she not know that the trustees, not the employer, set the defaults and make other decisions about her savings, but more importantly, it suggested she was not aware of the risks she could face.

When we asked employees about employee benefit communication, they invariably referred to their annual benefit statement, which is consistent with UK research that suggests this is the primary source of information about retirement funding[24]. Recent research on benefit statements suggests that they are largely ineffective in stimulating financial engagement or communicating risks to employees[25]. Changing this would require the administrator to change the benefit statement design.

Incorporating advice

Although education and communication might provide the worker with enough information to make informed financial decisions, some workers may wish to seek advice. In addition, counselling has been shown to play a powerful role in helping employees with financial distress.

However, most South Africans do not seek advice formally. When it comes to general financial products, 54% receive advice from TV or radio or from friends and family who do not work in financial services. About 53% use TV, radio and the internet to make choices about private retirement savings[26]. Across all products, advice from the employer was found to be consistently important, with 11% using their employer for financial decisions, more than those approaching financial advisers.

However, the Financial Advisory and Intermediary Services Act (FAIS)[27]requires that advice is provided by accredited advisers only. This makes the continued provision of advice in the workplace unlawful if the advisers are not accredited. Inevitably, there’s a cost implication in getting accredited advice.

Paying for advice is somewhat controversial: there is an obvious benefit for the adviser, but the benefit to the person getting advice is more difficult to quantify. This is partly because individuals tend not to follow advice[28], but when they do, the after-fee improvement in benefit outcome can be equivalent to 1.8% per year in additional returns[29]. However, any benefit depends on getting the right advice at a reasonable price. The National Treasury has raised concerns about the cost and bias involved in advice in the retail market[30].

The challenge is ensuring the right advice is offered in a place where employees will look for it, and at the right price.

The Financial Services Board (FSB) is responsible for financial advice and education in South Africa. However, despite initiatives in banking and short-term insurance, little progress has been made on the broader savings and debt environment. Given the scarcity of funding, corporate sponsorship is needed, without expectation of marketing or significant brand exposure in return.

> **Individuals tend not to follow advice, but when they do, the after-fee improvement in benefit outcome can be equivalent to 1.8% per year in additional returns. However, any benefit depends on getting the right advice at a reasonable price.**

Conclusion

Improving benefits outcomes through education, communication and advice will require a number of stakeholders, such as the government, financial services providers, unions and employers[31], to focus their attention on this area.

For their part, employers and unions, retirement fund administrators and boards of retirement fund trustees need to reconsider their communication strategies in a way that incorporates the FSB's public service financial education messages. New strategies need to ensure that the content covers basic financial literacy topics as well as employee benefits and that it is presented in an engaging way.

Employers and the FSB will have to address offering advice in the workplace to ensure appropriate, regulated advice at the right price.

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