[The way forward to improving employee benefit engagement]

The heart of the matter – What do individuals need?

South Africa | 01 June 2014 | Insight

Authors and contributers

Anne Cabot-Alletzhauser

Kristin-Ann Cronjé

In this article we look at how we could think differently about benefits design. What we've come to learn over time is that the one-size-fits-all approach to employee benefits is just not cutting it.

In a country with a population as culturally diverse as South Africa, a tick-box approach to benefits design serves no one well. We need to recognise that for some people educating their children may be more important than buying disability cover.

Meeting needs must also be a dynamic process. Our approach to meeting needs must change over time as society changes and as markets and industry develop innovative new ways to address individual needs.

What we propose instead is a needs-based approach to benefits design. This approach looks holistically at the needs of the individual and should afford them the ability to structure their benefits, such as retirement, risk and healthcare, within the confines of a group arrangement.

Ensuring that individuals are provided with enough protection to sustain them throughout their lives regardless of whatever life throws in their path, proves to be important for stemming the re-direction of savings meant for retirement towards more immediate needs. The ultimate objective is to enable the individual to optimise consumption, saving over their entire life cycle and protection against risks.

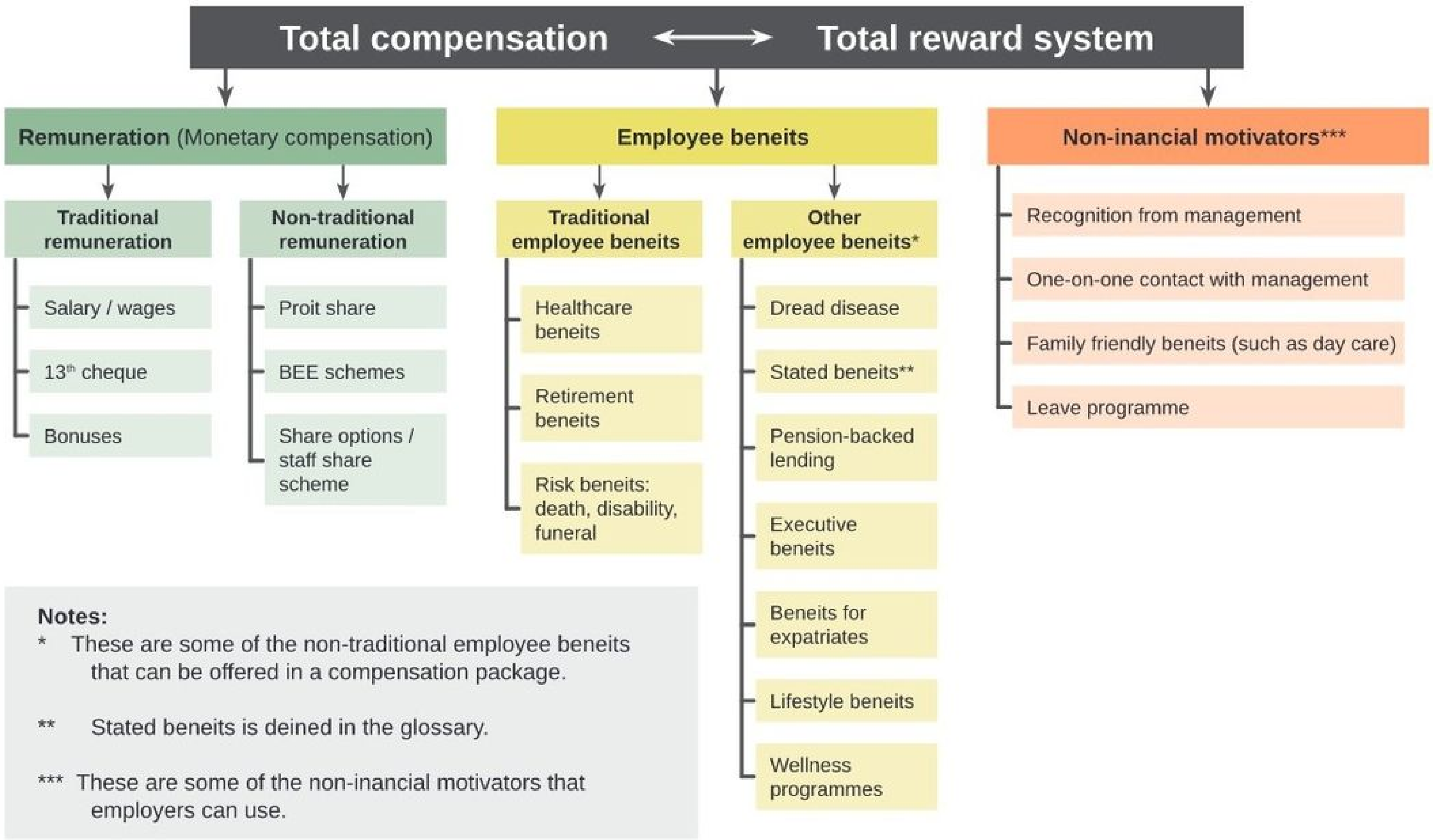
> **What we've come to learn over time is that the one-size-fits-all approach to employee benefits is just not cutting it.**

Why we need a more evolved approach

A shift from the traditional approach to employee benefits design is as much a mind shift as it is one of design. To start with, designing an employee benefits package has to move beyond an approach where employers simply offer what the rest of the market offers. A needs-based approach demands that we develop solutions from the bottom up: begin with a clear understanding of the unique features of the workforce and assess how those needs are likely to evolve over time. Although our goal might be to optimise a member's exposure to income protection, family protection and savings requirements as their life dynamics change, this needs to be done within the cost and contribution constraints that the fund may impose.

If employee benefits are to be as valuable to the employer as they are to the employee, we need new tactics: the total rewards that a company could potentially offer their employees must be highlighted to them and not just the risk benefits provided by the fund. Non-traditional benefits like discounts on products can be a powerful reward for employees and this means that employee benefits can become an important tool in enhancing employee engagement and ultimately improving productivity.

The diagram below provides some sense of how expansive this potential could be. Many companies may recognise that they already provide many of these services to employees. The point here is that if employees don't understand the full extent and value of their benefit offering, employers are missing an opportunity to capture the positive knock-on effects of having such benefits in place.



Source: Alexander Forbes Research & Product Development

How exactly can we establish what members need?

What follows is a description of the process we can follow to either establish a new total rewards offering or review the existing offering:

STEP 1: Carry out a needs analysis

The employer or fund – with the help of experts, if necessary – needs to carry out a comprehensive analysis of their employees or members. They must consider the following:

- Employee profile: This includes a look at the earnings, job type, age, gender, level of education, level of financial education and, if possible, family structure of employees.
- The sector the person falls into: The type of industry the employed person works in generally dictates the level of pay they can expect. This directly affects the basket of goods they can hold and limits their ability to access those benefits outside the fund if they are not offered. The sector can also affect the level of risk that the member represents to the insurer.
- The split of the employee base between different geographical areas: Some provinces have greater exposure to certain types of diseases.
- The past claims experience of the fund.

Payroll systems rarely capture the level of detail required. As such employers need a process that allows members to give additional information about their family structure and number of dependants on an ongoing basis.

STEP 2: Set up a benefit matrix

There is a whole universe of employee benefits, both savings and risk-related, that companies can include in an employee's total rewards package. From the information gathered in the needs analysis in Step 1, we can make a list of benefits suitable for particular groups of employees.

STEP 3: Compare the current offering with the benefit matrix

Add another column to the matrix you established in Step 2 to set out whether employees currently receive this benefit. This helps you not only to identify the gaps in your benefits offering, but where you may have overlaps.

STEP 4: Benchmark your current total rewards system against the market

To remain competitive, this kind of review has to consider what the market is offering. Each employer should be particularly interested in what other companies in their sector offer.

STEP 5: Determine cost constraints

Employers (and members) have to balance offering benefits that meet employees' needs while controlling associated costs. For benefits offered through the retirement fund, like group life cover, the cost is constrained by the fixed contribution rate that the member and employer pay. Contribution rates from an employer's previous defined benefit arrangement, like with so many other retirement fund features, may not have been reviewed for appropriateness over time. For employer-owned policies, the cost is constrained by the other demands on an employer's finances.

The cost of certain employee benefits will determine whether employers can include them in the benefits offering. So, despite the needs of the workforce, the decision about what to include will depend on weighing up potential benefits against the cost of providing these benefits.

STEP 6: Determine employee satisfaction levels to gauge return on investment

In Benefits Barometer 2013 we touched on the fact that you can boost employee engagement with an appropriately structured total rewards system. You can use employee satisfaction as a proxy for the success of the employee benefits programme. Companies can measure employee satisfaction by surveying your employees. This should tell you if your current benefits meet your employees' needs.

However, treat the results of the survey with caution. Sometimes when employees indicate that they're not satisfied with their benefits offering, it may just be that they don't understand a benefit or how it works because your communication strategy may be flawed. If they don't understand the purpose of the benefit or the protection it gives them, they may think the benefit is unnecessary. We discuss communication strategies in more detail in 'STOP THE PRESSES! WE NEED TO TALK'.

Benefit design in detail

In this section we examine specific benefit designs to illustrate the extent to which a needs-based approach can enhance outcomes for members.

Designing death benefits in a defined contribution environment
In general there are two reasons why a fund member would need life cover:

- To pay their debt.
- To provide for their dependants.

Debt cover is usually provided through personal arrangements outside the fund. For instance, when you take out a home loan, the bank may require that you take out life cover equal to the outstanding loan and may arrange the cover for you.

Group life cover generally focuses on providing protection for dependants of the fund's members. This is why we need to be aware of the family and dependency structure of employees when designing these benefits.

To establish whether the current structure is appropriate, we need to make some assumptions about our members' benchmark needs. For instance, where members may be married, then a possible benchmark for sufficient death cover would be to provide the spouse with 60% of the member's pensionable salary in the event of death. We can then use this benchmark to see how effective current death benefit coverage is at meeting this requirement.

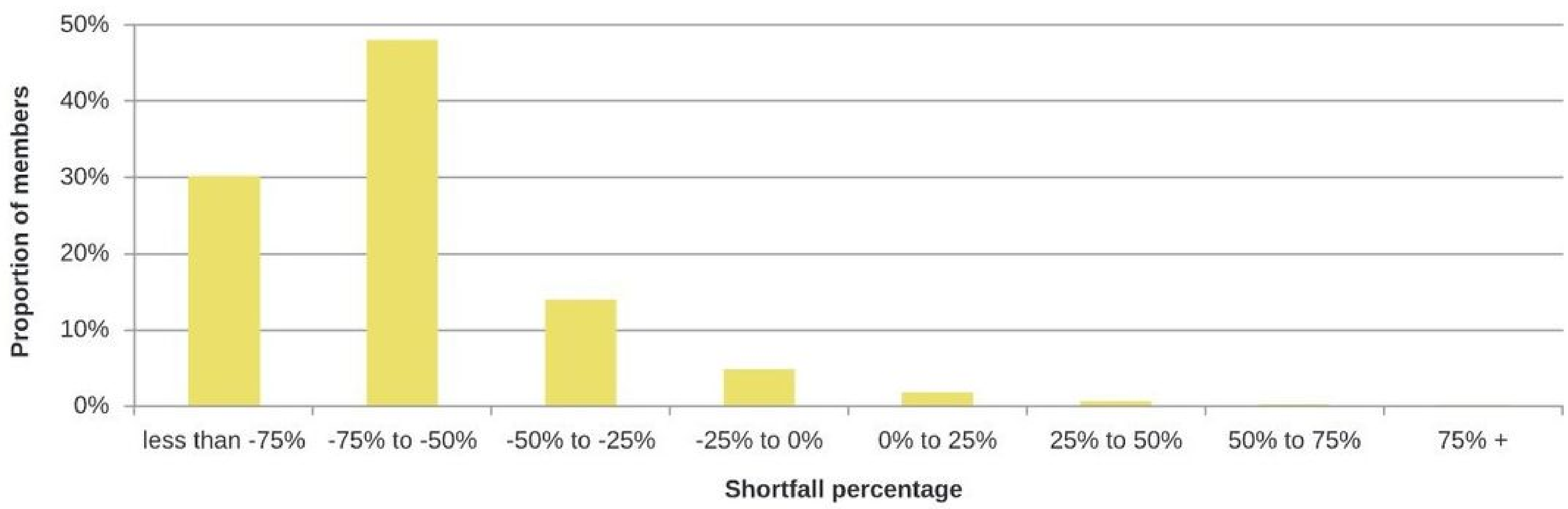
The graph below summarises how actual benefits compare to the assumed benchmark need. The data sample reflects the full range of members in the Alexander Forbes Member Watch™ data set.

A 'shortfall' of 0% means that the benefit payable on the death of the member provides for the benchmark needs. A 'shortfall' of –50%, for example, means that the benefits payable on death are 50% below the benchmark needs, and a 'shortfall' of +25% means that the benefits payable on death are 25% above the benchmark needs.

It is clear from the graph below that for many members, their current benefit offering is falling short of their actual needs.

A warning with this analysis is that it does not take account of an individual's family structure and the extent to which any risks and insurance can be internalised. This was discussed in 'What's the context?'. Having more information about an employee's family structure can be a useful part of a needs analysis as it will help to identify employees who may only need very basic levels of cover.

Analysis of death benefits against benchmark need



Source: Member WatchTM Survey (2012)

Results like these clearly suggest that there is a need to review and change the existing structure of death benefits. But deciding what structure to put in place is not a simple task and it might differ for different employers or subsets of employees within one employer. For example, when a dependency structure goes significantly beyond a single spouse, these assumptions may not be adequate.

But there are other drawbacks to employing established conventions in setting benefit policies. One of the most common death benefit structures is a benefit based on fund credit plus some multiple of salary at the date of death.

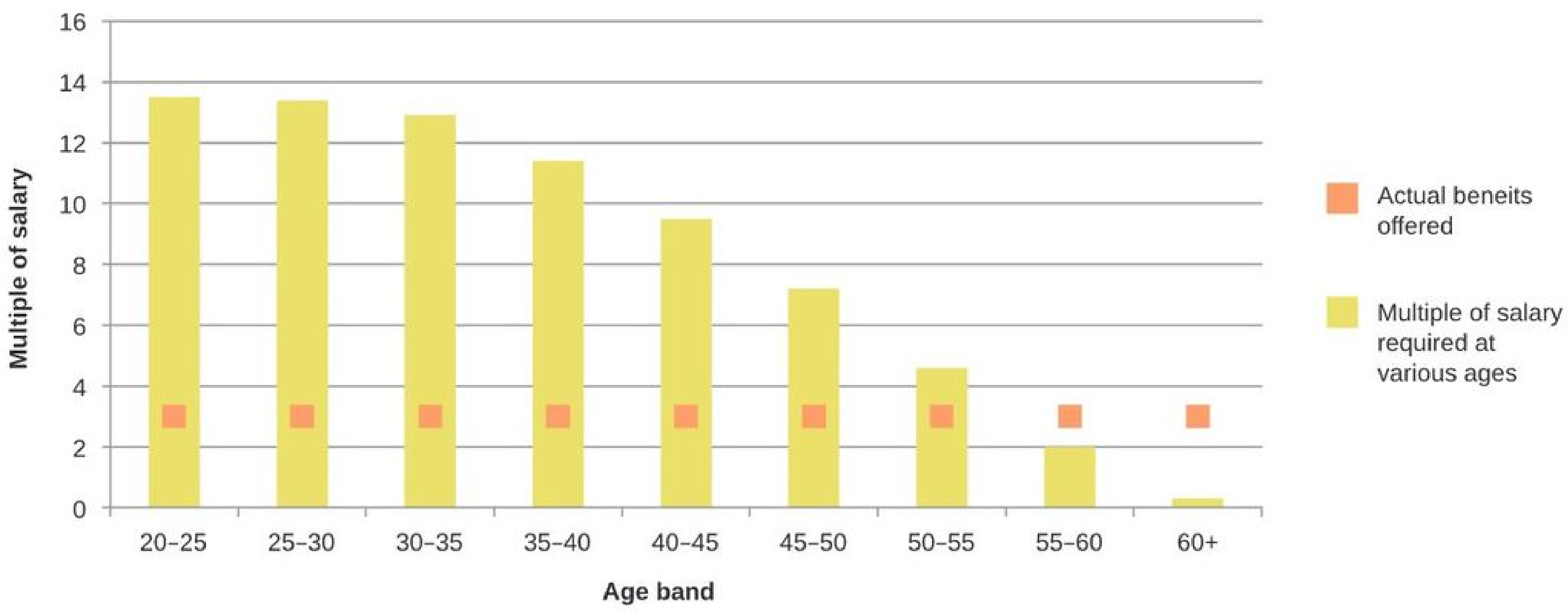
Assuming positive salary increases and a static benefit multiple of three times salary, the total lump sum death benefit is at its lowest at younger ages and highest immediately before retirement.

We could argue that the need for cover is higher at younger ages where the member has a younger family and fairly low retirement savings compared to an older member with accumulated retirement savings and a shorter time to provide for dependants. This is reflected in the required multiples of salary payable on death, as shown in the chart below.

An age-related benefit may therefore be more appropriate. One argument for age-related benefits is that they eliminate the cross-subsidy from younger members to older members. Older members are more likely to claim, that's why the cost of benefits will be higher at older ages. An age-related benefit will help to avoid younger members carrying the cost of benefits for older members, depending on how the benefits are priced. But the main advantage is that it can be tailored to better meet the needs of members at various stages.

Another arrangement would be to structure multiples which better meet the needs of individuals at various ages using a single unit rate. This approximates needs but retains an element of cross-subsidy. However, there are several ways in which age-related benefits can be structured and priced, each with their own pros and cons. One method may involve cross-subsidies while other methods can be used to retain cross-subsidies

Death benefit need against actual benefit offered



Source: Alexander Forbes Research & Product Development

Disability benefit choices

If we think about the type of benefit that will best meet members' needs, there's much less flexibility available when designing disability benefits than when designing death benefits. There are two main types of disability benefits:

Permanent income benefits: These are typically provided at a level of 75% of an employee's risk salary (the employer defines the risk salary and this is the salary on which risk benefits are based). The fact that the income is less than 100% serves as an incentive for employees to return to work, once recovered, if they can get their full salary again.

Capital disability benefits: This pays a once-off lump sum when the employee is declared disabled. While most people think the cash lump sum disability benefit is more valuable, an income disability benefit better meets the needs of most individuals, because if you're truly unable to return to work, there is no risk that you will run out of money before your retirement date.

To ensure that the benefit best meets the needs of employees, employers may need to revise their definition of risk salary. Given that the insurance policies are based on risk salary (which is often just a fraction of total income and not the individual's total income), they may face a significant decline in living standards in the event of disability.

Employers in sectors that involve physical labour often provide a capital disability benefit because it's cheaper than the alternative. But even when they offer high multiples of salary, the benefit is often not big enough to meet the income needs for the rest of the individual's working life.

Changing medical needs

As people grow older, their medical expenses are expected to change according to changes in their personal circumstances and health status.

When you start working, you generally only need basic cover for unexpected medical events and emergencies. You typically find this kind of cover in a hospital plan within medical schemes. At this stage, people are usually single with no dependants. People who earn less money may also choose health insurance products at this stage of their lives. These products are cheaper than full medical scheme cover, but they generally pay only a portion of the actual medical expenses incurred. Members get a predetermined fixed amount payable on admission to hospital, no matter what the actual cost of the procedure.

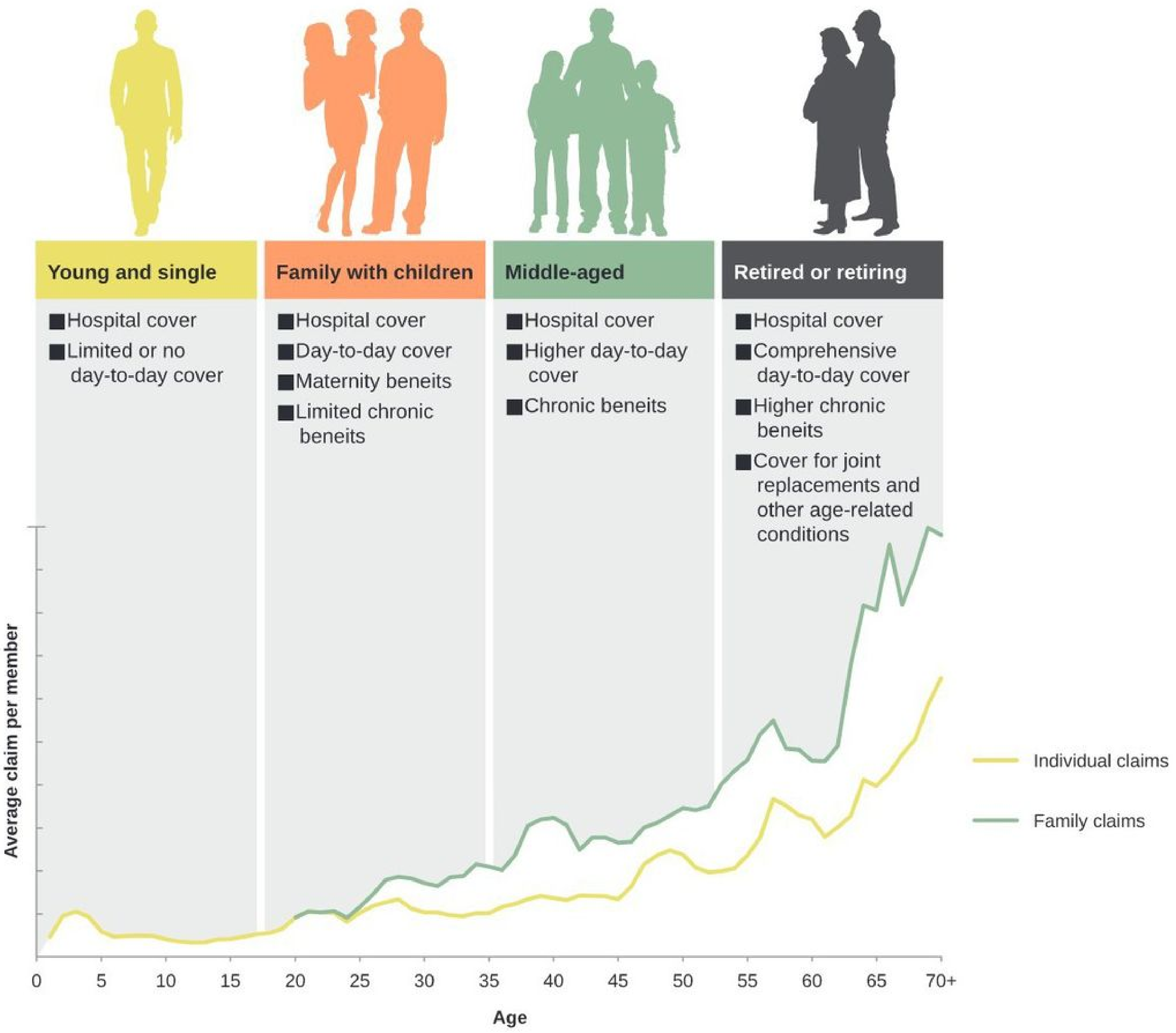
As a family starts to grow, members generally need to add some day-to-day cover as well as generous maternity benefits. When your children are young, they typically need regular day-to-day benefits for common illnesses. These are covered by benefit options that offer generous out-of-hospital benefits for GP visits, dentistry and medication. You may be able to reduce this cover as children grow older.

During middle age, you may start to develop certain chronic conditions like high cholesterol and diabetes as a result of either poor lifestyle choices or genetic predisposition. You'll need regular medication and monitoring for these chronic conditions to ensure they don't cause further complications.

The risk of developing more serious conditions increases as people move into their retirement years. This is when you need additional comprehensive cover.

Smoothed claims over an individual's lifetime.

The diagram below represents general needs, but actual needs will depend on an individual's own circumstances.



Source: Restricted Medical Scheme client of Alexander Forbes Health (Pty) Ltd, Technical and Actuarial Consulting Solutions (2011)

Saving for retirement is a complex task that demands discipline on the part of the saver.

Fitting in retirement savings

Saving for retirement is a complex task that demands discipline on the part of the saver. They must start from an early age and contribute enough to achieve a decent outcome in retirement. In theory this is simple, but when an individual has to find more money to pay for living expenses, one of the first things they may be tempted to sacrifice is their retirement savings rate if they have the option.

Our main proposals here are:

- For contributions to be structured so that they increase over time, in line with the individual's age or some other factor. (We discuss this further in 'The journey on autopilot')
- For risk benefit structures to have variable elements that change according to the needs of the individual over their life cycle. Such an approach is best accommodated by a contribution rate that either increases over time or is variable over the life cycle.

Many people might be unwilling to increase their total gross contribution rate because they don't understand the implications of inadequate protection.

This means that to pay for risk-benefit expenses, you have to vary the amount of money you channel towards retirement savings over time. As long as we are able to achieve the same average contribution rate towards retirement savings as we would under a fixed benefit offering, then the retirement outcome should remain similar.

Alternatively, the employer could provide a fixed benefit offering and present the results of the employee benefits review to the employee. This would allow them to take up the benefits not offered, but which they need, at their own cost.

The cost issue in funds is often clouded by how well employees understand the 'cost advantage' to them of having their fund or employer use economies of scale to provide them with services they might normally procure in their own right. An effective total rewards framework is hugely dependent on communicating this point effectively.

Bring it all together

As we mentioned earlier, the goal of needs-based benefit design is to get the best benefit structure possible within the cost constraints. We need to work within the contribution rate the member has selected and attempt to allocate it between death, disability and retirement savings to best meet the needs of the individual at each life stage. The aim is to ensure that we achieve the most efficient allocation of the contribution rate over time.

Efficiency involves maximising benefits that engage the employee at that period of their life cycle, while providing minimum levels of cover on other benefits. Because disability benefits are vital to sustaining employees and their families through illness and injury, it is assumed that this benefit would always be a priority. That's why in our modelling it is secured before allocating the rest of the contribution rate to retirement and death benefits.

Efficiency is measured by looking at the shortfall between what each benefit offering will give members and what their needs are at each point in life.
Let's consider four death benefit structures:

1. A fixed, flat multiple of salary
2. Primary Lifecycle default
3. Secondary Lifecycle default
4. A fully flexible benefit without an increase in the total contribution towards risk and retirement.

A fixed multiple of salary offers the same benefit regardless of 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.

In the two Lifecycle options the same benefits are assumed to be on offer.

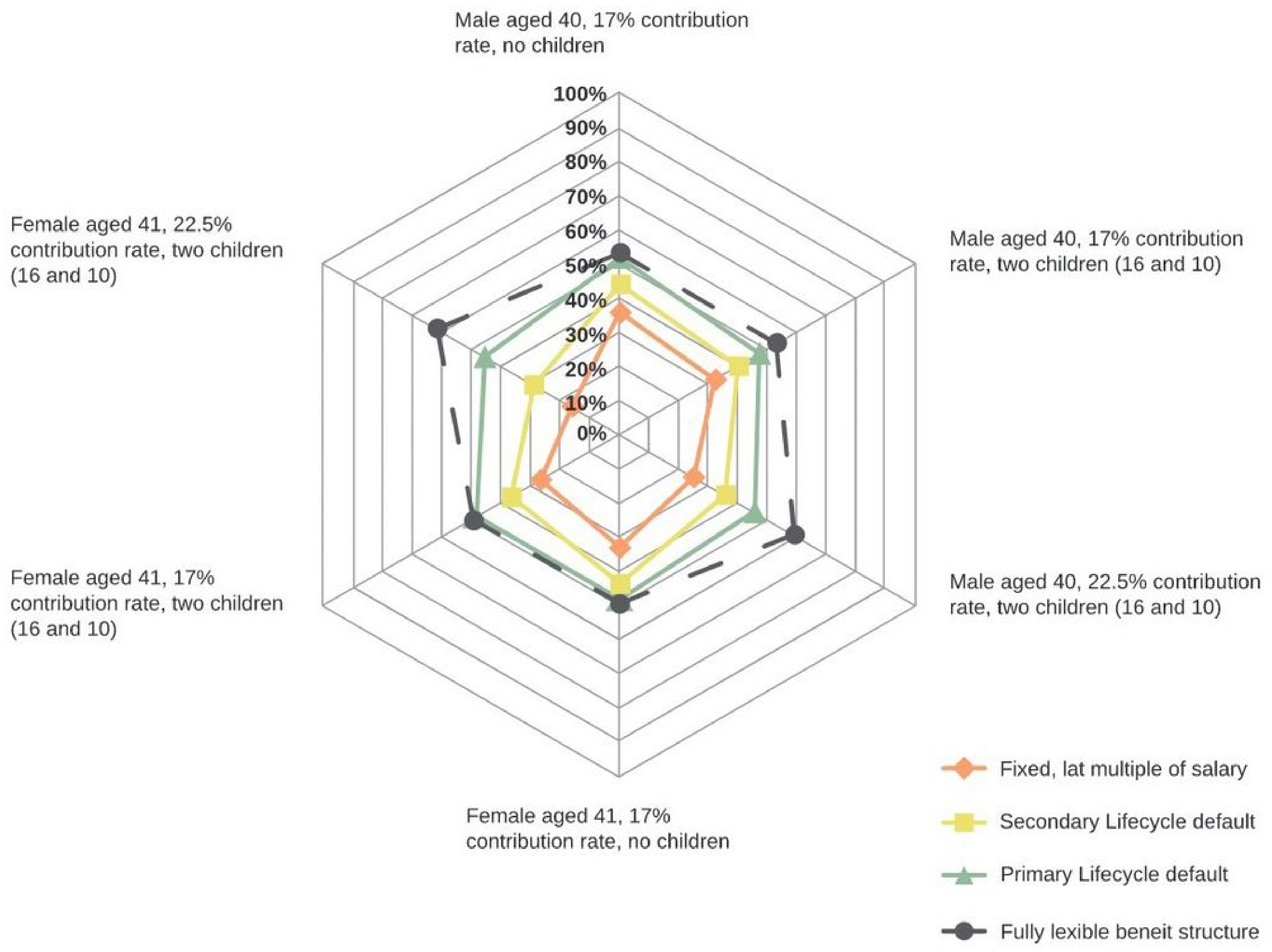
The difference, however, is that the secondary offering simply offers lower multiples in the benefit coverage at some ages in an attempt to lower the cost of death benefits. The secondary offering is also for membership groups where the family structures are such that they can absorb more of the risks and hence a lower level of overall cover is required.

A fully flexible benefit will aim to offer the same disability benefit as stated above, but retirement funding and life cover will be assumed to be variable over the life cycle to achieve the most efficient allocation to each of these benefits. This means that their allocation to death benefits will reduce automatically as they approach retirement.

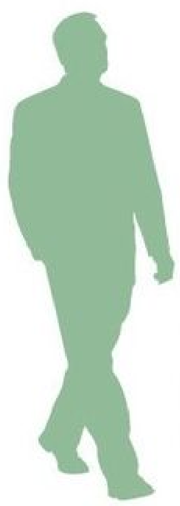
Efficiency involves maximising benefits that engage the employee at that period of their life cycle, while providing minimum levels of cover on other benefits.

To illustrate how you can achieve an efficient allocation we consider two retirement fund members, Rivash and Lerato. Lerato is a 41-year-old woman with a contribution rate of 17% of pensionable salary and Rivash is a 40-year-old man with a contribution rate of 17% of pensionable salary. A needs-based approach requires that we take account of additional factors like whether they have any dependants, debt or affordability constraints. The graph below shows which benefit package ends up maximising efficiency for members under various scenarios. The higher the number on the spider graph the greater the efficiency.

Outcomes-based efficiency in various scenarios



The output from the graph on the previous page can be summarised in the following tables.



Rivash

Male aged 40

Debt level	Number of children	Total contribution rate	Most eficient beneit stucture	Least eficient beneit structure
-	-	17%	Primary Lifecycle default	Fixed multiple of salary
R300 000	2 (aged 10 and 16)	17%	Fully lexible beneit structure	Fixed multiple of salary
R300 000	2 (aged 10 and 16)	22.5%	Fully lexible beneit structure	Fixed multiple of salary

Lerato

Female aged 41

Debt level	Number of children	Total contribution rate	Most eficient beneit stucture	Least eficient beneit structure
-	-	17%	Fully lexible beneit structure	Fixed multiple of salary
R300 000	2 (aged 10 and 16)	17%	Fully lexible beneit structure	Fixed multiple of salary
R300 000	2 (aged 10 and 16)	22.5%	Fully lexible beneit structure	Fixed multiple of salary

This analysis has important implications. It shows that simply implementing a fully flexible benefit structure may not be appropriate for all members. For example, when Rivash has no children and no debt, a Primary Lifecycle default, along with retirement savings and disability cover, represents the most efficient allocation of his contribution rate. But perhaps the most important message here is that a flat multiple of salary at all ages is not an efficient benefit for members under any circumstances.

With the correct benefits structure we are able to achieve efficient outcomes for members. But this demands a contribution rate big enough to meet the cost of death and disability benefits while still providing a sufficient allocation to retirement savings. And as mentioned before, the allocation to each element of the package will vary over time in response to the member's changing needs.

Outside the fund the member must also ensure that out of their take-home pay, they are able to balance other costs like medical aid contributions.

Ensuring employee well-being

The final element of a holistic employee benefits programme is one that deals less with the specific benefits on offer and has more to do with how well employees understand how to manage their financial, physical and mental well-being. Securing mental well-being is a harder task for employers and until recently was not recognised as a key issue affecting profitability.

Unhealthy finances have a direct impact on productivity because it distracts people from their work. In the longer term, it can create physical and mental health problems because of stress and not receiving appropriate medical treatment. These health problems themselves create even more financial distress for employees as well as increasing absenteeism. Both of these decrease productivity further. Poor personal finances could also lead to increased workplace fraud and theft of company property.

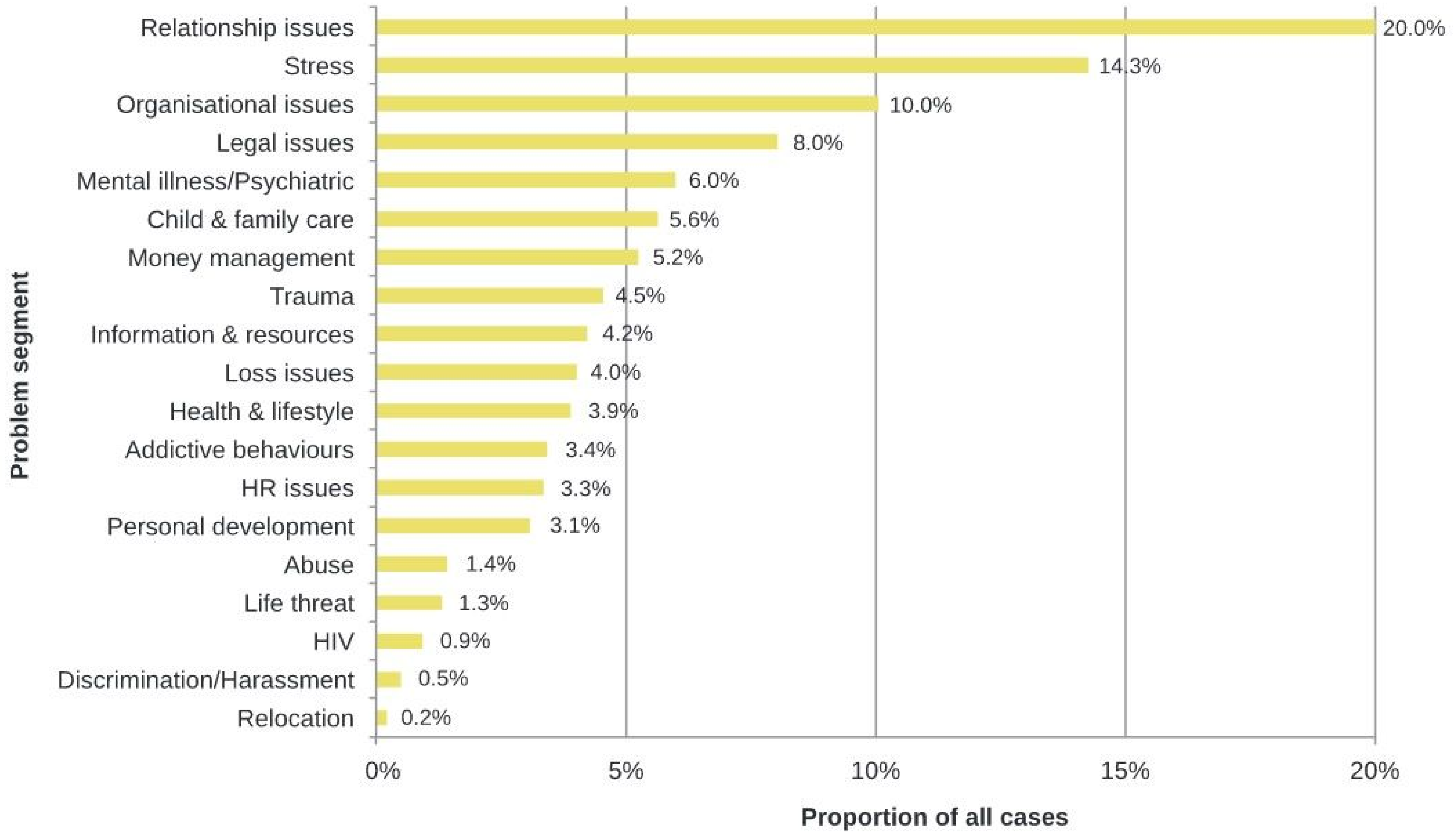
We are seeing evidence of shortcomings in securing physical, mental and financial well-being in South African workplaces. The graph on the next page shows the most common types of issues reported to employee wellness provider ICAS in 2013. Stress was the second most prevalent concern for employees, with money management and mental health concerns ranking among the most reported problems.

For an employee benefits/total rewards programme to translate into a programme that enhances employee engagement, a comprehensive wellness programme that helps employees develop effective budgeting skills and financial literacy could stop minor financial worries from turning into major concerns. It can also provide insights into how to manage their health and family needs. In addition, it can offer one-on-one emotional support for the individual and their family following a traumatic event.

We discuss wellness programmes and personal counselling further in 'Failure to launch'.

> **Effective budgeting skills and financial literacy could stop minor financial worries from turning into major concerns.**

Proposition of cases of each problem segment in 2013



Source: ICAS (2013)

Conclusion

As we said in Benefits Barometer 2013, achieving efficiency involves maximising benefits that are most significant for the employee at different life stages, while providing minimum levels of cover on other benefits. We can improve efficiencies for the same total contribution level by tailoring benefit design to the individual's position in their life cycle. We can further improve it with higher contribution rates.

It's not impossible to migrate from the traditional approach. We can tweak current programmes gradually to introduce more flexibility. A needs-based approach to benefit design is not 'a nice to have' but an imperative if individuals are to have a chance at safeguarding their journey, both along their way and at their retirement destination.

TOTAL REWARDS | BENEFIT DESIGN | NEEDS-BASED BENEFITS DESIGN | EFFICIENCY OF BENEFITS STRUCTURE | EMPLOYEE BENEFITS | WELL-BEING