The role of financial products in creating well-being

Financial products as facilitators of well-being

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ENABLERS AND SAFETY NETS

Previous parts of this edition of Benefits Barometer describe the concept of the well-being economy and the importance of social mobility in sustaining that economy. They show how classifying households as 'poor', 'middle income' or 'elite' excludes both the potential for improvement and the fragility of an apparently sound position. In this chapter we affirm the role that providers of financial products must play in enhancing well-being. We tap into global research to explore the types of shocks that low-income households typically experience, and show how insurance and saving play a part in protecting against these shocks.

An analysis of the financial positions of South African households by the Southern Africa Labour and Development Research Unit[2] provides two insights of invaluable significance to the financial services industry. First, households that may be considered 'poor', as measured by levels of expenditure, may be further divided into two categories: 'chronically poor' and 'transitory'. Those classified as 'chronically poor' have a relatively low probability of exiting poverty. Those in the 'transitory' category have an above-average chance of moving into the middle class. They are the theoretical beneficiaries of social mobility, as they have prospects for improvement.

Second, households currently classified as 'middle class' may be subdivided into 'safely middle class' and 'vulnerable'. Those that are safely middle class have only a small chance of falling back into poverty. Those that are 'vulnerable', however, face circumstances that could combine to push them into the category of 'poor'. The existence of this group may help explain why South Africa has failed to establish a stable middle class.

A society that looks after its people well is characterised by mechanisms that enable upward mobility as well as by safety nets which protect its members from falling into poverty. Such a society uses a dual-focus framework, prioritising both social mobility and social protection.

How might South Africa improve the prospects for those who are currently 'poor' of moving into the middle class? Similarly, how might members of the 'middle class' be protected against events that make them vulnerable to falling into poverty? Some suggest that the answers to these questions lie with government. We take the view that in the dual-focus framework other parts of society have important parts to play, but they must do so responsibly.

Government as provider

Whereas universal and lasting peace can be established only if it is based upon social justice… . (Preamble of the Constitution of the International Labour Organization)[3]

The International Labour Organization (ILO), a specialised agency of the United Nations, was established in 1919 as part of the Treaty of Versailles, which brought to an end the First World War. At latest count it has 187 member countries.[4] It aims to encourage and establish the conditions for social justice referred to in the preamble to its constitution.

The ILO differs from other intergovernmental organisations in two important respects. The first is its tripartite nature. Representatives of both worker and employer organisations, along with policymakers, participate in the development of its standards. The second is the way it establishes and supervises standards. The ILO lays down conventions and recommendations and calls on the leaders of member countries to ratify these. Governments report to an independent committee of experts on ratified conventions, and their reports are made available to the representatives of worker and employer organisations, who may comment on them. The governing body of the ILO may even require reports from member countries on recommendations and unratified conventions.

Convention 102 of 1952 calls for minimum standards of social security with regard to nine benefit types:

- medical care
- sickness benefit
- unemployment benefit

- old age benefit
- employment injury benefit
- family benefit
- maternity benefit
- invalidity benefit
- survivors' benefit

The convention requires signatories to adhere to the minimum standards of at least three of these benefit types, at least one of which must be unemployment, old age, employment injury, invalidity or survivors' benefit.

Recommendation 202, passed in 2012, recognises that circumstances and means in countries differ and calls for social security systems in different countries to at least meet the requirements of a specified floor. The implications of these and other conventions and recommendations are that governments are regarded as the primary channels for providing social security.

The roles of other players in facilitating financial well-being

South Africa is not a signatory to Convention 102. However, this should not be regarded as evidence of poor commitment to the principles of social security. The Constitution makes this commitment quite clear:

1) Everyone has the right to have access to… (c) social security, including, if they are unable to support themselves and their dependants, appropriate social assistance. (2) The state must take reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of these rights.[5]

A number of commentators, among them the so-called Taylor Committee,[6] have acknowledged the constraint on government alone to meet acceptable standards of provision. The committee recognises two further important facts:

- While the government has a coordinating role and may perhaps directly protect the most vulnerable in society, individuals and institutions have supporting parts to play in meeting the objectives of a social security system.
- The concept of social security as the provision of benefits needs to be broadened to encompass all of the strategies and programmes intended to ensure a minimum standard of living for all citizens, hence the term 'social protection'.

In summary, South Africa is committed to the principles (espoused by the International Labour Organization) under which the protection of its vulnerable citizens is of priority to government.

This is enshrined in the Bill of Rights. Government is not, however, solely responsible for adhering to these principles. Individuals, employers and financial services providers also play a key part in enhancing the social mobility of all our people.

If the private-sector contribution to social protection is to be effective, product providers must recognise the role they play and act accordingly. Consider the market for individual pension savings products, typically known as retirement annuities, which is supported by the tax incentives government provides to savers. Industry lobbying for a continuation of these incentives is undermined by policymaker concerns regarding high charges and excessive early-termination penalties.[7]

The continued right of financial entities to provide products that contribute to social protection and social mobility requires evidence that they do so responsibly. Providers of financial products are not the only entities with an interest in meeting these needs. Employers stand to gain a great deal from improving the well-being of their employees. The principles and supporting detail put forward in this part of the *Benefits Barometer* should be considered by all companies serious about raising the effectiveness of their employees.

Insurance and savings as contributors to well-being

Figure 4.1.1: Three key functions of social protection

Source: Deblon & Loewe (2012)^8

Social protection schemes perform these functions in three different ways:

- They may prevent risks, reducing the probability of a shock.
- They may limit the effects of a risk event, through arrangements made in advance.
- They may cope with risk by absorbing the effects of a risk event after that event has taken place.

Private insurance and saving play a part in all these strategies, most effectively in the second: reducing the impact of a potential disaster. Insurance aims to mitigate or remove the impact of a risk event by replacing lost assets or income. Saving mitigates the impact of a risk event by providing the means, at least partially, to offset lost assets or income.

Saving also differs from social protection and insurance arrangements. It is proactive and preventative, like effective primary healthcare or behaviour-modifying tools such as driving trackers. South Africa's low saving rates are calamitous not only because the available investable assets are lower as a result but because so many people, in the absence of this preventative safety net, are one small incident away from disaster.

Jacquier et al. also consider the question of how microinsurance contributes to the fabric of a social protection system.[9] They point out that a number of globally significant microinsurance schemes were established by civil society organisations in the interests of improving the positions of the poor. They also describe how microinsurance may be used to extend the reach of social protection schemes. This illustrates the potential for private-sector initiatives to support social policy.

In the discussion that follows, we summarise global research on the risks low-income households are exposed to and the measures they use to cope with these risks.

The risks that low-income households face

Heltberg et al., conducting an analysis for the World Development Report 2014,[10] group the shocks that people face as follows:[11]

- **Price shock:** input, output and food-price shocks
- **Disasters:** drought, water scarcity, flood, crop disease, storms and more
- **Employment shock:** reduced earnings or wages, job loss
- **Asset shock:** loss of land, house, livestock (most commonly from disease) and machinery
- **Heath shock:** death, illness, accidents and disability
- **Crime and safety:** common theft and violence of all kinds
- **Household breakup:** separations or incidents involving the police or other authorities

Shocks may be split into two broad risk types. Systemic risks affect many households simultaneously. Examples include weather events, price shocks and economic recession. Idiosyncratic risks typically affect a single household. Illness, death, crime and business failures are typically idiosyncratic. Generally, idiosyncratic risks are more easily insured through private insurance markets than systemic risks.

Table 4.1.2 sets out the reported distribution of shocks across a selection of country surveys. What's immediately clear is the variation in experience from country to country. South Africa did not form part of the study, and we believe it is inappropriate to estimate its corresponding spread of experience, not least because this is likely to vary across communities. Should South African insurers not consider carrying out (or supporting) this type of analysis to understand the risks to which people are exposed?

Table 4.1.1: Range of shocks experienced by households in the previous year (%)

	Prices	Natural disasters	Employment	Death and illness	Asset and crop loss	Household breakup	Crime and safety	Other
Afghanistan	2.2	34.2	5.5	11.5	15.8	-	4.9	-
Bangladesh	-	-	2.8	4.9	4.1	2.5	0.7	4.3
China	-	-	0.6	11.1	25.2	2.6	1.9	3.1
Iraq	-	-	10.1	2.0	-	-	8.1	2.7
Laos	5.3	18.5	5.0	25.2	23.5	0.6	3.5	-
Malawi	32.8	38.8	3.1	13.9	2.3	7.2	8.5	3.1
Peru	-	6.7	4.2	8.8	-	0.8	3.3	1.7
Uganda	1.5	32.4	1.4	11.4	0.6	-	13.9	2.6
Uzbekistan	-	-	38.6	20.1	3.5	9.8	4.6	7.8

Coping mechanisms

Heltberg et al. also list and assess the coping mechanisms that survey respondents report using to cope when risk events occur. These range from selling assets to reducing food consumption – see Table 4.1.2 for a summary of selected findings. The authors suggest that these mechanisms may be split broadly into 'good' and 'bad':

'Good' coping comprises use of savings, credit, asset sales, additional employment and migration, and assistance (for example, from friends, family, community members, and social safety nets); it often requires a degree of ex ante preparation [based on forecasts rather than results].[12]

Sound coping strategies usually involve being prepared for a shock or risk event. Poorer strategies tend to be reactive. They include selling productive assets, farming equipment or livestock, reducing critical consumption, and compromising expenditure on health and education. They also tend to increase vulnerability to future shocks because they erode existing coping strategies.

Insurance as a form of risk protection is not limited to the formal sector. Insurance may be provided, facilitated or mandated by government or by informal sectors of society.

- **Formal-sector insurance** is not mentioned as a coping strategy in the Heltberg analysis. (It may not have formed part of the line of questioning in each of the countries assessed.) This hints at significant potential for the growing global microinsurance industry. The World Development Report 2014 suggests high transaction costs, particularly for assessing claims, as the leading reason for the poor take-up of formal insurance.
- While insurance companies generally target individuals or specified groups, insurance can also form part of a **national strategy** for extending social protection. For example, just as some governments mandate third-party risk cover for drivers of motor vehicles, weather insurance may be provided to small-scale farmers to improve the social protection framework.

  South Africa's Sasria SOC Ltd was formed in 1979 by the government at the time to focus on political risk, perhaps a unique event in the insurance world. It was expanded in 1998 to provide protection for other events, such as strikes and labour disturbances.[13]
- **Informal insurance networks** such as burial societies, while not considered part of the surveys, are nevertheless covered by Heltberg et al. in the review of the literature. Communities play a large part in the management of all risk, but particularly of idiosyncratic risk, which generally affects people within that community rather than a whole village or region.

Table 4.1.2: Range of response to shocks (%)

Largely good strategies					
	Savings	Sale of non-productive goods	Employment or migration related	Credit	Assistance
Afghanistan	20.9	2.4	10.1	26.1	9.6
Bangladesh	-	4.0	-	77.3	-
China	20.4	3.0	51.0	-	-
Iraq	48.4	13.9	3.1	42.3	20.6
Laos	18.4	0.7	-	2.2	4.4
Malawi	24.6	1.6	4.8	1.8	25.4
Peru	17.2	3.7	9.3	16.4	0.9
Uganda	33.2	3.0	23.5	12.0	21.7
Uzbekistan	24.8	-	14.1	26.1	15.5

Largely poor strategies					
	Reduction in health and education spending	Reduction in food consumption	Reduction in non-food consumption	Sale of productive assets	Other
Afghanistan	2.8	35.3	37.9	14.9	4.3
Bangladesh	-	-	-	13.0	2.4
China	5.5	56.4	-	10.2	-
Iraq	3.0	60.2	74.5	2.9	2.6
Laos	-	43.8	0.6	29.8	
Malawi	-	4.4	0.5	1.2	8.9
Peru	-	11.9	-	10.6	
Uganda	-	38.7	0.5	4.7	34.4
Uzbekistan	0.5	0.7	0.7	13.7	52.5

Note: for Laos and Peru, the distinction between food and non-food consumption reduction was not available.

Source: Heltberg et al. (2013)

The work of Heltberg and his colleagues shows the substantial benefit of saving as a risk-protection strategy. The first column of Table 4.1.2 on the previous page shows how frequently saving is used to protect against shocks, though it's not clear how much of this saving takes place through formal institutions.

Insurance has the potential to provide a safety net against the prospect of a disaster but is usually designed to protect against one risk and can be inefficient. Saving, however, is a broad enabler. It not only helps low-income households protect themselves against shocks, stabilise their cash flow and avoid taking on expensive debt but also contributes significantly to social mobility by allowing people to invest effectively in their most productive assets.

Bringing it back to South Africa

We turn back to the work of Schotte et al. on poverty levels and the tendency for households to move between different bands of income security.[14] Since data is available at two-year intervals, the authors of that study were able to identify triggers associated with upward and downward movement between these bands. Households that enjoy an increase in the number of workers, for example, are more likely to move from poverty into the middle class.

The following examples show the existing or potential role for financial products in raising well-being by enhancing social mobility or providing financial safety nets:

- The existence of **health and life insurance** is associated with a more secure stay in the middle class or elite bands. While this suggests that insurance plays a part in providing this security, this is not necessarily the case. The authors acknowledge it may be that wealthier members of these groups, who are less likely to be financially vulnerable, are also more likely to own these products.
- The **movement from rural to urban areas** is associated with the increased possibility of transitioning from poverty to the middle class, probably linked to prospects for higher income through employment. We note the usefulness of short-term insurance products (for example those that insure against the loss of household goods) in protecting against the risks associated with a move to the cities and the improved income this move may bring. Such a move typically brings both challenges and opportunities, particularly if supported by higher income. Financial education to consumers, discussed in the next article, plays an important part in facilitating the improved financial capability needed to respond to these proactively.
- One of the events strongly associated with an exit from the middle class and into poverty is the **birth of a child.** This is not regarded as an insurable event, as its occurrence is not entirely random, but saving can play a substantial part in managing the costs and risks associated with the birth itself and the arrival of a new member to the household. Affordable medical cover also has a part to play in managing this kind of risk.

This article has built on the foundation laid in others by pointing out that government is not solely responsible for building a nation characterised by social mobility and well-being. The products and services offered by the financial sector have a significant role to play in this regard, as do the financial decisions of households to save or insure.

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SAFETY NETS | FINANCIAL SAVINGS | INSURANCE PRODUCTS | MIDDLE INCOME | ELITE | POOR | MIDDLE CLASS | VULNERABLE | TRANSITORY | CHRONICALLY POOR | INTERNATIONAL LABOUR ORGANIZATION | FINANCIAL WELL-BEING | SOCIAL PROTECTION | SOCIAL MOBILITY | HOUSEHOLD SHOCK | COPING MECHANISMS | INFORMAL INSURANCE NETWORK | URBAN MIGRATION | HEALTH INSURANCE | LIFE INSURANCE | SDG 1 | SDG 3 | SDG 12