Fleshing out the vision a better model

Managing risk

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Why our current approaches may be failing members

In our Benefits Barometer 2013: 'Employee benefits system' edition we vigorously challenged the 'one-size-fits-all' convention of risk benefit coverage that appears so broadly with South African employers. That analysis looked at the rigidity of these 'average' benefit structures by assessing the potential shortfall in the level of death benefit cover as a multiple of salary relative to the required capital needed to target an assumed liability. In our case a spouse's pension of 60% of pensionable salary at various ages on death. The required multiple was then adjusted to take into account assumed retirement savings at the various stages. The results can be summarised as follows:

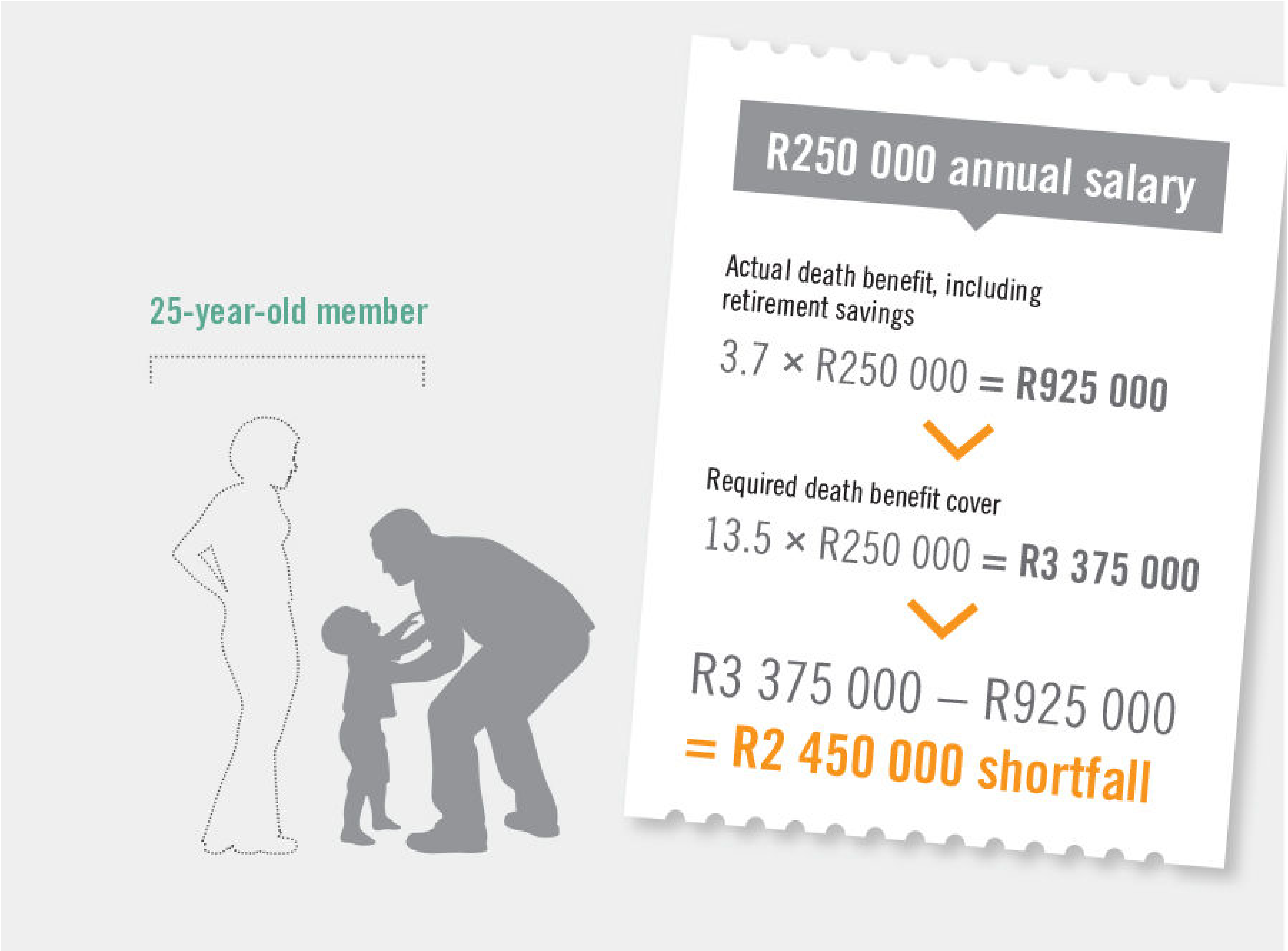
Age band	Required multiple of salary	Adjusted multiple of salary, including 'savings'	Actual multiple of salary
20–25	13.5	13.5	3.7
25–30	13.0	13.4	3.6
30–35	12.5	12.9	3.6
35–40	11.7	11.4	3.5
40–45	10.5	9.5	3.4
45–50	9.2	7.2	3.3
50–55	7.7	4.6	3.2
55–60	6.2	2.0	3.0
> 60	4.8	0.3	3.1

Source: Benefits Barometer 2013

> **We can get much more value from our contributions if we pay closer attention to what we need to save for and when we need those benefits most.**

The reality of these disheartening shortfalls can be summed up in a simple example:

Let's consider a 25-year-old member who passes away. The required death benefi t cover (capital) to target the 60% spouse's pension is 13.5 times the member's annual salary, while the actual multiple insured is only 3.7 times annual salary. What does this mean?



This example puts the potential shortfalls in context.

But we also saw that exactly the opposite could occur in an undifferentiated approach to determining risk coverage. In many funds we have cases of older members with large multiples of life cover, but insufficient retirement savings.

Since those 2013 and 2014 insights we've had to contemplate an additional factor: regulation that introduces and mandates a consideration of 'Treating Customers Fairly'. Treating Customers Fairly (TCF) is an outcomes-based regulatory and supervisory approach. This means ensuring that products and services meet the member's needs, fulfil their expectations and provide appropriate advice to suit their circumstances. Essentially the existence of TCF means that trustees and employers need to be far more circumspect when considering whether what they place on offer really addresses this best. The challenge is trying to find a balance between solving for the 'average' member and solving for a constantly changing member reality.

The potential shortfalls are significant. We have previously highlighted the plight of a younger member starting out in the working environment, where their retirement savings are relatively low or zero as they haven't had enough time to accumulate savings. During this phase individuals may start expanding their families, incurring long-term debt such as a housing loan or vehicle finance, and even still be paying off their student loans. It's clear that a death benefit based on the 'average' and on a low start-up salary would certainly not cover their debt, let alone provide for a family.

Designing the offering with choice or introducing more appropriate defaults (or a combination of defaults with choice) would clearly take us some way towards addressing these inefficiencies.

Our initial work on solving for this established that while it would be difficult to achieve an **efficiency score** of 100% in terms of whether the coverage was adequate over time, giving individual members the ability to choose higher cover at a young age and then maximise their retirement savings as they got older proved to be an efficient solution. In a lifecycle approach, the default and flexible death benefit is priced on the whole member risk pool (per one times annual cover) and not based on the age bands. This still allows for cross-subsidisation, which is beneficial for a larger number of members.

The efficiency score reflects the extent to which retirement and death benefits can be met from the current contribution levels after purchasing disability income cover.

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How can we get better outcomes?

Including such flexibility for individuals within the retirement fund or as a separate risk benefit scheme provides an employee benefit programme that is of much greater value than one that purely targets the average. Some of the options that have been used to introduce flexibility in the confines of the group arrangement are as follows:

1. Age-related approach to risk benefits

- They provide a fixed multiple of cover per age.
- There's no cross-subsidy.
- Because the cover is based on the age band, the lower level of cover within an older age band could cost as much as the highest multiple of cover for the younger members.
- The higher cost then affects the allocation of contribution to retirement when older members need it the most.

2. Lifecycle approach to risk benefits

The lifecycle concept for saving and investing is not new. Introducing a default lifecycle death benefit, with an opportunity for individuals to opt out, would complement the current range of choice found within a group arrangement:

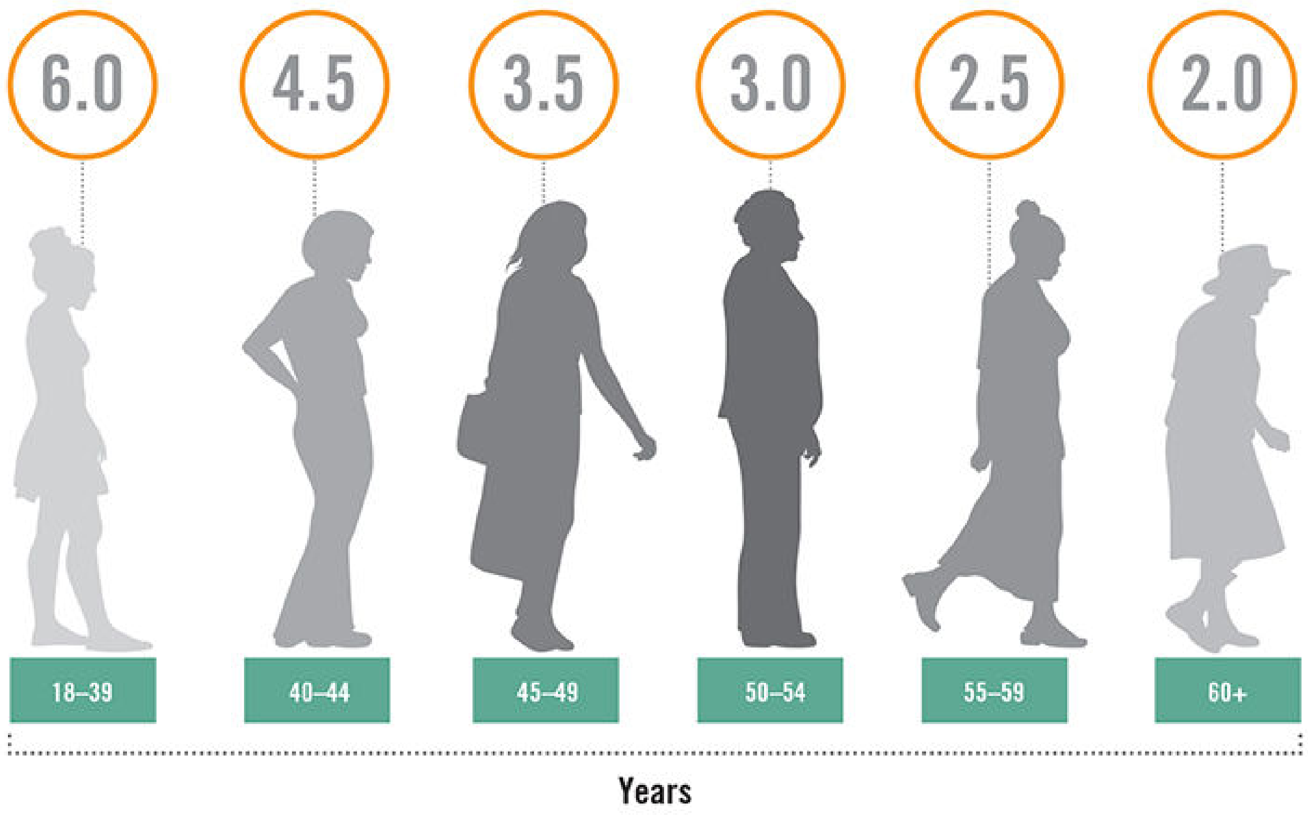
- It's a needs-based approach to employee benefits design.
- Individuals have the flexibility to structure their benefits to suit their personal circumstances. Members can structure their benefits based on what they are prepared to spend on death benefits relative to their projected retirement income.
- Offering choice would mean that an appropriate level of default cover must be implemented.
- Structuring the pricing as a percentage of salary roll and not on rate per age means there's still cross-subsidy, which benefits all members.

3. Flexible approach to risk benefits

- The individual can choose any level of cover within the range provided by the scheme – it could be based on full flexibility or a core level plus flexible benefit.
- The pricing of this cover would be based on a rate per age. The cost increases as the individual ages, which could affect retirement savings. Therefore as the member gets older, it becomes more and more expensive, to the detriment of retirement savings.
- In most instances, individuals will be required to provide evidence of good health before being able to increase their levels of cover.

Here's an example of an age-related structure

Cover as a multiple of salary



GAINING MORE TRACTION

However, despite the fact that we've seen efficiencies from a lifecycle risk benefit structure when compared with individual member investment choice which was introduced a number of years ago, this new way of structuring employees' benefits has gained only minimal traction.

Members opting for flexible benefits in standalone funds increased by 45% from the previous year in a 2015 survey[1]. The survey also highlighted that there had been a move away from a 'core + flex' benefit towards agebanded and lifecycle cover.

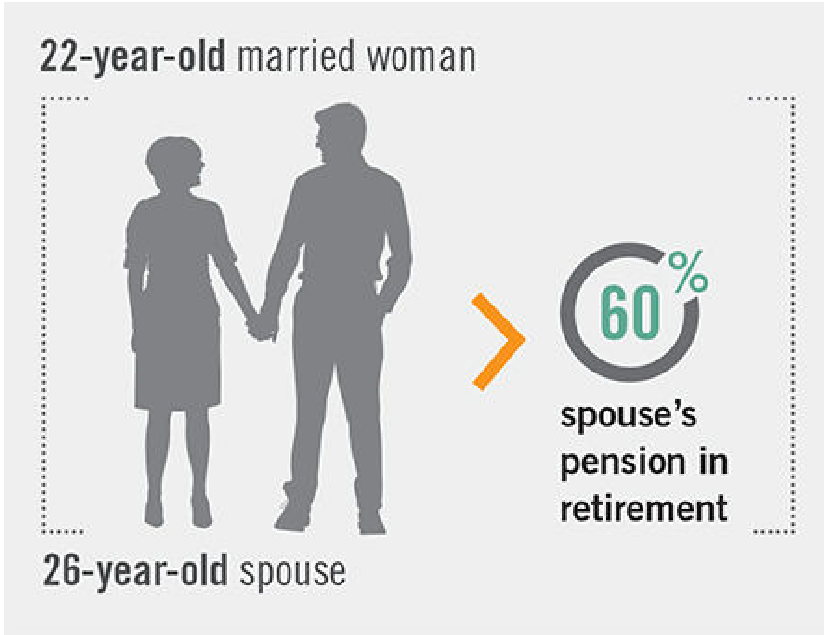
While the sample surveyed is relatively small, it does suggest that flexibility within the group arrangement might be gaining a bit more traction. There's certainly a growing realisation that group benefits can be designed more efficiently to assist individual members to achieve their personal outcomes. Additionally, there's recognition that using group efficiencies is more cost-effective and enables individuals to access cover without proof of good health.

But while risk benefits are important, they have historically been treated purely as ancillary to retirement savings. As a result, the cost of these benefits has been the driver of the design of the overall offering, resulting in the gaps that have already been highlighted. The main concern is

Potentially the change in the cost could have an impact on the replacement ratio, but at the same time, the benefit offering is better matching the overall need of the individual throughout their journey to retirement. Clients can make use of our risk benefits tool to assess the potential effect on the replacement ratios to better assess the viability of offering flexible death benefits. The opportunity cost of saving more for the future can then be weighed up against immediate needs that may occur along the way. Typically, a small sacrifice in replacement ratio goes a long way to better covering the risk benefit needs in a lifecycle approach.

Assumptions

Let's consider a 22-year-old married woman, who currently enjoys death benefit cover of three times annual salary. Her spouse is 26 years old and they are targeting the 60% spouse's pension in retirement. If she has the option to default into a lifecycle approach or opt out and access full flexibility, what is the impact on her replacement ratio? Based on actual data, we can see that the change in the risk benefit cost over her lifetime does not have a significant impact on her replacement ratio, even though she has had full access to choice or a benefit that changed based on her age.



We have assumed

Pension increase target	100%
Replacement ratio target	75%
Growth scenario	0%
Retirement age	65
Spouse's age	26
Spouse's pension	60%
Guarantee period	5 years

Current cover – 3 times annual salary	
Current age	22
Salary	100 000
Investment amount	–
Net contribution to retirement savings	14.6%
Output of pensionable salary	
Pension	165 441
Replacement ratio	70.6%

Lifecycle approach	
Current age	22
Salary	100 000
Investment amount	–
Net contribution to retirement savings	14.8%
Output of pensionable salary	
Pension	162 080
Replacement ratio	69.2%

Buy up to 8 times annual salary	
Current age	22
Salary	100 000
Investment amount	–
Net contribution to retirement savings	13.8%
Output of pensionable salary	
Pension	156 250
Replacement ratio	66.7%

Funds offering choice have not lost sight of the fact that retirement savings should be maximised over time, but they do recognise that each member is an individual with different needs. A proviso in offering flexibility would be to ensure that individuals do not spend all their contributions on risk benefits only and that there's balance between saving and protection, giving them the freedom to fine-tune their personal balance over time. This concept of balancing core benefits is a central theme of this year's Benefits Barometer. Employers, trustees and management committees can effectively set certain parameters to protect these interests.

Where to from here?

It's evident that the shift from the employee benefits norm is to provide a solution that meets the needs of individuals throughout the various stages of their lifetime, recognising that no two individuals are the same. The approach should not only be holistic to afford the individual flexibility to structure their benefits – retirement, risk and healthcare – within the confines of a group arrangement, but also be cost-efficient.

While all indicators might show that flexible risk benefits offer a better member-specific solution, the real challenge is changing the mindset of the various stakeholders in the employee benefits programme to move away from the traditional group structures and cater for a more individualised focused programme that uses group efficiencies.

Importantly, compulsory group life cover is normally the only cover a member has, and in many cases may be the only cover they can get for medical or other reasons. For this reason, most rely on the employer and the fund benefits to 'look after' them and their families. The ability to provide more suitable benefits in the design of the offering is readily available. Making use of group economies of scale adds to the appeal. Last, but not least, being able to integrate this type of solution into a holistic long-term programme that creates wealth, grows savings and protects in the event of loss not only fulfils the requirements of TCF, but is in the best interest of the individuals represented within the funds.

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Concluding thoughts

We have come a long way in recognising that the purchasing power of the group can be used to provide a more efficient benefit offering for the individual and, while we recognise this, it’s time now to put this into action. These benefits fulfil a vital role in any individual’s financial plan and if they are not structured properly, this can have a devastating effect on the wellbeing of the individual in the event of disability and on financial dependants in the event of death.

Providing more meaningful benefits for the individual goes a long way in meeting these targeted needs and, more importantly, allowing individuals the opportunity to access more suitable benefits through their trusted group arrangements.

References

1 Sanlam, 2015

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