HOT TOPICS

Summit 2013
The issues surrounding savings, investments and trustee duties are complex and depend entirely on the particular circumstances of each fund. Trustees must in all cases take their own decision on issues based on their particular fund’s circumstances at the time. It is for this reason that trustees cannot rely simply on what we have discussed here today, neither should they regard our discussions as legal advice. Trustees should get specific assistance where they are uncertain of the consequences or reasonableness of any contemplated action.

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REMEMBER JOE?

Together with Joe, we have been on a journey of discovery. In particular the discovery that despite our best designs and our most sincere of motives, the vast majority of South Africans will not experience physical, mental and, especially, financial wellness.

We began this journey at the Hot Topics Summit 2011 where we considered the future of benefit design. We discovered that employee benefits, at their fundamental level, exist to meet the needs of individuals. Employers provide their employees with benefits as part of the employment proposition. Traditionally, employers have provided employees with retirement fund benefits, death and disability insurance cover as well as medical scheme insurance.

We recorded that evolution had occurred within the realm of employee needs and increasingly trends pointed to a growing appetite for choice as well as an increased demand for lifestyle benefits. We also observed that although employees’ needs had evolved, the benefits offered to meet those needs had not necessarily kept pace. We considered a lifecycle framework cognisant of an individual’s varying needs over time, and took a closer look at the state of employee benefits in South Africa and the trends relevant to the employee benefits arena and their potential impact.

We concluded with some solutions or approaches which we believed were the future of benefits design.

At the 2012 Summit we took a wider view, framing the problem as one that:
• Urgently required a fix
• Held benefits for multiple stakeholders
• Was the responsibility of all parties, not only trustees.

We looked at the outcomes achieved and how these could be improved with increased engagement from stakeholders, notably employers. We honed in on the concept of healthy financial states and tried to unravel this concept from various angles.
We found that individuals needed to understand the various components relevant to their financial health and be proactive about managing it. Furthermore, from an employer’s perspective, the issue of financial health was particularly relevant as the evidence pointed to how poor financial health could affect an employee’s productivity at work and lead to decreased engagement levels.

Where do we end up? How do we create and contribute to this most important of dialogues? In 2013 Alexander Forbes released a book, a research publication for the layperson, entitled Benefits Barometer. The Benefits Barometer provides a comprehensive overview of the employee benefits system. It highlights the key problems as we see them and identifies some principles for addressing them. However, it also acknowledges the practical problems that arise when trying to apply these principles in the real world. An analysis of the problems, principles and practicalities is hence also performed at an economic sector level.

The last 30 years have been significant in the development of employee benefits. We have seen a shift from defined benefit to defined contribution arrangements where individuals have greater input and accountability for benefit design and outcomes. There has been a development of more equitable and inclusive employee benefit systems that reach a greater number of South Africans than ever before. And more recently, we have seen employees being given choice and flexibility in their benefits and setting their own course.

As such, South Africa now stands as one of the few countries globally with such breadth and depth of experience around defined contribution arrangements. The lessons we have learned, and the lessons we continue to learn, should be of critical interest to any number of other economies, both developing and developed.

Without doubt, we have made progress, but the truth of the matter is that we still have some way to go before we can translate any gains we may be making into a more financially stable world for our workers. If we can create a more effective link between employee benefits, employee wellness and engagement between employer and employee then both stand to benefit financially.

Also if we can begin to recognise the place of employment as the natural environment for advancing financial education and effective budgeting and financial planning in the individual, we can begin to address the challenge that has seemed almost unachievable to the government and the financial services authorities: “How can we get South Africans to save?”

Our research shows unequivocally that the problems go beyond purely financial issues. They demand that we understand the complex social and cultural fabric that makes the South African work environment the considerable challenge that it is. A fragmented approach does not help to address or resolve these challenges. The research highlights the critical interconnectedness of a number of defining considerations:

- The need to balance current needs with future needs.
- The need to balance contributions at the right levels to provide for retirement benefits, healthcare and risk benefits as part of a Total Reward System.
- The need to balance behavioural factors such as individual preference, age, culture, upbringing, educational background and lifestyle.
- The need for a system that balances individual choice with certain minimum default options on design issues such as contributions and preservation.
- The need to balance the interests of the employee, employer, trade unions, all taxpayers and the government through greater financial literacy and benefits design.

South African savings rates are extremely low and have deteriorated in recent times.

The question this book addresses is “How effective have these programmes been” or, more importantly, “What should we be doing to make these outcomes more impactful?”
There is also a growing recognition that employee benefits should meet the needs of individual employees and not a hypothetical average employee. The financial services industry has applied some of its best and brightest thinking to the delivery of a new generation of needs-focused benefits, and we have made some progress. However, for employee benefits to reach its full potential, we need to more deeply appreciate the complex relationships between the issues, benefits and stakeholders. Unless this is done, the outcome will remain ineffective in terms of meeting member needs, enhancing business imperatives and safeguarding the government from having to address the shortfall.

The major employee benefits of healthcare, risk benefits, retirement benefits and financial education could provide a major catalyst for boosting employee well-being and stimulating employee engagement. Currently, we are using this opportunity, but not to its full potential.

**Healthcare** - Contributions to medical schemes have been increasing faster than salaries due to rapid increases in the cost of healthcare. Very few employers still offer post-retirement medical benefits and individuals find the ever-increasing contribution rates on medical schemes unaffordable. Participation on the most appropriate benefit options becomes crucial in a world of limited resources.

**Risk Benefits** - An individual’s risk benefits needs will differ according to their circumstances and change over the course of their lives. However, the typical bundle of group risk benefits is static and is structured for the average employee as opposed to being tailored for the individual.

**Retirement Benefits** - The current retirement savings environment is characterised by low contributions, low expected investment returns, climbing annuity prices, 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 their immediate needs. We should nudge employees towards more responsible decisions about their savings, but even then the retirement fund may not be able to deliver levels of savings that will see employees through their retirement years. Where this is anticipated, employers should offer ‘financial wellness’ programmes that help members develop effective budgeting skills and financial literacy - before they require debt counselling.

**Financial Education** - Low and declining household savings rates illustrate the lack of awareness that individuals have regarding their future financial needs, and is a good indication of a lack of engagement with employee benefits generally. At the heart of the problem is the absence of financial advice relating to effective planning and budgeting on offer at the right place, and at the right price.
WHAT CAN BE DONE ABOUT THIS?

Firstly, we need to recognise that the current fragmented approach to employee benefits does not lend itself to obtaining the best outcomes for employees or employers as it does not take into account the connections between:

- The various financial services products and safety nets that an individual may have privately, through the employer, through a union or through the government.
- Physical, mental and financial health and employer profitability.
- Employee benefits, employee engagement and employer profitability.

We propose an integrated approach to employee benefits that focuses on what employees need, with a benefits structure that reflects the employer’s values. The benefits should be communicated effectively to employees and reviewed regularly. The approach also needs to take into account practical issues.

This kind of employee benefits system will also benefit employers by increasing employee engagement and organisational commitment, two essential ingredients to boosting productivity.

Secondly, for various reasons, the employee benefits provided are often different to what the individual needs. One reason for this is a ‘one size fits all’ approach to the benefit design as opposed to tailoring benefits for the individual over their lifetime.

Thirdly, a key finding of our research is that individuals are typically not engaged with financial issues ranging from savings to ensuring sufficient protection of their earning capacity from risk events. Over the years, the industry has attempted to improve financial literacy through education programmes, but indications are that we need to step up our efforts to help improve financial awareness and behaviour.

In preparation for the Hot Topics Summit 2013, Alexander Forbes believes that the employee benefits system still represents one of the most effective formal channels for creating a savings culture in South Africa, as well as ensuring that individuals have enough protection in place for events that put their earning potential at risk. The focus of the Benefits Barometer is to try and identify sources of inefficiency and slippage. It sets out a framework for a dialogue that must occur between all stakeholders in the delivery chain if we are going to extract the best results for all stakeholders.

The right people at the table, focused on the right issues, with a collective resolve and unified sense of purpose, will get to the right answers.

Join us at the 2013 Hot Topics Summit as we take a closer look at the lessons learnt from the Benefits Barometer focusing on practically improving the financial well-being of our employees to equip them with tools to weather the storms that lie ahead.

We hope that this Hot Topics session proves to be insightful! As always, we welcome and look forward to your feedback on the sessions.

Regards
The Hot Topics team
Let’s start by understanding what this concept of reform really means. When someone tells you that there is a need for reform, the suggestion is that something in the status quo demands improvement. At the very least reform suggests we need to identify and ‘fix’ whatever is perceived as wrong, corrupt or unsatisfactory. So when National Treasury introduces the notion of pension fund reform, what exactly is it that they feel needs addressing in our retirement fund system?

In many respects the retirement industry in South Africa should be regarded as one of the most advanced globally. When contrasted to other developing or even developed economies it has a broad and rich experience in defined contribution funds that should be a point of pride. But when National Treasury suggests that we still cannot demonstrate tangible benefits for individuals both during their life’s financial journey and at retirement, it’s time to take stock and understand how and why we may be falling short.

As far back as 2004, National Treasury believed that we needed to have some hard discussions around retirement fund reform. These views were likely informed by the findings of the Taylor Commission in 2002, which recommended:

- A comprehensive social protection scheme to create income security for the poor
- A framework for the implementation of this scheme that took into account health, retirement, unemployment, children, disability, constitutional and legal requirements
- A framework for deriving reasonable income in old age
- One type of retirement fund with no distinction between pension or provident funds
- The removal of tax concessions on lump sum benefits to encourage pensions
- That the FSB monitor fiduciary duty compliance by the trustees
- Enforced preservation of benefits on withdrawal
- That funds pay unemployment benefits to members
- All funds to have elected Trustees, including umbrella funds
- That funds invest in socially desirable investments
- The prohibition of further increases in international investing
- One tribunal for all retirement fund disputes
- A low-cost national savings scheme for people in informal employment.

Does any of this sound familiar? Much of it should, as many of these principles are contained in the latest 2013 proposals on retirement fund reform discussed at Hot Topics Q1 2013.

In spite of the emergence of a fairly sophisticated retirement and savings industry, the chilling insight of National Treasury’s 2004 discussion document was that three quarters of South Africans still reached retirement age without a funded pension benefit and relied on government assistance grant programmes.

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1 National Treasury “2013 Retirement Reform proposals for further consultation”
SO, WHERE ARE THE SHORTCOMINGS?

From government’s perspective, the objectives of retirement policy were to:

- Encourage individuals to act in the best interests of themselves and their dependants as regards their savings and retirement.
- Use the employment remuneration contract as a framework for nudging employees (and employers) to the right behaviours as regards encouraging savings.

Critical to its success, though, was the assurance that the industry develops cost efficient, prudent, transparent and fair options aimed at helping employed individuals effectively plan for retirement. Also essential was a framework that could promote the purchasing power of pensions through solutions that focused on protection against inflation. Ultimately though, success was also dependent on an assumption that there were high standards of governance, trustee competence and a shared accountability of all parties in protecting the members’ interests first and foremost. This last point meant that there needed to be particularly effective communication and disclosure made to members of information that would be material to meeting these ends.

All well and good – except, there still was an absence of clarity or guidance around a number of issues that have since been well-documented. In summary, these issues related to:

- The degree and form of compulsion that would be imposed on individuals to establish a retirement savings programme.
- The degree to which these savings should be preserved or ‘ported’ when individuals leave one employer and join another.
- The accessibility of these vehicles to people who might not have continuous employment.
- The degree to which individuals should make their own determinations about how they should invest their retirement funds, what contribution rates and benefit structures worked in their best interests or how they should structure their pay package in terms of pensionable salary allocations.
- How best to create meaningful incentives to elicit the right decisions by individuals with regards to their savings and benefits programmes.
- The degree to which individuals should be able to access these savings – without severely impairing them – in times of crisis.

Clearly there were a number of unresolved debates that were creating inefficiencies in the system. As a result, the current level of retirement income secured with retirement fund savings typically lays far below the level of pre-retirement earnings. Levels of insured death benefits are typically insufficient to meet the family’s needs following the death of a breadwinner and the cost of belonging to a medical scheme is taking up an increasing part of household budgets.

Our 30 year experiment into defined contribution arrangements may to some degree have made us global thought leaders on the topic. Yet retirees today who have spent most of their working life in this construct may have a different view. This is not an attack on defined contribution as a funding mechanism – any funding mechanism can work! But only if the participants understand and can adapt to environmental changes timeously. At an individual level, the problem was, is and always will be an asset-liability problem. Merely accumulating assets without being aware of the liability (income) is sub-optimal.

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3 National Treasury Republic of South Africa, “Retirement Fund Reform, a discussion paper” December 2004, p.4
5 Member Watch Survey 2012, showed the average actual replacement ratio achieved based on savings in the fund was 31.7% of pensionable salary.
Effectively what policymakers have really been grappling with is an unspoken debate around exactly when the outcomes achieved demand intervention. To what extent are these outcomes a function of the financial services industry, a failure of the government to effectively structure and incentivise the required outcomes, a failure of employers (or unions) to shoulder responsibility in light of the shift from the defined benefit to defined contribution construct, or a failure of individuals to accept a measure of responsibility for their own destinies?

ALEXANDER FORBES WEIGHS INTO THE DEBATE WITH THE BENEFITS BAROMETER

In early February 2013, Alexander Forbes decided to weigh in with our own careful examination of the issues. With the publication of Benefits Barometer we provided an in-depth assessment as to why our defined contribution system was not as effective as it should be in meeting the savings and benefits needs of South African employees.

The book summarised the problem as follows: in spite of the potential that the employee benefits system holds for being one of the most effective formal channels for creating a savings culture in South Africa, the current inefficiency and slippage is a function of an inadequate dialogue between all the stakeholders in the delivery chain.

Currently there are highly interdependent relationships between all of these entities as regards the structure of our employee benefits programmes as shown in the figure on the following page. This includes retirement benefits, death and disability benefits, medical scheme subsidies and financial education – all of which play a crucial role in ensuring the stability of an employee’s physical, mental and most importantly, financial well-being. This stability needs to be ensured throughout the course of their employment in addition to the period after their retirement from employment.

But right now, the conversations between these different stakeholders tend to be fragmented and devoid of an appreciation as to how interconnected decisions in any of these areas are to each other. Unless the inter-dependencies between different aspects of well-being, different stakeholders and different benefits are recognised, the system is unlikely to deliver to its full potential.

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6 An e-book version of Benefits Barometer (complete with video clip explanations is available at through the following link: http://www.aforbes.co.za/BenefitsBarometer/HTML/Benefits%20Barometer/index.html/#/0
Securing financial well-being

Taking the debate to the next level

Trustees are typically aware of the poor actual and expected retirement outcomes. Less awareness is found about the correct levels of risk benefits, both in absolute terms and relative to retirement savings. But finding out why the outcomes can be so poor has always been tricky.

Part 2 of the Benefits Barometer introduces some new dynamics into the discussion. It identified thirteen issues which, while being far from exhaustive, helped tease out the complexity of those interdependencies and where we believed some of the initial debates needed to focus.

The challenge these issues posed was that each encapsulated an incorrect perception from stakeholders about their significance, and until those were addressed, the effectiveness of the employee benefit system would be severely hampered.
<table>
<thead>
<tr>
<th>Issue</th>
<th>In theory…</th>
<th>The practical reality is that…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unhealthy finances</td>
<td>Employees should focus on work in the workplace.</td>
<td>They are often distracted by their personal financial problems.</td>
</tr>
<tr>
<td>Low-income earners</td>
<td>Employees who earn enough should save for retirement and those who do not earn enough, should not.</td>
<td>It is sometimes difficult to tell who will benefit from saving and who won’t.</td>
</tr>
<tr>
<td>Absenteeism and incapacity</td>
<td>Employees who are able to come to work must do so and employers should take care of those who are unable to work due to ill-health or injury.</td>
<td>Employees often abuse sick leave, and the disability management processes are often inefficient. Employers seldom plan for workers being forced to retire early.</td>
</tr>
<tr>
<td>Incentives</td>
<td>People will save more if we incentivise them to do so.</td>
<td>They’re unlikely to behave any differently, particularly if the value of the incentive is not clearly understood.</td>
</tr>
<tr>
<td>Temporary and informal workers</td>
<td>Everyone has a job with benefits.</td>
<td>Many South Africans don’t, particularly temporary and informal workers.</td>
</tr>
<tr>
<td>Choice</td>
<td>Providing people with choice allows them to tailor solutions to meet their own needs.</td>
<td>People seldom choose at all and when they do, those choices rarely address their long-term financial needs. Financial education doesn’t always help.</td>
</tr>
<tr>
<td>Bricks and books</td>
<td>Everyone has a place to live and access to education for their children.</td>
<td>Many people need their employer to help them.</td>
</tr>
<tr>
<td>Strikes</td>
<td>You can always avoid industrial action.</td>
<td>Not always and when there is a strike, employees lose benefits coverage.</td>
</tr>
<tr>
<td>Young workers</td>
<td>Employees start saving early and get into responsible habits.</td>
<td>Young workers don’t appreciate benefits or get an opportunity to set those responsible habits.</td>
</tr>
<tr>
<td>Pensionable pay</td>
<td>If employees do all the right things, they will replace a reasonable percentage of their take-home pay in retirement.</td>
<td>If employees do all the right things, they might replace some of their pensionable pay in retirement – and too often this is much less than they need.</td>
</tr>
<tr>
<td>High salary inflation</td>
<td>High salary increases are a good thing.</td>
<td>They create shortfalls in retirement funding relative to salary at retirement.</td>
</tr>
<tr>
<td>Mass exits</td>
<td>No one is ever forced to leave their job.</td>
<td>Industries shut down, companies liquidate and when companies retrench, employees lose both their jobs and benefits.</td>
</tr>
<tr>
<td>Longevity</td>
<td>The right retirement age is 60, 63 or 65.</td>
<td>The choice between 60, 63 and 65 is typically arbitrary and with increasing longevity, this is too early for some workers, unnecessarily reducing their benefits.</td>
</tr>
</tbody>
</table>
Top of our list, for example, was ‘Unhealthy Finances’ which posed the suggestion that if employers were only focusing on the retirement point of their employees and not considering their employees’ financial wellness throughout their working lives, they would be missing a crucial link in the effectiveness of their employee benefits programmes.

Clearly National Treasury agreed. In its follow-up discussion document, ‘2013 Retirement Reform Proposals for further Consultation’, they made the point that “if the system is integrated, and the benefits structures are needs-based, regularly reviewed values-consistent and coupled with an education strategy, this should improve employee welfare and employer profitability”.

But National Treasury’s discussion document took the debate much further – in a direction that echoed many of the issues highlighted in the Benefits Barometer.

In fact, when Pravin Gordhan gave the introductory speech at the launch of the Benefits Barometer he made these three key points:

- Addressing the savings and retirement issues of South Africa means that we need to place as much attention on the journey and the holistic needs of individuals while they make that journey, as we now place on reaching the end goal of achieving an adequate retirement.
- To meet those dual ends of maintaining a stable journey and accumulating adequate retirement savings, the ambit of accountability and responsibility needs to broaden for all stakeholders: trustees and fiduciaries, employers and unions, policymakers and regulators.
- We need to begin a dialogue between those stakeholders to identify the most effective way of meeting those needs for our employees, union and fund members and all citizens.

In saying this, Minister Gordhan not only echoed the central thesis of the Benefits Barometer itself, but he gave South Africa a pre-Budget, sneak peak at where government’s vision on pension and savings reform might be headed.

If we focus on the principles, and not necessarily the detail that was released at the subsequent Budget Speech, the picture that emerges is particularly compelling.
THE MESSAGE TO TRUSTEES – MOVING FROM ‘AVERAGE’ TO INDIVIDUAL

As trustees of pension funds, we are now being asked to gently shift from assessing whether, on aggregate, our retirement funds and their benefit structures are being effectively governed, to whether we have actually done all within our (soon to be expanded) powers to ensure that individual members are actually succeeding in terms of maintaining financial stability, both pre and post-retirement.

Historically, trustees used to worry about the funding level of the fund as a whole. This meant solvency in the accounting sense. Then there was a shift in design to be cognisant of the average member. (As long as the “average” member was still on course, all was right with the world – in theory.) The reality is that the needs of individual members and their dependants are anything but homogeneous. Not only does the population of members of a given fund cover a broad spectrum of different socio-economic snapshots, but those snapshots are, in reality, action videos, constantly shifting in their demands and needs as an individual and their families move through time.

The shift in focus to individual members and the success of their personal journeys suggests that trustees might well need to more actively engage employers about the optimal structure of those rules and benefit offerings. Communication lines need to be opened up to the employer’s human resources department to ensure that the right behaviours are being addressed both when a new employee is hired and when an individual leaves the company.

Assuming greater accountability for members’ welfare also suggests that a completely new set of tools need to be at trustees’ disposal to provide that critical level of monitoring.
In a perfect world, such tools should help trustees understand the following:

- Whether newly entering members are starting with fund credits that are appropriately reflective of their full working lives.
- Whether contribution rates are high enough to meet desired replacement ratios.
- Whether there is adequate and flexible enough benefit coverage for each of the members given the changing dynamics of their lives.
- Whether the choice of investment options appears to be adequate to meet their targeted outcome.
- Whether members are making appropriate choices about the annuitisation or cashing out of their fund credits at retirement.

Ideally such tools should also allow trustees to assess the impact of the following decisions on the specific outcomes of their fund’s population:

- A change in the contribution rate
- Increasing the retirement age (a topic explored later on this publication)
- Increasing the total savings period
- A change in the cost structure of the fund
- A change in the definition of pensionable salary for fund members
- Incremental increases or decreases in investment returns.

All the problems we are trying to solve are asset-liability problems, and they must be approached in that manner. Similarly, it suggests that there needs to be a new way of assessing investment performance. Instead of simple measures of fund performance against deemed investment policy benchmarks, trustees could measure performance against the projected replacement ratio. In other words calculating and measuring the explicit liability of each member of the fund, relative to the investment strategy, would place trustees in a far better position to address members’ requirements.

**GETTING THE DEFAULT SOLUTIONS RIGHT IS MORE IMPORTANT THAN EVER**

National Treasury’s important insight in their 2013 paper was the recognition that dynamics of human behaviour in relation to effective financial decisions absolutely demands that trustees place a far greater focus on the design of their default solutions. Here we are not just referring to their default investment option or their default benefit structure. Rather we need to consider the full range of ‘default’ processes that have significant implications for the outcomes experienced:

- **How employees are ‘on-boarded’ into the fund.**
  - Does the default process raise the issue of preservation of benefits from the previous employer?
  - Does it set the highest pensionable salary level?
  - Does it impose an adequately high contribution rate?
  - Does it then automatically increase this contribution rate in relation to any salary increase?
  - Does it introduce a flexible benefit scheme that varies over the life cycle of the individual?
- **How are employees dealt with if they elect to leave the fund?**
  - Does the default preservation choice do as much as possible to ensure the continuity of the investment strategy (and costs) during the preservation period?
- **How are employees dealt with as they near retirement?**
  - Is there an automatic system that introduces free financial counselling several years before retirement and then repeats that counselling each subsequent year?
  - Are there default annuities that provide the optimum annuitisation programme that best addresses the broadest needs of members?

The final two points above will be further explored in this session.
IS THE FUND GETTING THE RIGHT MESSAGE TO ITS MEMBERS?

Financial education and member communication remain one of the greatest failures. Three insights from the Benefits Barometer stand out here:

• Many trustees and employers presume that the two key points when financial education is relevant to their members is when they join the fund and when members are nearing retirement and are about to leave the fund. In reality, employees need coaching and counselling throughout their whole experience as fund members. How are they proceeding on their course to providing themselves with an adequate income replacement? What needs to be “tweaked” at various points in time to ensure that their endeavours are responsive to market changes?

• Benefit reports or updates to members need to be very carefully thought through. Present a member with projection statements that suggest they stand to get R1 200 000 on retirement and the member assumes they will be ‘sitting pretty’. Translate that into a monthly income of only R4 500 per month for the rest of the years that they are estimated to live and you have a different discussion altogether.

• Behavioural Finance teaches us that human beings are much more responsive to requests for higher contribution rates, for example, when they can translate it into something tangible that they can relate to. How much money you need each month to survive is usually a number most of us have a handle on.

THE MESSAGE TO EMPLOYERS

Defined contribution funds were initially welcomed as a more effective and transparent way for employees to tailor solutions that were in line with their own requirements. But the move was one that, at face value, shifted responsibility for an individual’s financial well-being to the member themselves.

An open architecture that provides transparency and freedom in terms of decision-making around how to best deploy your savings seems hugely appealing… until you understand how poor most of those decisions are in terms of addressing a requirement that sits 20 to 30 years into the future. This hints at the growing need for employers and unions to rethink their benefits structures and employment practices to ascertain whether these are effectively aligned to meet these complex objectives.
For employers, the total cost to company construct (TCTC), while conceptually appealing, is at the root of many of these problems. TCTC provides employers with a neat solution to compensation. Tell the employee what the total package is that the company will stand behind and then it’s up to the individual to structure the package according to their lifestyle needs. But therein lies the rub. For most individuals, answering that question applies to their immediate needs, not the long term ones. And the employer who offers the least restrictions on how that TCTC is allocated often wins the heart of the job-seeker.

But if employers understood better how not focusing on addressing issues around members’ physical, mental and financial well-being during the course of their employment can impact their bottom line (a significant percentage of payroll), they might be more circumspect about the latitude allowed.

In the Benefits Barometer we identified the following choices as critical to maintaining employee wellness both pre and post-retirement.

- Insisting on medical coverage for employees above a certain minimum income level.
- Removing (lower) options around pensionable salary.
- Changing the options around contribution rates to a default that increased contributions in line with increases in salary.
- Insisting on adequate disability and death cover.
- Monitoring employee preservation of fund credits both as the employee joins from a previous employer as well as if they move on to a subsequent employer.

Again, the challenge to employers is having the tools or framework to have the right dialogue with employees. As we highlighted above, it’s simply not enough to say to employees: “you need to preserve your fund credits” or “you need to have a higher contribution rate to meet your post-retirement income requirements”. Rather, employees need concrete illustrations of the trade-offs:

- If I don’t preserve my fund credits and cash them in to buy a new car – how will that affect me now AND over time?
- If I elect a pensionable salary of 50% rather than a pensionable salary of 80% – how will that affect me now AND over time?

THE MESSAGE TO UNIONS

In many ways the message to unions is not too dissimilar to the message to employers. Both have a vested interest in ensuring that the employee maintains physical, mental and financial wellness over the life of the employee.

Because unions are often deemed the ‘trusted ally’ of the employee, their contribution to financial education and encouraging the right choices for members is absolutely paramount. With the right tools, (tools not dissimilar to those provided to human resources departments), they should be in an effective position to have the right debates with their members. More importantly, the more insight unions are able to gain around the impact of the decision made by their members on their lifetime welfare, the more meaningful their debates will be with employers and policymakers.
If there was one area that the Benefits Barometer identified in which unions had a more important role to play than either the employer or the trustees of funds, it was in addressing the issues of continuity when employees were retrenched, on strike, or on contract and therefore subject to intermittent work periods. Here we are talking about continuity of benefits, of medical coverage and insurance coverage, of maintaining some portion of fund credits that wouldn’t be required to maintain the individual during the periods of intermittent employment.

Here is where Part 3 of the Benefits Barometer can make a significant contribution. The study looks at each of the 10 economic sectors that encompass South African productivity. In addition to providing the reader with the relevant statistics to each industry (like average contribution rate, pensionable pay, exit rate and preservation rate) it maps the most pertinent issues to each economic sector. So there are three barometer readings for every single economic sector: high, medium or low priority. In addition to naming the top concerns for each industry, we also identify how the problem could be addressed and who we believe should address it.

THE MESSAGE TO POLICYMAKERS

Policymakers are effectively trying to address a number of these issues. Whilst their actions widen accountability, they also offer protections to trustees. In addition to demanding preservation of funds, they provide a safety valve that allows limited access to funds in times of crisis. In short, policymakers are doing their bit by:

- Ensuring that trustees offer fund sponsored, non-commission-based advice, that is exempt from being deemed as offering financial advice to members.
- Insisting that all members preserve as they change employers (by offering members an annual withdrawal safety valve of some minimum withdrawal which, if not used, could be rolled over to the next year).
- Requiring funds to provide default preservation options.
- Insisting that members annuitise their fund credits as opposed to simply cashing them out and harmonising the annuitisation requirements between pension and provident funds.
- Requiring funds to provide default annuities as a way of keeping annuity costs as low as possible.

Where could policymakers go further?

- We need better incentives for lower income workers.
- Incentivise employers to provide financial wellness programmes to staff members through further tax breaks.
- Recognise that if the individual is important – and we believe they are – there is a cost/benefit consideration that needs to take place in our industry to ensure individuals get what they require.
- Require that retirement fund communication meets certain standards.
- Either launch a viable Gap Fund product, or require that service providers design and supply low cost products to the masses rather than contribute to their annual corporate social responsibility contribution requirement.
- Potentially, go down the route of compulsory automatic enrolment, as other economies have done.
- Democratise basic information through an on-line basic financial advice service.
CONCLUSION

Here is the ‘elephant in the room’ that we haven’t had the courage to put a name to as yet. It’s that 11 letter word: paternalism. Do we need some measure of it to set things right – and if so, how much?

This is not a popular discussion in a country that has worked hard to provide individuals with enough rights and autonomy to conduct their lives as they see fit. But if the facts are showing that we are not getting those same citizens to levels of financial security that they require, a re-think may be in order.

We take as given that it is not appropriate in defined contribution schemes to leave members of the public with varying levels of financial literacy vulnerable to poor advice or exploitation. But increasingly there is a body of thought that suggests that at the root of much of the failure of the system is what might be termed ‘behavioural market failures’. This refers to the growing body of evidence that suggests that “people make choices that are not in their interests, even when the stakes are high” or even when the education might be thorough. It’s just what we human beings do! We are myopic, we are instant gratification junkies, we procrastinate, and we make affective forecasting errors. But most of all, we cannot produce the complex computations for what we should do to solve a problem that will only appear twenty or thirty years hence.

What we do know about human behaviour is that the dominant force in decision-making that deals with such levels of complexity is not fear, or greed, or even regret. Rather it’s inertia. Essentially, “when the going gets tough, the average among us….. do nothing”.

It’s for this reason that one of the greatest weapons we have to defeat our natural failures is to create default mechanisms that serve the best interests of as much of our working population as possible. Behavioural market failures do in fact justify some level of paternalism, but in whose hands (the government, the employer, the unions) should the determination of these defaults exist?

National Treasury themselves state, “The overall approach of these policy proposals is to alter the defaults implicit in retirement fund design, where appropriate, to nudge, rather than force, individuals into making decisions which serve their long-run interests”. Clearly National Treasury would like the industry and the stakeholders to determine the optimal structure of these defaults. But as Benefits Barometer highlights repeatedly, this will not be effective until we can understand the complex interactions of each of these decisions.

As Minister Gordhan generously pointed out, the Alexander Forbes Benefits Barometer provides us all with a roadmap to help guide the debate – reminding us that there are still many aspects of this complex dialogue that we have yet to air.

So join us over this coming year in following the dialogue and participating in the debate. If you haven’t yet had the opportunity to see the book or follow the discussion, both are available on our blog: http://benefitsbarometer.co.za.
In 1880, the social security system in Germany was introduced with a retirement age of 65. Why 65? Not because of some fundamental model that established that this was an appropriate age to stop working or to accumulate sufficient life savings, but merely due to socio-economic conditions, where most of the populous did not attain age 65, and those who did, were fortunate enough to live for perhaps another two years.

Age 65 was given further credibility when US president Franklin D Roosevelt set it as the normal retirement age in the social security legislation in the 1930s (55 years later). This at a time when the average life expectancy in America was only 61.7 years. In addition, the rationale behind this decision was to get old workers out of the workforce, to make room for the hiring of younger workers in an attempt to revive the economy.

Of interest, is the fact that this was in the Great Depression, and implemented with the intention of ensuring that the younger workers with families would have jobs. At the time, the short-term solution worked as older workers were discouraged to stay on in employment. Furthermore, it is important to remember this was a government provided benefit. The government set aside funds for this purpose – funds which have over time proved inadequate with an ageing population, low yields and increasing longevity.

But it nevertheless set the course for the next 70 years. We have really only seen the retirement age pertaining to social security systems across the developed world come under scrutiny over the last five years, especially after the global financial crisis.

The economic realities have changed over this time and the factors that made identifying age 65 as the normal retirement age may no longer be true. So now, while we hear all the time that 40 is the new 30, 50 the new 40 and so on, and there are rampant improvements in our life expectancy, our savings culture has not followed suit.
THE SHIFTING SAVINGS LIFETIME

The defined contribution environment provides greater flexibility to members to manage their potential outcomes in retirement. However, there are cyclical forces (such as short-term volatility affecting members’ accumulated benefits, high inflation and low interest rates) as well as the choices that members make during their ‘savings lifetime’, that potentially results in the destruction of value.

Over time we have also seen a shift in the ‘savings lifetime’ of the average member on our retirement funds. Most members only start saving for their retirement once they are formally employed. Younger members are starting to work later in life after finishing studies, internships, training or articles for example. They are also taking longer to find formal employment resulting in more temporary and informal employment (which has its own challenges as illustrated by the Benefits Barometer). This also means that participation in any formal type of employee benefits programme, is deferred. In general, members therefore experience shorter working lives and, consequently, lower accumulations of savings.

Despite this shift, we have not seen a corresponding adjustment to normal retirement ages. In fact, over the last 20 years, the retirement ages of some occupational schemes have reduced their retirement ages from age 65 to 60, in line with the reduction in age for individuals to qualify for the state pension. While the lower age may be beneficial to individuals claiming the state pension, lowering the retirement age on an occupational scheme to age 60 reduces the ‘savings lifetime’ even further.

NORMAL RETIREMENT AGES – CURRENT PRACTICE

South Africa does not have a general retirement age, this is normally set by or agreed to with the employer in either the employment contract or referenced in the rules of the retirement fund. Within our private pension system, normal retirement ages of 60, 63 and 65 are the norms.

The gradual equalisation between genders in the state old age pension age to 60, resulted in a number of employers reviewing the normal retirement ages in their employment contracts and their retirement fund rules, adjusting this downwards to 60 for new members and negotiating changes for existing employees. Was this opportune for employers, or did policy drive this behaviour?

The Alexander Forbes Benefits Barometer detailed the average retirement age per sector, illustrated below:

Source: Member Watch™ 2012 data set
The average actual age of retirements during 2011 was 60.9 years\(^7\), compared with the industry average of 63.3 years as reflected above. The actual retirement age here refers to the age when members retired from funds, which may be, and in most instances was, prior to the normal retirement age. The latter is the contractual age agreed to in the employees’ employment contract when work is set to cease, unless the employer specifically allows a late retirement following agreement with the employee.

In negotiating the normal retirement age initially, and whether or not extending the age is appropriate in the future, would be dependent on the sector. Where a sector is more labour intensive, an earlier retirement age may be suitable, but in a sector which is based on intellectual and people skills, a later retirement age may be better.

While there may be certain aspects outside of any one individual’s control, such as the fund’s contribution rates, normal retirement age, possibly the investment strategies or even having uninterrupted savings, certain choices are often within an individual’s control, like when to retire. One may argue that some employees are offered voluntary early retirement packages due to employer restructuring or face compulsory early retirements prior to normal retirement age, thereby eliminating this control. There is still, however, a tendency, from age 55, for employees to opt for early retirement.

THE REPLACEMENT RATIO AND THE ALEXANDER FORBES PENSIONS INDEX

Most South Africans accumulate savings for retirement in defined contribution funds. The easiest way of describing a defined contribution fund is to liken it to a savings account. The expectation is that the more money a member directs towards savings, the bigger the end benefit. The perception is that this benefit will be sufficient at normal retirement age to live on during retirement. The replacement ratio provides individuals with an indication, in today’s terms, of what their position really is, while the Alexander Forbes Pensions Index tracks the impact of market conditions on these savings.

The Index highlights that since 1 January 2002, declining bond yields and general market conditions have contributed to a reduction in the expected future investment returns that members can expect to achieve. Furthermore, at retirement it costs more to convert the accumulated fund credit into a monthly income due to increases in annuity costs (again a function of lower bond yields).

Based on the Index, a member now aged 41, who was on track in January 2002 at age 30 to replace 75% of his monthly pensionable salary, will now only be able to target a replacement ratio of 30% at age 65\(^8\).

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\(^7\) Source: Member Watch™ 2012 data set
\(^8\) Alexander Forbes Pensions Index – 31 March 2013
However, based on current withdrawal and preservation statistics, the member may not necessarily stay on contributing until normal retirement age, resulting in an even lower replacement ratio.

These are projected numbers – and some believe forecasting is a ‘dark art’. So let’s consider cold hard evidence. What we saw in 2011 was that the overall actual average replacement ratio for retirements during 2011 was 31.7% with lower income earners having the worst outcomes.

Additionally, longevity has and continues to improve due to medical advancements. By implication, an employee has the prospect of having to fund his lifestyle for another 20 years or more if he retires at age 65.

So, what are we left with? A shorter working life, lower expected future returns and lower incomes in retirement, which now need to last much longer than previously anticipated – a grim picture indeed! Individuals now need to make more use of their time, while working (for as long as possible), to fund their lifestyles post-retirement.

Members can be encouraged to keep their accumulated benefits for retirement when they change jobs or to increase their contribution rates where they have the flexibility to do so to maximise their allocations to retirement savings. But this may still not be enough to counter the cyclical forces. Disposable income is typically limited with increasing indebtedness and the rising costs of living. It may therefore be difficult for members to practically increase their contributions.

In addition, most of the retirement fund investment strategies are at the maximum in terms of what can be done to generate additional returns, within regulatory limits.

What levers are left? It seems one of the few viable options to improve the outcomes is to increase retirement ages. This does not result in a massive increase in cost to the employer, yet it can have a material difference to the retirement prospects of employees. It is even possible that this may have positive returns for the employer because it ensures people who work with them for long periods are able to afford a reasonable retirement, in other words it may engender loyalty, which in turn limits staff turnover the consequent loss of productivity and the cost of recruitment and training.

To put the earlier example in perspective and illustrate the impact of even a relatively small change in the retirement age from 65 to 67, the now 41 year old, who, at the end of March 2013, could only replace 30%, can boost his pension in rand terms by between 7%-21% depending on factors such as contribution rates, size of the fund credit and current age.

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9 Alexander Forbes Member Watch™ 2012 – note that this assessment only takes into account the accumulated values held in the funds administered by Alexander Forbes.
10 Author’s own calculation.
Illustrated below is the potential impact of changes on the normal retirement age in this example and how this can improve members’ outcomes, based on the size of the accumulated fund credit:

<table>
<thead>
<tr>
<th>Income replaced (retiring at age 65)</th>
<th>Income replaced (retiring at age 67)</th>
<th>Increase in pension buying power</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low projected pension</td>
<td>10.78%</td>
<td>12.99%</td>
</tr>
<tr>
<td>Moderate projected pension</td>
<td>36.67%</td>
<td>40.02%</td>
</tr>
<tr>
<td>High projected pension</td>
<td>69.17%</td>
<td>73.95%</td>
</tr>
</tbody>
</table>

As illustrated earlier, early retirement, be it on a voluntary or compulsory basis, is widespread in South Africa today. So, while an employer can consider extending the normal retirement age, a change does not preclude the employer from retiring an individual early due to restructuring, for example. Nor does it preclude the employee approaching the employer with the intention of retiring early. Do those affected understand the implications?

South Africa lags behind some of its European counterparts where steps have already been taken to extend normal retirement ages. More than half of the Organisation for Economic Cooperation and Development (OECD) countries have increased the retirement age from 65 to 67, with the longer term intention to increase this age beyond 67 to target age 75 by 2050. This action has been driven by the global recession which impacted on the long-term financial sustainability of the public pension systems. A few of these countries have also introduced more stringent incentives to encourage individuals to save for longer even in their private pension provisions11.

WHY CONSIDER INCREASING THE NORMAL RETIREMENT AGE?

Longevity strongly motivates the need for retirement ages to be reviewed upwards. Consider the table below which shows the average life expectancy for individuals once they reach either age 60 or 65. Those retiring at 60 can expect to live at least another 19 years in retirement, with almost half the time spent in relatively good health.

<table>
<thead>
<tr>
<th>Life expectancy (average age reached)</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
</tr>
<tr>
<td>Male</td>
</tr>
<tr>
<td>Lower income</td>
</tr>
<tr>
<td>Higher income</td>
</tr>
</tbody>
</table>

---
While our rationale to change and improve the normal retirement age is slightly different from our European counterparts, the end result is the same, to improve individuals’ outcomes in retirement and ensure that their monthly annuity income is sufficient to sustain a reasonable standard of living in retirement.

A positive for pushing out the retirement age in South Africa, is that aside from living longer and longer, there are often skills shortages, which makes the pool of skilled retirees quite valuable.

Post the financial crisis where company closures, downscaling and restructurings have taken place, employees are more wary. Job security is vital. The retirement age, while not guaranteed, does provide some additional comfort for potential and existing employees.

Reforming the retirement age can also provide advantages to an employer, including but not limited to:

**Stability of staff**
Employees may not find it necessary to look for alternative employment due to job insecurity as they mature within the business. The stability in the staffing complement may provide for a more motivated and engaged staff.

**Skills and expertise being retained in the business**
Depending on the industry and, in particular, where intellectual and people skills are required, individuals can often add value well beyond 60, 65 and in some instances even beyond 70. Extending the retirement age keeps the knowledge and experience in the business. They can also be used to mentor and up-skill the younger generations coming through. Employers will need to actively manage the approach within the business to facilitate the skills transfer.

The result of this approach is an environment where the mature, experienced skills set is retained in the business where these have been nurtured rather than leaving as part of a ‘plan b’ to set up rival businesses.
Performance management and employee engagement

Research conducted in 2012, highlighted that employee engagement is an integral part of having a successful business\(^{12}\). Performance management and employee engagement is all about motivating employees. It has been argued that motivation is highly correlated with engagement and that both engagement and motivation often increased with age. It was shown that there was also a strong relationship between employee engagement and financial performance, showing that companies with higher levels of employee engagement tended to outperform those with lower levels of engagement\(^{13}\). The Benefits Barometer highlighted similarly the link between engagement and performance.

The U.S. Bureau of Labor Statistics (BLS) has also noted the shifting demographics of America’s workforce. According to the BLS, about 39 million Baby Boomers will be working in 2018 and make up 23.8 percent of the workforce. That’s up from the 12.4 percent of the U.S. workforce that was 55+ in 1998.

Attractive to new hires

The employer may be in a position to attract new skilled employees based on the revised policy and potential increased job security. This does not necessarily mean attracting an older workforce, but the change to an approach that encourages the transfer of skills, provides an opportunity for younger employees to learn from the experience. Consequently, if the skills transfer is implemented properly, the attraction of younger employees will be due to the depth of expertise within the organisation.

Aside from the advantages to the employer, additional advantages to employees include, but are not limited to:

Funding for healthcare

With pressure already on the Baby Boomers and those who are part of Generation X, who are helping to support their parents who retired with insufficient savings, as well as supporting their children, the cost of providing healthcare in retirement is a significant expense that needs to be considered in retirement planning. The key is how much extra, over and above the normal retirement fund contributions, is required purely to fund this.

Employee benefits

While still in employment and participating in the employer’s benefits programmes, employees and ultimately their families remain covered for benefits. So, if an employee dies or becomes disabled, the family needs would still be met from the participation in the benefits programme. In addition, perks such as company cars and wellness programmes would continue.

Future generational indebtedness

Extra time in employment could potentially be the saving grace, not only for the employee, who now has extra time to save from income while in employment, but the entire family unit that relies on the ongoing monthly income and may potentially be dependent on the income in retirement.

As a result, extending the retirement age beyond the current set boundaries further reduces the generational indebtedness that is being handed down from one generation to the next. It therefore provides future generations the opportunity to start on a relatively clean slate – where their parents are reasonably funded in retirement and do not need to be assisted.

\(^{12}\) Engagement at work: Its effect on performance continues in tough economic times. Key findings from Gallup’s Q12 Meta-analysis of 1.4 million employees (Gallup Inc.)

\(^{13}\) Management issues.com: Nic Paton: Engagement & motivation increasing with age 23/12/2005
WHAT IS THE DOWNSIDE OF INCREASING THE NORMAL RETIREMENT AGE?

Potential increase in future liability for employer
The employer may currently ‘cherry pick’ those individuals they would like to keep on beyond normal retirement age on a contractual basis (or possibly even permanent staff in late retirement, although many prefer contracts). These appointments mostly mean that the contract employee does not participate in the employee benefits programme and therefore reduces the cost for the employer.

Increasing the retirement age for all employees or categories of employees means a potential increase in the employer’s future liability (a) to keep all these employees employed and (b) to cover the full benefits programme for these members. In addition, there is potentially a higher cost for longer serving skilled employees. However, to attract and recruit younger skilled employees to fulfill a higher level position may not result in a saving to the employer.

Increase in cost of risk benefit cover
Group risk premiums are based on an average rate per age and as a result an ageing membership leads to an increase in the overall cost of providing these benefits. This is based on current mortality levels. So, one may see a short-term increase in group life rates.

However, with increasing life expectancy, it would be expected that insurers would over time review their pricing based on the improved statistics and the employed ageing population, resulting in lower group life rates, although this would happen slowly.

There would likely be an increase in income disability policy rates because of the later retirement age, due to the longer period for which payment is possible. The effect should be manageable for many funds, and could be counteracted by changes elsewhere.

Decrease in productivity
The general perception is that productivity will reduce with age. However, productivity is dependent on the specific sector the employee is working in. Certain jobs have characteristics that lend themselves to earlier retirement while others lend themselves to later retirement. Extremely high stress jobs (no, we don’t all have those...), and those that demand certain physical attributes may demand lower retirement ages. More sedentary jobs could comfortably have higher ages. In either scenario, the design could provide a reasonable chance of a dignified retirement.

There is mixed evidence as to how age influences productivity, if at all. Some studies show that productivity declines with age; others show that older workers tend to be better in terms of accuracy and output consistency\(^\text{14}\). Then there are studies showing that there is almost no relationship between age and productivity once other factors are taken into account.

The objective is to ensure that the right people are employed in the right jobs. This is not an age-related issue, but rather one as to how the employer best uses the skills it has and changing some practices to work to the strengths and benefits that older employees can bring to the workforce.

\textsuperscript{14} Butler (2012), Raising retirement age in defined contribution funds, Quarterly, edition 3, 2012
Youth unemployment

In some quarters it is believed that keeping older workers on in the workplace leads to less demand for younger workers.

Just over half of economically active South Africans between the ages of 15 and 24 are unemployed\(^1\). A comparison of retirement ages and youth unemployment rates shows no real relationship between the retirement age adopted by workers and youth unemployment\(^2\). It is therefore expected that raising retirement ages is unlikely to dramatically increase youth unemployment levels.

Economists do agree this is due to economies slowly adjusting to gradual changes in the size of the working population. As retirement ages are adjusted, the size of the working population should change.

**SOME PRACTICAL ASPECTS TO CONSIDER**

Retirement age stands out for employees as something they can measure and work towards. It provides a clear signal for individuals choosing when to cease work. So while there may be many reasons to increase the normal retirement age, this exercise may prove contentious in some instances and will need to be carefully managed.

Fixing a retirement age in an employment contract creates certainty for both the employer and the employees as to when the employees will retire. Therefore the retirement age must ideally be agreed with the employee on the commencement of employment, and if changed thereafter needs to be agreed.

Different categories of employees may require different retirement ages based on the type of work that they perform. Any differential treatment must be fair and in line with labour requirements. Not only that, but the design should allow appropriate retirement income to be paid.

**HOW SHOULD THIS BE APPROACHED?**

The fund trustees cannot change that the normal retirement age in the fund rules without agreement from the employer, review of the employment contracts and negotiation and communication with employees. Should trustees or management committee representatives, however, feel that this is an item for consideration for the employer, this should be tabled by the board and the employer trustees or employer representatives tasked to take this back to the employer. A full motivation from a funding perspective would assist with the assessment of the viability of increasing the normal retirement age. As there are other labour considerations to take into account, it cannot be taken for granted that the employer will make the decision purely based on the proposal from the retirement fund.

From a practical perspective, the trustees would need to demonstrate the potential value to the employees should the retirement age be increased. A starting point would be for the trustees to determine the replacement ratios for each member on the fund. This would provide an indication of whether or not these members are on track to meet their end objective, such as targeting 75% of pre-retirement salary at the normal retirement age.

Depending on the current normal retirement age, scenarios can be obtained to extend the retirement age to various ages, for example to 63, 65 or 67, to illustrate the impact on the individual members’ outcomes. The results of this exercise would then form the basis of the motivation to the employer for consideration, along with a detailed overview of the trends, advantages and disadvantages in such a change.

Even once a retirement date is extended, individuals could be tempted to take early retirement. Members should be shown the impact of retiring early, in today’s terms, as illustrated below:

<table>
<thead>
<tr>
<th>Date of calculation as at 30/06/2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of pensionable service</td>
</tr>
<tr>
<td>Annual pensionable salary</td>
</tr>
<tr>
<td>Current fund credit</td>
</tr>
<tr>
<td>Membership number</td>
</tr>
</tbody>
</table>

Your expected annual pension at retirement, in today’s money terms and based on three different growth scenarios, can be shown as follows:

<table>
<thead>
<tr>
<th>Your annual pension (in today’s money terms) at normal retirement age</th>
<th>Favourable scenario</th>
<th>Expected scenario</th>
<th>Unfavourable scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extra contributions needed to get a pension of R90 146.61 a year at normal retirement age</td>
<td>3.41%</td>
<td>19.62%</td>
<td>37.39%</td>
</tr>
<tr>
<td>Age you need to work to, to be able to retire with a pension of R90 146.61 a year</td>
<td>61</td>
<td>68</td>
<td>79</td>
</tr>
</tbody>
</table>
CONCLUSION

Extending the retirement age may not be appropriate for all sectors as highlighted above, each employer will need to assess whether this change is economically viable and suitable for their employees and business.

The biggest question is: Will moving the goal posts by extending the normal retirement age improve members’ retirement outcomes? In other words, given the opportunity, will members save more or will members, who currently know they need to save for retirement, still leave it to the very end to try and play catch-up.

Early intervention and education will be imperative to ensure that the changes are not in vain and that members understand the extent of the lifeline that they are handed where employers do review their policies. In order to fully appreciate and benefit from this change, individuals need to change their mind-set (or through policy) regarding their accumulated benefits in retirement funds and ensure that these savings are preserved and kept for retirement. A change in this behaviour coupled with more time will definitely benefit individuals over the long term and help to improve their retirement outcomes.

Providing this lifeline does not eliminate the possibility of members electing early retirement where this is permitted in their employment contracts, nor does it limit the employer from offering early retirement packages in the course of restructuring. It also does not limit the employer’s ability to manage performance of employees and deal with under performers. A low retirement age should not be seen as a ‘soft’ performance management tool. In addition, a change in the normal retirement age does not prevent an employer from employing young, dynamic people with new ideas to bring new blood into the business and offer new skills.

And finally, an interesting point to note raised in the 2013 Retirement Reform Proposals (27 February 2013) states:

“Any biases in retirement funds which may discourage individuals from working past the retirement age of their funds will be identified and removed.”

We certainly live in interesting and challenging times where our future retirees’ fate should not be sealed by a history that is no longer relevant.
Earlier this year, National Treasury announced their proposals for retirement reform in South Africa. While many of these proposals focused on the alignment of the tax treatment of pension and provident funds, there were also other, more practical issues concerning pre-retirement withdrawal and retirement.

When looking at National Treasury’s proposals, it is clear that they want to simplify a complex industry and reduce costs where possible. Given the level of financial literacy of South Africans, these proposals are not surprising and in fact welcomed by many stakeholders.

The Alexander Forbes Member Watch Survey, published last year, revealed that 70% of members retired with income of less than 40% of their pensionable salaries. The main reason for this low number is the lack of preservation of accumulated retirement benefits when individuals left employment historically. What is more alarming is that these retirees took, on average, 61% of their benefits in cash (seemingly a direct result of the tax scales on retirement – one of the issues raised in the Benefits Barometer is that of incentives and the effect they have on behaviour) and most members who did purchase an annuity, chose living annuities. It is however very unlikely that living annuities were the best product for many of these members. So what is going wrong?

Deciding what to do with a retirement benefit is possibly the single most important financial decision an individual will make during his lifetime. Why is it so crucial? After retirement there is less of an opportunity for additional income generation so if the retirement benefit is poorly invested, the damage is irreversible.

However, most people approaching retirement do not understand the decisions they face and many don’t seek financial advice until the day they retire. What’s more, research highlights that individuals are averse to seeking out and paying for advice, with almost two-thirds of people in the study believing the advice was not worth paying for1. Ironically though, of those that do take up the advice, and pay for it, the vast majority were extremely satisfied and would use the advisor again. Not only this, but a growing body of research points to the clear tangible benefits of obtaining financial advice – advised households have substantially higher investible assets than non-advised households, regardless of household income level and age group and advice has a positive and significant impact on wealth accumulation, even after accounting for a myriad of other socio-economic variables known to affect wealth11.

This is not an article on advice per se, but advice is an indispensable part of the annuitisation process. Our research shows that individuals do not understand the features of, and differences between the types of annuity products available. Even after talking to a financial adviser, they may not always understand what they are signing despite the best efforts of the most experienced advisers. In light of this massive information gap, National Treasury’s proposals come into focus:

- Trustees will be required to guide members through the retirement process, to identify a default retirement product in accordance with a prescribed set of principles, and to automatically shift members into that product when they retire, unless members request otherwise. The fund itself may provide the default product, or it may use an externally-provided product.
- Living annuities will be eligible for selection as the default product, provided certain design tests, including on charges, defaults, investment choice and drawdown rates, are met.

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1 Aviva Report: The Value of Financial Advice, June 2011
11 IFIC: The Value of Advice Report, 2012
• Trustees that make commission-free financial advice available to members on retirement, paid for out of the fund on a salaried basis, will be given some legal protections in respect of the choice of the default. To increase competition, providers other than registered life offices will be allowed to sell living annuities.

We examine the two highlighted concepts above in more detail.

DEFAULT RETIREMENT PRODUCT

Providing a default retirement product will force trustees to consider the profile of their membership in detail, including information not typically available to funds, and analyse the features of different types of annuities. It will be important to understand what members are currently doing in this respect.

The difficulty however is identifying a default that is appropriate for most, if not all members. This will be very difficult for funds with a diverse range of employees, for example from factory workers to top management executives.

In fact, an Alexander Forbes actuarial research paper19 presented at the 2012 Actuarial Society of South Africa Convention looked at precisely the question of “what type of annuity construct is optimal?” The answer to this was, not unexpectedly, complicated, and depended on an individual’s circumstances.

The research considered various models for determining the optimal annuity decision. For all model classes considered, the results were very sensitive to the full accumulated wealth, which limits the extent to which the process can be automated or outsourced, in other words, there is no real substitute for having the results interpreted in a holistic fashion with consideration of all the risks.

The research findings suggested that a one size fits all default option is unlikely to result in optimal annuity decisions. This is mainly as a result of the circumstances, preferences, savings patterns and histories before retirement and financial needs post-retirement differing significantly between individuals in South Africa. A critical point is that much of this information is not available to Trustees in the normal course of events. The research confirms that there is a place for both life and living annuities, although greater controls would be required for living annuities in addition to ensuring the remuneration of intermediaries is aligned to providing individuals with the most appropriate solution for their circumstances.

Importantly, even trustees who have historically not faced dealing with annuities (for example provident fund trustees where most members access 100% in cash at retirement) will in future have to start thinking about these complicated issues as the current proposal is to harmonise the annuitisation requirement of pension and provident funds to that of pension funds. Pension fund members currently must annuitise at least two-thirds of their accumulated wealth at retirement as opposed to taking benefits as a cash lump sum. In this context annuities include living annuities as well as life annuities.

For the interested reader, a summary of the detailed findings of the paper is available from Alexander Forbes.

National Treasury has not yet provided any indication of the ‘prescribed set of principles’, but the trustees will have many issues to consider:

What do members want versus what members need?
One of the main reasons living annuities are so popular is that the remaining balance of the member’s benefit is paid out on death. This is a big issue soon after retirement – people don’t want to lose all their savings if they die early – but also
older people wish to leave an inheritance to their loved ones, even if they aren’t financially dependent any more. The benefit on death is therefore a very high on the list of ‘wants’ of retirees.

Living annuities do however not provide any protection against longevity. It is very possible (even likely with higher drawdown rates) that members outlive their retirement savings, a problem which only emerges later in retirement and is a lower priority at retirement date. This is just one example of how members’ needs differ from their ‘wants’.

Another example is the draw down rates on living annuities. Retirees may draw an unsustainably high pension facing the risk of running out of money at a later stage. Again the short-term want outweighs the long-term need in the mind of the individual.

Other things that members look for in their retirement products include:
- **Simplicity** (easy to understand)
- **Predictability** (in particular with regards to pension increases)
- **Flexibility** (to customise the benefits to their needs)
- **Cost effective** (though few members actually understand the cost structures of annuities)
- Maximum pension and pension increases
- Need for ongoing advice.

The challenge that trustees face is balancing all these factors to meet members wants and needs.

**What are the features of different annuities?**
Trustees will need to understand and analyse the features of the different types of annuities available and how these will or will not meet the needs of the fund’s members. Their job does, however, not stop there. Trustees will need to monitor the take-up of the annuity and continually assess whether the annuity provides the optimal benefit for their members. In addition, some annuities may require ongoing management for example selecting the range of investment portfolios available in a living annuity. The ongoing management could indeed take up a lot of time and effort on the part of the trustees.

The table on the next page is a useful summary of the salient features of each, but also serves to highlight why when combined with the endless demographic considerations, the actual decision of what is best suited for an individual is extremely complex:
<table>
<thead>
<tr>
<th>TYPE OF PENSION</th>
<th>PENSION INCREASES</th>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation-linked pension</td>
<td>Pension increases are based on the inflation rate for the preceding year.</td>
<td>• The pension keeps up with inflation and is protected against increases in the cost of living.           • The pension is paid for as long as the pensioner alive.*</td>
<td>• The pension is expensive to buy because increases are fully linked to inflation. • The pension increases can be low (or even 0%) if the inflation rate is low.</td>
</tr>
<tr>
<td>With-profit pension</td>
<td>The annual pension increases are determined by the insurance company, based on actual investment performance.</td>
<td>• The starting pension amount and subsequent yearly increases that are declared by the insurer are guaranteed. The pension increases can be good if investment performance is good.</td>
<td>• The pension may not keep up fully with inflation. • There may also be a 0% pension increase in years where investment returns are poor.</td>
</tr>
<tr>
<td>Fixed increase pension</td>
<td>The annual pension increases at a fixed percentage each year. Pensioners have to choose the increase category when they buy the pension.</td>
<td>• The pension increases are predictable as they increase every year at the fixed percentage you chose. • The pension is paid for as long as the pensioner is alive.*</td>
<td>• The increase percentage chosen at retirement is fixed at life and can’t be changed. • The pension may not keep up fully with inflation.</td>
</tr>
<tr>
<td>Level pension</td>
<td>No annual increases. The pension stays at the same level as the year in which it was bought.</td>
<td>• The starting pension is higher (if no increase chosen). • The pension is paid for as long as the pensioner is alive.*</td>
<td>• The pensioner is not able to adjust the income level as time goes by. It remains fixed for life. • The pension will not increase at all over time and will therefore not keep up with inflation.</td>
</tr>
<tr>
<td>Enhanced pension</td>
<td>Increases depend on whether a fixed, level or inflation enhanced annuity is taken.</td>
<td>• The starting pension is higher than a standard (fixed, level or inflation) annuity depending on the health status, occupation and income level of the pensioner • The pension is paid for as long as the pensioner is alive</td>
<td>Depends on whether a fixed, level or inflation linked pension is taken – disadvantages the same as for those annuities</td>
</tr>
<tr>
<td>Living pension and Alexander Forbes LifeStage pension</td>
<td>Pension increases depend on how much of their capital the pensioner decides to draw each year.</td>
<td>The pension is flexible and the pensioner can leave money to your beneficiaries.</td>
<td>The pensioner can easily run out of money if they draw too much of their capital too soon in the retirement years. It’s also only appropriate if they have more than R1 million to invest.</td>
</tr>
</tbody>
</table>

* If the member chooses the pension continuation option, the spouse will receive a pension when the pensioner passes away.
In-fund or external provider?
Most funds do not pay pensions directly anymore, and the rules typically require members to purchase a pension from an insurer. However, National Treasury’s proposal requires trustees to reconsider the advantages and disadvantages of offering the default annuity within the fund or externally with a product provider. Some of the issues to consider include:

<table>
<thead>
<tr>
<th>Issue</th>
<th>In-fund</th>
<th>External</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintain relationship with retirees</td>
<td>Yes, as the retirees remain members of the fund. Only if the insurer can identify the individuals that were members of the fund.</td>
<td></td>
</tr>
<tr>
<td>Level of control</td>
<td>High (for example investment portfolios, pension increases and draw-down rates). This may be necessary to meet the requirements of a default annuity.</td>
<td>May be able to exercise some control if insurer can accommodate the requirements.</td>
</tr>
<tr>
<td>Time and effort</td>
<td>While in-fund pensions provide trustees with control, it also requires them to manage the arrangement. This may require considerable time and effort from trustees.</td>
<td>A large portion of the governance requirements are taken over by the product provider.</td>
</tr>
</tbody>
</table>
| Legal issues | - Exemption from Long Term Insurance Act  
- Pension Funds Act applies  
- Subject to fund rules  
- FAIS applies to accredited advisors providing Advice Information by trustees is not considered advice. | - Long Term Insurance Act applies  
- Pension Funds Act does not apply  
- Guided by Fund Rules  
- FSP and rep must be Category 1 FSP accredited to provide advice/ intermediary services under sub-category Retail Pension Benefits and/ or Long Term Insurance Category C |
| Flexibility | Members will only be able to exercise their own decision within the limits placed by the trustees and the administration capabilities. | If the provision of pensions is the core business of the annuity provider, they may be better geared to accommodate a wider range of member requests. The trustees may still be able to place limitations on what members can do. |
| Costs | Trustees can often take advantage of institutional investment and administration charges (as opposed to higher retail costs), but low take-up can result in low economies of scale and high per-member costs. | Using bulk buying power, trustees could negotiate lower charges from the product provider. Increased competition could also reduce expenses in future. |
| Administrative issues | Managing a book of retirement pensions could have administrative implications such as loss of valuation exemption, operational issues and increased audit scope (and cost). | Providing a default annuity with an external product provider does not affect the current operation of the retirement fund to any significant extent. |
| Risk to funding level | Unless fully insured, in-fund pensions may affect the solvency of the retirement fund. This is the case where the fund carries longevity, investment and expense risks. | The product provider carries the risk associated with paying the pensions. |
| Security of pension benefit | Unless pension benefits are fully insured, the impact of insolvency of the retirement fund on pensioners’ benefits is bigger. | A large established insurer with thorough risk-management strategies provides more security for pensioners than a fund can. |
| Advice | Take up of these options is sometimes problematic if there is no support and advice function. | Advice is typically sought and provided – either at the decision stage for life annuities and at the decision stage and ongoing for living annuities. |
| Drawdown rates for living annuity | Comply with Asisa standard 1 | Comply with Asisa standard 1 |
| Investment portfolios | - Usually make do with existing member choice portfolios  
- Usually limited range of choices  
- Important to ensure post-retirement investment options made available to pensioners are appropriate for pensioners - may need distinct set of options and default | - Specifically tailored post-retirement investment portfolios designed and managed  
- Broad range of alternative portfolios available  
- Product provider sets menu of portfolios and financial advisor guides annuitant to select appropriate portfolio or combination of portfolios |
What are the risks with a default annuity?
Would a one-size-fits-all approach be appropriate for the fund or would a range of annuities be more suitable? One should consider where the default should be “pitched” – should it be for the lowest level of member or the highest, or should it be a good base for the majority or are the members so diverse that a range of options would be most suitable to ensure better targeting of the defaults.

An obvious risk is that the default annuity does not meet members’ expectations. Retirees may select the default annuity as they see it as being supported by the trustees and therefore “must be the best option”. It will be crucial that trustees communicate all important aspects of the annuity to members before they retire so that they can make an informed decision.

The key point, which we have demonstrated, is that where funds have a diverse profile of members, it is unlikely that a single default annuity will meet the requirements of all the members. Whether or not more than one default product will be allowed is unclear at this stage, but may be an important requirement of the default annuity arrangement.

FINANCIAL ADVICE
Providing a default annuity does not actually solve the main problem. Members have to make retirement decisions but lack the financial knowledge and understanding to do so. A default annuity aims to reduce the potential damage of an inappropriate decision but does not address the issue of financial illiteracy.

National Treasury identified this problem and addresses it by requiring trustees to “guide members through the retirement process”. It is however important that the advice starts at an early stage to:

- Ensure members are actually saving enough for retirement (and not spending it before retirement)
- Align members’ retirement plan to their targeted retirement strategy (in particular their investment strategy)
- Educate members on what to expect at (and after) retirement and the decisions they’ll face.

Although not yet a requirement, trustees should already consider the implementation of financial advice and education on their fund. Trustees spend a vast amount of time, money and resources providing members with the best possible benefit at retirement, but uninformed retirees could destroy most of the value with a single inappropriate decision.

And that is only the financial impact. There are significant ‘softer’ issues to consider. Retirees often feel a sense of loss, are uncertain of their future and are all of sudden ‘unplugged’ from the mainstream. This can be extremely disconcerting and create serious angst – not what we dreamt of for our retirement. Having pre-retirement coaching or counselling is critical to enter the world of retirement prepared, not just financially, but emotionally and physically too.

A financial understanding of their retirement benefits will also increase the appreciation that members have of the benefits provided by the fund (and employer), often at a high cost to the employer. The employer will therefore also benefit from the return on its investment in the employee benefit scheme.

Alexander Forbes recently conducted research in South Africa using an external company who constructed several focus groups of consumers. This research
investigated, amongst other things, the approach taken by individuals to make financial decisions, their preparedness for such decisions and the channels they used. While the sample was by no means statistically significant, it did give important insights, especially considering that those who participated were already likely to be more engaged than the average citizen by their mere willingness to participate, in other words the situation is perhaps more dire than the results below suggest. There are a few key take-aways from the member research which we believe are pertinent to this debate and which we believe National Treasury should be aware of and take into account:

- There is a wide variation among the individuals as to their need and take up of education and advice before retirement. This is mainly as a result of short-term focus, apathy, financial issues being ‘boring’ or ‘scary’. However, at retirement the individuals were consistently more engaged and placed high reliance on the advice provided to them at retirement to ensure an appropriate conversion of capital into income.
- Generally speaking those who enjoy a good relationship with a financial adviser tend to be more involved and more financially astute. This may be down to the role of their adviser, or just more ‘naturally’ involved consumers who seek out advisers.
- Most individuals were vague on the levels of insurance cover they had and the benefits they could expect at retirement. What was of concern, was that few individuals had even tried to ‘do the sums’, only those who had a financial adviser had looked at this aspect of financial preparedness.
- Long-term financial decisions including those of insurance cover and retirement have ‘gravitas’ and individuals are more cautious in making these on their own.
- Pensioners interviewed had started planning their retirement a year or two before they stopped working or not at all, but all felt the need for advice on the retirement decision. Interestingly they saw investment risk as the key risk, not longevity.

When asked what they would have done differently or preferred to receive, pensioners said:

RETIREMENT SAVINGS: PENSIONERS RETROSPECTIVE VIEW

Looking back - would have done more homework, would have liked:

- MORE communication and EARLIER (40’s)
- Info on additional contributions
- More emphasis on medical aid
- Better understanding of draw-down rates
- Better understanding of risk and member level investment choice
These are simple yet critical insights for any trustee who is going to put in place structures that will direct members into a certain pension path. A key point from the work was the fact that individuals do not see all financial events and decisions as created equal – and some events or decisions do require higher levels of advice, in whatever form that may be provided.

IN CONCLUSION

We support the principle of increased annuitisation and of retirement arrangements providing default annuity processes and options. Our research, presented at 2012 Actuarial Society of South Africa Convention, suggested that a one size fits all default option is unlikely to result in optimal annuity decisions. This is mainly as a result of the circumstances, preferences, savings patterns or histories before retirement and financial needs post-retirement differing significantly between individuals in South Africa. The research confirms that there is a place for both life and living annuities, although greater controls would be required for living annuities in addition to ensuring the remuneration of intermediaries is aligned to providing individuals the most appropriate solution in their circumstances.

Given this, we believe that trustees of retirement funds should put in place a default annuity framework at retirement and guide members through the retirement process. This framework should be subject to principles, ensuring that trustees take into account the membership demographics, make available a suitable range of annuity solutions (which could include living annuities and could be in or out of fund), and advice if required, appropriate to their members. In addition, the trustees can select a default product from this range suitable for most members, with members who have different needs being able to select from the other options made available by the trustees.

We also suggest that irrespective of the default framework (and range of options), that members should still be allowed to structure the most appropriate annuity for themselves (if none of the arrangements selected by the trustees are suitable) should they wish to.

Given the above, there is an expectation that employers or trustees will guide or assist members who are approaching retirement. But how can you practically do this?
The following simple checklist should help initiate the discussions which may be required:

<table>
<thead>
<tr>
<th>Step</th>
<th>Action required</th>
<th>Responsible person(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pre-retirement phase (more than 5 - 10 years before normal retirement age)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Create awareness among members as to what they can expect as an outcome (make use of projection statements). Alexander Forbes Pensions Index can also be used to create awareness.</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Arrange appropriate educational workshops (age-related or change in personal circumstances).</td>
<td></td>
</tr>
<tr>
<td><strong>Pre-retirement phase (5 years or less before reaching normal retirement age)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Identify members within 5 years of normal retirement age</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Arrange pre-retirement seminars – internal workshops specific to your members or inform members about external seminars hosted by service providers. Members need to be financially and, possibly even more importantly, emotionally prepared for retirement. Arrange pre-retirement seminars which incorporates both of these aspects.</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Engage with these members to gain insight into their expectations about retirement and when they're planning to retire (if they want to retire early – are they aware of the consequences? If not, direct them to a financial adviser or to the fund's advisory process to help them make an informed decision about when to retire).</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Ensure that members are made aware of potential medical costs during retirement, so that they can make the necessary provisions for this before actual retirement. Generally, members do not even consider saving for post-retirement medical expenses.</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Retirement income statements (appropriate for members within 2 years before retirement date)</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Is there a high level of engagement between the employer and members who are approaching retirement? If not, liaise with the employer in this regard.</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Request that the employer review its exit procedures for retirees to ensure that it remains appropriate to their needs. Put forward a few recommendations for consideration by the employer’s HR director or executive.</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Ensure that retirement brochures and online tools are made available.</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Make advice available to provide general information about annuities and the advantages or disadvantages of each option. It’s important to show the actual impact of annuity choices, so that members are aware of the long-term consequences of their decision.</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Trustee board could ‘pre-approve’ advisers for members to approach with peace of mind.</td>
<td></td>
</tr>
<tr>
<td><strong>Retirement phase</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Is there a default? What does it look like? How is it communicated and mostly importantly, how is it supported.</td>
<td></td>
</tr>
</tbody>
</table>
There are things in life which we have no control over, like the weather and inflation. Then there are those important choices which we do have control over that can change the course of our lives – like our finances. As a matter of fact, to a large degree, all the choices we have made over the course of our lives, have defined who and what we are today.

The study of human behaviour is a fascinating subject. As Jim Rohn said, “If you keep doing what you’ve always done, you’ll keep getting what you’ve always got”.

It is remarkably uplifting to watch ordinary people arrive at the point where they decide to turn their lives around and through self-realisation, proactive action and hard work proceed to do astonishingly well for themselves.

For decades employers have believed that the management of employees and delivering a healthy work experience involves extrinsic rewards such as salary, promotions and status in the company. But looking holistically at the needs of individuals involves recognition of the fact that being healthy is not only a physical state but it involves being mentally and financially well too.

At the last Hot Topics Summit we introduced the concept of financial health. Achieving a healthy financial state involves having enough income and net assets to meet your needs throughout your life with enough protection in place to ensure that this is maintained irrespective of what life throws in your path. And while achieving financial security is something that many aspire to, recent reform proposals from the National Treasury have highlighted that this is not always a simple task.

While government looks at ways to reform the employee benefits system to achieve better outcomes for all South Africans, employers, too, have a vital role to play in helping employees achieve a healthier financial state by offering their workforce in-house education and advice.

“YOU CAN'T CONTROL THE WIND, BUT YOU CAN ADJUST YOUR SAILS.” – PROVERB

21 The economy – post-recession, Accountancy South Africa, October 2010
22 GDP Statistics, Statistics South Africa, Q3 2010

To improve both productivity and profitability, employers began to restructure their operations and that meant that many workers faced short-time, lower than expected salary increases and even insecure employment. Mounting worker stress over financial concerns led to mass action and unprotected strikes that left many in those industries without work and without employee benefits. We have also seen increased numbers of disability claims submitted.
And while the economic situation has improved, South African workers are still under enormous pressure – the unemployment rate in the first quarter of 2013 now stands at 25.2%\(^\text{23}\) of the population. When we account for discouraged work-seekers this number climbs to 38%. Another factor contributing to employee stress over finances is as a result of the increase in the cost of living. Consider the diagram below which compares the increases in food prices to headline Consumer Price Inflation (CPI) between January 2012 and January 2013:

![Diagram comparing CPI increases](image)

(Source: Statistics South Africa, 2013)

The Labour Research Service reported that while headline CPI between January 2012 and January 2013 was 5.6%\(^\text{24}\), the inflation rate for food and non-alcoholic beverages was 7.4%. However, products and services with administered prices, like electricity, municipal rates and services and telephone fees averaged around 9.9% over that period. What the figure above illustrates, is that the personal CPI of most South Africans is probably well above the official consumer inflation rate of 5.6%.

Many others may use credit to finance current consumption. In 2012 the Financial Services Board conducted research and concluded from their survey that 49% of South Africans are finding it difficult to pay all their expenses and bills each month. In the same study, the Financial Services Board also highlighted that financial literacy levels are very low in South Africa, even among higher income earners. Interest rates have come down prompting many to increase their spending. The National Credit Regulator found that, at the end of 2012, 46.3% of credit-active South Africans had impaired credit records\(^\text{25}\). This translates into 9.34 million people who are struggling to meet their debt obligations despite the application of the National Credit Act by credit providers.

The factors mentioned above have left many workers desperate for extra income. And while many workers may feel that an increase in take-home pay will improve their ability to afford necessities, it can be argued that people cannot take measures to save more unless they are able to cut back their spending. Showing people how to survive within the limits of the income they already earn, can lead to employees who are financially independent in future. Employers who do not offer their employees information about budgeting and other financial literacy topics, may be feeling the cost of not helping employees manage their finances in other ways.

\(^{23}\) Quarterly Labour Force Survey, Statistics South Africa, Quarter 1, 2013

\(^{24}\) Inflation Monitor, Labour Research Monitor, February 2013

\(^{25}\) National Credit Regulator, 2013
THE LINK BETWEEN PERSONAL FINANCIAL PROBLEMS AND ORGANISATIONAL COMMITMENT

Organisational commitment is a term that is loosely defined as an employee’s attachment to a company and their intention to remain with it and remain productive. But how is organisational commitment linked to the financial well-being of employees? Well, employees who are troubled about their finances bring this stress into the workplace, leading to lower productivity and resulting in a cost for the employer.

In the past emphasis was placed on health wellness. Many companies now recognise the correlation between financial distress and health problems and the lines of distinction between health and financial wellness are fading.

The effect of unhealthy finances can be felt on three fronts:

**Loss of productivity while at work**
Research into the topic of worker stress around money matters has found that unhealthy employee finances can lead to workers being distracted from their daily tasks resulting in lower productivity. In one study it was found that 53.9% of employees use work time to address their personal financial problems.

MetLife’s 9th Annual Study of Employee Benefits Trends found that 78% of the surveyed employers said that concerns over financial problems while at work can have a negative impact on employee productivity.

**Absenteeism**
Unhealthy finances can lead to health problems, which if left untreated can result in absenteeism. In the Metlife study referred to above, 58% of employers stated that financial ‘illness’ played a role in employee absenteeism. Research carried out by Alexander Forbes into the absenteeism rates for one very large client, found that on average, absenteeism is costing the organisation around R51 million each year. Even with a very large payroll, this represents a big rand cost to an employer’s bottom line.

**Increase in illegal activities**
While employers are faced with reduced productivity and resulting lower profit margins, they are also faced with the possibility of increased workplace fraud and theft of company property.

An employer who takes an interest in the personal financial concerns of their workforce can reap the rewards of higher productivity and lower costs in some areas. Studies have shown that an employer’s efforts to improve the overall well-being of employees can lead to better employer-employee relations, higher morale, increased retention rates and increased output. In 2006, it was found that an engaged work unit was 38% more productive and 27% more profitable than a disengaged one. And it is precisely this increase in productivity which should motivate employers to take a more active role in the finances of their employees.

Taking responsibility for the overall well-being of individuals should not be the role of employers alone. Governments, as well as households, stand to gain if the problem of unhealthy finances can be solved.

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27 Gallup Organisation (2006), Engagement predicts earnings per share
“To achieve a targeted pension of 75% of pre-retirement salary, a 25 year old individual, retiring at age 65 will have to contribute just under 30% of their pensionable salary towards retirement savings”

THE ROLE OF THE EMPLOYER

Engaging employees in the right financial behaviours can be as simple as achieving an appropriately structured remuneration package – but this involves consideration, not only of the level of take-home pay of workers but the structure of the employee benefits package too. If the employee can see the value in their remuneration package they are more interested in retaining these rewards through hard work and commitment to the goals of the organisation.

An efficiently structured employee benefits package is one which meets the employee’s requirement for risk benefits (as a function of their family structure), the required level of retirement funding at every age and financial education to understand the intricacies of their situation. These benefit requirements then have to be balanced against the daily expenses of the household. Arguably the most important element of that package is the education and advice offered by the employer.

Last year, we spoke about the retirement fund being a conduit for creating good financial behaviour among employees. For many employers, the retirement fund became the ideal way for messages about future financial planning and the structure of the employee benefits packages to reach members. But data from the Alexander Forbes Member Education Services division showed that in 2011, only 10.2% of the seminars delivered to retirement fund members related to budgeting and other financial literacy topics.

Seminar topics are normally chosen on behalf of the fund members by the board of trustees or the HR department of the company concerned, and historically the focus has been on retirement issues. And while there has been a shift in focus towards looking holistically at the needs of the individual throughout their lives and the use of alternative platforms for communicating with members, such as the use of social media and online access to fund and other financial information, more needs to be done to create financially savvy members in the future.

This time last year, a 25 year old individual, retiring at the age of 65, would had have to contributed 19.7% of their pensionable pay over the next 40 years towards retirement savings to achieve an expected pension of 75% of their pre-retirement salary. However, to achieve this pension target today, the same individual would have to contribute just under 30% of their pensionable salary towards retirement savings.

This is a staggering amount, brought about by the effects of falling bond yields and the resulting low returns across the main asset classes going forward. But equally important is the fact that the cost of converting those savings into a post-retirement income stream through the purchase of an annuity has been continually rising, with interest rates dropping and increasing longevity forcing insurers to increase their rates.

The problem is that for many people, retirement is 20 to 30 years away and when current projected outcomes sound so poor they may feel that deferring retirement saving is the best option for them.

However, once you’ve established your consumption at a particular level it is incredibly difficult to give up things that you’ve become accustomed to. For many South Africans having a higher take home pay leads to more discretionary spending and most find it difficult to live within their means. So by the time markets look up, many people are forced to service debt rather than save. Again education may be the key to helping members understand the importance of early and sustained retirement savings.

30 Guardbook Data Set, 2011
31 Authors own calculation
POLICYMAKERS TAKE AN INTEREST

National Treasury has decided to address the problem of poor personal financial behaviour of individuals by focusing on measures to improve the savings behaviour of people. In a set of recent discussion papers, the National Treasury outlined the following proposals to address the issues of inadequate lifetime savings of individuals and the poor use of savings over their lifetime:

- The implementation of tax preferred savings and investment accounts to promote pre-retirement savings. The account will have annual, tax-free contribution limits of R30 000 and a lifetime limit of R500 000, to be increased with inflation over time.
- Compulsory preservation of funds accumulated in a retirement savings vehicle when changing jobs.
- Individuals will be able to receive a tax deduction on employer and employee contributions to a pension fund, provident fund or retirement annuity fund up to 27.5% of the greater of remuneration and taxable income, subject to a cap of R350 000.
- Retirees will be required to annuitise their accumulated fund value once it exceeds a certain limit.

INDIVIDUALS HAVE A ROLE TO PLAY TOO

We’ve said before that simply increasing the take-home pay of workers will not solve their financial crises. Ultimately what stakeholders face is a problem of poor financial literacy levels of South Africans. And this is not a problem that’s endemic to one particular group of workers – a recent study by the Bureau of Market Research found that only 35% of the surveyed affluent market (those earning above R750 000 per year) are financially knowledgeable32.

When the Alexander Forbes Research and Product Development department carried out some research into the buying process of consumers of financial products like disability insurance and retirement solutions, we received some startling feedback about the level of financial literacy of survey respondents. When asked about the amount that is paid out on their death, one respondent said: “I know more or less. I know my place gets paid off. I don’t know what the change is. There is something left over but I don’t know the figures”33.

Showing individuals how they can take control of their finances requires that they have a feel for concepts like compound interest and an understanding of how financial products work, among other things.

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33 Alexander Forbes Consumer Research, Qualitative report, 2013
From the same research we found that most respondents were vague as to the specifics of the amount of insurance cover they had and some were also vague on which companies they have cover with, with one respondent saying: “I have life RAs [retirement annuities] and a whole lot of things... they just go off [my bank account]... I don’t know which one is which... my broker should know”34.

MEETING THE NEEDS OF ALL WORKERS

Offering all employees the same static package of benefits is unlikely to meet their individual needs. Rather workers have different benefit requirements depending on where they are in their lifecycles. Furthermore, a holistically structured employee benefits package does not only feature the retirement fund but also contains risk benefits that members either overlook or view as an unnecessary expense.

The 2012 Finscope study found that while 28% of the surveyed population were members of a burial society and a further 10% had funeral cover, only 12% had life cover. Worse still was the fact that only 10% of the surveyed population had medical cover35. The government recognises the importance of risk benefits for all South Africans and one of the proposals that they tabled, along with reform proposals, was a social security arrangement that would offer members death and disability cover at a lower cost than an institutional alternative.

However, while all workers need risk benefits, they do not need the same benefits in the same amounts. For example, older workers with grown-up children and who are close to retirement may be over-insured: the intention of life cover is provide a benefit to the family of the deceased so that they can maintain their lifestyle when a breadwinner passes away. Employees who are close to retirement should instead be focusing their resources on contributions to a retirement savings vehicle in order to enjoy financial security in their twilight years, without relying on their children or the state for income support.

Young employees and workers employed in their first job present more of a challenge. These workers often fail to see the value of risk benefits, nor do they want to contribute towards a retirement savings vehicle when retirement is up to 45 years away for some. They do however present the ideal opportunity for employers to instil the right behaviours, in terms of saving for retirement and having the necessary risk benefits in place, at an early stage so that they remain financially independent throughout their lives. The diagram below summarises the risk benefit requirements of individuals over their life-cycles.

34 Alexander Forbes Consumer Research, Qualitative report, 2013
Thus, offering individuals of different ages and who are at different stages in their lifecycle the same package of benefits can leave them exposed to the risk of not being able to meet their financial needs in the event of temporary or permanent disability, or the financial needs of their family in the event of their death.

One way to address the problem of inefficiently structured benefit packages is through financial education. Helping employees to better understand the purpose of each of their risk benefits can, on the one hand, help them identify the value in their benefits and on the other hand prompt them to ask for benefits that best meet their needs at that point in their lives, ultimately resulting in a benefits package that is more efficient.

ACHIEVING FINANCIAL SECURITY

Up to this point we’ve highlighted the importance of the employee benefits package and financial education in helping employees to achieve financial security. But the aim of this year’s Hot Topics Summit is to build on the ideas presented a year ago and to provide workable solutions to employers and employees in order to create a healthy workplace for employees and help them overcome the financial difficulties they may be facing. Let’s consider a few practical ways of taking steps in the right direction.

Rethink the delivery of financial message

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\(^{36}\). However, the medium used to convey messages may make a significant difference to their use. Email communication is prevalent but 66.8% of email traffic in South Africa is spam\(^{37}\).
With the growing recognition that people learn at different paces and in different ways and that the reiteration of messages is critical to retention, experts recommend using a number of different media to convey consistent messages. A number of pilot programmes in Poland have shown that short television segments featuring celebrities and an online film portal of three minute segments were particularly effective at reaching younger and older people and levels of financial understanding continued to improve after viewings, possibly due to the discussions that they provoked.

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

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

Quantifying the cost of absenteeism in your company

The figure below shows how an employer can calculate the cost of workers who are absent from work due to financial difficulties.

The formula works as follows:

- Start with the number of employees in the company.
- Multiply by the salary of the average employee who is habitually absent from work. This is the total cost of absenteeism.
- Then multiply by 15%, which is the proportion of South African employees subject to garnishee orders.
- Finally, multiply this number by two to account for the indirect costs faced by the employer as a result of fraud and lost productivity due to ill-health brought about by financial distress. Employers should note that the multiple of two will increase or decrease depending on the significance of the work produced by a particular worker and the impact their absence will have on the productivity of the organisation.

If the number you get is a significant portion of your operating cost, there is an opportunity to reduce this cost and improve productivity and ultimately the lives of employees and shareholders.

39 Ibid
43 Kronos Labour Management suggests that the indirect costs of absenteeism may exceed the direct costs by as much as 200%. View the document here: http://www-bytebi.co.za/ downloads/Kronos/KronosLabourManagement/WhitePapers/TAM_WP_SA_280111.pdf
AN EFFECTIVE EMPLOYEE ASSISTANCE PROGRAMME

A comprehensive employee assistance programme is an employer initiative aimed at improving the financial, physical and mental health of workers through seminars and group/individual counselling sessions. However, when we examined the seminars presented by the Alexander Forbes Member Education department, it was found that only 16% (including the 10.2% referred to earlier) of the seminars related to general financial wellness topics. With respect to each of the three pillars underlying well-being, the following discussion topics may be offered:

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**Physical Well-being**
- Fitness and exercise
- Weight management
- Healthy Eating
- Disease prevention

**Mental Well-being**
- Fitness and exercise
- Dealing with the social climate in the workplace
- Overcoming challenges with the organisational cultures, values and structures
- Stress management

**Financial Well-being**
- Debt Counselling
- Structuring risk benefits over the lifecycle
- Budgeting
- Preserving retirement benefits
- Investment planning
- Understanding savings options
- Estate planning

The characteristics of an effective employee assistance programme are:
- It must provide ongoing support to workers.
- The education and advice that is given to employees must be structured with their specific needs in mind.
- Feedback on the challenges facing employees must be given to employers so that they can see whether further intervention is required.
- The programme must be dynamic, adapting to changes in the structure of the workforce or changes in the economic condition. For example, if the employer is about to go through a restructuring exercise, seminars should cover the topic of preservation of retirement fund benefits.

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[44 Guardbook data set, 2011]
HAVE SOME USEFUL TOOLS AVAILABLE

In most cases, we are quite good at demonstrating the short-term impact of decisions (dummy payslips for example), but it’s often difficult to understand the long-term impact of poor financial health and offering employees tools that help them quantify the impact of their decisions which can lead to a better understanding of the decisions they make. Here are some of the outcomes that could be achieved with appropriate tools:

Replacement ratio sensitivity tool
This tool would show members how their replacement ratio (the ratio of monthly income in the year after retirement to the monthly income in the year before retirement) would change if they changed their contribution rate, their retirement age or their pensionable salary percentage. This tool would show members the long-term effect of their decisions in the short-term. Such a tool would also show members the impact of a change in factors that are beyond their control, like an increase or decrease in investment returns or a change in the cost structure of the fund.

Preservation tool
A preservation tool would show members the cost, in terms of accumulated fund value or income foregone at retirement, of not preserving their benefits when changing jobs.

Investment choice tool
An investment choice tool would show members whether they can meet their desired replacement ratio target by employing a particular investment strategy.

Budget tool
A tool that shows individuals in a simple way the income and expenses they face on a monthly basis will immediately highlight a number of financial wellness issues.

Insurance needs tool
Most individuals cannot determine what their insurance cover needs are, and cover is either whatever is provided on a group basis or only determined by affordability (for those few who take additional cover). Showing employees what their insurance need is, based on their circumstances, will allow them to better appreciate the trade-offs in the insurance versus savings versus spending decision.
HAVE A CLEAR OBJECTIVE IN MIND FOR THE EMPLOYEE BENEFITS PACKAGE

Employers need to be clear about what it is they are trying to achieve with their employee benefits package as it can result in very different types of workers being attracted to the company. It is not always the absolute rand based value of the package that is important but the structure of the package too. If the package is flexible and meets the needs of a worker over their lifecycle, the employer is more likely to attract and retain productive and committed individuals.

WHAT IS THE ROLE OF THE TRUSTEE IN ACHIEVING FINANCIAL SECURITY FOR WORKERS?

Some of the recent reform proposals issued by National Treasury relate specifically to the role of the trustee in the life of the retirement fund member, both pre- and post-retirement. As the role of the trustee becomes more and more onerous, some may be asking why this is still a worthwhile activity. Well, the importance of the trustee in employer-employee relations cannot be understated and to put it plainly, they are there to negotiate on behalf of those who sometimes don’t fully understand the ins and outs of the retirement fund.

The trustee sits between these two parties and is in an excellent position to feed information back to the employer about the needs and concerns of their workforce. Further, trustees could issue the employer with a newsletter that summarises the transactions of the latest board meetings, major decisions that they have made on behalf of members, the progress of the fund and the projected outcomes of the members, among other things.

Trustees are also the medium of communication when it comes to requesting advice for the members. They can request that education and advice be offered, not only around retirement issues, but around debt counselling, financial planning and risk benefits. They can also ensure that the form of communication is appropriate, easily accessible and that plain language is used.

Finally, the impact of retirement fund reform remains unclear for most ordinary retirement fund members. In a survey carried out by Old Mutual in 2012, it was found that 79% of respondents have little to no understanding of the pension reforms and what is being proposed. Trustees can also play a role here – they can request the preparation of a capacity report that will show each member how much money will end up in their pockets after the reform process. Showing members the impact of the reform process, along with an explanation of how the mechanisms work, can go a long way in improving their understanding.

CAN THIS WORK IN PRACTICE?

Last year Alexander Forbes conducted an in-depth study into the financial health of organizations and their staff. The research showed among other findings that nine out of ten of the employers interviewed were keen to introduce a financial wellness programme to improve financial wellness within their respective organisations. As a follow up, Alexander Forbes piloted a financial education and coaching programme created to help improve the overall financial wellness of employees – to test the theory presented at last year’s Hot Topics and many of the tenets contained in the Benefits Barometer.

Drawing from widespread research on behavioural finance, the pilot was a six-module wealth-lifestyle course. The material was then tested on a group of our own staff and a selection of staff from several employers. The goals were to educate delegates on:

- The measures anyone can take to improve their financial circumstances.
- The psychology behind why some struggle with their finances.
- The misunderstood and hidden dynamics that are working against your ability to improve your finances.
- How to reach a completely new way of thinking when it comes to finance.
- How to plan a winning strategy to help you succeed in your finances.
- Using tools to understand and stay in control of what is happening with your finances.
- Taking the necessary practical steps that lead to success.
- Getting the right support to see you through.

The underlying philosophy is that the six-module course only forms the first steps of the overall programme in which each graduate begins his or her journey to becoming financially independent through an ongoing coaching program that he or she commits to.

Financial wellness and independence should be attainable for everyone who wants it (admittedly it won’t be the same level for all). It is just a matter of education (showing why) and coaching (showing how).

The levels of financial literacy in South Africa are discouraging to say the least. Much effort is made to teach our children calculus, trigonometry, geometry and algebra at school. Financial education like compound interest and time value calculations, which form the basis of wealth creation and therefore are more useful to the majority of our citizens are somewhat ignored or at best, downplayed in our educational system.

We sometimes make finance a complicated subject for the man on the street and express ourselves in a language that most citizens find ambiguous and boring. During the pilot, we spoke to delegates on the subject of money and described some of the measures anyone can take to improve their financial circumstances. We spoke in terms that they could understand and found that when they began to grasp the reasons why they were struggling with their money, the hidden dynamics that were working against them and how to use the strategies of the wealthy to turn their lives around, they found the subject fascinating and were keen to learn more.

But possibly the most meaningful way to evaluate anything, is to hear from the participants:

“I appreciate the valuable lessons learnt from the course. I am usually fairly smug that I manage my finances well. I found out that I have a lot of work to do to get myself into a financially strong position before I retire. I feel like the course put me onto the right road.” K.F.

“This has been an eye opener to me. You presented the complex (and emotional) tasks in simple, easy to understand steps. In summary, you have given me the tools I will pass to my children and hopefully my grandchildren will also benefit.” T.S.

“This course really opened my eyes and it made me realize how little I knew (know). I think that it should be made a compulsory subject in schools for grade 12’s. I can see how older people struggle because they did not plan correctly. Please carry on with this training, educate South Africa and save us from economic disaster.” L.V.

“Fantastic initiative! I’m very impressed and excited to learn more.” K.M.

“I found tremendous value in the course materials that you shared with us and it made me very aware of how I’m spending my money.” J.P.
In an ideal world, we would have unlimited access to healthcare when needed and would be able to afford it throughout our lifetime. This isn’t the case in today’s world however, so something needs to change. There are two main approaches to change: Either we change the system or we change our behaviour and adapt to the system.

Changing the system is an ongoing debate, with National Health Insurance (NHI) a common feature in our newspapers and other media. However, this will take time. The immediate focus therefore is our behaviour and adapting to use the system we already have in the most efficient way.

Saving for retirement is important if one wishes to maintain their current lifestyle in their retirement years and the impact of a few years of not contributing can be significant down the line. It is therefore imperative to start making provisions as soon as possible in order to position oneself to be financially secure. The concept of ‘maintaining lifestyle’ includes maintaining adequate provision for healthcare expenses (including medical scheme contributions).

Given the importance of starting to save today, let’s disregard the opportunity to change the current system, and rather focus on what individuals and employers can do in the short-term, given the current environment. In other words: Let’s set our sails to adjust to the winds so that we sail off in the right direction.

To do so, we need an understanding of the system and its workings. Included in this would be an understanding of the systemic flaws.

UNDERSTANDING THE CURRENT ENVIRONMENT

As set out in an earlier article, reform is a topic that is only discussed when a broken system needs to be fixed. Considering that the current healthcare system that doesn’t meet the needs of all potential beneficiaries, which is to have access to appropriate and affordable healthcare, it is clear that reform, in some form, is needed. In the healthcare industry, this reform comes in the shape of the proposed National Health Insurance (NHI), where the intention is to ensure that everyone has access to appropriate, efficient and quality health services.

The Benefits Barometer highlights ever-increasing medical scheme contributions, which are resulting in a larger proportion of an individual’s income being directed towards medical expenses each year. In it, we explore some of the implications of this for individuals as well as some of the reasons. These reasons included certain regulatory requirements in addition to the increasing base cost of medical care.

In this article we consider some of these reasons in more detail to assist in our understanding of the healthcare benefits system. Improving our understanding of the system in its current form should allow us to better set our sails.

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MEDICAL AID 101

Medical aids (or medical schemes) work on the concept of ‘risk pooling’, where the contributions charged to members based on a combination of the following:

- The expected medical expenses of the entire membership group (claims)
- The costs associated with any administration of claims and day-to-day operations (expenses)
- The interest or returns expected from any positive balances in the medical aid’s ‘bank account’.

In simple terms, a medical scheme could be described by a few main factors, shown in the equation below:

\[
\text{CONTRIBUTIONS} + \text{INVESTMENT INCOME} = \text{CLAIMS} + \text{EXPENSES}
\]

Other key features of medical aids, which are separate from their administrators and other providers, are that they are non-profit entities – all funds belong to the members of the medical aid. In addition to this, medical aids are priced on an annual basis, making them a short-term product.

SHORT-COMINGS IN THE MEDICAL SCHEMES INDUSTRY

The intention of the Medical Schemes Act (the Act)\(^4\) is to facilitate life-staging so that individuals can choose cover that is appropriate to their stage of life, at a suitable price. This is seen by the annual pricing of medical aids, the multiple options that are allowed to be offered (ranging from basic hospital or network plans to fully comprehensive cover), as well as the fact that members may change their benefit option each year if desired. Another requirement of the Act is that all benefit options should be self-supporting which means that each benefit option should be priced in line with the level of cover offered.

However, at present, there are a number of short-comings in the industry which appear to be working against the intention of the Act, making it almost impossible to achieve the desired outcome of affordable, quality healthcare cover at all stages of life.

Understanding these short-comings allows for some insight into the main flaws of the current system that would need to be addressed in the reform of this industry.

\(^4\) Act No 131 of 1998
Voluntary Membership
At present, it is not compulsory to be a member of a medical scheme in South Africa. In addition to this, not all employers make it compulsory to join a medical scheme as a condition of employment, with approximately 41% making it compulsory to join and another 37% making it compulsory for only a certain group of employees to join⁴⁹.

This results in anti-selective behaviour whereby some individuals will elect not to be part of a medical scheme until they are sick and require some sort of cover. This situation undermines the concept of effective risk pooling where the healthy subsidise the unhealthy, so we are left with a situation where the relative proportion of healthy members is reduced, leaving a more unhealthy population on average, and thereby increasing costs.

Those who do not join a medical scheme will either have to obtain cover through self-funding for private care (through out-of-pocket payments) the use of public healthcare facilities or may not obtain any treatment at all.

PMBs and payment in full
Prescribed Minimum Benefits (PMBs) are a list of 270 medical conditions, 27 chronic conditions and any emergency medical conditions, for which all members of medical schemes are entitled to receive treatment and care. This forms the base package of benefits that all medical scheme options must offer with the intention being to provide a basic level of treatment and care for the most common conditions.

Regulation 8 to the Medical Scheme Act, states that medical schemes must pay in full, without co-payments or the use of deductibles, the diagnosis, treatment and care costs of PMB conditions. However, the concept of ‘payment in full’ provides an opportunity for abuse of the system where some providers may charge higher rates for PMB cases which then results in higher overall costs.

Self-supporting benefit options
The requirement for all benefit options of a medical scheme to be self-supporting means that each benefit option should at least break even on an operational level⁵⁰. This requirement however, is not achievable in the current environment.

Where members are reasonably well-informed, they tend to choose benefit options based on their needs, but subject to affordability. This generally results in the more comprehensive options attracting older, less healthy members, which drives up claims costs to a point where contributions would be completely unaffordable if the options were priced to be self-supporting.

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⁴⁹ Alexander Forbes Health Client Survey 2010
⁵⁰ Definition: The operating result of a medical scheme is equal to Risk Contributions less Risk Claims less Expenses. It does not allow for Investment Income.
On the other side of the spectrum, the low-cost, basic plans which are targeted at low income individuals are often priced to produce a deficit. If contributions were set at levels to ensure that these options were self-supporting, they would become unaffordable for the very individuals that they are designed to cover.

As a consequence of the above, what we tend to see happening in the industry at present is that the lower and higher options are being subsidised by the mid-level options. This is clearly not ideal and works against the Act, but forcing Schemes to adhere to this requirement could destabilise the medical schemes industry as contribution rates would become unaffordable.

The table below shows data on the number of benefit options generating surpluses or deficits in the top 10 medical schemes in South Africa and it is clear that mid-level options are subsidising the more comprehensive ones.

**Benefit options generating surpluses or deficits**

<table>
<thead>
<tr>
<th>Benefit richness</th>
<th>Low cover</th>
<th>Medium cover</th>
<th>High cover</th>
</tr>
</thead>
<tbody>
<tr>
<td>% with operating surpluses</td>
<td>49%</td>
<td>64%</td>
<td>30%</td>
</tr>
<tr>
<td>% with operating deficits</td>
<td>51%</td>
<td>36%</td>
<td>70%</td>
</tr>
</tbody>
</table>

Data Source: CMS Annual Report 2012 (based on 2011 Annual Financial Results)

**UNREGULATED TARIFFS**

At present, there are no regulated or guideline prices in place for the fees that should be charged for various healthcare services. This allows providers to charge what they will, and in the case of PMBs, schemes are effectively forced to pay these costs.

**RAPIDLY INCREASING COSTS**

In addition to the short-comings outlined above, there are a few other factors influencing the rising costs of medical schemes. These include, amongst others:

- Technological enhancements in healthcare
- An increasing burden of disease
- Solvency requirements which are in no way related to the risk faced by schemes. (The solvency requirements for schemes could increase or decrease depending on their current risk profile.)

Having a basic understanding of the current environment is a start, but in order to know how to best set our sails, we not only need to understand the environment, but also need to understand why individuals make the choices that they do, and effectively how our theoretical yacht will react in the current conditions.
**WHY DO WE MAKE THE CHOICES WE DO?**

**Lack of understanding**
Healthcare costs have increased at rates higher than inflation for a number of years as shown in the graph below. While medical care and health expenses have increased at an average of 8.4% (CPI + 2.5%), average medical scheme contributions paid by members have only increased by an average of 7.6% (CPI + 1.7%). This has been influenced by a number of member buy-downs to lower cost options, new entrants joining lower options and changes in family size due to the removal of dependants, possibility due to affordability constraints.

![Comparison of Medical Scheme Contributions and Inflation](image)

Source: Statistics South Africa and CMS Annual Report 2012

In response to the increases in the cost of medical care, the healthcare system is becoming increasingly complicated. Medical schemes are being forced to introduce cost-containment measures in intelligent ways, in order to manage the fine balance between providing affordable healthcare benefits and ensuring that members still have adequate cover.

**Ensuring adequate healthcare cover**

**Providing affordable healthcare**

The consequence of this complicated system however, is that it is becoming increasing difficult for individuals to understand exactly what is being offered when it comes to their health-related benefits. This problem affects individuals at two stages: 1) when they need to choose their cover, and 2) when they need to claim.
Choosing cover
With the current complications in the system, benefit brochures are becoming longer and more detailed in an attempt to include all relevant information. When considering some of this detail, one may think that these brochures contain all the information needed to make an informed decision, however this is not so. Detailing the exact protocols, medications and other intricacies would require reams of paper, and even if they were included, would need someone qualified and with relevant experience to interpret their meaning.

Getting treatment
Even once the decision has been made regarding which benefit plan to participate on, an individual’s lack of understanding could result in claims not being covered to the extent that they would expect.

This could come as a result of claiming for benefits that are not covered, utilising one’s entire Medical Savings Account, different rates of reimbursement compared to the actual cost of treatment, the use of service providers not in the specified network and certain treatment protocols not being covered for specific conditions (eg: only certain treatments for cancer being covered, with newer, less well-known treatments not being covered).

These are examples of the types of concepts that individuals should ideally understand when choosing their benefit option and when claiming. It is clear that not understanding one’s benefit entitlements can lead to poor decisions being made with regard to the type of cover required at different stages of life which, as we will see later, could have compounding effects later on in life.

‘Just in case’ cover
Many people want to ensure that they are covered ‘just in case’ something happens, and will often choose the most comprehensive cover that they can afford as a type of security blanket.

Whilst this is not necessarily a bad decision, a lack of understanding of benefit entitlements as well as how claims are accounted for and accumulated, often leads to individuals choosing cover that is unnecessarily comprehensive and that they are unlikely to use.

An example of this misunderstanding would be the fact that all medical scheme options, regardless of comprehensiveness, must provide cover for PMBs in full. As a result, participating on a hospital plan may provide just as much ‘just in case’ cover for a wide range of treatments (per rand) as being on a more comprehensive plan.

In these cases, where people are over-insured (their level of cover is higher than what they would reasonably require), they are putting too much money towards healthcare cover where it could rather be used for other purposes such as discretionary savings.

The behavioural finance aspect
Considering the psychology of decision-making allows for another interesting angle to be explored. Some common behavioural finance concepts may explain the poor decisions made by some individuals.

Often, individuals will choose their cover based purely on the fact that they have always been on that benefit option. Whether or not it is still suitable is irrelevant as people tend to choose what they know. This is the concept of Status Quo Bias or Anchoring.

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52 The Role of Behavioral Finance in the Development and Evolution of Target Date Funds
53 See note 52.
Recency Bias\(^{44}\) considers the fact that individuals will place more weight on the most recent events that have taken place. In a healthcare sense, someone who has been sick in the last year will place more likelihood on becoming sick again and may opt for a more comprehensive plan than their circumstances justify. On the other hand, people who are generally in good health tend to expect that they will remain healthy and may choose a less comprehensive option than required. However, healthcare costs tend to escalate with age which would mean that more cover is generally required the older one gets.

When individuals are faced with many choices, the concept of ‘choice overload’\(^{55}\) occurs. When faced with too many choices, individuals tend to become overwhelmed and to then disengage from making a decision. The medical schemes industry provides members with significant choice, with some medical schemes offering over 10 options each. Adding significant complication to each benefit option makes the exercise of choosing an appropriate plan a rather difficult and tedious one if doing so without assistance.

**THE IMPACT OF POOR DECISIONS**

In the short-term, poor decisions around medical aid will result in members being either over- or under-insured.

The short-term impact of being under-insured is that individuals will be faced with more out-of-pocket expenditure for medical treatment as their benefit option will not provide adequate cover. Individuals who can’t afford these additional expenses may be forced into accepting compromised medical treatment (or no medical treatment at all) and as a result, may end up in poorer health which could result in further claims.

In the extreme case of under-insurance where individuals currently have no cover, choosing to join a medical scheme later in life could result in Late Joiner Penalties being applied, which results in a permanent loading to an individual’s personal contributions for life.

On the other hand, being over-insured (by participating on a benefit option with excessive cover) results in an inefficient use of income which could be used for other purposes. Although out-of-pocket expenses should be minimal, the individual is effectively wasting income that could be used for other household expenditure or as savings towards children’s education or medical cover in retirement.

Over the long-term, the impact of these poor decisions adds up.

In our introduction, we mentioned the importance of saving for retirement and with the poor outlook for individuals’ income in retirement as discussed in earlier articles, any spare funds should be used to try and bolster one’s savings.
The graph below gives an idea of the funds that are needed in today’s terms in order to be able to pay for medical scheme contributions in retirement. The graph is shown for a married male and we assume that the individual will neither resign nor pass away before retirement.

As an example, a married 50-year male intent on retiring at age 60, requires almost R1.56 million in capital today (at age 50), to be able to afford comprehensive cover for himself and his wife in retirement.

Considering the graph below, retiring early increases the capital required today, as there is less time for the individual to save and a longer time period over which payments must be made. Using the same example as above, the married 50-year old male would need another R300 000 (in addition to the R1.56 million) if he wanted to retire 5 years early, at age 55 instead of age 60.

Conversely, extending one’s retirement age by a few years increases the opportunity to save towards retirement and reduces the amount of time spent in retirement. Following on from our example above, the 50 year old married male could reduce his required savings (in today’s terms) by R160 000 if he were to extend his retirement age to 63. Again, this is reflected below.

*Estimated retirement age.
An example
Going back to the impact of a poor decision, let’s consider the case where a 30 year old single, relatively healthy, female is over-insured.

She participates on a comprehensive option with a monthly contribution of R3 000 in 2013, but actually only needs to participate on a mid-level option with contributions that are R1 400 in 2013. Assuming she exhibits the expected or average claim pattern for her status, effectively, she is wasting R1 600 per month that could be used for other purposes.

Now let’s consider her needs in retirement where she would most likely need to participate on a comprehensive plan. According to our calculations, she would need R700 000 in today’s terms to be able to cover these premiums in retirement. If she started saving today, purely for this purpose, she would need to set aside approximately R2 200 per month (increasing each year with contribution inflation) for the next 30 years.

This figure is rather high and it may seem unrealistic to set this amount aside each month purely for medical cover in retirement, but given the correct advice, she could to the following:

- Downgrade benefit options to the plan that costs R1 400 per month.
- This would result in an immediate saving of R1 600 per month (increasing with healthcare inflation each year).
- This amount could then be invested in a savings or investment vehicle and set aside specifically for her medical cover in retirement.
- Using the same assumptions as above, this investment would potentially be worth R 505,000 in today's terms, in other words 72% of the R700 000 required for her medical cover in retirement or seen another way, sufficient capital to fund medical scheme contributions for 21 years of her expected 25 years of retirement.

The above is a simplified example of the impact of one’s decisions on their retirement savings and makes a number of simplifying assumptions. However it does illustrate how a simple change (through a better understanding of benefit needs and entitlements) can make a significant difference to one’s retirement prospects.

The trick here is to ‘know your status’ or be aware of your actual needs. This may require assistance but is worth it in the long run.
SO WHAT SHOULD WE DO?

As mentioned above, medical schemes are priced on an annual basis and members can change their benefit option each year if required. It therefore does not make sense to participate on a benefit option that provides greater benefits than necessary at any point in time. This is because the additional contributions payable for unused benefits will not specifically be set aside to help the individual in later years when more comprehensive cover is required i.e. an individual cannot pre-fund medical expenses within their medical scheme and therefore needs to look elsewhere to house such savings such as retirement funds, retirement annuities and discretionary savings.

Planning for current medical expenses
Being able to choose different benefit options from year to year has the advantage of providing flexibility to individuals as well as an opportunity to change the level of cover according to their needs. In an environment as complicated as the South African medical schemes environment, it is important to ensure that adequate advice is sought.

Seeking suitable advice, through one’s medical scheme broker, should not only ensure that individuals choose the correct plan for their needs, but would also allow them to understand their benefit entitlements and understand what to do to ensure they have as much cover as possible.

As employers, it is therefore not sufficient to merely offer healthcare cover to staff as making the incorrect decisions can cause more harm than good. Employees should also be given the opportunity to educate themselves on the types of cover that they should be choosing, as well as some of the nuances of the system so that they understand their benefit entitlements as far as reasonably possible. This will allow for an optimal use of benefits and minimal out-of-pocket expenditure. In addition, employees should be informed of their entitlement to change benefit options each year and should be encouraged to at least consider how their circumstances may change over the next year and whether this warrants a change in benefit plan.

Planning for future medical expenses
The main dilemma that individuals face when planning for future medical expenses is that healthcare costs are expected to increase as one gets older while at the same time income is expected to decrease. Failing to plan appropriately for retirement could therefore result in individuals being unable to afford the comprehensive cover that they require in their retirement years which could lead to significant out-of-pocket expenditure as well as a significant deterioration in their health.

Although the costs of medical cover are rapidly increasing and the situation may seem rather dire, the example on the previous page illustrates that one or two simple changes can have a significant impact on the future.
CONCLUSION

The topic of personal finances is one that is often avoided and leads to a lack of understanding and hands-on management. People usually only worry about finances when they don’t have enough, and at that stage, it is often too late.

Critically, too narrow or short term a view on any employee benefits issues, whether they be medical, insurance or savings related, will not take into account the fact that the employee benefit system is interconnected. This will result in sub-optimal outcomes, at a time when resources seem stretched to the limit.

It is thus extremely important to ensure that employees are educated about their current benefits and about the impact of today’s choices on their future. Illustrating the benefits of informed decisions should encourage further learning and education and at the end of the day, should result in their being able to weather the storms that lie ahead.

We would like to thank the following Alexander Forbes employees who contributed to this work:

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