

Defined Contribution Risk Arrangements

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This is the second in a four part series of articles in which Old Mutual looks at the increasing cost of group risk benefits and the possible actions that retirement funds can take in order to mitigate escalating costs. In this article we will be looking specifically at Defined Contribution risk arrangements as a possible solution.

A long-term solution to combating escalating group risk costs

The late 80's and early 90's saw a lot of South African retirement funds, particularly within the private sector, convert their retirement benefit design from a Defined Benefit (DB) arrangement to a Defined Contribution (DC) arrangement. In addition to providing improved withdrawal benefits to employees, the move to a DC arrangement also allowed employers to contain retirement costs through the transfer of investment risk to employees.

For some funds, risk benefits were also converted from DB to DC. At the time group risk mortality experience was still at manageable levels, hence for other funds there seemed no need to convert risk arrangements as well.

Since then, the Aids situation in South Africa has significantly worsened the mortality experience of most funds. For funds facing escalating risk costs that "missed the boat" and did not convert risk benefits with retirement benefits, the long-term cost-containment advantage of a DC risk arrangement provides a compelling reason for biting the bullet and effecting conversion as soon as possible.

What is a defined contribution risk arrangement?

A DC risk arrangement allows for a fixed contribution, defined as a percentage of the salary bill, towards the purchase of risk benefits. The benefits are then determined based on what can be purchased with the fixed contribution rate, as opposed to a traditional DB risk arrangement where the level of benefits is chosen first and then the contribution rate is determined. Benefits are reduced as the cost of providing cover increases.

How would you structure the arrangement?

1. Define the fixed contribution towards group risk benefits

The first step is to define the fixed contribution towards risk benefits. The future sustainability of the fixed contribution rate would need to be considered in terms of the trade-off between retirement savings and risk benefits and what the employer is ultimately willing to contribute towards both.

2. Decide on the structure of the cover

Once the fixed contribution rate is determined, the benefits can be structured in one of two ways:

2.1 The same cover for all members

This arrangement allows members to enjoy the same level of cover regardless of their risk profile.

Older, higher risk members are cross-subsidised by younger members as the cost of their cover is more expensive and yet they receive the same cover. These cross-subsidies may be viewed as unfair or inequitable as younger members have no guarantee that they will be cross-subsidised when they are older.

This is a simple structure, on a yearly basis the affordability of the level of cover will be reviewed and any changes will affect all members in the same way.

2.2 Cover for members based on their age

Under this arrangement, members are grouped into age-bands chosen by the fund. The level of cover that the fixed contribution can purchase is determined separately for each age-band. This typically results in a reducing cover profile; older members with higher mortality risk receive less cover, reflecting the higher cost of their cover.

A reducing cover profile could be viewed as acceptable given that the total benefits that would be paid out at death would be the sum of the member's accumulated credit and death benefit. The graph at the bottom of the page illustrates the total cover as a multiple of salary (accumulated credit plus group life cover) across different age-bands.

In this example members at the youngest age-band (18-35) receive group life cover of 9 times salary and very little accumulated credit (0.5 times salary) whereas members at the oldest age-band (61-65) receive very little group life cover and a high accumulated credit. In general as member's age, their increasing accumulated credit will dovetail with their decreasing group lifecover such that over time, the total cover remains stable (around 10 times salary in this case).

A good DC Risk arrangement provided by an insurer should allow the fund flexibility to manipulate the cover profile to produce benefits appropriate for the fund within a fixed contribution context.

3. Provide options for members who lose cover

Older members could lose cover on conversion from a DB to a DC risk arrangement. In addition, all members will lose cover as they move from one age-band to another under a reducing cover profile.

As a compromise a fund could offer members a limited guarantee-period of cover on transition from defined benefit to defined contribution; for a limited period of time (e.g. 2 years) existing members could retain their defined benefit level of cover while they make alternative arrangements on an individual basis to top-up cover that they will lose at the end of the period.

The voluntary top-up of individual cover lost by members could be more cost-effective if implemented on a group scheme basis. For such a group scheme, an insurer would normally require a minimum take-up percentage for the voluntary top-up of cover.

4. Register the rule change

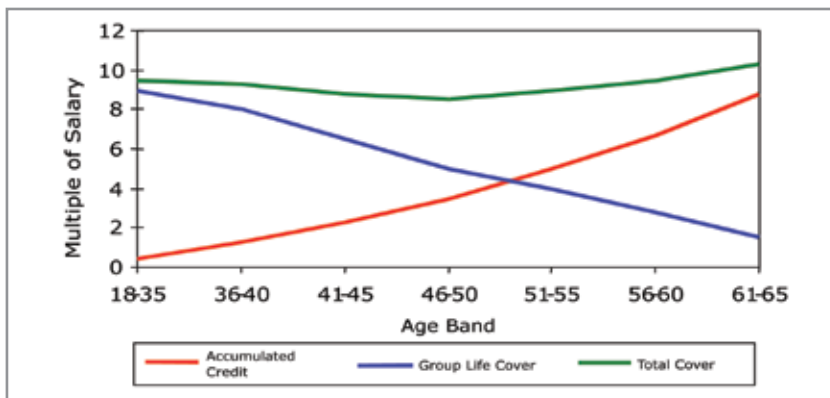
For a registered fund, the change from a defined benefit to a defined contribution risk arrangement would constitute a rule change. The new rule would need to be approved and registered with the registrar of pension funds before being implemented.

The administrative challenge

The administrative challenge is one of the perceived drawbacks of a defined contribution arrangement. In a reducing cover profile arrangement, communication would need to go out to members informing them of their reduced cover as they move from one age-band to another. In addition where funds allow members to voluntarily top-up cover lost through a group scheme, additional insurance premiums would need to be accurately collected from members who exercise the option.

Employers with a good HR capability should be able to handle these challenges effectively. The real difficulty is not with the administration of a defined contribution arrangement but more in getting buy-in from members who will no longer be able to enjoy a guaranteed defined cover. Some funds have dealt with this by implementing a defined contribution arrangement on a compulsory basis for new employees, while offering existing employees the option to move to the defined contribution scheme. The defined benefit risk arrangement is then closed to new entrants.

Ultimately, there is a very strong case for moving towards a defined contribution risk arrangement, which is a long-term solution for curbing the escalating cost of risk benefits. Future articles will look at other alternatives for dealing with increasing costs, namely flexible risk arrangements and pre-benefit testing.



Total cover as a multiple of salary (accumulated credit plus group life cover) across different age-bands