



Flexible Risk Benefits

This is the third 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 the Flexible Risk Benefits approach to risk arrangements, the advantages of such an approach; and why this approach is still not common in practice.

What is a flexible risk benefits approach?

The basic concept behind flexible risk benefits is that each member of a retirement fund chooses a level of death and disability cover that fits in with their individual life cover needs. To give an extreme example, a bachelor aged 55 with no dependants may need far less cover than a woman aged 30, with three young children, who is the sole breadwinner in the family. Our bachelor would possibly prefer to put a greater proportion of retirement fund contributions towards saving for retirement, whereas the young mother may want to make a significant contribution towards protection against the risk of death and disability.

In practice, a typical flexible risk benefits approach would include a level of cover that is compulsory for all members (often known as "core" cover.) This will be done on the premise that everyone should have some basic monetary protection against unforeseen events. Members will then be able to choose varying levels of "top-up" cover, and would usually be able to adjust this level on certain life events, such as marriage and the birth of a child.

Advantages of flexible risk benefits

As a response to the issue of increasing costs of risk cover, flexible risk benefits make a lot of intuitive sense in that they pass the choice of balancing risk and retirement contributions

on to the member. Members who have less need of potentially expensive risk benefits will be able to save more for retirement, whereas those who need the risk cover will be able to get it.

At a philosophical level, flexible risk benefits allow an individual choice rather than a "big brother knows best" approach that sets a single benefit level for all members. It is consistent with current trends towards more flexible remuneration and transparency. As the rates for the flexible portion of cover are normally differentiated by age, it also eliminates some of the cross-subsidies inherent in traditional risk cover.

So why don't we see more of these arrangements?

Based on the above, one might be lead to believe that all retirement funds would be queuing to move to such arrangements. However, the reality is that there are very few of these around in practice. There are a few reasons for this, and these are described below.

i) Complexity for members

Flexible risk cover requires each member to make an individual choice on an appropriate level of life cover. For members to make a decision, a reasonable amount of financial education is required. This is because members will need to be able to assess their own life situation and then translate that into a monetary

amount of life cover. This would often require expert financial advice that should be given by someone who is accredited under the FAIS regulations, and this would add another level of administration to such arrangement. It may be possible to provide members with a simple computerised tool to assess their own life cover needs, but this would still require some level of financial sophistication and computer literacy. The employer may also have a reputational risk if someone chooses a low level of cover which turns out to be inappropriate and leaves that person or their dependants in a difficult financial position after death or disability.

ii) Cost

The cost of flexible cover will be greater than that of conventional risk benefits in which everyone has the same level of cover. This is due to the risk that people may choose higher levels of cover if they know they have an increased likelihood of claiming. Put another way, someone in poor health is likely to choose more cover than someone in good health, and this increases the overall likelihood of claims for the insurer. This means that the cost of the "top up" cover will be more expensive than group cover obtained on a compulsory basis. It should be noted that the overall cost of risk cover will probably be lower for the employer, as the level of "core" cover provided will generally be lower than the level of benefits provided on a compulsory, "one size fits all" basis.

iii) Administration

Group risk benefits are based around simple administration as a result of the simple benefit structures and compulsory nature of the cover. As soon as you have individual members having the option of setting their own levels of cover, the amount of administration increases somewhat. This is due to greater record-keeping requirements, increased amount of medicals required for members, increased complexity of reconciling different levels of premiums from each member, and administering differing splits of retirement and risk contributions. It should be noted that technological advances and better administration systems have made these arrangements much more practical in recent years.

Conclusion

Flexible risk benefits is a very valid option in addressing the risk costs issues, and it ties in with current trends encouraging individual choice and transparency. The group insurance industry has seen an increasing interest in this as a possible benefit structure, and one may see a greater adoption of this approach in the future. While every retirement fund will need to consider this approach in the light of their own circumstances, and note the challenges set out above; as a general rule, the flexible approach may work better for organisations that

- (i) are reasonably large, in order to spread the administration overhead
- (ii) have some level of financial sophistication across the workforce.

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