Reassess your risk life cover regularly

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Illustration: Colin Daniel

When did you last assess how much life assurance risk cover you need for such things as early death or being unable to work because of severe disability; or even whether the life assurance cover structure you have actually meets your needs?

The chances are, if you do not have your risk life assurance cover revised on a regular basis, that your cover is out-moded, incorrectly priced and simply does not meet your needs.

The reason is that risk life assurance has changed significantly over the past 50 years and is still changing dramatically – but not every change may have been in your best interests.

To get the best value for money you need to keep a constant watch on two main issues, namely:

u **Cost.** There is lively competition between life assurance companies, increasingly on price, but be warned: cheap is not necessarily in your best interests. Next week we will publish research undertaken by True South Actuaries and Consultants on behalf of newly created life assurance company BrightRock, which will demonstrate why taking the cheapest premium when you are young can be dangerous for your long-term financial security.

* **Changing needs.** Risk assurance should be based on your long-term changing needs. For example, when you are young with dependants, your main need will be to support your family in case something happens to you. When you are older and richer you may need life assurance to cover estate duty and capital gains tax when you die.

It is not a matter of assessing your needs once and then simply escalating the amount in line with inflation.

Depending on your needs, you may have too little life assurance when you are younger and too much when you are older.

In a six-part series every second week over the next 12 weeks, Personal Finance will tell you about your need for risk life assurance and what you should take into account to get the best value for money.

Assurance arose from people pooling money

Life assurance is about people clubbing together to share risks they otherwise could not afford. The main risks are dying or being disabled and being unable to support yourself or your dependants. By pooling together regular payments (premiums), when the unexpected happens you and your dependants are then assured of financial security.

Life assurance as we know it today started on a co-operative basis, in much the same way as stokvels operate, where club members pool money. In the case of life assurance, the club members and their dependants could draw on this pool in the case of death or being disabled and unable to work.

Many of these initial clubs grew into massive organisations, mainly as mutual societies. These organisations were owned by their members (policyholders), but the members actually had very little say in the running of the organisation.

The Professional Provident Society is the biggest mutual society left in South Africa after the demutualisation of Old Mutual, Norwich and Sanlam.

The original mutual companies very quickly developed into competitive businesses which, among other things, had to offer keenly priced premiums to attract new members (policyholders).

One way to do this was to wisely invest the money that was being received in premiums from policyholders. The better the investment returns that could be made from the pooled premiums of policyholders, the lower could be their monthly premiums.

This gave birth to professional asset management.

The life assurance organisations then realised that they could profitably put the services of their asset managers to work by selling investment products as well as risk assurance.

Most of the early products combined both risk assurance and investment into a single structure (universal policies) that would pay out the greater of your accumulated savings (plus investment returns) or the death value if you died. If your policy matured before death you were paid the accumulated cash value of your savings (plus returns).

Historically you were not given much investment choice, with your money being placed in balanced portfolios and all the investment decisions being made by the life assurance asset managers.

This was a very cosy set-up, but one which increasingly allowed for greater exploitation of consumers, who were increasingly sold products that were built around the incentives paid to sales staff and profits for the company rather than consumer needs.

On top of this, many structures were built in to prevent your cancelling your policy before its maturity date. These structures included paying a penalty of as much as 100 percent of your accumulated savings if you reduced or halted payment of premiums, or losing out on what was called a terminal bonus – a poorly defined bonus for staying faithful to the end.

So even if you realised that costs and poor investment returns were playing havoc with your savings targets, you were a captive customer because of the penalties and the loss of your life cover. And you could not reduce your life risk assurance either without paying a penalty.

The structure, however, began to splinter slowly. In 1957, Donald Gordon opened shop with Liberty Life, a privately owned company, which would list on the Johannesburg Stock Exchange five years later.

The main thing he did was to offer what are called market-linked policies where you could see the value of your investments, which was tied to the actual value of the underlying investments.

In 1966, Momentum Life was established, also bringing innovative products to the market.

But poor investment returns, contractual commitments and the rigid structure of the products that kept you locked in for many years continued to cause problems. Professional asset managers saw the opportunity of giving investors better returns on their savings than what the life companies were achieving.

So was born the unit trust industry. It started slowly, and its clarion call was virtually that you should buy risk life assurance and invest your money elsewhere, namely in unit trust funds.

The unit trust industry really got off the ground only in the 1980s, when billions of rands suddenly started becoming available to the industry from investors seeking better returns than those offered by the life companies.

The consequence has been life assurance companies now competing with pure risk products that have become increasingly complex.

SA’s retirement fund revolution

One major reason why South Africans are under-insured when it comes to life risk cover is because of the move during the 1980s and 1990s to convert retirement funds from defined benefit (DB) funds to defined contribution (DC) funds.

Under the DB regime members knew what pension they were entitled to, and the employer took the risk of ensuring there was sufficient money in the pot. The switch to DC funds meant that members had to start taking responsibility for how much money they saved for retirement.

The total assets of the retirement fund industry dwarfed, and still do, the savings of individual investors.

The retirement industry has also increasingly been a major source of life assurance business, with retirement funds using their size to negotiate better life assurance risk rates for their members.

The change from DB to DC schemes also held out challenges for the life assurance risk business.

Most DB funds simply assured their members for a fixed amount of cover based on a multiple of annual pensionable salary, which averaged two to three times annual salary.

However, a non-member spouse would also receive a pension calculated mainly on a projection of the member having been a member from date of employment to date of retirement.

In the DC environment, the calculation of the assured benefit becomes problematic because a non-member spouse will receive from the retirement fund only the amount of money saved plus investment returns and then an assured amount as a multiple of salary.

So if, as a member, you die young, before being able accumulate much in the way of retirement savings, the life assurance component, as a multiple of salary, will not be sufficient for the requirements of your dependants.

On the flip side, however, a member nearing retirement would need very little life assurance cover.

This has left a significant retirement fund life assurance gap that needs to be filled. Retirement fund members are now starting to be offered products where they can select above a certain minimum how much of their contributions will go to savings and how much to life assurance; or they are being offered assurance products which start at a much higher level of benefit when

they are young (say, eight times annual pensionable income) and which reduce to one times salary near retirement.

But in the main, the old multiple of salary remains, meaning that fund members, particularly younger members with dependants, need to ensure that they have sufficient life assurance cover.

Most South Africans are woefully under-assured

This year about 160 000 South African income earners will die and an estimated 52 000 earners will suffer total and permanent disability.

As sad is the fact that most will have dependants who will not be able to maintain their current living standards. The reason is that very few will have had life risk assurance, or sufficient assurance.

Two years ago a major study undertaken by True South Actuaries and Consultants on behalf of the industry association, the Association for Savings & Investment SA (Asisa), found that South Africa's 12.4 million income earners between the ages of 16 and 65 are woefully under-assured – by about R18 trillion – against death or a calamity that would leave them unable to work.

Most South African families would be forced to cut their monthly spending by about a third on the death or disability of a breadwinner, Asisa deputy chief executive Peter Dempsey said at the time.

The researchers found the only people who come anywhere near being fully insured against death are higher-income earners over the age of 55 who have saved enough and who have group life assurance attached to a retirement fund. On the disability side, however, this group is also under-assured.

Single people are most likely to be over-assured, and top earners and breadwinners with a tertiary education are more likely to have life assurance.

The people who are most exposed to potential financial disaster, particularly if they were to become disabled, are those under the age of 30.

The research found that the average South African income earner is under-assured by 62 percent for death and 60 percent for disability; or by R600 000 in the event of death and by R900 000 in the event of disability.

So, if you are Mr or Ms Average and the main breadwinner in your family dies or is disabled today, you will either have to cut your living expenses by between 30 and 34 percent, on average, or earn more – an extra R3 177 a month if the breadwinner dies or an extra R4 696 a month if the breadwinner is disabled and unable to work.