

Risk cover must be adaptable

August 12 2012 at 12:10pm
By Bruce Cameron

You need risk life assurance for a number of reasons, but, in effect, risk assurance does one thing: it provides cover for loss of income. You are buying cover against the risk of being unable to earn a living, either temporarily or permanently, because of illness, injury or death.

However, your reasons for taking out risk life assurance will vary over the course of your life. Marriage, having children, inheriting a substantial amount of money or building up a small fortune are examples of the changes that will affect the amount and, importantly, the type of life assurance that you will require at different stages of your life.

Traditionally, life assurance has been sold in separate bundles, both in terms of what the policy covers and the periods covered. For example, when you are younger, you will have one policy to cover debt on your home, another policy to ensure either that you will have sufficient money if you become disabled and cannot earn a living or that your dependants will have enough money if you die prematurely, another to pay for your children's education and another for dread disease.

The cover is for "whole of life" – that is, you are covered until the day you die. Often, the amount of cover will be increased each year to take account of inflation.

Traditional life assurance does not take account of your actual needs – you may need less or more cover at any stage of your life, depending on your commitments and how wealthy or poor you are.

And if your circumstances do change, such as having children later in life, you may then find that you are unable to buy additional life assurance because your health has deteriorated.

On the other hand, you may find that a change in circumstances has resulted in your being over-assured, which means you are paying out money needlessly.

The effect of changing circumstances on the amount of life assurance you need has been exacerbated in recent years by the disappearance of the "job for life". The "job for life" meant it was highly unlikely that you would be retrenched and unemployed. Importantly, it also meant you belonged to a defined benefit (DB) retirement scheme that paid you a guaranteed pension based on your final pay cheque at retirement. And you were also covered against disability, with your payout based on a multiple of your pay cheque. The defined benefit schemes were usually the traditional pension schemes, where at retirement you got a pension from the employer.

All that has changed.

Anyone can face retrenchment and unemployment, and in the private sector DB retirement funds have largely been replaced by defined contribution (DC) funds. Defined contribution schemes are usually provident funds; where at retirement you get a lump sum, which you have to manage.

From an assurance point of view, DC funds mean you need:

- * A lot more life assurance when you are younger, with the cover normally a multiple of your annual income plus what you have saved in your retirement fund; and
- * Less life assurance when you are older and have accumulated retirement savings. By that stage, you will probably have fewer dependants and you will have a lot more money at your disposal in your retirement savings.

The change from DB to DC funds, where members take responsibility for their fund's underlying investments, has changed the way investments are sold.

In the initial years of DC funds, investments were packaged mainly as balanced funds, with a set amount being allocated to the different asset classes. But over the past 10 to 15 years, there has been a dramatic switch to lifestage investing, where the asset mix in the investment portfolios changes to take account of the increasing inability of people approaching retirement and in retirement to sustain shocks to their savings.

Unfortunately the life industry has trailed way behind these changes, continuing to sell life assurance in fairly rigid packages.

What is required, is needs-based assurance (the life assurance version of lifestage investing), which allows you, with a single package, continually to adjust your life assurance cover without having to buy a new, or cancel an existing, policy whenever your personal circumstances change.

Equally important is the fact that you will not face being unable to buy affordable life assurance when you actually need it.

Ideally the days when, you need one policy are gone. A multipronged approach is a pro-active manner to tackle your needs. For example, when you are young and have children, a policy will provide for their education should you die prematurely or become disabled and are unable to work. Then, once your children have left home, the education policy could be closed down and another one that will provide cover for other expenses, such as estate duty and capital gains tax on death, could be increased, in line with your increased wealth.

In other words, your risk life assurance will change as your needs change over time.

Malan says that structuring your life assurance around actual needs makes your assurance more affordable, because you will pay only for the cover you require.

Traditional products are structured around the events that will trigger a payout – namely, the three D's of death, disability and dread disease – rather than around the financial consequences you face as a result of having to claim.

With traditional “3-D” products, “there is no visible link to your actual needs and how your needs will change over time. This creates inefficiency, which has an impact on the long-term relevance and affordability of your cover,” he says.

Traditional risk life assurance products are priced in advance over the lifetime of the policy. In many cases, the result is that you pay now for cover that you will never need. This, coupled with affordability constraints, often results in your compromising on the amount of cover you buy.

By contrast, the focus should be on making sure your assurance is relevant and appropriate, both for the events it covers and your underlying financial needs, he says.

WHY IT PAYS TO BUY ASSURANCE FOR SPECIFIC NEEDS AS THEY ARISE

Your risk life assurance can be grouped efficiently into six distinct financial needs: debt, health care, education, household expenses, estate duty and additional illness- and injury-related needs. These groupings are based on how the different needs tend to behave over time.

Once your specific needs among the six financial needs have been determined, you can specify the cover you require for each one. You can make choices about the term (number of years), growth in cover (to keep pace with inflation) and payout structure of your cover, for assured events and financial needs.

For example, for education cover, you can choose to:

- * Increase your cover at a faster rate than the consumer price index, while your cover for your other needs grows in line with inflation;
- * End the cover for each child between the ages of 18 and 24, depending on whether you expect to finance their tertiary education, and if you do, when you expect each child will graduate; and
- * Have the policy structured so that it will pay out a lump sum or a monthly amount to meet ongoing education costs.

Your policy should also be designed so that it will pay claims more than once. For example, you may need the policy to pay out when you contract a dread disease and then again if you become permanently disabled or on death.

There are five important benefits to matching your risk life assurance more closely to your needs. They are:

1. You will know what you are getting. Your cover will match your existing needs. You will not buy cover now for a need that may or may not arise in future.

2. Your cover will remain relevant. Life assurance must be adaptable so that it can meet three requirements:

- * The ability to increase your cover to take account of a new specific need (for example, the birth of a child) without necessarily having to go through the whole underwriting process (a risk assessment, including a health check-up) again. This will be to your advantage if your health has deteriorated in the interim.
- * The option to convert cover that was taken out for a financial need that has now fallen away (for example, your children's education) into more cover for another, still relevant need (for example, to pay estate duty); and
- * The ability to end the cover once a need has fallen away. Your life assurance should match your needs at every stage of your life, so that your cover will remain as relevant as it was at the inception of the policy.

3. You will pay only for what you need. Your cover will be more cost-efficient, because the product is structured to bridge shortfalls and remove waste, making it possible to apply your premium more effectively. In this way, funds are freed up that can be deployed elsewhere within your risk portfolio. In addition, your premiums will be sustainable, because future premiums will be appropriate to your needs.

However, you should also structure your policy so that it is priced properly. Many people choose to "buy now, pay later" so they can afford life assurance, with the result is that you may have to pay a substantially higher premium as you grow older. Your assurance cover must be cost-efficient from day one to ensure you will still be able to afford the cover when you are older.

4. You will have a better understanding of what your policy covers and how it does this. If, because of affordability constraints or other reasons, you find that you are under-assured, you will have a better understanding of these shortfalls and their potential impact on your financial plan.

5. Reviewing your cover. You can expect and request your financial adviser regularly to review your financial risk and your policy to ensure that your cover stays on track to meet your changing needs.

Most life assurance policies state what you are covered for, but a direct link is not made between the policy benefits and your financial needs and the needs of your dependants.

HEALTH WARNING

Don't be a statistic – act today to ensure that you have the risk life assurance you need.

- * Some 160 000 income-earners died in 2011;
- * Some 52 000 income-earners incurred a temporary or permanent disability in 2011;
- * Some 212 000 families suffered from financial distress, which affected their finances; and
- * A typical South African family will lose 50 percent or more of its household income after a tragedy because the breadwinners do not have sufficient life assurance.

Source: Association for Savings & Investment SA

NEEDS-BASED LIFESTAGE ASSURANCE

- * **Household expenses.** This need is based on calculating the type of lifestyle that you and/or your family will want to maintain if you are no longer able to earn a living due to disability or death. The amount of cover will vary based on the number of your dependants and for how long they will be dependent on you.
- * **Debt.** Your debts that require assurance can range from short term to longer term. Usually, however, this cover will last for about 20 years but is likely to decrease over that period.
- * **Education.** Cover to meet this need will be required for a limited term, which will depend on the number of children, their ages and aspirations.
- * **Health care.** This need will grow over time, because the older you get, the more likely it is that you will need quality health care. The challenge is that, historically, medical inflation has been higher than headline inflation. The main expense that you need to cover is your contributions to your medical scheme.
- * **Additional illness- or injury related-expenses.** You will require assurance to meet unforeseen and unpredictable costs arising from an injury or an illness that are not covered by your medical scheme. This cover will be for your entire life and should grow in line with medical inflation.
- * **Estate duty.** The extent of cover for death taxes will grow as you get older and richer. This cover is required to pay the estate duty and capital gains tax that will be levied on your assets, over and above the permitted exemptions. Cover for estate duty is particularly necessary if you hold illiquid assets that may be difficult to sell at their true value if market conditions are adverse when you die.