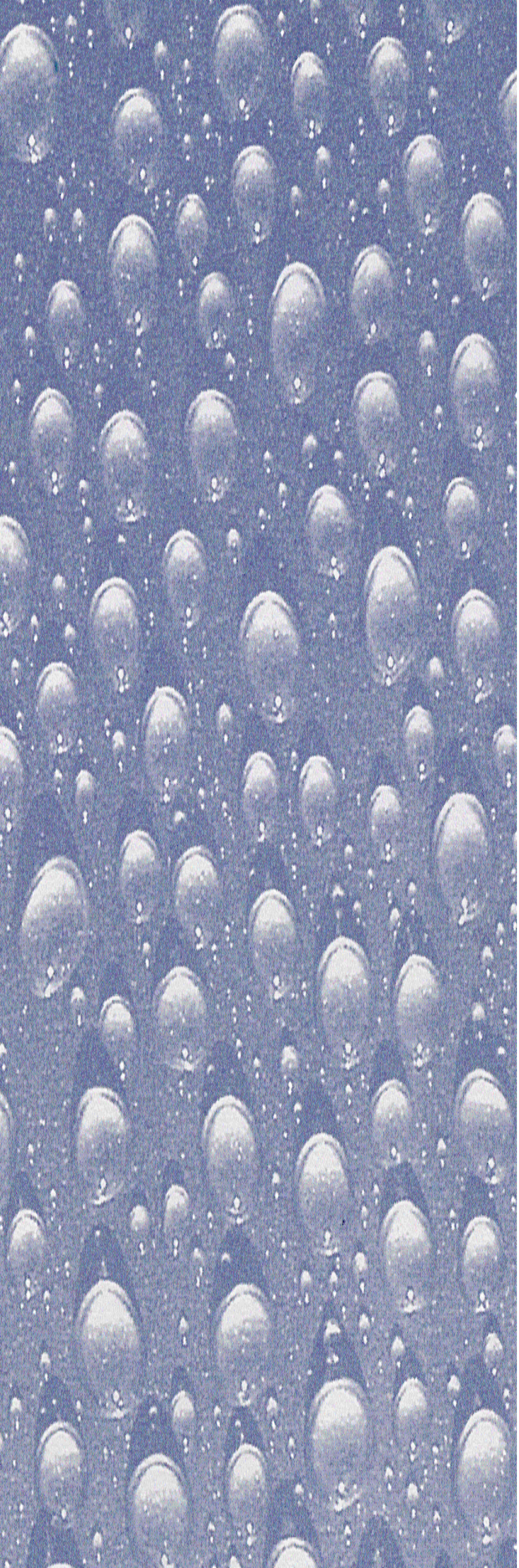

EMPLOYMENT SECTOR

– SOCIAL FINANCE PROGRAM –

The Poor and Voluntary Long Term Contractual Savings

Lessons from South Africa

J. Roth, R. Rusconi, N. Shand

Working Paper No. 48

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Geneva

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Acronyms

AMPS	All Media and Products Survey (South Africa)
ASCRA	Accumulating Savings and Credit Association
ATM	Automatic Teller Machine
FSA	Financial Services Authority (UK)
GDP	Gross Domestic Product
ILO	International Labour Organization
IMF	International Monetary Fund
LOA	Life Offices Association (South Africa)
LSM	Living Standards Measure
MFI	Micro Finance Institution
PPP	Public Private Partnership
ROSCA	Rotating Savings & Credit Association
UNDP	United Nations Development Programme
VLTCS	Voluntary Long Term Contractual Savings
ZAR	South African Rand

Executive Summary

The market for voluntary long term contractual savings (VLTCS) products aimed at low-income clients appears beset by market failure. There seem to be large numbers of low-income clients willing and able to pay for VLTCS products, but yet are unable to obtain them. When they do manage to make a product purchase, the products, often prove to be of disappointingly poor value. This paper investigates why this is the case and suggests ways to improve the situation. It does so through an examination of the low-income VLTCS market in South Africa, one of the few places with an established low-income VLTCS market.

The researchers conducted a survey of VLTCS clients in South Africa and found that a significant proportion of the respondents with VLTCS products were drawn from the poorest section of South African society. In addition, the researchers found that many of the respondent households were dedicating a major part of their total household income (in some cases up to 10% of it) to VLTCS. This was not anticipated. One would have expected that poorer household would need to consume more of their income and therefore have less of it to save. Yet respondent households placed an enormous importance on such savings.

VLTCS policies were bought for a range of purposes. As anticipated from the demand studies conducted elsewhere, chief among them were to provide for education and old age. With respect to education, respondents were keen to save for their children’s tertiary education, an action seen as key in the escape from poverty. With respect to old age, respondents were concerned that the state pension that they would receive would not be sufficient, and additionally, they wished to avoid depending on their children in their old age. Most respondents who had purchased VLTCS to alleviate old age poverty viewed their VLTCS products as a complement to the state pension. The majority of respondents saved little more than the equivalent of four years of a state pension.

There were other less significant reasons for buying VLTCS products. These included the need to save for a large physical asset (such as real estate) as well as the usefulness of the product for obtaining credit from formal lenders (it is an acceptable form of collateral). Respondents distinguished carefully between VLTCS products and

other types of savings such as flexible savings in banks or through informal mechanisms. The idea of a contract with some degree compulsion to save regularly proved to be an important motivation for choosing these products over more flexible ones.

One of the likely causes of market failure in the provision of VLTCS products to the poor is related to the difficulties in selling and servicing the products. In contrast to VLTCS products, short term savings products, like open-access passbook type savings schemes, are relatively easy to sell. They are simple to explain, they do not require any significant initial commitment, and because they are short term, the client soon has a demonstration of how they work. Once the term of the product gets longer, the difficulties associated with selling the product also grow. VLTCS are a significant commitment for anyone. For poor people with multiple demands on limited household income some convincing is required to get clients to buy the products.

Like insurance products, VLTCS are “sold not bought”. VLTCS are rarely sold passively, through a client coming to a bank or an MFI and requesting a product. More typically a salesperson needs to develop a relationship with the client, using selling techniques akin to those of insurance - "What will happen to you when you grow old? Who will take care of you?" etc. The salesperson needs to reassure the potential client that the institution is stable and safe because unlike short term savings, the client has no immediate way to test the seller’s claims. Moreover, even if sales could occur without such an individual, there are questions as to whether they ought to. VLTCS products are almost certainly among the largest and most important financial commitments an individual may ever make. There is a need for some advice.

So without a well motivated, well-remunerated seller, there would be limited sales. At least this has been the historical experience of South Africa. This explains why VLTCS products are sold predominantly through insurance companies rather than banks. Insurance companies have a network of individual sellers, trained in selling similar products.

Banks do however play a large role in the distribution of VLTCS. Almost all respondents with VLTCS policies had some kind of bank account with an electronic debit facility from which monthly deposits were taken. This process dramatically reduces the transaction costs of both the buyer and the seller. It also helps the buyer to avoid the temptation to spend their savings by deducting them before they have the chance to spend them.

All the existing products available on the South African market were analysed through the lenses of affordability, costs (charges), flexibility and the quality of the documentation. Entry level premiums on products were found to go as low as $7 per month, but most were double that.

Charges are complex to compare because the products differ in the features. Some for example provide (or at least claim to provide) more advice than others and some offer more flexibility than others. The range of charges is significant. Of the six VLTCS products available at a monthly contribution of R100 ($14), the cheapest is obtainable at an annual cost on assets of 3.25%, the most expensive at nearly 11%. The equivalent aggregate impact on total savings varies from under 16% to over 40%. The key concern that the authors have with the charges is the almost total lack of transparency about the charges. It was not possible to obtain any information on charges without first taking out all of the policies and then cancelling them. Even with the policies in hand it required an actuary to calculate the charges from the information provided.

Flexibility refers broadly to the extent to which the product allows some early withdrawals. Most products penalised very early withdrawals heavily because the providers paid their agent’s commissions up-front. There was however a strong variability in the degree of flexibility indicating possibilities for improvement. Almost all products had extremely poor documentation that was very hard to obtain. Not only was the documentation hard to obtain but in many cases also difficult (even for an actuary) to understand. The combination of not being able to obtain documentation and not being able to understand the documentation even if they get hold of it effectively means that consumers cannot shop around.

In all, only a quarter of respondents with VLTCS products were happy with them, i.e. they knew the key terms and conditions, bought VLTCS for an appropriate purpose and have had a generally positive experience with the products and their providers. The positive take on this is that it is possible to provide quality VLTCS products to the poor.

The bulk of respondents were not happy customers. Clients were unhappy with their products for a variety of reasons. A significant cause of this unhappiness was that they were unaware of key terms and conditions of the policy. Mostly clients tended to be unaware of early termination penalties, believing that they would get back at least what they had put in, even if they stopped saving before their policy matured.

Policy makers in South Africa have paid relatively little attention to the potential role of VLTCS products. The reason for this is that the products are perceived to offer poor value to low-income clients. Until they offer better value they are not likely to receive much attention from policy makers in South Africa or elsewhere. There are number of interventions that policy makers, regulators and providers could make that would greatly improve the quality and quantity of VLTCS products sold to the poor in South Africa and in other countries. They include:

- Creating systems to collect national level data on VLTCS usage by the poor.
- Recommendations for reforming the tax on VLTCS products used by the poor.
- Considering setting a ceiling on agent's commission levels, prescribing the structure of agent's commissions and considering placing a floor on early termination values.
- Compelling providers to disclose the details of the products in ways that can be understood by low-income buyers.
- Compelling providers to change agent's incentive structures in order to motivate agents to better consider the long term interests of their clients

And with respect to providers:

- Looking at ways to reduce selling costs through market education and simplified products.
- Improving voluntary disclosure.
- Voluntarily reconfiguring agents incentives.

One bold way of expanding the provision of high quality VLTCS products to the poor may be in the form of a public private partnership, an option explored in detail in the final chapter.

In most developing countries with aging populations and poor or non-existent provision for old age there is a huge potential market for quality VLTCS products. However, unless the value of VLTCS products can be improved, they are not likely to attract the attention of either potential policy holders or policy makers. The first step therefore is for states, donors and providers to look at the causes of poor value and work towards improving the quality of VLTCS products sold to the poor. This paper provides an analysis of some of the causes of poor value VLTCS products and provides recommendations for preliminary steps which could be taken to improve the quality of VLTCS sold to the poor.

1. Introduction

In its simplest form a contractual saving scheme is a relationship between a client and deposit taking institution in which the client undertakes to regularly deposit an agreed amount for a set period of time. At the end of the period the client can withdraw their funds, usually with interest or growth through market returns. As the name implies, with voluntary long term contractual savings (VLTCS) the set period is relatively long—under South African insurance law, at least five years.

Poor people often have access to small amounts of money. However, there are few ways to accumulate sufficient savings, safely and systematically, to buy a major asset like real estate, pay for children's education or provide for old age. In some cases credit may be a viable substitute, for example in funding the purchase of a home or providing for education costs, but in other cases such as pensions, credit is not a suitable alternative to saving.

There is a global market failure in the provision of voluntary long term contractual savings to the poor. On the one hand there is a demand for such products (Roth et al., 2006) yet on the other hardly any seem to be sold. Some of this failure may be related to a broader market failure in the provision of formal savings services to the poor. There are many reasons for this such as:

- the relatively limited number of formal financial institutions in most developing countries, and where they do exist they tend not to focus on the poor or entry level market;
- misguided notions that low-income people are too poor to save;
- the political economy of donors and government that rewards spending and hence favours credit activities over savings;
- a sense among microfinance practioners that savings are an expensive way to generate loan capital - in many cases where donors subsidize wholesale finance this perception may indeed be accurate; and
- the inability of many microfinance institutions (MFIs) to obtain licenses to accept deposits.

Many of the above problems become magnified when the savings term increases, in particular issues of trust and the security of deposits. With accessible short-term savings products, clients have the ability to test the deposit-taking institution, i.e. test that it will return the deposits as promised. This is more difficult with inflexible long term products. Long term savings are therefore, on the whole, a harder sell than accessible short term savings. This, as we shall see, has crucial implications for the method and cost of sale.

This study seeks to understand why take up of voluntary long term contractual savings by the poor has been so minimal and what can be done to rectify the situation. It does so through an analysis of the supply and demand for such products in South Africa. This country is one of the few to provide VLTCS products to the poor in significant numbers. The combination of large numbers of low-income people with VLTCS products and a long history of providing these products makes South African an appropriate field site for study. This paper looks at the South African experience to determine how South Africa achieved success, how the VLTCS products could be improved, and what lessons the South African VLTCS experience can offer for other countries who may wish to utilize VLTCS schemes.

Part of what motivates this study is the increasing concern among multilateral organisations such as the International Labour Organization (ILO) about old age poverty in developing countries. VLTCS products are also of great interest to financial service firms, especially insurance companies who are often the major providers. Insurance companies interest in VLTCS stems from the potential for VLTCS products to yield more income for the company than from traditional insurance. In other cases the interest arises from being able to offer clients a greater range of products.

The paper begins with some background on the South African environment in in which VLTCS are sold, with a particular focus on pension provision. It goes on to discuss the clients, looking at issues of who they are and why they buy VLTCS products. It then examines the existing VLTCS products in South Africa and explores customer satisfaction with the products. The paper concludes with a series of recommendations for providers and policy makers to improve the quality and quantity of VLTCS sold to the poor.

1.1 A socio-economic overview of South Africa

South Africa, similar to India and Brazil, has islands of prosperity within a sea of poverty. Hand-in-hand with this inequality is uneven economic development. A broad overview of key economic indicators for South Africa is provided in the following box.

Table 1. South Africa: socio-economic indicators

Population	Statistics South Africa (2007)	47.9m
GDP per capital (USD) - Nominal	IMF (2004)	$5 386
Growth in Real GDP	IMF (2004)	3.7%
Inflation (Consumer Price Index)	IMF (2004)	1.4%
Unemployment	Statistics South Africa (2007)	25.5%
Life expectancy	UNDP (2005)	47 years
Probability of not Surviving past age 40	UNDP (2005)	43.3%
HIV prevalence	South African National HIV Survey (2005)	10.8%
Adult Literacy rate	UNICEF (2004)	86.4%
Children underweight ages 0-5 years	UNDP (2005)	12%

South Africa has a well-developed banking sector. It has a central monetary authority, the SA Reserve Bank, a few large, financially strong banks and investment institutions and a number of smaller banks. Electronic banking facilities are fairly extensive with a nationwide network of automatic teller machines (ATMs) and internet banking facilities available

The insurance sector is regulated by the Financial Services Board (FSB) and tasked with promoting sound and efficient financial institutions and services together with mechanisms for investor protection. In South Africa the insurance industry is divided between what is referred to as "long term insurance"—primarily life insurance but also the associated savings products—and "short term insurance," meaning most other types of insurance such as household and business cover. Short term insurance is referred to in the United States as property and casualty insurance and in the United Kingdom as general insurance. According to the FSB there are approximately 180 insurers registered in the country, with 72 companies listed as long term and the rest as short term. In 2006 the long term insurance industry attracted R50.2 ($6.92bn) [1] billion in new individual life business (recurring and single premiums) according to the Life Offices Association (LOA). Most long term insurance companies are members of the LOA, a forum which allows member

Box 1: The Financial Sector Charter

The Financial Sector Charter is a wide-ranging government-led initiative to partner with the financial services industry with the aim of "actively promoting a transformed, vibrant, and globally competitive financial sector that reflects the demographics of South Africa, and contributes to the establishment of an equitable society by effectively providing accessible financial services to black people and by directing investment into targeted sectors of the economy." Much of the Charter is concerned with transforming South African services providers from institutions that are largely owned and run by white South Africans to a scenario that reflects the demographics of the country, i.e. a scenario in which most of the institutions are owned and run by black South Africans. In addition to this there are requirements to sell and service products to low-income South Africans. Although in theory this is a voluntary arrangement there is a degree of moral pressure to comply, as well as the threat that if the financial institution does not meet the agreed targets the South African government will not conduct business with it.

The Charter has resulted in a degree of focus on the bottom-end of the market and has been the impetus for the creation of a range of new financial services including entry-level banking products (labelled Mzanzi) and funeral insurance offerings (Zimele). These products are standardised and sold by a range of institutions.

A standardised VLTCS product is not currently in the offing. The industry argues that establishing such a standardised product is not possible because of the policy uncertainty under which key components of the product, such as commission maximums and early termination minimums, are yet to be decided. This is partly true but as shall be seen it is also likely to be motivated by the fact that long term contractual savings are difficult to sell profitably, that providers take very different approaches to product design, and that it could be difficult for them to agree on what would constitute an acceptable low-end VLTCS product.

[1] In the paper an exchange rate of (USD) $1 = (ZAR) R7.25 has been used, the approximate average rate for 2006.

offices to interact in promoting their interests and the interests of current and future stakeholders. The South African Insurance Association (SAIA) promotes the short term insurance industry in the much the same way as the LOA does for the long term. There is both a long term and short term insurance ombudsman that is available to mediate disputes between subscribing members and policyholders.

Well-developed infrastructure allows financial institutions to provide a wide range of products to the poor. The presence, for example, of a strong network of ATM machines together with electronic wage payments created a revolution in microlending in South Africa. It has also, as shall be seen, created a large number of complex VLTCS products that have been repackaged for poor households. In spite of this, however, the numbers of low-income South Africans with access to formal financial services are not at levels that the South African government would prefer. To rectify the situation financial services providers and the government collectively developed the Financial Sector Charter. This is in essence a "voluntary" commitment by service providers to develop and sell products to low-income clients (see Box 1).

1.2 Savings instruments used by poor households

There is relatively little data available on the access to savings by low-income households in South Africa. The two key pieces of existing research in this area are provided by the Financial Diaries Project and a study by Meltzer (2007). The Financial Diaries Project tracked the use of financial instruments by poor households and found that these save up to a huge 25% of their income. Poor households save through a wide variety of instruments including bank accounts, informal savings schemes like Accumulating Savings and Credit Association (ASCAs) and Rotating Savings and Credit Associations (ROSCAs), often referred to as *Stokvels* in South Africa, along with a number of specialised formal savings instruments such as compulsory pension schemes and VLTCS plans. The study also found that poor households had multiple types of savings instruments and implicitly distinguished between the instruments, i.e. they recognised that different instruments had different features and that one type of savings instrument (e.g. an ASCA) was not a neat substitute for a VLTCS.

Many savings instruments, in particular formal bank accounts, are available to a significant proportion of poor households. According to Meltzer, "around one third of those in Living Standard Measurement (LSM) 1 – 5[2] (aged 16 or more) have bank accounts, corresponding to more than six-million people. Around half of those who have a bank account appear to use it for savings purposes”

1.3 Savings instruments used by the poor to provide for old age

A core demand for VLTCS arises from a need to provide for old age. Two other significant means used by the poor to provide for their old age – the state pension and work place contractual savings schemes – will be briefly discussed before examining VLTCS products.

1.3.1 The government pension

There are only 15 developing countries where the state provides a non-contributory pension (Barrientos, 2003). South Africa provides such a social assistance benefit to its citizens, along with a range of other social welfare schemes. The origins of state pensions in South Africa date back to the formation of the Union of South Africa in 1910 when the state treasury had a department whose chief task was the administration of colonial pensions. In the 1920s pensions were gradually introduced for whites, and in the 1950s, pensions were extended to black South Africans. These pensions are means-tested and are payable to women and men from the age of 60 and 65, respectively. Historically, the amounts paid varied, broadly mirroring the racial allocation of state resources in apartheid South Africa. In 1982, for example, white people’s pensions were double those of “Indians” and “coloureds” and ten times those of black people (Lund, 1993). The post-apartheid government has created full parity.

South Africa has one of Africa’s most rapidly ageing populations. Twenty-five percent of those age 50 and over are chronically poor. They are compelled to continue productive activities well into old age and fulfil an important economic role (May, 2003). As with most developing countries, informal old age support from families and communities is coming under increasing pressure from adverse economic conditions, migration, HIV/AIDS and changes in household composition (Barrientos, 2003).

[2] When this study refers to the poor or low-income clients it is referring to clients who are in categories 1 to 5 of a South African measurement of livings standard known as the “Livings Standards Measurement”. Appendix 1 contains further information on this measurement.

A University of KwaZulu-Natal report commissioned by HelpAge International investigated the extent, distribution and nature of chronic poverty among older people in South Africa. It found that state-provided old age pensions were the most important form of social security for older people in South Africa. Pensions go to women more than men; reach deep into rural areas; can often secure credit for the household; contribute to the education of grandchildren; ensure respect for the beneficiary; and secure the right of an older person to stay in the home and be cared for by family (May, 2003). Studies have shown that pension benefits are shared within households, so that they act as household cash transfers channelled through older people. They have a clear impact on poverty, significantly reducing the probability that individuals in households where there is a pension recipient will remain in poverty. Households with a non-contributory pension recipient show greater financial stability and lower probability of experiencing a decline in living standards (Barrientos, 2003).

Social security and welfare expenditures form an essential part of government's programme to address poverty. Close to 90% of the South African welfare budget is allocated to social security, in the form of old age pensions, pensions for the disabled, child and family benefits (maintenance grants), and social relief. The old age pension programme consumes 60% of the social security budget. It is generally considered to reach a high proportion of those eligible, to be well-targeted, and to provide many poor households with a regular income which provides a basic level of food security. Black households comprise 89% of those receiving old age pensions, and two thirds of the pensions go to rural areas (May and Budlender, 1998).

The Old-Age Pension Grant, administered by the South African Social Security Agency and financed by general taxation, is the second-largest social grant. The number of beneficiaries increased from 1,8 million in 2000 to more than two million in 2003. Women qualify at the age of 60 years and men at the age of 65. (Capegateway, 2006) This is 94% of those over 65 achieving near universal coverage. The old-age pension makes up 1.4% of gross domestic product (GDP) and 38% of the department's total cash transfer expenditure (Barrientos, 2003). The current standard state pension is R840 ($120) per month. Although this may appear generous, the very high levels of unemployment in the country in general, and among the poor in particular, means that this pension is often the only source income for entire household.

For example, this would bring the individual income of such a household (of on average 6 people) down to less than $2 each per day.

A means test was administered which in 2004 stipulated that one could not get the grant if one's assets were worth more than R280 800 (approx $39 000). Real estate that one lives in is not taken into account. Income must also be less than R19 128 ($2 640) per year. The figures can be roughly doubled for married couples. Broadly the vast majority of people falling within LSM 1 – 5[3] (in so far as there is a vague correlation between LSM and income levels) are likely to be eligible for a state pension.

There are however difficulties with the pension system, mostly administrative, many of which were brought to the fore during the poverty hearings held in 1998 (Budlender, 1998). Many people faced administrative and other difficulties when trying to access grants, while others complained that their grants had been stopped without warning. Some women, for example, struggled to get pensions because of problems with identity documents and the distance to pay points. These problems persist to this day - disgruntled pensioners in 2006 with the help of human rights lawyers took the state to court for their failure to deliver pensions.

1.3.2 Saving for retirement – work place contractual savings schemes

South Africa has a thriving formal sector. Many firms in this sector offer their employees the opportunity to buy into the company pension scheme. A recent report by the South African Treasury based upon statistics from the Financial Services Board (FSB) indicates the size of the sector:

> There are about 9 million members of retirement funds. However, there is some double-counting in this number because members can belong to more than one fund. The coverage rate for formal-sector employees is estimated to be in the region of 60 per cent. This is comparatively high, even relative to countries with compulsory participation, and it reflects the extent to which membership of an occupational fund is accepted as an obligatory condition of employment. The ratio of pension fund assets to gross domestic product (GDP) in South Africa is about 63 per cent, which compares

[3] See Note 2.

> favourably with countries such as Australia, Chile, Malaysia, Singapore and the United Kingdom" (Social Security and Retirement Reform).

However for the worst paid of formal sector employees, the picture is not quite as rosy. According to Meltzer (2007) only 8% of those above 16 years old in LSMs' 1-5 belong to such pension schemes.

1.4 Public Policy – Voluntary LTCS & Social Security

There is significant on-going debate about the ideal structure of a social security system to provide for old age. The debate focuses, among other things, on the role of the state and role of the market. One particular aspect of the debate is the role that the private sector should play in social security provision. The debate is ongoing and different countries have taken different approaches. For example, in 2002 Nicaragua replaced its public pension scheme with a private pension scheme (Mesa Lago, 2002). Costa Rica on the other hand developed a system in which the public sector offers a basic pension and private sector offers a supplementary scheme (Ibid.). These are just two countries of the many, mostly in Latin America and Eastern Europe, that have taken one of these approaches, or variations on one or the other. While there is debate about *what* exactly the role of the private sector should be, there is broad consensus in most countries and indeed among most multi-laterals that there should be a role for the private sector in old age pensions. The ILO for example sees old age pensions as a responsibility of the state and foresees a role for the state and donors in the "creation of an environment for the development of voluntary provisions for retirement income" (Gillion, 2000).

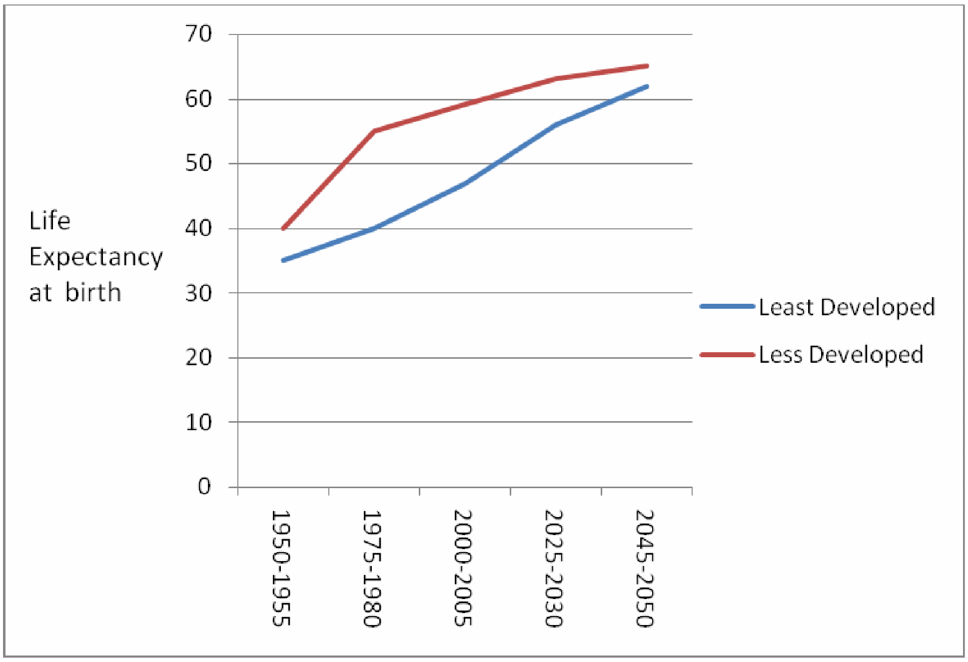
The context of this debate is a world in which "90 per cent of (its) working-age population is not covered by pension schemes capable of providing adequate retirement income" (Ibid.). Already in the developing world there are significant numbers of people over age 60 not covered by any sort of pension. The current figures are provided in the table below (UN Department of Economic & Social Affairs, 2007).

Table 2. Population aged 60 or over, 65 or over and 80 or over by sex (thousands)

	Total >60 years	Total >65 years	Total >80 years
World	704 817	495 126	94 174
More developed regions	252 026	188 800	47 873
Less developed regions	452 792	306 325	46 301
Least developed countries	40 744	26 011	3 018

If one assumes that 90% of the aged in the less developed and least developed world do not have access to pensions, than at present 444m people are without an old age pension. While the current figures may appear dramatic, additional concern is needed for future as more and more people are likely to live longer in the developing world. This can been seen in the graph below which depicts UN demographers predictions of life expectancy at birth for developing country populations (UN Department of Economic & Social Affairs, 2007).

Chart 1. Life expectancy at Birth



It is in this context of very low penetration of pension coverage, significant numbers of elderly citizens and expectations that the numbers of elderly will increase that states and donors have sought to think widely about the kinds of instruments both the public and the private sectors could provide to help finance old age.

One of these instruments is voluntary long term contractual savings. It is by no means the only instrument; it is one tool in a large toolkit of possible instruments including purchasing assets like real estate, cattle, plantations of hardwood trees etc. Voluntary LTCS products are deeply flawed in all kinds of ways. They are for example beset by high administration costs which eat away at their final benefit and they are often mis-sold. The purpose of this paper is not to present LTCS as the solution to the problem of the old age poverty but rather to examine it as one of a potential array of tools in the toolkit of solutions, explore its flaws and problems and suggest ways in which these could be addressed both at a product design level and at a policy level.

This holds true of the public policy debate within South Africa on VLTCS for the poor. The most recent policy documents on pension reform in South Africa have been developed by two government departments; the Department of Social Development which released in 2007 a document entitled the “Reform of Retirement Provisions” and the “Social Security and Retirement Reform” which was released by the Treasury Department of the South African Government also in 2007.

The Social Security and Retirement Reform provides in its first statement on the framework for pensions in South Africa that "mandatory, universal participation in a pooled social insurance arrangement recognises that those who are most vulnerable will tend to be excluded if participation is subject to choice or selection. If everyone is to enjoy equal, basic protection against life crises, participation has to be obligatory". The need for the state to provide for income when voluntary savings are inadequate is presented as "Objective 1" of the state retirement system in the Department of Social Development's document.

Indeed no significant actor or contributor to the pension reform debate in South Africa has suggested terminating the SOAP as the primary means of providing for old age security to South Africa's poor. In this context the question is therefore not one of the SOAP *vs.* VLTCS. There are two reasons for this that will be discussed in detail in this paper.

Box 2: Update on retirement reform in South Africa

Plans to overhaul South Africa's old age and retirement system are well under way, following many years of discussion and a succession of commissions. A recent discussion paper was released by the National Treasury in February 2007.

Among a number of proposals, the most significant for product providers in this part of the market is the recommendation that all South Africans be required to contribute:

- to a centrally managed defined contribution fund a fixed proportion of earnings up to a threshold; and
- above that threshold, a similar proportion of earnings to an accredited provider of retirement saving services.

The key variable affecting providers of long term contractual saving products is the level of the threshold. All contributions are paid on income below this level. It is proposed that this will be managed by a public sector entity and all contributions above this level in private sector counterparts. Financial services companies may benefit, in aggregate, from compulsion at higher income levels but this is tempered by a shrinking private sector market at the lower end.

The current proposal is for all contributions based on annual income below R60 000 ($8 275) to be directed to the central fund and for individuals earning above this to retain the option to direct contributions on income above this level to this fund as well. Since South Africans earning a little over R60 000 ($8 275) annually would not benefit from splitting this between two funds, it can be assumed with reasonable certainty that private access to the savings of South Africans earning less than R80 000 ($11 035) or R90 000($12 415) would be very limited.

Firstly, only a tiny percentage of the South African low-income population is covered at present by private sector voluntary LTCS products. It is not surprising that the policy debate on the role of the private sector (with respect to VLTCS) has focused on the wealthier segments of the populations (*cf.* for example the proposal discussed in box 2).

More significantly perhaps is the fact that the small number of VLTCS products are offered to the poor are of questionable value. Until such time as voluntary LTCS products aimed at the poor can provide better value and achieve high degrees of customer satisfaction it is not likely that the government of South Africa or indeed governments elsewhere are likely to show much enthusiasm for voluntary LTCS products. Indeed the National Treasury's discussion document describes its move to recommend compulsory savings as motivated by "market failures in the form of high costs of financial services for low-income workers". That said both the Treasury and Department of Social Development are committed to exploring the complimentary role that voluntary LTCS products could play in pension reform. In order for them to have any useful role their quality would need to be improved. This paper provides an in-depth analysis of the causes of poor value of these products and some ideas as to how value could be improved.

2. The clients – who buys VLTCS and why?

2.1 Coverage

One of the key questions asked of any financial service sold to low-income people is does it really reach the poor? Does it reach the poorest of poor? And finally, what motivates the poor to buy these services? The answers to these questions play a central role in the design and development of VLTCS products. This chapter examines these core issues based on fieldwork and other data. A detailed description of the fieldwork is provided in Appendix 1. How many low-income South Africans have VLTCS policies? There is no accurate answer to this question. VLTCS providers are not required to provide the regulator with figures on VLTCS usage by income level.

Two national surveys provide a range of numbers. The first derives from the FinScope data set. FinScope is a survey that presents data on the usage of financial services in a number of Southern African countries. This is probably the best dataset available on financial services used by the poor in South Africa (and perhaps the best dataset of financial service use by the poor in any developing country). Unfortunately with respect to the use of VLTCS products sold by insurance companies (such as endowments) the results need to be treated with caution as very few respondents in the dataset have such policies. For example, there were only 11 in the most recent survey (2006). Extrapolating from this low number to LSM 1-5 of the entire South African population would inevitably cause difficulties. FinScope data on national VLTCS usage is depicted in the following chart.

Box 3: Fieldwork methodology & sources of data

For a very detailed exposition of the fieldwork methodology used in this study please refer to Appendix 1. In brief, data for the study was obtained from four main sources: policy documentation, fieldworker interviews, consumer advice office archives, stakeholder interviews and a workshop. Policy documents were obtained for all the major existing VLTCS products in the country. These were sought using the mystery shopper method in which the researcher actually purchased the products. These were then analysed by an actuary.

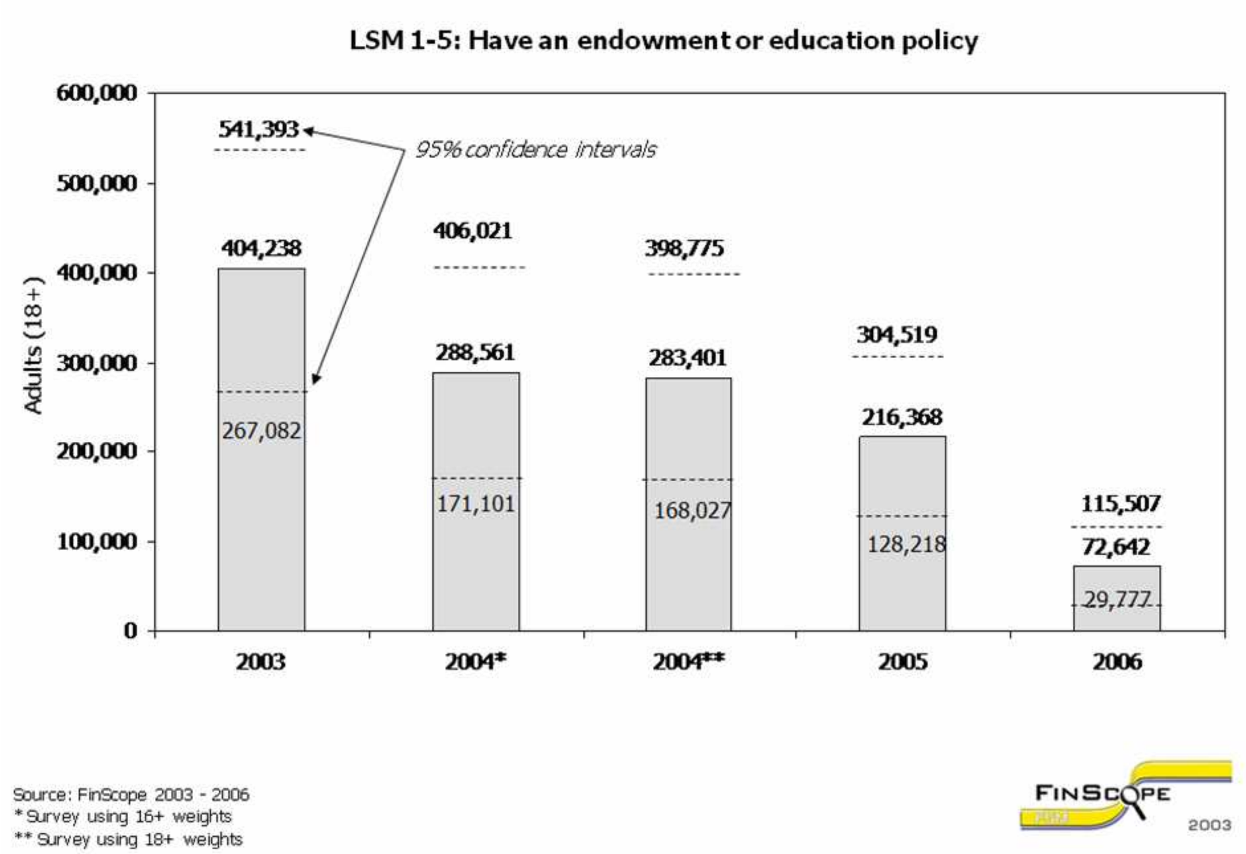
The fieldworker interviews were conducted with low-income holders of VLTCs policies using the snowball or chain referral sampling method. In this methodology, once a single respondent is located, that respondent refers the researcher onto another respondent and so forth. For an in-depth study of the limits of the inferences that can be drawn from the data obtained through this method refer to Appendix 1. Interviews were conducted in the Western, Northern and Eastern Cape Regions from September to November 2006.

The archives of a consumer advice office run by the Black Sash, a non-profit organisation, were searched from 1989 to 2002. In all 160 cases studies were selected for the study.

Stakeholders were interviewed during the course of the research and a workshop was held with key people in December 2006.

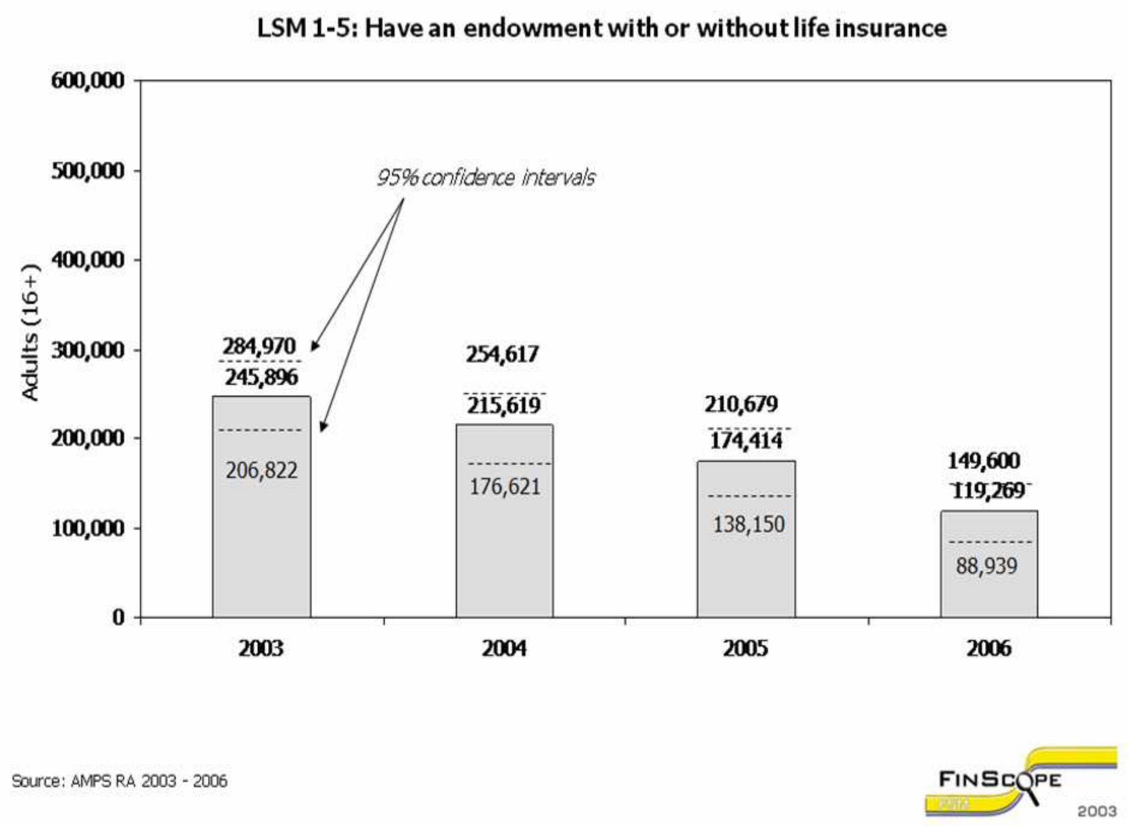
Finally, the study was extensively reviewed by a large number of actuaries, microinsurance specialists, donors and others from whom very valuable additional information was obtained and included.

Chart 2. FinScope™ data on national VLTCS usage



The next source of data on VLTCS usage among the poor in South Africa comes from a national survey undertaken by All Media and Products Survey (AMPS) depicted on the following page.

Chart 3. AMPS data on national VLTCS usage



The sources both show a sharp decreasing trend in VLTCS by low-income South Africans, but the credibility of such a dramatic fall-off is questionable. VLTCS products are, by definition, long term so unless for some reason such as large numbers of policies maturing simultaneously in 2005, or receiving bad publicity and policy holders cancelling en-masse, one would not expect to see such drop-offs. Discussion with insurers indicated no such dramatic changes occurred. The authors were informed by one of the largest sellers of VLTCS products that lapses were stable and that the overall LSM 1-5 business grew from 2005-2006. The research team believes the datasets to be unreliable in this instance.

In the case of the FinScope data it is likely that the problem emerged because small changes in the numbers of respondents with VLTCS policies result in very large changes when extrapolated to the entire LSM 1-5 of the South African population. By implication then the FinScope data cannot reliably tell us anything more fine-grained about the low-income VLTCS policy holders, such as whether they are men or women, what they do for a living, how old they are and how they are divided by LSM. The

AMPS data was drawn from a similarly small dataset as it was the small sample meant that the results should be treated with caution.

There is therefore currently no publicly available data on VLTCS usage by low-income South Africans. This most basic data is crucial to policy makers concerned with improving the quality and quantity of VLTCS products to the poor, and the South African government should, as a first step, develop systems to obtain this data.

2.2 Do the poorest households buy VLTCS policies?

A study commissioned by Finmark on access to life insurance in LSM 1-5 found, as anticipated, a positive relationship between total household income and LSM, as shown in the chart below.

Table 3. Relationship of LSM to household income of respondents

LSM 1	R 2,217	$[4]306
LSM 2	R 2,812	$388
LSM 3	R 2,960	$408
LSM 4	R 3,495	$482
LSM 5	R 4,000	$552

Source: "Towards a benchmark for access to life insurance in LSM 1-5" (Meltzer &Smith, 2004)

Unexpectedly, among the respondent households, the poorer the household the higher their apparent propensity to purchase and VLTCS policy as can be seen in the following chart.

[4] The original exchange rate in this table (7:1) has been changed to be consistent with the 7.25:1 in the product analysis chapter.

Table 4. Households by LSM with a VLTCS policy

LSM 1	51
LSM 2	46
LSM 3	37
LSM 4	16
LSM 5	1
Grand Total	151

Source: Fieldworker interviews

A reason for this may be to do with the way in which the LSM classification works, i.e. based on, in part, a count of the households' possession. So those who have the most possessions (highest LSM) may have the lowest propensity to save, because of other commitments, for example, repaying loans taken out to purchase the goods[5]. The distribution of respondents illustrated in Table 3 may also result from the 'snowball' survey methodology – perhaps respondents have greater social connectedness at lower income.

Whatever the reasons it is clear that the poorest segments of South African society purchase VLTCS policies. The purchase of such products by poor households was also found in work conducted by Daryl Collins and others in the Financial Diaries Project (Collins, 2005), despite the fact that the project did not specifically set out to find very poor households with VLTCS products. Collins found examples of households with a total monthly income of as little as R2 014 ($278) in possession of VLTCS products.

Whether it is wise for the poorest households to purchase VLTCS products is, of course, a separate question. While there is no relevant publicly available information on lapse rates, according to Andrew Cartwright, the Chief Operating Officer of Old Mutual's Mass Market Business, the lower down the LSM scale one goes, the higher the lapse rate[6]. This was due to the positive correlation between the precariousness of incomes and poverty, Cartwright suggested during a workshop for industry representatives held by the researchers.

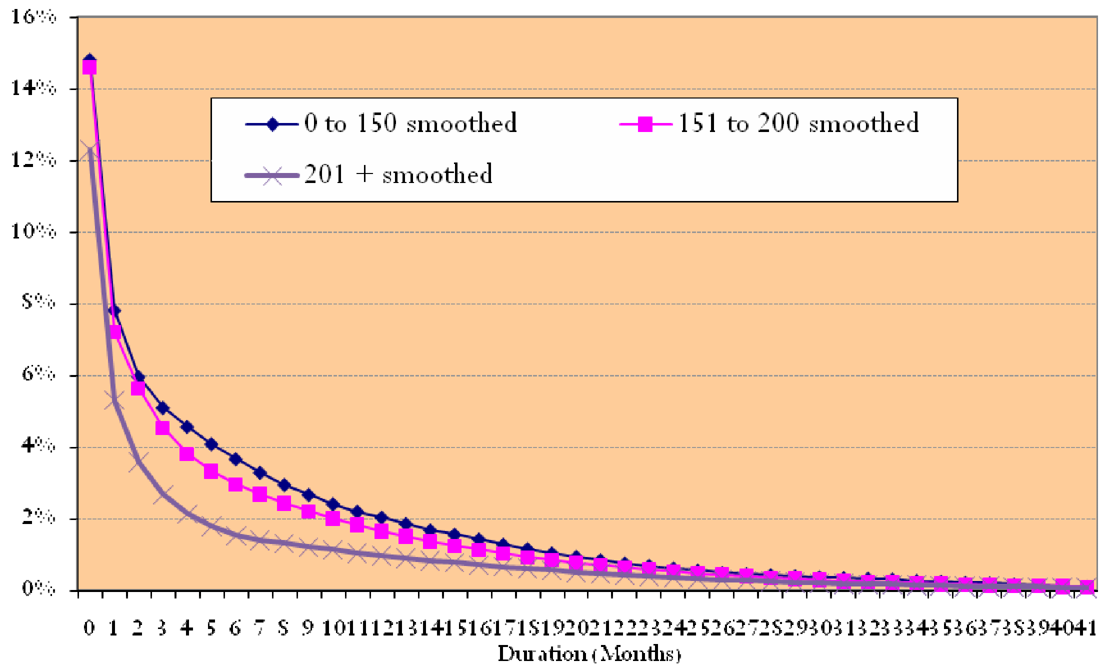
5 We are grateful to Andrew Cartwright for this insight.
6 A lapse occurs when a policy holder fails to pay-in the amounts required by their contract.

A major South African insurer (that did not want to be individually identified) conducted an analysis of its VLTCS products sold during a 12-month period ending 30 Sep 2006 and split premiums into 3 bands:

1. R0 - R150 (US$21) (exposure is very small in the R0 - R100 band)
2. R151 (US$21) - R200 ($28)
3. R201(US$28)+

It found that the cheaper the policy, the higher the probability of lapses occurring especially early on. Their results are depicted in the chart below.

Chart 4. Lapse rates



However it is not clear that the poorest households were most likely to purchase the cheapest policies. The data from the field study (which is representative of national trends- see Appendix 1 for the methodology) indicated that when compulsory pension plans are stripped from the dataset to leave only VLTCS, it appears that VLTCS policy holders are buying more than just the cheapest policies analysed in the previous section. Indeed as can be seen in the following table, the poorest VLTCS policy holders were saving just over 10% of their household income. In addition, the average spending on policies was nearly 5 times the price of the cheapest policy available.

Table 5. How much were poor respondents saving through VLTCS?

LSM 1	Ave. household income	R 2,213	$305	
	Ave. premium	R 239	$33	10.78%
	Total in this LSM	49		
LSM 2	Ave. household income	R 2,795	$386	
	Ave. premium	R 237	$33	8.48%
	Total in this LSM	44		
LSM 3	Ave. household income	R 2,890	$399	
	Ave. premium	R 217	$30	7.52%
	Total in this LSM	35		
LSM 4	Ave. household income	R 3,521	$486	
	Ave. premium	R 248	$34	7.05%
	Total in this LSM	15		
LSM 5	Ave. household income	R 4,000	$552	
	Ave. premium	R 165	$23	4.13%
	Total in this LSM	1		
	Total Ave. household income	R 2,710	$374	
	Ave. premium of sample	R 234	$32	8.62%

Source: Fieldworker interviews

The trend towards a higher proportion of income going into these premiums is broadly consistent with the sample of households obtained by the Financial Diaries Project. Two of the poorest households in the sample spent just over 7% on VLTCS savings[7]. Although less than 10% in the above table, a considerable proportion of household income was spent on VLTCS savings. The figures in Table 5 challenge the idea of the poor being too poor to save. Indeed it would appear from these figures that the poorer the household the greater the proportion of their income they are willing to save!

7 Collins found on average, her respondents with VLTCS spent 2.61% of their monthly household income on their VLTCS polices, with one relatively wealthy household spending only 0.37% (Collins, 2005).

2.3 What sectors of the economy do VLTCS policyholders work in?

Almost all VLTCS policy holders with VLTCS products worked in the formal sector. Only 2 respondents in the surveys described in Appendix 1, were self-employed and worked in the informal sector. The likely reason for this is that formal jobs offer the option of electronic premium deductions. In practice, either the amount is debited from the client’s bank account or the employer deducts the premium from wages and pays the savings company directly. In addition to this banks are more likely to allow debit-order facilities for the formally employed with a regular income than for people employed in the informal economy with irregular incomes. Only five respondents paid for their policies manually.

Electronic payment has two crucial consequences. Firstly, it is much cheaper for both clients and the insurance company. In the absence of electronic payments it is likely that the client would need to go to the insurance company or *vis versa*. If the latter were to take place the collection costs would have to be incorporated into the price, making it significantly more expensive. Sixty-two percent of respondents said that they preferred to pay electronically because their transaction costs were lower than paying manually.

Secondly, because the money is deducted from the client's salary before the client receives it there is no temptation to spend it on something else, resulting in high levels of persistency. Ten percent of clients said that this was what they most valued about electronic payment.

This yields a number of implications for the possible spread of VLTCS to other low-income countries and wider dispersion within South Africa. The most significant implication is that the products are likely to be difficult to sell to clients with irregular incomes. It may be possible to, for example, work with farmers who sell their crops annually to a central buyer who can then deduct a percentage of the payment and pay it over to a savings firm. It would be far harder to sell these products to an informal hawker, even in the unlikely event that they had a bank account that allowed electronic transactions, because they would receive their income first and then have the option to decide whether to spend it or save it.

Because of the need for regular income flows, from which the savings component can be deducted before wages/income are received, it is unlikely that VLTCS would be available to the vast majority of informal workers. Large groups of informal sector workers among the global poor, however, could meet these conditions, for example:

- workers in South Africa and Brazil with formal jobs who may have a banking system that allows for automatic deductions;
- the beneficiaries of migrant workers remittances who receive regular payment through a formal remittance agency; or
- workers who sell their products on a regular basis to a centralised buyer, e.g. many coffee, sugar and cocoa farmers.

2.4 Why do the poor buy VLTCS?

In order to design better products it is crucial to understand why low income people buy VLTCS products. Two key needs are for income in old age and to pay for their children's education.

2.4.1 Old age and education

There were few surprises in the reasons respondents gave for savings. Once respondents with compulsory savings were removed from the sample, savings policies were almost invariably bought either to provide for retirement (32%) or to provide for education expenses (46%) or some combination of these. In the case of education expenses these were typically for tertiary expenses where the respondent child would be sent off for tertiary education to become, for example, a teacher or nurse. As one respondent, Gift I (Gift is his first name), said

> *"…I was thinking about what would happen to my son in the future if I don't have a policy for him. When I grew up there were no such things as policies so my mother had to take (to pay for) my brothers to teachers training college out of her own pocket – it was not that easy because my big brother had to go to the college and then my other brother had to wait for him to finish – it was a long process. So because of that situation I did not want the same for my son".*

2.4.2 Purchase of an expensive physical asset

A very small percentage of respondents bought the policies to buy a physical asset. For example, four of the respondents bought the policies to use the maturity value to buy real estate.

2.4.3 Protection against emergencies

Some respondents bought the policies for the wrong reasons. Some 5% of them bought their policies primarily as protection against emergencies, or confused the products with funeral insurance. These latter categories are discussed in the Chapter 6 on VLTCS problems and possible solutions. In a minority of cases the reasons were unspecified, with responses like:

> *"… everyone else at my work bought one of these so I thought I should get one as well."*

2.4.4 Use as collateral

A number of respondents provided more than one reason for purchasing the VLTCS product. One of the great advantages of a VLTCS policy is that the policy value can be used as collateral to obtain credit from formal financial institutions. This useful feature was not widely known. Only 38% of respondents were aware that they could do this and only 39% of those who were aware that they could use the policy for this purpose indicated that this was an important feature of the product for them.

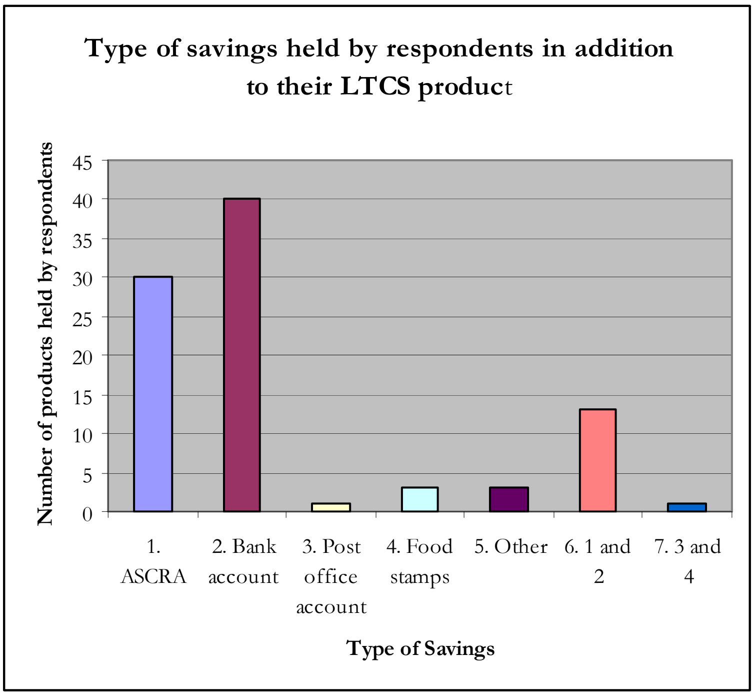
2.4.5 Bought for the insurance component

Some respondents purchased the product for its ancillary benefits, such as life or funeral insurance, which are relatively easy to add to a VLTCS product as it is with a credit product. Some form of term life cover, like funeral insurance, is commonly added to insurer-provided products. Just under 15% of respondents who had compound savings and insurance products reported than the insurance component was of greater value to them than the savings component.

2.5 Did the respondent distinguish VLTCS from other savings instruments?

Most respondents (60%) indicated that they had some other form of savings. The implication of this is that they distinguish between long terms contractual savings products and other forms of savings As can be seen from the following chart most respondents held other kinds of savings products in addition to their VLTCS products.

Chart 5. Distinguishing between types of savings products



Source: Fieldworker interviews

Assuming that respondents who had other types of savings products consciously selected those policies i.e. they were voluntary (and all indications are that they were voluntary), the implication would be that the vast majority of respondents who bought VLTCS policies distinguished between voluntary long term contractual savings and other kinds of savings products. This has important policy implications. In microfinance policy makers have often tried to provide one kind of product to substitute for a product that they find undesirable. A common instance of this is for example when policy makers attempt to obviate the need for moneylender's loans by substituting them with loans from government banks. This strategy rarely works as the substitutes are often less perfect than the policy makers think they are. For a moneylender may be able to provide a loan at a high interest rate, but at the same time they provide the loan rapidly, require little or no collateral and no paperwork. A government bank may well provide loans at a lower interest rate but because they have different terms and conditions they are not likely to substitute for the rapid, "collateral light", paperwork-free loans of the moneylender. Much the same may be true of long terms contractual savings. The fact that respondents distinguish between VLTCS and other savings products should serve as a cautionary note for those who may attempt to meet the demand for VLTCS by providing another kind of savings instrument.

2.6 VLTCS for old age

2.6.1 Saving for old age – which products exist?

Few products are marketed for pension or retirement purposes. While there were many products on the market that had the word education in their names, there were none that made any reference to retirement or pensions. The exception to this were five products referred to by respondents as "retirement annuities." It is unclear whether they were in fact retirement annuities or just called that by the respondents. The three most popular products that were bought for pensions are listed in the following table. All remaining products had an individually insignificant market share of the total. Since a third of the sample bought the products specifically for retirement, it would seem that there is a good marketing opportunity to highlight the words pension or retirement in the product's name.

Table 6. Market share (of the sample) of products bought for retirement

Old Mutual Group Schemes Money Care Plan	Old Mutual	37%
Financial Package Provider	Metropolitan	12%
Dreambuilder Cash Plan	Metropolitan	12%

Source: Fieldworker interviews

2.6.2 Why do they save for old-age?

Given the existence of a state pension, why did respondents purchase VLTCS for retirement? Respondents gave a range of reasons for purchasing VLTCS for pensions. Most frequently, respondents were concerned with the size of the state pension. As some respondents put it:

- *"…I wanted to save money for me when I retire. I cannot rely on my children because no one can tell me what the future is like. Maybe the state can give me a pension also."*
- *"…I know the state's money will be too little to maintain me hence I decided to save for myself for the future."*
- *"The (state) pension will not be enough and I am not sure whether my children will be working."*
- *"I know the state will provide for me, but it is not enough."*
- *"I bought their policy because I knew that the state will not be able to financially accommodate all my needs."*
- *"Maybe the pension from the state won't be enough, therefore I decided to invest for the future."*
- *"I know my children will be looking after their own families so I don't want to be their burden financially. I might need their love and careness (sic) but I don't need their money."*
- *"I do not want to depend on my children. I want them to enjoy their money."*
- *"I don't want to be somebody's burden."*
- *"…when the children grow up they will be supporting and looking after their own families, not me."*

There was frequent reference to not wanting to depend on other family members. Some respondents felt that they may want to stop working before they were old enough to qualify for a state pension or that they simply just wanted more money. One respondent intended to use the lump sum to start some kind of business and the state pension to cover their living expenses. Another wanted to use the endowment to pay off their housing loan: *"I know the state will provide me with a pension but I have a house loan and I don't know when I will finish paying it off."*

Some were concerned with the state and its ability to process state pensions. In this regard a respondent said that she had *"…seen people retire and end up not having enough money to live on, especially when a pension claim is put in - it takes very long to be processed."*

The more pessimistic of the respondents had doubts about whether there would be a state pension at all in the future or if there was, concern that they may be ineligible. As two respondents noted:

- *"I cannot rely on my children, even [if] the government, [pays me a pension] that will be a bonus."*
- *"I cannot rely on a government pension because it has politics involved."*

One very pessimistic respondent seemed entirely confident that when she retired the state pension would no longer be in existence: *"The main motivation is to ensure that I am financially taken care of upon retirement because there'll be no other form of finance."*

There was no evidence uncovered of any desire by the state to attempt to eradicate the state pension fund and replace it with a privatised VLTCS. Given that pensions are one of the few sources of income available to the poorest South African households and that VLTCS products are sold mostly to the "wealthy poor" it is unlikely that this would be considered by the state. All evidence in this study points to the conclusion that state policy makers, and low-income VLTCS policyholders, view these products as a useful complement rather than a substitute to the state pensions.

2.6.3 How much do poor South Africans save for old age through VLTCS?

In terms of maturity values there was a great difference between the highest and lowest values, a large standard deviation and very few samples (19 of the respondents knew their maturity values), so the results in the table below should be treated with caution.

Table 7. Amounts saved for old age through VLTCS

Mean	**R 79,382**	**$10,949**
Median	R 40,000	$5,517
Mode	R 25,000	$3,448
Standard Deviation	R 86,848	$11,979
Minimum	R 3,500	$483
Maximum	R 300,000	$41,379

Source: Fieldworker interviews

Using the median maturity value of approximately US$5 500 this amount is a fairly considerable sum for low-income households with monthly incomes of between US$300 and $500 per month, i.e. between 18 months and 11 months of income. It is also equivalent to almost four years of state pension at the current levels. This amount however is still fairly limited as a source of income for retirement. At these levels VLTCS policies could not be thought of as being a substitute to other income sources and strategy pursued by low-income people to sustain them in their old age. Indeed the most common reason stated for taking out a VLTCS policy as a pension was to supplement the income they were anticipating receiving from the state.

VLTCS product providers are taxed on income at a rate of 30%, passing on this tax to policyholders. South Africa is committed to a progressive taxation system in which the more one earns the more tax one pays. The deduction at source is a flat tax, regressive relative to income tax. If this anomaly were corrected the poor would receive considerably higher maturity values.

3. The products

This chapter presents an analysis of all the VLTCS products aimed at low-income South Africans. The analysis is done through the lens of four key variables: affordability, charges, flexibility and the quality of the product documentation. The products in this study are sold by private firms who (until this point) had not been compelled to sell them. We can assume therefore that the motivation for selling the products was related in some way to making a profit, although in some cases they may have been sold as loss-leaders to spread the brand name or for some other marketing purpose.

Affordability, charges, flexibility and the quality of documentation all have an important bearing on whether a product meets the needs of the policyholder. Affordability considers the minimum premiums required for participation in the contract. If this threshold is too high, the contract fails to meet the needs of those who can only save small amounts. Charge statistics consider the aggregate impact on maturity values of all fees, showing which products are cheapest and which the most expensive. Flexibility summarises the extent to which the policyholder can change the savings plan, in particular the freedom to terminate early. Quality of documentation provides an assessment of the extent to which complex concepts are clearly communicated to policyholders.

3.1 Affordability: How low do the premiums go?

Affordability can be difficult to determine because it depends on a range of factors, including accessibility. Providers whose products are difficult to access increase the transaction costs for the poor. These could include transport costs to distant towns, one or more days of lost work, etc. The size of the distribution channel, the number of branches and the variety of options available for product purchase are strong determinants of the accessibility of a VLTCS provider to the public. A lower premium provides a more realistic option of saving to those with very little disposable income, notwithstanding the evidence that some customers are willing to save more than the minimum. The following table shows the minimum premium for the products included in the study.

Table 8. Minimum possible monthly savings amounts

Name of the Company and its policies	R	US$	Available at R50 ($7)	Available at R100 ($14)	Available at R200 ($28)
African Life					
Graduate Cash Growth Plan	R 130	$18	×	×	✓
Assupol Life					
School Fund Provider	R 144	$20	×	×	✓
Study Policy	R 72	$10	×	✓	✓
Cash Provider: New Wave	R 84	$12	×	✓	✓
Clientèle Life					
Saver and Protector Plan	R 75	$10	×	✓	✓
Hollard Life					
Secure Savings Endowment	R 100	$14	×	✓	✓
Umbono As'Investe	R 50	$7	✓	✓	✓
Metropolitan Life					
Dreambuilder Cash Plan	R 160	$22	×	×	✓
Momentum					
Investo Investment Plan	R 200	$28	×	×	✓
Old Mutual Group Schemes					
Money Care Plan	R 50	$7	✓	✓	✓
Sanlam					
Halala Savings Plan	R 80	$11	×	✓	✓
Endowment & Edufocus	R 150	$21	×	×	✓

Source: Policy documents obtained from insurance companies

The lowest available monthly premium is R50 ($7) at which Old Mutual and Umbono are prepared to sell an endowment policy. All other contracts require a premium higher than this, one of them as high as R200 ($28) monthly. What stands out from the table is that it is possible to design and deliver a commercial VLTCS that requires savings of as little as R50 ($7) per month.

3.2 How much do the providers charge?

The following table summarises the calculated charges under all policies assessed in this study. The reduction in yield is equivalent to the aggregate impact on annual investment returns from all charges. Put another way, it is the cost of the charges in investment reduction terms. For example, if a fund earned 7% per annum and the investor received 6% per year, the reduction in yield would be 1%, the difference between the two.

The reduction in yield assists in determining whether a contract may provide net returns that exceed the rate of inflation. It is reasonable to assume that, in the long term, investment returns on the type of balance portfolios used by providers for these products should exceed the rate of inflation by between 4% and 5%. An annual reduction of yield exceeding 5% is therefore quite likely to provide an overall return to the policyholder below the rate of inflation.

The charge ratio is the equivalent overall percentage impact on the maturity value from all charges. At one extreme the charge ratio takes the value zero where we have no charges or fees of any form. The other extreme is where the ratio is one hundred were charges are so high that they consume the entire maturity value.

Table 9. How much do providers charge?

Name of company and policy	R100 ($14) pm contribution		R200 ($28) pm contribution	
	Reduction in yield	Charge ratio	Reduction in yield	Charge ratio
African Life				
Graduate Cash Growth Plan	-	-	5.34%	24.1%
Assupol Life				
School Fund Provider	-	-	6.34%	27.9%
Study Policy	-	-	5.73%	25.6%
Cash Provider: New Wave	10.83%	42.4%	6.34%	27.9%
Hollard Life				
Secure Savings Endowment	6.47%	28.4%	4.63%	21.3%
Umbono As'Investe	3.25%	15.5%	2.29%	11.2%
Metropolitan Life				
Dreambuilder Cash Plan	-	-	7.69%	32.6%
Momentum				
Investo Investment Plan	-	-	4.46%	20.6%
Old Mutual Group Schemes				
Money Care Plan	5.53%	24.8%	4.78%	21.9%
Sanlam				
Halala Savings Plan	4.32%	20.0%	4.04%	18.9%
Endowment & Edufocus	-	-	4.45%	20.6%

Source: Policy documents obtained from insurance companies

Notes to the table

Values are not calculated where the product is not available at the monthly premium. Conversion to monetary amounts may be achieved as follows: on the assumptions in the model, a contribution of R100 ($14) monthly without charges is expected to grow to R19 986 ($2 757), say R20 000 ($2 759), in the 10 year period considered. As the charge ratio represents the aggregate reduction of maturity value, each percentage point of charge ratio is equivalent to a monetary reduction to the maturity value of R200 ($28) or twice the monthly premium. For example, the 20% charge ratio on Sanlam's Halala Savings Plan for a 10-year policy is equivalent to a reduction of maturity value from R20 000 ($2 759) to R16 000 ($2 207), which is R4 000 ($552) or 40 months of contributions. On the R200 ($28), each percentage of charge ratio is equivalent to a reduction to the maturity value of R400 ($55), again equal to two months of the specified monthly premium.

3.2.1 Comparing charges

It is difficult to establish an objective assessment of what an appropriate level of charges should be or indeed whether or not it makes any sense to establish a benchmark with such diverse products. South Africans have been discussing the difficulty of achieving a reduction in yield of 4% on low-income products, so this would seem to set the benchmark for comparison, at least the goal that some feel should be attained. An average charge of 4% of assets also provides reasonable probability of an overall return in excess of the rate of inflation on a portfolio invested across a number of asset classes. This is regarded in South Africa as a typical 'balanced portfolio'.

The Financial Services Authority (FSA) provides comparative tables of charges for United Kingdom endowments. Though comparison across countries is difficult, not least because the UK products are sold essentially without advice, the corresponding figures in the UK appear to be substantially lower than in South Africa, perhaps by as much as half.

FSA charge figures are expressed in pound sterling money amounts, which are sensitive to modelling assumptions, particularly the assumed rate of return on investments. They nevertheless appear to be significantly lower than the figures presented in this paper. For example, Old Mutual Group Schemes total charges, for a R200 ($28) 10-year policy, on assumptions consistent with those used in the FSA calculations, amount to R6 715 ($930), 20.7% of the before-charges maturity benefit of

R32 495 ($4 882). The charges for FSA products, for a £20 ($40) 10-year policy, chosen to be roughly equivalent to a R200 policy in South Africa, amount to between £237 ($474) and £456 ($912), between 7.3% and 14.0% of the before-charges maturity benefit of £3 250 ($6 500). The FSA survey is likely to be biased downwards as providers with low charges are more likely to participate, but the comparison between a R200 ($28) policy and a £20 policy is probably slightly generous to the South African product and differences between the percentages are significant. Although the equivalent VLTCS products in the UK aimed at the low-income market are typically sold without costly advice and so are not really comparable.

The range of charges is significant. Of the six available at a monthly contribution of R100 ($14), the cheapest is available at an annual cost on assets of 3.25%, the most expensive at nearly 11%. The equivalent aggregate impact on total savings varies from under 16% to over 40%.

Only the Umbono As'Investe endowment sold through Hollard comes in under the proposed 4% benchmark at a premium of R100 ($14) per month. The product is distributed through Post Office branches, which makes it highly accessible to customers. The salespeople are paid by the Post Office and so the product does not have to support the sales cost. However, customers interested in this product may not have access to banking and must incur the additional costs that such new access requires. Nevertheless, the distribution channel may be effective. The product is intended for low-income South Africans, who are high users of the services offered by the Post Office.

The Sanlam Halala Savings Plan is also designed for the low-income market. It is based on the better-selling Sanlam Endowment product but has been tailored to be more appropriate to those who cannot afford large premiums, reflected in lower fixed charges and significantly cut commission. The reduction in yield comes close to the 4% threshold, giving a reasonable possibility of net returns above the rate of inflation.

The Old Mutual product is more expensive, with a reduction in yield of 5.5%, but if offers a starting premium of only R50 ($7), while Sanlam's Halala is available only at R80 ($11) upwards. The Hollard Secure Savings Endowment is more expensive than these.

At the other end of the scale, the Assupol Cash Provider is unmistakeably clear: at these charges the possibility of a positive overall return is small, let alone a return that keeps up with the rate of inflation.

A monthly premium of R200 ($28) opens up a larger range of products. The Umbono offering is by far the cheapest, followed by a cluster of products offering reductions in yield of less than 5%. The range of charges is not as great as at R100 ($14), but a few products would be regarded as expensive, with reductions in yield in excess of 6% rendering a low probability of a real return to the policyholder.

3.2.2 Pricing for sale or pricing for value?

How much difference does the commission rate make? Metropolitan Life is known in the market for its commitment to providing products for low-income savers, but appears to be pricing its products to sell them rather than to offer good value to its customers. The reduction-in-yield at a premium of R200 ($28) is around 7.7%, well behind all of its peers, yet it offers commission at 95% of the allowable maximum, compared with 44% for Sanlam Halala, 67.5% for the Assupol Maximum Wealth School Fund Provider and a completely different salary-plus-incentive approach from Old Mutual Group Schemes.

Would Metropolitan Life offer much better value if it cut its commission rate? The policy document indicates that quoted charges exclude commission, so it is possible to recalculate charge ratios at a lower rate of commission. If the firm were to reduce commission from 95% of the maximum to 50%, the reduction-in-yield on a R200 ($28) premium policy would fall from 7.69% to 7.00%. The equivalent cut to the charge ratio would be from 32.6% to 30.2%, giving back to the policyholder a little under 2.5% in maturity value.

This is not a significant cut. The policy would remain the most expensive in the sample, still way off the pace-setters, Umbono at 2.29% reduction-in-yield and Sanlam Halala at 4.04%. What is not clear from the numbers is whether charges would rise if sales fell on the need to cover the same fixed costs from a smaller set of policies.

Another way to control costs is to avoid selling small policies. Metropolitan does this already. Premiums must be R160 ($22) or larger. Is it making unreasonable profit or running an inefficient operation? We cannot tell from the information available whether either of these conclusions have any validity, but the firm would probably need to make some changes if policyholders were more sensitive to costs and had the means more effectively to compare products across providers.

3.2.3 Conclusion on charges

It is difficult to establish in any absolute sense what would constitute a fair charge. However consumers should certainly be in a position to judge for themselves whether or not they are willing to pay charges. At the present charges are not transparent. Working out charges involved taking out and then cancelling all the policies to obtain policy documents. An actuary then extracted the charges from thin data. Considerable calculation was then required to enable comparison of products on a like-for-like basis. This has three negative social consequences:

1) consumers do not know how much they are being charged for their products;
2) consequently they cannot shop around; and
3) competition is inhibited.

3.3 Flexibility: How easily can savers draw part of their savings before their policy matures?

An endowment provides a mechanism for disciplined saving and in this sense promotes a significant social good. Poor consumers with multiple demands on limited income value the discipline imposed upon them by the contract. As one of the respondents in the study, noted about the use of debit orders to pay for her VLTCS policy:

> *"…because the little money that I get is difficult to save – the money just goes through your fingers, but if you have something like this [a debit order] then you know that they have to take the money from the bank"*.

A similar sentiment was expressed in research conducted by Aliber (2001) around the motivation for joining Accumulating Savings and Credit Associations (ASCRA), i.e. members liked the fact that they had an obligation to save. A balance needs to be struck between this obligation and reasonable flexibility. If a VLTCS product is so constraining that the financial commitment to the product results in significant risk of borrowing to cover expense overruns or emergencies, its positive utility is outweighed by the corresponding negative expensive credit. Product design, in most cases, seeks to balance the discipline of regular deposits with the benefit of limited access to accumulated funds.

In addition to a need to withdraw funds, some VLTCS policy holders will need to terminate their VLTCS. The causes and consequences of early termination are dealt with in the following section, but in brief, a client is said to terminate a policy early when they do not save until the policy matures (what they had contracted to do). They can do this either actively by notifying the VLTCS provider of their intentions, or passively by failing to make regular savings contributions. (This is often referred to as lapsing the policy).

The problem with early termination is that the VLTCS policy holder typically only receives a small percentage of their savings back, known as a surrender value. This is because the VLTCS provider incurs fixed costs in selling the product and recovers those fixed up-front cost from the deposits on early termination. If there are very few deposits then recovering the upfront costs may result in the saver receiving none of their savings back (although South Africa has recently introduced legal minimums to the payout on early termination).

The table below summarises the extent to which each product (10 year products are used in this table) permits access prior to maturity.

Table 10. Overview of product flexibility

Name of company and policy	Earliest surrender	Cash penalty	Percent penalty	Regular withdrawals
African Life				
Graduate Cash Growth Plan	11 months	✗	✓	✗
Assupol Life				
School Fund Provider	1 year	Not spelled out		✓
Study Policy	3 years	Not spelled out		✗
Cash Provider: New Wave	3 years	Not spelled out		✓
Clientèle Life				
Saver and Protector Plan	No mention of surrender terms in documents.			
Hollard Life				
Secure Savings Endowment	1 year	✓	✗	✗
Umbono As'Investe	1 year	✗	✓	✓
Metropolitan Life				
Dreambuilder Cash Plan	1 year	Not spelled out		✓
Momentum				
Investo Investment Plan	1 year	✓	✓	✓
Old Mutual Group Schemes				
Money Care Plan	2 years	✓	✗	✓
Sanlam				
Halala Savings Plan	1 year	✓	✓	✓
Endowment & Edufocus	1 year	✓	✓	✗

Source: Policy documents obtained from insurance companies

In the above table, all products covered by the research are included, whether or not full policy documents had been received. Ideally, surrender values should be compared by drawing identical quotes from each provider. This is difficult in practice, since the lowest premium at which all firms could quote on was at the high end at R200 ($28) monthly, as some firms do not offer products at less than this.

Four different policy characteristics are set out in the previous table. A cash penalty is probably easier for most consumers to understand than a percentage penalty, but the method used is intricately tied in to the overall charging basis and it is not possible to infer the value provided on surrenders from the data.

3.3.1 Benchmarking flexibility

The most important information in the previous table is set out in the first and fourth column. A policy is deemed flexible if it provides access to:

1. a surrender value from a reasonably early duration; and
2. a flexible withdrawal option, albeit limited, sometime during the policy term.

The products of Metropolitan and Momentum Life, the Assupol School Fund Provider, the Hollard/Umbono As'Investe and Sanlam's Halala Savings Plan appear to provide the benchmark against which others might be compared. All of these products provide access to a surrender value from the first policy anniversary at the latest and all of them grant some form of flexible withdrawal facility. Some of these policies pay out earlier than the first anniversary if sufficient funds have been accumulated under the contract.

Others provide one or the other, but not both. The African Life product, for example, permits surrender from 11 months onwards, but not flexible withdrawal. Old Mutual's Money Care Plan provides for regular withdrawal, but only allows surrender after 2 years, at least at a premium as low as R100 ($14) monthly.

Product design almost invariably concerns trade-offs. Some of the more expensive products provide greater flexibility but do not permit small premiums. The Metropolitan Life Dreambuilder Cash Plan is an example of such a product. Others, like Old Mutual's offering, are cheaper and provide better access in terms of low premiums but cannot also offer high levels of flexibility.

3.4 Document quality

The criteria used to assess the clarity of the documents are set out in the next table, together with the average score on each rating.

Table 11. Weighting for assessment of the documentation

	Criteria	%	Average
	Total	100	51.1
1	Style & clarity of language:	55	31.0
1.1	- sentence length	5	3.5
1.2	- use of active verbs	5	3.1
1.3	- use of simple pronouns, "you" and "we"	5	3.0
1.4	- appropriateness of words to reader	5	2.9
1.5	- clarity of instruction	5	3.0
1.6	- glossary of terms used	5	0.5
1.7	- overall sense of navigation & document clarity	5	3.0
1.8	Overall appropriateness of document length	10	5.4
1.9	Overall sense of numerical disclosure	10	6.5
2	Candour: clarity of the description of	45	21.0
2.1	- early termination benefits	10	4.5
2.2	- general terms and conditions	5	3.2
2.3	- consequences of missing contributions	5	1.9
2.4	- VLTCS provider flexibility to vary charges	5	2.1
2.5	- fees and their impact	10	5.4
2.6	Overall assessment of candour	10	3.5
3	Deductions for gross errors	up to 20	-0.9

Source: Policy documents obtained from insurance companies; Plain English guide

One key component was candour. There are two broad parts to this, firstly, whether all the relevant information was disclosed and, secondly, whether the information that was disclosed was true. As there were almost no cases of non-disclosure, in this context candour refers to disclosure of relevant information. All members of the Life Offices Association (LOA) must adhere to the Code on Policy Quotations. The code maintains that providers are required to include a certain amount of prescribed information, so candour has been given a slightly lower rating than writing style. Information required under compulsory disclosure standards can be set out in a way that does little to enhance understanding, however, so candour has been assessed with a view to considering the clarity with which the information has been presented, not just whether it is included at all. Not all life insurers are LOA members, but all of those included in this study are.

Few South Africans receive product documentation in their language of choice. The country has eleven official languages but policy documents are produced in only two of these. This is partly due to legitimate problems, expressed by speakers of the vernacular, of the difficulty translating insurance terms into other languages, but this reflects poorly on the efforts of VLTCS providers to use language that is clear and simple. As 'choice of language' would be assessed very poorly for all providers, it has been omitted from the ratings, but concerns on this issue are strongly expressed. In particular while it may be difficult to translate very technical terms into the vernacular, the most crucial basic information like "What will happen to my policy if I stop paying?", "When can I withdraw money from my policy?" and "When can I get my lump sum?" can all be expressed easily in any language.

3.4.1 Assessing language clarity

Language clarity itself is assessed using the guidelines established by the Plain English campaign[8]. This can only be carried out on policy documents written in English, but all providers meet this requirement.

Average scores for clarity (refer to Table 11) are reasonably consistent across categories with the exception of the glossary. Very few providers attempted to define terminology properly and the highest score awarded is 2 out of 5.

3.4.2 Candour

The criteria used for assessing candour of presentation represent our assessment of the most important aspects of policyholder communication plus a generic measure to capture document clarity and overall approach. The extent to which the layout contributed to comprehension was also included in the overall assessment.

This time average scores vary significantly across categories (see the previous table). General terms and conditions are expressed fairly well and fees disclosed, though

[8] This is a UK campaign, that among other things, has developed an applies a set of metrics to documentation to rater how easy they are to read and understand.

in many cases sufficient only to meet LOA standards of disclosure rather than ensure clear understanding by policyholders.

Other scores are poor. Very few providers set out with any clarity the consequences of missing contributions or the freedom of the VLTCS provider to vary charges. Early termination benefits are in most cases not clearly described. A table of cash values is not regarded as sufficient to meet the requirements of good communication, which should include a description of the consequences of terminating early, like the actual charges on exit.

The overall assessment of candour is marked down in many cases for a variety of reasons, for example:

- the inclusion of irrelevant information, like policy exclusions on death and disability cover that do not apply to a contract providing saving only;
- absence of information like fees or the available investment options;
- poor description of complex concepts;
- layout or terminology that does not appear to enhance policyholder understanding; and
- gross errors.

An example of a gross error is in the Sanlam Halala policy document, which has an inconsistent quotation of policy charges.

3.4.3 Combined evaluation of the documentation quality

The following table summarises the results for each policy.

The scoring suggests that most of the documents are mediocre. This is supported by our overall impressions. They are generally long, technical and opaque. Documents do not appear to have been written with the policyholder in mind and there is no evidence that the understanding of policyholders is tested as part of the writing process.

Table 12. Product assessment overview

	Clarity	Candour	Errors	Total
Maximum score	55	45		100
Assupol Life				
School Fund Provider	32	17	-	**49**
Study Policy	31	17	-	**48**
Cash Provider: New Wave	33	17	-	**50**
Clientèle Life [a]				
Saver and Protector Plan	23	8	-	**31**
Hollard Life				
Secure Savings Endowment	30	21	-	**51**
Umbono As'Investe	30	23	-	**53**
Metropolitan Life				
Dreambuilder Cash Plan	25	25	-	**50**
Momentum				
Investo Investment Plan	28	19	-	**47**
Old Mutual Group Schemes				
Money Care Plan	37	30	-	**67**
Sanlam				
Halala Savings Plan	37	27	-10	**54**
Endowment & Edufocus	37	22	-	**59**

Source: Policy documents obtained from insurance companies

Products in the previous table are only included where the research results in a policy document rather than a simpler product summary, except in the few instances where it was not clear that what was an official policy document rather than a general information document.

Not all documents score badly. The policy document for Old Mutual's Money Care Plan is carefully written with the policyholder in mind. It seeks to explain with care the impact of fees and the early termination benefits. However, the document is not perfect. It includes no explanation of terms and it fails to describe the investment approach. In one or two other areas it is a little confusing in its use of terminology.

The Sanlam documents are probably adequate but not flawless. Both of them are shorter and more clearly laid out than many of their counterparts.

It has been very difficult, in many cases, for a qualified actuary to understand the technical content of the policy document. On this experience, it is likely that no more than a very small proportion of policyholders and a slightly larger proportion of intermediaries would have a clear understanding of the details of these contracts.

3.5 Putting it all together - which product offers the best value to the poor?

The table below summarise the features already discussed into a “traffic light” set of signals.

Table 13. Which product offers the best value to low-income consumers?

Name of company and policy	Affordability	Charges	Flexibility	Document quality
African Life				
Graduate Cash Growth Plan	No policy document			
Assupol Life				
School Fund Provider				
Study Policy				
Cash Provider: New Wave				
Clientèle Life				
Saver and Protector Plan	No charges information			
Hollard Life				
Secure Savings Endowment				
Umbono As’Investe				
Metropolitan Life				
Dreambuilder Cash Plan				
Momentum				
Investo Investment Plan				
Old Mutual Group Schemes				
Money Care Plan				
Sanlam				
Halala Savings Plan				
Endowment & Edufocus				

Source: Policy documents obtained from insurance companies.

Only those products with information on all aspects of the analysis are included in this table. Green is allocated to the three products with characteristics most beneficial to the policyholder and red to the three worst. However, on flexibility, those products offering partial withdrawal and surrender within one year are awarded a green rating; the one product offering neither has a red rating; all others are yellow rated.

The table shows how difficult it is for product designers to meet all objectives. None of the products achieve the highest rating on all measures. The Hollard/Umbono offering appears to be the most appropriate to low-income savers, achieving a green rating on access, charges and flexibility. It falls slightly short of the highest rates on the quality of its documentation. Sanlam's Halala achieves three green ratings, compromising on minimum premium, where it falls only just outside of the green category. Old Mutual's Money Care Plan achieves two green ratings and two orange ratings. Only one other product of the ten, the Secure Savings Endowment from Hollard, avoids a red category rating.

All other products show a combination of ratings. None of them have more than two red ratings of a possible four, suggesting that there is no such thing as an unambiguously "bad" product and that all providers make a reasonable attempt to find a way through the priorities faced. Note that the trade-offs do not apply to the issue of policy documentation and that there is considerable room for improvement on this aspect across nearly the entire product range.

4. Customer Satisfaction

Respondent satisfaction is difficult to quantify because some clients may express satisfaction with their policies but may be unaware of issues that would negatively affect their satisfaction, such as early termination penalties. Assessing satisfaction therefore required a degree of judgment on the part of the research team.

Client satisfaction was assessed as follows: since the project concerned itself with voluntarily purchased products, those with compulsory-purchase LTCS, associated with pension provision, were excluded. This left 144 respondents. The first marker of customer satisfaction was the ***reason for purchasing the VLTCS policy***. The team excluded all the respondents who bought the policy for a purpose which it could not serve. For example, respondents who bought the policy thinking that it was funeral insurance or that it could be drawn upon easily, i.e. confused it with flexible savings. This left 115 respondents who bought their policies for entirely appropriate reasons such as future education and retirement needs.

The team then looked at how ***much the respondents knew about their policies*** and used knowledge of the maturity date as an indicator of this. Only 87 of the 115 knew when their policies matured. A further indication of important knowledge of their policies was awareness of the consequences of early termination i.e. surrender values. Of the 87 only 35 knew about the consequences of early surrender (there were consequences of early termination for all policies in the sample). Finally, the respondent's subjective sense of whether or not they were satisfied with their purchases was examined. Two of the remaining 35 expressed dissatisfaction with their policies. One respondent noted that the agent had not fully disclosed all policy features, the other said that the agent disappeared after the sale and was not contactable.

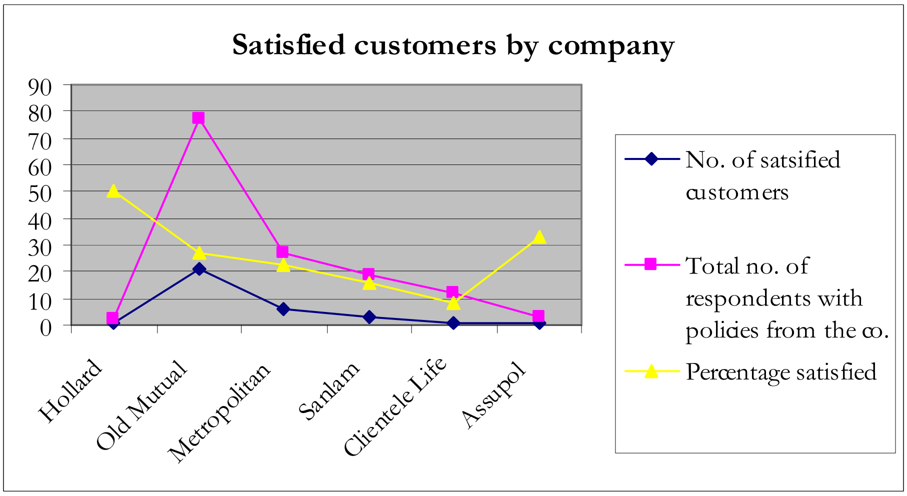
So of the initial 144 VLTCS purchasers approximately a quarter of the sample:

- bought the policy for an appropriate purpose;
- knew the crucial terms and conditions of the policies; and
- expressed satisfaction with their purchase.

On the face of it this is not a good proportion. Those who received crucial policy information that was incorrect could lose a big proportion of the little savings they have, if for instance, their maturity dates do not coincide with their retirement dates.

The group of 33 VLTCS policy holders were examined in detail to see if they had any common characteristics. The first place to look was of course by company. The results of which are presented in the following chart.

Chart 6. Satisfied customers by company

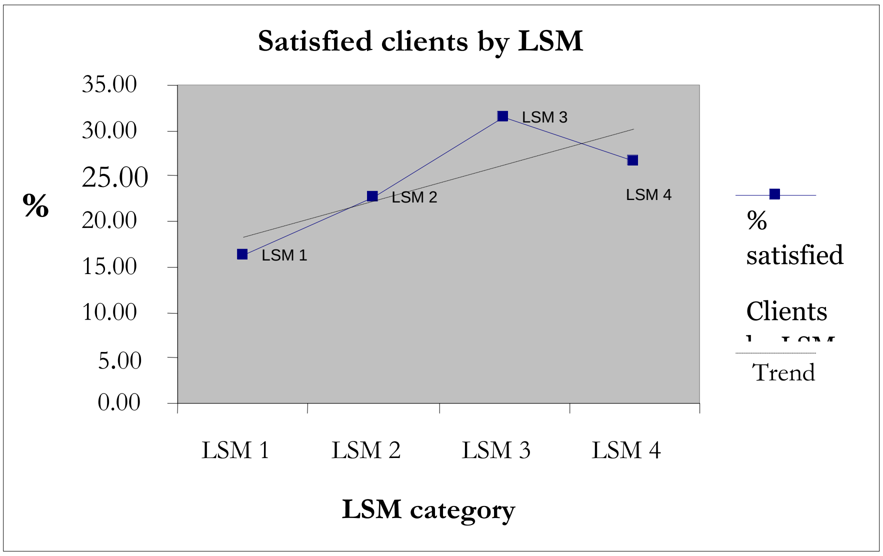


Source: Fieldworker interviews

No company seemed to do very much better than any other. Hollard is the exception but as only two respondents had policies from Hollard the results are not very meaningful.

The only significant correlation between client satisfaction and another variable was with LSM, the results of which are presented in the next graph.

Chart 7. Satisfied customers by LSM



Source: Fieldworker interviews

The trend lines demonstrate a relationship between LSM and client satisfaction i.e. as LSM level increases, client satisfaction increases. A possible candidate explanation for this is that higher LSM households have higher levels of formal education and so are better able to understand the product they have bought (understanding was a key component of the measure of client satisfaction).

4.1 What makes for unhappy VLTCS clients?

Eight key problems with VLTCS products emerged from the respondent and advice office[9] data:

1. Disclosure
2. Early termination penalties
3. Mis-selling and fraud
4. Poor after-sales service
5. Inflation
6. Tax
7. Lack of bank accounts
8. Provider inefficiency

> **Box 4: The glass is half full?**
>
> While it reflects badly on existing insurance companies that only a quarter of the respondents could be deemed satisfied with the product they bought, there a is positive take on this. What the figures do tell us is that however small a proportion, at least some policyholders are buying and receiving what they want. In other words South Africa has succeeded in selling VLTCS policies to the poor. The crucial challenge that remains is how to shift the ratio of dissatisfied to satisfied clients. The figures *confirm* suspicions that the vast majority of low-income clients are not satisfied with their purchase but *refutes* claims that VLTCS products sold to the poor cannot in principal offer good value to them.

4.1.1 Non-disclosure - not knowing what one is buying

Poor disclosure was evident in all the types of data considered, i.e. respondent interviews, examination of advice office case studies and policy documents. On the products, the analysis summarised in Table 12 rates nearly all policy documents as very poor. All of the team members in the research team, including the actuary, commented that they had difficulty understanding key sections of the various policy documents. It is extremely unlikely therefore that many low-income clients or their agents would be able to comprehend the documents. They appear to have been

[9] Advice offices are NGOs in South Africa that offer free legal advice to poor people.

written largely for regulatory compliance with little thought given to whether or not they could actually be understood by low-income people, often with low levels of formal education, who were in many cases reading the documents in a second or third language.

Even this criticism of the industry is perhaps getting ahead of itself. Most damning with respect to disclosure was that the mystery shopper was unable to obtain policy documents without first taking out the policies and then cancelling them. In some cases, companies were prepared to provide quotations first, but it was very difficult to obtain key details of the policies without first purchasing them. In two cases, the mystery shopper found that monthly premium deductions had commenced before policy documents arrived. Cancelling the policies was an administrative nightmare, involving sending certified copies of Identity Documents and relevant bank statement, all of which needed to be sent by fax.

Providers tend to give two responses to this criticism. The first is simply to suggest that they have no disclosure obligations beyond the legally required standards. This stance can facilitate all manner of injustice and fraud. For example, the advice office had a case (albeit an insurance and not VLTCS case but the principle applies) in 1999 where the client claimed she was misled by an insurance agent who came to her workplace selling burial insurance. She understood from the agent that her premiums would be R60 (approx. $8 at current exchange rates) per month but when she received her payslip, it was R123 ($16). The response from the insurance company was to stick to their minimal legal obligations and assert that the client had received a policy document that gave her the right to review the policy and cancel within 30 days if she was not happy. A deadline which she missed.

A more reasonable response by VLTCS providers on the question of policy documents is that their agents are tasked with explaining the terms and conditions in person to clients. Indeed this process was mentioned by agents to the mystery shopper when she requested the policy documents. The agents responded that they do not give them out but would visit her to explain the terms and conditions. Providers may make such claims but a great number the advice officers indicated that a significant percentage of agents do not provide advice. Also, as evidenced in some of the advice office cases, insurance providers tend to distance themselves from the advice given by independent intermediaries, claiming that they are not responsible for the accuracy of such advice.

Data from the sample of respondents who bought VLTCS indicated that agents failed to disclose crucial information, for example:

- 41% of respondents said they were not told of the consequences of early termination and a further 28% said they could not remember if they were told;
- 19% did not know when their policy matured;
- 3 respondents believed they had purchased funeral insurance alone; and
- 8 respondents said they had purchased their VLTCS to provide them with an emergency savings fund if they were to lose their jobs.

Of the advice office cases, 18% (of 160 cases with relevant data) arose from non-fraudulent lack of disclosure, that is clients when asked by advice office workers about details of their policies indicated that they had no knowledge of them and were never provided with information.

At the macro level the lack of disclosure reduces meaningful client choice and hence the prospect of competition between providers with its attendant benefits. At the micro level the consequences for low-income clients are often tragic: they are spending much more of their household income than they need to if all they want is funeral insurance; they may not get the funds when they need them; they may not get as much as they thought they would get when the policy matures; and finally, and perhaps most importantly, they are often not aware that if they terminate their policy early they only get a very small percentage of their savings returned to them..

4.1.2 Early termination penalties

In contrast to VLTCS products, short term savings products like open-access passbook type savings schemes are relatively easy to sell. They are simple to explain, they do not require a significant long term commitment and because they are short term, the client soon has a demonstration of how they work. As policy term lengthens the difficulties associated with selling the product increase. VLTCS products are a significant commitment for anyone. For poor people with multiple demands on limited household income some convincing is required to get clients to buy the products. Like insurance products, VLTCS are “sold not bought”. VLTCS are rarely sold passively, through a client coming to a bank or a MFI and requesting a product. More typically a salesperson needs to develop a relationship with the client, using selling techniques akin to those of insurance - "What will happen to you when you grow old? Who will take care of you?" etc. The salesperson needs to reassure the potential client that the institution is stable and safe because unlike short term savings, the client has no immediate way to test the seller’s claims.

In South Africa where attempts have been made to sell VLTCS without using agents, the attempts have had limited success. Three respondents from South Africa, who attempted to sell VLTCS through banks indicated that their attempts had been unsuccessful. The reason they gave was essentially that bank staff were not trained and motivated to sell the products. All three informants held that without a motivated, well-remunerated seller, there would be no sales. Presently the environment is strongly dominated by a commissioned sales force.

Aside from the need to sell, there is also a need to give advice. The more complex the product the greater the need for advice and explanation. VLTCS products by their nature are some of the most important products that a person can buy. They are bought for a variety of reasons, but clearly the key reason is to provide a substantial sum for when purchasers are no longer able to earn (e.g. retirement) or when they suddenly have large expenses (e.g. education expenses). In addition to being important, they are also one of the largest financial commitments a person is likely to make. Although some VLTCS products are simpler than others, most require advice at the point of sale. Some products that combine savings with insurance can be very complex, but even the simplest of VLTCS products require significant advice about issues such as the risk of the investment, the impact of inflation, product charges, ensuring that the maturity date coincides with a retirement date or some other appropriate date, ensuring that the client’s income is likely to be stable enough to keep to the contract, and advice about any potential tax implications. It would be unreasonable to assume that low-income clients, often with low levels of formal education or indeed literacy are likely to be in a position to easily understand the terms of their contract or ask about these crucial issues unprompted. As one respondent, Gideon, noted:

"… I am not that educated and this agent took advantage of that and did not say anything about inflation and how it affects my policy savings. I have no plans to protect myself against this".

It would be deeply inappropriate to sell all but the very simplest VLTCS products (one of the most important, expensive and complex financial commitments a low-income client may ever make) without advice tailored to the needs of the client.

Motivated sellers and advice providers are expensive. With low-income clients saving small amounts, it can be hard to cover the costs of motivating sellers and compensating advice providers. If this has to be done from scratch (as in a bank or an MFI that wanted to start selling VLTCS) the costs of setting up the infrastructure to provide this can be prohibitive. This is one reason why VLTCS products have often been provided by insurers, which usually have a network of agents used to selling more complex financial products than credit and short term savings products.

The costs of selling and the initial advice provision are incurred by the VLTCS provider up front. If the buyer terminates the contract early these are taken from whatever savings have accumulated. In practice this means that many savers who terminate early (for example within the first few years of saving) may lose all of their savings. Clients may terminate their VLTCS policies early for a number of reasons:

4.2 Reasons for early termination penalties

4.2.1 A drop in saver's income

Early termination penalties caused by a drop in saver's income occur because the client is retrenched, retires, their income is precarious and fluctuates or because they have unexpected demands on household income that take priority over saving. It is often the case that the poorer one is the more precarious one's income tends to be and therefore the more likely one is to lapse. However, the advice office cases studies generated a number of examples where the agent sold policies either knowing that they would lapse or not providing the advice that they ought to have provided.

A case where the blame for early termination due to loss of income could be laid at the door of the agent (and therefore the provider) was where VLTCS policies were sold to employed clients without ensuring that the maturity date coincided with their retirement date. There were three instances of clients who approached the advice office needing help surrendering their policies because they were about to retire and could no longer afford the payments. In one instance from 1997, a client with five policies wanted to "cash in". Three of his policies had been taken out less than three years previously and so had no surrender value. He was illiterate (signed the documents using thumbprints) and should never have been sold a VLTCS policy with no surrender value in the first three years only three years before retiring.

4.2.2 An increase in saver's expenses

There were comparatively few instances of early termination because of increases in the saver's expenses. It is unclear why this is the case. It would require more research to find out why contractual savers seem rarely to terminate when other expenses increase. One possibility could be the stop/debit method of saving which physically removes the savings from disposable income. The few cases of early termination due to expense increases could unfortunately mostly be blamed on the agent (and hence provider). These cases included a large number of instances where agents sold client policies over and above their existing policies to the point where the client could no longer afford the policies and surrendered them.

The advice office had an example from 1993 that involves a caretaker at the then Department of Education and Training, earning R708.50 (approx US$100 at current exchange rates). He had been sold six policies and his premiums were in total R448.42 ($62) per month. Along with other deductions such as medical aid, pension, unemployment insurance, his take home pay was R170 ($23). He came to the advice office for help in cancelling some of the policies.

In another case from 1994, the client came to the advice office wanting help to surrender three policies he had taken out in 1992 and 1993. While the bureaucratic issues of the case were being dealt with, the client was sold a further four policies. It transpired that the policies he wished to surrender had lapsed. By far the worst case was of a labourer within the South African Defence Force who had seven policies. He was about to be retrenched in 1997 and wanted assistance surrendering all the policies, two of which had, as yet, no surrender value. It took a total of six months for all the policies to be cancelled or surrendered and monies paid over. In all of these cases the agent (and therefore the provider) was in breach of their duty to advise the client that the policies they were sold were likely to exceed their savings capacity and would therefore likely result in early termination and the loss of their savings.

4.2.3 Mis-sold or fraudulently sold policies

There is a fine line between fraud and mis-selling. In cases of mis-selling a client buys a product that is inappropriate to their needs because they have not been informed by the seller of all the terms and conditions. Fraudulent behaviour usually involves the buyer being provided with false information about the product. In both cases the result is similar – the client ends up with an inappropriate product. If the client discovers that is the product inappropriate before its maturity they often seek to terminate the policy.

4.3 The consequences of early termination penalties

The consequences of early termination penalties for low-income policyholders can be both tragic and socially perverse. This is because the poorest members of society lose much of the little savings they have mustered together. They are socially perverse because when applied in effect the savings of low-income clients are transferred to the agents as penalties. The agents are typically wealthier than their clients and so the result is in effect a transfer of resources from poor buyer to wealthier agent.

4.3.1 Mis-selling and fraud

The VLTCS industry unfortunately lends itself to mis-selling and fraud, mainly because of the asymmetric distribution of information between buyer and seller. Contracts are complex and difficult to understand and the buyer has to trust the seller to disclose information. The long term nature of product can furthermore hide the mis-selling or fraud for a long period.

Even in some of the most well-regulated markets large numbers of VLTCS products are mis-sold. In the UK, the Treasury Select Committee estimated that 5 million people were mis-sold endowment policies. For the most part, these clients bought endowment policies together with a mortgage believing that the endowment policy would pay off their loan when the endowment matured. They were not told of the possibility that the maturity value may not be sufficient to cover the outstanding loan which is precisely what occurred to large numbers of the policyholders. The UK Treasury Select Committee that investigated the problem estimated a nationwide shortfall of £40bn ($69.6bn). This in a market which is widely regarded as having one of the world's most sophisticated, and well-resourced regulators, and with an almost entirely literate population.

When buyers have low levels of formal education or indeed are illiterate the informational advantage of seller over buyer increases and with it opportunities for mis-sell and defraud, examples of which have been uncovered in the analysis of advice office cases.

Box 5: Some examples of fraud

One advice office case 1996 involved a client who alleged that the VLTCS agent asked him for his payslip. The agent took the payslip and promised she would give him a t-shirt and a tracksuit. The payslip was never returned and the promised clothing was never delivered and the client never saw the agent again. However, a policy document was sent to him and R100 (approx $13 at current exchange rates) was deducted from his salary. He claimed he never signed the stop-order authorising the deduction of premiums.

In 1998 the advice office had two cases that involved clients being persuaded to take out a second policy when they already had a perfectly good policy. They were both persuaded by agents to cancel the first policy in favour of the second. In the first case, the client claimed that the agent convinced him to cancel the policy he had because he would not be able to get a loan on it, and to take out the alternative that she was selling. The second case involves a client claiming to have been tricked by the agent who had persuaded him of its benefits. However, when he examined his older policy closely, he felt that the new policy was not what he had been promised and the old one was better.

4.3.1.1 Varieties of fraud uncovered

From the respondent interviews a single case of fraud emerged where a client was misled about what the savings could be used for and when she thought she could withdraw them. The cases of fraud from the advice office were mostly a variety of getting clients to agree to sign (or thumb-print) policy documents informing them that they were something other than policy documents, or in the most extreme cases falsifying their signature.

While most VLTCS providers approached attempted to rectify the situations of fraud (and mis-selling), often after considerable effort by the advice office, the response of some was to stall or hide behind minimum legal obligation. For example a case from 1991 involved a foreman who was sold an endowment plan. He came into the advice office wanting to cancel the plan because he was led to believe that it also contained health insurance and he had subsequently found that it would not pay for his doctor's visits. He came to the advice office and requested that they write a letter to the provider cancelling the product because he could not write.

The advice office case worker contacted the provider’s agent (an insurance broker) who said that since the client had signed the 12-month stop order, he could not cancel the policy. Upon contacting the insurance company itself to try and cancel the policy, the representative is recorded as saying that “they [the company] have endless problems with unscrupulous brokers who, because they are qualified, are permitted to sell their policies. They will sell any policy to anybody and most times illiterate people don't understand the details.” The only way a stop order can be cancelled by the insurance company is if the broker requests them to do so or the (providers) pay office sends them a letter requesting them to do so. But the pay office will not send the request unless it receives notification from the insurance company that the policy has been cancelled. The broker, in his/her own self-interest, is unlikely to consent to this because he/she will lose money. And the company noted that at the end of the day the client did sign a legal document and so had no legal right to get refunded. Fortunately for the client in this case, the intervention of the advice office led to the insurance company stopping the policy and refunding the money.

4.3.1.2 Varieties of VLTCS mis-selling uncovered

Far more common than outright fraud in the advice office records and from the interviews with VLTCS policy holders was mis-selling. This comes in a variety of forms, for example:

- the sale of VLTCS products to clients who already have such products to the point where their total expenditure on the products exceeds their saving capacity;

- the sale of VLTCS products that mature after the VLTCS policy holder retires; and
- misleading the client not through the provision of false information but by not disclosing crucial information such as the existence of early termination penalties (the most common type of mis-selling).

As discussed in the section on disclosure this is a pervasive problem with significant numbers of respondents unaware of the existence of early termination penalties and other crucial information.

4.4 Poor after-sales service

One respondent, Linda, noted the following in response to a question about her after-sales service experience:

> *"…when I call them then I want to talk to the agent and I always have to wait long…I want to contact them, but they have moved their offices and they have not let me know where to, so I don't know where they are, and when I phone them I cannot get hold of the agent. This is a problem because I cannot hold on the phone very long and I cannot go there in person because I don't know where they are."*

The advice office records indicate that clients from all insurance companies needed help with their policies and that none of the insurers was providing decent after-sales service. Customers who ended up at the advice office should not have needed to, as they should have been serviced by the insurer and agent. The available data does not permit analysis of consistent discrepancies in the level of service from each provider. What is clear, however, is that there are major gaps in the provision of after-sales service by all companies. A similar picture emerged from the interviews with VLTCS policy holders – 28% of respondents who had attempted to obtain after-sales service were unable to do so.

After sales service is required for a variety of tasks, these include:

- questions about terms and conditions;

- questions about actions taken by insurers, for example, when deposits are not made and the policy lapses;
- surrendering policies;
- simple administrative tasks like changing personal details;
- taking a loan against the surrender value of an VLTCS policy; and
- other inquiries and requests to change the policy, for example to increase deposits.

A possible cause of the lack of after-sales service is the tendency of providers to pay most of the agent's commission up-front in the first few years. Once the agent has received their full commission the incentive to provide after-sales service is diminished. Without the agent the client either needs to go to an office of the VLTCS provider or phone the provider. Both options are difficult for the low-income clients. The former may not be viable because the VLTCS provider does not have an office in the same town as the respondent and may involve significant expense for the policyholder may need to take leave from work to visit the office. Telephone contact may prove difficult for low-income clients who may not feel confident or have any experience of dealing with companies over the phone.

4.5 Inflation erodes long term value

Inflation may erode the value of the savings. Over the last decade inflation in South Africa has been both low and stable. This may account for the fact that 35% of respondents were not aware of inflation and its effects on their VLTCS policy. The majority (69%) of the sample of VLTCS policyholders knew about inflation but felt helpless to deal with the problem. A very small percentage of respondents had dealt with the problem by:

- increasing premiums;
- taking out additional VLTCS policies; or
- planning future income sources - e.g. one respondent believed that his son would be working and supporting him when he retired.

A few optimistic respondents believed that inflation would not be a problem either because it would be very low in the future or because they believed the rate of return on their investment of the savings would be greater than the rate of inflation. As we see from the analysis, this is likely for some policies, but not all of them.

4.6 The poor are unfairly taxed on their policies

The issue of tax was mentioned briefly in the second chapter. In summary: VLTCS policy holders in South Africa are taxed on the income they earn on VLTCS products by 30%. The tax is deducted before the saver receives their lump sum. As South Africa, like most countries, has a tax system based on the concept that the wealthy pay tax at a higher proportional rate than the poor, the flat tax on some VLTCS products is anomalous. A typical low-income policy holder would not be earning sufficient income to pay tax on these earning if they were required to do so themselves. Sixty six percent of respondents were not aware that their investment income would be taxed. In the words of a respondent, Toto, on whether or not he knew if his investments would be taxed and that he indirectly would be paying that tax when he withdraws his savings:

> *"...no [I do not know], but if I need to pay tax I do not think it will be a lot of money because I am not a business man. I am only saving money."*

4.7 Lack of bank accounts

A few cases came to the attention of the advice office where the client had either lost his or her job or retired. Once the client no longer worked and received a salary through their bank account the client closed the account because they felt it was not worth the expense of maintaining. The surrender or maturity value of the VLTCS product was posted to the ex-policy holder as a cheque and they had no way of cashing the cheque. These cases were relatively old and it is possible that the new low-income Mzanzi accounts with the low operating costs may have ended this problem.

4.8 Provider inefficiency

Many cases presented to the advice office were a result of provider inefficiency. For example in April 1993 a client came to the advice office because he was having double premiums deducted on both his policies each month. This had been going on since November 1992. He had already consulted with the insurance company independently and had received a refund for one of the months. However, the deductions continued. A second cheque arrived with refunds for a further four of the months. The deductions continued. Letters were also sent to the provider to cancel the duplicate stop orders. A further refund cheque arrived but there was still an outstanding amount not refunded. In January 1994 a letter arrived from the company - the case file reads: "Letter includes a breakdown of payments etc. Someone has done some proper homework at last." The outstanding refund cheque was enclosed. The client was so annoyed with the way he was handled by the provider that he then decided to cancel all his policies with them.

Deductions continuing after the policy had been surrendered was a common problem at the advice office. An example of such a case is that of a client who tried to surrender his policy in June 1998 and came to the advice office in October 1998 as he had received no response from the company. He was still having the premium deducted from his pay. He said he had never received the policy document and could not remember when he had taken the policy out. The appropriate surrender value forms were submitted to the company. By May 1999 the advice office decided to write a letter of complaint to the Ombudsman, which finally elicited a response from the company acknowledging that the policy had been cancelled in October of the previous year and enclosing a refund of premiums from that date.

In addition to making errors there was much inefficiency in the correcting of errors by the provider. It is assumed that the advice office was efficient in its presentation of the facts. This is likely to be the case as the correspondence sent by advice office volunteers is closely supervised by experienced staff. The advice office records show for six of the least efficient providers, it took an average eight letters per complaint, between insurer and the advice office, to get the problem resolved. The impact of provider inefficiency is likely to be greatest among the poor.

5. Conclusion and recommendations

The South African financial services industry has succeeded in selling VLTCS products to low-income clients. At least some of these policy holders are satisfied with their products. Thus it is possible to provide VLTCS products to the poor that meet customers’ needs and expectations.

However, the research has also brought to the fore that (at least of the sample of respondents) only a quarter of those with VLTCS could be deemed to be satisfied with their product. Unless the quality of VLTCS products can be improved it would be inappropriate for policy makers to consider VLTCS as part of a national social security framework.

The challenge therefore is to increase the ratio of satisfied customers and remove the worst practices. What follows are a series of recommendations divided into two broad categories: policy makers and the VLTCS providers (although there is some overlap). These recommendations are not magic bullets. They should rather be viewed as some of the potential tools in a toolkit of options available to improve the provision of VLTCS to the poor in South Africa and, where appropriate, elsewhere.

5.1 Recommendations for policy makers

5.1.1 Systematically collect data on VLTCS usage by poor households

There is no reliable source of detailed data on the national usage of VLTCS by the poor in South Africa. While useful surveys of financial services and their usage by the poor more broadly exist (such as FinScope), detailed information on the usage of VLTCS products by the poor does not exist. This research can shed light on benefits and costs to individuals who hold VLTCS policies, but policy makers and regulators have no sense of the extent of these costs and benefits. Without data it is difficult to predict the impact of regulation on VLTCS policies and their holders. There are two broad ways of collecting this data. One way is to compel providers to submit the data. On the face of it this is fairly straightforward. In South Africa, at least, many providers will already be segmenting their VLTCS sales data by LSM. However if there are benefits or costs associated with the data, for example if a provider needs to have *x* percentage of the clients falling into some demographic category to obtain a reward or avoid a penalty, then of course there are incentives to “fiddle the books”. In such cases it is not clear how useful this approach would be.

A better approach would be to get an independent body to undertake the research that does not have a vested interest in the data turning out in a particular way.

This could be the board of a national statistics body or it could be an independent organisation that is sub-contracted specifically to undertake the research.

This would have benefits not just for clients but for providers. For example, if lapse rates were made public it would help VLTCS providers get a sense of which VLTCS providers were doing things right.

5.1.2 Tax reform – treating VLTCS policy holders fairly

In a progressive tax system low-income policy holders are taxed according to their income. There are a number of ways to ensure that the investment of the poorest get taxed accordingly. One way is to create a class of products aimed at low-income clients that receive their investment income tax-free. The problem with this approach is that it would be difficult to avoid regulatory arbitrage, i.e. wealthier clients buying many low value policies so as to avoid tax. Another approach may be to allow low-income clients to obtain a rebate. Perhaps agents could help them do this and obtain a percentage of the rebate as commission for their effort.

In South Africa, the Minister of Finance recently announced the removal of the taxation of income produced by the assets of retirement funds. This is a welcome development for low-income members of retirement funds whose directly held savings are largely exempt of income tax. However, similar improvements to the treatment of contractual savings products offered by life insurers have not been forthcoming.

5.1.3 Revisiting commission scales

Following the disturbing analysis of the level of charges in individual retirement savings products[10] and a series of rulings by the Pension Ombudsman, policymakers at South Africa's National Treasury[11] are undertaking a review of the financial services industry. They have indicated that the policy priorities are to establish a revised set of commission scales and introduce the basis for a set of minimum values payable on early termination. Later regulatory review will cover disclosure standards, intermediary status and other issues. Longer term impacts, probably more profound,

[10] Rusconi, R (2004) *Cost of Saving for Retirement: Options for South Africa*, presented to the 2004 Convention of the Actuarial Society of South Africa, October.

[11] National Treasury (2006) *Contractual Savings in the Life Insurance Industry: Discussion Paper*, Government of the Republic of South Africa, March.

will result from the comprehensive government review of South Africa's system of old age provision.[12]

Turning to commission scale issues, commission influences the design of policies and the financial outcome to policyholders, particularly on early surrender. Current maximum commission scales[13] strongly emphasise up front incentive payments, permitting three quarters of commission to be paid at policy inception and the remainder at the end of the first year of the policy. While the level of commission has a significant impact on policy outcome, the shape of commission also has considerable influence, particularly on early termination values.

Early indications are that the overall value of maximum commission will be cut, but that the major change will be a forced shift of commission from nearly all of it being paid up front to half, at least, being spread over the term of the contract in the form of servicing commission.

The proposed commission basis could have a mix of impacts on the policies considered as part of this study. As a high proportion of providers do not pay commission equal to the maximum currently allowed, a cut in the value of commission may not have a significant impact on policy design or values. On the other hand, most providers pay commission up front, in line with existing scales, so a forced spreading of commission creates the potential for enhanced surrender values. Looking outside of the issue of policy values, it should also be noted that the development will make survival more difficult for new entrants to the broker market, perhaps to the detriment of potential customers.

This study has highlighted the need for ongoing support for policyholders and indicated the salary-plus-incentives approach rather than a straight commission approach as a method of aligning the interests of policyholders and sales intermediaries. The overall impact of the policy change i.e. whether the positive effects of enhanced surrender value will outweigh the potential negative effect of some providers being reluctant to provide these products because they are only willing to do so if they can pay

[12] National Treasury (2007) *Social Security and Retirement Reform: Second Discussion Paper*, Government of the Republic of South Africa, February.

[13] South Africa is one of the few countries that still has scales of maximum commission payable to distributors of insurance products. Most countries have opted for a deregulated commission environment together with tight standards of disclosure.

up-front commissions to their agents remains to be seen. It may be useful o monitor this in South Africa to guide other countries considering such an intervention.

5.1.4 Setting minimum early termination values

Changes to commission scales will allow the payment of higher surrender values, but the system of minimum early termination values would force the change. There is a material risk that the scale of minimum early termination values will be financially burdensome to product providers, possibly forcing them to raise minimum premiums and in the process reducing the affordability of these products. The positive spin-off from this is that insurers will be forced to pay more careful attention to their selling techniques in an effort to enhance customer understanding of their financial commitment and reduce surrender rates.

This paper has discussed at length the trade-offs faced by product designers. Policymakers face a difficult set of trade-offs of their own. The intention to improve the protection for policyholders who terminate their contracts must be tempered by the reality that these initiatives may result in reduced access to such policies for low-income savers.

This research provides no easy answers but the range of charges emerging from the analysis suggests that some providers may have the space to absorb the impacts of higher early termination values without increasing their minimum premiums or charges. It is recommended that any prescription of early termination values is done with caution and in consultation with providers.

A related problem is the fee levied by banks, the so-called “RD” fee, to reinstate a debit order where the balance in a bank account is insufficient to cover the monthly payment. This fee is often higher than the monthly contribution and reportedly many multiples of the cost to the bank of executing the transaction. It would be worth investigating the fairness of this fee given its impact on long term saving by the poor[14].

5.1.5 Compelling disclosure

Despite years of self-regulation by the industry of disclosure, documentation remains undeniably opaque, voluminous and, with few exceptions, very difficult to

[14] The ongoing competition commission banking enquiry will address the issue of penalty fees - http://www.compcom.co.za/banking/

understand, even for the expert. Self-regulated disclosure appears to have failed. Providers are doing enough to meet the rules but fall way short of ensuring that their customers understand the documents provided to them. It is clear that the policymaker envisages shifting the responsibility for setting disclosure standards to the regulator. This is likely to result in a stiffer set of rules but there is no certainty that it would improve the clarity of documents and the level of understanding by policyholders. An independent assessment against customer understanding benchmarks may be appropriate, at the very least to pressure providers to make improvements.

Clients cannot at present shop around for products. There is no single place that a customer can go to get a comparison of the product features likely to be attractive to them. The FSB in the UK has created a website that allows potential purchasers of VLTCS to compare crucial features of each product.

It is recommended that aside from any other information that provider's display, that they be compelled to provide key information about their products in an easy to understand standardised format, and that potential clients should have access to this information without needing to take out the policy first or see an agent. This could be done in a variety of ways, for example, by working with the VLTCS industry to determine the key facts and then ensuring that on every piece of information provided about the products the key facts appear in an easy to understand standardised format. A comparison table could be publicised by the regulator.

5.1.6 Reconciling agents incentives to ensure a client focused approach

The current National Treasury discussion document, Contractual Savings in the Life Insurance Industry: Discussion Paper, moots the possibility of changes to the model governing the status of intermediaries, suggesting that intermediaries could not provide objective advice while receiving remuneration from product providers. It proposes that intermediaries declare themselves to be representative either of the product provider(s), in which case they may be remunerated by commission, or of the individual that they advise, in which case they may be remunerated only by fees paid by the individual. While in theory this may help ensure a client focused approach it is not clear how this would work in practice, particularly with low-income clients who would not have the fees to pay upfront for advice.

5.2 Recommendations for VLTCS providers

5.2.1 Tapping the informal sector

A large percentage of low-income people in South Africa, and perhaps the majority of low-income people in most developing countries, work in the informal economy. It is important to work on ways to market VLTCS to this sector. There are a number of possibilities. In general it will be very difficult to collect cash on a regular basis directly from the savers. One of the likely necessary conditions for increasing VLTCS access to informal economy workers is to increase access to cheap bank/MFI accounts with debit order facilities. In South Africa this is happening with the Mzanzi account. In other countries VLTCS providers could work with MFIs. MFIs have had some success with deducting payments from informal workers for insurance policies by having their loan officers work with clients to get a sense of their cash-flow. For example, in some countries informal shop-keepers often have the highest amounts in their accounts at the beginning of each month[15]. By building more flexibility into the premium collection system, VLTCS products will be more appealing to self-employed informal sector workers with fluctuating incomes.

Other ways to increase access to informal economy workers it to work with the beneficiaries of formal regular remittances and their providers. Finally, many small farmers especially in the coffee, sugar cane and cocoa sector sell their entire crop to a single purchaser. Such purchasers may have an interest in acting as agents for VLTCS providers.

5.2.2 Reduce selling costs – market education

VLTCS products are, like many kinds of insurance, “sold not bought”. The costs of selling are passed on to the buyer and in the case of low-value VLTCS products this can make the product expensive. By educating the market on the benefits of long term savings and the safety of long term products, the task of the seller is made easier and, so the argument goes, cheaper. It is not likely that market education would

[15] The authors are grateful to Michael McCord of the MicroInsurance Centre for this insight.

eradicate the need for selling it but it could certainly play a role in reducing the amount of selling and hence its proportion of the cost. This insurance industry in South Africa has agreed to contribute to market education. There may be scope for partnerships in other countries between the industry association, the regulator and donors to provide market education.

5.2.3 Reduce selling costs- simplify products

Part of the high cost of VLTCS products derives from the need for an agent to explain the complex terms and conditions of the product. The argument is that if the products were simplified, then less costly advice would be needed. It is difficult to know where to draw the line with this recommendation, i.e. how simple should the product be? On one extreme the regulator could compel VLTCS provider to provide a very simple standard product. This however would be unlikely to meet the complex needs of clients who may need different at amounts, at different times. Less extreme would be to create easier to read product documents with terms and conditions laid out in such a way that they allow themselves to be compared easily to other policies. It may also make sense to strip out any added components such as insurance. It is recommended that the regulator works with providers to establish how products could be simplified so as to reduce the need for costly advice. It is not clear how much of a saving this recommendation would bring about as it would be unwise, given the cost and importance of VLTCS products, to sell them without any advice.

5.2.4 Reduce early termination – improve disclosure

Neither policy holder nor providers (on the whole) benefit from early terminations.

A large number of advice office clients and VLTCS policy holders from the sample were not fully aware of the terms and conditions of their policy. When they discover that the terms do not suit them or when they retire or resign before their maturity date they needlessly terminate their policies early and in most cases suffer an early termination penalty.

A significant percentage of these cases could be avoided through improved disclosure of the terms and conditions. This could be done in a number of ways.

Already mentioned is the creation of a table of comparable terms and conditions and reducing the quantity of disclosure needed by simplifying the products. There is room for dramatic improvement in policy documents. It is recommended that insurers work with literacy experts and editors to rewrite the relevant policy documents with the low-income policy holder in mind. It is also recommended that the policy documents are translated into the vernacular or at least the largest South African language groups other than English and Afrikaans. Better disclosure would have the additional benefit of reducing the need for and hence cost of some of the after-sales service that involves explaining terms and conditions to policy holders.

5.2.5 Improve after sales service – separating out after-sales service costs

Many policy holders are unaware that they have a right as consumers to after-sales service. Agents are often not incentivised to provide after-sales service. Separating out the component of the VLTCS product that covers after-sales service from the price may help improve client awareness and agent incentives to provide the service. This could be done in a number of ways. Clients could simply purchase cheaper policies and then pay agents a fee for after-sales service when they need it. This would have to be carefully managed as some after-sales service ought to be provided for free. In addition it may create a disincentive for the poorest policy holders to seek after-sales service. Another option to explore would be the creation of after-sales service vouchers. Each policy sold could come with a series of after-sales vouchers attached to it. When a client needs after-sales service they would take their voucher to the agent who would in turn submit the voucher to the provider and receive payment.

5.2.6 Reconfigure agent's incentives

There is a tendency of some VLTCS agents to "hit and run," i.e. sell policies without a care for whether they are likely to be terminated early and concurrently fail to provide after-sales service. The agents in this study for the most part were paid commission upfront or in the first few years of selling a policy. This creates incentives for behaviour that is not in the interest of low-income policy holders, such as.:

1) to sell as many policies as possible without care for whether they are appropriate or likely to mature;

2) to focus on selling the next policy rather than on servicing the products already sold; and

3) to stop selling to low-income clients once the agent has acquired the ability to sell high value policies to wealthier clients.

The first two problems are sometimes managed through claw backs i.e. VLTCS providers recovering from the agent part or all of the commission paid if the policy holder terminates early. Claw backs are predictably unpopular with agents.

Old Mutual has come up with a novel solution to this problem which it refers to as “controlled marketing,” a salary-plus-incentives approach under which members of its sales team are required to meet the needs of a specific group, usually defined by geographic area. This enhances the commitment of the agent to provide sound advice because much depends on the reputation and good standing of the individual in the community that he or she is trying to reach. If possible, the agent is identified from among the community that they are servicing and literally lives among them.

Sales staffs are remunerated on a model that aims to incentivize both selling and retention through rewarding a combination of the number of sales made and the extent to which the policies originally sold by the individual concerned are still on books. To reduce the pressure to sell at all costs, agents are paid a salary which also has the effect of providing some time for sales to flow from the commitment of the intermediary to advising the members of their target group.

At present the Old Mutual model consists of the following elements:

- Basic remuneration [the foundation]. This is the salary and combination of car and housing allowances. Production bonuses are calculated from this amount, because it reflects the cost to the company of employing the agent.
- Production bonus [the sales incentive]. This is paid quarterly to reward sales achieved. The bonus is a percentage of production over a target, which is a multiple of the quarterly basic remuneration of the agent. The required multiple gradually reduces with increasing years of service by the agent, reflecting the growing need for agents to service existing policyholders as their book of business grows. The bonus percentage is tiered, increasing with the monetary amount of the production.

- Service and lives bonuses [the servicing incentive]. Agents receive a small percentage of premiums received on all business written by that agent. They also receive a per-policy bonus, subject to their quarterly sales being sufficient to qualify for a production bonus.

Agent turnover is not as low as the Old Mutual would like it to be, but it believes that it is lower than the corresponding rates for competitors operating in this market and is confident that its agents, with more than three years' service, are considerably more loyal than their counterparts at other insurers.

5.3 Public private partnerships

There may be a possibility to generally improve the quantity and quality of VLTCS sold to low-income clients through a public private partnership. The government is currently considering establishing its own VLTCS scheme for the poor. This may be better done through a partnership with the private sector – a public private partnership (PPP).

A useful definition of a PPP is provided by the Canadian Government - a PPP is "…a cooperative venture between the public and private sectors, built on the expertise of each partner, that best meets clearly defined public needs through the appropriate allocation of resources, risks and rewards." Instead of the government setting up its own VLTCS scheme that government could create a partnership with the private sector, in which it pays the private sector to sell and service more VLTCS products to the poor.

This has a number of advantages over the traditional model of setting up a VLTCS scheme for the poor directly.

- Most importantly it makes use of the private sectors' delivery infrastructure obviating the need to set up its own. This would reduce the overall cost of provision.
- The private sector has more expertise than the government in selling and servicing VLTCS products.
- The risk of cost over-runs are transferred to the private sector.

There are of course downsides *viz.*:

- private sector companies can go bankrupt and not deliver;

- it is sometimes more difficult to enforce a contract than to change the behaviour of public sector employees if things were to go wrong; and
- if the initial contracting is poorly done, than the public sector may not get what it wanted and still be committed to pay for it.

However, defences are possible to manage these risks. It is recommended that the costs and benefits of a PPP for the provision of VLTCS products to the poor be compared to their direct provision by the state.

5.4 The future of VLTCS products for the poor

The case study demonstrates that quality voluntary long terms contractual savings can be provided to the poor on a sustainable, commercial basis. There are of course a great number of problems with the quality of VLTCS currently provided to low-income clients in South Africa. Yet, there remains a strong willingness on the part of many private sector VLTCS providers to provide quality products to low-income clients. The problem of quality is not deemed to be insurmountable. With careful intervention by policy makers and regulators, along with the perceived willingness of many in the industry to make changes, the authors believe that the quantity and quality of VLTCS products to the poor can be greatly increased. In so doing, it will play a larger role in the alleviation of old age poverty.

Appendix 1 - Methodology

6.1 Overview

Data for the study came from four main sources:

1. an analysis of the VLTCS products sold to low-income people;
2. interviews with low-income VLTCS policy holders;
3. a review of the records of a consumer advice office that provided assistance to low-income VLTCS policy holders who encountered difficulties with their policies over a 13 year period; and
4. interviews and discussions with key stakeholders.

6.2 Product Survey

Policy documents were obtained for all the major existing VLTCS products in South Africa. These were obtained mostly from insurance companies. Although banking institutions have started to offer VLTCS products aimed at low-income clients, the uptake has been extremely poor, primarily because only insurers have the commission-driven distribution channels to sell these products in sufficiently large numbers for financial viability. In at least two cases reported by informants (in one instance a product sold by Standard Bank and in the other a product sold by First National Bank) uptake was so low that the products were dropped entirely.

The unit trust (mutual fund) industry has encountered similar problems selling its products through long term contracts to low-income clients.

> *On the whole, only insurers have been successful in selling VLTCS products to the poor in South Africa. The essential reason for this is that they have a structure of agents that can sell and service the products. No other providers have this structure. There are initiatives which show promise but over the last few decades insurers alone have sold and continue to sell the vast majority of all VLTCS sold in South Africa.*

Insurers tend to sell three types of policies: retirement annuities, endowment products and straight savings products. Retirement annuities are very rare in the low-income end of the market and so have not been considered in this study. The bulk of the market of VLTCS for low-income clients consists either of endowment products or straight savings products sold by insurance companies. Only these types of products/policies were therefore considered for the study.

6.2.1 Obtaining policy documents

In the insurance industry the document that sets out the full details of the insurance product is known as a "policy document". The policy documents were obtained through mystery shopper methods, commonly used for similar purposes by the Financial Services Authority (FSA) in the UK. The researcher poses as a new client of the service provider to obtain information on the policy. The advantage of this method is that the data obtained is more likely to be the data that a client would actually receive than the data that would be obtained by contacting the service provider as a researcher.

The results of this method immediately brought to light a significant problem with the industry, which would not have been evident through other research methods. Written, detailed product information was not available for most products without actually buying and then cancelling the policy.

> *The inability of consumers to find out about VLTCS products without buying them is deeply concerning. It is impossible or at least very difficult to shop around for policies. This in turn has implications for the competitiveness of the industry. In the UK, a prospective customer can log on the website of the FSA and compare key features of endowment products. While this may not be of relevance to low-income consumers in a developing country, at the very least they should be able to obtain a simple easy-to-read sheet of key product features in a format that would allow them to compare products.*

Policy documents were analysed to assess:

- the affordability of these products to low-income South Africans as indicated by their minimum premiums;

- the flexibility of products, as measured by the extent to which savers were permitted partial contributions or complete surrenders with a monetary payment;
- the cost of saving, by scrutinising and analysing the charges levied by product providers, summarising them into a set of key statistics; and,
- the clarity of documentation, both the technical detail and the overall appropriateness of the language, by reference to an objective set of criteria.

The goal of the analysis was to establish how closely existing products met a set of desirable characteristics.

The focus of this study was on contractual saving, so products that bundled savings with the provision of protection were largely excluded. Some products provided principally saving, but included optional risk elements or very simple risk additions at an explicit price that could be excluded without risk of distorting the results.

On some products the research team was not able to obtain the required details, either because it proved difficult to obtain the cooperation of the product provider (in selling the product!) or because the product was in the final phases of launch during the period of research.

Table 14 lists the products that form part of the study, indicating the extent of data that was available to the mystery shopper.

Table 14. Products covered by the study

Products covered by the study	Was all relevant information provided to the customer?
African Life	
Graduate Cash Growth Plan	No policy document
Assupol Life	
School Fund Provider	✓
Study Policy	✓
Cash Provider: New Wave	✓
Channel Life	
LifeSave	No charges information or policy document
Clientèle Life	
Saver and Protector Plan	No charges information
Hollard Life	
Secure Savings Endowment	✓
Umbono As'Investe	✓
Metropolitan Life	
Dreambuilder Cash Plan	✓
Momentum	
Investo Investment Plan	✓
Old Mutual Group Schemes	
Money Care Plan	✓
Sanlam	
Halala Savings Plan	✓
Endowment & Edufocus	✓

Source: Policy documents obtained from insurance companies

6.3 Policyholder interviews

The second major source of data about VLTCS products came from interviews with low-income holders of VLTCS products.

6.3.1 Defining "low-Income"

Respondent income levels can be determined through two main methods: the first to directly inquire about their typical monthly income, as well as that of all the members of their household (a household was defined as the group of people who ate regularly together). Household income data is, however, notoriously inaccurate. This is the case because sometimes respondents feel uncomfortable about disclosing their income and they then lie about it. At other times they may not know what other members of the household earn. Finally some respondents may not know their monthly household income as they have multiple informal sources of income.

To compensate for this, the marketing industry in South Africa devised a system of classifying households by their living standards. The Living Standards Measure (LSM) is a composite household statistic based on location, access to basic services and ownership of a range of products. From this statistic, socio-economic levels are inferred. Neither personal nor household income is used in the LSM equation. The precise questions asked and the manner in which they are ranked is described in Appendix 2. The households are broken down in LSM categories from 1 to 10 with 10 being the most well-off and 1 the least. Households that fall within LSM 1 – 5 are regarded as low-income households for the purpose of this study. The classification methodology is widely used in South Africa and ensures that the findings of this report are compatible with research conducted by the Finmark Trust such as their study of access to insurance by LSM 1 – 5 in South Africa (Meltzer & Smith, 2004).

6.3.2 Selecting the sample of VLTCS policy holders

Ideally probability sampling would have been undertaken to allow the users of this research to be able to generalise from the results to the entire population of low-income VLTCS policy holder in South Africa. Under this approach the sample is deemed to be representative of the population from which it is selected if all members of the population have an equal chance of being selected. But members of the population can only have an equal chance of being selected if the entire population has been identified. For low-income endowment VLTCS policy holders, indeed for endowment VLTCS policy holders as a whole in South Africa, there is no publicly accessible directory of VLTCS policyholders, making population identification impossible.

From 2007 insurers and other VLTCS providers will have to record the income of the buyers of their products to ensure that they comply with South Africa’s Financial

Sector Charter. Once such a directory exists, it would, in theory, be possible to do representative sampling at least for newly-acquired VLTCS products.

Another significant issue that the project had to manage were the difficulties involved in accessing respondents. The questionnaire required that the respondents shared intimate details about their lives, in particular about their income, expenditure and savings. Research by Roth (2005) on financial services among low-income people in South Africa indicated a strong tendency to be secretive or at least resistant to sharing the details of their financial lives with strangers. In order to obtain intimate information of this type from respondents the enumerator needed to develop a relationship of trust with the respondent. This was also found to be the case in attempting to obtain information from respondents who for other reasons may be unwilling to share it, for example criminals, drug addicts, sex workers and people with stigmatised medical conditions (e.g. AIDS sufferers in certain societies).

Snowball sampling is a method commonly used in researching such populations. The technique, also known as chain referral sampling, involves finding a respondent who provides the researcher with the name of another potential respondent, who in turn provides the researcher with the name of a third respondent and so on. In South Africa it has been used by Gilmour *et al.* (2000) in assessing the availability of condoms in urban and rural areas of KwaZulu-Natal. It has also been used by Francis (2000) in her analysis of rural household livelihood strategies in South Africa. Francis interviewed commercial farmers who in turn introduced her to their employees, who then referred her to their friends and relatives.

Snowball sampling facilitates access because the process of referral can imbue the researcher with a sense of having been vetted by an insider. The technique facilitated the relatively rapid and cost effective creation of a database of respondents.

One problem with the sampling method is the possibility of bias because respondents in the referral chain are known to one another, and may share characteristics. This possible bias can be reduced by using a number of different starting points and initial informants. It can be further reduced by closely monitoring enumerators as they collected data to ensure that their choices of respondents were as varied as possible. For example, the research project initially had planned, for practical reasons, to obtain respondents only from the Western Cape, one of South Africa's nine provinces. Unfortunately the fieldworkers could not find sufficient low-income clients in the Western Cape to meet the project requirements and a new group of enumerators and researchers were trained to conduct research in two other regions.

The consequence of obtaining samples dependent on choices rather than randomly drawn from an enumerated population is that one cannot generalise the results of this research to low-income VLTCS policy holders in South Africa, or even to the areas in which the research was conducted.

Therefore ideographic research was undertaken using respondents that were subjectively chosen. The advantage of this approach is that it allows for thicker descriptions of complex processes. Ideographic research is particularly useful for policy in that it provides a deep, textured understanding of complex processes.

The interviews conducted with respondents who were not drawn from representative samples, were conducted over a three-month period in 2006 from 1 September to 27 November, covering 151 respondents from three regions, Western Cape (33.8%), Northern Cape (18.5%) and the Eastern Cape (47.7%). The selection of regions was primarily a function of access, i.e. where enumerators had an informant who could provide access to a respondent. Roughly equal numbers of men (46%) and women (54%) were interviewed. The project attempted to find respondents who had policies with each of the insurance company providers that provided VLTCS products. The products found were not necessarily those described in the previous section because many products were bought many years prior to the study and are no longer sold. In total, respondents used 11 companies that provided long term contractual savings policies: Hollard, Old Mutual, Metropolitan, Sanlam, Channel Life, Momentum, African Life, Clientele Life, Assupol, Liberty Life and Commercial Union.

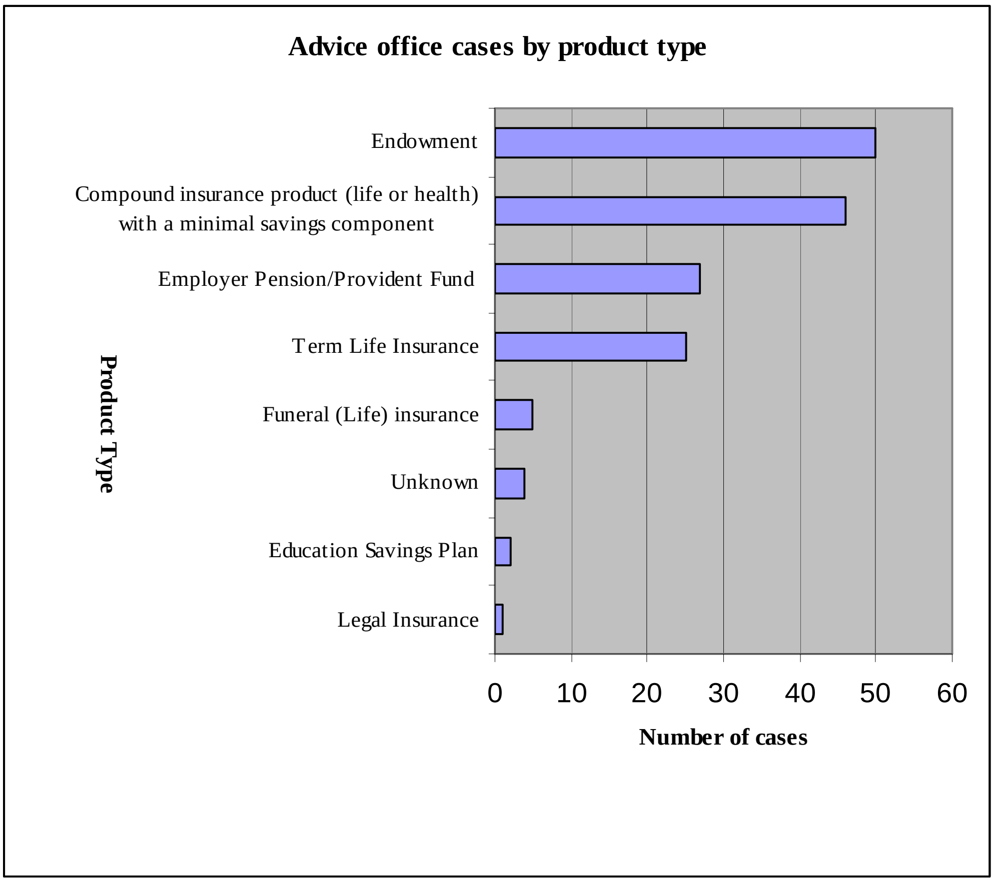
6.4 Consumer advice office record review

The third source of information came from a consumer advice office run by a charity (the Black Sash). This advice office provided a variety of consumer advice services to low-income clients in Grahamstown, a mid-sized town with significant socio-economic dispersion in the Eastern Cape. The archives for the Grahamstown branch of the Black Sash are held at the Cory Library, Rhodes University. The records used stretch from 1989 until 2002 and 160 cases were selected for inclusion into the study.

One cannot generalise about the typical sorts of problems faced by VLTCS in South Africa or indeed even in Grahamstown from the sample drawn from the advice office. Many policyholders with problems may not have come to the advice office. Cases were used to provide a detailed analysis of precisely the kinds of problems that emerged and how they were resolved.

Most of the policies examined were endowment cases, but a range of other products were included to determine whether or not the problems found in endowment products were common to others, in particular compulsory VLTCS products such as employer pension funds. A breakdown of the cases by product type is presented in the chart below.

Chart. 8 Advice office cases by product type



6.5 Key stakeholder interviews

The fourth and final source of information came from key stakeholders, a range of whom were interviewed during the course of the research. In addition to this, valuable information was also obtained from attendees of a workshop held on 7 December 2006 in Pretoria. The following table provides a list of interviewed stakeholders. Additionally, a list of workshop participants is presented in Appendix 3.

Table 15. Names and organisation of stakeholders interviewed

Respondent	Organisation
Chafeker, Ismael	Old Mutual (Insurer)
Jarvis, Dave	Standard Bank (Commercial Bank)
Joubert, Gerhard	Life Office Association (Insurance Association)
Kaplan, Sid	Retired (ex- Liberty Life) (Insurer)
Lamond, Bridget	Savings Institute (NGO)
Le Roux, Andrew	Old Mutual (Insurer)
Masilela, Elias	Sanlam (Insurer)
Meltzer, Illana	Eighty20 (Consulting Firm)
Turpin, Di	Association of Collective Investments (Unit Trust Association)
Van Zyl, Melanie	Financial Services Board (Regulator)

Source: List of interviews conducted by the authors

Appendix 2 - Calculating LSM

If a person has access to the following goods or services[16] and if the person answers in the affirmative, then the following value are added:

If have access to:	**Add this value**
Built In Sink	0.165505
Electric Stove	0.163219
Hot Water	0.1582
Motor in household	0.155217
Freezer/Fridge	0.152515
Flush toilet In/Out	0.142228
Washing Machine	0.13893
Polisher/Vacuum	0.135318
VCR	0.134488
TV Set	0.13383
PC	0.132148
Electricity	0.128613
Water	0.127671
Microwave	0.126829
Mnet/DSTV	0.126068
Dishwasher	0.119925
Tumble Dryer	0.117338
Hi fi	0.105378
Telephone (home)	0.09714
Deep Freezer	0.093849
Home security service	0.091632
Sewing machine	0.09032
Live in W.Cape	0.079999
Live in Gauteng	0.056788
Live in a rural area	-0.09322
Radio	-0.15825
No Cell phone	-0.17518
Hut	-0.20108
No Domestic	-0.22236

16 Note that the basket of goods and services changes frequently. The selected basket corresponds to the 2004 basket in order to be consistent with work done by (Meltzer & Smith, 2004)

If the total value is:

$0 < x < 0.721$ then LSM = 1

$0.721 < x < 1.053$ then LSM = 2

$1.053 < x < 1.356$ then LSM = 3

$1.356 < x < 1.726$ then LSM = 4

$1.726 < x < 2.127$ then LSM = 5

$2.127 < x < 2.685$ then LSM = 6

$2.685 < x < 3.01$ then LSM = 7

$3.01 < x < 3.324$ then LSM = 8

$3.324 < x < 3.65$ then LSM = 9

$x > 3.65$ then LSM = 10

Appendix 3 - Workshop participants

Name	Organisation	Organisation Type	e-mail
Angove, Janice	Quindiem Consulting	Actuarial Consulting firm	Janice-angove@quindiem.com
Rusconi, Rob	Tres Consulting	Actuarial Consulting firm	rusconihome@wol.co.za
Chellakooty, Thesan	ABSA	Commercial Bank	thesan@absa.co.za
Visser, Stefan	ABSA	Commercial Bank	stefanvi@absa.co.za
Kumbula, Mary	Standard Bank	Commercial Bank	Mary.kumbula@standardbank.co.za
Mabuela, Edith	Standard Bank	Commercial Bank	edithmabuela@standardbank.co.za
Gibson, Katherine	National Treasury	Government	Katherine.gibson@treasury.gov.za
Khambule, Faye	Liberty Life	Insurer	Faye.Khambule@liberty.co.za
Cartwright, Andrew	Old Mutual	Insurer	acartwright@oldmutual.com
Monaghan, Liam	Old Mutual	Insurer	lmonaghan@oldmutual.com
Rapiya, Marshall	Old Mutual	Insurer	mrapiye@oldmutual.com
Steffen, Stefan	Old Mutual	Insurer	ssteffen@oldmutual.com
Masilela, Elias	Sanlam	Insurer	Elias.masisela@sanlam.co.za
Smith, Anja	Genesis Analytics	Management Consulting Firm	anjas@genisis-analytics.co.za
Ndlovu, Thabisile	Markinor	Market Research Company	thabisilen@markinor.co.za
Ndlovu, Sipho	ILO	UN	ndlovu@ilo.org

Appendix 4: Model assumptions

The standard assumptions for all projections are as follows:

Table 16. Model parameters

Table A1.
Model parameters

Financial assumptions	
Inflation rate, pa	5 %
Investment return, pa	10 %
Policy assumptions	
Investment term	10 years
Contribution rate, monthly (A)	R100 ($14)
Contribution rate, monthly (B)	R200 ($28)
Contribution growth, pa	0 %

All quotations assumed that contributions would grow — providers and intermediaries have a strong incentive to ensure a contract with fixed contribution increases — but not at a consistent rate of growth, making comparison difficult. It is also seldomly clear how costs are to increase in the event that contributions grow and commission payments are particularly opaque in this regard. Furthermore, as all saving policies are assumed to last for a period of 10 years, premium increases would have a lower impact on charge ratios and the absence of increases is a little more likely than for longer-term saving or retirement alternatives.

Where policy fees are not guaranteed, we have assumed that they increase at the rate of inflation. The assumed rate of return is applied to all policies, regardless of the investment policy followed. This assumption has low impact on charge ratios and attempts to allow more accurately for expected investment returns would be spuriously accurate.

Glossary

Administrative charge	A general-purpose fee that may apply on a once-off basis, like an *initial cost* or *administration charge*, or on a regular basis, in the same way as a *premium charge or levy*.
Balanced fund	A general term used to describe an investment allocation mixing a number of asset classes. In the South African context, a balanced fund is usually dominated by equities, taking up around half of the fund, and fixed income assets, with perhaps 30% of the fund.
Bancassurance	A general term given to distributing insurance products through the infrastructure provided by banks, sometimes through bundling banking and insurance products, sometimes more simply by utilising the branch structure of banks to sell insurance.
Bid-offer spread	The difference between the price at which a market security, most commonly a listed company share, is sold and the price at which it is bought. The margin of difference is used to cover trading costs on the stock exchange. It is seldom passed on explicitly to policyholders.
Bonus rate	The rate of return declared by the provider of a *guaranteed fund* and credited to the *notional policy value* of the policy. (See more detail under *guaranteed fund*.)
Charge in lieu of shareholder charges	This term, specific to a single provider, seems to be an attempt to justify an addition to the list of charges. It is essentially the return required by shareholders for capital put at risk, but avoids terminology like 'profit margin' or 'return on shareholder capital'.
Charge ratio	The percentage reduction to each premium over the lifetime of the saving that is equivalent in overall impact to the erosion of value due to all charges. Under most conditions – certainly all cases in this research – this is equivalent to the percentage reduction to the maturity value due to the aggregate impact of all charges.

Commission	Payment by the VLTCS provider to the intermediary. Unlike most countries, a scale of maximum commission exists in South Africa. For endowment policies, the scale permits immediate commission of 3.25% of annual premium for each year of the policy, subject to a maximum of 85% of the annual premium. At the end of year 1, the scales permit a further 1/3rd of the first year commission. Many of the policies in this research appear to pay less than the maximum commission and this is indicated in the notes to each product assessment where it is possible to calculate it. Commission scales are currently under review by the authorities.
Distribution fee	A charge levied by the VLTCS provider that is a percentage of the commission payment. This is helpful to the VLTCS provider to cover costs incurred early in the policy term that are related to the payment of commission, but does not make it any easier for the policyholder to understand exactly what charges are to be deducted from the *notional policy value* and when.
Endowment policy	A contractual saving policy with a fixed term paying a lump sum benefit at maturity in return for regular premiums. For purposes of tax definition, the term may be no shorter than 5 years. It may be extended indefinitely from the original maturity date. Premiums are usually payable monthly throughout the term of the contract. *Surrenders* are possible after an initial minimum term. Some contracts also permit partial *withdrawals* prior to maturity, giving a degree of flexibility to savers.
Fund charges	The term is sometimes used to refer to the fees levied to cover the costs of asset management. More generally, and more realistically, the phrase is used to apply to all fees expressed as a percentage of the assets held against the policy, the *notional policy value*.
Guaranteed fund	An insured investment fund providing some form of investment guarantees and year-to-year performance smoothing. The most common form of guaranteed fund today provides annual bonus declarations, never less than zero, which bear some reference to the return on underlying assets, normally invested consistently with those of a *balanced fund* but aim to hold back returns in periods of high performance and give it back in periods of poor. The overall profile of returns is smoother, but policyholders are charged, not always explicitly, for the risk to shareholder capital resulting from the guarantee and this charge reduces overall performance by between 0.5% and 1% annually.

Initial costs	A once-off deduction from the *notional policy value* at its commencement, creating a negative value at the start of the policy.
Marketing expenses	A fee, ostensibly designed to match the VLTCS provider expenses of marketing and distribution that may be once-off, like an *initial cost* or *administration charge*, or on a regular basis, like a *premium charge or levy*.
Money market fund	An investment fund invested in short term fixed income securities, essentially overnight bank lending instruments and equivalents of lending term up to one year. These investments are characterised by lower return than others, but hold their value much better and are appropriate to policyholders requiring short term capital security.
Notional policy value	A theoretical value of the policy at any point in time, used to determine an appropriate surrender value, on early termination, and maturity value, at the maturity date of the policy. It usually starts at below zero and takes some time to cross over to positive values. During this time a surrender values are usually not paid on early termination of the contract because it would result in financial loss to the VLTCS provider.
Paid-up conversion	Cessation of all premiums. The contract is regarded as "paid up" because no more premiums are due. The notional policy value is affected only by any explicit termination charge, but policy values after the date of conversion are significant reduced by the absence of continuing contributions.
Paid-up value	The value attributable to the policy at the date of *paid-up conversion* after any termination charge.
Performance bonus	A fee paid to the investment manager or product provider that is dependent on investment performance in excess of a specified benchmark over a specified period. It is designed to align the incentives of the investment manager and the client but can produce results not in the interests of the client like inappropriate investment risk.
Policy projection	A financial projection of the maturity and interim values of the policy. The assumptions governing the projection are established by the Life Offices Association, covering the majority of South African insurers. The practice of projecting policy values is under review by the regulatory authorities.
Premium charge or levy	A rand or percentage charge deducted from each premium, usually increasing over the policy term at the discretion of the policy provider. The terms are used interchangeably by providers. The percentage fee is sometimes applied to the net premium after deduction of the fixed fee.

Premium waiver benefit	An optional benefit, sometimes available on a savings policy, that covers the cost of all premiums still due on the policy from the date of some pre-specified event, such as permanent disability of the policyholder, in return for an addition to the premium. The benefit in monetary terms is seldom high. Its primary value lies in preventing the *surrender* of a saving policy through default of the disabled policyholder.
Reduction in yield	The percentage point reduction in annual return over the period of saving that is equivalent in overall impact to the erosion of value due to all charges.
Sum assured	Lump sum due on the event of a pre-specified event, usually death, sometimes also permanent disability, in return for an addition to the premium. Conditions for payment may be tightened, for example by specifying that death must be due to an accident.
Surrender	Early termination of the contract in return for a cash payment, if available from the VLTCS provider. Policies surrendered in the earlier years of the policy often attract no payment and, in these cases, often result in financial loss to the VLTCS provider because premiums received are insufficient to offset costs incurred.
Surrender value	The value paid to the policyholder on *surrender*.
Termination charge	In general terms, an explicit fee levied in the event of policy termination. In practice, it is not applied on maturity, only on an early termination requested by the policyholder. It is used to cover the VLTCS provider expenses of administering the termination.
Waiver of premium benefit	In return for a (small) premium, the insurer agrees to cover the cost of premiums outstanding on the policy on a specified event, such as death or permanent disability of the policyholder.
Withdrawal	Most policies permit a partial termination of the policy in the form of a cash payment. This is referred to as a withdrawal, to distinguish it from a full *surrender*.
With-profit smoothed bonus	An earlier name for the guaranteed fund, reflecting its origin as a profit-sharing instrument for policyholders of products offered by mutual organisations – since they have no shareholders, all profits belong to policyholders – through the mechanism of annual bonuses that smooth investment performance over time.

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