TRUE SOUTH
ACTUARIES & CONSULTANTS

Assessing the efficiency of the South African insurance market in its provision of disability cover

An update to the 2013-study

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1 TERMS OF REFERENCE

In 2013, FMI retained True South Actuaries and Consultants to investigate the market for disability insurance cover in South Africa and report on such efficiencies and inefficiencies as were found. The results were contained in a report entitled "*Disability cover: Assessing the efficiency of the South African insurance market in its provision of disability cover*" (available from *www.fmi.co.za* or *www.truesouth.co.za*).

FMI has now requested an update on the initial study, by reference to data that has become available since. This report contains our findings, is addressed to the management of FMI (who has authorised release hereof into the public domain) and is set out as follows:

Section	***Contents***
3	Executive summary of the findings
4	The extent of under-insurance for disability, split between permanent and temporary disablement
5	The macro mix of recent insurance sales: Life cover vs. disability cover vs. critical illness cover
6	The internal mix of recent sales of disability cover: Permanent disability vs. temporary disability
7	The internal mix of recent sales of disability cover: Lump sum benefits vs. income benefits
8	The internal mix of recent sales of disability cover: Accelerated cover vs. standalone cover

2 APPROACH & SOURCES OF INFORMATION

This update follows the approach and methodology that was used for the earlier study. For ease of reference, the summary of results from that report is included as an appendix hereto and, in addition, each of the main sections starts with an excerpt from that report.

In order to perform this update, data was required on the composition of insurance business sold to South African consumers since the earlier study. We are grateful to acknowledge the contribution from Swiss Re Life & Health Africa in this regard, who made available to us their most recent results "*Swiss Re Individual Risk Market New Business Volume Survey, 2013*".

In addition this update references the *2013 True South ASISA Insurance Gap Study*, mid-2013 labour force information from Stats SA and information on FMI's in-force disability cover.

3 SUMMARY OF FINDINGS

- *The disability insurance gap*: Due to persistent underinsurance, consumers remain massively exposed to the possible financial impact of both permanent and temporary disability events. In respect of permanent disability, only 40% of the total need was insured in 2013. Although somewhat improved, the figure for temporary disability events was even lower, with only between 12% and 27% of the total need being covered.
- *The macro sales mix between life, disability and critical illness*: Theoretically the average breadwinner should have more disability cover in place than life cover. However, new insurance sales continue to be dominated by life cover at 61% of sales, with disability only comprising 29% of sales in recent years. As such there is sustained evidence of market inefficiency that overly skews the sale of new cover towards life (away from disability).
- *The mix between permanent & temporary disability cover*: Temporary disability is theoretically expected to account for around 3% of the total sales of disability cover. In the most recently available data the figure stood at 1.4%, compared to 0.8% at the time of the earlier report. While temporary cover is thus still undersold in lieu of permanent by a factor of around two, the consistent increase (since 2008) in sales of temporary cover, compared to permanent cover, is encouraging.
- *The mix between lump sum & income cover for disability*: While some lump sum disability benefits would be entirely appropriate (e.g. to meet once-off expenditures at the time of becoming disabled), the well advised consumer should probably be buying the bulk of his/her disability cover in the form of income benefits. However, income benefits still only account for 18% of new disability sales. This seeming over-reliance on lump sum cover potentially remains an area of financial exposure for many.
- *The mix between accelerated and standalone disability cover*: Standalone cover accounted for more than half of total disability sales for the first time in 2013. However, as the proportion of accelerated cover is still at relatively high levels, the question remains as to whether consumers are seeking advice to a sufficient extent to ensure correct usage of accelerated cover.

4 THE DISABILITY INSURANCE GAP

In order to provide the necessary context, this initial section considers the extent of underinsurance that was prevalent in the South African market in 2013, with respect to both permanent disability cover and temporary disability cover.

4.1 The permanent disability insurance gap

The *2013 True South ASISA Insurance Gap Study* quantified the total need for permanent disability insurance at R24.4 trillion[1], with the cover that was actually in place only amounting to about R9.7 trillion, thus leaving a disability insurance gap of around R14.7 trillion. I.e. only around 40% of the permanent disability cover that was theoretically required by South African earners was actually in place, leaving a massive gap (the gap being 60% of the total need).

4.2 The temporary disability insurance gap

The 2013 disability study concluded that potentially only between 7% and 25% of the true underlying need for temporary disability cover was in place. Using updated data from Swiss Re[2], mid-2013 labour force information and FMI in-force cover, it is now estimated that the situation has improved somewhat, with between 12% and 27% of the underlying need being covered.

Table 1 - Estimated 2013-range for the temporary disability gap

Amounts in R-billion	***Earlier study***		***Updated results***	
	High gap estimate	Low gap estimate	High gap estimate	Low gap estimate
Net insurance need	R565bn	R516bn	R726bn	R673bn
Actual cover in place	R40bn	R131bn	R90bn	R183bn
Insurance gap	R526bn	R385bn	R636bn	R489bn
Gap as % of the need	93%	75%	88%	73%

4.3 Comments and conclusions

Due to persistent underinsurance, consumers remain massively exposed to the possible financial impact of both permanent and temporary disability events.

[1] 1 trillion = 1 000 billion = 1 000 000 million = 10^{12}

[2] Swiss Re uses a two-year period to derive total temporary disability cover; for the purposes hereof this was adjusted throughout to achieve consistency with the earlier study's use of a six-month temporary definition.

5 THE MACRO MIX: LIFE VS DISABILITY VS CRITICAL ILLNESS

5.1 Excerpt from the earlier report

"... we would thus expect earners with households to buy on average 43% more disability cover than life cover."

"In relation to the levels of life cover and disability cover that are sold, the level of critical illness cover is surprisingly high."

"We conclude that there is evidence of market inefficiency that overly skews the sale of new insurance cover towards life cover (away from disability cover) ... In addition there is evidence of inefficiencies that result in an inappropriate balance between the levels of critical illness cover and disability cover being sold."

5.2 New insurance sales: 2007 - 2013

The table below provides insight into the macro life insurance sales mix, showing the proportion of sales (by sum insured) going towards life cover, disability cover and critical illness cover.

Table 2 – Split of new insurance sales between life, disability and critical illness

	Data that was available to the 2013-study					**New data**	
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Life cover	60%	58%	60%	60%	61%	61%	61%
Disability cover	31%	32%	31%	30%	30%	29%	29%
Critical illness cover	9%	10%	10%	9%	9%	9%	9%

5.3 Comments and conclusions

- The average breadwinner should probably buy life cover to replace 64% of his/her income after death, whereas disability cover should probably be sufficient to replace 98% of income (replacement factors from the *2013 True South ASISA Insurance Gap Study*). As such disability sales should theoretically exceed sales of life cover by some margin.
- However, data for the two recent years shows that life cover still accounted for 61% of sales, with disability cover at 29%. As such there is sustained evidence of market inefficiency that overly skews the sale of new cover towards life (away from disability).
- In relation to the sales of life cover and disability cover, the level of critical illness cover remains high. It is possible that some consumers are buying critical illness cover as a proxy for disability cover.

6 THE DISABILITY MIX: PERMANENT VERSUS TEMPORARY

6.1 Excerpt from the earlier report

> *"We expect first time buyers of insurance to buy more permanent cover than temporary cover (given that temporary cover is intended for a much shorter period of time)."*
>
> *"We theoretically expect temporary cover to be around 3% of the level of permanent cover."*
>
> *"We conclude that there is evidence of market inefficiency that overly skews the sale of new disability cover towards permanent cover (away from temporary cover)."*

6.2 New insurance sales: 2007 – 2013[3]

The table below shows the make-up of disability insurance sales, highlighting the proportion of sales (by sum insured) that was for permanent disability cover versus temporary cover.

Table 3 – Split of new disability insurance sales between permanent and temporary cover

	Data that was available to the 2013-study					New data	
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Permanent cover	99.4%	99.7%	99.5%	99.3%	99.2%	99.1%	98.6%
Temporary cover	0.6%	0.3%	0.5%	0.7%	0.8%	0.9%	1.4%

6.3 Comments and conclusions

- Sales of temporary disability cover is theoretically expected to account for around 3% of the total sales of disability cover. In the most recently available data the figure stood at 1.4%, compared to 0.8% at the time of the earlier report.
- While temporary cover is thus still undersold in lieu of permanent by a factor of around two, the consistent increase (since 2008) in sales of temporary cover, compared to permanent cover, is encouraging.

[3] Swiss Re uses a two-year period to derive total temporary disability cover; this was adjusted to achieve consistency with the 2013-study's use of a six-month temporary definition. Some past figures have undergone minor restatement.

7 THE DISABILITY MIX: LUMP SUM VERSUS INCOME COVER

7.1 Excerpt from the earlier report

> *"We expect the average consumer to buy a mix of lump sum and income benefits. However, we would expect him/her to buy more income benefits than lump sum, given that the income benefit should be used to replace income up to retirement age, whereas the lump sum benefit should only be used to cover once-off expenditures at the time of becoming disabled."*
>
> *"To the extent that the observed trend points to consumer behaviour whereby incorrect reliance is placed on lump sum cover, it is questionable whether the average consumer would have sufficient understanding of the extent to which he/she is exposing himself/herself to risk in the process."*
>
> *"...we conclude that there might well be proof of market inefficiency insofar the sale of permanent disability cover is skewed towards lump sum benefits (away from income benefits)."*

7.2 New insurance sales: 2007 - 2013[4]

The table below shows the make-up of disability insurance sales, highlighting the proportion of sales (by sum insured) that was for lump sum disability benefits, as opposed to income benefits.

Table 4 - Split of new disability insurance sales between lump sum and income cover

	Data that was available to the 2013-study					New data	
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Lump sum benefits	93%	88%	88%	87%	85%	83%	82%
Income benefits	7%	12%	12%	13%	15%	17%	18%

7.3 Comments and conclusions

- While some lump sum disability benefits would be entirely appropriate (e.g. to meet once-off expenditures at the time of becoming disabled), the well advised consumer should probably be buying the bulk of his/her disability cover in the form of income benefits.
- However, income benefits still only account for 18% of new disability sales. This seeming over-reliance on lump sum cover potentially remains an area of financial exposure for many.

[4] Swiss Re uses a two-year period to derive total temporary disability cover; this was adjusted to achieve consistency with the 2013-study's use of a six-month temporary definition. Some past figures have undergone minor restatement.

8 The disability mix: Standalone versus accelerated

8.1 Excerpt from the earlier report

> *" … if disability cover is bought on an accelerated basis, it would be important to ensure that the amount of life cover is ratio-ed up appropriately from the level that would otherwise be required."*
>
> *"Acceleration reduces the remaining level of life cover … e.g. if the life cover was actually intended to provide for estate duties, accelerating it in the event of disability will eventually leave the estate financially exposed."*
>
> *"While we don't have proof of market inefficiency in this regard, there are at least some questions as to whether the average consumer has sufficient understanding of his/her needs and the available products, to ensure correct usage of accelerated cover."*

8.2 New insurance sales: 2007 - 2013[5]

The table below shows the make-up of disability insurance sales, highlighting the proportion of sales (by sum insured) that was for standalone disability cover, as opposed to accelerated cover.

Table 5 - Split in new disability insurance sales between standalone and accelerated cover

	Data that was available to the 2013-study					**New data**	
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Standalone cover	42%	38%	42%	45%	48%	50%	51%
Accelerated cover	58%	62%	58%	55%	52%	50%	49%

8.3 Comments and conclusions

Standalone cover accounted for more than half of total disability sales for the first time in 2013. However, as the proportion of accelerated cover is still at relatively high levels, the question remains as to whether consumers are seeking advice to a sufficient extent to ensure correct usage of accelerated cover.

[5] Swiss Re uses a two-year period to derive total temporary disability cover; this was adjusted to achieve consistency with the 2013-study's use of a six-month temporary definition. Some past figures have undergone minor restatement.

9 APPENDIX: SUMMARY OF EARLIER RESULTS

For ease of reference, this appendix reproduces the summary of results from the earlier report. For more detail the reader is referred to that report, which is available from both *www.fmi.co.za* and *www.truesouth.co.za*.

9.1 The market offers a sensible product suite, but not enough cover is sold

- Considering the consumer's financial exposure in the event of disability, we conclude that the market is efficient insofar as it offers a product suite that can sensibly be used to protect against the financial risk of disability.
- However, not enough cover has been sold historically to ensure appropriate levels of cover being in place:
  - **Permanent disability**: The extent of underinsurance for permanent disability has been a known fact since the 2007 Gap Study. Despite the availability of appropriate insurance products, the 2010 update showed that still only 38% of the true need for permanent disability cover in South Africa is actually covered (i.e. with the underinsurance gap accounting for the balance 62% of the real need). The retail insurance industry must increase its current provision of permanent disability cover more than six-fold in order to close this gap.
  - **Temporary disability**: This study for FMI now also quantifies the extent of underinsurance for temporary disability. The results show that temporary disability is even more underinsured, with potentially only between 7% and 25% of the true need for temporary disability cover actually being covered (i.e. with the underinsurance gap accounting for the balance 75% to 93% of the need). The retail insurance industry would have to increase its provision of temporary disability cover by a factor of between twenty-nine and seventy-nine times in order to close this gap.
- Given the extent of underinsurance of disability cover, we conclude that there must be market inefficiencies and/or constraints, preventing market participants from solving this imbalance. In addition, the proportionally larger degree of underinsurance for temporary disability than for permanent disability, points to the fact that there might well be additional inefficiencies that result in sales being skewed towards permanent disability cover (away from temporary cover).

9.2 At a macro level the mix between life, disability and critical illness is wrong

Relative to life cover, too little disability is sold

- From the Swiss Re info, we see a relatively stable picture over recent years, with around 60% of sold cover being life cover, 30% disability cover and 10% critical illness cover.
- It is surprising that life cover is sold at double the level of disability cover, since theoretical reasons exist why we would have expected the relativity to be the other way round.
- We conclude that there is evidence of market inefficiency that overly skews the sale of new insurance cover towards life cover (away from disability cover).

Relative to critical illness, too little disability is sold

- In relation to the levels of life cover and disability cover that are sold, the level of critical illness cover is surprisingly high. There is a possibility that this might point to some consumers perhaps incorrectly buying critical illness cover as a proxy for disability cover.
- We conclude that there is evidence of inefficiencies that result in an inappropriate balance between the levels of critical illness cover and disability cover being sold.

9.3 The internal mix of disability cover being sold is not always appropriate

The previous sub-section considered the big picture sales mix, i.e. sales of disability cover against the other main cover types. In this section we consider the internal make-up of disability sales.

Sales are overly skewed to permanent cover away from temporary

- Information on new sales in recent years show that temporary cover is probably undersold in lieu of permanent cover by a factor of around four.
- We conclude that there is evidence of market inefficiency that overly skews the sale of new disability cover towards permanent cover (away from temporary cover).

Sales are overly skewed to lump sum cover away from income cover

- New sales of permanent disability cover show a heavy skew in favour of lump sum benefits, which could point to some consumers buying lump sum benefits for use as income replacement. This would expose the consumer (perhaps unknowingly) to a number of material, additional risks. E.g. just protecting against the market risk element could require the consumer to buy between 32% and 41% additional lump sum benefits (or have access to such a level of reserve assets otherwise).
- It is questionable whether the average consumer has sufficient understanding of the extent to which he/she is exposing himself/herself to risk in the process. Even if the consumer did understand these risks, it might still not be entirely fair for the market to offload these risks onto the individual. A resource rich insurer would be far better equipped to carry these risks.
- We conclude that there might well be proof of market inefficiency insofar as the sale of permanent disability cover is skewed towards lump sum benefits (away from income benefits).

About half of permanent cover is sold on an accelerated basis

- In recent years roughly half of all permanent disability cover is provided on a stand-alone basis, with the other half being accelerated.
- We theoretically expect the average consumer to buy around 43% more disability cover than life cover. If disability cover is bought on an accelerated basis, it would thus be important to ratio-up the amount of life cover appropriately. If this is not done, it might imply that the consumer is potentially underinsured for permanent disability (even though he/she might be under the impression that an adequate level of cover is in place).
- In addition the sales process must allow for the fact that an accelerated disability pay-out would reduce the amount of remaining life cover. E.g. if the life cover is intended to provide for estate duties, accelerating it in the event of disability will eventually leave the estate financially exposed.
- While we don't have proof of market inefficiency in this regard, there are some questions as to whether the average consumer has sufficient understanding of his/her needs and the available products, to ensure correct usage of accelerated cover.