Career Ready Academy

TEXTBOOK

Long-Term Insurance

Final Module for COB 3

virtualclc.co.za 010 597 0835

14 Vermooten Street Alberton

Copyright Notice

© 2023 by Anna Bouhail

All rights reserved. No part of this publication may be reproduced, distributed, or transmitted in any form or by any means, including photocopying, recording, or other electronic or mechanical methods, without the prior written permission of the author, except in the case of brief quotations embodied in critical reviews and certain other non-commercial uses permitted by copyright law.

For permission, email the author a request: anna@virtualclc.co.za

Ordering information

If you would like to order the publication, please contact the author at anna@virtualclc.co.za

TABLE OF CONTENTS

Topic 1	Long Term Insurance: Overview	5
Topic 2	Aspects Relating to Specific Long-Term Insurance Products	14

INTRODUCTION

An FSP must ensure that it, its key individuals and representatives are proficient in respect of, understand, and have completed adequate and appropriate class of business training and product specific training relevant to, the particular financial products in respect of which they render financial services or manages or oversees the rendering of financial services.

Class of business training, where appropriate must include training on the following:

The range of financial products within the class of business.

The general characteristics, terms and features of financial products in the class of business and any specialist characteristics, terms and features in respect of financial products in the class of business.

The typical fee structures, charges and other costs associated with products in the class of business.

General risk associated with investing, purchasing or transacting in the products in the class of business.

Investment and risk principles, options and strategies in respect of products in the class of business.

The appropriateness of different products or product features in the class of business for different types of clients or group of clients.

The typical role players or market participants in respect of products in the class of business, including their legal structure.

The impact of applicable legislation, including taxation laws, on product in the class of business.

The impact of applicable economic and environmental factors on the products in the class of business and the performance of those products including:

- The economic and business environment and cycles.
- Inflation.
- Government monetary and fiscal policy.
- Interest rates and exchange rates.

Any inter-relationship within and between particular classes of business.

Industry standards and codes of conduct relevant to class of business

This module is the final module in order to be certified for COB: Class 3 – Long-term insurance

To be certified, complete all of the required modules:

- COB General Module: All Classes of Business
- COB Intermediate Module: Class 3, 4, 7 & 8
- COB Final Module: Class 3

Topic 1 Long Term Insurance: Overview

LEARNING OUTCOMES

After study the topic, the learner should be able to-

- Define a long-term insurance policy.
- Outline the general features of the different type of life risk policies and long-term investment policies.
- Define the different parties to a long-term insurance policy.
- Explain the principles underlying long-term insurance policies.
- Describe the fees and charges applicable to long-term insurance policies.
- Outline the general risks associated with long term insurance policies.

1.1 INTRODUCTION

Long-term insurance companies offer a variety of life policies and variants thereof. A long-term insurance policy is a contract between the insurance company and an individual or individuals, where payment by the insurance company in return for premiums paid, depends in some way on the duration of the life/lives of the individual/individuals.

Examples of long-term insurance companies are Discovery, Momentum, Sanlam, etc. They each offer their own products with potentially different names and definitions, and it is these basic names and definitions that are covered in this module.

Independent advisors (not tied to only one product supplier) will look at more than one product supplier to see who has the best offering for a comparative premium.

Once the client has agreed to a specific insurance provider, an application for insurance cover will need to be completed and will include the answering of medical questions by the client.

The application is then underwritten by the insurer before a decision is made to either accept, load or decline the cover.

Cover and premiums paid are risk rated, depending on the client's medical history and lifestyle (e.g. smoker versus non-smoker). Therefore, two clients are very unlikely to receive the same premium for the same amount of cover.

There are essentially two classifications of long-term insurance policies: life risk policies and investment policies.

1.2 GENERAL FEATURES OF LIFE RISK POLICIES

Life risk policies are aimed at assisting clients to cover costs associated with adverse life events such as illness, disability and death.

© Anna Bouhail

An overview of main types of life risk policies are considered in the subsections following. Each of these covers provided varies from insurer to insurer and there are different options with their own features and benefits that will be considered in detail in later topics.

Life risk policies can be issued to individuals or as group risk benefits. Group risk benefits is cover is provided to a group of people, such as the members of a specific employer's pension fund.

1.2.1 Funeral Cover

Funeral cover is cover that is specifically designed to pay out a limited amount of cover within a short period after death. Funeral policies usually fall within the category of assistance policies as defined in the long and short-term insurance acts.

1.2.2 Life Cover

Life cover is cover that pays out a pre-defined sum of money (the life cover as contracted with the insurer) in case of the unexpected death of the life insured (the person whose life is being insured).

The main purpose of life cover is to provide financial security to those left behind or to ensure that certain debts can be paid off at death.

Life cover falls within the category of life policies as defined in the Long-Term Insurance Act.

1.2.3 Disability Cover

Disability cover is cover that pays out either a predefined lump sum of money in case of the unexpected disability of the person who is insured; or that pays a predefined income during the time that the insured is disabled.

The purpose of disability cover can thus be either to cover additional costs associated with disability for example, restructuring one's home to cater for day-to-day needs as a result of the disability, or to provide the disabled person with a replacement income while they are unable to earn an income as a result of the disability.

Disability cover falls within the category of disability policies as defined in the Long-Term Insurance Act.

1.2.4 Dread Disease Cover

Dread disease cover is also known as trauma, severe illness or critical cover. This is cover that pays out a predefined sum of money (the insured benefit), based on the insured person being diagnosed with a dread disease (or severe/ critical illness), e.g. cancer or a heart attack.

The purpose of this cover is to provide funds to pay for additional costs associated with a dread disease, e.g. out-of-pocket medical expenses that may not be covered by the client's medical aid.

Dread disease cover falls within the category of health policies as defined in the Long-Term Insurance Act.

1.2.5 Other Types of Long Term Health

We also get other types of long term health policies which include the following:

- ☐ Hospital cover which provides additional predefined lump sum amounts or amounts per day in hospital for non-medical associated costs relation to hospitalisation.
- ☐ HIV cover which provides predefined lump amounts to cover the costs of HIV, Aids, tuberculosis and malaria testing and treatment.
- ☐ Medical emergency cover which provides predefined amounts to cover the cost of medical emergency evacuation or transport.

1.3 GENERAL FEATURES OF LONG-TERM INVESTMENT POLICIES

Long-term investment policies assist clients with saving up for a specific goal such as children's education.

1.3.1 Endowment Policies

Endowment policies, in return for a premium paid, provide a mix of life cover and investment. Such policies have a surrender value and can be with-profit policies i.e., the return on the investment portion of the policy is linked to the investment performance of the insurance company. The endowment policy will pay out the benefit after a fixed period or on earlier death. Endowment policies must have a minimum term of five years.

An endowment policy falls within the category of life policies as defined in the Long-Term Insurance Act.

1.3.2 Sinking Fund Policy

While the main purpose of a sinking fund policy is similar to that of an endowment, the difference between these two types of policies is that an endowment makes provision for a life insured and may thus become payable before the maturity date in a case where the life insured dies prior to the policy maturing, while a sinking fund does not make provision for a life insured and will thus continue until the maturity date.

1.4 TERMINOLOGY RELATING TO LONG-TERM INSURANCE POLICY

1.4.1 Parties in a Long-Term Insurance Policy

The following parties can be involved in a long-term insurance policy:

- ☐ **Proposer**: The person or entity applying for a policy.
- ☐ **Policy holder**: The policy holder is the owner of the policy but is also sometimes known as the contracting party. This is the person who takes out the policy with the insurer and originally owns it. He is the only person authorised to make changes to the policy.
- ☐ **Premium payer:** This is the entity or person who pays the premium. It is usually the policy holder but can also be another third party. However, the responsibility still rests with the policy holder to ensure that the premiums are paid.
- ☐ **The life insured:** This is the person whose life event will determine the provision of benefits by the insurer. If the policyholder is a different person from the life assured, the policy holder must have an insurable interest in that person. The life assure is also known as the insure of life covered.
- ☐ **The beneficiary:** The beneficiary is the person to whom the benefits are payable. The beneficiary of a policy can be the policy holder, the life insured or another nominated person.

- ☐ **The insurer:** The insurer is the party who accepts the risk and will pay the insured amount when the insured event occurs as stipulated in the insurance contract. The insurer need to be registered as a long-term insurer with the relevant regulatory authority.
- ☐ **Cessionary:** The new policy holder in the event of the cession of a long-term policy. A cession is a contract in terms of which one party, the cedant, agrees to transfer his/her rights and obligations in a concern for example, life cover benefit, to another person or institution, the cessionary. The cessionary becomes the new owner of the policy.

1.5 PRINCIPLES RELATING TO LONG-TERM INSURANCE POLICY

1.5.1 Long-Term Insurance Cover Principle

Long-term insurance is not indemnity insurance. This means that the policy holder can choose his own level of cover (within reasonable amounts, based on their current income), the sum assured and whether he is insuring his own life or that of a family member or debtor.

In principle, a person can place almost any value on the life to be insured and implement insurance for that value, subject to affordability and underwriting criteria.

1.5.2 Contractual Capacity

A person or legal entity can only legally enter into a long-term insurance policy, if the person has contractual capacity.

Contractual capacity includes factors such as being over the age of 18, and being of sound mind, as the client must be able to understand the detail contained in the policy contract, as well as the implications of the contract, in order for it to be valid.

Once contractual capacity has been determined and verified, the client's authority to contract (where an investment is being made on behalf of a group of people) must also be verified, e.g. if a company-owned policy is to be implemented, a resolution must be passed by the company's directors to that effect, or else the policy contract could be of no force and effect.

1.5.3 Amendments to a Long-Term Insurance Policy

Only the policy holder may make amendments to the policy, in other words, make changes to the premium, benefits or cover, end the policy (full surrender), or sell or donate the policy to another person.

A person who is married in community of property may take out a policy without the consent of his spouse, but when that person wants to amend the policy (e.g. sell, donate or surrender the policy), he/ she will have to get permission from his/ her spouse to do so.

1.5.4 Insurable Interest

The proposer must have an insurable interest in the life of the person who is insured under the policy. Insurable interest relates to the fact that the owner of the policy stands to suffer financially if a life event happens with regard to the life assured.

The purpose of the requirement for insurable interest is to allow a distinction to be drawn between wagers (bets) and insurance. If the need for insurable interest to be present was not a requirement, then any person could insure any high-risk person's life as a money-making scheme. Therefore, there must be an insurable interest when taking out a policy.

An insurable interest is only required at inception of the policy.

There are three principles used as criteria (except on own life or between spouses) to establish whether a bona fide insurable interest exists:

- ☐ A financial interest which can be assessed.
- ☐ An expectation of suffering a loss.
- ☐ An interest that exists at the time the policy is affected.

Examples of an Insurable Interest

The following is examples of an insurable interest:

- ☐ A person in his own life to an unlimited amount.
- ☐ A husband and wife in each other's lives to an unlimited amount.
- ☐ A parent in the life of his/ her child, or a child in the life of his/ her parent(s) up to a reasonable amount.
- ☐ Partners in one another's lives limited to their interests in the partnership.
- ☐ A creditor in the life of his/ her debtor at least to the amount of the debt.
- ☐ An employer in the life of his/ her employee (limited to his/ her value to the employer).
- ☐ An employee on the life of his/ her employer limited to the value of his/ her future salary.

1.5.5 Policies Taken on the Life of a Minor

Section 55 of the Long-Term Insurance Act stipulates that Long-term insurance policies may be taken out on the lives of minors as well as unborn children.

The amount of cover that can be taken is limited, depending on the age of the minor/ child to be insured. The limitations that are in place setting out the respective maximum cover amounts are as follows:

- ☐ In the case of an unborn or a child under the age of six years: R10 000.
- ☐ In the case of minor children between the ages of six to 14 years: R30 000.

However, if the value of the total premiums paid plus interest exceeds the above limits, then that value will apply.

These limits are in place to ensure that there is no financial incentive for anyone to harm children, and it also relates to the main purpose of insurance, namely to protect a person against financial losses. There is no financial loss caused by the death of a child, and so the cover limits relate largely to funeral costs.

1.5.6 Misrepresentation and Failure to Disclose Material Information

Section 59 of the Long-Term Insurance Act provides for the fact that the insurer can reject or reduce a claim if any material information was misrepresented by the client that could have affected the insurer's assessment of risk.

For example, if a person withheld the fact in a policy application that he suffered from heart disease, then this would have a bearing on the level of risk taken on by the insurer in terms of the cover granted. If that person then died as a result of a health-related incident, the insurer would be within their rights to reject or reduce the claim amount payable.

However, no policy will be invalidated, nor will the obligation of the long-term insurer be excluded or limited, nor the obligations by the policyholder be increased by any misrepresentation, unless the misrepresentation materially affects the assessment of the risk in terms of the policy at the time of issue or the variation of the policy.

This means that the insurer cannot deny liability on proving the client made a misrepresentation, unless the misrepresentation was material to the assessment of risk.

For example, the insurer cannot refuse to pay out a disability claim when they discover that the client dies not update the contact details. However, the insure can refuse a claim if the client withhold the fact that he/she has a dangerous job as this materially affects the assessment of risk.

1.5.7 Protection of Policies Against Insolvency

Section 63 of the Long-Term Insurance Act provides protection for life, disability, assistance and health policies from the claims of creditors. The benefits of the policy will be protected if the policy meets the following conditions:

- ☐ The policy must be provided under one or more assistance, life, disability or health policy/ policies.
- ☐ The policy must be on the life of the policy holder or his spouse.
- ☐ The policy must have been in force for at least three years.

The protection also provides for the following:

- ☐ The policy will not be attached by creditors during the person's lifetime.
- ☐ On the death of the person, the policy benefits will be protected if they are payable to his spouse, his child, stepchild, or parent, subject to the prescribed limit.

The protection does not apply to debts secured with the policy benefits. The protection is limited and applies to the following:

- ☐ Assets acquired with the proceeds for a period of five years from the date the benefits were provided.
- ☐ The benefits and assets acquired with the proceeds are protected to for the total policy value payable; for example, if a policy had matured within five years before insolvency, the proceeds (or asset(s) into which the proceeds were converted) are also protected.

The protection is applied to marriages out of community of property as follows: If, in terms of a duly registered antenuptial contract, a man cedes a policy to his wife or to a child born of the marriage, the protection in respect of the full value of the policy applies, provided that the cession was affected at least two years prior to the husband's sequestration.

The protection is applied to marriages in community of property as follows: The policy will still form part of the joint estate. Together with the other insurance of both parties, it will still enjoy total protection.

For example, Kenneth took out a life policy in 2010 with lump sum death cover of R1 000 000 and stand-alone severe illness cover of R500 000. He nominated his wife as the beneficiary when he took out the cover. Kenneth's business, which he ran in his personal capacity, has recently been liquidated. Kenneth has been diagnosed with cancer. The severe illness benefits and the life cover benefit will pay out. As his wife is the beneficiary, the creditors will not be able to claim the benefits payable to settle Kenneth's debts, as the policy meets all the conditions for the benefits to be protected from creditors.

1.6 FEES AND CHARGES ON LONG TERM INSURANCE PRODUCTS

Fees and charges are an important issue in long-term insurance policies. All policy quotes will detail the fees and charges that will be applicable for the particular structure of the product that is being quoted.

1.6.1 Life Risk Policies

For long-term insurance risk policies, fees and charges include the following:

- ☐ **Plan Charge:** This is a monthly fee which is added to the total risk payment to cover the monthly administration costs. The monthly plan charge will normally increase annually, in line with inflation.
- ☐ **Commission:** Currently remuneration for selling and servicing life risk policies (commission) is paid to intermediaries at the beginning of the first and second policy years.

1.6.2 Long-Term Investment Polices

The fees and charges on long-term investment policies include the following:

- ☐ Effective annual cost
- ☐ Commission / advisor fees

Each of these is considered as a subsection.

I) Effective Annual Cost

The Effective Annual Cost (EAC) is a measure of the Association of Savings and investments South Africa (ASISA) which allows the client to compare the charges incurred and its impact on investment returns. EAC is expressed as an annualised percentage.

The lower the EAC, the more cost-effective the investment is.

EAC is made up of the following four components, which are added together:

- ☐ **Investment management:** The investment management is calculated based on the current investment funds using the total investment cost (TIC) of each of the selected investment funds. The TIC equals the sum of the total expense ratio (TER) and the total cost ratio (TCR). The TER includes the yearly fees that an asset manager charges, which are the fee at benchmark and any performance component, as well as any custodian fees. The TCR includes the more direct investment costs, which mainly consists of trading costs (for example brokerage), and taxes for example VAT, STT, STRATE and FSCAuy Investor Protection Levy. TIC is expressed as a percentage of the investment fund assets.
- ☐ **Advice:** This component shows the effect of the charge levied on the plan to recover any commission paid to the intermediary. These charges are outlined in subsection (II).
- ☐ **Administration:** Administration includes part of the variable marketing and administration charge used to cover the cost of administration of the plan.
- ☐ **Other:** Other fees include the plan charge (rand amount per month, e.g. R16 per month), fixed marketing and administration charge, and part of the variable marketing and administration charge used for marketing and any other distribution costs (% of fund value).

The effect of some of these components may vary over time.

II) Commission / Advisor Fees

This is included under advice in the EAC.

An adviser currently has one of the following two choices on recurring premiums:

1. Take up to 2.5% initial commission per recurring payment (discounted up to 6% over investment term), and the rest of the commission as payment-based commission.
2. Take payment-based commission of up to 5% per recurring payment.

An adviser currently has one of the following two choices on lump sum investments:

1. Initial – maximum 3.0% (excluding VAT) deducted prior to the investment being made. Where the annual fees are more than 0.5%, initial fees are capped at 1.5%.
2. Annual – Maximum 1.0% (excluding VAT) of the investment account. Where the initial fee is more than 1.5%, the maximum annual fee is 0.5%

1.7 GENERAL RISKS ASSOCIATED WITH LONG TERM INSURANCE POLICIES

The most important aspects that need to be considered before entering into long term insurance policies is to ensure that the product will adequately insure the policy holder for their personal risk level or that enough money is saved toward the saving goal of the client over the expected time frame while considering the investment risk of the product.

For life risk products specifically, it’s important to know that insurance is not meant to unjustly enrich clients, it is meant to assist clients in maintaining their current lifestyle in case of adverse life events (such as disability or critical illness) or enabling family members who are left behind to maintain their current lifestyle in case of unexpected death.

The main objective of a financial advisor is to assess clients’ risks to ensure there is the correct amount of cover in place, which should be reviewed annually or at life events – such as getting married, having children, etc. Failure to do so could mean that the client is either under-insured or over-insured.

1.7.1 Under Insurance

Under-insurance can cause clients to find themselves in a serious financial crisis, with inadequate means to maintain their standard of living or pay their debts in case of insured events, depending on the amount of cover for a specific event that is insured, and the extent of the shortfall in insurance.

In terms of disability cover specifically, if a client owns more than one disability policy and becomes disabled, he/ she may only qualify for benefits in terms of the definition of one of the policies owned.

If the definitions of the various types of disability are misunderstood, then the client may falsely believe that all his disability risks are covered.

1.7.2 Over Insurance

In terms of over-insurance, the client is at risk of paying too much in premiums and potentially not receiving the benefit, since insurance companies can decide not to pay out the full benefit if it would unjustly enrich the client. Note that, at cover levels below R10 000 000, the insurance companies have more difficulty enforcing the enrichment rule; however, if the amount is in excess of R10 000 000, life insurers will request financial statements from clients to prove that the cover is required.

Therefore, it is essential to ensure that clients are adequately covered, and to review clients' cover levels at least annually. It's also beneficial to take out different insurance policies for specific purposes.

For example, Thabiso has the following insurance in place:

- ☐ Individual life cover of R1 500 000, ceded to the bank, which is the current value of his bond. The policy includes 75% replacement of his current salary as an income replacement benefit.
- ☐ His group cover policy has 75% replacement of income in the event of disability; and 0.5 x annual salary as a severe illness benefit.

As Thabiso's salary is covered twice (150% of his current salary as a disability income replacement), the insurance companies will only pay out a percentage (less than 100%) of his monthly income, according to his income and age on a sliding scale. This will be paid as a monthly income in the event of disablement.

The income replacement premium is paid with post-tax money and therefore the income benefit is not taxable. This is the reason why the income will be less than 100% of taxable income.

Topic 2 Aspects Relating to Specific Long-Term Insurance Products

LEARNING OUTCOMES

After study the topic, the learner should be able to-

- Explain the legislative and tax implications applicable to specific sub-categories of long-term insurance products.
- Assess the appropriateness of specific sub-categories of long-term insurance products for specific client needs.
- Describe the options and strategies applicable to specific sub-categories of long-term insurance products to provide effective combinations of cover/ savings to suit the needs of different investors.

2.1 INTRODUCTION

Previously we considered the main types of long-term insurance policies and their general purpose and features as a whole. In this topic, the variations in cover offered, and the definitions for insured events used by insurers relating to the main types of long- term cover are considered.

2.2 ASSISTANCE POLICIES (FUNERAL COVER)

Funeral benefits provide cover for the payment of costs and other expenses associated with the funeral arrangements that arise on the death of the life assured. Expenses could include the settling of debts, the costs of relatives travelling to the funeral, the costs of the funeral itself and some of the dependants' immediate living expenses.

In terms of the Assistance class of the Long-term Insurance Act, cover should be R30 000 or less (this is the current amount prescribed by the Minister of Finance).

Standard funeral benefit policies range from R3 000 to R30 000 for the main member and his/ her spouse. Non-standard funeral benefit polices are often registered under the life policies class but operate on the same principles as assistance policies through insurers. These range in cover from R50 000 to R100 000.

There are different types of funeral cover benefits. Some policies pay out a cash lump sum and others provide the funeral benefits, e.g. a coffin, hearse, burial, gravestone, etc. A funeral advisory service is included in some funeral policies, where advice and assistance are given to the family on the funeral arrangements, choice of coffin, and so on.

Most products include the life assured's spouse and children at very low cost. Cover for extended family – such as parents and even parents-in-law may also be added in some product plans. Where additional family members are covered, the main policyholder is called the sponsor. If the sponsor does not pay the premiums, then the whole policy will lapse.

2.2.1 Waiting Periods and Exclusions

Most insurers apply a waiting period or pre-existing period to assistance policies. A pre-existing period is where a claim may not be paid related to a health condition or disease with which the deceased was diagnosed, or for which they received treatment or care in the 12 months prior to joining. This is to prevent people from taking out funeral cover only once they become aware of a severe health problem.

Waiting periods are subject to each insurer's rules. This ranges from 3 to 12 months, during which premiums must still be paid. If the life assured dies during the waiting period, the benefits will not pay out unless death was as a result of an accident.

There is typically a two-year suicide exclusion clause, where no benefits will be payable for this period if death is as a result of suicide.

2.2.2 Benefits of Funeral Cover Benefits

The following are the main benefits offered by funeral cover:

- ☐ Cover on the policy is available for a single life covered, or for the life covered and his/ her immediate family, such as a spouse and children; as well as for the extended family, such as parents and parents-in-law. Some insurers also include uncles and siblings as part of an extended family.
- ☐ Benefits on funeral cover policies pay out tax free to the beneficiaries.
- ☐ Benefits are generally available within 48 hours of the claim requirements having been met.
- ☐ The proceeds of the cover can be used to address any costs associated with finalising the funeral arrangements of the life assured.
- ☐ Funeral benefits are relatively low-cost benefits.
- ☐ The benefit is available to cover the client for life (whole life) or for a particular term.

Funeral cover is suitable for any client who needs to make provision for costs associated with funeral arrangements, for themselves, or for their immediate and extended family.

2.3 LIFE COVER

Life insurance is a contract between an insurer and a policyholder in which the insurer guarantees payment of a death benefit to named beneficiaries upon the death of the insured. The insurance company promises a death benefit in consideration of the payment of premium by the insured. The purpose of life insurance is to provide financial protection to surviving dependents after the death of an insured.

2.3.1 Types of Life Cover

A client has the following main choices of life cover options:

- ☐ Term (or temporary insurance) policies.
- ☐ Whole life (or permanent insurance) policies.
- ☐ Accidental life cover policies.

I) Term Cover

Term assurance, or term cover, provides for the payment of the capital sum of cover on death of the life assured on the policy, only if this occurs within a set period/ term. The maximum term on these policies is 30 years (but most allow the policyholder the option of converting the term policy to a whole life policy, subject to conditions).

If the life insured survives until the end of the term assurance policy, then no cover is payable, even if death occurs one day after the policy ends. Term assurance is therefore cheaper than whole life insurance as the insurer may not need to pay any benefit out, whereas with whole life cover, a benefit will become payable sooner or later.

Term assurance can be level, i.e. the same life cover for the whole period, or decreasing, i.e. where the cover reduces in line with a debt that is paid off over time. Decreasing term assurance is less popular these days due to mismatches of cover versus the debt due.

Premium and cover levels are determined at the inception of the policy.

II) Whole Life Cover

Whole life cover provides for the payment of the capital sum of life cover on death. Premiums on these policies are usually payable until the death of the life assured. The level and nature of the premium payments will be determined at the outset according to the structure of the benefits, whether the cover amount remains constant or if it increases incrementally on a yearly basis or not.

Annual premium increases may also apply. Most insurers guarantee a set premium for a level of cover and benefits, but review this after a certain period of time, usually around 5 or 10 years. This review period, or premium guarantee period, has been implemented so that insurers can adjust premiums upwards if their risk pool has had adverse claims experience (for example, as a result of an epidemic such as HIV/ Aids).

III) Accidental Life Cover

Accidental life cover fulfils the same purpose as a regular life policy. The key difference relates to the cause of death. Accidental death policies only pay out in the event of the life assured dying as a result of an accident.

An accident is defined as an external, unexpected event that is not traceable, even indirectly, to the life assured’s state of mental or physical health before the event. This means that benefits, if the life assured dies as a result of a health condition, such as a heart attack, or suicide at any stage, will not be payable.

2.3.2 Life Cover Pattern Options

Most life cover products provide two main choices of cover patterns. Cover patterns are how the life cover behaves over time.

I) Level Cover Pattern

This results in cover being fixed at a certain amount and remaining level (i.e. at the same amount) for the duration of the policy. A policy with level cover is generally suitable where the cover is needed to cover a specific amount or debt, for example to cover a home loan.

II) Escalating Cover Pattern

This makes provision for the cover to escalate (increase) on a yearly basis, and thus allows for the amount of cover to keep up with inflation or a fixed percentage. The cover will automatically increase each year on the policy anniversary. The corresponding premium will also increase. The policy owner usually has the choice of accepting or rejecting the annual increase but will forfeit future cover increases altogether if he skips more than two increases in a row (although some insurers have different rules). Insurance companies usually offer one or more of the following options on escalating cover options:

- ☐ Compulsory increases of 5%, 7.5%, 10% or 15% (or anything in between)
- ☐ Options linked to the South African Consumer Price Index
- ☐ Age related increases.

2.3.3 Exclusions on Life Cover Policies

Life cover policies typically have certain exclusions and limitations, which include general exclusions and specific exclusions that apply to a specific client due to his/ her lifestyle and/ or health factors.

Common general exclusions include the following:

- ☐ **Suicide clause:** This excludes payment of the life cover amount by the insurer if death is as a result of suicide within a two-year period of taking out the life cover. Usually, during this initial two-year exclusion period, only a refund of premiums is payable by the insurer. This exclusion clause prevents clients from obtaining life cover to provide their dependants with a way out of financial hardships when they intend to commit suicide.
- ☐ **War exclusion clause:** This excludes payment of the life cover amount by the insurer if the cause of death is a result of civil war, revolution, insurrection or military or usurped power, riot, civil commotion or public disorder.
- ☐ **Participation in criminal/ illegal activities:** This excludes payment of the life cover amount by the insurer if the cause of death is as a result of the insured's intentional participation in criminal activities, or if the insured wilfully breaks the law.
- ☐ **Drug or alcohol abuse:** This excludes payment of the life cover amount by the insurer if the cause of death is as a result of the insured's excessive intake of alcohol, or wilful consumption of drugs, medications (unless as prescribed by a doctor), fumes, poisons, etc.

When it comes to specific exclusions, as mentioned previously, insurers will assess the level of risk presented by a client and may then either provide cover at an increased premium rate (loading the premium) or decide to decline the cover.

Common specific exclusions (these are listed separately in each client's policy schedules if applicable) include the following:

- ☐ **High-risk occupations:** If the client's occupation is considered high risk for example, certain construction or mining occupations.
- ☐ **Risky hobbies & sports:** Clients who regularly engage in risky pastimes such as parachuting, hang-gliding, cave diving, mountaineering, professional boxing, professional kick-boxing or motor sports.
- ☐ **Health history:** Clients who have a history of serious health problems, such as high blood pressure, cancer or diabetes.
- ☐ **Lifestyle issues:** Clients with lifestyle issues that make them a greater risk to insure, such as heavy smoking or being seriously overweight.

2.3.4 Benefits of Life Cover Policies

Life insurance can help the client's family to cover the following costs:

- ☐ Funeral costs.
- ☐ Costs associated with the administration of the client's estate.
- ☐ Repaying outstanding debt.
- ☐ Regular living expenses of dependants left behind.
- ☐ Children's education costs.

The client's beneficiaries do not pay tax on the proceeds of the life insurance. If there is no beneficiary nominated, it will pay into the client's estate and thus attracts estate duty costs.

If the client is diagnosed with a terminal illness and his/ her life expectancy is less than one year, they can opt to receive an immediate tax-free, once-off pay-out, if they choose this.

We have looked at specific types of life cover, which each offer specific benefits and suitability as follows:

- ☐ **Term cover:** Term cover is a more affordable form of life cover as it applies for only a set term, and either for a level cover amount or for a decreasing cover amount, making it a suitable choice for clients who want to cover the outstanding value of a debt that is payable over a set term, for example, a home loan.
- ☐ **Whole life cover:** Whole life cover provides a comprehensive type of cover which is payable regardless of the client's cause of death, and which is provided for the duration of a client's lifetime, meaning that a pay-out of the cover will be certain at some time in the future. In addition to this, whole life cover also provides the option of increasing the level of cover to keep pace with inflation. This makes it a suitable choice for those who need to provide for their dependants' in case of their unexpected death.
- ☐ **Accidental life cover:** Accidental life cover provides a cover amount only when death occurs as a result of an accident, which means that it is also a cheaper form of life cover, and which usually requires no medical testing. It is a suitable option for clients who:
  - Are young and feel they only need (or can afford) accidental life cover to start with.
  - Have a higher exposure to accidents, for example, people who are on the road 8 hours a day. In this case, it is often used as a top-up, where a certain amount of whole life cover is taken out by the client (more expensive) and supplemented with accidental life cover at a much cheaper rate. Accidental life cover is around 50% cheaper than whole life cover, as the insurer is only taking on the risk of death from an accident.
  - Have been declined whole life cover due to health reasons.

2.4 DISABILITY COVER POLICIES

In terms of its definition as a separate class of long-term insurance business, a disability policy is a contract in terms of which an individual undertakes to, in return for the payment of a monthly or annual premium, receive policy benefits on the occurrence of a disability event.

A disability event refers to an event or occurrence which results in the functional ability of the mind or the body of an individual becoming impaired. Disability products address the need for a payment of either a lump sum, in which case the nature of the disability must be permanent, or an income benefit payable to the life insured for the period of his/ her incapacity.

The lump sum type of disability benefit is called a capital disability benefit, and the income benefit has many names in the industry, including monthly income protector and permanent health insurance (PHI).

When deciding on a particular type of disability product, or when a policy owner decides to add this benefit, it is very important that he makes sure that he understands exactly how that particular disability event is defined. Each insurer has their own definition of disability, and different definitions apply to different products.

For example, some products' benefits are related to occupational disability, i.e. the ability of the insured to be able to perform a specific occupation. Another product may cover disablement from the perspective of performing daily tasks of living, and not the ability to work.

2.4.1 Types of Disability Cover (Disability Events)

Disability cover is a risk benefit which provides a capital or income benefit in the event of total and/ or partial disability. It is very important to take careful note of the company-specific definitions of disability, as these vary across product providers. One product provider may pay for a particular type of disability, while another may reject the claim.

There are the following four main types of disability cover available:

1. Occupational disability
2. Functional disability
3. Physical disability
4. Accidental disability

We consider each type in the subsections following

I) Occupational Disability:

This type of cover relates to the insured no longer being able to perform the normal activities of his/ her occupation. The most important factor to take into account for a client is how the definition of occupation is applied. The different definitions are as follows:

- ☐ **Own occupation:** The benefit will become payable if the life insured, as a result of injury, disease or surgical illness is, and has been for a period as selected by the insured, totally and permanently incapable of performing the functions of his/ her own occupation. Under this definition, details of the insured's particular occupation will need to be recorded at the outset. Not all occupations will be eligible for cover. In terms of this type of disability, the benefit will pay out if the insured is unable to perform the duties specifically related to his/ her own occupation; for example, a surgeon who damages one hand will be paid out, as he cannot continue his own occupation.
- ☐ **Own or similar occupation:** This benefit will become payable if the life insured, as a result of injury, disease or surgical illness is, and has been for a period as selected by the insured, totally and permanently incapable of performing the functions of his/ her own occupation or a similar occupation, and any other occupations for which he/ she may be qualified due to his/ her knowledge, training and expertise. In terms of this type of disability, the benefit will pay out only if the insured is unable to perform the duties related to his/ her own or any reasonably similar occupation, e.g. a surgeon who damages his hand would not be paid out, as he could perhaps lecture, or remain a medical practitioner in another field (like specialist physician).

- **Any occupation:** This benefit will become payable when a state of total disability exists, where the life insured, as a result of injury, disease or surgical illness, is totally and permanently incapable of performing the functions of any occupation. Evidence of total disability may be the loss of either both hands, both feet or total and permanent blindness. However, this depends on the individual circumstances of each case. For example, a call-centre agent who becomes a paraplegic would not be paid out, as he could still answer phones.

II) Functional Disability

Functional disability refers to the level with which an individual can perform the daily tasks of living, e.g. bathing, dressing, going to the toilet and feeding himself/ herself. This benefit is payable after a set waiting period, and only pays if the insured is permanently prevented from performing the normal actions and functions in relation to his/ her personal care or personal affairs. This type of benefit is usually calculated on a points scale, where the inability to perform certain tasks is linked to a specified number of points, which will determine the level of benefit paid.

III) Physical Disability

Physical disability refers to the insured suffering from an actual physical impairment, e.g. loss of use of one or more limbs or senses. It can include paraplegia, blindness, loss of limbs, burns, deafness and facial disfigurement. Benefits are payable in terms of a scale of severity up to 100% of the sum assured, as selected.

Physical and functional impairment policies are cheaper than occupational disability policies, as the pay-out probability on occupational disability policies is substantially higher. Many insurers now offer a combination of these benefits so that the client is covered in the event of partial as well as total disablement.

IV) Accidental Disability

Accidental disability cover pays out a lump sum if the insured meets the definition of disability as defined by the particular insurer, but the key difference pertains to the cause of disability. Accidental disability cover pays out the determined amount of disability cover to the insured if the insured's disability is caused as a result of an accident. An accident is defined as an external, unexpected event that is not traceable, even indirectly, to the life assured's state of mental or physical health before the event. Accidental cover is usually available as a benefit that can be added to an underlying accidental life cover benefit, so that the cover amount will pay out either on death due to an accident, or in the event of disability due to an accident (whichever occurs first).

2.4.2 Types of Disability Products (Form of Benefit Payment)

I) Lump Sum Disability Products

Lump sum disability benefits are specified at the start of the policy and may, like life cover, be structured to escalate annually at a specified rate selected by the client.

Lump sum disability products pay out in the form of a tax-free lump sum in the event of total and permanent disablement of the insured, and can be used to repay debts, provide for lifestyle changes and to replace income lost due to the inability to work.

The following are options to structure a capital disability benefit:

© Anna Bouhail

- ☐ **Stand-alone (or independent) benefit:** A stand-alone lump sum disability benefit provides cover that is separate from any life cover of the insured on the policy, so that, in the event of a disability claim, the amount paid out in respect of the disability claim is totally separate from, and will not affect, the level of life cover. Life cover stays intact and becomes payable on the death of the life assured; i.e. two separate benefits are therefore insured and paid for.
- ☐ **Accelerated benefit:** An accelerated lump sum disability benefit provides that all or a part of the life cover on the underlying policy becomes payable, in the event of the life assured becoming disabled. This is cheaper as only one benefit amount is insured. If only a part of the life cover on the underlying policy pays out due to the disability, the underlying policy will continue and there will still be life cover payable in the event of the death of the life assured. Clients choose this as it is often cheaper and can be used specifically to settle debts or as a loan cession. Note that your life cover must be more or equal to the capital disability cover.

EXAMPLE

Pam has taken out a life policy with R200 000 life cover on her own life. In the event of Pam's death, R200 000 will be payable. Pam has also added a disability accelerator to the value of R150 000 to the policy. This means that if Pam becomes disabled, R150 000 in cover will be accelerated from the life cover and will pay out to Pam even though she is still alive. The balance of the R50 000 life cover on the policy will remain intact and become payable at death.

An additional benefit, such as a premium protection benefit, can also be added to capital disability cover. This is a benefit where the premium for the life cover becomes payable by the insurer in the event of the insured becoming disabled. Most additional benefits can be added to a policy at the start of the policy as well as during the term of the policy, subject to underwriting.

Accidental disability cover is also structured as a lump sum disability product, as it is also added as an accelerator to an underlying life cover benefit.

Note: Capital disability is available as whole life or term cover.

II) Income Disability Products

Disability products are also available in the form of a monthly income benefit payable in the event of the insured becoming disabled. Monthly benefits are payable until the earlier of the insured's recovery, death or reaching retirement age. Income disability benefit products are available as stand-alone products only, i.e. they cannot be accelerated from an existing death benefit.

The income disability benefit is designed to replace the earned income of the individual should this earned income cease or decrease as a result of the disablement of the individual. Most insurers have a maximum age at entry; this is usually 65.

The income disability benefit is restricted in the sense that the income payment may not exceed 100% of the average monthly income after tax that the life insured earned directly before the disability. The income disability from the plan, plus any income that the life insured might receive from other individual or group disability income type plans, will be taken into account when the average monthly income after tax are calculated. Advisors must, therefore, make sure that they don't over-insure their clients for disability income benefits. All group income benefits and income benefits from other insurance companies must be taken into account.

On-going health reviews will be requested by the insurer in order to continue the payment of the income benefits.

The life insured must provide proof of loss in income during the disability period, before the monthly income benefits will be paid.

Other income benefits payable will influence the payment of the income disability benefit.

III) Sickness Benefit

There is a significant difference between a sickness benefit and an income protection benefit.

The sickness benefit pays out when the life insured, as a result of illness or injury, is on sick leave, regardless of whether income is still earned over that period or not. For clients who qualify for it, it is therefore considered to be a simpler solution for short-term inability to work.

The sickness benefit is not reduced for other disability income benefits that may be payable at the same time. Premium payments are not waived during a sickness claim. Sickness benefits (currently only offered by two life assurers in South Africa) are pitched for the professional market, i.e. clients with a professional 4-year plus degree e.g. doctors, attorneys, accountants, etc.

With a sickness benefit the holder does not have to prove loss in income.

Other disability income benefits do not influence benefit claim payments.

2.4.3 Waiting Periods

Lump sum disability products generally have waiting periods of up to 6 months. The reason for waiting periods on this type of cover is that it often takes a long period of time to assess the permanence of a disability. More recently there has been a move away from having an explicit general waiting period, and rather including the waiting period in the various definitions of disability. This can ensure that in cases where permanence is easily assessed (for example, becoming a paraplegic), policyholders do not have to wait a mandatory period of time to receive payment.

The waiting period on an income disability cover, on the other hand, is the period of time that a client has to be partially or fully disabled in order to be able to claim a benefit. Selecting the correct waiting period on an income disability benefit is important in terms of financial planning. When choosing the waiting period, one should consider the period of time that one can be off work without losing an income. For example, many salaried employees will have at least 30 days' sick leave and will only experience a loss of income after being disabled for more than a month. These individuals could select a 1-month waiting period on their policy, which means it will only start paying in the event of being off work for more than a month. The longer the waiting period one selects, the cheaper the premium will be for the income disability product.

2.4.4 Exclusions on Disability Cover Policies

Insurers, in general, will exclude the payment of disability benefits if the disability is as a result of the indirect or direct consequence of active participation in hostilities or warlike operations; or attributable to negligence or wilful exposure to danger; or due to intentional self-inflicted injury.

As in the case of life cover specific exclusions, clients will similarly be underwritten before being offered disability cover, and their policies may be loaded, or even be declined disability cover, as a result of lifestyle and/ or health factors.

2.4.5 Benefits of Disability Benefits

I) Lump Sum Disability Benefits

The tax-free payment of a lump sum on permanent disability assists the client to settle his/ her debts at disability, pay for lifestyle adjustment costs, and any other costs associated with the disability; thus, it is a suitable choice when the client would like to settle debts at disability, and to make provision for lifestyle adjustment costs.

Lump sum disability benefits are also more suitable to provide key person protection, as well as for other business insurance needs, such as buy and sell agreements.

Accidental lump sum disability benefits added to an accidental death benefit is a suitable option for clients who want both accidental life and accidental disability cover due to a higher exposure to accidents, e.g. truck drivers, young people, or those who want to supplement their existing life and disability cover.

II) Income Disability Benefits

Income disability benefits are generally more suitable for clients who wish to specifically provide for living expenses while they are disabled. A client may be temporarily disabled, meaning that he/ she will recover and return to his/ her occupation within a specified period of time. Income protection benefits provide protection for both temporary and permanent disability, whereas the lump sum benefits, typically, only pay when a client is permanently disabled.

Income disability cover can be structured to include escalators so that disability benefit levels will increase each year to keep pace with inflation.

2.5 DREAD DISEASE/ TRAUMA/ SEVERE OR CRITICAL ILLNESS COVER

Statistics show that one in three men and one in four women in SA will have a heart condition before age 60; whilst one in six men and one in seven women in SA will get cancer during their lifetimes. Advancement in medical technology means that most people who suffer from a severe illness (such as cancer, stroke or heart attack) will actually survive the illness.

However, there are financial implications for the client and their families due to the loss of income of these individuals, the costs of medical treatment and on-going care. A severe illness condition brings with it human as well as financial suffering. A comprehensive medical scheme may cover medical treatment or costs, but what about costs over and above the medical costs, and the long-term implications for the family?

Clients not only need the financial resources to survive, but also to concentrate on maximising recovery. A severe illness benefit is the ideal way in which the costs over and above the medical costs can be dealt with. The individual client may have special needs (not covered by medical aid) subsequent to suffering or contracting one of these illnesses.

The severe illness product assists in covering extensive medical costs, general lifestyle adjustments that may have to be made in the circumstances, and any other related financial needs. Not all severe illnesses will result in disablement, but often it will result in astronomical medical costs, such as those related to heart bypass surgery or chemotherapy to treat cancer. The purpose of dread disease cover is therefore to supplement other aspects of the client's financial plan, such as disability cover and medical scheme cover.

© Anna Bouhail

2.5.1 Dread Disease Cover Options

Dread disease/ trauma/ severe or critical illness cover is a risk benefit that provides for the payment of a lump sum on the confirmed medical diagnosis of a predetermined medical condition.

Insurers generally offer a choice of a Core and a Comprehensive dread disease cover benefit. This is also available as whole life or term cover.

The core dread disease/ severe illness option usually covers heart attacks, cancer, strokes, and coronary bypass grafts for heart disease; as these, according to the Association for Savings and Investment South Africa (ASISA), account for approximately 70 – 90% of severe illness claims in South Africa.

The comprehensive dread disease / severe illness benefit includes the core dread disease/ severe illness conditions, plus an extended list of other diseases and conditions, some of which are listed below (the list varies by insurer):

- Accidental HIV infection
- Advanced AIDS
- Alzheimer's disease and progressive dementia
- Aplastic anaemia
- Cancer and leukaemia
- Cardiovascular system
- Cerebrovascular incident (stroke)
- Chronic liver failure
- Chronic pancreatic disease
- Coma
- Inflammatory bowel disease
- Loss of and loss of use of limbs
- Loss of hearing
- Loss of sight
- Major burns
- Motor neurone disease
- Multiple sclerosis
- Muscular dystrophy
- Other central nervous system disorders
- Paralysis
- Parkinson's disease
- Renal failure
- Respiratory failure
- Rheumatoid arthritis
- Systemic lupus erythematosus
- Traumatic brain injury

The dread disease product can either be bought as a stand-alone option, or it may be added as an accelerated benefit to an existing life policy. The benefit is generally paid out on diagnosis, subject to the product-specific rules of the particular insurer.

2.5.2 Dread Disease Cover Structure Options

Some policies pay out the full assured amount on diagnosis, while others pay out a percentage of the amount, depending on the severity of your illness – these are known as tiered benefits. These benefits typically pay out 25%, 50% or 75% of the insured amount.

Some life assurers offer policies with a single cover amount, and each claim decreases the cover left. If you had a R1 000 000 policy and were to make a claim of R250 000 for cancer, you could make another claim of up to R750 000.

Other insurers offer cover reinstatement, whereby you can make multiple claims against the same policy without depleting the cover amount. The level at which your policy pays out can determine if you can claim more than once for the same illness.

Structure variations to these benefits may be selected by the policyholder; the more comprehensive the cover chosen, the more expensive the benefit will be.

© Anna Bouhail

2.5.3 Dread Disease Cover Versus Medical Scheme Benefits

It is important to understand the difference between dread disease cover and medical scheme benefits. While medical scheme benefits provide indemnity cover related to the medical expense incurred by the insured (they usually cover the actual costs incurred), dread disease cover simply pays out a predetermined amount (the sum the assured chose) in the event of diagnosis of the illness. This pay-out is not necessarily related to the medical cost incurred and does not need to be spent on medical care at all – if he wanted, and was able to, the client could even take a holiday with the dread disease pay-out.

Dread disease payments are always made to the policyholder. Also, with dread disease cover, a claim is payable upon verified diagnosis of a condition only, whether the client undertakes any medical treatment or not. However, with medical scheme cover, benefits are only payable in the event of treatment, and often these are paid directly to the hospital or other medical provider.

EXAMPLE

Jeremy recently had a stroke and was hospitalised. His medical expenses amounted to R500.000. He belongs to a medical scheme, but the pay-out for the treatment he received was limited to R300 000. He also had a policy with dread disease cover to the value of R600 000. This amount was paid to him in full.

He could have used it to settle the difference in medical expenses, or on anything else. The pay-out is to assist him with additional expenses that he would not have incurred if he was in perfect health.

Many insurers also offer a children's severe illness benefit. This benefit is aimed at providing cover for the child of the life assured and covers severe illnesses for the child for a specific term (usually until the child turns 18). The proceeds from this benefit can be used for any lifestyle adjustment costs that may be needed as a result of the child surviving the severe illness. It usually pays out as a percentage of the life assured cover amount, e.g. a percentage of the father's dread disease cover amount; or it can be bought as a stand-alone benefit for the child at some of the assurers.

2.5.4 Waiting Periods on Dread Disease Cover Policies

Dread disease cover typically has three types of waiting periods:

- ☐ The first waiting period is the period of time that must pass before your cover comes into effect. During this time, you are unable to claim. This is to prevent people from waiting until they are ill before taking out cover.
- ☐ Then there is what is termed the survival period. This is the length of time the client has to wait after being diagnosed with an illness before a claim is paid out.
- ☐ Finally, the claims process can take time based on the reason for the claim, the need for medical tests to confirm diagnosis, and the wait for medical test results. These can sometimes delay a claim pay-out.

2.5.5 Exclusions on Dread Disease Cover Policies

Insurers, in general, will exclude the payment of dread disease benefits if the illness is as a result of the indirect or direct consequence of active participation in hostilities or warlike operations; or due to intentional self-inflicted injury.

As in the case of life cover specific exclusions, clients will similarly be underwritten before being offered dread disease cover and may have specific exclusions imposed based on pre-existing medical conditions.

2.5.6 Benefits of Dread Disease Cover Policies

The tax-free payment of a lump sum on the diagnosis of a listed dread disease, assists the client to pay for any additional treatment that the medical aid may not cover, pay for any lifestyle adjustment costs and any other costs associated with the dread disease; thus, it is a suitable choice when the client would like to make provision for lifestyle adjustment costs associated with dread disease.

Note that dread disease cover is NOT a suitable choice to replace one's medical scheme cover, it should be used as an additional cover to cover other unexpected expenses.

2.6 LONG-TERM REINSURANCE POLICY

Reinsurance, also known as insurance for insurers or stop-loss insurance, is insurance that is purchased by an insurance company from one or more insurance companies (the reinsurer), to reduce the likelihood of having to pay a large obligation resulting from an insurance claim. The ceding company and the reinsurer enter into a reinsurance agreement which details the conditions upon which the reinsurer would pay a share of the claims incurred by the ceding company. The reinsurer is paid a reinsurance premium by the ceding company, which issues insurance policies to its own policyholders.

The main objective is to reduce the risk on one insurer and helps ensure that insurance companies can remain solvent – particularly after a major disaster, such as a hurricane – because the risks and costs are spread.

2.7 LIFE INVESTMENT POLICY

Clients need to save for a variety of reasons, e.g. saving for a new car, a deposit on a house or saving for retirement.

When saving for a particular goal, the term and purpose of the saving is very important, as this could determine the type of investment vehicle (product) selected.

As previously discussed, once a suitable investment product has been selected, the investor also has to choose an underlying investment portfolio within the product or vehicle. The choice or investment portfolio will depend on the client's risk profile and lifecycle stage, as each investment portfolio is made up of a different combination of asset classes, which affects the degree of risk it involves and the expected return on the investment.

The following matters need to be considered in order to find the most appropriate investment (wealth creation) solutions:

- ☐ The risk profile of the client when choosing the appropriate investment vehicle or product and investment portfolio.
- ☐ The client's goals when choosing an investment vehicle to address a particular savings need.
- ☐ The features and benefits of investment vehicle (product) options, such as endowments and sinking funds, collective investments (unit trusts) and banking products.
- ☐ The term of the investment.
- ☐ Liquidity needs of investor.
- ☐ Health and age of the client e.g. a very old and sick person must rather consider shorter-term investments.

In the subsection following, the different types of investment vehicles or products available under the Long-term Insurance Act, for investors who want to save towards a certain goal are considered.

2.7.1 Endowment Policies

An endowment policy is an investment policy taken through a long-term insurer. It is a vehicle that encourages disciplined contractual savings. The use of an endowment policy has become an important investment vehicle in a person's medium- to long-term investment portfolio. Certain endowments, such as those set up for children's education purposes, may have life cover attached to them.

I) Liquidity Considerations on Endowments

Endowment policies are subject to Section 54 of the Long-term Insurance Act, which, in practice, imposes a minimum of a five-year term on policies – called a restriction period. Proceeds will then be paid out to the original owner tax free. If, however, the premium is increased by more than 20% (compared to the premiums paid during the previous two premium-paying periods), a new five-year restricted term will start running.

During a restricted term or an extended restricted term, only one loan and one surrender may be made against the policy. The value of such a loan or surrender will be limited to premiums paid plus 5% compounded annual interest.

Endowment policies have an investment account (savings) and, therefore, the client can also take a loan from the policy, take cash withdrawals or surrender the policy. However, any loans or surrenders would be subject to the provisions of Section 54. The value of the investment account may also be used as collateral for a loan from a bank.

EXAMPLE

Mario invested R1 000 000 into an endowment three years ago and is in desperate need to access the funds. The current value of his endowment policy is R1 404 928.

He is entitled to access the premiums plus 5% compounded annual interest which is calculated as follows:

$$Future\ value\ =\ Present\ value\ X\ (1 + interest)^{time}$$

$$= R1\ 000\ 000 \times (1 + 0.05)^3$$

$$= R1\ 1576\ 625$$

Therefore, R1 157 625 is allowed as a loan.

II) Investment Risk Considerations

The client must choose an investment portfolio(s) from the range on offer. The value at maturity will depend on how well the underlying investment portfolio has performed. The client may change portfolios during the term of the policy. The risk associated with endowments relate to the choice of the underlying investment portfolio. These options range from low-risk guaranteed funds to higher- risk equity portfolios.

The volatility of an endowment policy depends on the exposure that the client has to market fluctuations in the underlying investment portfolios chosen for the investment. If the client's portfolio is invested in the stock market, the underlying investment portfolio will experience volatility as the market goes up and down over the period of the investment.

Over the longer term, and dependant on the underlying choice and performance of the fund, the performance of endowment policies generally outperform inflation.

III) Tax Implications

Income and capital gains in the portfolio are taxed in terms of the five-fund approach. If an individual investor (i.e. a natural person) therefore invests in an endowment policy, then the income earned in the investment fund will be taxed at a rate of 30%, whilst capital gains are taxed at an effective rate of 12% (30 x 40%), which may be lower than the individual's personal marginal rate of tax. The end benefits (pay out at maturity) are tax-free in the hands of the first owner of the policy.

Attractive tax-friendly options, such as regular withdrawals with no tax implications in the hands of the investor, whilst preserving the capital amount, are available once the policy has reached its full term and matured.

IV) Benefits of an Endowment

There is provision of a lump sum payment at the end of a specified term, which is aimed to provide a growth in excess of the inflation rate, subject to the performance of the underlying investment portfolio.

Endowments allow the client access to a range of underlying investment portfolios (funds).

Endowments are thus a suitable choice for realisation of specific saving needs over medium to long-term, especially for clients who need a structure for disciplined savings (premiums are automatically deducted from the client's bank account).

The lump sum is paid out tax-free at maturity, since tax was already deducted from the investment within the insurer's five-fund approach. The insurer's five-fund approach also provides a flat rate of tax, making it tax-efficient for clients with a marginal tax rate above 30%.

Endowment policies enjoy protection in the event of insolvency. The full value of the endowment will be protected against creditors in the event of the policyholder's insolvency, subject to a number of requirements.

Premium protection benefits can be added so that if, for instance, the payer of the policy passed away unexpectedly, premium payments can continue to be made by the insurer.

2.7.2 Sinking Fund Policy

A sinking fund is also an investment policy. It is an investment vehicle that supports disciplined contractual savings and is very similar to an endowment. Sinking funds are also policies and are also subject to the Long-term Insurance Act. Therefore, the provisions of Section 54 are also applicable to sinking funds. Sinking funds are also taxed in terms of the five-fund approach, and if it is a first-hand policy, the proceeds at maturity are also tax-free in the hands of the policyholder (just as with endowments).

The main difference between endowment policies and sinking funds is that sinking funds do not have a life assured attached to them. With sinking funds, the owner's death will not result in the policy paying out and therefore ending. A sinking fund policy can only pay out and end when it matures or when it is surrendered by the owner/ policyholder. No risk benefits (disability or dread disease) can be added to a sinking fund policy.

Another important difference between sinking funds and endowment policies is that sinking funds do not provide any protection against the insolvency of the policyholder.

© Anna Bouhail

I) Benefits of Sinking Funds

The sinking fund is an appropriate investment vehicle where the client needs to save up a sum of money for a specific goal over a certain term. As the minimum term is five years, it is a good vehicle to assist with disciplined contractual savings that may be needed to achieve specific goals. For example, the client may need a lump sum to be available to pay for his child's university education when the child turns 18; or a mining company wants to set aside revenue over a period of time to fund a future capital expense, or to repay a long-term debt.

This is also an appropriate product for investors with high marginal tax rates (above 30%) who are looking for tax-efficient growth.

2.7.3 Fund Policies

Fund policy means a contract in terms of which a person, in return for a premium, undertakes to provide policy benefits for the purpose of funding, in whole or in part, the liability of a fund to provide benefits to its members in terms of its rules.

Fund includes one of the following:

- ☐ A friendly society, as defined in Section 1 of the Friendly Societies Act.
- ☐ A pension/ provident fund, or a retirement annuity.
- ☐ A medical scheme, as defined in the Medical Schemes Act.

It also includes a reinsurance policy in respect of such a contract. A policy contract that relates exclusively to a particular member of the fund or to the surviving spouse, children, dependents or nominees of a particular member of the fund.

2.7.4 Voluntary Annuities

A voluntary annuity is a type of product sold by long-term insurers that can be used when an investor has a lump sum of money that comes from after-tax discretionary funds, such as from an inheritance or a bonus and wants to invest this amount in return for which he can then receive a regular income known as the annuity).

I) Types of Voluntary Annuities:

Insurers may offer two options:

- ☐ **Specific term annuity:** On a specific term annuity, the client can select the term for which payment is required. The longer the term, the lower the income paid. The client can also select if he wants the income to remain level or escalate each year. The higher the escalation rate chosen, the lower the income will be.
- ☐ **Voluntary life annuity:** On a voluntary life annuity, the income will be based on the life expectancy of the client, the younger the client, the lower the income paid. Similar to the specific term annuity, the client can also select an annual escalation rate on a life annuity. The higher the escalation rate chosen, the lower the income will be. Some long-term insurers also offer an option of a guaranteed term (minimum period payable), or the option of a joint & survivorship annuity, which would mean that when the client dies, the remaining spouse will continue to be paid for the remainder of the term selected.

II) Tax Implications

The client will need to pay income tax on a portion of the income received from the voluntary annuity. Basically, the capital element (i.e. that portion of the annuity that is, in effect, one's own capital being paid back in the form of an annuity) is exempt from tax, while the portion of the annuity that represents investment earnings (the interest) is taxable.

The formula used to calculate the capital element (the portion that is NOT taxable) of a voluntary annuity is:

$$\boldsymbol{Y = \frac{A}{B} \times C}$$

Where

Y = value of capital element for current year of assessment

A = initial lump sum consideration paid to insurer

B = total expected return of all annuities for term (or life expectancy) – therefore this is the annuity per year multiplied by the life expectancy.

C = annuity amount for current year.

EXAMPLE

Joe aged 66, pays R800 000 to the insurer to buy a voluntary life annuity (for life). He receives an annuity of R94 000 per annum. His life expectancy is 13.131 years.

Calculate the taxable portion of the annuity.

$$Value\ of\ capital\ element = \frac{R800\ 000}{13.131 \times R94\ 000} \times R94\ 000 = R60\ 925$$

This is the non-taxable portion.

Therefore, the taxable portion is R94 000 – R60 925 = R33 075

When comparisons are made between voluntary annuities and other options (for example an investment in a bank account where money can be drawn from on a monthly basis) the effective after-tax income offered by each option should always be compared, in order to ensure that the best option is provided to the client.

III) Liquidity

The client has access to the capital, if required, by means of a partial surrender. The maximum amount of the partial surrender will be limited to a return of the annuity consideration, plus 5% compound interest, less the accumulated value of the payments already made under the annuity contract, plus 5% compound interest, in terms of Section 54 of the Long-term Insurance Act.

IV) Interest Rates, Term and Inflation

A voluntary annuity is based on the prevailing interest rates at the time the contract is affected. As mentioned in the Economic and Investment Overview module, over time, the capital value of an investment may be eroded as interest rates seldom outperform inflation over the longer term. Voluntary annuities that are structured over a long-term may, therefore, not necessarily be in the client's best interests, since the capital could have been invested into asset classes that have a chance of outperforming inflation over the longer term. Careful planning is required to ensure that the client's overall investment is structured in a way that best meets short-term, medium-term and long-term income or investment needs.

V) Benefits of Voluntary Annuities

Voluntary annuities can be an attractive option in a high interest rate environment because the annuity payment can be locked in at a higher rate. They provide certainty to the investor in that the income received over the set period is known and will not fluctuate with the market.

EXAMPLE

John, a wealthy entrepreneur, has just earned an after-tax dividend of R800 000. He wants to be able to draw an annual income from this investment, because he has offered to sponsor his nephew's education and internship over the next five years and needs annual funds for this over the next five years. As he has other interest-bearing investments already in place, his annual interest-exemption for tax purposes is already used up.

If he invests the additional R800 000 with his bank, they are willing to pay a guaranteed interest- rate of 7.5% per annum, compounded annually over the next five years.

Cash flow, based on bank investment if he draws an annual amount of R173 000 at the beginning of each year, assuming an effective interest rate of 7.5% p.a. is as per the table below.

Year	Amount invested at beginning of each year after deducting study fees of R173 000	Effective interest amount paid by bank	Tax payable on interest earned @ 45%	Balance at end of year	After-tax balance at end of year
1	R627 000.00	R47 025.00	R21 161.25	R674 025.00	R652 863.75
2	R479 863.75	R35 989.78	R16 195.40	R515 853.53	R499 658.13
3	R326 658.13	R24 499.36	R11 024.71	R351 157.49	R340 132.78
4	R167 132.78	R12 534.96	R5 640.73	R179 667.74	R174 027.00
5	R1 027.99	R77.03	R34.66	R1 104.03	R1 069.37

The insurer, on the other hand, offers John a guaranteed annuity of R210 000 per annum (payable at the end of each year) over a five-year period if he invests R643 000 (after deducting the first year's study fees).

Which option, bank account or voluntary annuity provides a better after-tax deal?

Answer:

$$Non - taxable\ portion\ of\ annuity = \frac{R643\ 000}{5 \times R210\ 000} \times R210\ 000$$

$$= R128\ 600$$

$$= Taxable\ portion = R210\ 000 - R128\ 600 = R81\ 400$$

At a tax rate of 45%, the annual tax on R81 400 = R36 630

This means that the after-tax annuity amount per annum will be R210 000 less R36 630 = R173 370.

Note that the annuity will cease at the end of the five-year period.

If John invest the remainder R370 also in an interest bearing account at 7.5% p.a. he will have R2 149.10. This is a better balance as the bank account option.

2.8 SPECIFIC NEEDS APPROPRIATE FOR LONG-TERM INSURANCE PRODUCTS

Most people have both personal risk (wealth protection) and investment (wealth creation) financial needs. In such situations, it is important to prioritise these needs.

It is recommended that personal risk (wealth protection) needs are addressed first. This means looking after the protection of the family in the event of death, disability and ill health, and the protection of personal assets (such as one's home and car), since, if these are not protected, even the most well-laid savings and investment are at risk should an adverse life event occur.

Depending on one's own financial goals and objectives, one would then prioritise between the risk needs first, and then plan for achieving savings and/ or investment goals.

In this topic, we covered the various risk products that can be used to address personal risk (wealth protection) financial needs:

- ☐ **Whole life cover:** Suitable for a client who needs cover for life, to provide for beneficiaries or settle debts in the event of death.
- ☐ **Term cover:** Suitable for a client who needs cover for a specific term.
- ☐ **Accidental death cover:** Suitable for a client who wants to supplement other life cover or who is more at risk for accidents due to the nature of their occupation; also suitable for uninsurable clients.
- ☐ **Lump sum disability cover:** Suitable for a client who wants to cater for lifestyle adjustments in the event of disability or to settle debts
- ☐ **Income disability cover:** Suitable for a client who wants to protect his ability to earn an income in the event of disability prior to retirement.
- ☐ **Dread disease cover:** Client is concerned about severe illnesses and would like to provide funds to cater for lifestyle changes after a severe illness, such as a need for home care.
- ☐ **Funeral (assistance) cover:** Suitable for a client who wants funds to be available immediately to pay for the funeral or even fly loved ones home in the event of the death of a family member.
- ☐ **Endowment policy:** An appropriate investment vehicle where the client needs to save up a sum of money for a specific goal over a certain term; investors with high marginal tax rates (above 30%) who are looking for tax-efficient growth or investors who want protection from creditors.
- ☐ **Sinking fund**: An appropriate investment vehicle where the client needs to save up a sum of money for a specific goal over a certain term; and investors with high marginal tax rates (above 30%) who are looking for tax-efficient growth.
- ☐ **Fund Policy:** A contract in terms of which a person, in return for a premium, undertakes to provide policy benefits for the purpose of funding, in whole or in part, the liability of a fund to provide benefits to its members in terms of its rules.

- ☐ **Voluntary annuity**: An appropriate vehicle where the client wants to have a set income over a specific period, which will not fluctuate with the market. These instruments tend to offer more value in a high interest-rate environment when the high interest-rate can then be ‘locked in’ for the duration of the term.