NZIG
New Zealand Income Guarantee

30 May 2013

Submissions
2013 Review of Retirement Income
Commission for Financial Literacy & Retirement Income
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Dear Sir/Madam

The following is our submission addressing areas of interest identified in the 2013 terms of reference;

- Trends in KiwiSaver, particularly withdrawal patterns of those retiring and the issues that these may raise
- Alternative retirement savings approaches
- The role of the financial services sector in helping to ensure the adequacy of retirement income for New Zealanders.

Submitted by New Zealand Income Guarantee Limited (NZIG)

This proposal is submitted by NZIG, a privately owned company established to identify if a private sector solution could be developed to provide private pensions in New Zealand.

Approach to Submission

In conjunction with Melville Jessep Weaver, NZIG has undertaken comprehensive research into the volume and value of KiwiSaver account holders that are eligible to withdraw their savings over the next 15 years. The objective of the research is to establish the prospective scale of the future private pensions market in New Zealand that would be generated by maturing KiwiSaver accounts.

NZIG, in conjunction with Ruark Insurance Advisers, Inc., Connecticut and Milliman worldwide, are working on the initial product design for a new variable annuity based private pension that is tailored for the New Zealand market. In parallel, work is also underway to confirm regulatory capital requirements and capital market volatility management programs denominated in New Zealand dollars.

The purpose of this submission is to apply our recent experience in developing a new private pension product to inform the debate surrounding:

1. The significance of the value and volume of Maturing KiwiSaver accounts over the next 15 years
2. The ability to combine modern asset management and insurance advances in order to overcome historical barriers to annuitisation
3. The potential to provide a practical, economic and transparent life time income solution to supplement National Superannuation

Maturing KiwiSaver Accounts

Appendix 1 details the summary of the research completed to date, including all accumulation, growth, investment and tax assumptions.

The following is an executive summary of the immediate findings:

- There are 70,000[1] Kiwi Savers aged 65 or older today who can access their savings now
- Over the next 15 years, 525,000 Kiwi Savers will have reached 65 years of age and will have the opportunity to drawdown their Kiwi Saver balances
- The estimated value of all maturing account balances over the next 15 year period is estimated to be $36b
- Within said 15 year period, the average maturing account balances are forecast to grow from $19k in 2013 to $110k by 2028
- 28% of all maturing Kiwi Savers have an annual income in excess of $80k and will have an average account balance of at least $50k within 4 years
- 14% of all Maturing Kiwi Savers have an annual income in excess of $120k and will have an average account balance of at least $90k within 4 years
- For those Kiwi Savers earning more than $120k, the total value of their accumulated account balances on maturity (65 years) over the next 15 years is $13b
- By 2028 over 70,000 high income KiwiSavers will have an account balance of greater than $280k

Early indications of volume and value suggest there is sufficient scale to justify the investment of private capital. Capital could be raised to develop New Zealand specific private pensions if appropriate returns can be achieved.

No significant consideration has been given to the term deposit ($112b)[2] or maturing corporate superannuation plan market for private pensions in the initial research.

[1] Includes maturing accounts which became eligible for withdrawal in 2012.
[2] Reserve bank Monetary Statistics February 2013

NZIG New Zealand Income Guarantee

Annuitisation in New Zealand

The scale of income replacement in retirement provided by National Super, has reduced the practical ability of the government to provide specific annuity tax relief. This is in stark contrast to major OECD country's where state funded income replacement is significantly less. Notably, the US has an indicative replacement ratio 50% of New Zealand's (33%[3]).

When one considers a local capital market that does not offer long term fixed interest products to offset longevity risk, combine with the potential for providers to selecte against an annuity book that is composed of individuals with a propensity to outlive average mortality, it is clear why annuities in New Zealand are almost non-existent.

Within other global economies, in which the replacement values are lower than that provided by National Super, benefits have been derived from private sector insurers innovating to meet consumer demand for supplementary retirement income.

The United States is the most illustrative model, where early development of deferred and variable annuities has lead to a US1.6[4] trillion dollar industry today. Globally, sales in the UK grew 15% in 2012 to Stg1.1b[5], the Japanese Market has grown to US$100b[6] in 2012 and sales in Europe are forecast to grow to Euro $45b[7] in the next 5 years.

International Innovation in the Provision of Retirement Income

International innovation is by no means a straightforward success story. The Financial services industry has been guilty of placing profit ahead of people i.e. the incentivisation of sales by offering heightened commissions to intermediaries and agents; designing complex products and charging expensive withdrawal and cancellation fees.

Despite this, strong consumer demand for a reliable, guaranteed retirement income products remains. Consumers (particularly in the US) continued to buy annuities, attracting more life company competitors, increased competition and more benefits and features at lower prices.

Pundits in the US annuity market[8] argue that the intense competition led to annuity products being offered with consumer benefits that were not adequately, or appropriately, insured.

The economic frailties of under insuring became clear when long term income guarantees funded from current assets were faced with extreme capital market volatility: the tech bubble of 1998; the terrorist attacks of 2003; the subprime meltdown of 2009 and the EU crisis of 2011.

Asset and liability mismatches combined with increased statutory reporting requirements resulted in many insurers seeking to buy back in-force contacts from clients in order to reduce their own liabilities.

In 2008, 53%[9] of the market capitalisation of the top 10 variable annuity providers was lost as worldwide capital markets crashed, leading to $36b in variable annuity related losses. The sharp reduction in assets focused the spotlight on the disparity between generous product features and poor reserving.

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[3] Insured Retirement Institute, USA May 2013
[4] Limra December 2012
[5] UK Annuities Association 2012
[6] Towers Perrin Japan 2012
[7] MMC Oliver Wyman, VA VA Voom 2009
[8] IRI Fact book, A guide to information, trends and data in the Retirement Income Industry 11th edition
[9] Responding to the Variable Annuity Crisis, Mckinsey & Co. 2009

International Experience

Variable annuity providers in the US continue to manage US$1.6 trillion dollars in variable annuity assets. In addition, they continue to be attracted by the needs of an aging population, uncertainty over future social security payments and strong demand for retirement income products.

The experiences of the previous decade has resulted in material changes in product design and a consolidation in supply.[10] Key developments include;

- Improved asset and liability management to more accurately manage and report on underlying longevity and asset and liability risk

- Reduced product benefits and features to more accurately reflect the industry capability to hedge risk

- Price increases which better reflect the true cost of capital to providers

- Simplification of product design

- The emergence of new hedging strategies to improve the management of capital markets volatility

Variable Annuities – Strengths & Weaknesses

We are in a strong position to develop a solution that applies the learnings from the international experiences and recognises the specific requirements of the New Zealand market place.

We have identified a number of key product design features that reduce the fundamental risks associated with variable annuities for providers, without excessively diluting underlying benefits to investors.

Capital Markets Risk – The underlying systemic risk of guaranteeing long term income levels based on investment, in volatile shorter term investment assets. The international norm has been to offer retirees a range of investment options with different rates or return, different prices and different terms i.e. To optimise consumer demands in order to provide a product that had the greatest propensity to sell.

The New Zealand product proposes to work in reverse by optimising the guaranteed level of income with the most appropriate asset mix, in order to keep capital markets risk at a minimum. The product may not offer asset allocation choice, with the underlying portfolio remaining fixed by NZIG to reflect the most efficient use of growth and income assets in order to deliver an annual indicative return of 5% gross.

[10] IRI Fact book, A guide to information, trends and data in the Retirement Income Industry 11th edition

Basis Risk – The underlying portfolio cannot be entirely hedged against short-term capital market although removing multiple investment options substantially reduces the basis risk.

The fixed New Zealand asset allocation is achieved by investing in underlying assets that can be offset by established, liquid derivatives that are traded on global exchanges. Milliman the global leaders in hedging variable annuity risk have established active volatility and guarantee management programs than can be accessed by NZIG.

The following is an indicative portfolio design that is low cost and can be easily be correlated to liquid deravitives. :

Income Assets

Vanguard Bond market ETF	20%
Vanguard International Bond Index ETF	15%

Growth Assets[11]

Vanguard FTSE All World ex US ETF	7%
Vanguard 500 Index Single ETF	7%
iShares S&P small cap ETF	3%
iShares S&P mid cap ETF	3%
Vanguard FTSE Emerging Markets ETF	10%
Vanguard REIT - US Real Estate	10%
DJ Wilshire International Real Estate SPDR	10%

Hedging Risk - It has been standard practice to offset market volatility on a total exposure basis. For example, the total life company annuity exposure to US shares being offset by a determined level of equivalent put options, exchange traded futures contracts or specific investment bank generated swap program.

Milliman, and or similar, complete the modelling to determine the optimal mix of assets to support the 5% minimum income guarantee. This can in turn be hedged with the greatest probability of coverage. Milliman and others provide daily portfolio management recommendations to the mix of assets (growth and income) and the appropriate hedge coverage.

Longevity Risk – The most notable innovations have been the development of longevity bonds which of themselves are not a perfect solution as they are time bound, however when combined with active volatility management and reinsurance further spread longevity risk.

The bond value is based on New Zealand life expectancy data, bondholders receive regular payments, in exchange for bearing longevity risk for a portion of the liability to a nominated age and term

[11] Vanguard equivalent portfolios vis wholesale mutual funds which under some circumstances can be used at lower cost

The first longevity bond was a $50 million issue in December 2010 from Swiss Re. The bond matures in January 2017.[12] The next came from Dutch insurer Aegon N.V. (AEG), which in February 2012 brought a EUR300 million ($402 million) longevity bond arranged by Deutsche Bank to cover EUR12 billion of reserves.

At this time, longevity risk is managed through conservative product design, active capital hedging, reinsurance and prudent reserving. NZIG may be able to purchase longevity bonds in the future

Anti-Selection Risk – Consumer behaviour can be as much of a risk as trying to manage short term assets to deliver long term guarantees. US insurers facing increasing competition experienced high lapse rates as customers moved from one private pension to another. This was due to customers seeking better combined product features.

High lapse rates forced providers to cash in long dated investments, which were often at a loss to meet liquidity needs.

The NZIG product is specific in offering a commercially responsible yield (5% gross) to reflect the likely and possible returns from balanced index investment over long periods of time. By crediting surplus returns and losses to the individual's private pension account, the holder is able to secure all the available returns from their retirement capital, whilst also enjoying the benefits of a minimum lifetime guarantee at the same time. While not complete coverage the crediting of all income to the individual private pension account partially off sets the impact of inflation on a fixed pension.

Complexity Risk – The NZIG product follows the design of a variable annuity with Guaranteed Life Withdrawal Benefits (GLWB). There are additional features and benefits that can be added to customise the base product. In the US, Europe and Japan the popular 'add on' has been return ratchets and return of premium.

- Return Ratchets - Through the use of long equity options, some providers have been able to lock in account values in raising markets on an annual and quarterly basis. For example if the individual pension account has a balance of $100k and the underlying investments increased to $105k at the end of the first quarter of investing, the account value would be reset at a minimum of $105k. This facility has proved popular as the income remains guaranteed and prospective investment returns are captured regularly, however it also adds cost, complexity and potential risk when capital markets are stressed. NZIG does not propose the inclusion of return ratchets.

- Return of Premium – or Guaranteed Minimum Death Benefits (GMDB) have also been offered in conjunction with GLWB. These benefits provide for the pension holder to receive a nominated sum on death, normally the higher of the pension account value of the original pension investment. These additions were severely tested by the capital markets downturn in 2008 and proved a significant contributor to the losses incurred by annuity providers. NZIG will not be providing return of premium benefits, but will return the pension account balance to the estate of the deceased pension holder.

[12] WSJ, Feb 2007, 2013

Poor Return on Capital - The net effect of purchasing a life time private pension is the transfer of longevity risk at a fixed rate of return to the insurer. The risks for the insurer are significant and private capital will not be deployed unless a reasonable return can be achieved for accepting the risk. A simple product that is actively hedged reinsured with reserving at circa 2%, may be able to be developed at a total cost to the pension holder of less than 3% p.a., which is inclusive of a capital cost of 15%. Pricing remains work in progress with positive indications emerging. At present, limits are emerging of 3% maximum in total cost and 15% minimum return on stakeholder capital.

New Zealand Specific Variable Annuities

NZIG is working towards confirming the viability of a New Zealand launch in April 2014 of a customised variable annuity, offering guaranteed life withdrawal benefits (GLWB) for investors aged 65 years or older.

The product will be issued by a new life Insurer (NZIG) and reinsurance (if required) is currently being sought. The product is unique to New Zealand offering the following benefits:

- The opportunity to annuitise part of a retiree's retirement capital (KiwiSaver, life time savings, employer sponsored superannuation).
- The annuity operates in the same way as a retirement income account. The capital is always owned and controlled by the investor and is available to view online.
- Indicative 5% before tax is paid monthly to the retiree from the retirement income account.
- NZIG guarantees income payments for the life of the retiree, or for a nominated period, with every $100,000 invested equating to circa $100 per week or to an indicative gross weekly national superannuation supplement of 23.5%.
- The retiree can draw on their retirement capital if needed for life events, however a withdrawal of greater than 5% in any year will result in the guarantee being reset at a lower level. For example, if the retiree draws 20% of their annuitised capital, the guarantee is reset at circa 80% of the original guarantee level i.e. 4% before tax.
- The retirement income account is invested in indexed growth and income assets, where the returns from these assets are credited to the individual retirees account daily and can be viewed online. Over the last 20 years the returns from low cost indexed investment to balanced fund asset allocation has been 7%[13]
- Annual fees for investing the assets and providing the lifetime guarantee are deducted from the retirement income account.
- Upon death the balance of the retirement income account can be paid to the estate of the account holder.
- The account can be closed at anytime

[13] NZX Morningstar November 2012

Positive Market Conditions

To progress the product form concept to launch requires the co-operation and support of the Reinsurance industry, Financial Markets Authority, Reserve Bank, Inland Revenue Department and Commission for Financial Literacy and Retirement Income.

The Ministry of Social Development has also released a submission which draws on, in part, the findings of the Capital Market Development Taskforce of December 2009. The paper considers superannuation deferral, purchasing additional superannuation above the ordinary entitlement and establishing a public annuity fund. The paper concludes "*A public annuity fund could solve the decumulation problem and do so without the complications of a NZS-based proposal*"[14].

This is an excellent example of how, with conviction and focus, a public and private partnership could be established to improve the retirement options for the majority of New Zealanders. NZIG is progressing its reinsurance partnerships with proposals currently under consideration in the US and Japan, however there is every reason the government could provide reinsurance on commercial terms in conjunction with a robust regulatory requirement of private providers.

Indeed, Government may be better placed than the private sector to facilitate the development of annuities products, or potentially assist in providing them. The government may be able to support a well-functioning "actuarially fair market to develop"[15] through provision or underwriting

There are no regulatory capital provisions for variable annuities in New Zealand other than for life company liability matching for standard immediate annuity products. NZIG seeks to work with the Reserve Bank to determine the appropriate reserving levels. International norms differ, with between 1-5% of invested capital in the US, to 7% in Japan which is moderated by the asset allocation, hedging and degree of reinsurance. NZIG believes 1-2% is appropriate for the simple, transparent product proposed.

The current Minister of Revenue has indicated there will not be tax relief offered to investors willing to defer consumption in favour of providing for future income. Given the level of income replacement provided for by National Superannuation this is understandable. However, there is an unintended complication in the application of capital gains tax to the management of liabilities.

One of the fundamental international innovations has been the improvement of asset hedging strategies to offset the long term income liability to the insurer (NZIG). To support the indicative 5% gross income payment, indexed growth and income assets are invested in on a 'buy and hold' basis.

These assets are hedged through the use of derivatives to offset market volatility in order to preserve the income guarantee. The potential for the hedging transactions to be taxed on a capital gains basis would substantially limit the viability of the product.

This is especially so when the income earned in the retirement income account is subject to taxation in addition to the income that is drawn from the retirement income account, which is also taxed at a marginal rate higher than the majority of retirees. Further work is required to confirm the taxation of liability hedging.

[14] Berthold, T. (2013). Assuring retirement income working paper 01/13. Wellington, NZ: Ministry of Social Development
[15] The Capital Markets Development Taskforce (2009, pp.41,49)

There is a lot of work yet to be done, however early research suggests that NZIG would be able to successfully apply international experience within a New Zealand context. The result will be a guaranteed, low cost, simple and transparent retirement income product.

The future cash flows from KiwiSaver alone are substantial. Without innovation, these could be lost to consumption, or capital market volatility, further increasing the reliance on National Superannuation.

It is hoped that this submission provides insight to help inform an annuity debate that, to date, has largely focused on historical barriers. Active co-operation between the private sector and the industry regulators and advisers is required to bring much need innovation to the retirement savings sector.

Drawing on the core principals of asset management and life insurance, there is genuine potential to provide retiring New Zealanders with simple, low cost transparent options for converting savings into life time income.

Support and co-operation from the industry regulators and advisers is required.

Thank you for the opportunity to provide this submission.

By E-Mail

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