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2013 Review of Retirement Income Policy

Dear Malcolm,

Thank you for the opportunity to make a submission on your three yearly review.

First NZ Capital (FNZC) is one of New Zealand's leading finance houses offering our clients share broking, portfolio management, investment banking, financial and economic research services. We have been a trusted provider of wealth management and investment advice to New Zealand individuals, companies, institutions and governments for over 50 years. FNZC has approximately 32% market share of trades on the NZX and have won INFINZ's NZ Sharebroker of the Year award five times in the last six years. Details about our company can be found at https://www.firstnzcapital.co.nz/public/Home.html

Like most western countries New Zealand society is changing in a unique way. There is no precedent for the demographic changes occurring now and those that will occur as a result of an aging population over the next 20 years.

We believe good government retirement policy is not just important, it is critical, in setting a platform to ensure financial well-being and social sustainability.

We assume there is little appetite in New Zealand for an increase in government borrowing and an increase in government debt. Many European countries tried this (until the 2008 global financial crisis) and now face a range of uncertain outcomes and difficult decisions ahead.

New Zealand is for the time being in a good position with the relative advantages of lower public debt to GDP levels, fiscal balance as a government objective, positive GDP growth and relatively broad agreement across the political spectrum on many policies such as a role of KiwiSaver and the NZ Superannuation Fund.

Our brief submission seeks to identify two major macro themes relevant to this review and four possible solutions.

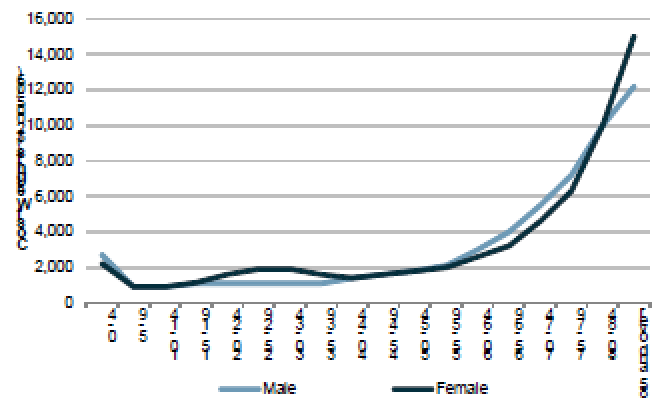
Macro themes

1. Demographics trends mean the theme of funding extra welfare demands from an aging population group (the over 70's age group is NZ's fastest growing population cohort) make savings more of an imperative.

   More of the available health budget in the years ahead will likely be consumed by the elderly. There is a real risk for private individuals that savings earmarked for retirement may well not last the distance of longer life expectancies which are often characterised by an extended period of frailty in later years. Healthcare costs ramp up over time, but the proportion now spent on New Zealanders above the age of 70 is growing exponentially (Fig. 8).

   Funding extra healthcare places demands on both the government and private accounts (eg aged care facilities and services) through savings already accumulated will logically become even more important as funds are sought to pay for this.

Figure 8: Health care costs by age



Source: Ministry of Health

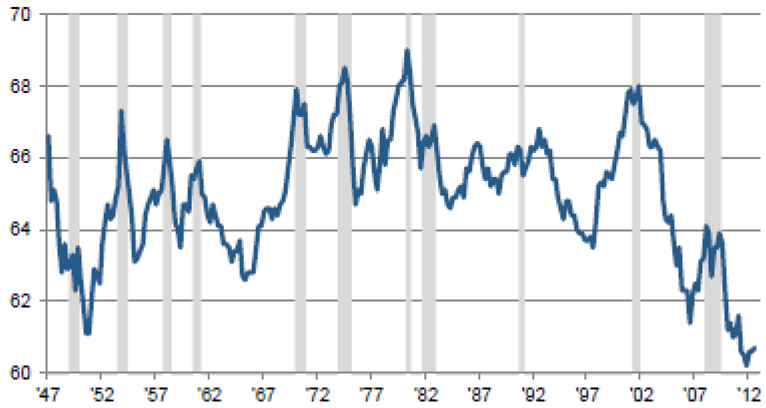
2. The growing asset and income inequality between the haves and haves nots (already problematic) will be exaggerated if savings (and retirement security) are not addressed. Credit Suisse recently wrote the gap between rich and poor in the US for example has been widening for decades and, by some measures, is now the largest it has ever been in the post-World War II period.

   Additionally further societal problems come from age discrimination (the ability to earn a wage as a person gets older at the cost of allowing access to new workers entering the workforce). There is a huge gap between aspirations for old age and reality (HSBC, The Future of Retirement. A New Reality 2013). Equity inequality has distorted some asset prices, e.g., it is more difficult for young people, to buy a new home.

   The implication is that it makes savings inequity a likely louder theme as well as a more important macro variable. The Reserve Bank of New Zealand recently observed monetary policy cannot remedy increases in income inequality.

Exhibit 5: Labor's Share of Income Remains Near the 2011 Postwar Low

Nonfinancial corporate sector, percent



Source: Bureau of Economic Analysis, Federal Reserve, Credit Suisse

Suggestions for improvement

There will be a range of suggestions to address these two major macro-influences. Increasing the pension eligibility age, the on-going shift from defined benefit to defined contribution pension schemes (the retiree takes more risk) and watering down benefit levels are some global solutions already being observed. There are no-doubt others. We offer four suggestions for consideration:

1. If NZ pension entitlements (currently paid at 65 years) are to remain as generous as they currently are (universality, pension to average wage ratio, minimal means testing) then superannuation savings should be compulsory (even if the pension age is eventually raised to reflect a longer life expectancy). Otherwise New Zealanders can continue to be less thrifty over their working career in the knowledge that the state will eventually fully fund their retirement.

   This sends the wrong signal for a saver and is set against a background of increasing doubt whether this is affordable. Generous NZ pensions remaining at 65 are probably a promise that can't be kept. Compulsory savings (rising from a minimum of 3% of incomes matched by employer contributions) can alleviate the fiscal stretch in the government's budgets ahead.

   New Zealander's (like many in the OECD) struggle with retirement savings and many households spend more than they earn (The Age of Aging, George Magnus 2009).

   Whilst compulsory savings may be seen as an additional tax on today's income they are arguably more palatable to the public than higher taxes and/or reduced pensions in the future.

   Without compulsory savings rising "pensioner poverty" seems more likely.

2. Renewed contributions by the government to the NZ Superannuation Fund (NZSF) should be a strategic priority. Renewed contributions would:
   - Recognise the balance required between public and private sector savings funds given most New Zealanders expect their primary retirement revenue to be derived from the state;
   - Take advantage of the relatively lower cost of the funding source that NZSF fund gets by gaining funds at the cost of NZ government debt;
   - Provide some diversity in the crowns investments. Many NZSF fund investments are non-correlated to NZ's economic performance and risks to the NZ economy;
   - Take advantage of the track record generated by the fund's managers across a range of asset classes;
   - It should be an aspirational goal for NZ to have a well-run, well connected, performing sovereign wealth fund.

3. At some stage NZ's KiwiSaver model should evolve to include a Self-Managed-Super-Scheme (SMSF) option. The reasons for this are:
   - It encourages savings diversity. It is not best practice to have all of an investor's savings with one manager. Some managers are better than others in different asset classes. Having different managers also reduces risk of manager default. Savings would be allocated to managers by the investor from their KiwiSaver account to managers or investments as appropriate to their goals, objectives and risk tolerance. A minimum balance may be required before this occurs (e.g. $200,000);
   - Having all KiwiSaver funds with one manager distorts asset allocation as it encourages much more defensive (probably too defensive) asset allocation (as the investor juggles their other investments such as the value of their business, their house and any other savings);
   - SMSF's can be more fees and tax efficient (for example in a capital gains tax free environment long term equity holdings attract little expense);
   - SMSF's can be more performance effective. Currently cash and term deposits could be directly invested at higher interest rates by an investor (4%) than their wholesale provider (2.5%). Regulatory arbitrage is currently penalising some KiwiSaver returns. Additionally the recent IRD-Treasury joint report on the Taxation of Savings and Investment Income recommended a cut in tax on interest income and reforming the PIE regime. This would assist savings performance;
   - Adopting self-directed savings as an option already occurs successfully in Australia, US, Canada and UK. These countries recognise the importance of a greater self-provision in retirement savings;
   - SMSF's would build depth and maturity in NZ's capital markets. Housing should not be a substitute for savings. The investing public could be expected to become more interested and fluent on their investments as their balances grow. The minimum balance required before an SMSF is possible would probably attract net savings.

4. Changes to retirement schemes result in uncertainty and costly administrative charges (particularly in an environment of low levels of financial literacy). It is important scheme goals and objectives are well flagged, change is minimal and the public are well aware of the detail. Savings policy should endure the range of business and government cycles. Less change to schemes is generally better. Recent tinkering (e.g. FDR on investments) has probably been counterproductive.

   We believe the financial sector can take up much of the role of investor education (as it has done overseas). Fortunately much of those incentives come from companies seeking to build better commercial models.

In conclusion First NZ Capital is a major participant in NZ financial markets. We are well placed to observe savings behaviour both domestically and through international example. New Zealand is not unusual in facing the problems of an accelerating and more expensive retiree population, as well as the challenges from less equal wealth distribution. We support commentary that government spending should be targeted, prudent and supported by balanced budgets. We advocate some evolution in the existing KiwiSaver to Self-Managed-Super-Schemes and supporting New Zealand Super Fund as a strategic priority. This is set against a background of supporting compulsory saving.

Yours faithfully
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