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2013 REVIEW OF RETIREMENT INCOME POLICY
THE COMMISSION FOR FINANCIAL LITERACY AND RETIREMENT INCOME

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MARSH & McLENNAN COMPANIES

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1

Introduction

The 2013 review of retirement income policy covers a range of topics encompassing both public and private provision. Given the interdependency of different policy initiatives, and how they have been shaped by emerging trends, this submission does not seek to address each topic in isolation.

This paper:

- Outlines the trends in the private provision of retirement savings, both domestically and internationally, and discusses the reasons for the observed changes;

- Considers the role of New Zealand Superannuation; and

- Discusses how private provision can be developed to ensure strong savings outcomes for New Zealanders, including how these savings can be used to provide an income for life.

- Proposes a post-retirement system that promotes the utilisation of savings to provide an income for life.

Mercer believes any review on the adequacy and sustainability of New Zealand's retirement income system as a whole should focus on:

- Increasing the level of retirement savings to raise retirement incomes, ensuring a more secure and dignified retirement lifestyle for all New Zealanders;
- Reducing the pressure on New Zealand Superannuation to fund for an individual's retirement; and
- Encouraging New Zealanders to use their savings to provide an income through retirement.

2

Emerging trends in private provision

New Zealand

Prior to the introduction of KiwiSaver in July 2007, the offering of superannuation benefits by employers in New Zealand was not compulsory, although some local employers and many international firms provided some level of post-retirement benefits to their employees in line with their global practices. However, the superannuation and retirement savings environment in New Zealand underwent significant change once the country-wide savings initiative was launched.

Since 1 July 2007 all employers have had to offer a workplace savings scheme to all new employees aged between 18 and 65 (with very few limited exceptions), either through KiwiSaver or through alternative qualifying workplace superannuation schemes. Whilst KiwiSaver is a discretionary scheme to the extent that employees can opt-out within 8 weeks of joining or take an indefinite contributions holiday, there are on-going discussions as to whether KiwiSaver participation may be made compulsory in the future. Although there are no current plans for such a move, it is expected that an auto-enrolment exercise will be conducted at some point in the next few years. Under the auto-enrolment scenario, all employees (not just those who change jobs) would become KiwiSaver members (although they would still have the ability to opt-out). In their 2012 Budget the National Government announced that such an exercise would be deferred until there was a sufficient surplus to meet the expected costs. Public consultation on auto-enrolment was also deferred. The 2013 Budget did not provide any further comment.

There have been a number of changes to KiwiSaver since its launch. These changes have primarily affected contribution levels, the impact of taxation on contributions and the maximum level of government contributions. Following the previous review of retirement income policy in 2010 the main amendments have effectively been targeted at reducing the cost of the scheme to the Government and increasing the onus on employers and employees to fund workers' retirement savings.

These changes, and the dates when they became effective, have been:

1 July 2011 - From the year ending 30 June 2012, the maximum level of the member tax credit paid by the Government was halved from $20 per week ($1,042.86 p.a.) to $10 per week ($521.43 p.a.). The rate at which the tax credit was earned also reduced from $1 to 50 cents for each dollar a member contributes.

1 April 2012 - Compulsory employer contributions to KiwiSaver and complying superannuation schemes became no longer exempt from Employer Superannuation Contributions Tax (ESCT). ESCT is a progressive tax, and the current rates are as follows:

Total salary or wages*	ESCT rate
Up to $16,800	10.5%
$16,801 to $57,600	17.5%
$57,601 to $84,000	30%
Greater than $84,001	33%

*Including gross employer contributions

Previously, where ESCT was payable, employers could opt to apply a flat rate of 33% across all employees.

1 April 2013 - For both employees and employers, the minimum contribution rate was increased from 2% to 3% of gross salary. Higher contributions are permitted.

The majority of employers now provide KiwiSaver, as required, and/or offer membership to a stand-alone defined contribution scheme in a master trust. This is in contrast to the position 20 years ago when a large number of the biggest employers were offering defined benefit arrangements. This shift in approach has been caused largely by the increased cost of offering defined benefits to employees due to falling investment markets, increased longevity and greater regulation. Furthermore, changes to accounting regulations have led to a greater awareness of the cost of these schemes as their net defined benefit obligations (liabilities) and the annual cost of the benefits accruing are shown in a company's financial statements. Also, in some instances the benefits obtained from membership were not clearly understood and did not fit in with a more transient workforce. The trend away from defined benefit schemes and into defined contribution plans has been seen globally and is not specific to the New Zealand environment.

There has been a clear indication that the government sees the KiwiSaver structure as the preferred vehicle for superannuation benefits. Furthermore, many employers see KiwiSaver as an easy way to meet their employees' retirement savings needs. Of the defined benefit schemes still in operation the vast majority are now closed to new entrants. The speed of closure was exacerbated by the introduction of KiwiSaver, due to the difficulty of integrating KiwiSaver into most defined benefit programmes. For members joining a defined benefit scheme since 1 April 2008, KiwiSaver contributions have become first priority and many such employees have been able to double-dip by accruing both defined benefits and receiving compulsory employer KiwiSaver contributions. Attempting to offset defined benefits by the cost of compulsory KiwiSaver contributions has proved to be complicated and ineffective for employers.

Closed schemes have continued to operate until the sponsoring company opts to wind them up, either paying the remaining members their wind up benefits as defined in the trust deed or transferring the liabilities, where possible, to an insurance company.

There is no legislation requiring sponsors to secure a minimum level of members' benefits and the treatment of liabilities on wind up is dependent on the wording within a scheme's trust deed. However, most employers seek to treat members fairly and secure a benefit that reflects its value in some way. Many schemes offer members lump sum benefits on retirement and on wind up, easing the process of removing the liabilities.

Some schemes that are closed to new members may have opted not to wind up because the cost of doing so on a basis fair to existing members far exceeds the assets available. For many schemes, the value of their assets has in turn been reduced significantly with the falls in market values during the global financial crisis, eliminating any surpluses in the schemes or further increasing deficits. Falls in bond yields and increases to life expectancies have also increased the cost of purchasing annuities in a limited market. We estimate that the cost of buying out pension liabilities in New Zealand is currently approximately 30% to 50% higher than the actuarial value placed on them, depending on the age profile of the members involved. In our experience the rate at which businesses were winding up their defined benefit schemes slowed during the global financial crisis as asset values fell and annuity prices increased. However this trend is expected to reverse as the recovery gathers momentum and companies become more willing to make the required top-up contributions.

The decline in the number of employer sponsored retirement schemes can be seen using data from the Financial Markets Authority's annual superannuation schemes report, summarised in the table below,.

	1990	**2007**	**2008**	**2009**	**2010**	**2011**
Defined Benefit	452	127	120	110	107	104
Defined Contribution	1,790	161	138	124	113	100
Total	2,242	288	258	234	220	204

Table 1: Number of employer sponsored schemes in force with balance dates within the year

It should be noted that defined contribution schemes are able to be consolidated within master trusts and so the reduction in the number of these schemes has not necessarily led to a reduction in the size of savings. This is illustrated in the chart below.

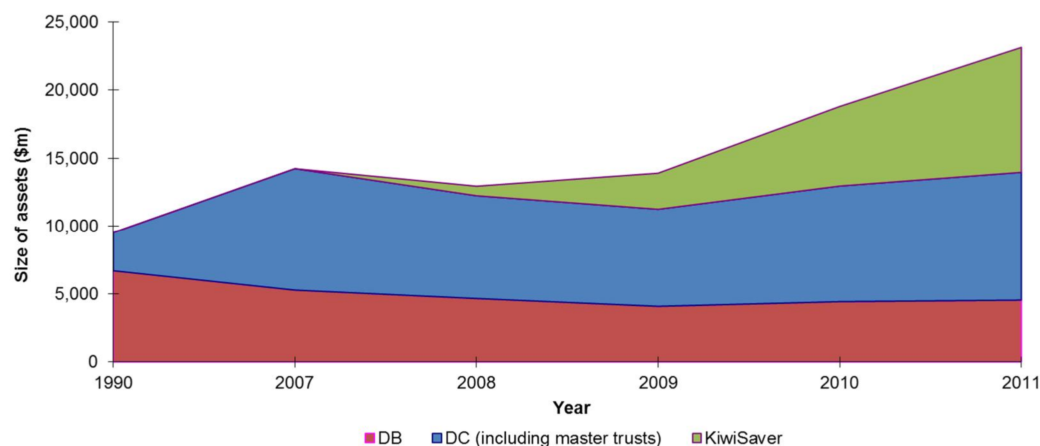

Chart 1: Level of assets in employer sponsored schemes

From 1990 to 2007, total assets in employer sponsored defined contribution and defined benefit schemes rose from $9.5 billion to $14.2 billion. By 2011 the amount had fallen slightly to $14.0 billion, due in part to the losses recorded during the financial crisis. It can be seen that the level of assets in defined contribution schemes has increased over the last two years, whilst the amount in defined benefit plans, following an initial decline, has remained fairly stagnant. The amount in accumulation (defined contribution) style arrangements is approximately double the amount held to meet defined benefit promises and is expected to increase in dominance in the future. Furthermore, once KiwiSaver assets are included the dominance of the defined contribution market increases markedly. It can also be seen that the speed at which KiwiSaver assets have grown to date has far outpaced the growth in employer sponsored schemes over the same period and is poised to overtake the combined defined benefit/defined contribution employer sponsored scheme total by the end of 2013.

KiwiSaver trends

The annual report from Inland Revenue details the key statistics regarding KiwiSaver each year. The most recent report, for the year to 30 June 2012, showed that the number of KiwiSaver members continues to grow, albeit at a slowing pace as the scheme matures. By 30 June 2012, there were 1.97m KiwiSaver members, and approximately half of these had opted-in to the scheme via a provider (rather than being auto-enrolled or opted-in via their employer). However this statistic is skewed by the number of KiwiSaver members under 18 years old (more than 320,000), who are unlikely to have been enrolled through employment. Auto-enrolment has, however, proved an important concept with statistics at the end of March 2013 showing close to 40% of current members were auto enrolled. Results from the 2010 Inland Revenue KiwiSaver Evaluation survey[1] showed close to half of these members said they would not have joined KiwiSaver if they had not been auto-enrolled.

[1] http://www.ird.govt.nz/resources/0/3/03e46600437177c5a25eb24e9c145ab7/ks-evaluation-individuals.pdf

Inland Revenue's 2011 annual report cites a report by the Financial Services Institute of Australasia in August 2011, which found that over half of New Zealanders between ages 18 and 65 were members of KiwiSaver, and more than half of these people were not saving for retirement prior to joining.[2] The same survey also found that the key reasons for people not joining were affordability, sufficiency of other retirement savings and uncertainty regarding the structure.

Since the inception of KiwiSaver, the proportion of members choosing their own provider has steadily increased, from 49% at 30 June 2008 to 65% in 2012. Most of this movement has come from members switching from default providers. The Financial Services Institute of Australasia survey found that most KiwiSaver members chose their bank as their provider, and more than half of those switching providers had done so to have their KiwiSaver account included with their other accounts with their bank. Other key reasons given for switching providers were for perceived higher returns and change following advice received from a financial adviser. Notwithstanding these findings, however, the 2010 KiwiSaver Evaluation survey found that 90% of the members interviewed had never changed their provider.

Further points of interest regarding providers collected from the survey showed that 27% of members considered more than one provider when joining KiwiSaver. When choosing a provider, the important factors identified included financial stability, good reputation and familiarity. These factors could be seen as tallying with banks holding a significant share of the market, with over half of the respondents who chose their own provider selecting a bank. Where a member's employer has chosen or the Inland Revenue has allocated a provider, more members have their accounts with financial institutions other than banks or do not know where their funds are invested. In total 38% of the KiwiSaver members surveyed were with banks, 47% were with other financial institutions and 15% did not know who their provider was.

At 30 June 2012 KiwiSaver was estimated to make up 17% of the managed funds market, with a value of NZ$12.9 billion. When added to other superannuation assets, this rises to about 40% of the market (compared to 30% prior to the launch of KiwiSaver in 2007). The Government Actuary's report for the year ending 30 June 2012 stated that non-KiwiSaver superannuation scheme membership had fallen to 434,000, in 512 schemes (including retail and private schemes). The corresponding figures for 2007 were 582,000 members in 560 schemes.

Part of the 2010 Inland Revenue KiwiSaver Evaluation survey considered the impact of KiwiSaver on savings and what alternative use the funds going into the scheme may have had. Analysis of the results found that 60% of respondents were quite likely or very likely to have saved for retirement in the absence of KiwiSaver.

The survey also asked the respondents to identify where their contributions would have gone had they not been made to KiwiSaver. The results suggested that 27% would have gone on

[2] Financial Services Institute of Australasia (August, 2011) *KiwiSaver and Retirement Savings: A report prepared for FINSIA and the IFA by Dr Claire Matthews*, *School of Economics and Finance, Massey University*.

other superannuation savings, 13% on other savings and 24% on reducing debt. The remainder would have been consumed so this proportion would constitute additional savings. The general savings behaviour (i.e. not retirement savings or debt repayments) for KiwiSaver members interviewed had not significantly changed since joining the scheme, with 17% increasing their general savings, 15% decreasing and the remainder maintaining the same level.

After weighting for individuals' incomes, analysis of the survey results in Inland Revenue's 2011 annual report posited that 29% of individual contributions represented new national savings. Extending these results to employer contributions and the cost of Government incentives for KiwiSaver the conclusion became that over the ten years to 2021, the introduction of KiwiSaver would have, at best, only a marginal positive impact on national savings. However, it should be noted that the reduction in Government incentives and other scheme changes, announced in the 2011 budget, would impact this analysis.

Impact of KiwiSaver

With KiwiSaver being a relatively new, and still evolving, initiative it is important to continue to monitor trends and results to gain a true understanding of its impacts on the retirement and savings landscape. The changes introduced in the 2011 budget may impact on members' attitudes towards the scheme and its popularity. They will, however, lower the cost to the Government.

One area where meaningful conclusions can not currently be drawn is in the utilisation of retiring members' KiwiSaver account balances. The first members have only been able to withdraw their savings since 30 June 2012 (provided they have reached age 65 and completed five years membership). These individuals would have only modest balances and KiwiSaver would be expected to only form a small part of their retirement savings. It is therefore unlikely that the manner in which they have opted to manage these funds post-retirement would reflect how individuals will behave once the scheme matures and members have 20+ years of savings accrued. There are also currently very few post-retirement products to help individuals manage their savings. Such products may reasonably be expected to become more prevalent once more significant balances become available.

Mercer's KiwiSaver Sentiment Study

Following the introduction of KiwiSaver Mercer launched its KiwiSaver Sentiment Study which periodically interviews a cross section of the New Zealand population to gauge their attitudes towards and knowledge of retirement savings and, specifically, KiwiSaver. The third such study was carried out in February 2012 with the results published in a report dated May 2012. The report considered the retirement savings landscape in 2007, just prior to the launch of KiwiSaver, and the findings of the second survey conducted in 2009.

The key findings of the 2012 report showed that:

- KiwiSaver had become increasingly polarising compared to 2009. A greater proportion of respondents were found to either be 'positive and embracing' or 'actively against'. This suggests that individuals now had a greater understanding of the scheme and increased clarity shaping their views.

- Overall, younger people were more positive whilst those who were more sceptical were mature (over 55) and owned their own home, perhaps suggesting that KiwiSaver was not such an important part of their retirement planning.

- 71% felt they had at least a reasonable knowledge of KiwiSaver but the remainder were less confident – showing a significant proportion of the population who could benefit from further education from the Government, employers and KiwiSaver providers.

- The main concerns cited by individuals who did not see KiwiSaver as a good way to save for retirement were the risk of share market volatilities and the potential for the Government to make adverse changes to the scheme.

- Sentiment among current participants was high and increasing. 92% of current members believed the scheme would be beneficial to their current retirement saving – up from 89% in 2009 and significantly higher than the 70% observed prior to launch.

- New Zealanders had increasingly realised that they were likely to have a lower standard of living in retirement with an increasing proportion, 52%, believing they would be less comfortable in retirement than they are now, compared to only 42% saying the same in 2007.

- Anticipated reliance on superannuation in retirement had increased materially from 2009 while anticipated reliance on government assistance and other investments and savings had decreased.

- 61% of survey respondents said they participated in the KiwiSaver scheme, compared to 44% in 2009 and 27% participating in an employer-sponsored workplace savings scheme in 2007.

- 19% of those interviewed who were not members of KiwiSaver intended to join the scheme in the next 12 months. The proportion in 2009 was 26% and in 2007 was 14%.

- 58% of members chose their own provider, 17% went to a default provider and 20% let their employer decide for them. This contrasts with people's intentions prior to the launch where 73% thought they would choose their own provider.

- The 2% contribution rate option (available as at the survey date) was a popular option with 41% contributing at this level, up from 29% in 2009. A further 44% contributed at

the 4% level.

- The number of survey participants in an employer workplace saving scheme had dropped from 32% in 2009 to 21% in 2012, reflecting the increased importance of KiwiSaver for retirement savings.

- The future actions towards KiwiSaver by the Government which were most preferred by those surveyed were a reduction in the amount of tax on investment earnings and policies which encouraged providers to reduce fees.

Internationally

The increase in emphasis onto defined contribution arrangements has been observed outside of New Zealand as well, with a shift away from the costs and risks associated with defined benefit schemes. New initiatives have been launched in the UK which focus on this market. There has also been a consolidation of this focus in Australia.

United Kingdom

Defined benefit schemes have fallen out of favour and have increasingly been replaced with defined contribution arrangements for much the same reasons as observed in New Zealand. However, the rules regarding the wind up of schemes are much more stringent, making the dissolution of schemes much more expensive. As defined benefit schemes have increasingly closed to new employees with the accrual of future benefits by existing members becoming frozen, there has been a resulting shift in scheme design.

Starting from October 2012 a programme of auto-enrolling the majority of employees into workplace savings schemes began in the UK. Initially this applied to large employers and over the next six years smaller employers will follow, although employees will be able to opt-out. Employees subject to auto-enrolment must meet certain age and income requirements. Companies are able to use their own schemes to meet the requirement (provided certain qualifying requirements are met) and / or offer the National Employment Savings Trust (NEST) – a vehicle set up by the Government. If an employee opts out, they will be re-enrolled automatically every three years.

As part of the auto-enrolment regulations minimum contribution amounts have been imposed, starting at 1% for both employers and employees, increasing to 3% employer and 5% employee by October 2018 (although an employer may choose to pay a larger proportion of the total minimum contributions).

In April 2012, the Government introduced a new low cost retirement savings vehicle, the NEST, which is aimed at employees who currently don't have access to a good quality work based scheme. NEST is a voluntary Government backed vehicle which employers can use to fulfil the auto-enrolment requirements. NEST has been designed to provide a low cost, simple, savings

vehicle for lower income employees and also enables small employers to meet the auto-enrolment regulations.

The UK Minister for Pensions, Steve Webb, wrote last year about the UK Government investigating the possibility of encouraging arrangements that allow a greater sharing of risk between employers and employees. Defined benefit schemes place nearly all the risk onto employers and as a reaction to the increased costs, the balance of interests has shifted whereby risk in its entirety is increasingly being passed onto employees in defined contribution schemes. Mr Webb sought to utilise "defined ambition" schemes, which did not produce a pensions promise but a better certainty of outcome than is currently the case in a defined contribution arrangement. Options for defined ambition schemes that were suggested were: cash balance arrangements (where a there is a guarantee regarding the size of the retirement pot but not of what pension this would purchase); a promise of a pension within a range; and a guaranteed pension but with a varying start date depending on life expectancies. Mr Webb noted that employers were keen to share the risks with employees, but would need encouragement to do so through an appropriate framework.

It remains to be seen whether such schemes can become viable alternatives, although it is worth noting that within New Zealand cash balance defined benefit schemes already exist, but are not widespread and are generally closed. The potential for their success could be encouraged however, for example through the use of low cost master trust arrangements that pool many of the administrative costs between several schemes. For such schemes to become viable, they would need to be integrated with the KiwiSaver requirements.

Australia

From 1 July 2013, the minimum level of employer contribution to superannuation will increase from 9% to 9.25% of Ordinary Time Earnings. Ordinary Times Earnings is subject to an earnings cap (currently $45,750 per quarter). Further increases will occur each year until the minimum contribution reaches 12% from 1 July 2019.

Superannuation legislation in Australia is also undergoing major change. These changes include:

- A standardisation of processes relating to contribution and data transfers from employers to superannuation funds and transfers of benefits between superannuation funds. Generally electronic processing will be required.
- Requirements for default contributions to be paid to a new type of fund (MySuper). MySuper products must comply with various rules aiming at low cost, standardised fee bases and limited options. The intent is to make it easier to compare different MySuper products.
- Increased governance requirements for trustees including significantly greater disclosure of the fund's investment holdings, risk levels and trustee remuneration.

3

The role of New Zealand Superannuation

Adequacy

The level of NZ Super is currently 66% of the national average wage, on a net of tax basis, for a married couple. This means that an employee earning the average wage at retirement will receive one third of this amount after retiring. For low earners this replacement ratio can increase sharply whilst for high earners it drops off. We believe that this is insufficient on its own to provide the quality of life that most people would desire in their retirement. In 2012 a survey was conducted by Massey University's Financial Education Centre and Workplace Savings to see how much people who are currently retired spend on core items such as transport, health and energy. The results showed that a couple who want a lifestyle with some money for treats or other luxuries such as travel would need an extra $160 to $230 a week over and above NZ Super. This excludes any expenditure requirements on rent, mortgage payments or rates. With few other retirement savings incentives currently provided by the state, this will need to be funded from significant self- or employer-funded private provision.

Funding

NZ Super is a pay-as-you-go system with the current population funding the cost for the recipients, although the NZ Super Fund will help to control the burden for future generations. As the population ages with increasing life expectancies, the ratio of taxpayers per retiree is expected to decrease from one in four as it currently stands to one in two by 2051. This shrinking tax base relative to the number of recipients is expected to increase the cost of funding NZ Super from 4.7% of GDP in 2010 to 8.0% by 2050[3], and while this future cost is not as high as the OECD average of 11.4% of GDP, it represents a significant increase that must be met. Such an increase is likely to seriously affect the sustainability of NZ Super and Mercer believes structural changes are required to manage these costs.

Alternatives

Whilst acknowledging the benefits of retaining a stable state pension system to enable New Zealanders to plan for their retirement, the projected rise in costs is likely to require addressing at some point. Announcing future changes well in advance of their implementation allows the population to build them into their retirement plans and adjust their strategies appropriately. Our recommendation is to consider one or more of the following:

[3] What's happening to Pension Ages in OECD countries (http://www.cflri.org.nz/sites/default/files/docs/RI-OECD-Countries-Pension-Ages-2012.pdf)

- **Change NZ Super Age**

  The current Government has shown it is unwilling to consider increasing the age at which all New Zealanders become entitled to NZ Super, although the Labour party unsuccessfully campaigned on an increase at the last election. Mercer's view is that the current eligibility rules are unsustainable and the age of entitlement should progressively rise. Whilst a forecast increase in the retirement age at some point in the future would not impact the current expenditure on New Zealand Super, it is however important that such a change is made well in advance of it becoming effective to provide a sufficiently long transition period. An increase of two years to 67 would bring New Zealand in line with Australia and the United States, although linking the age of entitlement to life expectancies would be preferable. A link between the age of entitlement and life expectancies would allow for consistency through time, rather than stepped changes that would be dependent on political parties having to make the unpopular decision as to when such a change occurs. The methodology could be relatively simple, for example fixing the retirement age as a percentage of life expectancy and updating the age of eligibility following the publication of the New Zealand Life Tables every five years, with a suitable lead-in time.

  An alternative and somewhat innovative solution that keeps the mechanics simple could be to increase the retirement age by 1 month each year. Such an increase rate would take 24 years (plus any lead-in time) before the retirement age reached 67 but crucially would not stop at this age and then require further discussions regarding increasing it again in the future. Based on our expectations for future life expectancy, this rate of increase also holds the proportion of an individual's lifetime spent in retirement fairly steady. Such a system would have the benefit of allowing individuals to forecast their retirement age well in advance and smooth the increases out in a fair and consistent manner. It is also extendable indefinitely, with the appropriateness of the rate of increase reviewable periodically to ensure it remains appropriate.

- **Allow flexible retirement ages**

  Older New Zealanders are increasingly remaining in the labour force beyond their age of eligibility for NZ Super. Information from Statistics New Zealand shows an increase in both the proportion of the labour force that is aged over 65 and the workplace participation rate of over 65s.

  One policy initiative could therefore be for a person continuing to work after age 65 to be able to elect to delay the start date for receipt of NZ Super (for example, until age 70). In exchange for this deferral, the person would be entitled to a one-off higher NZ Super payment, once payments commence. The effect overall on pension costs would depend on the level of additional entitlement once NZ Super payments commence. The additional entitlement should reflect a proportion of the NZ Super entitlements foregone in the deferral

period, given the individual would have had the opportunity to earn employment income in that time.

- **Introduce means testing**

  NZ Super is currently paid at the same rate to all eligible recipients regardless of their financial circumstances. Whilst the universal superannuation system is simple to administer and easy to understand, it does raise the question as to whether those who are able to adequately self-fund their retirement should be entitled to the full benefit?

  A means-tested benefit would reduce the funding costs of NZ Super for the Government provided the complexity of such a test did not outweigh the benefits. Such a system would need to work against the hiding of assets by wealthier individuals who would otherwise be ineligible for the full benefit. Care would also be needed to avoid individuals saving less during their working lifetime in order to fall below any threshold. It could, however, encourage individuals to save a greater amount in private schemes to fund the shortfall from a lower level of state benefit. A higher minimum contribution rate into KiwiSaver could help in this regard.

4

Improving outcomes from private provision

Looking at the trends in superannuation both domestically and internationally it is clear that defined contribution schemes are where the current and foreseeable future focus is for private retirement provision. These schemes provide a greater degree of certainty in cost for employers but result in individuals taking on a large amount of investment and longevity risk, against which there are few cost effective hedging strategies. This has been shown to discourage retirement saving and can lead to stark differences in outcomes between different groups of people.

Within New Zealand, the current compulsory contribution rates are unlikely to be large enough to result in a retirement savings pot which would be sufficient to maintain an average New Zealander's pre-retirement standard of living without being supplemented by additional non-superannuation income. However, unless an employer promises to match contributions above the compulsory rate, most people would find no compelling reason to lock more funds away in KiwiSaver until retirement. Doubts also persist over the sustainability of NZ Super in its current format and the suitability of a universal state benefit.

There are several ways in which private provision could be supported or altered to improve outcomes and improve the quality of life of retirees. Some of these would require specific Government policy changes whilst for others the financial service sector has a role to play.

Higher minimum contribution rate

Whilst Mercer believes the current KiwiSaver structure is a good starting point to get New Zealanders saving for their retirement, a higher contribution rate than the minimum currently in place will be needed to secure a meaningful retirement outcome. This will also be necessary to reduce the pressure on future generations and governments to fund an increasing superannuation bill. For a KiwiSaver member earning the national average wage of $55,000 p.a., the total of their minimum employee, employer and tax credits amounts to approximately 6.5% of their salary (after the deduction of contribution tax). As a comparison, the level provided by the Australian Superannuation Guarantee is currently due to rise to 12% of salary (10.2% after deduction for tax) in 2019. The Australian system also offers incentives for individuals to contribute more.

There is a risk that forcing the minimum contribution rate up too high, too quickly could discourage membership, particularly for the lower paid, but foreshadowing a future change early would allow individuals and businesses to make the necessary preparations and even encourage an early adoption. Alternatively the increase in the minimum contribution rate could be applied to the employer's contribution rate only.

One easy to introduce policy change would be to allow an employee contribution rate of 6%, filling the large jump between the current 4% and 8% rates. Whilst this would remain optional, and so perhaps fairly limited in its outcome, the introduction of an intermediate rate, together with a concerted education exercise, could encourage higher savings rates.

Compulsory membership

KiwiSaver has been seen to be a success with 2.1m members at the end of March 2013. According to Inland Revenue's 2012 KiwiSaver annual report, over half of eligible New Zealanders are not signed up to KiwiSaver. This is skewed somewhat by the inclusion of those not in the labour force, but more than 40% of those of working age are not members. Only a small fraction of these would be covered by other workplace savings schemes. Mercer supports the Government's stated aim of auto enrolment at some point in the future as a measure to get more people signed up and saving. Whilst likely to be politically unpopular, compulsory membership would ensure a much larger proportion of New Zealanders are making provision for their retirement and would improve the efficiencies of the KiwiSaver system.

Tax incentives

To avoid the unpopularity of compulsory membership and the possibility of pricing out low earners with higher minimum contribution rates a wider system of incentives to contribute could be applied. There are no incentives for New Zealanders to contribute more into KiwiSaver than the compulsory rate (or $1,043 p.a. if lower), beyond discretionary benefits offered by their employer. Coupled with a relatively low compulsory rate this discourages the setting aside of adequate funds for the future and is therefore likely to increase the pressure on future generations to help fund retirement benefits.

A review of the taxation of contributions could encourage individuals to increase the amounts deposited in KiwiSaver or other superannuation schemes. A preferential tax treatment on contributions made, rather than taken as salary could be implemented by amending the ESCT scale to lift the thresholds or reduce the rates applied. The Australian system, for example, allows for individuals to sacrifice some of their salary into their super, where it is taxed at 15%, rather than at their marginal tax rate.

Currently, investment earnings are taxed at a member's Prescribed Investor Rate, or potentially a higher rate if the scheme is not itself a PIE. Taxing earnings at a lower rate in KiwiSaver schemes would provide an incentive to lock funds away for retirement. To avoid overly subsidising the wealthy, appropriate caps can be put in place or such benefits could be implemented in conjunction with means testing on New Zealand Superannuation.

Education and engagement

A large number of savers, particularly default KiwiSaver members, are likely to be disengaged from their retirement savings and have relatively low levels of financial literacy. Greater support in making them aware of what their savings would be worth and how they could potentially

improve their outcomes can provide significant benefits. Mercer's 'Money for Jam' campaign in 2012 was an example of how providers can help – making KiwiSavers aware of the contributions needed to maximise the tax credit part of their savings.

More generally, the majority of New Zealanders are aware that they will not be as comfortable in their retirement as they are currently but many would not be aware of the amount needed on retirement, or a suitable savings pattern to reach a desired amount, to meet their goals. Educating them as to the estimated projected level of lifetime income afforded from savings would help individuals ensure they are saving a suitable amount during their working lifetime to fund the lifestyle they desire through their retirement years. Correcting misconceptions about life expectancies, whereby people tend to under estimate the period over which their retirement savings will need to be spread, should form part of this education. Calculators available on the Sorted website already have the capabilities to illustrate this, but KiwiSaver providers or retirement savings schemes sponsors could be more direct and include relevant information into annual benefit statements. An illustration of the estimated *income* afforded from balances would be useful.

The use of a lifecycle approach as detailed below is another example of where the use of clear education and communication strategies could help Kiwis make informed decisions and boost their savings.

Suitable investment policies

In the recent call by the Ministry of Business, Innovation and Employment for submissions on the KiwiSaver default provider arrangements Mercer expressed its support for life-cycle default investment options. Default funds currently adopt a relatively static asset allocation of approximately 20% in growth assets and 80% in defensive assets throughout their duration. While this may be appropriate for an older member, it may not be an optimal strategy for a younger member, who has time to recover from any risk events (although it is accepted that this strategy may have limited utility in the case of a younger member looking to purchase their first home).

We believe the default scheme can do more for KiwiSaver members to ensure they have an adequate income both leading to retirement and during their retirement years. A life-cycle investment approach within a default KiwiSaver fund would provide members with a framework to create adequate and sustainable incomes to and through retirement. Their use does also have a role outside of the default area, but introducing them in this way ensure a significant number of New Zealanders are alerted to their benefits and allows fees to be kept affordable.

A dynamic life-cycle approach means changing a member's investment strategy as their circumstances change throughout their whole life. Typically, a member's assets are gradually switched from a growth investment strategy to a more defensive one. Our research shows by changing the static default strategy to a dynamic life-cycle approach, members are better positioned to generate more retirement savings while not increasing the chances of a negative outcome during the critical 5-10 years leading up to retirement.

Age-based defaults are the most common type of default option in the UK and US and are recommended by the OECD ("Better Policies for Better Lives") as suitable default strategies for pension plans. In Australia, MySuper legislation has also allowed age-based investment strategies as a default MySuper strategy.

Despite the added complexity we believe age-based investment strategies are a significant and necessary improvement to the design of KiwiSaver which would result in better outcomes for members over the long term.

Mercer also believes that an improved default strategy for the majority of members is not a substitute for one to one financial advice. According to Mercer research, age 45-55 is an opportune time to re-evaluate a member's investment strategy and for the member to consider converting to a personalised, advice driven strategy.

Post-retirement options

The focus on KiwiSaver, and indeed the whole defined contribution retirement savings sector, has been on the accumulation side with very few targeted options for managing balances post-retirement. With no significant market for post-retirement products currently available, retirees with account based benefits are left on their own to manage the spending of their savings through retirement. Managing the longevity and investment risks is beyond the individual capabilities of most of the population and policies should be considered that encourage the introduction of post-retirement products that manage the utilisation of accumulated balances. A transparent and flexible structure would allow individuals to make the necessary preparations to fund their desired lifestyle and increase confidence in the whole retirement income system.

Annuities are usually offered up as the primary solution and while they provide a suitable hedge against the risk of an individual outliving their capital, they have proven to be unpopular in recent years in New Zealand. Issuers have been reluctant to offer them without suitable investments to back them; there has also been only a small potential market and high capital requirements. Potential purchasers have also been scarce due to fears over the security of issuers, the safety net provided by NZ Super and perceived low returns.

When pricing annuities providers must account for the risk of anti-selection, whereby the healthiest individuals are most likely to purchase, low future returns due to the capital requirements and the taxation of returns at the corporate tax rate, rather than an annuitant's own rate (or likely their Prescribed Investor Rate). All these factors combine to make annuities relatively expensive and so more flexible post retirement options are required. One such solution is set out in the next section.

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An alternative post-retirement investment approach

Mercer believes a better approach to funding retirees' post-retirement needs would come from a three-pronged approach, separating accumulated savings into income and discretionary accounts and a new approach to the provision and timing of annuity benefits.

The chart below shows how potential retirement spending needs may vary for a middle income retiree through time and how a post-retirement system can be set-up to provide the security and flexibility to meet these needs.

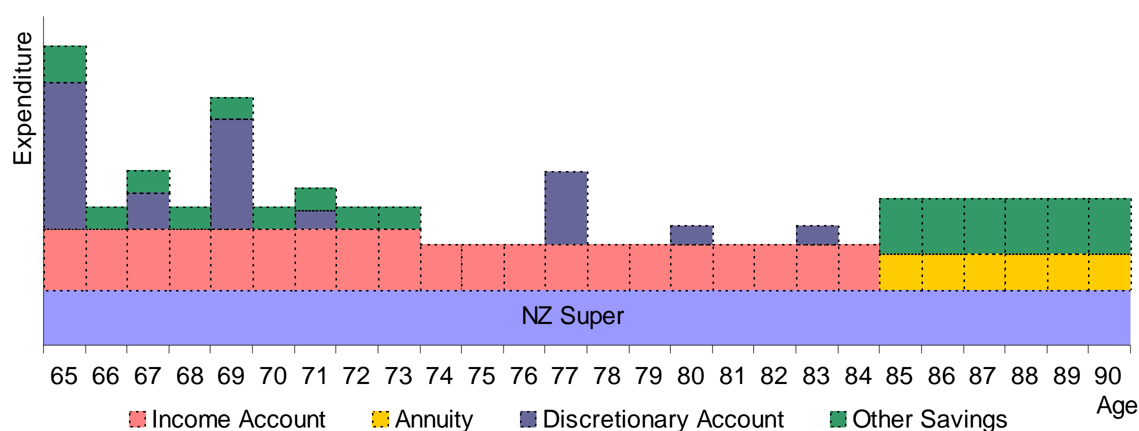

Chart 2: Expenditure pattern and sources of income for a retiree

The chart shows a need for regular income in excess of the base level provided by NZ Super, plus additional amounts needed at infrequent times to fund irregular large spending such as overseas holidays or a new car. The proposed system for meeting these needs involves dividing retirement savings into two parts – income and discretionary accounts. The *income account* must be used to provide a regular income either through the purchase of an annuity or an account based pension with maximum withdrawal amounts to encourage smoothed income over an individual's lifetime. *The discretionary account* can then be used to meet the irregular larger spending needs with limited restrictions. Other income or assets (including from continued employment or the release of home equity) may also be used as necessary.

To compensate individuals for the restrictions imposed by income accounts there would need to be savings incentives, which are already used to some extent through the kick-start and tax credits offered in KiwiSaver. These would possibly need to be extended to increase the level of savings and offset the unpopularity of restrictions. If means-testing NZ Super is introduced as a

way to fund these incentives it is easy to see that an increase in the amount provided by the income account can fill the gap in an individual's retirement income. A less popular, but more efficient, policy change would be to impose compulsory savings.

As well as the option to manage their own investments in line with their risk tolerances, individuals should have the (simpler) option of using their income account (and any other savings) to purchase an annuity at any time. However, it should be noted that by deferring an annuity purchase for 20 years post retirement an individual could realistically manage their investments to receive an income some 20% higher than by purchasing an annuity at retirement age. This demonstrates the value in allowing individuals the flexibility to manage their own savings during the early years of retirement. In Chart 2 the purchase of the annuity at age 85 can be funded from the unspent balance from both accounts, but could also be achieved by setting aside designated funds at retirement or through the payment of on-going premiums from regular income in earlier retirement years.

Global experiences show that Government interventions are likely to be needed to produce a viable private sector annuity market. One solution for New Zealand could be for the Government to act as an annuity provider, allowing individuals to purchase additional units of NZ Super. This builds on an existing framework and has the potential to provide annuities at a lower cost than possible through the private sector. Such a 'top-up' option may be particularly appealing for small accounts that are likely to be the norm for KiwiSaver over the coming years and also for individuals well into their retirement.

Taken together, these elements can produce an easy to understand and flexible system that encourages middle incomers to spread their retirement savings over their lifetime. A more generic retirement income design, that is non-country specific, can be found in Mercer's Retirement Design for the Future paper from June 2010.

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