

31<sup>st</sup> May 2013

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Commission for Financial Literacy and Retirement Income  
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Dear Malcolm

#### **Submission for Retirement Income Policy Review**

Thank you for the opportunity to comment on the terms of reference for the Commission for Financial Literacy and Retirement Income's (CFLRI) review of NZ retirement income policy.

FMA's main objective is to promote and facilitate the development of fair, efficient and transparent financial markets. We aim to do this by strengthening the public's confidence in NZ's financial markets, promoting innovation and supporting the growth of NZ's capital base, through effective regulation. As a regulator of NZ's financial markets, FMA has a keen interest in NZ's retirement income policy settings and in understanding and identifying potential implications for the operation of NZ financial markets and for NZ investors more generally.

#### **Background**

At the outset, it is worth noting some of the key demographic trends and challenges facing NZ. These challenges will directly impact the success of NZ's retirement income policy settings and FMA's role in regulating associated aspects of the financial markets.

Like most other developed nations, there is evidence that NZ is shifting towards a 'retirement economy'. Around 600,000 New Zealanders are currently aged over 65 years and this is expected to increase to around 1.5 million New Zealanders by 2061. FMA agrees with the CFLRI that there are serious issues arising for NZ due to the ageing of the population, leading to an increase in the dependency ratio. Migration is unlikely to solve the problems that this change will create.

At present the majority of working and retiring New Zealanders have a simple financial portfolio which consists of a home loan and credit card, property insurance and KiwiSaver, with their retirement saving heavily concentrated in the form of housing. Many OECD countries face a similar profile in terms of an ageing population but the invested wealth of seniors in those countries tends to be better diversified, with a larger proportion of financial assets in their portfolios.

With real estate being the dominant investment for the vast majority of New Zealanders, it is likely that many New Zealanders will want to find ways to extract equity from real estate to assist in

funding their retirement. This has the potential to impact financial markets in terms of significant changes in asset prices, new or novel financial products and financial market conduct.

Assuming no change to the pension age, the ability to accumulate sufficient private assets to fund retirement and the impact on the NZ fiscal position will both become increasingly significant. Issues arising from the transition to a retirement economy will crystallize at both the accumulation and decumulation phases of retirement savings and will impact different generations in different ways.

- Retirement of the Baby Boom Generation – For this generation, there are increasing concerns about the fiscal costs of NZ Superannuation (NZS). Those retiring from now until approximately 2030 will be increasingly reliant on liquidating real estate assets and on NZS to fund their retirement. Managing the de-cumulation process is the central issue.
- Retirement of Generation X, Y and beyond – Those retiring after 2030 should be encouraged to save for their own retirement as there is likely to be an increased reliance on private funds. Managing the accumulation process is the central concern.

### **Encouraging Private Savings & Investments**

In the context of the likely increase in fiscal pressures arising from large cohorts of retirees, FMA supports proposals to encourage private savings and investments.

KiwiSaver is one way to encourage individuals to support their own retirement and also helps to ensure New Zealanders diversify their asset holdings, an important risk mitigation strategy for all investors. Encouraging investment in financial assets also supports the growth of NZ's capital markets and has the benefit of encouraging financial market liquidity.

Notwithstanding the benefits of KiwiSaver, particularly for generations X and beyond, FMA also acknowledges that KiwiSaver will provide less assistance to baby boomers (as balances in KiwiSaver funds for these retirees will be lower at retirement). This is especially the case for retirees in the lower income quintiles.

### **The Aging Population may Impact Asset Prices**

As the baby boom generation has passed through its life cycle into middle age, we have seen increases in house prices in many developed economies. However in the coming years, a higher proportion of the population in retirement will be looking to sell their houses and draw-down on their superannuation savings (rather than contributing to super). There is likely to be some downward pressure on house prices as well as share and bond prices and upward pressure on bond yields (long-term interest rates) relative to where prices and yields would be in the absence of demographic factors.

### ***The Housing Market***

A paper by the Bank for International Settlements (BIS)<sup>1</sup> investigates how ageing will affect asset prices in a number of OECD countries. Econometric modeling was used to look at how economic and demographic factors drive asset, and in particular house, prices. The paper concludes that as the baby boomers reached working age and started buying housing from 1970, they helped to push up property prices throughout the world. The analysis concludes that in New Zealand over the past 40 years the baby boomers have increased real house prices by around 30% compared with what would have occurred had our age structure remained neutral. The ageing of these same baby boomers is

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<sup>1</sup> Ageing and Asset Prices – Elod Takats <http://www.bis.org/publ/work318.pdf>



projected to reduce New Zealand's real house price growth by around 45% over the next 40 years compared to neutral demographics (where the age profile of the population stays constant).

Statistics show that about one-third of older people sell their homes on retirement in NZ, meaning there will be an increase in the number of sellers of larger homes and investment properties as baby boomers reach the pension age. The process is likely to unfold further in later years as ageing baby boomers sell their smaller homes and move into care homes and hospitals.

Population is declining and aging much more rapidly in some regions than others. There is also a trend to urbanization, as the overall population drifts towards Auckland. This regional demographic picture could further exacerbate the potential for house price declines in the rural centres. This could affect the prices that can be obtained by homeowners in their 40s and 50s living in smaller centres when they come to downsize, if the number of young people available to buy those properties continues to decline.

### ***Financial Asset Prices***

Population ageing in NZ and overseas is expected to put downward pressure on equity prices as ageing households become less willing to bear risk and shift their portfolio mix toward lower risk and income-generating investments. Added to this is the uncertain impact of investors facing retirement searching for yield to increase the likelihood of their savings being adequate by planned retirement age. There is also likely to be an impact on both equities and bonds as retirees in NZ and overseas liquidate their portfolios to supplement their other sources of retirement income.

As the world is ageing slower than advanced economies, global financial assets might face smaller downward pressure than advanced country house prices<sup>2</sup>. The BIS study concluded it is possible that global financial asset price growth could be slowed by a full percentage point per annum over the next forty years as a result of aging factors. This price impact would be large, but in the context of average real stock market returns in the US for example, would not imply long term real asset price declines.

Even though the financial market effect is likely to be less dramatic than the housing market effect, the performance of KiwiSaver funds could be impacted by this and NZS and private pension schemes could face very similar difficulties as ageing reduces asset prices. The BIS study has concluded that this implies that privatizing pension provision might not be the panacea for societies with aging populations and that it may be advantageous for countries like NZ to diversify investment overseas to younger economies to try to avoid the problems of asset price reductions as an ageing population liquidates its financial assets<sup>3</sup>.

### **Financial Advice**

FMA encourages anyone who is thinking of investing, to seek financial advice. A good financial adviser can help investors identify goals, set a financial plan and invest appropriately to their needs. Access to good quality retirement planning advice will become increasingly important for retirees and pre-retirees.

Retirees are a particularly vulnerable group of investors who may face difficulties in getting access to retirement planning advice, especially if they do not have large sums to invest. At the same time, they could become targets for unscrupulous practices especially during the de-cumulation phase.

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<sup>2</sup> Ibid.

<sup>3</sup> Ibid

These types of issues may open the door for consideration of some specific policy incentives to encourage cost effective, quality retirement planning advice that may include some measures specifically aimed at improving access to affordable high quality financial advice. Attention should be paid in particular to those who have had adverse experience arising from finance company failures or other investment losses arising from the economic events of the past six years, given the effect of these events on investment balances and the concern that this could drive a further cycle of excessive risk-taking in search of higher yields needed to support retirement.

In the accumulation phase advice will be needed in the following areas:

- retirement planning
- The range of investment options available
- Investment strategies
- Importance of investors' active engagement with investments and the risk/return trade-off
- Impact of fees
- In the de-cumulation phase advice will need to take account of the following:
  - The problem of unknown longevity and predicting income requirements for living expenses and health care costs over a long and unknown timeframe
  - Guidance about de-cumulation strategies and products, including annuities and equity release products
  - Government assistance available for seniors for assisted living and healthcare costs

### **Financial Product Innovation and Regulation**

At present in NZ there are very few products available to help with the de-cumulation process at retirement and hence seniors face "longevity risk" – the risk that they will fail to adequately allocate their financial assets across their life. The crystallization of this risk is especially likely in an environment of increasing life expectancy.

The paucity of products available during the de-cumulation phase highlights the need for financial product innovation. FMA encourages innovation in the development of new products and distribution methods. However, we expect market participants to design and sell such products with customers' interests in mind. It will be important to balance such innovation with consumer needs and appropriate financial market regulation.

#### ***Annuities***

FMA supports the development of an annuities market in NZ - but acknowledges that this is not likely to significantly help the baby boomer generation. FMA supports a review of existing policy settings to assess impediments to the development of annuities or equivalent products in NZ. It may be the case that a concerted effort from both government and the private sector is the best approach to developing this type of product.

#### ***Releasing real estate equity***

Reflecting the concentration of retirement savings in real estate, it is likely that strategies that permit the liberation of housing wealth will be important for retirees.

The need to liberate housing wealth will drive the innovation and sale of equity release-type products in New Zealand. While well designed products may be useful, FMA notes that many overseas jurisdictions have had bad experiences with such products including mis-selling, poor product design, and burdensome terms and conditions. Against this background, FMA has some

serious misgivings about these products. Regulation and oversight of this market would be very important.

### **Investor Education**

FMA considers that the development of financial literacy in NZ is a key component in any strategy for improving the financial position of retirees in future generations.

FMA supports the work of the National Strategy Advisory Group on Financial Literacy and the existing CFLRI Older Kiwis Strategy and programmes for schools, tertiary institutions and community organisations. FMA considers that these programmes could be further extended into workplaces.

New Zealand's retirement income policies have the potential to affect the shape and operation of New Zealand's financial markets as it becomes increasingly clear that private provision for retirement needs to increase. FMA has identified "saving for later years" as one of the key themes of its Compliance Focus for financial markets regulation. The goal of this work is to ensure that New Zealanders can invest with confidence in our financial markets. We look forward to the contribution that the review of retirement income policies will make in this area.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Liam Mason', with a stylized flourish at the end.

Liam Mason  
Acting Chief Executive  
Financial Market Authority