Submission to the Savings Working Group

by

AMP Financial Services and AMP Capital Investors

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Introduction

AMP makes the following submission to the Savings Working Group.

AMP has one of the longest standing financial services operations in New Zealand having managed and invested the savings of New Zealanders since 1854. AMP's two main New Zealand businesses, AMP Financial Services and AMP Capital Investors, provide wholesale and retail savings and investment management services.

AMP Financial Services provides retail savings and investment schemes through 325,000 arrangements:

- KiwiSaver
- Workplace superannuation master trust
- Unit trusts
- Personal superannuation schemes
- Whole of life and endowment life insurance (now closed to new policies); and
- A retail wrap investment portfolio management service.

AMP Capital Investors is New Zealand's largest private fund manager managing over $11bn in equity, property, fixed interest and private equity assets. These investments are provided through listed and unlisted collective investment schemes, principally to wholesale clients. However funds are also available to retail investors through wrap platforms provided by AMP Financial Services and other retail platform managers.

AMP is therefore directly interested in savings as an issue of national importance to New Zealand both from a business perspective and as an issue of national and personal wellbeing.

Summary

AMP completely agrees that the lack of savings, the level and trend of national debt and a persistent balance of payments deficit that needs to funded by further international borrowing –

a) decreases the attractiveness of New Zealand as an investment destination;
b) increases the risk premium demanded by foreign investors and, as we are dependent on foreign investment capital, reduces the number of development projects that meet minimum return demands;
c) has the potential to become reinforcing as increased foreign ownership leads to increasing profit repatriation;
d) reduces household disposable income;

and therefore poses an increasing risk to New Zealanders' absolute and relative standard of living.

It is unfortunate that initiatives to address national savings are having to be considered in a post financial crisis environment where financial options to reduce savings disincentives, let alone provide encouragement, are severely constrained. However, the present disincentives and inconsistencies need to be recognised even if the resources needed to address them may be limited.

New Zealand stands out among the countries we naturally compare ourselves with in taxing savings at or near marginal personal income tax rates. While top income tax rates are not high internationally, it still needs to be recognised that deducting a third to a half of the real return on investment is a powerful disincentive particularly when investment risk is considered.

Another outcome of the increasing foreign ownership of New Zealand business resulting from the persistent savings deficit, is the lack of access to New Zealand imputation credits for potential New Zealand investors. This is particularly relevant to the financial services sector and to AMP's 65,000 New Zealand shareholders. Where a company has a small minority of New Zealand shareholders, New Zealand investors presently get proportionally little credit for underlying company tax through the imputation system. This practically doubles the tax paid on dividends (depending on relative domestic and foreign shareholding) – a particularly strong disincentive to New Zealanders investing in businesses with New Zealand operations. It is time to make progress on giving New Zealand investors access to New Zealand imputation credits – with or without Australia.

The number of KiwiSaver accounts that have been opened have greatly exceeded early estimates – the benefits of contributing are too hard to ignore. However, we submit that the incentives are unbalanced, being completely weighted to contributions, and do not support integrated saving and retirement income phases. If the present arrangements continue they may contribute to significant consumption expenditure of retirement lump sums in the future. KiwiSaver incentives should be directed to deferring tax and to encouraging retirement income.

Rebalancing household balance sheets will need a number of additional approaches including:

- a long-term commitment to increasing financial literacy;
- as much focus on managing and understanding debt as savings;
- addressing the disincentives and inadequate return on investment risk that the present savings tax arrangements contribute to;
- routine release of national income statistics that realistically reflect the effect of national debt and that contribute to awareness of the issue.

The Productivity Commission, announced earlier this year, would be an appropriate body to consider a wider framework to address national financial risks (e.g. healthcare, education) more broadly and appropriate funding or risk mitigation approaches.

Submission

AMP's business perspective

1. AMP's perspective on the risk posed by New Zealand's lack of savings is from the position of a:
   - foreign investor committing capital to a New Zealand business;
   - developer needing to access capital to develop and maintain significant, principally commercial property, infrastructure;
   - fund manager providing capital to enterprises and government through equity, debt and private equity investment; and
   - a provider of investment products to savers and investors.

2. From the perspective of a foreign company investing in a New Zealand business, the level and increasing trend of national debt, the persistent current account deficit with the consequent risk of a devaluation in the New Zealand dollar and negative impact on disposable household income, increases the risk and reduces the attractiveness of New Zealand as an investment destination for a financial services business.

3. As a manager of over $3bn of property assets, AMP Capital Investor's development capacity is constrained by access to development capital. The global financial crisis has demonstrated the risk of having to rely on foreign development capital in the absence of domestic saving and investment sources. With scarce investment capital, international investors demand a return premium for investment in a high currency risk country such as New Zealand (if they are willing or able to consider investing here at all). This reduces the range of development projects that are able to meet investor return demands with the result that desirable projects that would be justifiable on 'normal' investor returns do not proceed. This is to the detriment of New Zealand's infrastructure development.

4. As a manager of $1.2bn in New Zealand share, $4.1bn in fixed interest and over $115m in private equity investments, AMP Capital Investors provides capital to New Zealand companies and government. This capital is almost completely sourced from New Zealand savers and investors and therefore directly affected by the level of domestic savings.

5. And, as a provider of $5bn in retail savings and investment products that are a major source of medium and long-term investment capital (which is invested domestically and overseas), AMP has direct experience of the factors that encourage household savers and the economics of providing non-bank retail savings products. These factors are explored more fully below.

Taxation of savings and investment

6. The Issues and Options Paper identifies a number of issues of the taxation of savings that, while difficult to quantify their effect or what positive effect a change

would have, make New Zealand a stand-out in comparison with the those countries we typically compare ourselves with. These include:

- Taxing savings at or near the marginal personal tax rate taxes the inflation component of savings, significantly increasing the effective, real long-term taxation rate.
- Taxing long-term retirement savings at or near to present marginal tax rates whereas other countries tax long-term retirement savings at no or low rates.

7. The comment on page 11 of the Issues and Options Paper that New Zealanders may be less willing to save at a given interest rate than foreigners ignores the significant effect of tax. New Zealand is an outlier in the OECD in not providing tax relief on, particularly long-term savings with the result that New Zealanders' investment decisions are based on after tax returns whereas foreigners' decisions are largely pre-tax.

Imputation

8. AMP is an Australian based company that is listed on the NZX with a small minority of New Zealand shareholders. The New Zealand financial sector is dominated by the big four Australian based banks which have generated substantial New Zealand profits and paid corresponding New Zealand tax. As these companies' New Zealand shareholding comprise a relatively small proportion of overall shareholding, any imputation credits that are attached to dividends are effectively wasted on foreign shareholders. The result is that dividends paid to New Zealand shareholders have an element of double taxation the extent of which depends on the proportion of New Zealand resident shareholders.

9. Double taxation of dividends at marginal personal tax rates is a significant disincentive to New Zealanders' participation in the returns on investment in New Zealand business and potentially destroys any risk premium that would be expected on equity investment. (New Zealand investors have marginal effect on the price of these shares – prices that would otherwise be expected to fall as a result of the depressed, after-tax dividend.)

10. Both New Zealand and Australia support the concept of recognising the underlying tax paid on company profits through the respective imputation and franking regimes. Allowing New Zealand investors to benefit from the underlying tax paid in New Zealand from New Zealand operations would increase the after-tax return, increase the attractiveness for New Zealanders investing in such companies and thereby help to retain company profits paid through dividends in New Zealand. As after tax returns are increased this will also encourage saving in more risky equity investment and support saving overall.

11. Streaming of imputation credits to New Zealand resident shareholders would support listing on New Zealand exchanges for all overseas resident companies that have significant New Zealand operations and have the greatest effect on encouraging New Zealanders to share in the profits of foreign companies' New Zealand

operations. That would also support a greater depth and diversity of equity investment available to New Zealand investors. Full mutual recognition of imputation/franking credits with Australia would encourage investment in Australian based companies, allows New Zealand investors to fully benefit from profits generated in Australia and supports further development of the single Australasian financial market. However, mutual recognition needs the agreement of both Governments and this may take some time.

12. New Zealand needs to make an assessment of whether Australia will pursue mutual recognition of imputation/franking credits in the near future and, if not, introduce a scheme to allow access to imputation credits for New Zealand resident shareholders.

KiwiSaver

13. There is little doubt that the outstanding public success of KiwiSaver is due in large part to the nature of the incentives to join (there are presently over 1.5m accounts compared with initial estimates in 2006 of 680,000 accounts by 2013/14). An immediate kick-start of $1,000, matching 'tax-credit' of up to $20 per week and employer contributions up to 2% of salary or wages mean that for each $1 saved, a majority of members immediately have $3 in their KiwiSaver account (at least when member tax credits are paid). This is clearly too great and immediate an incentive to ignore.

14. While we completely agree that taxing savings, and particularly long-term savings at top marginal personal tax rates is extreme and a significant disincentive that needs to be addressed, KiwiSaver incentives are unbalanced and do not support an integrated approach to the accumulation and retirement income phases.
    - The encouragement is front-loaded in respect of contributions. Once the incentive is received there is only the statutory prohibition on withdrawal that encourages continuing membership and prevents savers immediately accessing the benefits.
    - Once savers reach the age of eligibility for NZ Superannuation, they have immediate access to their accumulated KiwiSaver funds – other than limited and complex PIE incentives, there is no inbuilt or regulatory framework to support or encourage a retirement income stream.
    - The large, up-front taxpayer support is not balanced by a corresponding contribution to the tax base by retirees once they receive their retirement income and make greater demands on public health and superannuation.

15. KiwiSaver is proving an effective scheme to provide a lump sum at retirement, but once eligibility age is attained there is not a strong framework to provide for or encourage the basic purpose – a retirement income. The unbalanced KiwiSaver incentives mentioned above (large and up-front on contributions), and the need to find a way to encourage an income in retirement, suggest that deferring tax on retirement savings until the retirement income phase is a viable option.

16. Employer contributions up to 2% of salary or wages are already tax-free and the member tax credit is equivalent to tax-free member contributions of substantially more than that (three to four times). While the fiscal cost of fully exempting the investment income of KiwiSaver investments would grow with time, a simple life-cycle model indicates that moving to an EET tax regime for both the accumulation and retirement income phase for KiwiSaver (i.e. not taxing contributions or investment income but taxing retirement withdrawals from KiwiSaver accounts as income when it is received) could both increase personal retirement income *and* total tax revenue over a life time. This results from the compounding effect the gross investment return has on the accumulated lump sum at retirement.

17. Deferring tax until retirement income is received would also;
    a) recognise that the various components of the tax base, particularly consumption and income, are set at a point in time – e.g. avoids the wealth transfer when income and consumption tax relativities are changed;
    b) be a continuing encouragement to KiwiSaver savings;
    c) not tax the inflation component of the investment return on long-term savings;
    d) provide an inbuilt incentive to deferring spending of savings in retirement as large withdrawals would attract high income tax – i.e. encourage an income stream;
    e) provide flexibility in withdrawing KiwiSaver funds, particularly considering individual circumstances in the transition to retirement;
    f) broaden the tax base at the point where the elderly are making the greatest demands on public services, particularly health;
    g) and, finally, provide a good reason to transfer Australian SGC contributions to New Zealand.

18. While this proposal may appear a radical change of direction and offend the policy stability criterion, given the short history of KiwiSaver and the level of government support applied to contributions up-front, such a change is justifiable given the benefits to a coherent overall retirement income framework.

19. As noted above, the incentives for KiwiSaver, while generous, are generally inflexible and front-loaded. On a salary of over $52,000 there is no incentive to save more than the minimum contribution rate in KiwiSaver and thereby lock additional savings away for the long term (and add to the pool of long-term savings for corresponding long-term investments). A move to an EET tax regime may allow more flexibility in contribution rates to provide appropriate retirement replacement income rates across wider range of earnings levels and a transition to retirement at later ages that recognises individual circumstances, particularly health and ability to continue working.

20. From an investment time horizon perspective, retirement income and first home purchase are widely divergent savings objectives. At present around 60% of KiwiSaver funds are invested in low risk, fixed interest investments. The first home purchase withdrawal option for KiwiSaver dictates the need for the low-risk, default

investment option which is typically inappropriate for long-term retirement savings. Consideration could be given to phasing out the first home purchase option so that more KiwiSaver funds could be allocated appropriately to long-term investments.

21. The passing of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver and Remedial Matters) Bill highlights the risk of the inconsistency of New Zealand's taxation of retirement saving compared with Australia's. Over the last 3 years the net Australian / New Zealand migration flow has been 76,000 to Australia. The difference in taxation of retirement savings between the two countries provides a significant incentive to transfer to, or retain retirement savings in Australia. Introducing free transfer of retirement savings between the two countries, while maintaining the different tax treatment, can only be detrimental to domestic savings.

Dual tax system

22. Deferring tax on retirement income is a dual tax system for a specific savings objective. The PIE rules with their top rate of 28% (from 1 October) and different income thresholds depending on PIE and other taxable income is also a dual tax system for some investment products.

23. While recognising the fiscal cost, we support further development of a dual tax system for the taxation of capital income that takes account of the inflation component of investment income. Ideally, capital income would be taxed in a consistent way regardless of the circumstances – in particular, whether it was short term or long term saving and investment. However, the very long-term investment period for retirement savings, the relative size of retirement savings goals in household savings objectives and the corresponding impact on national savings mean that retirement savings should be considered as a separate and special case for a dual tax system.

Indexation

24. Indexation, to avoid taxing the inflation component on investment returns, is administratively complicated when taking into account changing inflation and low or negative investment returns. Calculating taxable income would also be complicated for many individual investors to understand and therefore be a behavioural disincentive to saving and investment. We also note that the calculation of capital gains tax in Australia has changed from an index calculation to simply taxing 50% of the gain. We do not support indexation. A dual tax system that broadly takes account of the inflation component of the investment return is a simpler and preferable approach (e.g. through a lower tax rate).

Compulsory membership of KiwiSaver

25. The Working Group's terms of reference rule out discussion of the parameters of New Zealand Superannuation. If the key universal eligibility, flat rate features of New Zealand Superannuation are retained, to avoid individuals saving for a retirement income in excess of pre-retirement income, appropriate integration of compulsory KiwiSaver with NZS could be complicated. For an individual on

average income, a working lifetime saving in KiwiSaver under present saving rates of 2% each by employee and employer would be expected to provide an appropriate replacement income in retirement when added to NZS. Someone on considerably less than average earnings may be forgoing present consumption for a relatively bountiful retirement.

26. Given that there are presently over 1.5m KiwiSaver accounts compared with a national workforce of 2.17m, a one-off default enrolment of all those not presently enrolled may have the effect of enrolling those who are already well provided for in retirement or those ill-able to afford additional savings. Further analysis of those not enrolled would be needed to determine likely impacts.

Composition of savings

27. While New Zealand needs to increase its overall savings rate, policies to encourage savings need to also consider investment opportunities appropriate to those savings. Long-term savings such as superannuation are suitable for equity and infrastructure investment with a longer-term development and return horizon. While necessary to address the savings/debt imbalances, households simply paying off debt will not directly provide an appropriate mix of long and short-term savings suitable for overall investment needs, particularly in the short term.

28. It also needs to be recognised that diversified collective investment schemes will, overall, invest around half of savings in offshore assets. This is appropriate risk diversification but highlights the effect different savings policies will have on domestic investment opportunities.

29. Policy recommendations to encourage savings will need to be assessed in relation to the diversity of investment needs and opportunities.

Discourage debt

30. While, as outlined above, there are a number of initiatives that could reduce disincentives to save and invest let alone provide incentives, the alternative perspective, given the alarming level of household debt, is to explore ways to discourage debt – or at least encourage households to make informed choices about purchasing on credit and the potentially high cost to household finances of servicing that debt. $3.5bn in credit card debt attracting interest at 18% indicates the significant household financial burden of debt.

31. Households should be free to make choices regarding consumer, investment or mortgage debt but, as with the development of disclosure requirements for investment products, consideration also needs to be given to supporting informed debt decisions. For example, in the present relatively low interest rate environment, borrowers need to be aware of the risks of increases in interest rates. Anecdotally at least, a significant proportion of households simply budget for high consumer credit costs without full consideration of the consequences or alternatives – the level and cost of credit card debt would support that view. Simple, easily understood

ways to disclose the annual cost of credit and the inherent risks in a credit contract should be explored.

32. It is also ironic, given the effect of highly indebted households on national welfare, that, in terms of the Financial Adviser Act, consumer credit contracts are category 2 products and therefore do not demand the same standards of financial advice. Again this illustrates the asymmetrical way we treat debt and investment from a consumer perspective.

33. Increasing financial literacy is a key component of informed saving and borrowing choices but increasing overall financial literacy is a long-term national project and needs to be supported by other initiatives. In 2002 AMP commissioned some qualitative research on individual attitudes to saving and debt. While this was undertaken some time ago, it is unlikely that the basic attitudes have changed that much. The research underlined the wide range in individual approaches to debt and saving. In particular, a saving habit was not strongly associated with individual income. Rather, thrift was a basic trait with even those on low income finding ways to save. Policy responses need to be multi-dimensional to take account of different individual behavioural responses to saving and debt.

Focus on national statistics that reflect the effect of savings and debt

34. As the Issues and Options paper notes, there are difficulties in measuring national savings and inconsistencies between approaches. There are also difficulties in attributing savings and debt between sectors – particularly the boundary between household and business sector statistics.

35. As the discrepancies between savings statistics and interpretation have, in our view, provided grounds for an argument that New Zealand does not have a savings problem, effort needs to be directed to improving the detail and robustness of savings statistics. Greater detail in attributing savings and debt levels to sectors will also better inform the problem and policy response.

36. While internationally comparable, the routine publication of gross domestic product does not realistically reflect the impact of New Zealand's lack of savings and national debt. It would help awareness of the effect national debt has on New Zealand's disposable income if gross national income figures were released at the same time and on the same basis as gross domestic product. Routine publication of per capita figures would also highlight relative living standards that are important to an internationally mobile population.

The role of savings in other expenditure areas

37. An increased emphasis on savings and debt reduction will help address the immediate risk posed by an indebted household sector and help address the increasing income needs of an ageing population. Of course the demographic changes that will contribute to increasing retirement income costs will be more than mirrored in projected health cost increases.

38. Debt funding higher education costs through interest free student loans increases the government's potential borrowing requirement. It also increases the numbers of students entering the workforce with personal debt contributing to the normalisation of a debt culture.

39. Solutions may not be directly related to savings. Insurance may be a more appropriate approach, particularly where private provision is preferred – e.g. property, disability, health. As the Christchurch earthquake has demonstrated, while insurance is not commonly thought of as savings, at the aggregate level it represents a pool of assets that can be invested productively as well as insulate against financial risk at the personal and national level.

40. While changes to the student loan scheme, New Zealand Superannuation and the public provision of health care raise fundamental issues of political acceptability and the equity of public versus private provision, a national framework to consider future risks and what contribution the state and private sector (including households) could make, needs to be considered. The Productivity Commission, announced by the Government early this year, is an appropriate body to investigate broader savings / financial risk issues and solutions.