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15 November 2010

Savings Working Group
c/- PO Box 3724
Wellington 6140

Attention: Dr Brian McCulloch
via email savingsworkinggroup@treasury.govt.nz

Subject: Savings Working Group – Mercer (N.Z.) Limited's submission

Dear Members

I refer to Dr McCulloch's letter of 9 September 2010 inviting Mercer to contribute a submission on the savings issues currently facing New Zealand. This letter sets out Mercer's view.

Our submission is centred on 4 key areas:

1. Is there a need, either to increase savings or to diversify savings or narrow the variance of savings? We believe there is a need and provide evidence to support this;

2. The savings environment particularly KiwiSaver

3. Areas where change is underway – transparency and governance

4. Additional areas where change will make a position difference on savings in New Zealand

We also provide some insights into savers' expectations.

Many of these views draw on ideas which have been expressed previously in the following two published reports, which should be read in conjunction with this letter:

- ***Securing Retirement Incomes – Time to act***

  In 2009 Mercer published a paper entitled "Securing Retirement Incomes - Time to Act". We believe that this paper provides a comprehensive framework in covering the history of retirement incomes in New Zealand, the challenges we (New Zealanders, the Government and the financial services sector) face and potential solutions in the retirement incomes space and in particular in the post retirement income or decumulation space.

  http://www.mercer.co.nz/secureretirement

- ***Securing Retirement Incomes – Retirement Design for the Future***

  Mercer launched this thought leadership piece globally in June 2010 and colleagues spoke to this at the Workplace Savings conference in August. This paper provides some fresh thinking on retirement design and details what we believe successful retirement systems of the future will look like.

  http://www.mercer.co.nz/attachment.dyn?idContent=1391660&filePath=/attachments/English/Mercer_SRI_Retirement_Design_update_June_2010_WEB.pdf

Background

New Zealand Savings

The research regarding the level of savings by New Zealand produces contrasting outcomes reflecting different data sources and methods of measurement. We believe that:

- New Zealanders don't save enough
- There is a significant dispersion of the savings
- Savings are insufficiently diversified

Statistics New Zealand uses a flow measure (the difference between disposable income and expenditure) to estimate the level of savings. Statistics New Zealand's data has shown that over the past 15 years net private saving has averaged negative 1 percent of GDP (i.e. a net dis-saving). Over the same period[1], the level of debt taken on by households has doubled, as a percentage of disposable income.

However, alternative research has suggested that the level of savings has actually increased in recent years[2]. A recent paper[3] has used an alternative data source to further support this conclusion. One of the principle reasons for the differing opinions is the use of a stock measure of household savings which considers the net assets held, incorporating any changes brought about by the appreciation of existing assets – a key factor given the significant increase in house prices in recent times. It is reasonable to include property as part of an investment portfolio. However, the high allocation to this one asset class reduces the benefits of diversification and potentially creates problems when the need arises for liquidity or cash flow. You either have to sell the asset or realise a portion of it. The products to achieve the latter are not well developed in New Zealand and are expensive.

We note that your covering letter comments on "the availability and quality of relevant statistics" in the savings-related area. To correctly determine whether savings are sufficient and growing at an adequate rate, it is important that a consistent measure of savings is identified to determine the success of any policies implemented. We also need to recognise that there are a number of "experts" whose long standing views are dogmatically held and who do not believe there is any need for changes in any area of the savings landscape.

It is important to note that none of these papers considers the sufficiency of savings for any specific purpose, such as retirement, but are instead focussed on the trending rates of saving and the source of such savings.

In addition, the following comment is relevant in considering the New Zealand savings landscape:

Capital Market Development Taskforce (December 2009) – talked about "encourage better savings habits…" and this may allude to either additional savings or again at the minimum a need for the diversification of the total savings pie.

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1 http://www.treasury.govt.nz/publications/research-policy/tp/saving
2 http://www.nzbr.org.nz/site/nzbr/files/publications/household_savings_report.pdf
3 http://motu-www.motu.org.nz/wpapers/10_06.pdf

Mercer's position is that we believe the level of retirement savings in New Zealand is currently inadequate to meet the needs of the majority of the population and we welcome the introduction of policies aimed at encouraging individual retirement savings.

<u>Diversification</u>

While the proportion of disposable income invested in housing is comparable with other OECD countries, New Zealand households have much greater proportion (approximately 95%) of their net wealth invested in this area[4]. This may be a conscious investment decision or could reflect a low level of savings. It also reflects the sustained housing boom. The level of debt taken on by households is also strongly linked to the housing market, with almost 90% of total household debt owed to large financial institutions and 90% of this for mortgages[5].

To promote economic growth in New Zealand and reduce the risk to individuals it is important that the level of savings is increased and a variety of investments are included in any household portfolio.

Globally, institutional investors are increasing their allocation to non-traditional assets – including infrastructure, private equity, small cap companies and agricultural commodities.

There are many examples in the New Zealand market of such potential investment opportunities but these are currently not in a suitable form for widely-held investments. They may be either currently government or privately held, not available on suitable pooled product basis with transparent pricing, liquidity and reasonable cost structures. The Government and private sector can create the opportunity for "new" investment products.

[4] http://www.treasury.govt.nz/publications/research-policy/tp/saving
[5] http://www.rbnz.govt.nz/research/bulletin/2002_2006/2005jun68_2goh1.pdf

What is currently working well?

KiwiSaver Enrolment

Initially announced in 2005, launched in 2007 and revised to its current form in 2008, KiwiSaver has been well received by New Zealanders as a means to save for retirement. There are six default funds, which invest conservatively, for members who do not choose their own scheme or whose employer arranges for them to utilise a provider. Generally, savings are kept locked away until the age of eligibility for NZ Super (presently 65) at which point they are paid out to the member as a lump sum, although some flexibility exists for withdrawals in certain circumstances. This ensures the investments made are long term and so encourages an investment in growth assets.

As at 30 September 2010 over 1.5 million people had joined the scheme, with a third of members under the age of 25. In the year to 30 June 2009, members made $1.3 billion of contributions, topped up by $0.8 billion of crown contributions, including $0.5 billion of kick-start contributions.[6]

The six default funds have been effective so far, with their size and number ensuring that services are competitive and fees are kept low. The Government Actuary ensures that the fees charged by a registered KiwiSaver scheme are not unreasonable and for the six default schemes, the level of fees charged is constrained, having been negotiated by the Government.

The incentives available have rewarded membership and ensured a healthy base of funds in the system. Going forward the cost of the kick-start incentive to the Government will level off as the number of new entrants to KiwiSaver becomes restricted to the number of new entrants to the workforce.

However the member tax credits incentive ($1,043 per annum) will continue to be paid (provided members own contributions meet or exceed this amount) and members receive a tax break on the compulsory KiwiSaver contributions (2% of gross salary). These incentives are costly to the Government and must be balanced against the benefits of member's savings.

[6] http://www.kiwisaver.govt.nz/statistics/ks-stats-09-06-30.html

It should also be noted that as salaries and wages appreciate and since the member tax credits are fixed in dollar terms, in real terms they will cost the Government less and less.

While KiwiSaver has attracted a significant amount of savings, it is difficult to quantify precisely how much *additional* saving it has encouraged, as alternative superannuation schemes or private savings may have been used in its absence.

Areas for further consideration

We note that the Government has taken several items off the agenda including the age of eligibility for New Zealand Super and compulsory savings. However, for future generations, the Government should consider our paper "Securing Retirement Incomes – Retirement Design for the Future".

Another Mercer report "Securing Retirement Incomes – Time to act" sets out a series of measures we believe could be implemented to improve the retirement savings landscape in New Zealand. The following is a summary of some of the principle ideas in the reports but we recommend reading both to gain a comprehensive view.

Age of Eligibility

I am on record, as per my article in the Sunday Star Times of 5 September 2010 (http://www.mercerwealthsolutions.co.nz/news/3158/) as saying:

"According to modelling by Mercer, the Government could reduce the cost of NZ Super by at least $100 billion by 2061 if it were to increase the age at which individuals are eligible to receive the aged pension to 67. That would put a significant dent in the cost of funding our ageing population. Yet this measure, which has been introduced in Australia, the UK and the US with minimal backlash, seems to be regarded as electoral poison in this country when that needn't be the case. The Government could act now to increase the eligibility age to 67 but defer implementation. A phased approach would still enable significant cost savings to be achieved, but would be managed in a way that allows people time to adjust.

Perhaps the problem is that 2050 is too far off for many people to care, especially those who are looking forward to soon retiring at 65. Maybe some people think the ageing population threat will go down in history with other great anti-climaxes like the Y2K bug.

It might also be a question of attacking a source of immense national pride. Kiwis are proud of the fact we have a universal superannuation system that isn't means tested. And it's probable that many are failing to connect the dots between the debt crisis in Greece and that country's overly generous, and extremely costly, public pension system. "

Compulsion

Whilst the take-up of KiwiSaver has far exceeded initial Government expectations, introducing compulsory KiwiSaver contributions will provide benefits.

This may be seen as unpopular, especially amongst low earners, but a growth in the retirement savings asset pool will increase efficiencies (potentially lowering fees) and provide a significant injection of funds into the capital markets in New Zealand as well as being of long term material benefit to New Zealanders themselves. A proportion of this investment would go overseas but on a member's retirement most of this would then return to New Zealand and ultimately be spent here. A greater level of KiwiSaver savings would also open up the possibility to amend NZ Super in future and reduce the pressure on the Government. To overcome the problems of lack of affordability, high income earners could be targeted for compulsion over low earners (who still have the option to contribute higher amounts). The system of compulsion has worked well in other parts of the world, particularly Australia.

An alternative way to encourage a greater level of KiwiSaver investment and the benefits that this brings would be to offer incentives to employers to make higher contributions into member's accounts. This could be achieved by extending the tax breaks on employer contributions, either fully or partially, to a level above 2% of gross salary or mandating that employer's must pay contributions at a greater rate.

Where compulsion may be of material benefit is that for new, first time workers or those reaching 18, who may otherwise have opted out of KiwiSaver – we note that due to the impact of compound interest…"*the length of the period over which a KiwiSaver member saves is far far more important to the ultimate savings outcome achieved compared to the amount being saved.*" A key benefit of compulsion is that the new generation of savers will start at the right point i.e. immediately on joining the workforce and this will reap benefits in the longer term.

Fee structure

Mercer advocates the introduction of standardised fee disclosure to allow the comparison of different KiwiSaver products and provide transparency to members. Ideally one all inclusive fee should be published. This simple measure can reduce the confusing nature of investment to the many financially illiterate potential savers, encouraging them to join a scheme and increase national savings. While some encouraging steps are starting to evolve here we do believe that far more needs to be done and improved transparency is a key ingredient to building a successful long term retail savings framework.

Use of KiwiSaver funds - Decumulation

KiwiSaver benefits are paid as a lump sum at retirement age, the onus falls on the member to manage their finances in an appropriate manner to ensure they are able to provide themselves with an income for the remainder of their lifetime. It has been estimated that 60% of the retirement income for a person who joins KiwiSaver when they enter the workforce is earned from investment earnings accrued after the age of 65.

The lack of providers of retirement income products, coupled with low consumer awareness, means that many KiwiSaver members reaching retirement may not effectively use the retirement pot that they have built up. The report mentioned above compares the different products that could be used to fill this space and increase post retirement savings. This includes life annuities, allocated pensions and a NZ Super Plus – a concept that would allow retirees to purchase additional amounts of NZ Super using their KiwiSaver balances.

Change in default funds

Mercer has provided advice to the Ministry of Economic Development in regard to the potential use of alternative default funds for KiwiSaver which allows for a greater holding in growth assets. The current default funds have a benchmark with 75% of the investments held in defensive assets. For members with 10 years or more until retirement this is unlikely to be an appropriate mix to maximise investment returns over the period until withdrawal. A possible default fund which uses a dynamic benchmark, changing according to the member's age emphasising growth assets at younger ages is expected to increase the benefit at retirement.

First home withdrawal

Also, while it is noted that some KiwiSaver investors have a strong desire for capital protection as they may wish to use their KiwiSaver to assist with their first home purchase. We believe a conservative asset allocation is unnecessary and inconsistent with the scheme's objectives.

As noted in Cabinet Business Committee papers 29 August 2005 and re-stated in papers 31 Jan 2006-

"The primary objectives of KiwiSaver are:

- to support a cultural change in New Zealanders' attitudes toward savings to increase self reliance and forward planning; and
- to help create a financial buffer for New Zealand households through the building up of assets, reducing debt dependency and giving people increased financial independence and flexibility, particularly in retirement."

The 2007 budget went on to say

"In Budget 2007, the Government has significantly enhanced these incentives to support its objectives for KiwiSaver:

- For a better retirement - KiwiSaver is a simple, easy and low cost vehicle through which individuals can save for their retirement.
- The additional incentives will encourage greater take-up and make it easier for people to secure an adequate income in retirement. "

It is not clear that the primary objective is to protect contributions (although protection is desirable and a good regulatory framework is encouraged and welcomed), rather it is focused on long term retirement savings, within a well developed, transparent and regulated market with sufficient oversight from the Government and Government agencies.

Most importantly the **KiwiSaver Act** states under Clause 3 relating to purpose:

"*The purpose of this Act is to encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement. The Act aims to increase individuals' well being and financial independence, particularly in retirement, and to provide retirement benefits.*"
While home ownership in New Zealand (as in other countries) is seen as an integral part of total retirement assets and is a goal of many New Zealanders - the aims of KiwiSaver do not refer to the protection of contributions nor do they refer to short term savings to purchase a home. We believe that asset allocation should be focused on more growth orientated investment options – at appropriate life stages.

Investment Tax

The level of tax on investment earnings provides little incentive to invest in KiwiSaver, locking away their funds until age 65 once the member tax credits are used up. Mercer believes that the use of a preferential tax rate for income on superannuation savings would encourage investment in long-term superannuation funds and simplify the system for investment managers, administrators and members.

Such preferential tax systems are already in use overseas (e.g. in Australia, the UK and the US) and is a factor in many people's decision to maintain superannuation investments overseas, rather than repatriate them back to New Zealand.

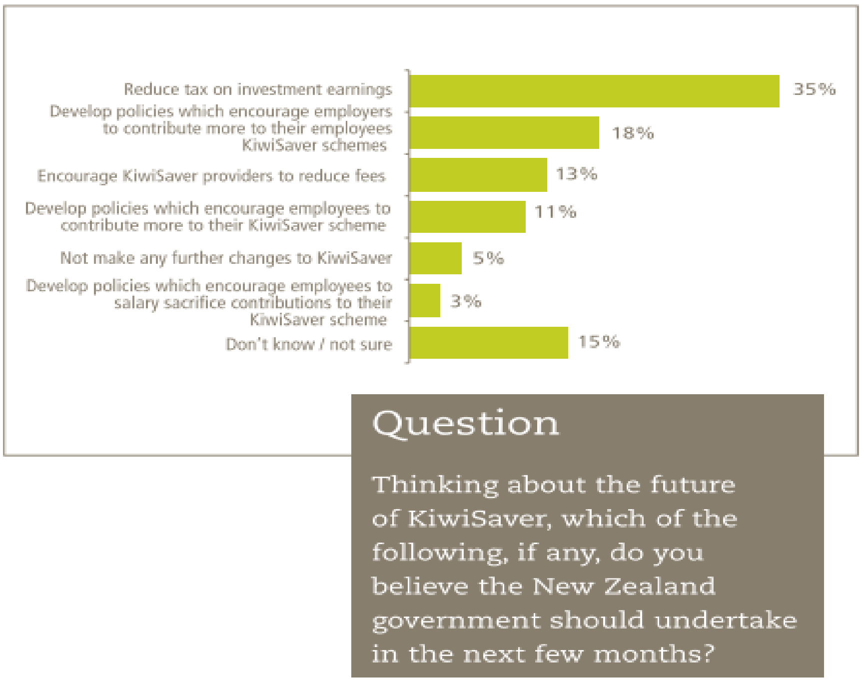
Consumer Driven Needs/Desires

In March 2010 Mercer published a KiwiSaver Sentiment Study of 513 working New Zealanders (http://www.mercer.co.nz/referencecontent.htm?idContent=1375390) provide some insights into the level of understanding of KiwiSaver, the benefits which are driving consumers in the KiwiSaver space and the areas for potential improvement to encourage further savings.

On this latter point, the KiwiSaver Sentiment Study said "Mercer sought to understand Kiwis' views on the future of the KiwiSaver scheme and asked respondents to indicate what they believed the New Zealand government should do in coming months. The most common responses focused on reducing tax on investment earnings; supporting greater employer contributions and encouraging providers to reduce fees.

These responses demonstrate where government, employers and providers should work together to enhance KiwiSaver and promote greater participation in the scheme".

Chart 17: Preferred future actions



<u>Conclusion</u>

Mercer does believe that additional savings in household savings is required in New Zealand. We believe this will have long term benefits for New Zealanders by securing a sustainable retirement income, rebuilding and deepening the capital markets and will provide a strong platform for sustainable economic growth.

Growing our economy and securing our retirement incomes doesn't simply mean making people work longer or pay more. If we consider the three pillars of our retirement income system – government pension, savings via the workplace (KiwiSaver), and additional voluntary savings – there are many measures that could be introduced to make our system more robust and provide individuals with more positive outcomes for their retirement.

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Future generations will thank the Government if they consider and implement the appropriate mix of suggestions contained in the two Mercer reports referred to.

Yours sincerely,

Martin Lewington

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