pensioncommentary

An article from the Retirement Policy and Research Centre

KiwiSpend: How to spend like a kiwi

RPRC contributes to the Retirement Commissioner's review on the topic of Decumulation

RPRC *PensionCommentary*[1] 2016-2

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Introduction

The three yearly review of retirement incomes policies is underway. Each month starting May 2016 a different aspect is being examined by the Commission for Financial capability. This commentary draws on RPRC thinking on decumulation, see, for example, St John, Dale & Ashton (2012) A new approach to funding the costs of New Zealand's ageing population, New Zealand Population Review, Vol 38, 2012.

Are catalysts required? A personal view[3]

My beginning premise is that we have a serious hole in our otherwise very good retirement income policies: we lack a simple, secure income insurance for middle income New Zealanders over and above the base annuity provided by New Zealand Superannuation (NZS). The problem is that under Defined Contribution (DC) schemes like KiwiSaver, potentially costly risks of ageing, especially outliving one's savings, are shifted on to the individual.

This worrying neglect is happening in the context of rapid ageing. We are already in year 6 of the 20 year baby-boom retirement. Once the boomers start turning 85 from 2030, we will see the true folly of today's inaction.

Older people are living longer on average, but the real problem is the large number of those who live longer, sometimes much longer, than the average and who need extensive and expensive long-term care. As well, rapidly increasing numbers of those over 65 are suffering dementia. Many may be exposed to being exploited financially if they have only a 'Do it Yourself' (DiY) decumulation plan.

In the international pensions world, the New Zealand experience clearly shows that with no state action whatsoever, the annuities market disappears. It is not an easy problem to remedy, and as Ralph Stewart's

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[1] An RPRC Pension*commentary* is an opinion piece designed to provoke discussion on an issue of public significance.
2 Hon Associate Professor Susan St John is director of RPRC.
3 This was to be the basis of St John's contribution to the CFFC Decumulation Panel May 20th 2016 which she was unfortunately unable to attend.

experience with the NZ Income Guarantee has shown, it is a costly and time-consuming path for private providers to develop profitable products. Without substantial state involvement, I do not see any consistent, stable outcome that is capable of providing cover for most middle-income people.

Seeing a serious market failure[4] in the voluntary annuities space, most pension experts and economists would argue for state intervention. State provision of longevity bonds to allow providers to take on the risk of increasing longevity, and long-dated indexed government bonds to protect against inflation, are the stock in trade recommendations for correcting market failure. Typically too, the discussion stops at this point. I think the New Zealand experience shows that the state needs to grasp a much bigger vision for there to be meaningful annuity options. I want to suggest that the state can act as a catalyst in three important ways:

1. First, the state must provide more resourcing to retirement policy development, and much more attention to overseas experience. How much do we know about the benefits people have from the certainty annuities provide? The annuitant population is fast diminishing in New Zealand and time is running out to explore this. Anecdotally, access to an inflation-linked pension enhances the retirement experience for those fortunate to still have one and is very good for their families too.

   And, importantly debate must be more inclusive. We rely on poor surveys and one-sided opinions too much. My own view is that the voices of women are sidelined. For many women, managing money after retirement, often when they are on their own, is daunting. Knowing how much they can spend each year and not run out of money is critical. New Zealand is unusual in taking a very a hands off approach to decumulation. It is also unusual in its seeming acceptance of a DiY or rule of thumb approach. Another gap in the debate is the financing of long-term care. Annuities can play a very significant part in paying for long-term care: many other countries such as the UK and Australia are recognising the looming health and care costs of increasing numbers of the aged.

2. Second, we need to recognise that there is a bias towards using property, either owner occupied or rental as retirement assets. This requires radical reform. Under current tax rules property wins every time. Of course a suitable debt-free home is a very good basis for retirement, but the current rules encourage over-investment in high-end housing.

   The use of rental properties as a de facto annuity has many downsides to middle income people using this vehicle, especially as they age and the management of rentals becomes problematic. While for the landlord, rental returns may be hedged against inflation and the asset generally grows in real terms, home ownership for the young is affected by investor demand (among other factors). The catalyst is to remove this advantage with wide housing tax reform. I favour the suggestions of the McLeod Review in 2001 to tax total equity over a base amount held in housing. If we get the taxation for housing on more of a level playing field, an emerging annuities market may have an easier time.

3. Third, the state could grasp the huge opportunity it has to build on the success of KiwiSaver and the KiwiSaver provider infrastructure. What is needed is a 'capped value' annuity product with generic branding, default provisions and oversight by the Financial Markets Authority (FMA). We could call such a product Kiwi something, eg ***KiwiSpend*** and in time it could be an accepted part of the retirement incomes

[4] Market failure, to an economist, occurs when a product that people want is not provided by the market or underprovided. In the case of annuities many of the conditions for optimal free market provision are not met. This include knowledge about future costs and longevity and inflation, and adverse section where the good risks (likely to die young) do not purchase annuities, leaving the bad risks (likely to live a long time) in the pool and ensuring costs of provision of a given annuity will rise over time.

mix. Using the opt-out experience of KiwiSaver, members could be defaulted into an annuity option with an opt-out provision for a limited time.

KiwiSpend could have the following characteristics:

- The same annuity for the same lump-sum for men and women at a given age (gender neutrality).
- Low cost administration, and
- At very least protection from inflation. The annuity could be linked to economic growth in some way to protect against falling behind growth in real wages.
- Have an add-on insurance for long-term care.

For example, retirees with modest KiwiSaver accumulations and other capital on retirement could have the option to purchase annuity of $10,000-20,000 pa with a provision for augmentation once the need for long-term care was established.

Currently middle-income people who need long-term care have to run down their assets to very low levels before they qualify for a state subsidy. Care costs alone are currently around $50,000 annually, with the need for another $5,000 to $20,000 for additional costs such specialists' appointments, including hearing and dental care. Only a small amount of this cost is met from NZS. A top-up annuity with a long-term care rider would spread the risk more fairly to the older population more broadly, and away from families who see the parental assets rapidly eroded away to very low levels. The annuity would be pitched at middle income retirees.

KiwiSaver providers would have a role with the possible involvement of the New Zealand Superannuation Fund to underpin the longevity and investment risk. The state would also have opportunity to make the purchase of such annuities attractive. In contrast to tax incentives for accumulation common in most OECD countries, subsidies for a capped annuity can be well-designed with clear social benefits in sight. The costs and regressivity of subsidies would be limited by the cap on the size of annuity that could be bought.

To conclude: nothing will happen until the social and personal value of annuities to middle-income people is more widely appreciated. Some ideas have been floated here for a new product ***KiwiSpend*** to complement ***KiwiSaver***. What is needed is a dedicated taskforce to flesh out the details. There is much work to do.

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